The Temporary Repeal Of The Federal Estate Tax And Its Effect On Your Estate Plan

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Introduction

As the New Year arrived on January 1 with confetti and champagne, so did a very significant change in U.S. tax law: the temporary repeal of the federal estate tax and the generation-skipping transfer ("GST") tax laws. Although some would see this as another cause for celebration, for many the repeal will create more problems than it solves. In addition, the repeal of the estate and GST tax laws — even though under current law it will only last for one year — requires most individuals to consider whether their wills and trusts still operate as planned or instead leave their beneficiaries facing unintended consequences. This Alert describes the new estate and GST tax landscape so clients can consider what steps they may want to take in order to avoid any unintended consequences.

How Did We Get Here?

You might recall that in 2001 Congress passed the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), a $1.35 trillion tax cut package that contained several changes to the federal estate, gift, and GST tax laws — the trio of taxes commonly known as the federal "transfer" taxes. Before EGTRRA, every individual could have left his or her beneficiaries $1 million, free of estate tax — the "estate tax exemption" amount — plus a somewhat larger amount (indexed for inflation) free of the GST tax. After EGTRRA, the estate and GST tax exemption amounts gradually rose to $3.5 million in 2009 (while the gift tax exemption amount remained at $1 million) and the top estate, gift, and GST tax rate declined from 55% to 45% over the same period. EGTRRA provided ultimately for full repeal of the federal estate and GST taxes (but not the gift tax) in 2010, but this was not to be a permanent repeal. In order to meet budgetary restrictions, EGTRRA contained a "sunset" provision that called for reinstatement of the estate and GST taxes in 2011 — but at their *2001* levels; *i.e.*, with a $1 million exemption amount and a 55% top tax rate.[1]

From 2001-2009: Much Talk, But Nothing Happened

As the years passed from 2001 through 2009, the scenario of the 2010 estate tax repeal and the 2011 reinstatement of prior law created increasing uncertainty for taxpayers and their estate planners. Tax policy typically disfavors such a wide fluctuation in taxes over such a short period (in this case, taxes resulting from death in 2009 vs. 2010 vs. 2011). This problem was so large and so well-reported that nearly everyone expected Congress to address the situation before the end of 2009. Some legislators *did* introduce tax bills before then; the House was even successful in passing an eleventh-hour bill that would have permanently extended the 2009 estate and GST tax rates and exemptions through 2010 and beyond. To many this seemed like the most reasonable approach, because the 2009 estate and GST tax rates and exemptions were considered relatively generous: a per-person exemption of $3.5 million ($7 million for married couples), and a top tax rate of 45% for estates or transfers in excess of that. Under these rules, less than half of one percent of all decedents' estates in the U.S. — or the estates of only about 5,500 decedents annually — are subject to the federal estate tax; more than 99.5% are fully exempt. However, the Senate did not take similar action to provide a temporary fix.

Capital Gains Rules Through 2009

One other component of EGTRRA must be mentioned, for reasons that will become clear below. For decades, assets in a decedent's estate have received a tax-free "step-up" in income tax basis to their value on the date of the decedent's death.[2] [3] This tax-free basis step-up at death for appreciated assets that existed as part of the estate tax regime allowed a decedent's beneficiaries to sell inherited property without having to realize the gain or appreciation that had accrued during the decedent's lifetime. (By contrast, when a beneficiary receives an asset by gift from a living donor, the asset retains the donor's "carry-over" tax basis, which can result in significant capital gains taxes payable by the donee if the asset appreciates significantly between the *donor's* acquisition and the *donee's* sale.) This basis step-up at death provided a valuable benefit to a decedent's beneficiaries.

2009 Rules No Longer Apply

With the absence of any federal legislation, the estate tax system disappeared on January 1. The media has focused on the benefits of repeal, in some cases without much attention to another one of its features: the loss of the tax-free basis step-up for appreciated assets. Instead of allowing beneficiaries to receive *all* of a decedent's assets with a basis equal to their value as of the decedent's date of death,[4] now only $1.3 million of appreciation (or unrealized gain) will qualify for a tax-free basis step-up; and the basis will be the*lower* of the decedent's basis or the fair market value of the asset on the decedent's date of death.[5]

