MORRISSEY, HAWKINS & LYNCH

CLIENT ADVISORY:  TAX RELIEF ACT OF 2010

January 1, 2011

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act of 2010"). The Tax Relief Act of 2010 at last addressed the applicability of the estate tax to decedents who died in 2010 and prescribed the future of the transfer tax system for 2011 and 2012, among many other tax measures.

Estate and Gift Taxes in 2011 and 2012

For 2011 and 2012, the estate tax exemption amount will be $5 million, with a tax rate of 35%. The Tax Relief Act of 2010 also reinstates the "step-up" basis rules, pursuant to which the basis in inherited assets is increased to date-of-death values.

In addition, the Tax Relief Act of 2010 introduces exemption "portability" between spouses. If one spouse does not use all of his or her $5 million exemption, it carries over and may be used by the surviving spouse. A surviving spouse may only take advantage of the unused exemption amount of a predeceased spouse by making an election on a timely filed estate tax return. Portability provides an important estate planning opportunity. By making a timely election and employing practical estate planning tools, married couples can effectively take advantage of a combined $10 million exemption.

The Tax Relief Act of 2010 also unifies the estate and gift taxes. Since 2001 the lifetime exemption against gift tax remained steady at $1 million, while the estate tax exemption amount gradually increased to a maximum of $3.5 million in 2009. The lifetime exemption against gift tax is now increased to $5 million for gifts made in 2011 and 2012. Gifts in excess of the exemption amount will be taxed at a rate of 35%.

Generation-Skipping Transfer Tax

The Tax Relief Act of 2010 revives the GST tax for 2010, but with a $5 million exemption and a tax rate of zero. As a practical matter, any generation-skipping transfers that occurred in 2010 were GST tax-free. Prospectively, the GST tax will be aligned with the estate and gift taxes. The GST exemption amount for 2011 and 2012 will be $5 million, with a tax rate of 35%.

2010 Estates

The estates of individuals dying in 2010 faced considerable uncertainty. The federal estate tax was repealed, but inherited assets received a "carry-over basis," which required heirs to take the decedent's basis. Determining a decedent's basis in inherited property could be burdensome and, in many instances, the carry-over basis rules threatened to produce a greater overall tax burden from capital gains tax than the estate tax would have been. Moreover, 2010 estates faced the looming possibility that the estate tax would be reinstated retroactively with an unknown exemption amount and tax rate.

The Tax Relief Act of 2010 puts the uncertainty to rest and gives the estates of decedents dying in 2010 an option. They can elect to accept the reinstated estate tax, with a $5 million exemption amount at a top tax rate of 35%, and receive a step-up in basis for inherited assets. Alternately, they can elect out of the new estate tax regime and have no estate tax apply to the estate, but accept the carry-over basis rules.

Further, estates of decedents dying in 2010 have nine months from the date of enactment (October 17, 2011) to file an estate tax return and/or a carry-over basis return and pay any tax due, as opposed to nine months following the decedent's date of death.

Sunset

The Tax Relief Act of 2010 provides taxpayers with some certainty in tax planning for the next two years. However, the new estate, gift and GST tax regimes are once again temporary and are scheduled to sunset on December 31, 2012. Once the legislation sunsets, federal transfer taxes will revert to 2001 exemption amounts and rates, unless Congress acts to extend the legislation or pass new legislation. The estate and GST tax exemption amount will be $1 million with a tax rate of 55%. The gift tax will likewise revert to a $1 million exemption amount and a top tax rate of 45%.

Going Forward

Due to the increased estate tax exemption amount, some clients may wish to simplify their estate plans by eliminating unnecessary trusts or tax-motivated trust provisions. Other clients may find the increased gift tax exemption presents a good opportunity to undertake additional lifetime gift planning. Additionally, the increased GST tax exemption amount offers the prospect of greater intergenerational wealth succession.

Of course, we recommend careful consideration before undertaking any aggressive or irrevocable planning given that the latest tax law changes are only scheduled to be in place for two years and no one can predict what Congress will do over the next two years. Moreover, despite the change in federal law, the Massachusetts estate tax exemption amount continues to be $1 million. Thus, while some estates may now escape federal estate taxation, they will remain subject to estate tax at the state level.

We urge all clients to review their estate plans in light of the tax changes brought about by the Tax Relief Act of 2010 and contact with us any questions.

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