Petrella Brown PLC

Estate Tax Changes: Avoid Legal Quicksand

March 2010

Dear Friend,

The principal purpose of this Special Report is to alert you to major changes in the federal tax law that went into effect in 2010 that could dramatically affect your estate plan. Though not all estate plans will be affected, you should determine if changes are required in your plan to avoid unexpected results.

We will discuss the law prior to and after the changes, then provide specific examples of areas of concern. We will show you why it is critical to review your plan to assure that it will still work as you expect.

The Law Before the 2010 Changes

In 2009, the federal estate and generation-skipping transfer ("GST") tax exemptions were $3.5 million per person, and the estate and GST tax rates were 45%. Thus, an individual could die with a $3.5 million estate and there would be no federal estate tax. A married couple with properly planned estates could pass $7 million free of estate tax.

There is also a $1 million gift tax exemption, which was applied against the estate tax exemption. Thus if you made $1 million of lifetime taxable gifts, you would have only $2.5 million of estate tax exemption on death.

Further, prior to 2010, inherited assets received a "stepped up" basis for income tax purposes. So if someone inherited property acquired by a decedent years ago which had grown in value by the time of death, and it was sold for the date of death value by the person inheriting it, there was no gain subject to capital gains tax.

Changes Effective in 2010

In 2001, Congress passed changes to the federal estate, GST, and gift tax rules that were to take effect in 2010. The estate tax and GST were repealed. The gift tax remains in effect, with the same $1 million exemption, but the rate is reduced to 35%.

The old rules regarding step-up in basis are significantly modified: Assets received from a decedent dying in 2010 take a carryover basis - the same basis as the decedent had in the assets - rather than the estate tax value, but subject to a couple of important adjustments. Those adjustments are that the "Executor" can allocate $1.3 million (and possibly additional amounts) to step up the basis of assets passing to any beneficiary on the decedent's death. Also, the Executor can adjust upwards property which passes to the surviving spouse which constitutes Qualified Spousal Property. The maximum adjustment for Qualified Spousal Property is $3 million.

These changes will affect far more estates than were affected by repeal of the estate tax. An extension of the 2009 estate tax rules would have resulted in estate tax being imposed on about 6,000 estates, while carryover basis will result in taxes on more than 70,000 estates.

Changes Scheduled for 2011

The 2001 law repealed the estate tax and GST for one year only, 2010. If Congress does not change the law, in 2011 there will be more changes: The estate tax will be restored with a top rate of 55%, a 5% surtax on certain estates over $10 million, and only a $1 million estate tax exemption. The GST will also be restored with a 55% rate and a $1 million GST exemption. The maximum gift tax rate will be increased to 55%. The step-up in basis rules will return, and carryover basis will be repealed.

The above is just a summary of some of the major changes. There are more technical changes in effect in 2010 and yet others would go into effect in 2011.

How Did We Get Into This Mess?

Most practitioners believed Congress would enact legislation prior to 2010 to avoid the current situation. In fact, the Senior Tax Counsel to the House Ways & Means Committee stated at professional seminars in late 2009 that he fully expected a one-year extension of 2009 law to be enacted before the end of 2009. However, health care reform took priority. Despite various bills on the subject and lots of haggling in Congress, that reprieve was not enacted, and we find ourselves in a very bizarre situation, to say the least.

Will the Changes Affect My Estate Plan?

Every estate plan should be reviewed to determine whether the changes in the law will have any effect.

The most important factors to consider are the language of your Will or Trust, how your assets are titled, and your intent. Other factors that will affect the analysis are: your family situation, the value of your estate (though previously non-taxable estates may also be affected), and whether your assets are appreciated (i.e., whether their value at the time you might die is more than their cost or tax basis).

Other imponderables are also relevant, i.e., the year of your death; and whether the estate tax, the generation-skipping transfer tax, and the step-up in basis of assets on death will be reinstated and, if so, whether that will be retroactive.

Isn't Repeal of the Estate Tax and GST Beneficial?

Since more than 99% of estates were under the 2009 exemption amount of $3.5 million for a single person, or $7 million for a married couple with a properly planned estate, repeal of the estate tax and GST is of no practical consequence for most people. This is because with those exemptions most estates would not have been subject to federal estate tax or GST anyhow.

However, many estate plans were drafted with reference to estate tax or GST concepts that are removed from the Internal Revenue Code as of 2010. These references could cause major problems in interpreting Wills and Trusts, and could actually frustrate your intentions, as discussed further below.

Can't Congress Fix the Situation Retroactively?

We cannot say for certain whether Congress will enact any changes in 2010 or, if they do, whether those changes will be retroactive. The Democratic leadership in both the House and Senate have indicated their desire to reinstate both the estate tax and GST early in 2010, and to make those changes retroactive, so the period of repeal would effectively be eliminated. Some say that the longer Congress waits to pass legislation, the less likely it will be retroactive. Given what happened - or didn't happen - in 2009, we are reluctant to make any predictions.

