ONE HOUR CLE CREDIT

ESTATE OF CONFUSION: FEDERAL ESTATE TAX "REPEAL" AND CARRYOVER BASIS

BY NICOLE M. VANCE, ESQ.

Inconceivable, unthinkable, incredible, unbelievable...no words appropriately describe the effect of the estate tax "repeal" and related changes. Although some compare the situation to an earthquake and aftershocks to be felt for years, this may seem quite an exaggeration. After all, for many, the estate tax matters little and affects daily life even less. Certainly the repeal is not a life or death matter...except technically. In all seriousness, however, for estate planners and their clients, the repeal and ensuing uncertainty give rise to significant issues, numerous questions and few answers.

Federal Transfer Taxes & Existing Law

To appreciate the repeal's significance, an understanding of transfer taxes is necessary. Transfer taxes apply to wealth transfers in excess of "exemption amounts"[1] set forth by law. There are three transfer taxes – the estate, gift and generation-skipping transfer (GST) taxes.

The estate tax applies to transfers at death. Last year the maximum rate was 45 percent with a $3.5 million exemption. The gift tax applies to transfers during life. In 2009 the top rate was 45 percent with a $13,000 annual exemption and a $1 million lifetime exemption. Therefore, an individual could transfer, free of gift tax, up to $13,000 per year to any number of people plus an additional $1 million during life. The GST tax applies in addition to estate and gift taxes and is imposed on transfers to grandchildren, certain other individuals and trusts.[2] In 2009 GST tax applied at a 45 percent flat rate with a $3.5 million exemption.

Under existing law, transfer taxes significantly changed this year and will change again next year. The 2001 law that triggers such changes (EGTRAA) was enacted when economists were projecting budget surpluses of several trillion dollars over the next decade. Accordingly, the intent was to return surpluses to taxpayers through tax cuts, including rate decreases from 55 percent to 45 percent, exemption increases from $675,000 to $3.5 million, and elimination of estate and GST taxes for 2010.[3] Under EGTRAA's "sunset" provision,[4] all changes expire December 31, 2010, and estate and GST taxes return in 2011 at higher rates with significantly lower exemptions. So what is the current status?

Current Status: No More Estate Tax?

Estate planners often hear statements that "the estate tax is finally gone" and "this year is a good year to die." Aside from the fact that there is never a good year to die, these statements are incorrect because they are incomplete. Although the estate tax has been repealed, the cumulative effect of EGTRAA is that a capital gains tax has replaced the estate and GST taxes for 2010. Nonetheless, there has been much speculation around the repeal and certain key facts often get lost in the hype.

First, the "new" capital gains tax for 2010 will in many cases offset the advantages of the estate tax repeal. This tax is arguably more onerous as it applies to all beneficiaries, whereas the estate tax is expected to apply to less than two percent of 2009 estates.[5] In addition, significant complexity and uncertainty exist regarding the tax and related reporting requirements. Second, the repeal is for

2010 only and consequently is not a true repeal.

The repeal and related issues can have a catastrophic effect on existing estate plans. Therefore, it is important to understand key changes for this year and anticipated changes for next year.

2010 & 2011 Key Changes

The estate and GST taxes have been repealed for 2010; however, Congressional action could reinstate both before year-end. Absent such action, the taxes return in 2011 at a maximum rate of 55 percent (with a 5 percent surcharge for estates valued between $10 million and $17.184 million) and a considerably lower $1 million exemption.

The gift tax remains for 2010 but the top rate decreases from 45 percent to 35 percent. The $13,000 annual exemption and $1 million lifetime exemption stay constant. Absent Congressional action, the maximum rate increases to 55 percent in 2011 and the lifetime exemption remains the same.

Finally, for 2010, changes in basis determination rules can result in the "new" capital gains tax. The step-up basis rules from 2009 and previous years no longer apply but return in 2011. So how have the basis rules changed?

Changes in Basis Rules

By way of background, capital gains tax typically arises upon sale of a capital asset if the asset's fair market value exceeds its cost basis. The cost basis is the amount paid for the asset, including improvement costs.

In 2009 and prior years, capital gains were determined under a step-up basis regime. Under this regime, the basis of a deceased person's heirs in inherited assets is the assets' date of death value.[6] Since the heirs' basis is the date of death value, immediate sale of the asset does not result in capital gain.

This year the step-up basis rules no longer apply.[7] Rather, capital gains are calculated under a modified carryover basis regime. Under this regime, the heirs' basis in inherited assets is equal to the lesser of (1) the deceased person's asset basis or (2) the date of death value of assets.[8] As compared to the step-up basis regime, immediate sale of an appreciated asset results in capital gain.

The new regime permits limited basis increases through two adjustments. The general adjustment allows increases up to $1.3 million[9] and applies to property passing to anyone, including spouses.[10] The spousal adjustment provides for increases up to $3 million in addition to the general adjustment[11] but is allowed only for property passing to a spouse. Basis increases under these adjustments are limited to the asset's date of death value.

