Finally, "Permanent" Federal Estate and Gift Tax Rules

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INTRODUCTION

The federal estate tax is based on the value of a decedent's assets (including retirement accounts and life insurance), as of the date of death, that exceeds an exemption amount. In addition, there is an unlimited marital deduction for assets passing to a surviving spouse.

The American Taxpayer Relief Act of 2012, which was signed into law in early January 2013, has finally brought some permanency to the rules governing the federal estate and gift taxes. Over the past several years, the federal estate and gift taxes have existed under a cloud that they could revert to the 2001 rules. In order to fully understand the significance of the American Taxpayer Relief Act of 2012, a review of the recent history of the federal estate and gift taxes is in order.

2001 ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted in 2001. Under EGTRRA, the exemption amount was set at $1 million in 2001 and increased as follows:

YEAR	FEDERAL EXEMPTION
2002	$1 million
2003	$1 million
2004	$1.5 million
2005	$1.5 million
2006	$2 million
2007	$2 million
2008	$2 million
2009	$3.5 million

In 2010, the federal estate tax was repealed under EGTRRA. However, because EGTRRA expired on December 31, 2010, the federal estate tax was scheduled to return on January 1, 2011, with an exemption of $1 million. Under EGTRRA the estate tax rate was reduced from 55% to 45%, but the 55% rate would also return on January 1, 2011.

Generally, there was no real expectation that the estate and gift tax rules would return to the year 2001, but the lack of certainty concerning the rules after 2010 made estate planning challenging.

THE TAX RELIEF ACT OF 2010

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the Tax Relief Act of 2010).

Under the Tax Relief Act of 2010, the federal estate tax did not revert to the pre-EGTRRA rules for the years 2011 and 2012. Instead, the exemption amount was increased to $5 million, and a flat tax rate of 35% was adopted for 2011 and 2012. The estate tax rate had not been less than 45% since 1931. Since the estate tax exemption is per individual, a married couple could shelter up to $10 million from the federal estate tax.

The law also significantly changed the gift tax. In 2009, although the estate tax exemption was $3.5 million, the lifetime exemption for gifts was only $1 million. The gift tax exemption was unified with the estate tax exemption so that both became $5 million. This was in addition to the gift tax annual exclusion of $13,000 in 2011 and 2012 (formerly $10,000) per donee. The gift tax rate was also set at 35%. If a person used any portion of the $5 million lifetime gift tax exemption, that amount was deducted from the $5 million estate tax exemption that would otherwise be available to that person's estate.

A new concept known as "portability" of the estate tax exemption was also introduced by the Tax Relief Act of 2010. Often, due to a lack of proper planning, the first spouse to die would fail to fully utilize the federal estate tax exemption. Either the surviving spouse held most of the marital assets or the deceased spouse left his or her estate directly to the surviving spouse under the marital deduction and failed to use the estate tax exemption. Previously, the amount of the exemption unused by the first spouse to die was permanently lost. With portability the unused estate tax exemption became available for use by the surviving spouse as an addition to his or her exemption. Thus, the federal estate tax exemption of a surviving spouse could be as high as $10 million. In order to pass the unused exemption to a surviving spouse, the estate of the deceased spouse must file a federal estate tax return and make such an election.

Unfortunately, although the Taxpayer Relief Act of 2010 provided clarity for the federal estate and gift taxes for 2011 and 2012, it did not permanently establish the rules beyond 2012. Similar to the 2001 EGTRRA, it was set to expire on December 31, 2012, and in 2013 the estate and gift tax laws would regress to 2001.

THE AMERICAN TAXPAYER RELIEF ACT OF 2012

The American Taxpayer Relief Act of 2012 retained most of the features of the 2010 act and finally removed the looming expiration date under which the rules would ostensibly return to 2001. The rules are now essentially "permanent" and can be changed only by new legislative action.

The estate and gift tax exemption of $5 million remains in effect and, in fact, is indexed for inflation so that the exemption is actually $5,220,000 in 2013. The portability of the exemption between spouses has been made permanent. However, the estate and gift tax rates were increased from 35% to 40%. There continues to be an annual exclusion from the gift tax, which is also indexed for inflation and is $14,000 per donee in 2013. Of course, the unlimited marital deduction for property left to a surviving spouse also remains in effect.

THE MASSACHUSETTS ESTATE TAX AND ESTATE PLANNING

The Massachusetts estate tax remains in force and unchanged. All taxable estates that exceed $1 million and do not pass to a surviving spouse are subject to the tax. The tax rates are graduated, ranging from 0.8% to 16%. There is no portability of the Massachusetts estate tax exemption between spouses. Massachusetts does not impose a gift tax on lifetime transfers.

In order for a married couple to take maximum advantage of both the federal and Massachusetts estate tax exemptions, both spouses must establish trusts known as A/B Trusts or Marital Deduction/Credit Shelter Trusts. Instead of leaving his or her entire estate directly to his or her spouse, each person leaves his or her estate to a trust for the benefit of the spouse. The trust divides into Trust A and Trust B. Trust B is funded first with an amount up to the federal estate tax exemption in effect at the time of the person's death. If the decedent's estate exceeds the amount of the federal estate tax exemption, the excess funds Trust A, which qualifies for the marital deduction. There will be no federal estate tax due upon the first spouse's death, and only the assets in Trust A will be included in the taxable estate of the surviving spouse when he or she later dies.

In order to address the Massachusetts estate tax, Trust B further divides into a Mass Exempt Trust and a Mass QTIP Trust. The Mass Exempt Trust is first funded with an amount equal to the Massachusetts exemption amount of $1 million, and the excess goes into the Mass QTIP Trust, which qualifies for the marital deduction under the Massachusetts estate tax. There is no Massachusetts estate tax due upon the first spouse's death, but the assets in the Mass QTIP Trust will be included in the Massachusetts taxable estate of the surviving spouse when he or she later dies.

As a result of the federal estate tax exemption being permanently set at $5 million, indexed for inflation, most people will no longer be subject to the federal tax. However, many people will still be potentially subject to the Massachusetts estate tax and the use of A/B Trusts is still relevant to avoid or minimize the Massachusetts estate tax. The A/B Trust used by Fletcher Tilton PC automatically adjusts to changes in the federal estate tax exemption, so our clients who have already executed A/B Trusts do not need to amend their trusts. However, we do suggest that it may be appropriate to review the division of assets between the husband and wife in connection with their estate plan.

CONCLUSION

We finally have certainty in regard to federal estate and gift tax rules and can engage in estate planning without concern that the rules will dramatically change. Before the 2001 Tax Act, it was not uncommon for persons with large estates to intentionally make large gifts in excess of the exemption and pay gift tax. This was advantageous for older persons, since the gift tax paid further reduced the taxable estate, and the combined gift tax and eventual estate tax would be lower than if only estate tax were paid at death. We should see a return to this strategy for high-net-worth individuals.

For married couples with estates under $5 million, planning to avoid or reduce the Massachusetts estate tax remains important.

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