

## **Estate and Gift Tax Relief in the 2012 Taxpayer Relief Act**

On Jan. 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (2012 Taxpayer Relief Act), which the President quickly signed into law on Jan. 2, 2013. The Act prevents many tax hikes from going into effect and retains many favorable tax rules that were scheduled to expire. It provides other relief as well including permanent estate; gift and generation-skipping transfer tax relief, albeit at a slightly higher rate than applied for 2012. The transfer tax relief is the focus of this Special Study and is explained below following the background leading up to it.

### **Background on Transfer Tax Changes**

Before enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), there was no gift tax and no estate tax on the first \$675,000 of combined transfers during life or at death for gifts made and individuals dying in 2001. These two taxes were tied together under a unified system having a top rate of 55%. However, there were differences between the gift tax and the estate tax. One difference potentially affected the income tax of donees (recipients) of gifts and heirs of estates. A donee generally gets the donor's basis (usually cost) for a gift. As a result of this carryover basis, if there is a gift of appreciated stock, for example, the donee will have a taxable gain if he sells at the gift value. Property acquired from a decedent, however, generally gets a basis equal to its value at his death (a "stepped-up basis"). This means that, on a later sale by the heir, he won't have to pay income tax on the appreciation in the property that occurred while it was held by the decedent.

EGTRRA substantially increased the \$675,000 exemption in stages after 2001. For individuals dying in 2006 through 2008, the exemption was \$2 million. It rose to \$3.5 million for individuals dying in 2009. EGTRRA also changed the unified system so that the gift tax exemption amount remained at \$1 million for all years after 2001.

Under EGTRRA, the top estate and gift tax rate was reduced in stages. It was 45% for transfers in 2007 through 2009. In 2010, there was to be no estate tax and the top gift tax rate was to be 35%. The top estate and gift tax rate was to revert to 55% in 2011.

For 2010, the basis rules for inherited property were to be similar to the gift tax rules, but with many opportunities for heirs to get increases in basis.

EGTRRA made other changes to the transfer tax rules. For example, it repealed the State death tax credit and replaced it with a deduction. EGTRRA also repealed the qualified family-owned business deduction and made modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the GST tax.

All of the EGTRRA changes were scheduled to sunset at the end of 2010. Under the sunset, the rates and rules were to revert to those that applied pre-EGTRRA.

However, the 2010 Tax Relief Act provided temporary relief from the EGTRRA sunset. Among other changes, it reduced estate, gift and GST taxes for 2011 and 2012 and continued other estate and gift tax relief provisions that were set to expire after 2010. It preserved estate tax repeal for 2010 in a roundabout way: estates wanting zero estate tax for 2010 had to elect that option, along with the modified carryover basis rules. 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.

The 2010 Tax Relief Act also introduced a new portability election for estates of decedents dying after 2010 under which a deceased spouse's unused exemption could be shifted to the surviving spouse. However, these generous rules were temporary—the much harsher pre-EGTRRA rules were slated to return after 2012. Now that won't happen as the 2012 Taxpayer Relief Act has provided permanent transfer tax relief by ending the EGTRRA sunset and permanently adopting the changes made by the 2010 Tax Relief Act. (Act Sec. 101(a))

### **New Permanent Indexed Exemption**

The 2012 Taxpayer Relief Act permanently establishes the estate exemption amount (technically, the basic exclusion amount) at \$5 million per person (as increased by indexing after 2011). (Code Sec. 2010(c), as amended by Act Sec. 101(a) (the provision eliminating the EGTRRA and 2010 Tax Relief Act sunsets)) Indexing increased the exemption to \$5,120,000 for 2012. Based on inflation data, RIA calculates the exemption to be \$5,250,000 for gifts made and decedents dying in 2013. The exemption is allowed in the form of a unified credit. (Code Sec. 2010)

