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Shock and Awe: Obama's Concession on Estate Taxes

Bruce Givner is a partner at Givner & Kaye in Los Angeles. He can be reached at bruce@givnerkaye.com

Owen Kaye is a partner at Givner & Kaye in Los Angeles. He can be reached at owen@givnerkaye.com

On Dec. 6, 2010, President Barack Obama shocked Senate Majority Leader Harry Reid and the estate planning community by announcing his agreement to a temporary reduction in the estate tax rate to 35 percent and increase in the exemption to $5 million. No details are yet available. However, we can speculate about the likelihood that his concession will become law and the impact on planning.

On Sept. 13, 2010, Sen. Mitch McConnell and other Republicans introduced the Tax Hike Prevention Act of 2010. This bill would reinstate the estate and generation skipping transfer taxes and repeal the carryover basis rules, retroactive to Jan. 1, 2010. However, it would allow the executor of the estate of a decedent who died in 2010 to elect to be taxed under either the pre-change law (no estate or generation skipping transfer tax and carryover basis), or the reinstated estate tax law. For estates of decedents dying after 2010, it would set the applicable exclusion amount for both estate and generation skipping transfer purposes at $5 million, indexed for inflation, and would - very importantly - re-unify the gift and estate tax exemption. By contrast, in 2009 the gift exemption was $1 million while the estate exemption was $3.5 million Also, it would reduce the estate tax rate to 35 percent in 2011, compared to 45 percent in 2009, and the 55 percent it would have become in 2010. Finally, it introduces "portability" - a surviving spouse may use the first spouse's unused exclusion amount. The bill is also significant for what it does not include: a long anticipated reduction in valuation discounts, which would impact family limited partnerships and family LLCs; and imposition of a minimum 10 year term for grantor retained annuity trusts (GRATs), typically used to transfer wealth (stocks and bonds, interests in closely held businesses) to future generations.

Will the President's concession lead to passage of the Republican bill? We do not know. However, 23 Democratic senators are up for re-election in 2012. They will not want to be labeled as supporting the "Death Tax." So they are likely to follow the President's lead.

What does this mean for year-end 2010 planning? Those making large gifts should wait. For example: Mom and Dad have used $500,000 each of their $1 million gift exclusions and plan to give another $500,000 each to their children. If the gift is in 2010, a gift tax audit is likely. Why? If the Internal Revenue Service can increase the value of the donated assets, a gift tax will be due. If they wait until January 2011, to make the gift, any increase in value should not trigger a gift tax audit because they will each have an additional $4 million exclusion. Another example: Mom and Dad have already used their $1 million per donor gift exclusions and plan to give another $200,000 to their children. If the gift is at the end of 2010, the gift tax will be $70,000. If the gift is in January 2011, the gift tax will be zero.

So what will this mean for some typical taxpayers?

First, consider a husband and wife, ages 65 and 60. They have $1 million of equity in their home, $1 million in retirement plans, and $1 million of personal liquid

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assets. Before the change in the law, they were unlikely to spend money for estate tax planning. With a $3.5 million per person exclusion, there would be no estate tax on the survivor's death. They might have a family trust to avoid probate and a conservatorship ensuring that the first $7 million would pass to their heirs free of estate tax. However, they would not spend money on sophisticated estate tax planning. The new $5 million per person exclusion will not change their decision to not engage in sophisticated planning.

Second, consider a husband and wife, ages 70 and 65. They have $1 million of equity in their home, $1 million in retirement plans, $1 million of liquid assets, and $5 million of equity in investment real property. Before the change in the law, they might have agreed to engage in some sophisticated planning: perhaps to transfer their home to a qualified personal residence trust; perhaps to transfer the investment real property into a family limited partnership and a 10 percent interest as a limited partner to a trust for their children. The change in the law may dissuade them from engaging in planning; they may be comfortable that their estate will not exceed $10 million on the survivor's death.

This second example illustrates that the primary impact of the new law is likely to be the higher exclusion: more than 99 percent of the families in the country will be outside the estate tax system. At a $3.5 million exclusion, however, only 16,000 decedents filed a federal estate tax return.

Third, consider a widow, age 85, worth $15 million. Before this change in the law, she would engage in sophisticated planning to spare her children the potential $5,175,000 estate tax ($15 million - $3.5 million = $11.5 million x 45 percent). The new law will not change her mind. She will still want to save her children the potential $3.5 million estate tax ($15 million - $5 million = $10 million x 35 percent).

Finally, consider a husband and wife, ages 75 and 70, worth $50 million. Before the new law, they engaged in sophisticated planning to spare their children the potential $19,350,000 estate tax ($50 million - $7 million = $43 million x 45 percent). The new law changes nothing: the estate tax will still be $14 million ($50 million - $10 million = $40 million x 35 percent).

One factor that may counteract the $5 million increase is the inflation likely to occur due to the federal government's ongoing multi-trillion dollar deficits. Consider the couple in the last example. Over the 20 years between now and the surviving spouse's death, at only 7.2 percent, their $50 million estate will become a $200 million estate, and there is no certainty that the $5 million exclusion will keep pace.

Obama's concession is a shock to the political system. However, if it becomes law, it is unlikely to have a resounding impact on estate planning and estate tax planning.

Bruce Givner is a partner at Givner & Kaye in Los Angeles. He can be reached at bruce@givnerkaye.com. **Owen Kaye** is a partner at Givner & Kaye in Los Angeles. He can be reached at owen@givnerkaye.com.

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