

## ESTATE TAX REPEAL (For Now)

The federal estate tax was repealed effective January 1, 2010. This one-year repeal has been looming since 2001, and many people assumed that Congress would “do something” before repeal actually occurred. Incredibly, nothing was done. This is a significant estate tax development which may impact the estate plans of many individuals.

There are several important facts to know about estate tax repeal, beginning with a brief background.

### **Background**

Repeal of the federal estate tax was set in motion in 2001 by the Economic Growth and Tax Relief Reconciliation Act (“EGTRRA”). In 2001, the estate tax exclusion amount was \$675,000. The estate tax exclusion amount is the amount that an individual can leave at death to anyone free of federal estate tax. Under EGTRRA, the estate tax exclusion amount increased incrementally, reaching \$3,500,000 in 2009. In addition, there were unlimited marital and charitable deductions for qualifying transfers to a spouse or charity.

*Supposedly the only certainties in life are death and taxes. For 2010, at least, death taxes are not a sure thing.*

**Estate Tax Repeal:** EGTRRA also provides for 2010, for one year only. “sunset” at the end of 2010, meaning that the estate tax laws will revert back to the laws in place before EGTRRA. This will result in reinstatement of the estate tax in 2011 and an estate tax exclusion amount of \$1,000,000, with a top marginal rate of 55%. The reason that EGTRRA only provides for one year of repeal stems from political compromise and budgetary constraints.

**Gift Tax:** Despite repeal of the estate tax, the gift tax remains in place. The lifetime gift tax exclusion amount has been \$1,000,000 for several years and remains at \$1,000,000 in 2010 and beyond. The gift tax rate in 2010 on gifts over \$1,000,000 drops to a maximum of 35% (a drop from the maximum rate of 45% in 2009). Gifts can also be made free of gift tax if the gifts qualify for and do not exceed the gift tax annual exclusion, which remains at \$13,000. The gift tax exclusion is scheduled to remain at \$1,000,000 in 2011, with a maximum rate of 55%.

**GST Tax:** The generation-skipping transfer (“GST”) tax is repealed in 2010, for one year only. The GST tax is a tax imposed in addition to the estate and gift tax on most transfers

to or in trust for grandchildren and other individuals two or more generations below the person making the transfer. In 2009, the GST tax rate was 45%, and there was a GST exemption of \$3,500,000 that could be allocated to exempt transfers from the GST tax. It is not entirely clear how certain transfers made to trusts during repeal of the GST tax will be treated if the GST tax is reinstated, as scheduled, in 2011.

**Tax Basis:** In order to offset the loss of estate tax revenue, EGTRRA changed the basis adjustment laws during 2010. This change, known as “carryover basis”, is a significant departure from prior law.

### **Carryover Basis**

For many years the rule has been that all of a decedent’s qualifying property receives a new basis equal to the fair market value of the property on the date of the decedent’s death. Basis is used in determining capital gain or loss when an asset is sold. This basis adjustment was often referred to as a “stepped-up” basis, but when the value of assets declines, this rule can result in a step-down in basis.

For decedents dying in 2010, unlimited step-up is not available. A decedent’s property will be permitted a \$1,300,000 step-up in basis, with an additional \$3,000,000 step-up in the case of property passing to a surviving spouse or a qualifying trust for the spouse. There are several reasons why this change in the law is significant, notably the following:

**1. Estate Plans.** Estate plans that were drafted to minimize payment of estate tax may work in surprising ways under the law change. For example, a plan that was drafted with the intention of leaving some assets to a family trust (credit shelter trust) and some assets to a surviving spouse, may instead leave all assets to the family trust. The family trust would qualify for the \$1,300,000 step-up in basis, but may not qualify for the additional \$3,000,000 in spousal step-up.

**2. Informational Returns.** For decedents dying in 2010, if the fair market value of the decedent’s property (excluding cash) exceeds \$1,300,000, then the executor (personal representative) must file a new type of informational return with the IRS. Penalties apply for a failure to file.

**3. Record Keeping.** Under the prior law, when full step-up was available, it was not necessary to determine the decedent’s historical basis in property. The decedent’s property was re-valued as of date of death and the decedent’s property received a new basis equal to date of death value.<sup>1</sup> As a result, determining the basis of property received from a decedent was fairly straightforward. Under the carryover basis rules, if the decedent’s non-cash property exceeds \$1,300,000, it will be necessary to determine the decedent’s historical basis in the property. This can require some complex tracing going back many years, or even decades. In some cases, it may be impossible to determine the basis, and it may be necessary to assume the basis is zero.

