



The Wealth Counselor

A monthly newsletter for wealth planning professionals

The State of the Federal Estate Tax

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Since 2001, when President George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) into law, we have known that the federal estate tax and generation-skipping transfer tax (GSTT) was scheduled for a one-year suspension beginning January 1, 2010, with the twist that basis adjustment at death would be limited for 2010 decedents. But even though that's what the law *said*, few, if any, of us thought Congress would actually allow it to happen. Nor did we think that the "sunset" would play out on December 31, 2010 and that those taxes would revert to their 2001-level exemptions rates.

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Estate Planning, Business
Planning and Wealth
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How Did We Get Here?

EGTRRA was designed to provide significant tax relief, including "permanent" relief from the federal estate tax. Under EGTRRA, the maximum estate tax and GST tax rate steadily lowered to 45%, while the tax exemption amounts increased to \$3.5 million. Under EGTRRA, in 2010, the federal estate and GST taxes went away completely, but with a twist and only for that one year. Because of the Senate rule that would have required an unattainable 60 votes for permanent repeal, EGTRRA was enacted with a "sunset" provision. Thus, on January 1, 2011, unless the Congress acts, the federal estate and GST tax laws will revert back to their pre-EGTRRA levels. The federal estate and gift tax exemptions will be unified at \$1 million and the GST tax exemption will be \$1 million, adjusted for inflation and the maximum rate will be increased from 45% to 55%.

What Will Congress Do Now?

In short, no one knows! In fact, considering recent history it is impossible to know if Congress will do anything at all. After the 2010 midterm elections, some have suggested that split control of Congress favors Congressional inaction. See *Results Of Midterm Elections Do Not Bring Certainty To The Federal Estate Tax* (Forbes 11/10/10), online at <http://tinyurl.com/http-Forbes-article-link>. See also *Election Results Are In...So Where Does That Leave The Estate Tax?: Split control of Congress doesn't bode well for action* (Trusts & Estates Journal, 11/9/10), online at <http://tinyurl.com/http-T-E-article-link>.

Planning Tip: No matter what happens, retroactive reinstatement of the federal estate tax seems highly unlikely. Several American billionaires have died since January 1, 2010, including Houston pipeline tycoon Dan L. Duncan and New York Yankees owner George Steinbrenner. With such vast estate values in the balance, heirs would certainly challenge the constitutionality of a retroactive estate or GST tax law. The Congress is well aware that a retroactive estate or GST tax law would be in legal limbo for however many years it took to get a U.S. Supreme Court decision.

One option under consideration by Congress is giving the estates of those who died in 2010 the choice of using the 2009 law (i.e., \$3.5 million federal estate tax exemption and maximum 45% rate) or the 2010 law (i.e., no estate or GST tax, but modified carryover basis).

Planning Tip: A choice between the 2009 and the 2010 law would require the planning team's careful analysis of the 2010 decedent's asset mix, historic gains, tax rates, and the timing and likelihood of sale of those assets in the future.

Modified Carryover Basis for 2010 Only

Before January 1, 2010, subject to some exceptions, inherited assets came with a new basis - fair market value at date of death. Thus if a client died owning publicly-traded securities bought many years ago, the beneficiaries could sell the stock shortly after the client's death and pay little or no income tax. The only tax the beneficiaries would have to pay would be on the difference between the sale price and the fair market value on the date of death. (Of course, the stock would also be included in the client's gross estate for estate tax purposes.)

Under EGTRRA, however, in 2010 alone the rules are different: A 2010 decedent's estate would have \$1.3 million in basis adjustment to allocate (plus in some cases an additional \$3 million for assets going to a surviving spouse). For other assets, the new basis would be the *the lesser of* the decedent's basis or the asset's fair market value on the decedent's date of death. Thus, EGTRRA eliminated the automatic 100% "step-up" to the date-of-death value but retained a "step-down" for depreciated assets. Significantly, *that modified carryover basis system could impact far more people than the estate tax ever would!*

Adding insult to injury, because of the EGTRRA "sunset" provisions, what the basis will be for an asset inherited in 2010 but not disposed of until after 2010 is uncertain. It may have the limited basis adjustment of the 2010 modified carryover basis rules or it may have the full step-up in basis. It will be up to the courts to decide.