> ***Example:*** *Assume your widowed mother owns assets currently worth $3 million that have an aggregate cost basis of $500,000 and she has no capital loss carryforward. If she sells those assets during her lifetime, she would be subject to capital gains taxes on $2.5 million in appreciation.*

- *If your mother had died last year and left you the assets, her estate would not have been subject to estate tax (because it was within the $3.5 million exemption), and you would have received the assets with a stepped-up basis of $3 million. If you then sold the assets for $3 million you would have paid no capital gains tax on the sales proceeds.*
- *If instead your mother dies this year with the same assets, there will be no estate tax (due to repeal), but you would receive the assets with a carryover basis of $500,000. After applying another $1.3 million of basis step-up, you would have $3 million in assets with $1.8 million of basis. If you sold the assets for $3 million you would be subject to capital gains taxes on $1.2 million of gain.*

Additional Basis Step-up For Assets Received By A Surviving Spouse

Assets left to a surviving spouse either outright or in a qualifying trust[6] will be allowed an additional $3 million in gain/appreciation that qualify for the basis step-up. This additional $3 million basis step-up can also be allocated to the surviving spouse's one-half interest in the couple's appreciated community property. This feature was likely included as a rough substitute for the marital deduction that was available under the federal estate tax system through 2009 for estates of married taxpayers. The marital deduction was unlimited if the estate was properly structured and the surviving spouse was a U.S. citizen. But this year, a surviving spouse who receives assets with aggregate unrealized gain exceeding $4.3 million will — when the assets are sold — be subject to capital gains tax on the gain or appreciation in excess of $4.3 million that accrued during the lifetime of the first spouse.

Difficult Administrative Problems

Of course, the $1.3 million basis step-up ($4.3 million maximum for a surviving spouse) will still mean that many estates and trusts in this country escape federal taxation. However, the new capital gains requirements will add new burdens in administering estates and trusts. In addition to the increased capital gains tax liability that will be borne by some beneficiaries, every decedent's executor or trustee ("fiduciary") will be responsible for choosing which assets will receive this valuable basis step-up. Think of the difficult decision a fiduciary will face when a decedent leaves assets with unrealized appreciation of over $1.3 million to multiple beneficiaries, and the fiduciary needs to choose which beneficiary(ies) will receive the basis step-up, effectively reducing the beneficiary's capital gains taxes later on — and which beneficiaries will receive assets with a (presumably lower) carryover basis, and future capital gains tax liabilities.

Not only will the basis step-up choices present difficulties in many estates and trusts, but consider the problems in determining a decedent's basis. Now families, fiduciaries, and beneficiaries may be faced with the task of combing through a decedent's records to find out what the decedent paid for each asset, and amounts spent thereafter to improve it. Certain tax penalties may apply if adequate basis information is not provided to the IRS. It will still be necessary to value the assets as of the decedent's date of death in order to calculate the application of the basis step-up. All this data, together with details about how the basis step-up was allocated, will need to be reported on a tax return that will be due on April 15 of the year following the year of the decedent's death. Filing extensions are available, however, but provide only limited time for fiduciaries to assemble this data.

Law Will Change Again In 2011

The system in place today will only last until the end of this year. On January 1, 2011 — barring legislative action — the estate tax will reappear. But it will be the estate tax we knew in *2001*, with an exemption amount of only $1 million and a 55% top estate tax rate. In other words, for a decedent who dies next year with a net taxable estate valued at more than $1 million, his or her estate will pay a 55% tax on the amount over $1 million before the remaining assets pass to his or her beneficiaries. On the positive side, all those assets should again qualify for an unlimited basis step-up. But this is not enough to forestall dire predictions that some taxpayers — otherwise nearing the end of their lives — might take steps before December 31, 2010 to ensure that they pass away before this form of the estate tax returns in 2011.

What, If Anything, Will Congress Do?

Many believe that this difficult situation will be fixed by Congress this year. An unlikely "fix" could be that estate tax repeal is made permanent. A more likely fix is the extension of the 2009 exemption and rates, possibly retroactive to January 1, 2010. Of course, this type of legislation would require enough consensus and political will in Congress to forge such an agreement. Consensus may be in short supply this year, what with the continuing health care debate, competing revenue needs, and midterm elections on the horizon. Given the current Senate makeup, it is difficult to predict what will occur or when. If Congress were to pass a retroactive estate tax, it would likely face a constitutional challenge and protracted litigation by estates and trusts of decedents who died between January 1 and the date of the legislation. And if tax legislation does not pass soon, some sources in Washington predict that there will be *no* fix, because tax legislation is too polarizing for Congress to deal with as the 2010 Fall election season approaches.