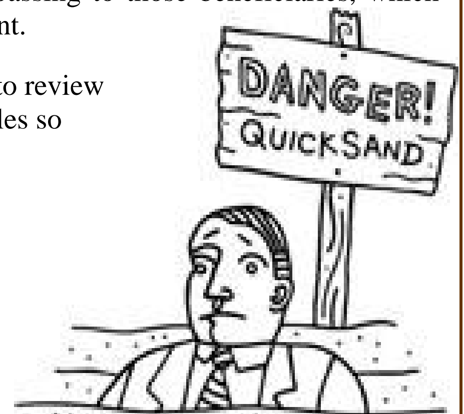
If the law is changed retroactively, commentators believe there will be legal challenges to such retroactive changes, but many also believe that the challenges will not be successful. Other cases have been litigated where retroactive changes in the law were deemed constitutional. In any event, if there are retroactive changes, extensive litigation is expected, and the legal status of these changes could remain up in the air for years.

Thus, we believe that it is dangerous to rely on the laws currently written to remain in effect. On the positive side, however, there are some planning opportunities under the current law which some may want to explore, particularly if this can be done in such a way that there is limited downside risk in doing so.

Effect of Repeal On Who Gets What

Many estate plans provide that the maximum amount which could be left without triggering estate tax, or without triggering GST, will pass to certain beneficiaries. This was often done to shelter the amount from estate tax in the second estate, or to maximize what might pass to lower generations, without triggering GST. After repeal of the estate tax and GST, that language could result in 100% of the estate passing to those beneficiaries, which may not be your intent.

Please take the time to review the following examples so you can see how the current situation could wreak havoc with an estate plan.



Example 1
Inadvertently Reducing the Spouse's Share

Don's estate is valued at $5 million. His Trust leaves the maximum amount that can be left without incurring estate tax to a Family Trust, of which his wife, Jan, and their children are beneficiaries. The Trust provides that the balance will pass outright to his wife, so she would get $1.5 million outright, and the Family Trust would get $3.5 million under the law in effect in 2009.

Under the law in effect in 2010, the Family Trust will get the entire $5 million, and Jan will not get any outright bequest.

Does this make a difference to Jan? She and the children are the Trustees of the Family Trust, there are no mandatory distributions of income, and she has no voice in making distributions under the Family Trust. The situation could work out, but she could well be uncomfortable being left in this position.

Example 2
Inadvertently Cutting Out the Spouse

The facts are generally the same as Example 1 except that the beneficiaries of the Family Trust are only Don's children by his prior marriage, and he put the plan into effect when the estate tax exemption was only $675,000 and has not updated his planning. He intended those children to receive only $675,000, now they will receive the entire estate, and Jan will receive nothing.

Example 3
Inadvertently Cutting Out the Children

Bill's plan provides that the maximum amount that can be left without triggering GST is to be left in generation-skipping trusts, with the balance to pass outright to his children. If there is no longer a GST, that could result in the entire estate passing to the generation-skipping trusts, and nothing to the children.

If the children are beneficiaries of the generation-skipping trusts during their lifetime, the situation may be tolerable. But if only grandchildren and lower generations are beneficiaries of those trusts, this could be inconsistent with Bill's intentions – and a major disappointment for his children, who would have been inadvertently cut out of his estate.

Example 4
Marital Bequest at Risk

Many plans include language to the effect that only property qualifying for the marital deduction will pass to the Marital Trust. In a situation of estate tax repeal there is no longer a marital deduction as such. This language could therefore cause any property intended for the Marital Trust to pass to other beneficiaries, perhaps to children or a Family Trust.

Example 5
Charitable Bequests at Risk

Some plans include bequests to charities, which are conditioned on bequests to the particular charity qualifying for the estate tax charitable deduction. In a situation of estate tax repeal there is no longer an estate tax charitable deduction, and arguably nothing should be distributed to the charity - even if it is tax-exempt and in 2009 a bequest to the charity would have qualified for an estate tax deduction.

Example 6
Problems with Bequests Expressed or
Capped at a Portion of the Gross Estate

Some plans provide for division of the estate based on certain bequests being no more than a certain percentage of the "gross estate" for federal estate tax purposes. For example, Jim leaves $500,000 to a trust for his parents' care for their lifetime, provided that this amount does not exceed 25% of his gross estate as finally determined for federal estate tax purposes. His gross estate was valued at $2 million when he signed the Trust in 2007. The Trust is now valued at $1.5 million.

How much should be distributed to the trust for his parents if he dies during a period of estate tax repeal when there is no "gross estate" and no final determination of the value of the gross estate?

