


 The logo features the letters 'ma' in a red, lowercase, sans-serif font, followed by the word 'perspective' in a dark grey, lowercase, sans-serif font. The background is a light blue gradient with a subtle pattern of overlapping white circles and lines.

The Three-Year Window: Making the Most of Recent Estate Tax Legislation

Among many other things, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed into law by President Obama in December, introduced changes to the estate and gift tax—specifically the rates and exemptions applicable to transfers by gift or bequest. Though in play for a limited time—tax years 2010, 2011, and 2012, absent additional legislation—the changes are significant, and they create major planning opportunities for individuals, families, and businesses.

A Choice for 2010 Estates

Prior to the new law, families whose loved ones died in 2010 owed no federal estate tax. Yet, with certain exceptions, many of these families didn't have the opportunity for a tax-free step-up in asset basis along with the ability to set aside assets in certain types of generation-skipping trusts that may have been provided for in the decedent's final documents.

The new law gives 2010 estates a choice: Opt in and be taxed under the new law, or opt out and be taxed under the law that existed prior to the new legislation. Let's take a closer look at each choice:

- **Opt in.** A bit of a misnomer, since this is the default option for 2010 estates—that is, if no

selection is made, the principles of the opt-in method will apply. So what are they? Estates below \$5 million get the best of both worlds: no estate tax and a tax-free step-up in basis for most assets, irrespective of the limitations in place prior to the new law. Unless certain elections otherwise apply, estates over \$5 million would be taxed at a 35 percent rate on the excess.

- **Opt out:** Unlike the opt-in default, the opt-out election must be actively chosen. Doing so means you'd essentially be forgoing the new estate tax law—that is, no estate tax will be payable by the 2010 estate, no matter its size, but its assets will be subject to the modified carryover basis rules that were in existence prior to the new law.

To opt out, the executor or trustee of the 2010 estate must file an estate tax return on time and make the affirmative opt-out election on that return. The earliest deadline for filing this estate tax return is September 19, 2011. This is also the earliest due date for the carryover basis allocation report for a 2010 estate that opts out of the new estate tax law.

What About 2011 and 2012?

The new rules apply through the next two years. But, without legislation to extend the new rules, everything reverts back to the 2001 rules after December 31, 2012. This makes it crucial to take advantage of the narrow window of opportunity that presents itself and make sure

your tax-planning strategies are best suited to your business and personal situation in 2011 and 2012.

Here are the major contours of the estate tax landscape over the next two years, compared with what things will look like after 2012 absent new legislation:

	RATES AND EXEMPTIONS	
	2011–2012	2013 and Beyond
Gift tax rate	35 percent	55 percent
Estate tax rate	35 percent	55 percent
Estate tax and lifetime gift exemption	\$5 million	\$1 million
Generation-skipping tax exemption	\$5 million	\$1 million (indexed for inflation)
Portability of estate tax exemptions between spouses?	Yes	No

Highlights of the New Estate Tax Law

Increased Exemptions and Decreased Rates

For the first time in many years, the lifetime gift exemption has been increased to match the exemption otherwise available at death. This means that (for 2011 and 2012 only) a married couple who has used none of their lifetime exemption could gift up to \$10 million (up to \$5 million each)—either outright or in trust for their children—with no gift taxes due. After 2012 (absent legislation to the contrary), if that same \$10 million were instead transferred at death, the bequest could trigger an \$8 million taxable transfer—\$10 million minus their combined \$2 million exemption—with a corresponding federal tax liability as high as \$4.4 million (55 percent of \$8 million).

In addition, the new law caps the highest federal marginal rate at 35 percent for gifts and bequests in excess of the \$5 million exemption (for 2011 and 2012 only). After 2012 the rate is scheduled to increase to 55 percent, the top rate in effect under the 2001 law.

