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Breaking Developments in Trusts and Estates Law

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Estate Planning 2010

The United States has imposed an estate tax since 1916. Approximately 85 years later, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). EGTRRA included a number of changes to the income, gift, estate and generation-skipping transfer tax statutes then in effect. Many of the changes included in the 2001 legislation are effective only in 2010.

For 2010, the most important changes to the federal transfer tax system include:

- The estate tax is repealed.
- The generation-skipping transfer ("GST") tax is repealed.
- The gift tax is retained, but the highest effective tax rate is capped at 35 percent.
- Each decedent will be allowed to step up the basis in her assets by $1.3 million. A deceased spouse can provide a step up in basis of another $3 million for qualifying transfers to or in trust for the surviving spouse. In other words, the beneficiaries or heirs of an estate will "carry over" the decedent's income tax basis except for the limited basis amounts described in the prior sentence.

These changes apply only for 2010. EGTRRA further provides that the federal transfer tax system will revert to the laws that were in effect prior to the enactment of EGTRRA, namely:

- The estate tax will return and each person will have a $1 million exemption.
- The GST tax will return and each person will have a $1.3 million exemption (adjusted for inflation).
- The estate, GST and gift taxes will impose a maximum tax rate of 55 percent, with an additional five percent surtax on estates between $10,000,000 and $17,184,000.
- Estates subject to federal estate taxes will receive a credit against the federal estate tax for any estate taxes paid to a state, subject to a maximum allowable credit tied to the size of the estate.

We had expected Congress to eliminate this one-year roller coaster since EGTRRA was first enacted. They have been unable or unwilling to address it to date. It is logical to assume they will address it in 2010 if only to avoid the evident unreasonableness of imposing a zero percent estate tax for deaths on December 31 and a 55 percent estate tax for death occurring on January 1. However, this same problem existed at the end of 2009 and Congress did not act. In addition to the uncertainty of whether Congress will enact estate tax reform this year, there is also the uncertainty as to whether the reform legislation would be retroactively effective to January 1, 2010.

It is important for clients and their advisors to address the issues present in the federal transfer tax system as it exists today and not wait until Congress eliminates the uncertainty through legislative action or inaction. In addition, residents of Oregon and Washington will be subject to state estate taxes. Residents in California and Alaska should be aware that state estate taxes in those states may be resurrected if the EGTRRA provisions expire at the end of 2010.

It is very important to review all existing estate planning documents to identify any provisions that should be changed to reflect the situation in 2010. Below is a list of common drafting terms that may be present in older estate planning documents and cause problems under 2010 law.

- Formula clauses – It is common for estate planning documents to refer to specific elements of the federal estate and GST taxes. These references will not make sense in 2010 if there are no federal estate or GST taxes. Examples of common references include:
    - The smallest amount that would reduce (federal) estate tax to zero
    - The largest amount that can pass free from (federal) estate tax
    - The maximum amount that can pass free from GST tax

- References to federal estate and GST terminology can also be nonsensical in absence of federal estate and GST taxes:
    - "Unified credit," "estate tax exemption," "applicable exemption amount" and similar references to the estate tax credit or exemption
    - Marital deduction, unlimited marital deduction and similar references to the federal estate tax marital deduction
    - GST tax exemption or then available GST tax exemption

These types of formula clauses and outdated language could cause some intended beneficiaries to be disinherited and other beneficiaries to receive windfalls unless corrected.
There are also a number of specific planning opportunities that should be reviewed for each high net worth client, such as the following:

- Gift Tax – In 2010, the federal gift tax is 35 percent (compared to 2009 when it was 45 percent and 2011 when it is scheduled to reach 55 percent), while there is no gift tax for Washington, Oregon, California or Alaska residents. This creates an opportunity to make gifts at an attractive tax rate. New IRC 2511(c), which is effective for gifts made in 2010, was designed to prevent taxpayers from shifting income through the use of trusts. The scope of section 2511(c) was uncertain due to the ambiguous language in the statute. The IRS has issued Notice 2010-19, 2010-7 IRB to clarify the intended scope and impact of section 2511(c). Section 2511(c) will apply to prevent income tax shifting techniques through the use of incomplete gifts but does not preclude traditional grantor trust planning opportunities. Also, as will be discussed in connection with the GST tax below, gifts into trusts from which generation-skipping transfers may occur may require special attention in 2010.

- Estate Tax – As there may be no federal estate tax in 2010, high net worth clients should consider amending their estate plans to allow for transfers that can pass free of federal estate tax for deaths occurring in 2010, yet qualify for the marital deduction for state estate tax purposes. A few clients may desire to change their estate plan for 2010, if they can transfer assets to their family subject only to state estate tax.

- GST Tax
    - Clients may make GST transfers this year free of GST tax (but subject to federal gift tax or Oregon estate tax). For example, clients should consider revising their wills to implement GST trusts rather than outright gifts should they happen to die during 2010. This type of contingency planning could allow the creation and funding of a GST trust that could pass free of estate and GST taxes for multiple generations.
    - It is also important for clients to review existing GST trusts to which they make annual contributions or gifts. Common examples include education trusts for grandchildren, dynasty or GST trusts for children and future generations, and insurance trusts. Prior to 2010, each transferor could allocate GST exemption to his or her gifts to GST trusts. The allocation of GST exemption to a GST trust exempts a proportionate part of the trust from GST tax. In 2010, there is no GST exemption because there is no GST tax. In prior years, transfers that qualify as tax free gifts can also qualify as tax free GST gifts if made to qualifying trusts under prior law. This rule for tax free GST gifts in trust does not apply for gifts in 2010 because there is no GST tax. Gifts into GST trusts for the benefit of grandchildren will not trigger GST tax if made this year, but it is important to recognize that future distributions from such trusts to grandchildren could be subject to GST tax to the extent attributable to any contributions made in 2010. It is necessary to review gifts to a GST trust on a case-by-case basis. In some instances, the contribution for 2010 may be a minor event in the life of a trust so that any resulting GST tax on future distributions may also be minor. In situations where a gift must be made to a GST trust this year, such as with a life insurance trust, one option would be for the client to loan the funds needed to the trust until we understand the consequences better.

- Income Tax – The assets owned by a decedent will not step up in basis for deaths in 2009 for federal tax purposes. Each decedent will receive $1.3 million in new basis that can be allocated among the decedent's assets. In addition, for certain transfers to qualifying marital trusts, the decedent may allocate an additional $3 million in basis. These new basis rules affect any decedents with estates valued in excess of $1.3 million. For residents of states that impose an income tax, such as Oregon, there is a concern that a decedent could receive a step up in basis for Oregon income tax purposes but not for federal tax purposes. This would create a record-keeping nightmare. At this time, we believe that Oregon will continue to track the federal income tax basis rules.

Before making any significant estate planning decisions, it is necessary to consider the possibility that Congress may retroactively reinstate the federal estate and GST taxes. There has been discussion that Congress would reenact a patch to extend the federal transfer tax rules from 2009 through 2010. Some commentators believe that Congress cannot retroactively enact a tax based on case law in which the courts concluded that the Constitution bars the retroactive enactment of a new tax. Other commentators conclude that Congress could retroactively reinstate the federal estate and GST taxes because the taxes are not new. It is also possible that Congress may not enact any estate tax legislation this year and that the estate and GST taxes will return in 2011.

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