

2010 Estate Tax Repeal and Estate Planning Implications

As many of you are aware, on December 31, 2009, the estate tax law, as promulgated under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), was repealed for one year. We at TFC, along with most estate planning attorneys and financial advisors, have been researching the impact of this repeal to determine what issues you may face and what potential planning opportunities this change provides.

In order to better understand what the repeal of the estate tax law means, it is helpful to review the estate tax law as promulgated under EGTRRA. In 2001, Congress passed EGTRRA which established a slow phase-out of the estate tax, ending with the estate and Generation Skipping Transfer (“GST”) taxes being repealed for one year in 2010, while the gift tax remained in place with a \$1 million exemption and 35% maximum tax rate. In addition, a “modified carry-over basis” regime was established that limits the step-up in tax basis of appreciated assets at death. Unless Congress acts to change the existing law, the estate, gift and GST taxes, as they existed before 2002, will be reinstated in 2011. The changes are summarized in the enclosed *Federal Estate Tax Chart*.

What Will Congress Do?

The most-discussed actions that Congress may take include:

1. Congress may do nothing. The further into 2010 we get, the more likely this scenario becomes. Most estate planning practitioners expected Congress to extend the 2009 estate tax rules for one year through 2010, but they did not do so before December 31, 2009 and have not done so as of this writing. If Congress does nothing, the \$1 million estate tax exemption will return, which means estates in excess of \$1 million will be subject to an estate tax rate of up to 55% (or more for estates in excess of \$10 million).
2. Congress may adopt legislation to carry the 2009 estate tax rules over to 2010, retroactive to January 1, 2010. This would extend the current \$3.5 million estate tax exemption, so that estates in excess of \$3.5 million would be subject to an estate tax rate of up to 45%. There is wide disagreement as to whether retroactive legislation would be constitutional and the issue is certain to be challenged in court. Such a challenge could take years to reach the Supreme Court, which would result in a long period of uncertainty during the ensuing appeal process.

3. Congress may adopt legislation to prospectively reinstate some version of the 2009 estate tax rules in 2010 (and may allow decedents who died in 2010 before the new law was enacted to apply it retroactively).

Planning Issues and Opportunities

These changes provide a number of challenges and opportunities for clients, executors, financial advisors and estate planners. A number of questions arise when reviewing the estate planning changes, many of which will remain unanswered until Congress acts or until they are resolved by court interpretation.

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Estate Planning Documents

Many estate plans have been executed that reference the Federal estate tax and apply a formula based on the estate tax credit and other provisions found in the estate tax code. A common estate planning technique uses a marital trust and a family (or by-pass) trust, with the family trust funded by a formula equal to the current Federal exemption and the remainder going to the marital trust.

With the repeal of the estate tax in 2010, these estate plans may result in unintended consequences such as the family trust being funded with all of the assets, leaving the marital trust with no assets, thereby potentially disinheriting the spouse. Similarly, children may be disinherited in favor of grandchildren and lower generations if a GST trust is funded by a formula equal to the maximum GST amount.

Likewise, many larger estates that direct the unused portion of the Federal exemption to charity may result in the entire estate going to charity and the heirs receiving nothing. Therefore, *it is important to review your estate planning documents to ensure that your intentions are met with the documents you have, whether estate and generation-skipping transfer taxes are in place or not.*

Carry-over Tax Basis

For 2010, estates comprised of assets that have more than \$1.3 million in unrealized capital gains (or more than \$4.3 million in unrealized capital gains if there is a surviving spouse) will be subject to capital gains tax when the assets are sold by the beneficiaries. The tax basis is the *lesser* of the asset's adjusted cost basis or the fair market value of the asset as of the decedent's date of death, which means that the basis may actually receive a step down at death.

This will create a number of issues, the first of which is determining the tax basis of the assets. If the basis is unknown, the presumption is that it is zero. In many cases, it will be difficult, if not impossible, to determine an asset's tax basis. If the asset was received as a gift and the donor is no longer living, there may not be any available record of the basis. Even though the estate tax is repealed for 2010, in many cases the capital gains tax bill on the assets transferred may be as large as the potential estate tax bill would have been.

Another issue is how to allocate the \$1.3 million special basis adjustment and the \$3 million spousal basis adjustment among the assets going to the beneficiaries, if the total gains of all assets in the estate exceed the total special and spousal basis adjustments. This could create conflicts between the executor and the beneficiaries, which will only be exacerbated if the executor himself or herself is a beneficiary.

Lifetime Transfers

Individuals who plan to make taxable gifts in 2010 may pay less gift tax because the gift tax rate has been reduced to 35% for 2010 (gifts in excess of \$13k per donee or \$26k per donee in the event of a split gift from spouses will be subject to gift tax in 2010). For this reason, individuals may transfer more assets to their grandchildren in 2010 because the Generation-Skipping Transfer tax has been repealed. If Congress does not act to change the law retroactively, the gift would not be subject to GST taxes and would not use any GST exemption.

If Congress enacts retroactive legislation, individuals that made taxable gifts in 2010 could be subject to higher tax rates than they anticipated (e.g., 45% or more). There is also some question as to how an individual would be credited for gift tax paid if they pay 35% gift tax now, but do not die until after 2011 when the gift tax rate is 55%.

