



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Planning After "Repeal" of the Federal Estate Tax

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From its inception, the 2001 tax act was scheduled to repeal the federal estate tax and generation skipping transfer tax (GSTT) for one year beginning January 1, 2010. This should come as no surprise. What is surprising, however, is the fact that the 2001 tax act has now played out and repeal, at least temporarily - and unless reinstated retroactively - is upon us. This issue of *The Wealth Counselor* explores how we got here (which may be instructive as to what will happen in the future) as well as some of the planning implications of no federal estate tax or GSTT for at least some part of 2010.

How Did We Get Here?

On June 7, 2001, President George W.

Bush signed into law the much-heralded Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), designed to provide significant tax relief, including "permanent" relief from the federal estate tax (with its then \$675,000 exemption and maximum 55% tax rate).

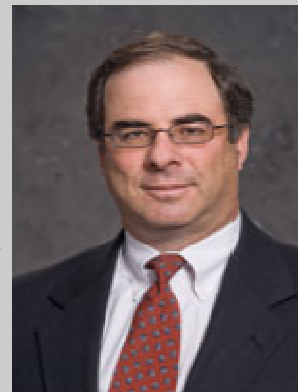
As we know, EGTRRA steadily lowered the maximum estate tax and GSTT rate to 45%, while increasing the exemption amounts to \$3.5 million in 2009 and eliminating federal estate tax and GSTT altogether in 2010. However, as a result of a Senate rule that limits laws with a negative fiscal impact to 10 years (the so-called Byrd Rule), from inception EGTRRA contained a "sunset" provision. Under this provision, as of January 1, 2011, the law is scheduled to revert back to pre-EGTRRA law as if EGTRRA never existed. In other words, the federal estate tax and GSTT exemption will become \$1 million (it was scheduled to increase under prior law) with a maximum rate of 55%.

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Planning Tip: As a result of the Byrd Rule, practitioners should accept with caution EGTRRA interpretations that offer tax savings beyond 2010.

Planning Tip: In 2010 the estate tax and GSTT are replaced by a modified carryover basis system. The impact of modified carryover basis is discussed more fully below.

What Will Congress Do Now?

No one knows with certainty what Congress will do to remedy this situation but several key Congressmen have stated publicly that they will attempt to pass estate tax legislation early in 2010. One of them, Senator Max Baucus, Chairman of the Senate Finance Committee, has said that swift action is necessary to prevent "massive, massive confusion."

Furthermore, many in Congress have expressed the desire to make such legislation retroactive to January 1, 2010. If Congress purports to make these tax charges retroactive to January 1, there are sure to be numerous lawsuits over the constitutionality of such retroactivity and, in all likelihood, these challenges would not be resolved until after years of litigation culminating in a Supreme Court decision. Where would that leave clients who die in the interim?

Planning Tip: It is not a foregone conclusion that Congress can make the estate tax legislation retroactive to January 1, 2010. Chief Tax Counsel to the House Ways and Means Committee, John Buckley, has opined publicly that reinstating the estate tax retroactive to January 1, 2010, would be unconstitutional.

Cynics, however, note that these same Congressmen were unable to pass a one-year patch that would have eliminated the confusion in the first place. They also suggest that it is in the best interest of both Democrats and Republicans to do nothing and let EGTRRA sunset - and their argument has gained traction recently.

The argument is as follows: Democrats have incentive to do nothing because this law was passed by a Republican Congress and signed by a Republican President - they have no responsibility for the insanity caused by the sunset. Republicans, alternatively, are incentivized to do nothing because they have steadfastly argued for total repeal of the "death tax," and this cry - at least in 2001 - resonated with the American people. Their argument is that Democrats had the opportunity to permanently end the "death tax" and chose not to. In what potentially will be a significant mid-term election, many in Congress will likely use their position on the "death tax" in an attempt to ensure reelection.

Planning Tip: Given the above factors, the most likely outcome for the estate tax will depend upon the other pressing priorities on Capitol Hill.

Modified Carryover Basis

Under our current estate tax system, subject to some exceptions, assets owned at death receive a basis "step-up" to their fair market value at the time of death. Therefore, if your client dies owning Walmart stock that he or she bought for \$10,000 many years ago, for example, the beneficiaries could sell the stock at its fair market value of, say, \$10 million, 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 at death. (Of course, the stock would also be subject to estate tax at the client's death.)

