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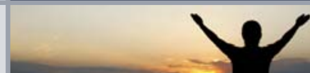
# Estate Planning Alert



## Federal Estate Tax Repeal in 2010

**BY FARHAD AGHDAMI**

The Federal estate and generation skipping transfer ("GST") taxes were repealed on Jan. 1, 2010. In 2010, the Federal gift tax still applies, with a $1 million exemption and a 35 percent tax rate for cumulative lifetime taxable gifts in excess of that amount. In 2011, the Federal estate and GST taxes are revived (along with the gift tax) with a $1 million exemption and a 55 percent tax rate. This *Alert* includes:

- A summary of the background and history of the wealth transfer tax law changes from 2001 to 2011;
- A discussion of current legislative activity to restore the wealth transfer tax laws to 2009 levels;
- A discussion of the constitutionality of a retroactive reinstatement of the wealth transfer tax laws;
- A discussion of planning considerations for individuals whose estate planning documents provide for distributions based on amounts tied to the terms, such as the applicable exclusion amount, that no longer exist in 2010;
- A discussion of new basis allocation rules and reporting requirements; and
- A discussion of planning opportunities in light of the repeal of the estate and generation skipping transfer tax and lower gift tax rates.

***Background and History of Wealth Transfer Tax Law Changes***

The immediate past, present, and future of the wealth transfer tax exemptions and rates (for 2009 to 2011) are summarized in the chart below:

| | 2009 | 2010 | 2011 |
|---|---|---|---|
| Estate Tax Exemption | $3.5 million | Unlimited | $1 million |
| Max. Estate Tax Rate | 45 percent | None | 55 percent + 5 percent surtax |
| Gift Tax Exemption | $1 million | $1 million | $1 million |
| Max. Gift Tax Rate | 45 percent | 35 percent | 55 percent + 5 percent surtax |
| GST Tax Exemption | $3.5 million | Unlimited | $1 million (indexed) |
| Max. GST Tax Rate | 45 percent | None | 55 percent |

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This "Now You See It, Now You Don't, Now You See It Again" tax regime traces it roots to the Economic Growth and Tax Relief and Reconciliation Act of 2001 ("EGTRRA"). EGTRRA provided for the increase of the estate tax exemption from $675,000 in 2001 to $3.5 million in 2009. In addition, EGTRRA provided for the repeal of the estate and generation-skipping transfer taxes in 2010. In 2010, the gift tax remains in place, although taxpayers will have a $1 million exemption from this tax and the top gift tax rate will be the same as the top individual income tax rate of 35 percent.

EGTRRA did not receive the vote of 60 Senators and, because of the so-called "Byrd" rule, EGTRRA sunsets in 2011 and is treated as having never been enacted. As a consequence, the entire wealth transfer tax system as it existed in 2001, is revived in 2011, restoring the $1,000,000 estate and gift tax exemption and the top marginal tax rate of 55 percent, plus a 5 percent surtax for estates between $10 million and $17,184,000.

In 2010, the cost basis of assets passing from a decedent will no longer be automatically "stepped up" to current fair market value on the date of death. Instead, the Executor of a decedent's estate will generally be allowed to increase the basis of certain designated assets by up to $1.3 million (with some adjustments) and the basis of property transferred to a surviving spouse by an additional $3 million. Carryover basis is discussed in greater detail below.

***Current Legislative Activity***

On Dec. 3, 2009, the House of Representatives, by a vote of 225-200, passed H.R. 4154, the "Permanent Estate Tax Relief for Families, Farmers, and Small Business Act of 2009", referred to herein as "PETRA." The Senate, distracted by the Health Care bill, did not take up PETRA for consideration before the Christmas recess. As a consequence, PETRA was not enacted and the estate and GST taxes were repealed in 2010. There is some discussion that the Senate may consider increasing the exemption to $5 million and, perhaps, indexing it for inflation. However, because the provisions of PETRA may be considered by the Senate over the next few months, some of its key provisions are noteworthy.

