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Estate Planning Bulletin

Who Would Have Thought . . . ? 2010 Arrives Without an Estate Tax

What You Need to Do Now to Survive the Estate Planning Mess Created by Congress

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act"), which was enacted on June 7, 2001, the federal estate tax was scheduled to be repealed in 2010 for one year. Because a one-year repeal of the federal estate tax would wreak havoc on many estate plans, it was widely thought that Congress would act before the end of 2009 to extend the tax. In fact, this is precisely what the House of Representatives tried to do when it passed H.R. 4154 on December 3, 2009. Unfortunately, the Senate failed to act before the end of the year. As a result, the unthinkable has now happened—2010 has arrived with no federal estate tax. By failing to correct a problem that everyone has known about for many years, Congress has created an estate planning mess and, for some persons, possibly an estate planning disaster.

We strongly recommend that every estate plan be reviewed to determine the impact of the new tax laws. Many estate plans will not work as originally intended or, even worse, may be ineffective in whole or in part, particularly if death occurs in 2010.

What happened?

Pursuant to the 2001 Tax Act, the federal estate tax has been repealed for 2010. The federal generation-skipping transfer tax ("GST tax") has also been repealed for 2010. The federal gift tax remains in effect, with a maximum rate of 35 percent for 2010 (reduced from 45 percent in 2009) and a $1,000,000 lifetime exemption. In addition, the income tax basis of property inherited from a person who dies in 2010 will now be determined under a modified carryover basis regime rather than under the stepped-up basis rules that were in effect before 2010. Because of the modified carryover basis rules, the estates of many individuals who die this year will actually be worse off from a tax standpoint than if the federal estate tax had not been repealed.

In 2011, the federal estate tax reappears, with a maximum rate of 55 percent and an exemption of only $1,000,000. The federal GST tax also returns, with a flat rate of 55 percent and a GST exemption of $1,000,000, indexed for inflation. The federal gift tax rate will increase to 55 percent in 2011. By comparison, for 2009 the estate and GST tax exemptions were $3,500,000, and the maximum federal estate, GST and gift tax rate was 45 percent. On the positive side, the stepped-up basis rules return in 2011.

Has the federal estate tax been repealed?

Yes, at least for now. Under the 2001 Tax Act, the federal estate tax does not apply to estates of individuals who die in 2010. However, the federal estate tax returns in 2011, with an exemption of $1,000,000 and a maximum rate of 55 percent. In 2009, the estate tax exemption was $3,500,000 and the maximum

rate was 45 percent. In addition, as discussed below, Congress may act to reinstate the federal estate tax, possibly retroactively to January 1 of this year.

Has the federal GST tax been repealed?

Yes, but only with respect to generation-skipping transfers occurring in 2010. In general, a generation-skipping transfer is a direct transfer or a distribution from a trust to a person who is two or more generations younger than the transferor, such as a grandchild. The federal GST tax returns in 2011, with a flat rate of 55 percent and a GST exemption of $1,000,000, indexed for inflation. In addition, a favorable provision in the 2001 Tax Act allowing a trust that is not entirely exempt from federal GST tax to be divided into separate exempt and nonexempt trusts will disappear in 2011. This could result in additional future federal GST tax. In 2009, the GST exemption was $3,500,000 and the tax rate was 45 percent. It is important to note that there is no GST exemption in 2010. Accordingly, if a trust is created in 2010 from which generation-skipping transfers may be made in subsequent years, there will be no GST exemption to allocate to the trust, at least until 2011. By then, the assets of the trust may exceed the GST exemption, with the result being a trust that is not entirely exempt from future federal GST tax.

Has the federal gift tax been repealed?

No, the federal gift tax is still in effect. However, the top rate drops to 35 percent in 2010 from 45 percent in 2009. The $1,000,000 lifetime exemption and the $13,000 annual exclusion remain unchanged from 2009. In 2011, the gift tax rate will increase to 55 percent. In addition, for 2010 there is a new provision, in section 2511(c) of the Internal Revenue Code, which could be interpreted to mean that a gift to a grantor trust (a common estate planning technique) is not a gift for federal gift tax purposes. Although this interpretation does not appear to have been intended, until the IRS provides guidance there will be great uncertainty with regard to gifts to grantor trusts.

Does the estate tax repeal have income tax consequences?