Problems with Pre-2010 Planning and 2010 Deaths

The elimination of the estate and GST tax for 2010 can have unintended consequences. Some plans fill up the family trust and some use up the remaining estate tax exemption. For a 2010 death, in the first case, the marital trust will go unfunded and in the latter, the marital trust will be overfunded at the expense of an unfunded credit-shelter trust. If the

clients are in a second marriage with his and her children, neither result is likely to be what they had in mind. Life estates and some QTIP trusts also can have unintended results with a 2010 death.

That being said, the odds that a client will want to make estate plan changes now in case of a 2010 death are extremely low unless death becomes imminent. All planning team members have made our clients aware of the need to look at their plans because of the 2010 anomaly and if they haven't done so yet, they probably aren't going to now. However, we could remind them one more time while advising them of the need to look at year-end actions to consider taking if it looks like the Congress will remain in stalemate on income and estate tax issues. And, if you hear of a client who is seriously ill, do not hesitate to raise the 2010 anomaly issues just in case.

Planning Tip: Where the family and marital trusts have identical beneficiaries and dispositive provisions, as is typical in nuclear families, a 2010 death will have no non-tax significance. However, if the family and marital trusts contain different beneficiaries or different dispositive provisions (such as in second marriage situations with his and her children), a 2010 death may cause dire consequences to the beneficiaries of the family trust or to the surviving spouse, depending on the division language used.

Planning Tip: If the clients' A-B trust division is based on using up the estate tax exemption, a 2010 death could mean not using the available credit-shelter trust planning, thereby exposing all of their assets to estate tax when the surviving spouse dies.

What Should Clients Do Now?

Clients should be reminded that a 2010 death can have unintended estate and tax consequences so that, if serious illness strikes before the end of the year, the team can be consulted.

For all clients, the key in today's uncertain environment is flexibility. Their plans can and should have sufficient flexibility to accomplish their goals no matter what - whether the "what" is a 2010 death or Congressional action or inaction.

With the deficits projected for the next few years at least, clients would be well advised to anticipate higher tax rates and lower exemptions for both estate and income taxes. That means that many clients who had assumed that they would not have taxable estates need to reexamine their assumption. There are also 2010-only opportunities for clients who will have taxable estates as long as there is an estate tax. Some of the planning opportunities that may now be of interest to clients are:

- Moving client-owned life insurance into an Irrevocable Life Insurance Trust (ILIT);
- Buying life insurance in an ILIT to provide liquidity to pay estate taxes;
- Doing charitable planning, including Charitable Remainder Trusts (CRTs) for

- highly appreciated property; and
- Using Testamentary Charitable Lead Trusts (TCLATs) to "zero out" the estate tax.

Other advanced estate tax avoidance strategies, such as Grantor Retained Annuity Trusts (GRATs), tax-burn trusts, installment sales to "defective" grantor trusts, and Qualified Personal Residence Trusts (QPRTs) will be attractive to more clients if we go back to a \$1 million estate tax exemption.

For 2010 year-end planning, clients with taxable estates should consider making:

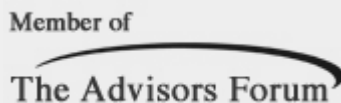
- Taxable gifts (to take advantage of the 2010-only 35% gift tax rate);
- Outright gifts to grandchildren while there is no GST tax (consider gifts of LLC interests, rather than outright gifts, for purposes of control); and
- Loans to family members to take advantage of historically low interest rates.

Clients with 401(k), 403(b) or IRA accounts should assess whether they would benefit from 2010 Roth conversions if it looks like the Congress will not extend the "Bush Era" income tax cuts applicable to them.

Conclusion

We strongly encourage all clients to review their estate plans to ensure that their plans continue to meet their objectives while minimizing *all* taxes, including state and federal estate tax as well as income tax. Now is the time for the planning team to encourage clients to move forward with planning to ensure that the clients meet their goals and objectives in retirement and upon disability or death.

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