How Can Income Tax on Inheritance
Be Increased Under 2010 Law?

Under the law in effect in 2010, when a person dies the step-up in basis at death is eliminated - except for the first $1.3 million that passes to anyone and the first $3 million that passes to the decedent's spouse if that bequest meets certain technical requirements. (Other adjustments are also possible.)

The extra $3 million in step-up basis will be available only for assets passing outright to a surviving spouse or in certain marital trusts.

This means that in many cases, where the heirs would have had a full step-up in basis under prior law, that will not be the case under 2010 law. They could be subject to income tax when they sell inherited property.

Record-keeping will be a nightmare. Under prior law, the date-of-death value or estate tax value became the new basis for income tax purposes, and that was fairly easy to determine. Under 2010 law your heirs will need to know your cost basis for the property they inherit.

Do you have cost basis information for all of your assets, regardless of how long ago you acquired them? Carryover basis, as it is called, was enacted decades ago, and repealed because of the tremendous administrative burden it created.

Further, the basis step-up is not automatic. It must be allocated to certain assets by the "Executor" (a defined term under the Internal Revenue Code), and Wills and Trusts should be modified to authorize the Executor to do this as he or she deems best. Otherwise, there could be claims that one beneficiary, receiving certain assets, was favored over another.

Consideration should be given to naming an independent fiduciary to do this, to avoid conflicts of interest. For example, if one child is the Executor and allocates the step-in basis assets that he or she will receive, the other beneficiaries could have a claim for breach of fiduciary duty.

If the entire estate passes to a Marital Trust which would have been a QTIP Trust under the law in effect in 2009, that should qualify as Qualified Spousal Property for purposes of allocating the special $3 million of stepped-up basis. However, the trust might be modified to allow distribution of assets to the spouse during the spouse's lifetime if the spouse would not otherwise have sufficient assets to get the available step-up in basis on his or her death. Assets left in the Marital Trust on the second death will not qualify.

Example 7: Income Tax Due to Limited Step-Up Basis

Joe dies in 2010, with no surviving spouse. He has a $4.3 million estate which will be distributed to a trust for his son. The asset is a family business which Joe started from scratch, and there is zero basis.

No estate tax is imposed, but because Joe is not married, only $1.3 million of the basis can be stepped up for the $4.3 million property. Therefore, the son's trust will receive the $4.3 million property with a $1.3 million basis. If the trust sells that property for $4.3 million, there will be $3 million of capital gain, which will be taxed at the capital gains rate. Assuming that the rate is 25%, the income tax due will be $3 million x 25% = $750,000.

Example 8
Surviving Spouse May Lose Additional $3 Million Step-Up Basis

Assume that Joe is survived by his wife, Andrea, and his plan still provides that the maximum amount that can be distributed free from estate tax will be distributed to a Family Trust for Andrea and their children. The Trust had not been amended to address the problem with the formula clause discussed above. As a result, the entire $4.3 million estate will pass to the Family Trust.

The bequest to the Family Trust would not be Qualified Spousal Property, because it does not provide for mandatory distribution of income to Andrea, and has beneficiaries in addition to her. There is only a $1.3 million step-up in basis; the additional $3 million step-up in basis is not available. Thus, if the Family Trust sells the $4.3 million in property, $3 million will be subject to income tax, and if the capital gains rate is 25%, then the tax due on the additional $3 million in gain will be $750,000.

What Does All This Mean to Me?

Try as we may, we are unable to draw any "bright lines" as to what types of estate plans will or will not be affected by the current confused state of the law. While married couples may seem to be more likely to have adverse consequences because of formula clauses that may no longer work as intended, unmarried people could have provisions in their plans which could also cause problems. Larger estates clearly stand to lose the most. However, we can imagine situations where even a very small estate, for example, with charitable bequests expressed with reference to the "gross estate" or the "charitable estate tax deduction" could also be affected.

If you are willing to assume that you will not die during this period of uncertainty, or perhaps that Congress will fix the situation with retroactive legislation that will be held constitutional, then your plan will probably work as you intended. However, many people will be unwilling to make either assumption.

The unfortunate truth of the matter is that only by reviewing your estate plan can we determine whether any changes need to be made to assure that it will function as you intended. The good news is that the changes to your estate plan are relatively simple to implement.

Invitation

Please contact Marisa C. Petrella or Linda B. Hagan to schedule a time to meet and discuss your current estate plan and determine what changes need to be made to minimize taxes and to reduce the possibility of future family conflict. For additional information, please contact Petrella Brown PLC at 248.223.9883.

Safeguard Your Family

Disclaimer

All of the foregoing is intended to provide general background information concerning a current legal issue and should not be construed to represent legal advice. It is not intended to apply to any specific factual situation.