Accompanying the repeal of the federal estate tax in 2010 is the introduction of a modified carryover basis regime for inherited property. Prior to 2010, the income tax basis of inherited property was generally the fair market value of the property at the decedent's death, known as a stepped-up basis. This allowed assets to be sold immediately after death without incurring capital gains tax. Under the modified carryover basis regime, the income tax basis of inherited property is the lesser of the decedent's adjusted basis immediately before death or the fair market value of the property at death, with certain adjustments. Therefore, sales of assets inherited in 2010 are more likely to result in capital gains tax. An especially troubling aspect of the modified carryover basis regime is the burden of maintaining cost basis records for all assets. This could be particularly difficult for assets that have changed hands via gift or were purchased many years ago.

Under the modified carryover basis rules, three significant upward adjustments can be made to the basis of inherited property, but the increased basis cannot exceed the fair market value of the property at the decedent's death. First, $1,300,000 of basis can be added to the basis of the decedent's property. Second, the $1,300,000 amount is increased by capital and net operating loss carryovers and the amount of any built-in losses existing at the decedent's death. Third, the basis of property passing to a surviving spouse,

either outright or in a qualified terminable interest property (QTIP) trust, can be increased by an additional $3,000,000. A QTIP trust is a trust that pays all income to the surviving spouse and has no beneficiary other than the spouse during his or her lifetime. However, property held in a QTIP trust will not be eligible for the $1,300,000 basis increase at the surviving spouse's death. Many trusts that would qualify for the federal estate tax marital deduction if the estate tax were in effect may not be eligible for the $3,000,000 basis increase if death occurs in 2010. The $1,300,000 and $3,000,000 basis adjustments must be allocated by the executor. Most wills and trusts prepared before 2010 do not include provisions addressing the allocation of the basis adjustments.

Have state death taxes been repealed?

It is important to keep in mind that many states still have death taxes, with significant differences from state to state. For 2010, Illinois does not have an estate tax or a GST tax. In 2011, Illinois may or may not have an estate tax and a GST tax, depending on what Congress does with the federal estate and GST taxes.

Should estate plans be reviewed?

The new tax laws may affect estate plans in ways that were never intended. Before 2010, most estate plans were prepared under the assumption that the federal estate and GST taxes and the stepped-up basis rules would always be in effect. If death occurs in 2010, estate plans prepared under this assumption may not work as intended. For example, under some plans, a surviving spouse could be disinherited. In other cases, generation-skipping trusts that were intended to be created for descendants may not be created. Under many estate plans, heirs may be exposed to unnecessary capital gains taxes due to the modified carryover basis rules. Accordingly, all estate plans should be reviewed to ensure that assets will pass as intended and adverse tax consequences will be avoided or minimized should death occur in 2010.

Although all estate plans should be reviewed, an immediate review is imperative if (1) the estate plan was prepared before enactment of the 2001 Tax Act, (2) the estate plan was prepared after enactment of the 2001 Tax Act but was not specifically designed to work if the federal estate and GST taxes and stepped-up basis rules were repealed, (3) there are children from a prior marriage, (4) the estate plan provides for a transfer of an amount equal to the GST exemption, either outright or to a trust, (5) there is a significant risk of death in 2010 or (6) the estate plan includes an irrevocable trust that is not exempt from federal GST tax.

In many cases, a simple amendment will be sufficient to avoid problems under the new tax laws. In other cases, more significant revisions may be necessary. If your estate plan was prepared by Vedder Price after enactment of the 2001 Tax Act, it is likely that few, if any, changes will be required because most such plans were designed to work even if the federal estate and GST taxes and stepped-up basis rules were repealed. Nonetheless, we recommend that these plans be reviewed to ensure that assets will pass as intended and adverse tax consequences will be avoided or minimized should death occur in 2010.

In addition, all estate plans should be reviewed because the 2010 tax law changes may create estate planning opportunities, particularly for persons who take action early in the year.

Will existing estate planning documents still work in 2010?

Before 2010, most wills and revocable trusts were prepared under the assumption that the federal estate and GST taxes and the stepped-up basis rules would always be in effect. If death occurs in 2010, wills and revocable trusts prepared under this assumption may not work as intended.

For example, many wills and revocable trusts create marital and family trusts (sometimes known as "A and B trusts") upon the death of the first spouse to die under a formula that allocates an amount equal to the estate tax exemption to the family trust and the balance of the deceased spouse's estate to the marital trust. The marital trust is for the sole benefit of the surviving spouse during his or her lifetime, while the family trust is often created for the benefit of children or other descendants. The surviving spouse may or may not be a beneficiary of the family trust. The problem with this type of formula is that it may not be interpreted as intended if there is no federal estate tax in place. If death occurs in 2010, such a formula could be interpreted to mean that the entire estate is to be allocated to the family trust. If the surviving spouse is not a beneficiary of the family trust, as is often the case with large estates and in situations involving children from a prior marriage, the surviving spouse could be inadvertently disinherited.

