



## Death and Taxes

Summer 2010

### What the Heck is Going on with the Estate Tax?

According to Ben Franklin, “nothing can be said to be certain, except death and taxes.” Today, due to legislation signed by President George W. Bush in 2001, nothing is more uncertain than the confluence of death and taxes—the federal estate tax.

Enacted in 1916, this tax applies to wealth transferred to beneficiaries upon the death of the property owner. There are several, fundamental moving parts—from the basic to the arcane—that must be navigated for the purposes of planning.

- 1) the exemption amount (the value of property at death above which tax is imposed upon),
- 2) the marital deduction for property passing to a surviving spouse,
- 3) the charitable deduction, and
- 4) the tax rate on the taxable estate.

Of course, estates face a myriad of collateral issues, such as

- the successor’s cost basis for inherited property,
- the Generation Skipping Transfer Tax (GSTT) when grandchildren and beyond benefit, and
- the federal gift tax imposed on total lifetime transfers above \$1,000,000.

Most taxpayers will need to tend to the basics. For others, execution of an intricate strategy through a highly skilled team of professionals may be advised.

### A Tortured History

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) raised the estate tax exemption gradually from \$675,000 in 2001 to \$3.5 million in 2009; lowered the maximum estate tax rate from 55% to 45%; eliminated the estate tax and the GSTT in 2010 only; and sunsets on December

#### Summary

Get your sense of humor ready if you need to tackle estate tax planning adjustments in 2010. The tug-of-war between the conservative and moderate/liberal sides of Congress has left families and estate planners in a legislative morass until the end of the year. From changes in the exemption amounts to impacts on what carry-over basis is used, the EGTRRA mess inherited by the Obama administration will require agility to navigate.

31st of this year—restoring prior law and satisfying the Byrd rule (for Senator Robert Byrd) against increasing the deficit for more than ten years. That makes the 2011 exemption amount \$1 million.

EGTRRA also contained another significant provision for deaths occurring only in 2010; namely changing the rule that “steps-up” the tax basis of inherited property from fair market value on the date of death to a “carry-over” basis (subject to certain exemptions.) This means, for example, that inherited shares of Microsoft purchased decades ago for \$10,000 and worth \$1,000,000 on a date of death occurring some time in 2010 would potentially be subject to capital gains tax on \$990,000 when sold, rather than receiving a “fresh start” basis of \$1,000,000. Limited exemptions provide that the executor may designate \$1.3 million of assets for stepped-up basis for any beneficiary and an additional \$3 million of stepped-up basis for a surviving spouse.

This chaotic state of affairs is the result of a political tug-of-war between conservatives who are bent on permanent repeal and moderates and liberals who want to retain the estate tax in some form. Regardless of the effects, both sides want to be able to blame the other for the turmoil.

### Talk About a Moving Target

Given the cost, complex planning, time, and emotional commitment that goes into a sound estate plan, families want one that, unrevised, works for five to ten years. The current legislative morass makes it unlikely that a plan could be optimal for deaths in 2009, 2010 and beyond. Of course, unless someone is extremely advanced in age or gravely ill, death in 2010 is unlikely. However failing to plan for that possibility may have considerable repercussions.

A typical estate plan consists of two (or more) trusts: one maximizes the exemption amount (a credit-shelter or family trust), the other captures the unlimited marital deduction. Properly drafted and funded, the two trusts eliminate estate taxes in an amount of family wealth equal to twice the exemption amount following the death of both spouses. As a result, the changes in the exemption amount could lead to a difference of millions of dollars for a given estate for a 2010 death vs. a 2011 death.

To further muddy the waters, lawyers have their preferred ways of defining and structuring these trusts. A favored formula funds the credit-shelter trust with “the maximum amount that can pass free of the federal estate tax” with the balance funding the marital trust. Upon a death in 2010 (no estate tax), this formula would place the entire estate in the credit-shelter trust and none in the marital trust—a potentially disastrous result in a situation where the two trusts have different terms and even different beneficiaries; such as in the case of a second marriage, where the credit-shelter trust might limit the income to the surviving spouse and ultimately benefit the children of a prior marriage.

Further, planning for the estate tax generally contemplates dividing assets by value. However, planning for modified carry-over basis for a possible death in 2010 suggests dividing assets on account of unrecognized gain. This likely will be a different amount and different assets than would pass to a surviving spouse under previous plans. Taxpayers with significant unrecognized gains may in particular want to review their plans.

## Will There be a Fix?

Only the most cynical thought we would be here today, with most practitioners confident of resolution before January 1, 2010. The House passed a bill making the 2009 rules permanent—the Senate never acted. President Obama's proposed budget includes similar provisions.

Could we see legislation retroactive to January 1st? Such an act might not be constitutional, and families could wait decades for the courts to decide—which could take years. In the face of such uncertainty, Congress is unlikely to pass a retroactive solution the further we get into 2010.

For those families and their advisors willing to wade into this mire together, extreme flexibility would be in order. Not to mention a sense of humor.