

## FURTHER UPDATE: TEMPORARY FEDERAL ESTATE TAX REFORM

### Introduction: Federal Estate Tax, Gift Tax and Generation-skipping Transfer Tax Reforms

On December 17, 2010 President Obama signed into law important reforms to the federal estate tax, gift tax and generation-skipping transfer tax, effective for 2011 and 2012 and, to a limited extent, for 2010. Here are a few details regarding the reforms in effect during 2011 and 2012:

- The federal estate tax has a \$5,000,000 exemption, up from 2009's \$3,500,000 exemption, and a 35% flat rate, down from 2009's 45% rate. The exemption amount will be indexed for inflation after 2011.
- The federal gift tax also has a \$5,000,000 exemption. Its rate remains 35%, down from 2009's 45% flat rate.
- The generation-skipping transfer tax also has an exemption amount of \$5,000,000, up from 2009's \$3,500,000, and a flat rate of 35%.
- The 2010 "carryover basis" rules were repealed and the beneficial "step up in income tax basis" rules have returned.

For decedents dying during 2010, the December 17 tax bill created a new election, allowing the estate either: (1) to use the new estate tax rules and step up in income tax basis rules mentioned above or (2) to elect to have no federal estate tax apply, and to use the carryover basis rules. This election will be made on a new Internal Revenue Service form which, so far, does not exist.

### Washington Estate Tax

The 2005 Washington estate tax continues in effect, with the same \$2,000,000 exemption and gross rates from 10% to 19%, and is unlikely to change for the foreseeable future. During 2011 and 2012, it remains a deduction for the federal estate tax, meaning an effective maximum rate of 12.35% (65% of 19%), resulting in an overall maximum combined federal and Washington effective rate of 47.35%. Washington still has no gift tax.

### What Might Happen in 2013?

If the Congress does nothing before the end of 2012, the federal estate and gift taxes will continue in effect in 2013 with a \$1,000,000 exemption and rates ranging from 41% to 55%; the generation-skipping transfer tax also will continue in effect with an exemption amount, as indexed for inflation, somewhere in excess of \$1,300,000 and a flat rate of 55%; and the beneficial step up in income tax basis rules will continue to apply. After 2012 most, if not all, of the Washington estate tax would be offset by the federal "state death tax credit." On February 14, the Obama administration proposed that in 2013 the estate tax exemption only decrease to \$3,500,000 and that 2009 rules generally return.

### It Is Now Time to Review Your Planning

Because many of the beneficial provisions of the December 17 tax bill are only in effect during 2011 and 2012, it is time to review your planning and, possibly, to make major lifetime gifts. Here are a few details:

- Many are considering **major lifetime gifts** to use the temporary \$5,000,000 federal gift tax exemptions. Good reasons to make such gifts include excluding future appreciation and income from the potential

taxable estate, using valuation discounts, and avoiding potential Washington estate tax. There is a technical problem with calculating federal estate tax for decedents who make such major lifetime gifts and die after 2012, which might involve a “postponed gift tax” on those gifts (some commentators have referred to it as the “clawback” problem). We have concluded that this problem is real, that it might not be substantial if the federal estate tax exemption only decreases to \$3,500,000 in 2013, and that there are ways to address the problem using agreements with donees.

- The next two years are a particularly good time to make **generation-skipping gifts** and “**direct skip gifts**” to use the new \$5,000,000 exemption. There appears to be no problem with using this exemption during the next two years, even if the exemption drops in 2013.
- **Formula clauses** (including marital and charitable deduction formula gift clauses) continue to be a potential problem, because the federal estate tax exemption is now \$5,000,000 and, for many pre-2001 wills, will mean that the surviving spouse receives substantially all of the deceased spouse’s assets in trust. If we recently updated your will or revocable living trust, the formula clause should automatically refer to the new exemption amounts. In any event, it is worth checking your documents to see whether this is a problem.
- For the first time, the December 17 tax bill allows the first spouse to die to, in essence, give his or her unused estate tax exemption to the surviving spouse. In some cases, this might mean that the surviving spouse does not have to receive the gift in trust to avoid federal estate taxes in the second estate. Avoiding the Washington estate tax often will require use of a trust, however. We are now preparing flexible wills that take this “**portable exemption**” concept into account, and would be happy to explain how it might allow you to simplify your planning.

### The Estate Taxes Are Here to Stay – What This Means for Other Planning

Even though we have had a temporary increase in the federal exemption levels, after 2012 those exemptions might decrease significantly (again, based on current law, to \$1,000,000). We think that lifetime strategies still make sense and that we should return to the basics – for example:

- Because the “Applicable Federal Rates” set by the Internal Revenue Service for intrafamily loans are still near record low levels (the March 2011 annual AFR for a 3-to-9 year loan is only 2.44%), **low interest loans to family members** still make sense.
- If you had been making **gifts using the federal gift tax “annual exclusion”** (currently \$13,000), consider restarting those gifts.
- For large and small gifts, **use of discounts** still makes sense (for example, gifts of partial interests in real estate, and gifts of minority interests in businesses). The February 14 Obama administration proposal calls for new limits on discounts in such intra-family gifting. If you are thinking about a gift of your residence, consider using a qualified personal residence trust, which also can involve significant discounts.
- While Congress continues to talk about eliminating **short-term grantor annuity trusts** (the Obama administration proposed that ten years be the minimum term), nothing has been done as yet. Any prohibition on short-term GRATs likely would apply only to those established after enactment of the prohibition.

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