For example, assume that: (1) John dies, leaving his son all assets; (2) John's basis in the assets is $7 million; and (3) the assets' date of death value is $10 million. Under a step-up basis regime, John's son takes a basis of $10 million in the inherited assets. Upon immediate sale, there is no capital gain because basis and value are the same.

Under the 2010 modified carryover basis regime, there is no longer a full basis step-up. Instead, John's son takes John's $7 million basis and receives an increase only as allowed by the adjustments. John's son can use the $1.3 million general adjustment but not the $3 million spousal adjustment. Thus, the son's basis is $8.3 million ($7 million carryover basis + $1.3 general adjustment). Upon asset sale, John's son will have capital gain of $1.7 million ($10 million value - $8.3 million basis). If John's assets passed to a spouse, the spousal adjustment could have been used to eliminate capital gain.

Clearly, the difference in results can be significant. These and other changes for 2010 and 2011 create a particularly challenging planning environment. Moreover, these changes trigger issues in existing estate plans.

Issues with Existing Estate Plans

Existing estate plans and related documents often include language based on transfer tax concepts that no longer apply in light of the repeal. In addition, many documents do not include language addressing the repeal.

One critical issue with existing plans is unintentional disinheritance of family, including spouses, children and grandchildren. This is

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possible because formula clauses based on transfer tax concepts may no longer operate as intended. For example, if a children's trust is funded with assets equal to the "exemption amount," children could be disinherited because there is currently no estate tax, thus no exemption amount. There may be income tax issues as well. Specifically, basis rules may result in unanticipated capital gains, inability to use the spousal basis adjustment and problems determining, tracking and reporting basis.

In summary, the widespread belief that it is best to "wait and see what happens" with the tax laws before revisiting estate plans can cause significant problems. Existing estate plans and related documents should be reviewed and updated as necessary while we await resolution.

Potential Outcomes

We will likely end up with one of three outcomes. First, Congress could do nothing, resulting in higher rates and lower exemptions for 2011. In such case, a $5 million estate would result in a $2.2 million estate tax. In contrast, the 2009 tax would have been $675,000, a difference of more than $1.5 million! Second, Congress could enact legislation effective at enactment or another specified date. Finally, Congress could enact legislation effective retroactively to January 1, 2010.

Legislation could either reinstate the 2009 tax regime or establish new rates and exemptions. Congressional leadership has expressed intent to pursue retroactive legislation to reinstate the 2009 regime, and this would certainly give rise to a constitutionality challenge. Although retroactive tax legislation seems intuitively unfair, such legislation has passed muster before, and many estate planners believe constitutionality would be upheld.

Note that Congress is also contemplating other changes, including valuation discount limitations and imposition of restrictions on grantor retained annuity trusts. Such changes could dramatically limit use of advanced planning techniques currently available to minimize transfer taxes.

Conclusion

In conclusion, I revisit the often-asked but unbelievable question – should one die this year? The answer is no. Enjoy your life, your health, your family and friends, but understand the transfer tax uncertainty, advise clients accordingly and update your estate plan. Do not leave an estate of confusion. ■

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1 The terms "exemption" and "exemption amount" are not technically correct because the calculation of estate tax involves a credit rather than a true "exemption." The tax due on a taxable estate is reduced on a dollar for dollar basis by the "unified credit" allowed under IRC Section 2010. Since this credit is often referred to as the "exemption equivalent," throughout this article this exemption equivalent amount will be referred to as the "exemption" or "exemption amount."
2 IRC Section 2613.
3 The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16
4 P.L. 107-16, Section 901.
5 Leichter, Elaine M., A Critical Moment to Review Your Estate Planning Documents: 2010 "Repeal" of the Federal Estate Tax (February 2010).
6 IRC Section 1014(a).
7 IRC Section 1014(f).
8 IRC Section 1022(a).
9 IRC Sections 1022(b), 1022(d)(2).
10 The general adjustment may also be increased for certain built-in losses and loss carryovers.
11 IRC Sections 1022(c), 1022(d)(2).

{Test #7}

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Questions: Answer True or False.

1. The three federal transfer taxes are the estate tax, the gift tax and the GST tax.
True or False

2. The maximum estate tax rate for 2009 was 55 percent.
True or False

3. At the time of enactment of EGTRAA, economists were projecting budget deficits, and the intent behind EGTRAA was to ultimately increase taxes to help minimize such deficits.
True or False

4. The cumulative effect of EGTRAA for 2010 is that the federal estate and GST taxes have been replaced with a capital gains tax.
True or False

5. 5. For 2010 the gift tax remains in effect at a higher rate and lower exemption.
True or False

6. Under the 2009 step-up basis regime, the basis of a deceased person's heirs in inherited asset is equal to the decedent's basis in the assets prior to death.
True or False

7. For 2010, there is a modified carryover basis regime in place.
True or False

8. The best course of action is to "wait and see what happens" with the federal transfer tax laws before reviewing existing estate plans.
True or False

9. If Congress attempts to pass legislation making the 2009 transfer tax regime retroactive to January 1, 2010, there would likely be a constitutional challenge.
True or False

10. Under existing estate plans, surviving spouses and children may be unintentionally disinherited.
True or False

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