A Radical New Concept: Portability of Estate Exemptions

Under prior law, if a married person died without using his or her entire estate exemption, the

unused portion was simply lost. The new law permits an executor or trustee to transfer the deceased spouse’s unused exemption to the surviving spouse. To do so, however, an estate tax return must be filed—even for estates of less than \$5 million. While the concept seems simple, there are numerous income and transfer tax implications related to planning with this new feature, each of which needs to be considered in your overall estate plan. And remember, this opportunity could disappear in 2013.

State Inheritance Tax Restrictions and Applicability

The increase in the federal lifetime gift tax exemption, from \$1 million to \$5 million, creates more transfer tax planning flexibility than appears at first blush, especially when taking into consideration the corresponding generation-skipping trust increase. But as you put together your lifetime gifting strategies or review and revise existing legal documents, don’t forget state tax considerations.

Certain states, including California, currently have no state inheritance tax. Other states, such as Washington and Oregon, have inheritance taxes due on estates in excess of \$2 million or \$1 million, respectively.

For states that do have an inheritance tax, your documents may require at least two separate kinds of trusts—a “credit trust” equal to the lower of your available federal or state exemption and a “marital trust” for the excess. Thus, it’s critically important that you structure your documents properly to take advantage of the increased federal exemption of \$5 million while also ensuring that, where appropriate, there are no state inheritance taxes due on the first death—by using a “state only” marital trust for the difference in exemptions.

Some states also have exclusions for certain types of asset holdings. Consider these provisions carefully before implementing any major gifting strategies if you reside or have assets in states where inheritance taxes apply.

Note also that state inheritance taxes are generally applicable only to bequests and not to lifetime gifts. Accordingly, the new law’s increased exemption indirectly creates a

potential windfall in state tax savings for your heirs in that any gifts you make as a result of the increased federal exemption also currently eliminate the possible state inheritance tax bite too.

In Gifting, the Tail Shouldn't Wag the Dog—or Should It?

Under normal circumstances, estate tax matters take a backseat to other considerations. After all, the manner in which certain assets should or shouldn't be transferred is a complex one that takes into account many different personal, family, and business factors. Any plan you create should make financial sense, business sense, and then tax sense.

But these aren't normal circumstances. And so while it's conceivable that Congress may wind up extending some or all of the current provisions, one has to acknowledge that—depending on the size of one's estate—the possible federal (and, if applicable, state) transfer tax savings are simply too big to ignore.

Parents should first be concerned about taking care of themselves, of course, since no parent ever wants to be a burden to his or her children. But beyond making sure your own future is provided for, gifting assets to your children now might make a good deal more tax sense than waiting. It's just a question of which of the planning alternatives best fits your particular business and family circumstances.

Considerations for Business Owners

Given the rapidly changing environment for income, health care, payroll, and gift and estate tax planning (including at the state and international levels), the time for discussing business succession planning has been accelerated by the new tax legislation. It's also a good opportunity to evaluate your business's entity structure to determine whether there's a tax advantage to switching from, say, a C corporation to an S corporation, LLC, or partnership.

Because the personal wealth of a business owner is frequently intertwined with the wealth of his or her business, the new estate and gift tax rules could present exceptional opportunities for business owners to modify their estate plans, integrate them with their business succession plans, and gain greater control of the overall transfer of wealth.

We're Here to Help

Not only does the estate tax horizon change dramatically in 2013, but income, payroll, health care, and other taxes are scheduled to increase significantly as well. At no time in many years has it become more important—or more advantageous—to plan than in 2011 and 2012.

While the new tax legislation introduces some compelling planning opportunities in a short time frame, it's important not to rush your decision making. Evaluating the right income, gift, and estate tax choices involves patient, careful consideration of your unique circumstances, and this is best done in consultation with your accountant and your legal counsel.

Moss Adams LLP can help you assess your needs and work with you to create a plan that meets your personal, family, and business requirements. For more information about the new estate tax legislation or to learn more about our estate tax planning, business owner succession, and other wealth services, please contact your Moss Adams professional.

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