PETRA eliminates the repeal of the estate and generation skipping transfer tax in 2010. Second, it makes the provisions of 2009 law permanent — that is, a $3.5 million estate and generation skipping transfer tax exemption, a $1 million gift tax exemption, and a 45 percent tax rate. A corollary to the retention of current law is that it preserves the rule that provides a fair market value basis adjustment at death. Finally, while the deduction for state death taxes is retained, the state death tax credit is not revived. As a consequence, decedents in jurisdictions, like Maryland and the District of Columbia, would continue to pay a state death tax, but receive an offsetting deduction for such taxes paid on the Federal return.

PETRA also retains some important provisions found in EGTRRA that would have otherwise been lost had EGTRRA been repealed in its entirety. First, many useful provisions related to the GST tax are retained. These provisions include automatic allocations of GST tax exemption, late allocations of GST tax exemption, qualified severances of trusts, and other relief mechanisms. In addition, important technical aspects of the provisions related to installment payments of estate tax associated with closely held businesses (under Internal Revenue Code("Code") § 6166), qualified conservation easements, and valuation reductions for family farms (under Code § 2032A) are retained.

Two additional points should be considered. First, 2010 is an election year; the entire House of Representatives and one-third of the Senate will stand for re-election. The so-called "death tax" is an enormously successful campaign fund-raising issue and may be used to raise dollars and votes. Second, Federal estate tax returns are not due until 9 months after the date of death; therefore, the Federal estate tax return for a decedent dying on Jan. 1, 2010 will not be due until Oct. 1, 2010. As a consequence, Congress may not see any urgency to act until the summer or early fall.

***Retroactive Reinstatement of Estate and GST Tax in 2010***

There is significant discussion about a retroactive estate tax bill in 2010 (possibly PETRA or a variation of PETRA), which would eliminate the repeal of the estate tax, so that estates of persons dying in 2010 would be subject to estate tax. Presumably, the GST tax would also be reinstated retroactively and the higher gift tax rate of 45 percent would also be reinstated retroactively.

There has been an equal amount of discussion on the constitutionality of such a measure. There is a fair amount of precedent which suggests that a retroactive reinstatement of estate and GST taxes for individuals dying in 2010 would be constitutional.

In *United States v. Carlton*, the United States Supreme Court concluded that the retroactive disallowance of a Code § 2057 estate tax deduction did not constitute a violation of due process. The Court held that a taxpayer has no vested right in the Internal Revenue Code and must "[take] his chances" with respect to the tax results of a particular transaction. The *Carlton* decision is buttressed by two additional lower court decisions. In *Kitt v. United States*, the Federal Circuit Court of Appeals upheld retroactive legislation imposing a 10 percent penalty on withdrawals from Roth IRAs that had been converted from traditional IRAs. In *Estate of Cherne v. United States*, the Ninth Circuit Court of Appeals upheld a retroactive increase in the maximum federal estate tax rate from 53 percent to 55 percent.

On the flip side, there are two U.S. Supreme Court cases, *Blodgett v. Holden* and *Untermyer v. Anderson*, that considered the application of the first gift tax to gifts made before the statute was enacted, and both held that such retroactive application of the tax violated due process. These are two older cases that are read quite narrowly. The Cherne court addressed the "new tax" argument

found in these cases and held that a "new tax" is imposed only when the taxpayer has "no reason to suppose that any transactions of the sort will be taxed at all." Given the one-year repeal and re-enactment of the estate tax in 2010 and 2011, along with the wide press coverage discussing this issue, it could be difficult for a taxpayer to argue that he or she has "no reason to suppose that any transactions of the sort will be taxed at all."

Nevertheless, we expect that, if Congress makes the estate and GST taxes retroactive to Jan. 1, 2010, the estate of a wealthy individual who dies after 2009, but prior to any 2010 legislative change, will challenge the constitutionality of such a provision. The outcome of such litigation will not be final for many years thereafter.

***Need to Review Estate Planning Documents***

Many individuals who executed estate planning documents provided that their estates are divided, by formula, into two broad portions — the first portion is the largest amount that can pass free of estate tax by reason of the estate tax exemption amount — this portion is placed into a trust, often referred to as a "Family Trust", "By-Pass Trust", or "Credit Shelter Trust." The second portion is transferred in a manner that qualifies for the estate tax marital deduction, typically to a "QTIP Marital Trust" or an outright bequest to the surviving spouse.

