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SEILLER WATERMAN ESTATE AND GIFT TAX LAW UPDATE

Recently Enacted Changes to Estate and Gift Tax Law and How They May Affect You *By C. Shawn Fox*



After a year of uncertainty, Congress finally enacted estate and gift tax legislation to provide some clarity, albeit temporary, to the thoroughly confusing 2010 estate tax landscape. On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "TRA"), which enacted broad tax changes, including changes to the federal estate and gift tax laws. Here is an overview of changes that may affect you:

Estate Tax Changes

In 2010, the federal estate tax was temporarily repealed until January 1, 2011 and individuals dying in 2010 were able to transfer assets of unlimited value to heirs free of federal estate tax. The "catch" was that, in general, the heirs inherited the assets with a tax value equal to what the deceased paid (in tax parlance, the carry-over basis) instead of the value at the time of death (the stepped-up basis). When heirs sell an asset for more than the tax value, they incur capital gains tax on the increase in value. This created a significant administrative burden to determine and maintain records of the deceased's basis in each asset.

TRA now reinstates the federal estate tax and establishes a \$5 million exemption for individuals dying in 2011 and 2012, with a maximum tax rate of 35% for assets valued over the exempt amount. The new law also introduces the concept of portability, which allows a surviving spouse to take advantage of the unused estate tax exemption of a deceased spouse, so as to no more than double the surviving spouse's exemption. Portability is only applicable if both spouses die before 2013, unless Congress acts to make it permanent.

TRA also allows personal representatives of individuals who died in 2010 to elect to be covered by the new estate tax rules for 2011. For estates with income tax consequences under the carry-over basis rules in place in 2010, the personal representative can now file an estate tax return and elect the \$5 million exemption and receive a stepped-up basis. For many estates valued near or under \$5 million this election will eliminate all

estate and income taxes, thus potentially saving the heirs significant sums of money.

The new estate tax estate exemption may have an unexpected and adverse impact on wills and trusts drafted with commonly used formula provisions, resulting in distributions contrary to those intended. For example, common formula based marital and non-marital dispositions could result in more assets than originally intended being distributed to other family members and away from the surviving spouse, possibly leaving the surviving spouse with insufficient assets. This result occurs most commonly in blended families with formula based distributions to the children

of the deceased spouse. Similarly, formula based distributions to a credit shelter trust (a trust designed to maximize the use of an individual's estate tax exemption) could have adverse income tax consequences by losing the stepped-up basis that would otherwise occur on the death of the surviving spouse, even in estates of less than \$5 million (\$10 million for couples).

Gift Tax Changes

TRA drastically increases the amount an individual can give away tax free during his/her lifetime from \$1 million to \$5 million. This presents estate planning opportunities not previously available, which may be enhanced when coupled with life insurance or other estate planning techniques, allowing individuals to transfer significant family wealth to future generations. Again, this opportunity may only be available for two years.

Generation Skipping Transfer Tax Changes

TRA raises the generation skipping transfer ("GST") tax exemption to \$5 million for transfers made during 2011 and 2012 (less previous transfers), with a tax rate of 35%, and otherwise extends the changes made to the GST tax under the Bush administration for two more years. This presents yet another significant opportunity for individuals to pass family wealth to future generations over the next two years.

For more information on this topic or any other legal concerns or questions, please contact your Seiller Waterman attorney.

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