IT'S 2010 – NOW WHAT DO WE DO?

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I am sure most practitioners including myself were "certain" Congress would act before Jan. 1, 2010, to modify the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). As a result of the sunset provisions in EGTRRA, as of Jan. 1, 2010, the United States has no federal estate tax for the first time since 1915. Also there is no federal GST for the first time since 1976. This set of laws is only scheduled to last during 2010. Beginning in 2011, the federal estate, gift and GST tax system will revert to their forms prior to the enactment of EGTRRA. During this system of estate tax repeal, the income tax basis of assets acquired from or passing from a decedent will not be made equal to their fair market value at the date of death. With some monetary exceptions, the decedent's basis in those assets will carry over to the recipient.

2010 Carryover Basis Rules

EGTRRA provides that for decedents dying in 2010, the assets of a decedent are transferred under a "modified carryover basis" value. There are two separate basis increase provisions that are generally available for property passing from a decedent. First, the executor generally can step up the basis of assets of the executor's choosing by a total of $1.3 million. This basis step up can be allocated to assets passing to any recipient. Second, for property passing to the decedent's surviving spouse, an additional $3 million in step up basis is available. Both the general basis increase of $1.3 million and $3 million for spousal property can be applied to property passing to a surviving spouse.

Basis Allocation

For the $3 million spousal property increase, the property transferred to the surviving spouse must be "qualified spousal property" as described under Internal Revenue Code ("Code") section 1022(c)(3). To be classified as spousal property, the transferred property must be either "outright transfer property" or "qualified terminable interest property" (QTIP). In order to qualify as property considered transferred to a surviving spouse, the interest must not terminate or fail on the lapse of time or on the occurrence, or the failure to occur, of some event or contingency. The definition of QTIP for purposes of the spousal basis increase rules closely tracks the statutory language of the QTIP provisions related to the allowance of the estate tax marital deduction available under pre-2001 EGTRRA law. However, the new rules do not require a QTIP election as the rules expressed under Code section 2056(b)(7).

The basis increases made under either of the basis increase provisions cannot be used to increase the basis of any property above its fair market value in the hands of the decedent on the date of his or her death. Additionally, the rules for allocation of basis increase, gives the executor the power to allocate the $1.3 million basis increase to property of its choosing. The general principles of fiduciary law will require that this allocation be made fairly.

For estates of nonresidents who are not U.S. citizens, the general basis step up is only $60,000 rather than the $1.3 million general basis increase amount that is available to estates of U.S. citizens and residents. The additional $3 million spousal property basis increase is not applicable.

In order for property to be eligible for either the $1.3 million general basis increase or the $3 million spousal property basis increase, it is necessary to show that the property was owned by the decedent at death. The decedent's ownership interest in property held in joint tenancy with rights of survivorship will be determined with reference to such factors as the number of joint tenants, whether they were husband and wife, the consideration furnished by the decedent, and how the property was acquired as provided under Code section 1022(d)(1)(B). For property owned jointly with a right of survivorship between the decedent and his or her spouse, one-half of the property is treated as basis adjustment property. For property owned joint with right of survivorship with someone other than his or her surviving spouse, the amount that would have been included in the decedent's gross estate under the estate tax rules is treated as basis adjustment property. Thus, for property owned jointly with a right of survivorship between the decedent and a non-spouse in which the decedent furnished consideration for the property, the decedent will be treated as the owner of the property to the extent of the part of the property that is proportionate to the consideration, and that portion of the property will be basis adjustment property.

The basis increase provisions do not apply to property acquired by a decedent by gift or by lifetime transfer for less than adequate and full consideration in money or money's worth during the three-year period ending on the date of death. However, this prohibition does not apply to property received by the decedent from his or her spouse during the three-year period, provided that the spouse did not acquire the property in whole or in part by gift or by lifetime transfer for less than adequate and full consideration. Therefore, a healthy spouse may transfer property to his or her terminally ill spouse and have the property pass back to the surviving spouse at death and take advantage of the general basis increase and spousal basis increase rules.