Since there is no Federal estate tax system in 2010, it may be uncertain how the provisions of an individual's estate planning documents will be interpreted. This is because many provisions of sophisticated estate planning documents are phrased in terms of tax concepts, such as the "estate tax exemption amount" and "marital deduction." Because those tax concepts do not exist in the law this year, there may be some question as to where assets should be distributed — do they pass to the "Family Trust" or do they pass to the "Marital Trust?" All of this uncertainty could have the effect of unintentionally disinheriting spouses, children, charities, or other beneficiaries.

The Virginia Bar Association's Wills, Trust & Estates Section is advancing emergency legislation that would create a rule of construction that treats a document with references to tax related terms, such as "unified credit," "estate tax exemption," or "applicable exemption amount," "marital deduction," or that measures a share of an estate or trust based on the amount that can pass free of Federal estate taxes or Federal generation-skipping transfer taxes to refer to the Federal estate and generation-skipping transfer tax laws as they applied with respect to estates of decedents dying on Dec. 31, 2009. As a consequence, assets would pass to the Family Trust or Marital Trust as if the 2009 law were still in effect. This may not produce the most robust income tax result, but it will prevent the inadvertent disinheritance of a family member. We understand that other states are considering similar rules of construction.

The impact on estate planning documents is unique for every situation and will require individual review and discussion to determine the appropriate course of action. Clients should consider a review of all estate planning documents (wills, trusts, etc.) to determine if their documents are affected and should be revised accordingly.

***Allocation of Basis and New Reporting Requirements***

Another important change occasioned by the repeal of the estate tax is that the cost basis of assets passing from a decedent will no longer be automatically "stepped up" to fair market value on the date of death. Instead, the Executor of a decedent's estate will generally be allowed to increase the basis of certain designated assets by up to $1.3 million (with some adjustments) and the basis of property transferred to a surviving spouse by an additional $3 million. In addition, certain assets do not qualify for the basis allocation under Code § 1022 — notably items that constitute income in respect of a decedent. This includes retirement plan assets (such as IRAs, 401ks, and deferred compensation arrangements) and notes receivable. The new carryover basis system may require new drafting approaches and re-titling of assets to maximize income tax benefits and attributes.

New Code § 1022 requires the Executor of an estate to allocate the basis modifications among the estate's assets and to file a return regarding that allocation. Code § 6018 requires the Executor of a decedent's estate to satisfy certain reporting requirements. An executor is subject to the reporting requirements of Code § 6018 for transfers at death of noncash assets in excess of $1.3 million and generally for appreciated property that the decedent had acquired within three years of death for which the law required the donor to file a gift tax return.

Under Code § 6018, the Executor of the estate (or the Trustee of a revocable trust) must report the following to the IRS:

- Information concerning the recipient of the property;
- An accurate description of the property;
- The decedent's adjusted basis in and holding period of the property;
- The property's fair market value at the decedent's death;
- Whether any gain on the sale of the property would be treated as ordinary income;
- The amount of basis increase the Executor allocated to the property; and
- Any other information as regulations may require.

The statute also requires the Executor to furnish the same information to the recipients of the decedent's property. Penalties are imposed for failure to file the required information subject to a reasonable cause defense.

The irony is that the repeal of the estate tax suggests simplification and the removal of burdens on taxpayers; however, the new basis rules and record-keeping requirements of Code § 1022 create the exact opposite result. In 2009, only taxpayers with an estate of $3.5 million or more were required to file a Federal estate tax return. Now, all taxpayers with an estate of $1.3 million in non-cash assets are required to file a tax return under Code § 6018. The new statute casts a much wider net and draws many more taxpayers into the compliance and reporting regime of Code § 6018 and the basis requirements of Code § 1022.

