Big changes to gift and estate tax

The recently enacted tax law (formally known as the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010) has far-reaching implications for taxpayers beyond the retention of the Bush-era tax cuts.

The new law has completely changed the gift and estate situation for many people. The gift tax is a federal tax on large financial gifts. It has two exclusions – annual and lifetime – that protect some gifts from being taxed.

The annual exclusion is the amount that a person may give to another during a single year without invoking the lifetime exclusion. The amount is currently $13,000 per recipient. There is no limit to the number of annual exclusions a person can use each year.

The lifetime exclusion is the amount a person can gift during their life in excess of their annual exclusion gifts. The lifetime gift tax exclusion was set at $1 million in 2001. The estate tax exclusion has been pushed up to $5 million for 2011 and 2012. The new legislation also made the exclusion "portable," which means that a surviving spouse inherits any unused exclusion from the deceased spouse. For example:

If Mr. Smith dies in 2011 and has made no taxable gifts during his lifetime, Mrs. Smith will inherit his unused exclusion of $5 million. Assuming she also dies in 2011, Mrs. Smith will have no estate tax as long as her estate does not exceed $10 million.

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This issue of *Federal Tax Watch* was written by Michael Koppel, CPA, MSA, PSF, of Gray, Gray & Gray, LLP, the Westwood, MA, affiliate of CPAmerica.

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The new tax law relinks the gift tax exclusion with the estate tax. This means that the gift tax lifetime exclusion is $5 million for 2011 and 2012. For a married couple, that is $10 million that can be gifted during their lifetime in addition to annual exclusion gifts. For a couple who had previously maxed out their lifetime gift exclusion, this provides an additional $8 million that can be gifted in 2011 and 2012.

It is important to remember that the basis of assets gifted and left through an estate are not treated equally.

Generally, gifted assets retain their basis, while assets passed through an estate will have fair market value basis. The carryover basis versus step-up in basis is an important consideration in deciding which assets to gift and which to leave through an estate.

During 2010, when there was no estate tax, the amount of assets that could have a step-up in basis was limited to $1.3 million ($4.3 million for a surviving spouse). For 2011 and 2012, there is no limit to the amount of assets that can have their value increased to fair market value. An estate of an individual who died in 2010 can elect either 2011 or 2010 rules

The new tax law also reinstates the generation skipping tax (GST). The GST is generally in place to stop people from avoiding gift and estate taxes by purposely skipping a generation. For example:

Let's say that Mr. Jones wants to give a gift with a fair market value of $1,013,000 to his granddaughter. Of this amount, $13,000 would qualify for the annual exclusion. The remaining $1 million would be charged against both the lifetime gift and GST exemptions.

One rule that did not change is the availability of lack of control and lack of marketability discounts. These discounts can significantly reduce the value of gifts and assets passed though an estate. Discounts can be especially important in succession planning for family-owned businesses. For example:

Mr. and Mrs. Green own 100 percent of their business, Green Enterprises. An appraisal indicates that the business

see **Big changes to gift and estate tax** *on other side*

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GELMAN, ROSENBERG & FREEDMAN
CERTIFIED PUBLIC ACCOUNTANTS

4550 Montgomery Avenue • Suite 650 North • Bethesda, MD 20814
301/951-9090 • Fax: 301/951-3570 • info@grfcpa.com • www.grfcpa.com

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has a fair market value of $10 million. They want to gift their daughter, Joan, who works in the business, 30 percent of the company. But they have already used their annual exclusion in previous gifts to Joan. Assume that the combined discounts aggregate 40 percent. Without the discounts, the gift would be $3 million. Taking the discounts reduces the amount of the lifetime exclusion used to $1.8 million, saving $1.2 million of lifetime exclusion to be used later.

Without further changes, the lifetime gift, estate and GST exemptions will return to $1 million in 2013.

It is strongly recommended that you review your will and estate plans in light of these changes.

So you think you owe no estate tax?

While the vast majority of estates will escape federal estate tax, that is not always the case with state estate taxes. Sixteen states plus the District of Columbia have their own estate tax. The following table indicates each state's exemption and maximum estate tax rate:

State	Exemption	Maximum rate
Connecticut	$3,500,000	12%
Delaware	$3,500,000	16%
District of Columbia	$1,000,000	16%
Hawaii	$3,500,000	16%
Illinois	$2,000,000	16%
Maine	$1,000,000	16%
Maryland	$1,000,000	16%
Massachusetts	$1,000,000	16%
Minnesota	$1,000,000	16%
New York	$1,000,000	16%
New Jersey	$675,000	16%
North Carolina	$5,000,000	16%
Ohio	$338,333	7%
Oregon	$1,000,000	16%
Rhode Island	$850,000	16%
Vermont	$2,000,000	16%
Washington	$2,000,000	19%

However, estate tax is not the only claim that states make against the assets of the deceased. Eight states also have an inheritance tax. Two states, Maryland and New Jersey, have both estate and inheritance taxes. Inheritance taxes are generally based on the value of specific inherited assets instead of the value of the entire estate. Generally, inheritance taxes have a much lower exemption than estate taxes. The following table indicates the general inheritance tax exemption and maximum tax rate:

State	Inheritance tax exemption	Maximum tax rate
Indiana	$100	20%
Iowa	0	15%
Kentucky	$500	16%
Maryland	$150	10%
Nebraska	$10,000	18%
New Jersey	0	16%
Pennsylvania	0	15%
Tennessee	$1,000,000	9.5%

Notice that 28 states have neither an estate nor inheritance tax.

Your residence, who your heirs are and the type and location of property left can significantly affect if, and how much, inheritance tax will have to be paid. For example, the following table indicates the inheritance tax rates for various types of heirs in Pennsylvania:

Type of heir	Rate
Surviving spouse or parent from child aged 21 or younger	No tax
Direct descendants and linear heirs	4.5%
Siblings	12%
Others except exempt entities	15%

The amount of state estate and inheritance taxes can significantly affect the value of assets inheritable by your heirs. Even if there is no federal estate tax, the amount left to your heirs could be significantly affected by state estate and inheritance taxes. ∎

GELMAN, ROSENBERG & FREEDMAN
CERTIFIED PUBLIC ACCOUNTANTS

4550 Montgomery Avenue
Suite 650 North
Bethesda, MD 20814