Unintended Consequences:
Repeal of Estate and GST Taxes in 2010

Provided by:

MRW FINANCIAL BROKERAGE

Life Insurance, Annuities and Long-Term Care

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA 2001) reduced estate and generation-skipping transfer (GST) tax rates and increased exemption amounts for the years 2002 through 2009. The Act then repealed estate and GST taxes for 2010.

The entire EGTRRA 2001, however, automatically terminates, or "sunsets," at the end of 2010, meaning that estate and GST taxes resume in 2011, generally as they existed in 2001.

It was assumed throughout 2009 that Congress would act to prevent the repeal of the estate and GST taxes in 2010 by, at a minimum, extending 2009 estate and GST taxation through 2010, when a more permanent reform of could be enacted for 2011 and beyond. That, however, did not happen...Congress did not take action and, effective January 1, 2010, the estate and GST taxes expired for 2010.

At first glance, many people might be tempted to say "so what, these are 'rich people's' taxes and of little or no consequence to anyone else." In reality, that's not the case and the current estate taxation environment could result in a number of unintended consequences that impact people of lesser means.

As you review the attached summary, pay particular attention to any provisions you feel may impact on your situation. If you would like additional information on the current estate tax environment or to discuss the impact of specific provisions on your planning, please call my office.

Table of Contents

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Current Estate Tax Environment:

Under current law, the estate tax does not apply to the estates of people who die after December 31, 2009 and before January 1, 2011.

For people who die after December 31, 2010, their estates will be taxed using 2001 tax rates as high as 55% and a unified credit equivalent of just $1 million, compared to a maximum 45% tax rate and $3.5 million unified credit equivalent in 2009:

2011 Federal Estate Tax Table

FOR A TAXABLE ESTATE FROM	TO	THE FEDERAL ESTATE TAX IS	OF THE AMOUNT OVER
$ 0	$ 10,000	18%	$ 0
10,000	20,000	$ 1,800 + 20%	10,000
20,000	40,000	3,800 + 22%	20,000
40,000	60,000	8,200 + 24%	40,000
60,000	80,000	13,000 + 26%	60,000
80,000	100,000	18,200 + 28%	80,000
100,000	150,000	23,800 + 30%	100,000
150,000	250,000	38,800 + 32%	150,000
250,000	500,000	70,800 + 34%	250,000
500,000	750,000	155,800 + 37%	500,000
750,000	1,000,000	248,300 + 39%	750,000
1,000,000	1,250,000	345,800 + 41%	1,000,000
1,250,000	1,500,000	448,300 + 43%	1,250,000
1,500,000	2,000,000	555,800 + 45%	1,500,000
2,000,000	2,500,000	780,800 + 49%	2,000,000
2,500,000	3,000,000	1,025,800 + 53%	2,500,000
3,000,000	10,000,000	1,290,800 + 55%	3,000,000
10,000,000	17,184,000	5,140,800 + 60%	10,000,000
17,184,000	Infinity	9,451,200 + 55%	17,184,000
Applicable Unified Credit:	$345,800	**Unified Credit Equivalent:**	$1,000,000

Current Estate Tax Environment: Unintended Consequence:

Surviving spouses could find themselves left with nothing if the will in place at a deceased spouse's death was a "credit trust" or "bypass trust" or "family trust" will.

A common estate planning technique has been to direct assets not subject to the estate tax to a trust for the benefit of children and/or grandchildren, with the balance directed to the surviving spouse. In the case of death in 2009, for example, this type of will arrangement would have resulted in an amount equal to the estate tax-free $3.5 million unified credit equivalent being placed in trust for the children/grandchildren, with the surviving spouse receiving the balance of the taxable estate. Through use of the unlimited marital deduction, however, the assets passing to the surviving spouse would have escaped estate tax.

What happens under this will arrangement if a spouse dies in 2010?

Since none of the estate is subject to estate tax, everything could end up going into a trust for the benefit of children/grandchildren, with nothing left to the surviving spouse. While most states allow a disinherited spouse to claim a portion of the estate, the process can be time-consuming and expensive.

What should you do?

Review your estate planning documents to see if they contain "formula clauses" designed to take maximum advantage of the estate tax unified credit exemption. A formula clause generally relates to the unified credit exemption, and not to a specific sum of money. Consider consulting your attorney to determine if your current estate planning documents reflect your intent if a spouse should die in 2010. If not, an amendment might be necessary.

Step-Up in Basis:

For income tax purposes, property received from a decedent generally receives a "step-up" in cost basis to its fair market value on the date of death (or the alternate valuation date).

For example, if property that was purchased for $100,000 has a fair market value at death of $1 million, the recipient of that property from the decedent has a cost basis of $1 million…the basis is "stepped-up" by $900,000 to its fair market value at death. This step-up in basis can provide significant capital gains tax relief to a recipient who later sells the property and then has a $1 million cost basis instead of the original $100,000.