Similarly, a will or revocable trust may include a provision giving an amount equal to the GST exemption to grandchildren or to a generation-skipping trust created for descendants. Because there is no GST exemption in 2010, nothing may pass to the grandchildren or the generation-skipping trust if death occurs this year.

The foregoing are only two common examples of provisions that could create significant problems should death occur in 2010. In general, all wills and revocable trusts using any type of formula should be reviewed to determine whether and how that formula will work should death occur in 2010.

Has Congress created an estate planning opportunity in 2010?

Yes, provided that Congress does not reinstate the federal GST tax and the 45 percent (or higher) gift tax rate retroactively to January 1 of this year.

For example, an individual who is contemplating making a large taxable gift in the next few years may want to make the gift early in 2010, when the maximum gift tax rate is only 35 percent. If the gift tax rate is not retroactively reinstated to 45 percent, the gift would produce significant tax savings, particularly if the federal estate tax rate increases to 55 percent next year. For a married person who is uncomfortable with the risk of retroactive legislation, the gift could be made to a QTIP trust created for his or her spouse. If the higher gift tax rate is reinstated retroactively, the donor could make an election on his or her 2010 gift tax return, which will not be due until April 15, 2011, to qualify the transfer for the marital deduction, in which case no federal gift tax will be due. If the higher gift tax rate is not reinstated retroactively, the donor could forgo the election, in which case federal gift tax would be due at a rate of 35 percent. In addition, the donor's spouse could disclaim all of his or her interest in the QTIP trust within nine months after the gift, in which case the trust would be distributed to the donor's children or other descendants. The advantage of making a gift to a QTIP trust is that it buys more time to decide whether or not federal gift tax should be paid.

Another planning opportunity is to make a distribution to a grandchild from a preexisting trust that is not exempt from federal GST tax. If the federal GST tax is not reinstated retroactively, the distribution will be free of federal estate or GST tax. Also, a gift could be made to a grandchild, either outright or in trust.

Although the gift will be subject to federal gift tax, it will avoid federal estate and GST tax if the federal GST tax is not reinstated retroactively. For those who are uncomfortable with the risk of retroactive legislation, it may be possible to make a distribution from a trust or a gift to a grandchild by means of a formula that would change the beneficiary from the grandchild to a child, depending on whether the federal GST tax is reinstated retroactively.

What will Congress do now?

Although it is impossible to predict what Congress will do, especially in an election year, there appear to be three likely scenarios. First, Congress may reinstate the federal estate, GST and gift taxes and the stepped-up basis rules, either as they existed in 2009 or with modifications, retroactively to January 1 of this year. Second, Congress may reinstate these taxes and rules, either as they existed in 2009 or with modifications, prospectively. In such a case, gifts that were made to generation-skipping trusts between January 1, 2010 and the effective date of the reinstatement may or may not be grandfathered from federal GST tax. Third, Congress may simply do nothing, in which case next year the federal estate, GST and gift taxes and the income tax basis rules for inherited property will revert to the law that would have been in effect had the 2001 Tax Act not been enacted. Unless Congress acts soon, the “do nothing” alternative may become more and more likely as we approach the November elections. To complicate matters, any retroactive legislation is likely to encounter a constitutional challenge, on due process grounds, that may end up in the U.S. Supreme Court and take years to resolve.

What should you do now?

Just because Congress has shown a propensity toward inaction does not mean that you can afford to take the same approach. To the contrary, there has never been a more important time than now to review your estate plan to be certain that it accomplishes your personal objectives in a tax-efficient manner.

If you have questions about how the tax law changes may impact your estate plan, please contact any member of the Vedder Price Estate Planning Group.

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For questions about estate planning opportunities created by the current economic environment, please contact any member of the estate planning group.

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The Estate Planning Group
Vedder Price P.C. has long recognized the importance of estate planning and has been at the forefront of this ever-changing area of the law. The firm's practice has both a national and an international scope. Vedder Price attorneys combine technical experience in all aspects of estate and financial planning with a strong appreciation of personal objectives and concerns in servicing clients in this uniquely personal area.

The firm represents clients with diverse personal objectives and financial interests, including individuals with large estates, individuals with personal situations requiring special planning, owners of closely held businesses, corporate executives and professionals. Vedder Price estate planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses and not-for-profit organizations, as well as other professionals who consult Vedder Price with respect to their own clients.

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