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The Uncertain Fate of Estate and Gift Taxes

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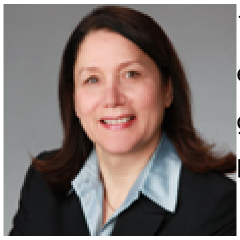

The estate and gift tax laws in effect today are uncertain at best. Despite last-minute efforts by Congress at the end of 2009 to preserve the federal estate and generation-skipping transfer ("GST") taxes, the scheduled repeal of these taxes for 2010 has gone into effect – or has it?

In 2002, Congress set a course for the repeal of the estate tax for one year – 2010. However, their actions over the last months of 2009 have caused the effectiveness of the repeal to be called into question and will make planning over the next year more complicated than ever. In 2009, many bills were introduced, including legislation that the House of Representatives passed on December 3, 2009, that would have made the 2009 estate tax exemption level of $3.5 million and top tax rate of 45 percent permanent. However, none of the proposed legislation passed due to a lack of action in the Senate. It is difficult to predict if and when Congress will act to address the current state of estate and GST taxes and whether the legislation will be retroactive to January 1, 2010. Moreover, if such legislation is retroactive, there will certainly be a constitutional challenge. Although the Supreme Court has previously found a retroactive imposition of an income tax constitutional, forecasting the final outcome of such challenge to estate and GST taxes is impossible.

What does this mean? Will estate and GST taxes be reinstated, and if they are, will it occur retroactively or prospectively? If reinstated in 2010, what will the level of the estate tax exemption amount and the applicable tax rate be; and what will be the rule with respect to the basis of property acquired from a decedent? The answer – no one knows.

Even though the estate tax and GST taxes have been repealed, the federal gift tax has not. However, the gift tax rate was, as part of the 2002 legislation, reduced to a thirty-five percent (35%) rate for gifts in 2010, with the same $1 million exemption that has been in effect since then. Whether these rules will be changed by Congress is also uncertain.

Moreover, without any further change, the assets of an estate of one who dies in 2010 will have, with limited exceptions, a carryover basis instead of the traditional "step-up" (or step down) in income tax basis to fair market value at the time of death. This is likely to increase future income taxes for the surviving spouse and other beneficiaries of the estate of one who dies in 2010.

Under the current tax regime, the federal estate tax and GST taxes are scheduled to again become effective in 2011. Without any further act of Congress, those taxes and the gift tax in 2011 and thereafter will be imposed at the highest rates seen in almost a decade. For decedents dying in 2011, the estate tax rate will again rise to 55 percent with a 5 percent surcharge on certain large estates. The estate tax exempt amount will be $1,000,000 ($2,500,000 less than the estate tax exemption in 2009), the GST tax exemption will be $1,000,000 [1] (also reduced from the $3,500,000 in effect for 2009), the gift tax exemption will remain at $1,000,000 and the basis of property acquired from a decedent again will be adjusted, generally, to its fair market value at the time of death. These rules could potentially cause many estates to unexpectedly pay estate tax in 2011. For example, an estate of a single person with a $750,000 life insurance policy and a $500,000 house would potentially pay estate tax.

Impact on State Estate Taxes

The repeal of the federal estate tax also repeals the Illinois estate tax. However, this is not true for all state estate taxes. As a result, an Illinois resident with real estate in a state whose estate tax has not been repealed will continue to be subject to estate taxes in that other state. [2]

The Disappearing Marital Trust: Planning for Spouses in a Zero Federal Estate Tax Environment

The most serious issue for most clients is the impact repeal has on inheritances for spouses.

Chief among the unintended consequences of the repeal is the problem of the disappearing marital trust. Under typical estate planning documents, two trusts are created after death: a marital trust for the benefit of the surviving spouse and a family trust for the benefit of a group of persons which may include children and/or grandchildren as well as or in lieu of the spouse. At death, the family trust is usually funded with that portion of the decedent's estate that is exempt from federal estate tax and the marital trust is funded with the remainder of the estate. This type of funding is intended to result in no federal estate tax liability for those who are survived by a spouse even if death occurs in a year with an effective federal estate tax.