What Do All These Changes Mean For You?

- First, you should check your estate plan or have an attorney review it. If your plan uses a formula keyed to the federal estate tax exemption in effect at the time of your death to allocate assets between or among different beneficiaries (*e.g.*, some to your spouse and some to your children), then the beneficiaries who would receive the "exempt" portion may now receive everything, leaving nothing for the other beneficiaries.

  Example: *In many of our firm's estate plans for married couples with children, the first spouse to die creates a "pecuniary" formula Marital Trust for the surviving spouse, and a "residuary" Bypass or Family Trust whose beneficiaries are the spouse, the children, and possibly other persons (such as the parents of the deceased spouse). In these types of plans, the Bypass or Family Trust would now receive all of the decedent's property if the decedent were to die this year. This may produce an appropriate result. However, the Bypass or Family Trust assets probably would not qualify for the $3 million spousal basis step-up otherwise available to the Marital Trust assets. Also, in some plans the surviving spouse may not be a beneficiary of the Bypass or Family Trust, in which case the children (and possibly others) could receive everything and the spouse could receive nothing.*

  If you have questions about your specific estate plan, or want to ensure that your plan would still operate as intended under the new laws and take full advantage of the available basis step-up, please call us for a review and analysis.

- If your estate plan — including not just your Will and Revocable Trust but any beneficiary designations for IRAs or retirement plan assets — leaves amounts to charities that depend (in any way) on the charitable deduction that was available under old estate tax rules, you may wish to consult with us about whether your plan would still operate as intended.

- If you have a buy-sell agreement (or similar contract or structure) for your business that would establish sales prices based on an estate tax return, you may wish to consult with us about the possible need for amendments.

- If your estate plan has multiple beneficiaries and you anticipate any discord among them, consider modifying your estate plan to provide specific guidance regarding who (or which assets) should benefit from any basis step-up.

- If you have not already done so, gather data that establishes your cost basis in your key assets, particularly those assets that are difficult to value or which you have improved over time. This could provide assistance to your loved ones or fiduciaries if anything were to happen to you during this year. If gathering documents is difficult, at least consider writing down your own notes regarding the history and cost of the major assets you have acquired over the years, and keeping those notes in an accessible place.

- This could also be a good time to consider whether any state inheritance tax laws might impact your estate. California does not currently have an estate or inheritance tax, but many states do. Depending on the nature and location of your assets, those laws could unexpectedly impact your beneficiaries.

- Now might be a good time to consider making taxable gifts while the top gift tax rate is only 35%, asset values remain depressed due to the weak economy, and interest rates are still low. This involves some risk, however, and may not provide an economic payoff if estate tax repeal is made permanent. There is an additional risk that Congress could impose a gift tax rate higher than 35% that is retroactive to January 1 of this year.

- More creative planning may be available, such as gifts to grandchildren while there is no GST tax. It will be easier to evaluate the risks and benefits of these types of planning options after seeing whether Congress addresses the estate tax situation over the next few months.

Please call us if you have any questions or would like to confirm that your estate plan would still function as you wish. We will also provide a follow-up alert if and when Congress passes any estate tax legislation.

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Footnotes

[1] This Alert will focus primarily on the estate tax. The gift tax — which applies to lifetime gifts so wealthy individuals won't give everything away in order to avoid future income, estate, and gift taxes — stayed fairly constant from 2001 through 2009, with a $1 million exemption and a top rate that declined from 55% to 45%; however, in 2010 the top gift tax rate drops to 35% before springing back to 55% in 2011.

[2] *Basis* is essentially the amount paid by a person for an asset that he or she acquires, adjusted upward to reflect certain improvement costs. When a person sells an appreciated asset, he or she pays capital gains tax on the difference between the adjusted cost basis and the amount of the net sales proceeds.

[3] This becomes a step-*down* for assets that have declined in value during the decedent's lifetime.

[4] Or six months later in certain cases.

[5] Any unused capital loss carryforward of the decedent will be added to this $1.3 million amount.

[6] This trust must meet the requirements of a "qualified terminable interest" (or "QTIP") trust.