

Dear Client:

I am writing this letter to tell you about changes to estate and gift taxes in the enacted 2010 Tax Relief Act. Before the new law, there was no estate tax for 2010, but some beneficiaries were expected to pay higher income taxes when they disposed of inherited property. Also, under the prior law, estate and other transfer taxes were scheduled to increase dramatically after 2010.

Overview of the new law. The 2010 Tax Relief Act provides temporary relief. Among other changes, it reduces estate, gift, and generation-skipping transfer (GST) taxes for 2011 and 2012. It preserves estate tax repeal for 2010, but in a roundabout way: estates wanting zero estate tax for 2010 must elect that option, along with the less favorable modified carryover basis rules that were set to apply for 2010. Otherwise, by default, the estate tax was revived for 2010, with a \$5 million exemption, a top tax rate of 35%, and a step-up in basis. For estates of decedents dying after December 31, 2010, a deceased spouse's unused exemption may be shifted to the surviving spouse. However, these generous rules are temporary—harsher rules are slated to return after 2012.

Lower rate and higher exemption for 2011 and 2012. For estates of individuals dying in 2009, the top estate tax rate was 45% with a \$3.5 million exemption. The top rate was scheduled to increase to 55% for estates of individuals dying after 2010, and the exemption was to be \$1 million. The 2010 Tax Relief Act reduces the top rate to 35% for 2011 and 2012. It also increases the exemption to \$5 million for 2011 with a further increase for inflation in 2012. But these changes are temporary. After 2012, the top rate is scheduled to increase to 55%, with an exemption of \$1 million.

Special tax saving choice for 2010. The 2010 Tax Relief Act allows estates of decedents who died in 2010 to choose between (1) estate tax (based on a \$5 million exemption and 35% top rate) and a step-up in basis, or (2) no estate tax and modified carryover basis.

Basis is the yardstick for measuring income tax gain or loss when an asset is sold. With a step-up in basis, pre-death gain is eliminated because the basis in the heir's hands is increased to the date of death value of the asset. On the other hand, with a modified carryover basis, an heir gets the decedent's original basis, plus certain increases, which can be substantial. Even so, if the decedent had a relatively low basis and significant assets, some pre-death gain may be taxed when the heir sells the property. These concerns make basis considerations extremely important for determining how to handle estate taxes in 2010. The executor should look at the lowest combined estate and income taxes for the estate and its beneficiaries. The decision would also include considerations of the decedent's basis, asset appreciation, and the beneficiaries' plans for any inherited assets.

Gift tax changes. Historically, the gift tax and the estate tax have been unified—they share a single exemption and are subject to the same rates. In 2010, the two tax systems were separate, with the top gift tax rate set at 35% and an exemption of \$1 million. For gifts made after December 31, 2010, the gift tax and estate tax have been reunified and share an overall \$5 million exemption.

GST tax changes. The GST tax is an additional tax on gifts and bequests to grandchildren **when** their parents are still alive. The 2010 Tax Relief Act lowers GST taxes for 2011 and 2012 by increasing the exemption amount from \$1 million to \$5 million (as indexed after 2011) and reducing the rate from 55% to 35%.

New portability feature. Under the 2010 Tax Relief Act, any exemption that remains unused as of the death of a spouse who dies after December 31, 2010 and before January 1, 2013, is generally available for use by the surviving spouse. The unused exemption is added to his or her own \$5 million exemption for taxable transfers made during life or at death. Under prior law, the exemption of the first spouse to die would be lost if not used. Trusts were used to get around the exemption limitations for the poorer spouse. Now, the portability rule may make setting up a trust unnecessary. Please consult us for additional details regarding the use of trusts in estate planning.

Conclusion. The estate tax relief in the new law is substantial, but temporary. Estate planning remains an important means of reducing taxes and maximizing the value of assets for the beneficiaries. Even if taxes are not a concern because an estate is below the exemption level, it is important to have a proper estate plan to ensure that the wishes of the decedent are being carried out to maximum benefit. Please schedule an appointment to discuss how you and your family can plan to benefit from the new estate and gift tax rules.

Sincerely,

A handwritten signature in black ink, appearing to read "Grumbly Coleman". The signature is written in a cursive, flowing style.