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This summary of estate and gift taxes is provided for general information, not as legal advice. If you require legal advice for a particular situation, you should consult an attorney.

Estate and gift taxes have been unsettled for a number of years. Some may recall that in 1997 the estate tax top rate was 55 percent on estates greater than $600,000. Since then the top tax rate dropped until in 2009 it was 45 percent. The exclusion amount steadily increased to $3,500,000 in 2009. Then in 2010, for one year only, the estate tax was eliminated. Beneficiaries of estates would pay capital gains upon the sale of inherited assets. On January 1, 2011, the estate and gift taxes were to increase as the tax rates passed under President Bush were set to expire. On January 1, 2011, the estate tax exempt amount was to revert to $1 million with a top estate tax rate of 55 percent.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act") became law on December 17, 2010. Among many other tax changes, the Act sets the gift and estate tax through December 31, 2012. Once again, but now on January 1, 2013, the estate and gift taxes are set to return to the $1 million exempt amount and the 55 percent top tax rate.

The following table captures the historic changes.

Year	Maximum Tax Rate	Exclusion Amount
1997	55%	$600,000
1998	55%	$625,000
1999	55%	$650,000
2000	55%	$675,000
2001	55%	$675,000
2002	50%	$1,000,000
2003	49%	$1,000,000
2004	48%	$1,500,000
2005	47%	$1,500,000
2006	46%	$2,000,000
2007	45%	$2,000,000
2008	45%	$2,000,000
2009	45%	$3,500,000
2010[1]	0%	Repealed
2011	35%	$5,000,000
2012	35%	$5,000,000[2]
2013	55%	$1,000,000

[1] See the section below on reinstatement of the estate tax exemption for 2010.
[2] The exemption amount is indexed for inflation.

The following pages contain simplified descriptions of the estate and gift taxes for 2011 and 2012. Adjectives like most, some, generally, special, etc. are marked with double asterisk ** because the specific rules are complex and beyond the scope of this introductory paper.

Estate and Gift Tax Overview

Gift and estate taxes apply to transfers of property during a taxpayer's lifetime and at death. The Act reinstates the estate tax effective for decedents dying after December 31, 2009. Beginning in 2011, the estate and gift taxes will be unified with a single graduated rate schedule with a top rate of 35 percent and single effective exemption amount of $5 million.

To the extent a taxpayer makes gifts it will reduce the estate tax exempt amount available at death. For example, a taxpayer who makes gifts adding up to $250,000 during his lifetime would reduce the amount of his estate that would be exempt from estate taxes from $5,000,000 to $4,750,000.

Gift Tax

A gift is any transfer where fair and adequate consideration is not received in return. For example, a loan on which the borrower does not pay adequate interest is a gift to the extent of unpaid interest. And a tenant who is paying $500 rent for an apartment for which the market rent is $800 is given a gift of $300 a month for the reduced rent.

The gift tax is imposed on most** lifetime transfers. For gifts made in 2010, the exclusion amount for gift tax purposes is $1 million, and the gift tax rate is 35 percent. This means that lifetime gifts totaling less than $1 million will have no tax liability. For those gifts that exceed the lifetime total of $1 million, there is a 35 percent tax on the gift amount over $1 million.

For most** gifts made after December 31, 2010, and until December 31, 2012, the gift tax is unified with the estate tax, with a total exclusion amount of $5 million and a top tax rate of 35 percent.

Annual Gift Tax Exclusion

There is a much smaller annual gift tax exclusion in addition to the lifetime exemption. Many people, who have adopted a gifting strategy to transfer wealth, make regular annual gifts just under the annual exclusion amount and use the lifetime exemption for larger gifts. The good news is that these small annual exclusion gifts do not count against the lifetime exclusion.

The gift tax annual exclusion is $13,000 per donor, per donee, for 2010 and 2011. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $26,000 for 2010 and 2011. The gift tax annual exclusion is indexed for inflation and will increase in future years in $1,000 increments. Gifts in excess of the annual exclusion or gifts that are not gifts of a present interest (such as certain** gifts in trust) are automatically applied to the gift tax exclusion amount.

For example, a mother who gives her son a car worth $40,000 would use the $13,000 annual gift tax exclusion. The remaining $27,000 would be applied against the mother's $5 million

lifetime gift tax exemption. No tax would be due so long as the lifetime gifts in excess of the annual exclusion did not exceed $5 million. If the mother is married, she could split the gift with her husband and use the $26,000 annual exclusion. This would reduce the lifetime gift amount applied against her lifetime gift tax exemption to $14,000.