### **Maximum Transfer Tax Rates Raised Slightly from 2012 Levels**

The maximum estate and gift tax rate was 35% for gifts made and decedents dying in 2012. The 2012 Taxpayer Relief Act changes the top rate to 40% for gifts made and decedents dying after 2012. Under the Act, transfers over \$500,000 are taxed at 37%, transfers over \$750,000 are taxed at 39% and transfers over \$1,000,000 are taxed at 40%. More specifically, the tax on a transfer over \$1 million is \$345,800 plus 40% of the excess over \$1,000,000. (Code Sec. 2001(c), Code Sec. 2502(a), and Code Sec. 2641, as amended by Act Sec. 101) Thus, the \$5,250,000 exemption for 2013 or, in technical terms, the basic exclusion amount for 2013, would offset \$2,045,800 in tax ( $\$345,800 + (.40 \times \$4,250,000)$ ). In other words, the unified credit for 2013 transfers is \$2,045,800. (JCX-2-13R)

### **2010 Tax Relief Act Gift Tax Changes Made Permanent with a Modification**

Under the 2010 Tax Relief Act, for gifts made in 2010, the exemption was \$1 million and the gift tax rate was 35%. For gifts made after Dec. 31, 2010, the gift tax was reunified with the estate tax, with an exemption amount of \$5 million (plus indexing after 2011) and a top rate of 35%. The exemption under the unified system covering lifetime transfers and transfers at death was allowed through a unified credit contained in Code Sec. 2010 (for estate tax purposes) and Code Sec. 2505 (for gift tax purposes). The 2010 Tax Relief Act also made clarifying changes to how gift taxes are taken into account in the mechanism for computing estate and gift taxes. All of these changes have now been

made permanent by the 2012 Taxpayer Relief Act, except that the Act has changed the top gift tax rate to 40%. (Code Sec. 2001(b)(2), Code Sec. 2001(g), Code Sec. 2502(a) and Code Sec. 2505, as amended by Act Sec. 101))

**Observation:** Based on inflation data, RIA has calculated the exemption to be \$5,250,000 and unified credit to be \$2,045,800 for 2013 transfers.

### **Generation-Skipping Transfer Tax Changes**

The 2010 Tax Relief Act made the GST tax exemption for decedents dying or gifts made after Dec. 31, 2010 and before Jan. 1, 2013 equal to the basic exclusion amount for estate tax purposes (e.g., \$5 million, as indexed), set the GST tax rate for transfers made in 2011 and 2012 at 35%, and extended the EGTRRA modifications to the rules regarding various technical aspects of the GST tax. The 2012 Taxpayer Relief Act makes these changes permanent, except that it increases the GST tax rate to 40%. In other words, under the 2012 Taxpayer Relief Act, for decedents dying and gifts made after 2012, (1) the GST tax exemption is equal to the basic exclusion amount of \$5 million as indexed, which RIA has calculated to be \$5,250,000 for 2013; (2) the GST tax rate is 40%; and (3) the technical modifications to the GST rules made by EGTRRA continue to apply.

### **Portability of Unused Exemption between Spouses Made Permanent**

The 2010 Tax Relief Act authorized estates of decedents dying after 2010 and before 2013 to elect to transfer any unused exclusion to the surviving spouse. The amount received by the surviving spouse is called the deceased spousal unused exclusion, or DSUE, amount. If the executor of the decedent's estate elects transfer, or portability, of the DSUE amount, the surviving spouse can apply the DSUE amount received from the estate of his or her last deceased spouse against any tax liability arising from subsequent lifetime gifts and transfers at death. The 2012 Taxpayer Relief Act has made this provision permanent. (Code Sec. 2010(c)(2)(B), Code Sec. 2010(c)(2)(4), and Code Sec. 2010(c)(5), as amended by Act Sec. 101) In addition, it has made a retroactive technical correction to Code Sec. 2010(c)(4)(B), which IRS had already implemented under regs, which greatly flesh out the statutory rules. For detailed discussion of those regs, see Weekly Alert ¶ 2 06/21/2012.

### **Other EGTRRA Changes Now Permanent**

As noted above, in addition to reducing transfer taxes, EGTRRA made a number of other transfer tax changes. For example, it repealed the State death tax credit and replaced it with a deduction. EGTRRA also repealed the qualified family-owned business deduction and made modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the GST tax. The 2012 Taxpayer Relief Act has now made all of these changes permanent. (Act Sec. 101)