Fiduciary Reporting in 2010

EGTRRA mandates rules for fiduciary reporting of basis and holding period information for property. Under the rules, the executor of a decedent's estate will be required to file an information return with respect to property transfers where fair market value of the assets is in excess of $1.3 million and when the decedent transferred assets by gift or other lifetime transfer for less than adequate consideration during the three-year period ending on the date of the decedent's death and for which the filing of a gift tax return was required.

In addition to the return required to be filed with the IRS, the executor must also furnish such information to each recipient of property. Failure to report such information to a beneficiary shall result in a penalty of $50 for each failure. Additionally, the executor is subject to a penalty of $10,000 for failure to report to the IRS information regarding an estate valued over $1.3 million or for certain transfers within three years of death. An intentional disregard of the rules may result in a penalty of 5% of the fair market value of the property for which reporting was required. There is no statute of limitations operating against the IRS with respect to values reported on the 2010 valuation returns.

Impact of Repeal

While the "repeal of estate tax" made a nice headline in 2001, the temporary suspension of the estate tax and replacement of the step up in basis with the carryover basis rules will likely affect estates more than any extension of the 2009 applicable exclusion. The Center for Budget and Policy Priorities estimates that only 5,500 estates would have been subject to the estate tax if the 2009 rules had been extended. The Center estimates that more than 71,000 estates could be impacted by the carryover basis rules in 2010.

Estate Tax in 2011

Unless the current law is changed this year, the federal estate, gift, and GST tax system will revert to the amounts prior to the enactment of EGTRRA on January 1, 2011. That means the estate tax exemption will drop to $1 million. The GST tax exemption will drop to an inflation-adjusted $1 million (estimated at $1.34 million). The top estate, gift, and GST tax rates will increase to 55% (60% for estate and gift tax transfers between $10 million and $17.184 million). The estate and gift tax system will again be unified. The state death tax credit under section 2011 will be restored. Other provisions such as the qualified family owned business interest rules under section 2057 will return to the rules before EGTRRA.

How to Plan for Two Different Tax Systems

Planning for the one year of tax repeal is difficult to say the least. The most obvious difficulty in planning for 2010 and future years is that many dispositions under wills and trusts are phrased in terms of tax formulas. Often times married couples have defined the division of their estates into two broad portions: one portion equal to the estate tax exemption and the other portion the optimal marital deduction amount to reduce the federal estate tax to zero or, if reduction to zero is not possible, to the minimum amount. The literal language of a formula bequest will result in radically different results if the person dies in 2010 as compared to a year in which estate tax is in effect. Since there is no federal estate tax for 2010, a bequest of the maximum amount that passes free of estate tax could be a bequest of the entire estate. Additionally, if a trust formula defines a bequest as the maximum amount that could pass under the unified credit, such amount would be zero. Additionally many documents have GST defined formulas which will be affected by the 2011 repeal of GST tax.

Drafting Tips to Define Tax Formulas

If you desire that an amount be funded towards a trust that is defined in terms of taxes in effect at death, you may consider the following drafting language as part of the definitions:

> Construction of Tax In Effect at Death.
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> In this agreement:
>
> a. The use, if any, in this Trust of the phrase “if there is a Federal estate tax in effect at my death” shall mean Chapter 11 of Subtitle B of the Code applies to my estate or is retroactively reenacted by the end of the calendar year of my death to so apply.
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> b. The use, if any, in this Trust of the phrase “if there is a Federal generation-skipping transfer tax in effect at my death” shall mean that Chapter 13 of Subtitle B of the Code would apply to any generation-skipping transfer occurring in 2010 of any property included in my gross estate for Federal estate tax purposes or is retroactively reenacted by the end of the calendar year of my death to so apply.
>
> c. The use, if any, in this Trust of the phrase, “if there is no Federal estate tax in effect at my death” shall mean that Chapter 11 of Subtitle B of the Code does not apply to my estate and is not retroactively reenacted by the end of the calendar year of my death to so apply.
>
> d. The use, if any, in this Trust of the phrase, “if there is no Federal generation-skipping transfer tax in effect at my death” shall mean that Chapter 13 of Subtitle B of the Code would not apply to any generation-skipping transfer occurring in 2010 of any property included in my gross estate (or that would have been so included in Chapter 11 of Subtitle B of the Code applied to my estate” for Federal estate tax purposes and is not retroactively reenacted by the end of the calendar year of my death to so apply.