Together with repealing the estate tax in 2010, the Economic Growth and Tax Relief Reconciliation Act of 2001 **replaces the step-up in basis with a modified "carryover" basis in 2010**:

- Step-up in basis is retained for up to $1.3 million of property acquired from a decedent.

- For certain transfers to a spouse, step-up in basis will be available for an additional $3 million of property acquired from a decedent ($60,000 in the case of a decedent nonresident who is not a U.S. citizen).

- For all other property, the cost basis of the person acquiring the property from a decedent will be equal to the **lesser** of (1) the adjusted cost basis of the decedent (carryover basis) or (2) the fair market value of the property at the date of the decedent's death.

- Information returns dealing with the value of carryover basis property will be required.

Without future Congressional action to the contrary, the step-up in basis at death will be reinstated in 2011.

Step-Up in Basis: Unintended Consequences:

Assets inherited in 2010 in excess of $1.3 million could trigger big income tax bills for beneficiaries and record-keeping headaches for executors.

In addition to wealthy families, moderately well-off families may face a number of consequences if a death in the family takes place in 2010 and the modified carryover provisions apply:

- Taxpayers may have to provide documentation proving the cost basis of assets (in some cases assets that may have been in the family for decades).

- Executors may be forced to decide which beneficiaries get the step-up in basis property and the income tax benefits that go with it ($1.3 million of property with a surviving spouse entitled to an additional $3 million).

- Significant capital gains tax liability may be created on inherited assets. In our earlier example, in 2010 the beneficiary inheriting and then selling the $1 million asset that was originally purchased for $100,000 may have to pay capital gains tax on the $900,000 difference, plus on any gain in value above $1 million at the time of sale.

Barring a change in the law, the step-up in basis returns in 2011. In the meantime, the executors of decedents who die in 2010 face a potential record-keeping nightmare if the estate exceeds $1.3 million.

Generation-Skipping Transfer Tax:

The generation-skipping transfer (GST) tax is a tax on transfers to a "skip person" (i.e., a person two or more generations younger than the transferor, such as a transfer from a grandparent to a grandchild). The Economic Growth and Tax Relief Reconciliation Act of 2001 made several changes to the GST tax:

- The generation-skipping transfer tax rate was gradually reduced from 50% in 2002 to 45% between 2003 and 2009.

- The generation-skipping transfer tax exemption was gradually increased from $1,100,000 in 2002 to $3,500,000 between 2004 and 2009.

The generation-skipping transfer tax is then repealed for 2010, meaning that high net-worth individuals can make substantial gifts to grandchildren that are subject only to the gift tax**.**

Without future Congressional action, the 2001 GST tax rules will be reinstated in 2011, with a top tax rate of 55% and a $1 million exemption.

Generation-Skipping Transfer Tax: Unintended Consequences:

On the face of things, 2010 would appear to be a great year for wealthy grandparents to give assets directly to grandchildren. Not only is there no generation-skipping transfer tax, but the value of those assets are then removed from the grandparents' estate for future estate tax purposes. There is, however, a potential "catch."

It is widely believed that Congress will reinstate the generation-skipping transfer tax and that reinstatement will be retroactive to January 1, 2010.

Since there is some question as to the constitutionality of a retroactive reinstatement, wealthy grandparents may want to take advantage of this potential opportunity to make substantial gifts to their grandchildren free of the GST tax by stipulating that they can take the gifts back if the current 2010 GST tax laws change. **This should not be done, however, without consulting a legal professional experienced in estate and gift tax matters.**

What Does the Future Hold?:

Considering that Congress has had eight years to address the 2010 repeal of the estate and generation-skipping transfer taxes, it's tempting to answer that question with a "Who knows!"

If Congress does nothing:

- The estate and generation-skipping transfer taxes will not apply in 2010 and the step-up in cost basis will not be available for inherited assets over $1.3 million ($3 million additional for surviving spouses).
- The estate and GST taxes will then reappear in 2011 with a "bang" at their much higher 2001 levels...a top marginal tax rate of 55% and a $1,000,000 unified gift and estate tax exclusion amount...and step-up in cost basis will return.

If Congress acts:

- It is widely believed that Congress will reinstate the estate and generation-skipping transfer taxes for 2010 and will make that reinstatement retroactive to January 1, 2010.
- The likelihood is that Congress will reinstate the estate and GST taxes at their 2009 levels for 2010 only, retroactive to January 1, and then address permanent reform for 2011 and beyond.
- There is disagreement among tax lawyers about the constitutionality of a retroactive reinstatement. While there have been Supreme Court cases that upheld the constitutionality of retroactive tax provisions, some tax practitioners predict there will constitutional court challenges, particularly if many months pass before the reinstatement is made retroactive and estates have been settled during that time period when the estate tax was repealed.