

## Navigating Your Way Through Changes in Estate Planning & Estate Taxes

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### Overview of Federal Gift Tax Statutes

- Annual Exclusion Gifts - \$13,000
- Annual Exclusions are only available for gifts of present interests
- Lifetime Exclusion for gifts in excess of the \$13,000 annual exclusion - \$5 million
- The use of the \$5 million lifetime exemption reduces the credit available at death
- Generation Skipping Transfer (GST) Tax exemption of \$5 million

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### Overview of 2010 Federal Estate Tax Statutes

- No Estate Tax!
- Carryover Basis
- Limited step-up in basis
  - \$1.3 million
  - \$3.0 million for spouse
- OR
- \$5 million exemption
- Step-up in basis
- 35% top rate
- AND
- Repeal of Generation Skipping Transfer tax

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### Federal Estate Tax Statutes for 2011 and 2012

- \$5 million exemption
- \$5 million exemption for GST purposes
- Step-up in basis
- 35% top rate
- Portability of spousal exemption

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### Comparison of Federal Estate Tax

Year	Exemption Amount	Highest Rate
2002	\$1,000,000	50%
2003	1,000,000	49%
2004	1,500,000	48%
2005	1,500,000	47%
2006	2,000,000	46%
2007	2,000,000	45%
2008	2,000,000	45%
2009	3,500,000	45%
2010	Repealed	No Estate Tax *
OR 2010	5,000,000	35%
2011	5,000,000	35%
2012	5,000,000	35%
2013	1,000,000	55%

\* Limited step-up in basis for income tax purposes.

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### New York State Tax Provisions

- \$1 million exemption
- Highest marginal rate is 16%
- NYS tax on a \$3.5 million estate amounts to \$229,000
- NYS Tax on a \$5 million estate amounts to \$391,600
- No gift tax provisions

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### Planning Opportunities – Gifting

- \$13,000 annual exclusion gifts
- Unlimited direct payment of tuition and medical expenses
- Utilize \$5 million lifetime gift exclusion
- No step-up in basis for gifted assets
- Unlimited marital deductions
- Charitable deductions
- Gifting of discounted assets

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### Planning Opportunities – Family Planning

- Make loans at low interest rates to family members
- Sales to grantor trusts
- Use of grantor retained annuity trusts (GRATS)
- Irrevocable Life Insurance Trusts

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### Grantor Retained Annuity Trusts

- Transfer of property to GRAT
- Grantor receives annuity payments during term of GRAT
- The annuity payments are based upon an IRS published rate and the term of the GRAT
- Any assets remaining in the GRAT at the end of the term passes gift and estate tax free to remainder beneficiaries
- Grantor must outlive term of the GRAT

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### Irrevocable Life Insurance Trusts

- Payment of premiums may qualify for annual exclusion gifts (Crummey Provisions)
- Proceeds at death are income tax free and also escape estate taxation (as long as decedent didn't have incidents of ownership within 3 years of death)
- Can be structured to skip a generation for estate tax purposes
- Provide liquidity for estate administration and tax expenses

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### Other Proposed Legislation

- Potential elimination of discounts for gift and estate tax purposes
- Potential elimination of discounts for gift and estate tax purposes for closely held business interest if the family retains control
- Potential elimination of GRAT benefits, including a required 10 year minimum term

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## Another Set of Estate and Gift Tax Rules

By: Dale B. Demyanick

The new tax cut extension package, which was signed into law on December 17, 2010, establishes a new (but temporary) estate and gift tax regime for 2011 and 2012. It also clarifies the situation for the estates of individuals who died in 2010 (see right-hand box).

Here is a brief summary of the relevant estate and gift tax provisions in the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*.

### Exemption and Tax Rate

For estates of individuals who die in 2011 or 2012, the federal estate tax exemption is \$5 million and the tax rate is 35 percent. In 2012, the exemption amount may be increased by an inflation adjustment.

### Deceased Spouse's Unused Exemption Is Portable

Under the new law, unused federal estate tax exemptions of individuals who die in 2011 or 2012 are "portable" which means they can be passed along to surviving spouses.

### The Impact for Married Couples

Thanks to the portable estate tax exemption in conjunction with the unlimited marital deduction, the first spouse to die can leave everything to the surviving spouse without any federal estate tax bill (assuming the surviving spouse is a U.S. citizen and is therefore eligible for the unlimited marital deduction). The surviving spouse will then have two \$5 million exemptions to work with, for a total of \$10 million (assuming the surviving spouse dies in 2011 or 2012).

Therefore, the surviving spouse can leave up to \$10 million to his or her heirs (typically the couple's children) without any federal estate tax bill (assuming the surviving spouse dies in 2011 or 2012).

In effect, the new portable estate tax exemption in conjunction with the longstanding unlimited marital deduction allows the first spouse to die to simply leave everything to the surviving spouse without losing the benefit of his or her \$5 million federal estate tax exemption. Because the deceased spouse's unused exemption can be passed along to the surviving spouse, he or she effectively is given a \$10 million federal estate tax shelter.

### Clarity for Estates of 2010 Decedents

The new law establishes two options for the estates of individuals who died in 2010.

*Here's how the options work:* The estate tax is actually reinstated for 2010 with a \$5 million exemption and a 35 percent tax rate.

