Estate Taxation

Lions and tigers and bears . . .
Ever since the estate tax was instituted in 1916, whatever an individual owns has been subject to the federal estate tax upon his or her death — until 2010, that is. The estates of those dying during that year were entirely free from federal taxation because Congress could not reach an agreement extending the federal estate tax in some form. An agreement was finally reached at the end of 2010 that cemented the federal estate tax rules for 2011 and 2012. If Congress fails to act before the end of 2012, the rules for 2013 will revert to the provisions prevailing in 2001. For 2011 and 2012, the tax rate on estates is 35 percent (see chart below).

That said, not all estates will be taxed. First, spouses can leave any amount of property to their spouses, if the spouses are U.S. citizens, free of federal estate tax. Second, the estate tax applies only to individual estates valued at more than $5.12 million ($10.24 million for couples) in 2012 (see chart). The federal government allows you this tax credit for gifts made during your life or for your estate upon your death. Third, gifts to charities are not taxed.

The heirs of those dying in 2010 will have a choice between applying the new rules for 2011 and 2012 or electing to be covered under the rules that applied in 2010 — no estate tax but only a limited step-up in the cost basis of inherited assets. The law for 2011 and 2012 also makes the estate tax exemption “portable” between spouses. This means that if the first spouse to die does not use all of his or her $5 million or $5.12 million exemption, the estate of the surviving spouse may use it. So, for example, John dies in 2011 and passes on $3 million. He has no taxable estate and his wife, Mary, can pass on $7 million (her own $5 million exclusion plus her husband’s unused $2 million exclusion) free of federal tax. (However, to take advantage of this Mary must make an “election” on John’s estate tax return. Check with your attorney.)

Tax Year	Tax Rate	Exemption Equivalent
2009	45%	$3,500,000
2010	N/A or 35%	N/A or $5,000,000
2011	35%	$5,000,000
2012	35%	$5,120,000
2013	55%	$1,000,000

The currently high federal estate tax exemption, coupled with the portability feature, might suggest that “credit shelter trusts” (also called bypass or AB trusts) and other forms of estate tax planning are needless for other than multi-millionaires, but there are still reasons for those of more modest means to do planning, and one of the main ones is *state* taxes. Nearly half the states also have an estate or inheritance tax and in many cases the thresholds are far lower than the current federal one. Many states used to take advantage of what was known as a “sponge” tax, which ultimately didn’t cost your estate. The way this worked was that the states took advantage of a provision in the federal estate tax law permitting a deduction for taxes paid to the state up to certain limits. The states simply took the full amount of what you were allowed to deduct off the federal taxes. However, the allowable state deduction was phased out under the Bush tax cuts enacted in 2001, and it disappeared entirely in 2005. This means that many states are changing their estate tax laws to make up the difference, and more changes at the state level can be expected as state politicians react to the new federal estate tax landscape. These changes may call for a restructuring of your estate plan; check with your attorney.

Making Gifts: The $13,000 Rule

One simple way you can reduce estate taxes or shelter assets in order to achieve Medicaid eligibility is to give some or all of your estate to your children (or anyone else) during their lives in the form of gifts. Certain rules apply, however. There is no actual limit on how much you may give during your lifetime. But if you give any individual more than $13,000 (in 2012), you must file a gift tax return reporting the gift to the IRS. Also, the amount above $13,000 will be counted against a $5 million lifetime tax exclusion for gifts. (This exclusion was $1 million for many years but was raised to $5 million in 2011 and $5.12 million in 2012.) Each dollar of gift above that threshold reduces the amount that can be transferred tax-free in your estate.

The $13,000 figure is an exclusion from the gift tax reporting requirement. You may give $13,000 to each of your children, their spouses, and your grandchildren (or to anyone else you choose) each year without reporting these gifts to the IRS. In addition, if you’re married, your spouse can duplicate these gifts. For example, a married couple with four children can give away up to $104,000 in 2012 with no gift tax implications. In addition, the gifts will not count as taxable income to your children (although the earnings on the gifts if they are invested will be taxed).