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Newsletter #9 • January 2011

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## The New Estate, Gift & Generation Skipping Transfer Taxes

With the new year, we have new legislation providing updated Estate, Gift and Generation Skipping Transfer Tax provisions affecting decedents dying between January 1, 2010, and December 31, 2012. Congress has finally given us a long-awaited answer to the question of what will happen with transfer taxes for 2010 and beyond by passing the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (the “Act”), signed into law by President Obama on December 17, 2010. However, since the provisions of the Act are only effective until the end of 2012, the new legislation falls far short of providing a permanent answer or long-term certainty.

### Estate Tax

The Act sets the Estate Tax exemption at \$5 million per individual and \$10 million per couple. This is a significant increase from the \$3.5 million dollar exemption of 2009 and the \$1 million exemption that would have kicked in on January 1<sup>st</sup> had Congress failed to take action. Additionally, the legislation sets the top Estate Tax rate at 35%, which is a significant decrease from the top rate of 45% in 2009 and the top rate of 55% that would have kicked in on January 1<sup>st</sup> without Congressional action.

A significant change in the Estate Tax laws that had been discussed for many years but had never been implemented until the Act was agreed upon is the “portability” (see the *Definition of the Month* below for a detailed explanation) of the Estate Tax exemption. Due to this change, married couples will be able to apply the remaining balance of the first decedent’s exemption to the second decedent’s taxable estate.

For example, assume that Harold passes away in 2011 with a taxable estate of \$3 million dollars. As long as a timely return is filed and election is made, Harold’s wife, Wanda, will be able to pass up to \$7 million of her taxable estate free of Estate Tax at her death, for a total of \$10 million between Harold and Wanda. Under prior

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law, Harold's remaining \$2 million exemption would have been lost. This added feature provides great flexibility and opportunity in Estate Planning to achieve Estate Tax savings, but the use of the deceased spouse's remaining exemption is not automatic.

In order for Wanda to have the remaining \$2 million of Harold's exemption available to her estate at her death, (1) a timely Estate Tax return must be filed by the Executor of Harold's estate, (2) a calculation of the decedent's remaining exemption must be made on the return and (3) an election must be made indicating that such remaining amount shall be available to the estate of the surviving spouse.

Since this is new terrain in the world of the Estate Tax, it remains to be seen how the IRS and the courts will treat this exemption and the practical issues or abuses that may arise once the feature is functional.

### **Gift Tax**

The Act reunites the lifetime Gift Tax exemption with the Estate Tax exemption by setting the former at \$5 million as well. In other words, an individual can essentially use his or her entire Estate Tax exemption during his or her life by making gifts and filing a Gift Tax return to apply the lifetime exemption. Additionally, the portability option also extends to the lifetime Gift Tax exemption.

The annual Gift Tax exclusion, which is indexed for inflation, will remain at \$13,000 for 2011.

### **Generation Skipping Transfer Tax**

The Act reinstates the Generation Skipping Transfer Tax and keeps the exemption equal to the Estate Tax exemption of \$5 million. The tax rate on Generation Skipping Transfers is a flat rate equal to the maximum Estate and Gift Tax rate in effect at the time of the transfer, which in 2011 will be 35%.

### **2010 Decedents**

For the estates of decedents who died during 2010, the Act offers the Executor the option to either (a) apply the 2011 Estate Tax laws to the estate or (b) elect to apply the 2010 Estate Tax laws and related accounting provisions as if the new legislation had not been enacted.

For example, assume that George passed away in 2010 with a taxable estate valued at \$10 million on the date of his death and that George's basis in the assets of the estate was \$6 million. The Executor of George's estate may either:

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- (a) apply the \$5 million Estate Tax exemption available under the Act, pay Estate Tax on the remaining \$5 million, and transfer the assets to the beneficiaries with a stepped-up basis of \$10 million (their value on the date of transfer); or
  - (b) apply the laws that were in effect prior to the new legislation and transfer the assets to the beneficiaries free of any Estate Tax, but with a modified carryover basis (basis equal to George's basis in those assets, plus a special basis adjustment of \$1.3 million resulting in a total basis of \$7.3 million).

Based on the facts above, assuming that George's beneficiary sells the assets for \$12 million, the taxable gain under option (a) would be \$2 million, while the taxable gain under option (b) would be \$4.7 million. As is evident from the example, this unique option will present the Executors and accountants of estates exceeding \$5 million with an interesting decision to be made.

Estate Tax returns for decedents dying in 2010, which were not required to be filed prior to the Act since there was no Estate Tax in 2010, will be due no earlier than nine months from the date of enactment of the Act.

### **State Laws**

The new legislation also reinstates the State death tax credit for decedents dying after December 31, 2010, without a cap on such credit. In other words, the State death tax credit returns to the form that was in effect for the estates of decedents who died prior to 2002. It remains to be seen whether individual states will continue or enact their own legislation imposing a lower Estate Tax exemption.

### **Course of Action**

As a result of the significant changes in the Federal Estate Tax laws, it is crucial to have your existing Estate Planning documents reviewed by a qualified Estate Planning attorney to ensure that the documents provide the flexibility necessary to take advantage of the options available to minimize tax liability. A poorly drafted document may (a) cause the estate to unnecessarily incur Estate Tax, (b) restrict the Executor from utilizing the portability option or (c) fail to take advantage of the increased Estate Tax exemption. Have your documents reviewed to increase the likelihood that your expectations and goals will be met at the time of your death.

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## Definition of the Month: *Portability*

The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* allows for the portability of the Estate Tax exemption between spouses—a new feature that has long been discussed in the Estate Planning community but has never been implemented until now.

Under the new law, if the first spouse dies and does not use all of his or her Federal Estate Tax exemption, the remaining balance can be added to the surviving spouse's exemption to be used at his or her death. According to an example provided by the Joint Committee on Taxation, the deceased spouse's remaining exemption may also be used for lifetime gifts by the surviving spouse.

The portability option is limited to the survivor's *last deceased spouse* only. Thus, if the surviving wife re-marries and survives her second husband as well, her estate will lose the option of using the first deceased husband's remaining exemption at her death. On the other hand, if she predeceases her second husband, her estate may still use the first husband's remaining exemption and her total remaining exemption amount, including any amount left over from the first husband's exemption, will be available to the second husband's estate at his death.

Since this is a new twist to the Estate Tax, it is important to have your existing Estate Planning documents reviewed by a qualified Estate Planning attorney, regardless of how recently the documents were drafted, to ensure that the language in your existing Will or Trust permits your Executor or Trustee to make the portability election if necessary.



Manish C. Bhatia is an Illinois attorney focusing his practice in the area of Estate Planning. Manish has focused his education and practice on Tax Planning, Estate Planning and Business Succession Planning since the first year of law school. He has also added Asset Protection, Elder Law and Nonprofit Organizations/Charitable Giving to his fields of practice. Manish is also a member of the Chicago Bar Association, the Asian American Bar Association of Chicago and the Indian American Bar Association.

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