Estate Tax Update

As you have no doubt read in the Wall Street Journal and similar publications, Congressional inaction at the end of last year has left us in 2010 with no Federal estate tax. Most experts were confident that Congress would act to prevent the one year repeal. Congress, however, failed to do so and the estate and GSTT repeal, at least for 2010 is now in effect.

Background

In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) became law. EGTRRA was designed to provide significant tax relief, including "permanent" relief from the federal estate tax (with its then $675,000 exemption and maximum 55% tax rate). Under EGTRRA the maximum estate tax and GSTT rate was over time lowered to 45%, while the exemption amounts steadily increased to $3.5 million in 2009 and the federal estate and GSTT were eliminated altogether in 2010. But because of a special Senate rule that limits budget deficits, EGTRRA was enacted with a "sunset" provision. Under the sunset provision, on January 1, 2011 the law will revert back to the rate and level that existed in pre-EGTRRA law. This means that the federal estate and GSTT exemption will again be $1 million, adjusted for inflation, and the maximum tax rate will again be 55%.

What will Congress Do Now?

No one knows with certainty what Congress will do but several leading Congressional members have stated publicly that they will attempt to pass estate tax legislation early this year. To date, no definitive action has occurred.

The real question is: does Congress have enough votes to act in any fashion in 2010? There are members on both sides of the political aisle fully committed to either (1) repeal the estate tax; or (2) raise taxes by allowing the estate tax to revert back to the $1,000,000 exemption level. Other members see estate tax legislation as a perfect vehicle for campaign contributions for the 2010 election. Even if Congress were to have the votes to enact estate tax legislation, there is great debate as to whether any action that might purport to "repeal the repeal" retroactively can be accomplished constitutionally. There will no doubt be numerous wealthy individuals who will die during the period where the estate tax has been repealed. If Congress attempts a retroactive repeal this issue is likely to be resolved in the future by the United States Supreme Court.

Modified Carryover Basis

While the abolition of a tax is usually a good thing, do not get too excited. As is typical of Washington D.C., when the IRS gives it usually takes away. This is no exception. Congress has substituted another method of taxation that will collect more taxes from potentially more families.

To replace the estate tax this year, Congress has increased the amount of income tax one may have to pay on inherited assets. Before January 1 of this year, subject to some exceptions, assets owned at death received a basis "step-up" to the asset's fair market value at date of death. That means that if you die owning publicly traded stock or real estate you purchased many years ago, your beneficiaries could sell the stock or real estate after your death and pay little or no income tax. (Of course the stock and/or real estate would be included in your gross estate for estate tax purposes.)

Under EGTRRA, in 2010 a beneficiary who inherits property from a deceased person receives that property with an adjusted basis equal to the *lesser of* the decedent's basis or the asset's fair market value on the decedent's date of death. Thus, EGTRRA eliminates the unlimited automatic "step-up" to the date-of-death value but retains a "step-down" for depreciating assets. Significantly, the modified carryover basis system will impact far more people than the estate tax ever would, if in no other way, than having to keep up with records of purchase price for years and years.

To offset this loss of the step-up in basis, EGTRRA provides that the Executor or Trustee may allocate a $1.3 million "aggregate basis increase" on an asset-by-asset basis up to the particular asset's fair market value at the date of the decedent's death. Assets left to the spouse may receive an additional $3 million "spousal property basis increase" (hereinafter referred to as the "spousal coupon") also asset-by-asset, up to the particular asset's fair market value at the date of the decedent's death.

To be eligible for either step-up, the property must be owned by the decedent. And for purposes of the $3 million spousal coupon, the property must be left to the surviving spouse alone, either outright or in a special trust known as a "QTIP" (Qualified Terminable Interest Property) trust. Absent modification to a client's estate planning documents to meet these requirements, many trusts will not qualify and for the spousal coupon, thereby losing the $3 million of basis increase.

Marital Formula Funding Clauses

For more than 50 years, in most tax planning wills, the "family trust" was drafted using a written mathematical formula to divide the assets of a married couple when the first spouse dies in order to maximize estate tax savings. For married couples, living trusts and wills typically use this formula to divide the decedent's property into the credit-shelter trust (also referred to as the "bypass" or "Family" trust) and a marital trust. Under the current law if clients created their estate plan when the federal exemption was significantly lower, this commonly used mathematical formula will force the trustee to put more assets into the credit-shelter trust than necessary, leaving the marital trust relatively empty and not able to take advantage of the spousal coupon, discussed above.

If the family and marital trusts contain different beneficiaries or different dispositive provisions (such as in second marriage situations, especially where there are children from a prior marriage), this may cause dire consequences to the surviving spouse – potentially disinheriting the surviving spouse if their spouse were to die in 2010! In addition, if the family trust includes lineal descendants or beneficiaries (other than the spouse) the trust will not qualify as a distribution to a spouse, which could again cause the spouse to lose his or her spousal coupon.

What should you do now?

Many estate plans fail to take into consideration the lack of estate tax and/or the modified carryover basis rules. Moreover, those who understand that the estate tax is repealed will automatically assume that the rules for them and their families will be positive or neutral. Unless informed they would little suspect that not only is it possible that more tax will be paid after their death, but that the amount and nature of the assets that they expected to go to spouse, family, friends and charity may be substantially different than they had planned. The people most affected by the current law are married couples with tax planning in their wills that have over 1.3 million of combined assets.

As the above discussion illustrated, the key is flexibility and ensuring that your estate plans contain enough flexibility to accomplish your goals under changing circumstances. Therefore, we strongly encourage you to review your estate plans to ensure they continue to meet your objectives while minimizing all taxes. At Fayette Law Group, we are drafting our 2010 wills with alternative provisions, not knowing which law will be in effect at the time of a client's death.