However, executors have the option of electing out of the tax for 2010, in accordance with the repeal of the tax for that year. If the election out is made, the modified carryover basis rules described in this article apply to heirs for income tax basis purposes. So heirs of large estates can wind up owing capital gains taxes on appreciation that occurs through the decedent's date of death, but there won't be any federal estate tax bill.

If an election out is *not* made, the \$5 million exemption and 35 percent rate apply for 2010, and the income tax basis of inherited assets equals fair market value on the date of death.

In other words, the familiar unlimited basis step-up rule applies if the election out is *not* made.

**Example 1:** Let's say a married man dies in 2011 with a \$3.5 million estate. Thanks to the new \$5 million federal estate tax exemption, he can leave the \$3.5 million to his children without any federal estate tax hit. The executor of his estate can then elect to pass along his \$1.5 million unused exemption to the man's wife, who is a U.S. citizen. If the wife dies in 2011 or 2012, she can leave up to \$6.5 million to the children without any federal estate tax hit (thanks to her \$5 million exemption plus her husband's unused \$1.5 million exemption).

**Example 2:** Same basic facts as in the preceding example except this time the husband takes the easy way out and simply leaves his entire \$3.5 million estate to his wife without any federal estate tax bill and without using up any of his \$5 million exemption. The executor of the husband's estate then elects to pass along his unused \$5 million exemption to the wife. If she dies in 2011 or 2012, her estate will have a whopping \$10 million exemption available (her \$5 million exemption plus her spouse's unused \$5 million exemption). So the wife could leave up to \$10 million to the children without any federal estate tax bill.

**Key Point.** Before the new law, it was necessary to take tax planning steps like:

- Transferring assets between the spouses while they were both still alive in order to equalize their respective estates or to make sure each spouse's estate was worth at least the estate tax exemption amount.
- Setting up credit shelter trusts to make sure the estate tax exemptions of both spouses were taken advantage of without shortchanging what the surviving spouse inherited from the deceased spouse.

Such tax planning steps may no longer be necessary if both spouses die in 2011 or 2012. But such steps might be necessary again in 2013 and beyond -- because we don't know what the rules will be then.

### Inherited Capital-Gain Assets

For heirs of decedents who die in 2011 and beyond, the familiar rule that allows the federal income tax basis of inherited capital-gain assets (such as real estate and stock) to be stepped up to reflect the date-of-death fair market value is reinstated. For decedents who died in 2010, the simple-and-easy unlimited basis step-up rule was replaced by a complicated modified carryover basis rule that limited basis step-ups to a maximum of \$1.3 million plus up to another \$3 million for assets inherited by a surviving spouse.

To summarize, the executor can choose to either:

- Elect out of the new estate tax rules established by the new law and instead follow the old rules established by the 2001 Bush tax cut legislation (no estate tax but modified carryover basis for inherited assets).
- Not elect out and follow the rules established by the new law (\$5 million estate tax exemption with the tax basis of inherited assets stepped up to the fair market value on the date of death).

**Important:** For estates worth less than \$5 million, making the second choice (following the new rules) is often preferable because it allows unlimited income tax basis step-ups for inherited assets. In contrast, big estates will often benefit from making the first choice (electing out of the new rules and following the old rules) because that results in zero federal estate tax. Your tax adviser can provide more information.

Year	Estate Tax Exemption	Maximum Tax Rate
2001	\$675,000	55%
2002	\$1 Million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	\$5 million or repealed	0% or 35%
2011-2012	\$5 million	35%

**What this means for heirs:** Thanks to the reinstated unlimited basis step-up rule, heirs won't owe any federal capital gains taxes on asset appreciation that occurs through the date of death--as long as that date is after 2010.

### **Estate and Gift Tax Rules Are Equalized**

For 2011 and 2012, the new law sets the lifetime federal gift tax exemption at \$5 million (the 2012 amount will be indexed for inflation). So the gift tax exemption is now equal to the estate tax exemption, which is a big improvement from the relatively paltry \$1 million gift tax exemption that was available previously. Therefore, an unmarried person can give away up to \$5 million in 2011 and 2012 while still alive without owing any gift tax, and a married couple can give away up to \$10 million while still alive. Those amounts are in addition to gifts that are already sheltered by the annual federal gift tax exclusion (\$13,000 per gift recipient for 2011). To the extent you make gifts that utilize part of your \$5 million federal gift tax exemption, your \$5 million federal estate tax exemption is reduced dollar-for-dollar.

The tax rate on 2011 and 2012 gifts in excess of the \$5 million exemption is 35 percent, same as the estate tax rate.

### **Estate Taxes in Your State**

It is not just Uncle Sam that charges estate taxes. So if you decide to update your estate plan, factor in your exposure to any taxes in your state.

### **Stay Tuned**

The new estate and gift tax rules are as taxpayer-friendly as we could have reasonably hoped for, but they are only in place for two years. It is likely these rules will become a major campaign issue during the lead-up to the 2012 election. What happens in 2013 and beyond will probably depend on how the 2012 election turns out. If nothing gets done on the estate tax front, we will once again be facing a confiscatory estate tax for 2013 and beyond -- with only a \$1 million exemption and a maximum tax rate of 55 percent. Similarly, the gift tax exemption would fall back to only \$1 million, and the maximum gift tax rate would jump to 55 percent.

Continued long-term uncertainty will make estate planning challenging. Consult with your estate planning adviser to ensure your documents are up to date and your wishes are carried out.



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