Planning for Clients with Short Life Expectancy

Other planning opportunities may exist for individuals where there is an expectation the individual will die in 2010 and the surviving spouse will likely live past the end of the year. While normally the basis increase exemptions under the 2010 laws do not apply to gift transfers made within three years of death, this prohibition does not apply to property transfers to a spouse. A healthy spouse could transfer property to his or her terminally ill spouse and take advantage of the step up in basis rules that can total $4.3 million in gain. At the death of the ill spouse, the property could be transferred back to the surviving spouse with the step up in basis values.

Use of QTIP Trust with Disclaimer

The use of a QTIP trust with disclaimer provisions may maximize planning flexibility during this time of uncertainty. A QTIP bequest with disclaimer may be recommended if there is a desire of both spouses to maximize the amount that may ultimately be distributed to beneficiaries on the second death and to minimize tax on the second death. Assets transferred to a QTIP trust for which an estate tax marital deduction is not allowed at the first spouse's death are not includible in the surviving spouse's estate under Code section 2044. The will or trust could leave all of the decedent's estate to a QTIP trust, and provide that any assets disclaimed by the spouse would pass to a bypass trust having the spouse as a potential beneficiary. The spouse could then pick and choose which assets to disclaim and pick those assets that are in excess of the amount needed for the $3 million spousal basis adjustment for a decedent that dies in 2010. The surviving spouse could also disclaim as to any assets for which a martial deduction is not needed at the first spouse's death.

Some clients may prefer this planning opportunity rather than complex formula provisions that apply only to estates of persons who die in 2010. The QTIP trust with disclaimer provisions provides a simple plan for those couples in agreement as to the ultimate beneficiaries and the desire to minimize tax on the second death. The obvious disadvantage of this approach is that the surviving spouse may refuse to disclaim assets even though a disclaimer would be recommended for tax purposes.

Other Planning Suggestions

For clients reluctant to rely on the QTIP disclaimer approach, the following provisions may be considered:

> "If I die at a time when the federal estate tax is not applicable to my estate but Code section 1022 is applicable, and the unrealized appreciation of the assets in my estate for which a basis adjustment could be permitted under Code section 1022 exceeds the amount otherwise allowed by Code section 1022(b)(2), I give to the Trustee of the QTIP Trust all of my interest in those assets passing under this Will selected by my Executor, the adjusted basis of which is less than their fair market value at the date of my death, that would not otherwise be eligible for a basis adjustment but for Code section 1022(c), if any."

Other drafting considerations include providing express authority for the executor to allocate the basis increases under Code section 1022 in the executor's sole and absolute discretion. Thought should be given to whether that it may be prudent to name an executor that is not also a beneficiary to allocate the basis increase. Also, individuals who make a bequest or gift equal to an individual's unused GST exemption at death will need special drafting provisions since the absence of a GST tax in 2010 may render such bequest or gift meaningless.

Large Gifts

If you have a client who is inclined to make a large gift that will be subject to gift tax, you could consider making the gift in 2010. Gifts above the lifetime exemption of $1 million and the annual gift tax exclusion are subject to a 35% gift tax in 2010. Under our current laws, the top rate in 2011 is 45%. Clients who pursue this plan should be advised that Congress may enact legislation that changes the future gift tax rates.

Conclusion

There has always been a saying that nothing is certain but death and taxes. Now the certainty of taxes is less clear. The public perception of the "repeal of estate tax" headline is widely misunderstood. Our role as advisors has never been more important than now as we educate our clients on the current tax laws and provide opportunities for them to plan.

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