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Preparing for estate taxes

By Armen Vartian | 05-11-12

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Most taxpayers need not concern themselves with estate tax avoidance.

Based on current estate tax thresholds derived from the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, only those whose estates are likely to exceed \$5 million (actually, \$5.12 million indexed for inflation) have any estate tax liability.

In addition, the unlimited marital deduction is still in effect, allowing a taxpayer to bequeath his or her entire estate to a spouse tax-free.

Changing thresholds

Nevertheless, these tax thresholds and other provisions change, and the 2010 act was a compromise between the Obama administration and House Republicans that by its terms expires on Dec. 31, 2012.

Unless Congress acts this year, always questionable with elections looming, 2013's estate tax threshold will drop to \$1 million, and the rate of estate tax will increase from its current 35 percent to 55 percent.

Taxpayers likely to leave substantial estates upon death should work with competent professionals to develop an appropriate estate plan. However, all taxpayers possessing collections of art or collectibles should be aware of the basic rules governing their part in an estate plan.

The decedent's basis in art and collectibles will be stepped-up to the fair market value at time of death. For valuable collections accumulated over time, this can result in surprises, as items for which the decedent paid relatively little may be valued much higher.

And Congress has had a habit of tinkering with the stepped-up basis rules, such as the \$1.3 million limit that applied in 2010.

However, stepping-up basis can be a huge benefit if proper planning is done. For example, by bequeathing art or collectibles to a spouse, the decedent allows the spouse to acquire items tax-free at then-current fair market value.

The spouse can then sell those items in the future without recognizing any gain or income, years worth of appreciation in value going untaxed.

Most of these same benefits also accrue to taxpayers who make gifts of art and collectibles to their spouses during their lifetimes, although certain guidelines should be followed when doing this.

The stepping-up is also beneficial to nonspouses who receive testamentary (by will) gifts of art or collectibles, although in those cases the assets will not be deducted from the decedent's estate.

Best approach

The best approach is often to take advantage both of the marital deduction and the \$5 million tax-free allowance by allocating part of the estate to the spouse and part to the decedent's children.

This protects the surviving spouse from estate tax at his or her death, when there's no marital deduction. Under current law, however, even that risk is minimal because the \$5 million allowance is "portable", i.e., is passed from the original taxpayer to the surviving spouse and then added to the spouse's own allowance.

For example, a husband with an \$8 million estate who wills everything to his wife makes no use of his \$5 million allowance because of the marital deduction.

Until the 2010 act introduced portability, the husband's allowance was lost, and upon the wife's death estate taxes would be due on the \$3 million excess over her own allowance.

With portability, assuming the law doesn't change this year, the wife can add the husband's unused allowance to her allowance, resulting in a \$10 million total allowance and a savings of more than \$1 million in estate taxes (at current rates) to her heirs.

It will be interesting to see what Congress does.

Always consult a professional in these matters.

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