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The Obama Tax Cuts and Your Estate Planning

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Since 2001 American's have been dealing with a large amount of uncertainty in the realm of estate and gift taxes. On Thursday December 17, 2010 Obama signed the much talked about Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Obama tax cuts). So what does the passage of the Obama tax cuts mean for the estate tax? Included in the Obama tax cuts are temporary changes to the estate tax. Changes to the estate tax are only effective until 2013, which continues to make it difficult for people to do their estate planning. So what are these changes and how does the average person plan in the light of these changes?

Modification of the Estate Tax Rate

Under the Bush tax cuts the top tax rate for the estate tax was fifty-five percent (55%). The Obama tax cuts modify the tax rate so that the top rate is now thirty-five (35%) until 2013.

Modification of the Estate Tax Exemption

Under the Bush tax cuts the estate tax exemption, (the amount you can pass to your heirs without incurring estate tax), was slowly increased to a maximum amount of \$3.5 million in 2009 and then in 2010 there was no estate tax. Under the Obama tax cuts the estate tax returns and the estate tax exemp

tion increases to \$5 million until 2013. Unless Congress extends the Obama tax cuts the \$5 million exemption will return to \$1 million on January 1, 2013. While the increase in the exemption is nice, the fact that it is only effective for two years makes it very difficult for people with estates worth more than \$1 million but less than \$5 million to plan.

Modification of the Lifetime Gift Tax Exemption

Under the Bush tax cuts the lifetime gift tax exemption was \$1 million. Under the Obama's tax cuts individuals now have lifetime gift tax exemption of \$5 million. This exemption will stay at \$5 million

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until 2013. However, it is important to remember that the federal gift tax and estate tax are integrated into one unified tax system often referred to as the unified credit. Making gifts in excess of the annual exclusion causes an individual to use all or a portion of his/her lifetime gift tax exemption which reduces the amount available to offset the estate tax at the individual's death. If, however, the individual pays the gift tax, such taxed gifts are added back to the individual's estate, and the estate tax is recalculated, with the gift taxes the individual previously paid credited against any final estate tax due.

For example, if John gifts \$1,013,000.00 to his daughter in 2011, \$13,000.00 will count towards John's annual gift tax exclusion. This leaves \$1,000,000.00 that John can either pay the gift tax on during his life or he can use part of his \$5 million gift tax exemption. If John uses his gift tax exemption when John dies his estate tax exemption will be re-

duced so that instead of a \$5 million estate tax exemption he only has a \$4 million estate tax exemption.

Modification of the GST Exemption

In the past under the Bush tax cuts the generation skipping tax (GST) exemption was \$1 million. Under the Obama tax cuts the generation skipping tax exemption is increased to \$5 million for the next two years. Again, it is important to remember the GST exemption is also part of the unified tax system and so using your GST exemption decreases your lifetime gift tax exemption and estate tax exemption.

Portability

In the past for a married couple to take advantage of both spouses' estate tax exemption they would have to use a trust to capture the exemption of the first spouse to die. For example, in the past if John and Susan had \$10 million and John died first, \$5 million would have to go into a credit shelter trust at

John's death to capture John's \$5 million estate tax exemption. Then when Susan died the remaining \$5 million will be covered by Susan's \$5 million estate tax exemption.

Under the Obama tax cuts for the next two years a married couple no longer needs to use a credit shelter trust to capture both exemptions. Instead portability of the federal estate tax exemption between married couples means that if the first spouse dies and doesn't use up all of his or her federal exemption from estate taxes, the portion of the exemption that the deceased spouse didn't use will be transferred to the surviving spouse's exemption so that the survivor can use the deceased spouse's unused exemption plus the survivor's own exemption when the surviving spouse later dies.

Step Up Basis Returns

In 2010 when the estate tax disappeared, so did the step up in basis heirs received on inheritances. Instead, 2010 was the year of carry-over ba-

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sis. With the Obama tax cuts the step-up in basis returns. This means that if Mom bought a house for \$50,000 and at her death the fair market value is \$200,000 when the heirs sell the house they will pay capital gains only on the difference between the sale price and the fair market value at the date of death of \$200,000.

So How Do You Plan?

Unfortunately rather than clarify the estate tax laws and create certainty the Obama tax cuts have just caused the uncertainty to continue for the next two years. This makes it very difficult for individuals to do their estate planning. I have had clients ask me if it is even worth doing their estate planning until the law settles into some certainty. My answer is always YES. Estate planning does not just attempt to plan for the years way out in the future, but it also plans for the risks of the immediate future. For this reason it is important to complete your estate planning sooner rather than later. I tell my clients that

estate planning is not something that is written in stone, so whether the law is temporary or becomes permanent there is a good chance you will have changes that have nothing to do with the laws and need to change your documents no matter what.

So how do you plan under the current laws? My approach is to explain the status of the current laws to my clients and give them the choice, they can plan as though the current laws will be permanent, or they can plan as though the current laws are temporary and the exemption will go back to \$1 million. In some cases the documents can be drafted with enough flexibility that if certain provisions are not needed they will not be used. Either way, everyone must be aware that in two years time, they may need to change their documents.

Conclusion

Hopefully it is clear that while there are some significant temporary changes to the estate, gift and generation skipping tax laws

under the Obama tax cuts, the fact that these changes are temporary should not stop you from doing your estate planning. If you wonder if your estate plan needs updating or if you haven't done your estate planning please call Armor Trust Attorneys at 919-571-4398 and make an appointment to speak with an attorney and discuss your options.

At Armor Trust Attorneys, we are committed to serving clients who have wealth preservation and transfer needs. We are a boutique estate planning and wealth preservation firm. Unlike large law firms, our clients always speak directly with an attorney, and we focus on their needs, so that they can sleep better knowing that their unique needs are being met.



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