

The Federal Estate and Gift Tax is Revised Again

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INTRODUCTION

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act of 2010"). While the new law primarily extends the lower income tax rates enacted in 2001 for two more years, it includes some significant changes to the federal estate and gift taxes.

The federal estate tax is based on the value of a decedent's assets (including retirement accounts and life insurance) as of the date of death which exceed an exemption amount. In addition, there is an unlimited marital deduction for assets passing to a surviving spouse.

In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was passed by Congress and signed by President Bush. Under EGTRRA, the exemption amount was set at \$1,000,000 in 2001 and increased as follows:

| YEAR | FEDERAL EXEMPTION |
|------|-------------------|
| 2002 | \$1,000,000 |
| 2003 | \$1,000,000 |
| 2004 | \$1,500,000 |
| 2005 | \$1,500,000 |
| 2006 | \$2,000,000 |
| 2007 | \$2,000,000 |
| 2008 | \$2,000,000 |
| 2009 | \$3,500,000 |

In 2010, the federal estate tax was repealed under EGTRRA. However, because EGTRRA expired on December 31, 2010, the federal estate tax was scheduled to return on January 1, 2011 with an exemption of \$1,000,000. Under EGTRRA the estate tax rate was reduced from 55% to 45%, but the 55% rate would also return on January 1, 2011.

THE TAX RELIEF ACT OF 2010

Under the Tax Relief Act of 2010 the federal estate tax will not revert to the pre-EGTRRA exemption amounts and tax rates in 2011 and 2012. Instead, the exemption amount is increased to \$5,000,000, and a flat tax rate of 35% has been adopted for 2011

and 2012. The estate tax rate has not been less than 45% since 1931. Since the estate tax exemption is per individual, a married couple can now shelter up to \$10,000,000 from the federal estate tax.

The new law also significantly changes the gift tax. In 2009, although the estate tax exemption was \$3.5 million, the lifetime exemption for gifts was only \$1 million. The gift tax exemption is now unified with the estate tax exemption so that both are now \$5 million. This is in addition to the gift tax annual exclusion of \$13,000 (formerly \$10,000) per donor. The gift tax rate is also now 35%. If a person uses any portion of the \$5 million lifetime gift tax exemption, that amount is deducted from the \$5 million estate tax exemption that would otherwise be available to that person's estate.

Another feature of the Tax Relief Act is that it retroactively puts the estate tax back in effect for 2010 with a \$5 million exemption, but with an option to elect out of the imposition of the tax. This is actually advantageous since it also restores "stepped up basis" for capital gains tax purposes. When the federal estate tax is in effect, assets such as stocks and real estate which are inherited from a decedent will have a basis equal to their fair market value on the date of the decedent's death, instead of the original cost paid by the decedent. This is known as "stepped up basis". If the estate tax had not been reinstated for 2010, inherited assets would retain the original basis of the decedent ("carryover basis"), with the exception that \$3 million of stepped up basis would be available for assets passing to a surviving spouse and \$1.3 million of step up would be available for assets passing to others. All estates with a value of less than \$5 million will now receive stepped up basis for the entire estate without paying any federal estate tax. Large estates in excess of \$5 million can elect that the estate tax not apply and be subject to the corresponding carryover basis rules.

A new concept known as "portability" of the estate tax exemption has also been introduced by the Tax Relief Act of 2010. Often, due to a lack of proper planning, the first spouse to die will fail to fully utilize the federal estate tax exemption. Either the surviving spouse holds most of marital assets, or the deceased spouse left his or her estate directly to the surviving spouse under the marital deduction and failed to use the estate tax exemption. Now the unused estate tax exemption is available for use by the surviving spouse as an addition to his or her exemption. Thus, the federal estate tax exemption of a surviving spouse can now be as high as \$10 million. In order to pass the unused exemption to a surviving spouse, the estate of the deceased spouse must file a federal estate tax return and make such an election.

THE MASSACHUSETTS ESTATE TAX AND ESTATE PLANNING

The Massachusetts estate tax remains in force and unchanged. All taxable estates which exceed \$1,000,000 and do not pass to a surviving spouse are subject to the tax. The tax rates are graduated ranging from .8% to 16%. There is no portability of the Massachusetts estate tax exemption between spouses. Massachusetts does not impose a gift tax on lifetime transfers.

In order for a married couple to take maximum advantage of both the federal and Massachusetts estate tax exemptions, both spouses will establish trusts known as A/B Trusts or Marital Deduction/Credit Shelter Trusts. Instead of leaving his or her entire estate directly to his or her spouse, each spouse leaves his or her estate to a trust for the benefit of his or her spouse. The trust divides into Trust A and Trust B. Trust B is funded first with an amount equal to the federal estate tax exemption in effect at the time of the person's death. Thus, if husband (H) dies in 2011 with a \$6,000,000 estate, the first \$5,000,000 would go into Trust B, and the remaining \$1,000,000 would fund Trust A, which qualifies for the marital deduction. There will be no federal estate tax due upon H's death, and only the assets in Trust A will be included in the taxable estate of the wife (W) when she later dies.

In order to address the Massachusetts estate tax, Trust B further divides into a Mass Exempt Trust and a Mass QTIP Trust. The Mass Exempt Trust is first funded with an amount equal to the Massachusetts exemption amount of \$1,000,000, and the excess goes into the Mass QTIP Trust which qualifies for the marital deduction under the Massachusetts estate tax. Using the above illustration, the first \$1,000,000 of Trust B is placed in the Mass Exempt Trust, and the remaining \$4,000,000 is allocated to the Mass QTIP Trust. There is no Massachusetts estate tax due upon H's death, but the assets in the Mass QTIP Trust will be included in the Massachusetts taxable estate of W when she later dies.

As a result of the federal estate tax exemption increasing to \$5 million, most people will no longer be subject to the federal tax. However, many people will still be potentially subject to the Massachusetts estate tax, and the use of A/B trusts is still

relevant to avoid or minimize the Massachusetts estate tax. The A/B Trust used by Fletcher, Tilton & Whipple, P.C. automatically adjusts to changes in the federal estate tax exemption, so our clients who have already executed A/B Trusts do not need to amend their trusts. However, we do suggest that with the change in the tax law, it may be appropriate to review the division of assets between the husband and wife in connection with the estate plan.

CONCLUSION

Unfortunately, although the Taxpayer Relief Act of 2010 provides clarity for the federal estate and gift tax for 2011 and 2012, and eliminates carryover basis for 2010 for most estates, it does not permanently establish the rules for the federal estate tax beyond 2012. If Congress takes no action prior to the end of 2012, the federal estate and gift tax reverts to pre-EGTRRA law, and the exemption would be \$1,000,000 with a top tax rate of 55%. Though that seems unlikely, we must await further action by Congress before we know what the federal estate rules will look like beyond 2012. For those who have large estates and are considering large gifts, it may be prudent to take advantage of the \$5 million gift tax exemption during the next two years, which will also significantly reduce potential Massachusetts estate taxes.

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