But if the decedent's death occurs in a year like 2010 during which there is no effective federal estate tax, the funding formula described above will result in the creation of a family trust funded with the decedent's entire estate and no marital trust. Depending on the terms of the marital and family trusts under a given set of estate planning documents, a decedent's surviving spouse could be partially or totally disinherited. The problem is illustrated by the following examples:

<u>Example 1</u>: H dies in 2009 owning $20,000,000 in assets and is survived by his wife, W, and three children, C1, C2 and C3. H's estate plan provides that a Family Trust, funded with his federal estate tax exemption, will be created at his death for the benefit of C1, C2 and C3 and that his remaining estate will be used to fund a Marital Trust for the benefit of W. The trusts are funded as follows:

Marital Trust for spouse: $16,500,000

Family Trust for children: $3,500,000

Example 2: H dies in 2010 with the assets described above. The trusts are funded as follows:

Marital Trust for spouse: $0

Family Trust for children: $20,000,000

As a result of H's 2010 death, W is disinherited.

Even if one's spouse is the beneficiary of both the family trust and the marital trust, the disappearing marital trust may also have deleterious income tax consequences that have to do with how the income tax basis of property inherited from a 2010 decedent is determined.

Changing Income Tax Rules

Until 2010, the income tax basis of inherited property was "stepped-up" at death to fair-market value, if it was higher than the income tax basis of the decedent. As a result, the appreciation of inherited assets occurring prior to death generally escaped income tax.

A new modified carryover basis system applies to those dying in 2010. Under the 2010 rules, inherited property will generally have an income tax basis equal to the decedent's basis in the property (i.e. the decedent's income tax basis is "carried over" to his or her beneficiaries) or date of death fair market value, if less. These new modified carryover basis rules, however, allow a limited "step up" in the basis of appreciated qualified inherited property equal to $1.3 million and an additional $3 million step up for appreciated property inherited by a spouse.[3] Other limited adjustments are available based on the decedent's own lifetime income tax attributes.[4]

The second problem of the disappearing marital trust is that if the marital trust is not created at death, then the $3 million spousal basis step-up is lost. This may cause families of those dying in 2010 to incur significant income taxes that could otherwise have been avoided had the 2010 decedent's estate plan been modified to account for the 2010 estate tax law changes.

Recommended Modifications

We are constantly reviewing the legislative developments, and we will keep you informed about any further significant developments. In the meantime, we are available to review your estate plans and implement any necessary revisions to effectuate your estate planning objectives.

At a minimum, plans should be modified to ensure that the marital trust is established in an amount that can absorb the special, spousal $3,000,000 basis step-up and that the family trust adequately benefits the surviving spouse. In addition, for clients with real property in a state whose estate tax has not been repealed by the federal repeal (or for those who reside in one of those states), a marital trust may need to be established to absorb the full state spousal estate tax exemption.

Gail Bley advises entrepreneurs, family and other closely held businesses and their families on tax and financial issues related to acquisitions, investments, mergers, strategic alliances and joint ventures. Ms. Bley is a partner at Gould & Ratner and has served on the firm's Management Committee. She is also a Certified Financial Planner™. Ms. Bley can be reached at gbley@gouldratner.com.

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[1] Indexed for inflation.

[2] These taxes should be based on the value of the real estate in that other state.

[3] The income tax basis of property inherited by a non-U.S. citizen may only be stepped up by $60,000. Property not eligible for the limited income tax basis step-up includes: (a) property included in a decedent's estate by virtue of a general power of appointment held by the decedent at death, (b) property acquired by the decedent by a gift occurring within the three year period preceding death (other than property acquired from one's spouse), (c) stock or securities of a foreign personal holding company, (d) stock of a DISC, (e) stock of a foreign investment company, (f) stock of a passive foreign investment company and (g) items constituting income in respect of a decedent.

[4] I.e., income tax basis is also increased by decedent's unused built-in losses, net operating loss carryovers, capital loss carryovers and any loss that would have been allowable under Code Section 165, had the property generating the loss been sold at fair market value immediately before death.