No estate tax in 2010 – isn't that a good thing?

In 2001, Congress enacted EGTRRA which provided for a gradual reduction in the estate tax rate and a gradual increase in the exemption amount culminating in a repeal of the estate tax for one year in 2010. In 2011, the estate tax returns at the pre-2001 levels ($1 million exemption, 55% top tax rate – 60% for estates from $10 million to $17.184 million). Conventional wisdom insisted that Congress would not let that happen. Most commentators suggested that the likely action would be a continuation of the estate tax at 2009 levels ($3.5 million exemption, 45% top tax rate) for 2010 and beyond.

Lo and behold! The New Year arrived and Congress had not acted to prevent the suspension of the estate tax in 2010. Estates of individuals dying after January 1, 2010 will completely avoid the estate tax. This is a good thing – right?

Not necessarily. In order to make the numbers pencil out, Congress instead imposed carryover basis to replace the estate tax. A bit of a review may be instructive. With the exception of a brief period in the 1970s, the estate tax regulations have always included a stepped-up basis at death. Putting it simply, this means that the assets composing the estate of the deceased are valued at their fair market value on the date of death. This is an easy figure to compute and does not subject assets which must be sold immediately to fund estate expenses to income or capital gains taxes.

The current (carryover) rules provide that assets in the deceased's estate are worth the *lesser* of their fair market value on the date of death or the basis (amount paid to acquire) of the property in the hands of the deceased. This will subject far more people to a tax at death. (A recent article[1] opined that about 6,000 people would benefit from the lack of estate tax, but about 70,000 would be subject, instead, to capital gains taxes.) Further, carryover basis is a bookkeeping nightmare. Imagine trying to research how much your father paid for shares of stock he purchased 40 years ago and which he has traded off and on over the years. Some relief is available. The personal representative of the deceased may increase the basis of assets in the estate by up to $1.3 million ($3 million for assets left to a spouse). Unfortunately, most peoples' estate planning documents do not address how this basis adjustment should be utilized.

Carryover basis is not the only worm in this can. Many wills and trusts include an allocation formula based on the estate tax unified credit exemption amount for determining what portion of the estate passes to the spouse under the unlimited marital deduction and which goes to a "credit-shelter trust" which generally is earmarked for other parties such as children. A phrase such as "the lesser of the maximum marital deduction allowable in my estate or the minimum amount necessary to reduce my Federal estate tax to zero" is not uncommon in defining

[1] Steve Leimberg's Estate Planning Newsletter #1605, dated 2/16/2010

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the portion of the bequest intended to qualify for the marital deduction. Because there is no estate tax in 2010, the minimum amount to reduce the estate tax to zero is zero. This would effectively disinherit the spouse in favor of other beneficiaries. Legal and tax professionals are currently recommending that all estate planning documents be reviewed for this sort of language and amended as needed.

Another area of concern is state death taxes. While EGTRRA eliminated the federal tax, many states (including Oregon and Washington) continue to impose taxes at death. Heirs of the estate may have to pay capital gains taxes to the state and federal governments in order to obtain the funds needed to pay the state death taxes.

So, what is the likely outcome of this situation? Many commentators believe that Congress will re-impose the estate tax, either temporarily or permanently, at the 2009 levels and that carryover basis will be repealed in favor of stepped-up basis. The general consensus in publications including *National Underwriter* and *Steve Leimberg's Estate Planning Newsletters* is that this change will be retroactive to January 1, 2010. If that happens, there is no doubt that such a retroactive imposition of taxes will generate massive litigation concerning the constitutionality of the measure.

Others argue that the Congress, in its present dysfunctional state, will take no action and allow the 2001 rules to reappear. This position is bolstered by the fact that the House, just before its holiday recess, passed legislation to extend the 2009 rules, but the Senate failed to act, even though the change was attached to other legislation that was fairly certain to pass. Suddenly, estates valued at less than the previous estate tax exclusion amount will be subject to income tax if forced to sell estate assets to pay estate expenses.

What should you do at this point? Your guess is as good as mine. At the very least, however, you should review your current plans in light of the above.

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