Like the current estate tax return, Form 706, the Executor will be required to identify assets, report basis, and make the appropriate allocations and tax elections. However, under the new system, this will become even more onerous. Under the former rule of a step-up in basis at death, there was no need to resurrect basis records, as death created a "fresh start." Now, in order for the Executor to make a judicious and accurate allocation of additional basis to those assets held by the decedent at death, the Executor will need to determine the starting point of basis in assets held by the decedent at death. This could be quite tedious, cumbersome, and expensive. The IRS has not issued any forms reflecting the reporting information required by Code § 6018 or regulatory guidance on the application of Code § 1022. We will continue to monitor these developments.

In 1976, Congress enacted a statute that provided for the repeal of the estate tax and a move to carryover basis. The estate tax was never repealed (and the system that stood in place from 1981 to 2009 was enacted in its place) once taxpayers fully realized the record-keeping burdens associated with carryover basis. History may repeat itself again.

***Planning Opportunities***

In 2010, the wealth transfer tax rules are radically different than the rules that existed for the last 29 years. The one-year repeal, followed by a reinstatement of the estate tax with a $1 million exemption and a 55% tax rate, creates complexity and uncertainty. It also creates the opportunity to make tax-advantaged transfers while there is no estate and GST tax in place and the gift tax rate (35 percent) is at its lowest. These planning opportunities will only exist while current law is in effect and Congress does not enact new legislation that reinstates prior law retroactively. Here are just a few planning opportunities that clients may wish to consider.

Example 1. Client wishes to gift $10 million to child during her lifetime. In 2009, assuming Client had consumed her prior gift tax exemptions, a $10 million gift will generate approximately $4.5 million gift tax liability (at a 45 percent tax rate) — thereby costing the Client a total of $14.5 million ($10 million gift + $4.5 million gift tax). In 2010, the same $10 million gift will cost Client $13.5 million ($10 million gift + $3.5 million gift tax at 35 percent tax rate), thereby saving the Client $1 million in gift tax.

Example 2. Elderly Client wishes to leave $10 million to child at his death. Client will likely live beyond 2010 and is concerned about reinstatement of estate tax at 55 percent tax rate in 2011 and thereafter. As discussed in Example 1, above, a gift of $10 million in 2010 will generate $3.5 million of gift tax thereby costing Client a total of $13.5 million. If Client does not make a gift to child in 2010 and dies in 2011 when the estate tax rate is 55 percent, it will cost Client $22,222,222 to transfer $10 million to child ($22,222,222 x 55% estate tax rate = $12,222,222 tax paid) and $22,222,222 - $12,222,222 = $10 million to child. The significant difference is due to the tax exclusive nature of the gift tax system, as opposed to the tax inclusive nature of the estate tax system.

Example 3. Client wishes to transfer assets to a trust for the benefit of grandchildren at a 35 percent gift tax rate and escape the application of the generation skipping transfer tax in its entirety. Client, however, is concerned that Congress may retroactively reinstate the generation skipping transfer tax in 2010. Client creates a trust for the benefit of grandchildren. The trust provides that the Trustee has nine months from the date of the gift to disclaim the assets. If the assets are disclaimed, they pass to a trust for the benefit of Client's spouse. If it appears that Congress will make the GST tax retroactive in 2010, Trustee of the GST trust can disclaim, thereby causing the assets to revert to Client's spouse, avoiding any estate, gift, or GST tax. This gives Client the ability to make a tax-advantaged gift in 2010, while protecting against a retroactive reinstatement of the GST tax and a 45percent gift tax rate.

Example 4. Client wishes to create a grantor retained annuity trust (GRAT) for the benefit of grandchildren. Under the pre-2010 GST tax rules, Client cannot allocate GST exemption until the expiration of the GRAT, thereby making the tax consequences of such an allocation uncertain and risky. In 2010, Client creates a GRAT for benefit of grandchildren; since the GST tax does not apply in 2010, assets can pass to grandchildren upon expiration of the GRAT free of GST tax.

It's a new and exciting world for us and we are just beginning to scratch the surface of planning possibilities; these few examples suggest that this year may provide a wonderful window of opportunity to engage in once-in-a-lifetime wealth transfer tax planning.

***Conclusion***

Please feel free to contact any member of the Williams Mullen Trust and Estate Planning and Administration Group. We are ready toanswer your questions and we are prepared to assist you and your family in creating an effective plan to reduce estate, gift and GST taxes.