

LEGAL UPDATES

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Service

Private Wealth

Possibility for a Year Without Estate Tax and Generation-Skipping Transfer Tax

In 2001, Congress enacted a 10-year law that included a one-year repeal of the estate and generation-skipping transfer (GST) taxes for 2010. However, the law "sunset" after 2010, and the estate and GST taxes will return. Consequently, unless Congress takes action:

No federal estate tax applies to individuals who die in 2010.

The long-standing law that inherited assets receive a stepped-up capital gains basis is replaced (in 2010 only) by a modified "carry-over basis" regime.

Except for certain exceptions noted below, the beneficiaries will receive the same capital gains basis as the decedent.

The gift tax laws remain intact in 2010, but the gift tax rate is reduced from 45 percent to 35 percent for gifts made in 2010.

The GST tax will not apply to transfers made in 2010.

Individuals may not be able to allocate GST exemption to irrevocable trusts in 2010.

On January 1, 2011, the estate tax and GST tax laws return in full force, with an estate tax rate of 55 percent and an estate tax exemption of only \$1 million (compared with the 2009 estate tax rate of 45 percent and exemption amount of \$3.5 million).

Estate planners almost universally believed that Congress would act before 2010 to avoid the one-year repeal of the estate tax, but Congress failed to do so

when the Senate refused to pass a temporary measure proposed by the House of Representatives that would have extended the 2009 law into 2010. Any attempt to reinstate the estate and GST laws retroactively for this year would likely be challenged in the courts on constitutional grounds. At this time we cannot predict what resolution, if any, Congress will reach with respect to the estate and GST taxes.

The New Carry-Over Basis Rules

For 2010 only, the executor of a decedent's estate may allocate up to \$1.3 million of basis increase to the decedent's assets. Another \$3 million of basis increase is available for any assets passing to the spouse or to a qualified marital trust for the spouse. Any remaining property will have a carry-over basis for federal income tax purposes unless, on the date of death, the value of such property is less than the carry-over basis, in which case the new basis will be the date of death value.

Impact on Estate Plans

The impact of these changes on an estate plan will depend on the specific circumstances. Obviously, if an individual does not die in 2010, or if Congress reinstates the estate tax and GST tax before the individual's death, then these changes should have no impact on his or her estate plan.

However, most estate planning documents include references to the estate tax and GST tax, and it is uncertain how those provisions will be interpreted if those taxes are not in effect at the time of death and could result in unintended consequences. Moreover, if the new carry-over basis rules are not repealed, it will be advisable to revise married couples' estate plans to take optimum advantage of the new basis step-up rules.

If Congress addresses this issue in 2010 and attempts to reinstate the estate and GST tax system with the same rules in effect in 2009, then there will be no impact unless the individual dies during a period in which no estate and GST taxes are in effect. However, because 2010 is an election year and changes to the tax law are likely to be a hotly debated issue, there is a chance that Congress will not enact any new tax legislation this year.

Recommended Actions

All married clients should have their estate plan reviewed to make sure their existing documents would work correctly if either spouse were to die this year.

This is especially important for clients who have a relatively short life expectancy, clients in a second marriage (where the portion passing to a spouse depends on a formula based on the estate tax exemption), high net worth clients, married clients with a low basis in most of their assets, and clients with marital or charitable share formula clauses that are based on the estate tax exemption.

Married couples should make sure their estate plans include trust provisions designed to shelter as much from estate taxes and capital gains taxes as possible. See the example below.

Clients concerned about estate tax exposure should contact us immediately to discuss estate tax avoidance techniques that may not be available much longer. These include short-term GRATs (grantor retained annuity trusts), leveraged gifts using valuation discounts, and other lifetime gift planning strategies.

Example

Mr. Smith dies in 2010 with an estate of \$5 million, which has a collective basis for capital gains purposes of \$1 million and unrecognized gain of \$4 million. His estate plan provides for the amount needed to reduce estate tax to zero to be allocated to a Marital Trust for his wife, and the balance of the estate to pass to a Family Trust for the benefit of his wife and descendants. Since there is no estate tax in 2010, presumably the entire estate would pass to the Family Trust. The estate would receive a capital gains basis “step-up” of only \$1.3 million under this plan, whereas if the plan were modified so that a portion of the estate passed to the Marital Trust, the entire estate could have received a basis step-up (which would then enable the beneficiaries to sell any of the estate assets at no or minimal capital gains tax cost). Note that if Mr. Smith’s children by prior marriage were the beneficiaries of the Family Trust, and his current wife was the beneficiary of the Marital Trust, no assets would be allocated to the Marital Trust if this interpretation were upheld. In addition, if Mr. Smith left all or any portion of his estate to his wife outright and free of trust, he may inadvertently be exposing those assets to the 55 percent estate tax upon his wife’s death.

Planning Opportunities to Consider

Some unique opportunities for advantageous transfer tax planning may exist in 2010, assuming Congress does not act to preclude them. These include:

Making direct gifts to grandchildren and more remote descendants while the GST tax is not in effect.

Making gifts or transferring ownership interests in business entities that would be valued with a valuation discount, because Congress is considering new laws that may include restrictions on valuation discounts in family transfers.

Making a taxable gift at the favorable 35 percent gift tax rate (the previous rate was 45 percent, the rate next year ranges from 41 percent to 55 percent, and the highest estate tax rate next year is 55 percent).

Some of these changes present a unique and rather substantial “window of opportunity,” especially for high net worth clients, to make lifetime transfers to certain types of irrevocable trusts before any new legislation is passed in this area. Certain advanced planning techniques (such as qualified disclaimers and marital deduction planning) may also be used to safeguard against retroactive application of any new changes in these taxes.

If Congress decides to make substantial changes to the estate tax and income tax system, either this year or early next year, there may be a number of tax planning strategies currently available that will be foreclosed after the tax laws change. You may wish to consider implementing these strategies while they are still available.

What This Means to You

Congress may enact legislation affecting the availability of these options. Such legislation may be retroactive to the beginning of 2010. We strongly suggest you consult with your attorney prior to taking any of these actions.

Contact Info

If you have any questions about this or any other estate planning, trusts and estates matter, please contact your Husch Blackwell Sanders attorney.

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