Marital Deduction

The marital deduction delays taxes for a married couple until the death of the second spouse. During marriage, one spouse can gift any amount to his or her spouse and not pay gift taxes. The deduction is equal to the value of the gifted property transferred between spouses. The marital deduction applies to outright gifts to the spouse and to qualifying trusts for the benefit of the spouse.

For example, if a husband transfers title to a $500,000 second home to his wife, there is no gift tax and it is not applied against the husband's lifetime gift tax exclusion.

Carry Over Basis

An asset's basis is important in determining capital gains tax liability. Basis generally represents a taxpayer's investment in the property, with some adjustments. Basis is generally increased by the cost of capital improvements made to the property and decreased by depreciation deductions.

A gift received from a donor generally takes a carryover basis for capital gains tax. This means that the recipient's basis in the property is the same as the person giving the gift. However, when the donor pays a gift tax then the basis of the property transferred is increased to the fair market value of the gift at the time of the gift.

For example, a father who owns a rental property would have a basis in the property equal to the original purchase price, plus the costs of improvements such as a new roof or updated plumbing, minus depreciation allowed over the years. If the father transfers title to the rental property to his daughter by means of a gift, she would take her father's basis in the rental property. When she subsequently sells the rental property, she would pay capital gains on the difference between the sale price and her carryover basis.

Estate Tax

The estate tax is imposed on certain transfers at death. The taxable estate includes not only assets transferred by will in a probated estate but also assets in a revocable living trust, certain life insurance proceeds, retirement accounts, annuities and other assets passing outside of a probated estate. Taxes are not paid on an exclusion amount (which has changed many times in the past dozen years), nor on most** transfers to a surviving spouse.

The total estate tax will be determined on the cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The estate tax exclusion is $5 million for a decedent dying after December 31, 2009 and is indexed for inflation in calendar years after 2011. The maximum estate tax rate is 35 percent. Lifetime gifts will reduce the estate tax exempt amount. For example, a taxpayer who made lifetime gifts of $250,000 (which exceeded the gift tax annual exclusion amount) will have an estate tax exempt amount of $4,750,000.

A recipient of property acquired from a decedent who dies after December 31, 2009, generally will receive a fair market value basis (i.e. a "stepped up" basis). Continuing with the daughter who was given the rental property from her father as a gift, she had to pay capital gains tax upon the sale of the rental property because her father's basis carries over to her. If her father had kept the property until his death and transferred it to his daughter then, she would have a basis in the rental property equal to the fair market value of the rental property on the date of the father's death. Waiting to make transfers after death is especially valuable for assets with low basis such as fully depreciated real property or investments purchased many years ago at a much lower value.

Marital Deduction

Similar to the gift tax marital deduction, the estate tax marital deduction prevents any tax on a transfer at death by the decedent to the surviving spouse. The decedent must be married at the time of death and the transfer must be to the surviving spouse either outright or in a qualifying trust.

The 2010 Repeal of the Estate Tax

We all remember that in 2010 the estate tax was repealed. However, you have also noticed that the Act establishes the estate tax exempt amount after December 3, 2009 as $5 million with a top rate of 35 percent. The Act brought back the estate tax for 2010. However, it also provides for an election to choose no estate tax and modified carryover basis for estates when the decedent died in 2010.

This allows a 2010 estate two options. Take the example of a single man dying in 2010 with an estate of $6 million and having his entire $5 million exemption available. The first option would be to exempt $5 million and pay the 35 percent tax on the $1 million over the exempt amount. This would mean a $350,000 estate tax. The entire estate would have a step up basis to the value on the decedent's death. Future sales of the estate assets by beneficiaries would have capital gains based on this new step up basis.

Alternatively, the estate could elect no estate tax. The law 2010 provided that $1.3 million of assets could get a step up in basis and the remaining estate would have a carryover basis. The estate would designate the assets that get the step up basis and those assets that get the carryover basis. While no estate tax is due upon the decedent's death, any future sale of estate assets by a beneficiary would be subject to capital gains based on the assigned basis.

Sunset

The gift and estate tax provisions of the Act expire or sunset on December 31, 2012. At that time the estate and gift tax exclusion will revert to $1 million with a top tax rate of 55 percent.