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2010 Estate Tax Planning – Congress Fails to Act; You Must Not

Unexpectedly, Congress allowed the federal estate tax ("FET") and generation-skipping transfer tax ("GST") to expire for 2010. While some estate plans will not be impacted by these changes, provisions in wills and trusts linked to FET and federal GST and other tax provisions will suffer unintended results.

In 2001, Congress implemented sweeping changes in the estate tax law. The amount effectively excluded from federal estate tax was gradually increased from $600,000 to reach $3,500,000 in 2009. The law then suspended the federal estate tax entirely for 2010. Now unless Congress acts, the FET and GST exclusion amounts will be reinstated in 2011 to $1,000,000 (plus an inflation adjustment for GST). So beginning in 2011, each estate over $1,000,000 will potentially be subject to estate taxation at rates as high as 55% plus a 5% surtax applicable to estates valued over $10 million. Additionally, the federal gift tax exclusion amount will be $1,000,000 adjusted for inflation (down from the $3.5M exclusion in 2009), and the maximum tax rate will be a flat 55% (was 45% in 2009).

Other changes and adjustments include narrowing the traditional rules for stepping up the bases of assets at death. The presently available limited step up must be elected even if filing an estate tax return is not required. It may be worth revisiting your estate documents in this limbo as the right to elect a step-up in the bases of some inherited assets may be inadequately addressed in many existing documents.

Estate planning documents also routinely employ tax references. These references such as the "unified credit exemption amount" are currently suspended as well, but are scheduled to reappear in 2011. In a typical estate plan, a document requires a transfer to a By-Pass Trust equal to the amount sheltered by the "unified credit exemption amount." Currently, it is unclear what will occur since there is no estate tax and, thus, no unified credit exemption.

This disconnect between current tax law and traditional language used in existing estate documents could cause the assets of a spouse dying in 2010 to be directed entirely to the surviving spouse instead of funding a By-Pass Trust. This would result in the loss of the use of the decedent's exemption. The estate of the surviving spouse might end up being funded well in excess of the exemption amount that Congress establishes, thus creating significant additional tax in the estate of the second spouse to die. The suspension of estate tax in 2010, however, may also create a unique opportunity to shelter carefully all of a decedent's assets by placing the entire amount in a By-Pass Trust. This Trust could benefit the surviving spouse for his/her lifetime, and the balance remaining at the death of the surviving spouse could pass tax-free to the next generation. Such provision may require the addition of new language into estate documents providing the power of the surviving spouse to disclaim a gift.

Whether Congress will act to fill the gap is uncertain. Some states are reacting to the Congressional impasse by providing statutory relief. The Virginia General Assembly, for example, passed legislation on April 7, 2010, effective back to December 31, 2009, which would give meaning to the standard language in wills and trusts to refer to the $3,500,000 exemption in place at the end of 2009. Such statutory relief, in states where applicable, will not provide the optimum solution for all estates.

It is not clear whether Congress will act in 2010 to change the federal estate, transfer tax laws, the carryover bases, or other pertinent provisions. Congress is considering many different tax law proposals for 2010 and beyond. In the meantime, estate planning documents should be reviewed for redrafting to reflect—and when possible, take advantage of—the current law, however temporary it may be, and to accommodate anticipated changes ahead.

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