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# NEW 2011

## ESTATE TAX ANALYSIS

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We have been waiting and waiting for literally years for Congress to make a decision on what the estate tax exemption would be for 2011 and thereafter. If Congress failed to act, the Bush-era tax cuts, which included a higher estate tax exemption, would sunset. That meant that the exemption would become only \$1 million per person in 2011 and thereafter, and the maximum tax rate would be increased from 45% to 55%. (Incidentally, the Minnesota Estate Tax exemption has been frozen at \$1 million for years and has an effective rate of about 10% over the exemption amount.)

When Congress did not act before the November elections, because it was already in the last quarter of 2010, we felt we could wait no longer to prepare a mailing to alert our clients of what may be a significant tax problem for them. About the time this Newsletter was to be mailed, there suddenly was a new interest in resolving this problem in the “lame-duck” Congressional Session. Even then, however, it took a month before a new bill was passed about a week before Christmas. We will try to outline the major provisions of the new law even though we only have the original text of the bill, without the regulations which will be issued by IRS to administer the new law.

It is noteworthy that the new estate tax law probably only passed because it was part of other provisions if the Bill which had popular support, namely the extension of lower income taxes and unemployment benefits. However, unlike income tax provisions which

*The new law increases the exemption from \$3.5 million to \$5 million per couple & introduces a portability of exemption between spouses.*

were merely extended, the estate tax exemption was actually increased from \$3.5 million to \$5 million per person. The new law also introduced a new concept to the estate tax laws by providing what is called *portability of the exemption between spouses*. What this simply means is that the second to die of a couple can use the unused exemption not used by the first to die.

While at first blush the new law seems to be beneficial, we believe the most important provision of the new law is that it is only temporary. This new law will also itself sunset on January 1, 2013. Therefore, unless a death occurs within the next roughly 730 days, clients are in the same position clients were in a few weeks ago in not knowing what Congress may do or fail to do in the future after 2012.

*This new law is only temporary.*

Remember, that if Congress fails to act by the end of 2012, after the new law has expired, the exemption will again revert to \$1 million and the estate tax rate will increase to 55%. Remember also that President Obama was opposed to any tax breaks for the wealthy, including the larger exemption and lower tax rate for estate taxes. He only compromised with respect to the new law (to the strong opposition of his Democratic colleagues generally) to gain some other concessions like extending unemployment benefits. But those reasons to compromise are not likely to be present as the new law approaches sunset.

The President's own words at the news conference he held on December 22, 2010, gives us some strong indications of his continued sentiments.

He said:

*"I still believe that it doesn't make sense for us to provide tax cuts to people \* \* \* who don't need them when our deficit and debts are growing."*

He continued:

*"I don't think that over the long run we can afford a series of tax breaks for people who are doing very well and don't need it; were doing well when Bill Clinton was in office. They were still rich then, and they will be rich if those tax cuts went away."*

\* \* \*

*"So we are going to compare the option of maintaining the tax cuts for the wealthy permanently versus spending on these things we think are important, and that's a debate that I welcome. But I completely understand why not just Democrats, but some Republicans, might think that part of the tax package we could have done without (emphasis added)"*

He also said the following about another part of his core agenda (Dream Act) which shows his mind set:

*"And so one thing I hope people have seen during this lame duck, I am persistent. I am persistent. If I believe in something strongly, I stay on it."*

Our conclusion from the foregoing is that we believe it is more unlikely than likely that the new law will be extended beyond 2 years with a \$5 million exemption at a rate capped at 35%. The question is whether the new law will just sunset because of

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no Congressional agreement and the exemption revert to \$1 million, or whether an exemption level of less than \$5 million will be adopted. Any other outcome other than allowing sunset requires an agreement between the members of Congress and the President.

Because any future compromise will probably be influenced more by politics than policy, an agreement could be difficult. And even a compromise agreement will likely have to incorporate an exemption amount which President Obama doesn't deem to benefit the wealthy. Some studies have indicated that an asset level of \$2.5 - \$3.5 million for a family should be considered wealthy in the same way that income in excess of \$250,000 per couple is considered wealthy by the Obama administration.

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### Portability of Couples Exemption

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First impressions of the portability of the exemption between couples may also conclude this to be beneficial to taxpayers. However, a closer analysis may give rise to some caution. Rarely does Congress make a tax law change that is for the benefit of taxpayers without some consequence. While we have yet to see the regulations the IRS will implement to administer portability, the new law itself gives some strong hints.

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In order to preserve the portability of the exemption of first spouse to die, an election must be made at the death of the first to die. This can only be done by filing an estate tax return. This may force the filing of a return in some cases where it would not have been required prior to passage of the new law. The new law requires the filing of an estate tax return to preserve the portability of the exemption.

Moreover, the new law seems to create some new rights in the IRS, if you make the election for portability. Under the new law, the IRS has the right to reopen the tax return of the first to die at the time of the second spouse's death. We question whether the reason for portability is to extend the IRS' right over a couple's estate to make it more likely to assess added taxes.

*The new law appears to provide a mechanism for the IRS to scrutinize and challenge asset valuations and estate planning allocations in connection with the death of the second spouse.*

Currently, at the first death it may not be worthwhile for the IRS to challenge asset valuations used because the formulas used in the estate plan would simply zero the tax by allocating more under the marital deduction. The new law appears to provide a mechanism for the IRS to scrutinize and challenge asset valuations and estate planning allocations in connection with the death of the second spouse.

By being able to extend the time to assert a higher valuation to time of the second death, the IRS may be obtaining an advantage that is disguised as a benefit. Therefore, as is often the case with new concepts introduced, time may reveal other unintended (or perhaps intended) consequences under the new concepts. If the first to die's estate tax return can be reopened, the advantage of freezing the valuation of at least one-half of the total couple's asset value is lost.

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## Gifts

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The amount of the lifetime gift tax exemption has also been increased under the new law. A few years ago, the estate and gift exemption had been decoupled, limiting lifetime gifts to only \$1 million. While the estate tax exemption increased, the new law again unifies the exemption and rate to be identical for gift and estate taxes. Consequently, for the next 2 years, gifting in amounts up to an aggregate of \$5,000,000 per

person will now be available during life or at death (or any combination thereof).

Whether increased gifting under the new law is advantageous or not may depend, however, more on the basis of the property to be gifted. Carryover basis rules apply to lifetime gifts, and, therefore, the basis of the donor will be passed to the donee. In contrast, a gift on death will give a new basis stepped up to the value at the time of death. The subsequent sale of the property by the donee(s) will, therefore, result in less capital gains tax because the capital gain on the appreciation is forgiven. A case by case analysis will have to be followed to determine what is the best course of action.



In conclusion, we believe that history has demonstrated that we should not wait to see what Congress does or doesn't do. Rather, planning should be based on a worst-case scenario so that your plan is bullet proof from future Congressional action. We also believe that estate plans should be developed to address both applicable state and federal estate tax laws, and be careful not to be based on what could be a Trojan horse. Traditional planning using marital and family trusts based on a formula should still be followed.

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