Under EGTRRA, along with repeal of the estate tax and GSTT in 2010, a beneficiary receives property with an adjusted basis equal to the lesser of the decedent's basis or the asset's fair market value on the decedent's date of death. Thus, EGTRRA eliminates the automatic "step-up" to the date of death value but retains the "step-down" for depreciating assets.

Planning Tip: Modified carryover basis will impact far more decedents than those who would have been impacted by the estate tax, 70,000 versus 6,000 according to some estimates.

To offset this loss of the step-up in basis, EGTRRA provides that the executor (or other person responsible for the decedent's property) may allocate a \$1.3 million "aggregate basis increase" on an asset-by-asset basis up to the particular asset's fair market value at the date of the decedent's death. Assets left to a spouse may receive an additional \$3 million "spousal property basis increase," also asset-by-asset, up to the particular asset's fair market value at the date of the decedent's death.

Planning Tip: Unless one can affirmatively prove the basis of an asset, the IRS presumes that the asset has a basis of the property's approximate fair market value on the date it was acquired by its last owner. Therefore, it is absolutely critical that clients keep adequate records for all assets.

Planning Tip: It is worth noting that Congress instituted modified carryover basis one other time in history and repealed it retroactively because of the difficulty in administration.

Lifetime Powers of Appointment

Under current law, for purposes of the basis step-up, a surviving spouse owns property in a marital trust over which that spouse has a ***lifetime or testamentary*** power of appointment. However, for purposes of the \$3 million spousal property basis increase, only a QTIP trust is eligible and EGTRRA treats property in a QTIP trust over which the surviving spouse has a lifetime power of appointment as not owned by that spouse. Thus, if the surviving spouse has a ***lifetime*** power of appointment over the QTIP trust the executor (or other person responsible for the decedent's property) cannot allocate the spousal basis increase to marital trust property. Alternatively, the executor can allocate the spousal property basis increase to QTIP property over which the surviving spouse has only a ***testamentary*** power of appointment.

Planning Tip: The planning team should review clients' marital trusts carefully to ensure availability of the spousal property basis increase.

The Impact on Existing Estate Plans

Residuary Marital Trust Formula Funding Clauses

Under a typical living trust or will, the document creates at least two trusts, a credit shelter (aka bypass or Family) trust and a marital trust. Often, the living trust or will language divides the decedent's property into the two trusts through what is known as a residuary marital trust formula funding clause, as follows: the amount of the decedent's property that will pass to the credit shelter trust equals the "maximum amount that can pass free of federal estate tax;" the balance of the decedent's assets pass to the marital trust.

If the client created this estate plan when the federal exemption was significantly lower, and in particular if the client dies in 2010, this common estate planning language will cause the unintentional over-funding of the family trust and under-funding of the marital trust. Where the family and marital trusts contain identical beneficiaries and dispositive provisions, this over-funding of the family trust and under-funding of the marital trust will have no significance. However, if the family and marital trusts contain different beneficiaries and/or different dispositive provisions, this may cause unintended and undesirable consequences to the client.

Planning Tip: The planning team should review all estate plans created more than five or so years ago to ensure that each plan meets the client's current planning objectives. The planning team should also review every estate plan created before 2001 to review the formula-funding clause.

For example, with second or subsequent marriages, and in particular where there are children from a prior marriage, the client often limits the surviving spouse's rights to the income from the marital trust, while the children from the prior marriage are often the beneficiaries of the credit shelter trust. If the client dies in 2010, all of the client's assets will pass to the credit-shelter trust, and the marital trust - i.e., the surviving spouse - will receive nothing! This is certainly not what the client wanted and it will not provide the state's statutory minimum to the surviving spouse. With few or no assets left to the surviving spouse, he or she may resort to a lawsuit against the trust or estate for the statutory minimum, thereby increasing legal fees and wreaking havoc with the estate plan.

Planning Tip: The planning team can help clients prevent this problem by working with the attorney team member to modify the will or trust language to ensure that assets are available for the surviving spouse.

Conclusion

Since most estate planners did not anticipate EGTRRA playing out into 2010, many clients' estate plans fail to take into consideration the lack of estate tax and its replacement, modified carryover basis. As the above discussion demonstrates, the key is flexibility and ensuring that clients' estate plans contain enough flexibility to accomplish their goals under changing circumstances.

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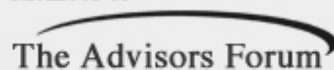
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