Generation-Skipping Transfers

For 2010, the generation-skipping transfer tax has been repealed, so distributions from existing GST trusts to skip-persons (those two or more generations below the transferor) and termination distributions will not be subject to tax. Assets from those distributions will later be subject to estate or gift tax when they are transferred, which may not accomplish the transferor's objectives.

In addition, the creation and funding of new generation-skipping trusts is not subject to GST tax in 2010, although there seems to be little significant benefit to creating such a trust in most cases. Furthermore, it is not clear how the GST exemption would be allocated to a trust created in 2010, which could cause it to be taxed in the future even more severely than a trust created in another year. For individuals who are terminally ill and not expected to survive 2010, GST trusts that are created by will or revocable

trust could receive very favorable tax treatment, since they will not be subject to estate or GST tax.

Because there is no Generation-Skipping Tax in 2010, it is not clear whether clients may be eligible to make a Generation-Skipping Transfer election. As a result, a 2010 gift to an Irrevocable Life Insurance Trust or "ILIT" and the insurance subsequently purchased may be brought back into the client's estate. Consequently, some estate planners are advising clients to use loans in lieu of gifts for Generation-Skipping Transfers in 2010.

State Estate Tax

The repeal of the Federal estate tax does not eliminate state estate or inheritance taxes in those states that have decoupled from the Federal estate tax. Currently, over 20 states (including Massachusetts, Connecticut and New York) have an estate or inheritance tax that is separate from the Federal estate tax. With mounting state budget deficits, it is likely that more states may decouple from the Federal estate tax system and establish their own separate estate or inheritance tax systems. Thus, estate tax planning still needs to be done in those states where a state inheritance or estate tax remains despite the repeal of the Federal estate tax.

Concerns for Fiduciaries

A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence, such as a trustee or an executor. Fiduciaries of estates for decedents who die in 2010 will face a number of issues. If the unrealized gain in the assets in the estate is greater than \$1.3 million (\$4.3 million if there is a surviving spouse), the executor will have to decide how to allocate the \$1.3 million special basis adjustment and \$3 million spousal

basis adjustment among the beneficiaries.

Clients should review their wills to determine whether they provide executors with express authority to make the basis allocation since this may not have been contemplated at the time the will was drafted. They may also want to consider protecting the executor by including exculpatory language regarding their decision as to how to allocate the basis. Although there are no rules as to how to allocate the basis, it seems reasonable to assume that it must be done fairly, based on the asset's fair market value, cost, or (most likely) gain.

Fiduciaries are also placed in the uncomfortable position of having to decide whether to sell assets (with possibly unknown basis) to raise cash and diversify out of concentrated positions (even though no estate taxes are owed) to preserve the assets against a decrease in market value for the heirs and the possibility that the estate tax may be reinstated and made retroactive.

Conclusion

With all the uncertainty surrounding the estate and generation skipping transfer tax law changes, the most important step that you, our clients, can take is to review your estate plan and documents with your estate planning attorney to ensure that they are flexible enough to accomplish your wishes whether an estate and generation-skipping transfer tax is in place or not. Some suggestions for review are listed below.

Estate Planning Documents:

- Ensure that a spouse or other heir is not unintentionally disinherited;
- Determine whether they may be amended to achieve your estate planning objectives while minimizing or eliminating the exposure to transfer taxes, regardless of the form those taxes take going forward.

This is especially important now, as actions taken in 2010 in generation-skipping trusts for GST tax reasons can have long-term GST tax implications in future years;

- Determine whether executors have been provided authority to allocate tax basis and whether exculpatory language should be included to protect the executor's decisions;
- Living Wills and Health Care Proxies should be reviewed and updated to comply with HIPAA (the Health Insurance Portability and Accountability Act that restricts access to personal health information of individuals – even for family members). Specific attention should also be paid to the provisions relating to life-sustaining care.

Estate Plan:

- Ensure that provisions have been made to take advantage of the tax basis adjustments available since assets may no longer receive a step up in basis to fair market value on the date of death;
- Estate planning continues to be needed in those states that have estate or inheritance taxes that have been decoupled from the Federal estate tax.

A Final Note

We encourage you to contact your estate planning attorney to review your estate plan to determine whether any changes need to be made. As always, we are happy to facilitate the discussion regarding your overall planning.

Federal Estate Tax Chart

Federal Estate Tax Chart			
	2009	2010	2011*
Gift Tax Exemption	\$1,000,000	\$1,000,000	\$1,000,000
Maximum Gift Tax Rate	45%	35%	55% (with a 5% surcharge on cumulative gifts between \$10 million and \$17,184,000)
Estate Tax Exemption	\$3,500,000	Unlimited	\$1,000,000
Maximum Estate Tax Rate	45%	None	55% (with a 5% surcharge on cumulative gifts between \$10 million and \$17,184,000)
Exemption from GST Tax	\$3,500,000	Unlimited	\$1,000,000 indexed for inflation since 1999
GST Tax Rate	45%	None	55%
Carryover Tax Basis	Step-up in tax basis on appreciated assets at death	\$1.3 million Special Basis Adjustment for appreciated property; \$3 million Spousal Basis Adjustment	Step-up in tax basis on appreciated assets at death

* assumes no further changes to the current estate tax law