2010 Federal Estate Tax Repeal – What Does It Really Mean?

The 2010 federal estate tax repeal has been nine years in the making, yet we can honestly say that no one saw it coming. Commentators and professionals universally predicted that Congress would take action in 2009 to prevent the repeal in 2010, with general prognostications that the federal estate tax exemption would land somewhere between $3,500,000 and $5,000,000. Congress did not act, and we now find ourselves in a system created by what some commentators are calling "congressional malpractice" and what the Senate Finance Committee Chairman describes as "massive, massive confusion." Here is the bottom line of how the estate tax landscape has changed and what to look out for over the next 12 months.

The "repeal" of the federal estate tax in 2010 is one step in a larger scheme enacted by Congress in 2001 which gradually increased the estate tax and generation skipping transfer ("GST") tax exemption amounts from $1,000,000 in 2002 to $3,500,000 in 2009, and ultimately to an unlimited exemption in 2010, followed by a return to a $1,000,000 exemption in 2011. Thus, rather than characterize this as a repeal, perhaps it is more accurate to simply state that the federal estate tax does not apply to estates of those who die in 2010.

While the elimination of the federal estate tax in 2010 may generally sound like a good thing for taxpayers, it very well may have some unintended consequences. The most prominent problems could arise where bequests under estate planning documents are based upon the maximum allowable estate and GST tax exemptions. In such circumstances, a taxpayer's spouse and/or children could be unintentionally disinherited. Estate plans should be revisited to review tax planning provisions.

While the federal estate and GST tax exemptions in 2010 are unlimited, the federal gift tax exemption remains at $1,000,000. The gift tax rate, however, has decreased to 35%. This rate decrease could offer certain taxpayers an incentive to make significant lifetime gifts.

One of the trade-offs of the elimination of the federal estate tax in 2010 is the elimination of the step-up in basis of assets owned at death. For decedents dying in 2009 and prior years, the appreciation on capital assets owned by a decedent was wiped out at death. For decedents dying in 2010, this adjustment in basis to fair market value has been eliminated. Generally heirs and beneficiaries will receive the carryover basis of inherited assets, with two exceptions: (1) a decedent's executor can allocate up to $1,300,000 worth of "basis" to assets passing from the decedent to any person; and (2) the executor can allocate up to $3,000,000 worth of "basis" to assets passing from the decedent to the

surviving spouse or to certain trusts for the benefit of the surviving spouse. Executors will be faced with difficult decisions about how to apportion this basis among assets and heirs. It is unclear who has the authority to make this allocation where planners succeed in avoiding probate entirely, and no executor is appointed because no probate is required. Executors and trustees may find themselves faced with challenges to their decisions and claims of breach of fiduciary duty.

It is important to remember that the 2010 repeal only applies to federal estate taxes. For states like Massachusetts and Rhode Island, the estate tax is still alive and well. The traditional planning to eliminate or defer state estate taxes remains of critical importance in saving state tax dollars, and estate plans should be reviewed to ensure that this planning is adequate.

A great deal of analysis continues over whether Congress can and will pass a law in 2010 which reinstates the federal estate tax for estates of decedents dying in 2010. Whether Congress will address this issue is anyone's guess, but one thing is certain - any retroactive action will be challenged in court, and will be interesting to watch.

For more information or if you have any questions or comments, please contact a member of the Probate Trust and Personal Planning Group at Partridge Snow & Hahn LLP.