## **Future of the Estate Tax**

Since EGTRRA was passed, Congress has considered numerous proposals to either repeal the estate tax permanently or to provide for revised estate and gift tax laws for the years 2010 and beyond. As recently as December 2009, a proposal to keep the estate tax in place in 2010 was passed by the House of Representatives, but then failed in the Senate. Due to inaction by Congress, EGTRRA remains the law.

It is impossible to predict with any certainty whether Congress will change the estate tax laws prior to 2011 and, if it does, exactly what changes will be passed. There are at least three possible outcomes:

**1. No Action by Congress.** In light of Congress' inability to reach consensus on the estate tax in the past, and the fact that Congress has other pressing concerns, it is possible that EGTRRA will be allowed to sunset, meaning that the estate tax will be reinstated in 2011 with an estate tax exclusion amount of \$1,000,000. The GST tax would also be reinstated with an exemption amount of slightly more than \$1,000,000 (possibly about \$1,300,000).

**2. Permanent Repeal.** Some legislators would like to see permanent repeal of the estate tax. Permanent repeal would quite possibly mean that carryover basis would remain in place.

**3. Reinstatement of the Estate Tax in 2010.** Congress could reinstate the estate tax sometime this year. If this occurs, there are a number of open questions including:

- Whether reinstatement would be retroactive to January 1, 2010, and, if so, whether a retroactive application is constitutional;
- Whether the estate tax exclusion amount would be \$3,500,000;
- Whether the gift tax exclusion amount would be "reunified" with the estate tax exclusion amount (*i.e.* would be the same amount); and
- Whether any other new estate tax laws (not in place before) would be passed.<sup>2</sup>

## **Planning Considerations**

**1. Review Your Estate Plan.** You should review your estate plan to make sure it meets with your wishes. The following issues should be considered (among others):

- How will your estate plan work during repeal of the estate tax? Some marital deduction formula plans could effectively disinherit a surviving spouse.
- Will your planning still work if the estate tax returns in the future? Note that if the estate tax exclusion amount drops below \$3,500,000 (*i.e.* to \$1,000,000) many individuals who did not have taxable estates in 2009 will have taxable estates.
- Should you continue to fund your irrevocable life insurance trust?

**2. Gifting.** Making gifts under the gift tax annual exclusion amount (currently \$13,000) is still a good planning technique for many individuals, especially those who would have taxable estates if the estate tax returns. Making other gifts (above the annual exclusion amount and in excess of any remaining lifetime exclusion amount) and paying the associated

gift tax (at a maximum rate of 35% in 2010) may also be a good planning strategy. However, such gifting should be weighed against the possibility that the estate tax repeal could be made permanent or that the gift tax exclusion amount could be increased if a comprehensive estate tax bill is passed. We may know more later this year.

**3. Record Keeping.** Many individuals currently own non-cash assets in excess of \$1,300,000. If you are one of these people, then, while carryover basis is the law you should assemble and retain for your successors as many records as possible pertaining to the cost basis of property you own. At the very least your records should include:

- stock purchase information, including dividend reinvestments;
- mutual fund statements;
- closely-held partnership and LLC capital account information;
- closing statements for real estate purchases; and
- rental property records, including depreciation schedules and tax returns.

If you are married, you may want to consider equalizing your estates with appreciated property to maximize the use of both \$1,300,000 step-up allowances. Transfers between spouses may impact rights on divorce, however.

**4. GST Tax Planning.** As explained above, it is not entirely clear how certain transfers made to trusts while the GST tax is repealed will be treated if the GST tax is reinstated, as scheduled, in 2011. Some commentators believe that such transfers should, in effect, be treated as GST exempt even though no GST exemption is allocated. If that is the case, then 2010 could be an excellent opportunity to fund trusts that are designed to be GST exempt. However, some commentators take the opposite view. It may be advisable to wait for guidance from the IRS later this year.

## **Conclusion**

The fact that the estate tax has been repealed is a significant event. You should understand how the tax changes impact your planning and make any necessary changes to take advantage of possible planning opportunities.

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<sup>1</sup> The general rule is that basis was determined as of date of death. However, in some cases, “alternate valuation” was elected, in which case basis was generally determined as of six months following date of death.

<sup>2</sup> One possible change to the estate tax laws that has previously been proposed is “portability” of estate tax exclusion amount, which would allow the surviving spouse to use any unused estate tax exclusion amount of the first spouse to die. Another proposed change would limit the ability to discount the value of gifts of closely-held business interests (*i.e.* partnership and LLC interests).

*The information in this newsletter is intended to give a general overview. You should not rely on it as legal advice. Please let us know if you would like us to review your estate planning and advise you as to your specific situation.*