

Wealth Strategies

SILVER BRIDGE INSIGHTS

WEALTH STRATEGIES

The Wealth Strategies team coordinates the delivery of wealth advisory information, strategies, and planning techniques for Silver Bridge Advisors. Working directly with clients and client advisors, the team develops customized solutions that integrate the estate, financial, and investment planning needs of our clients.

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New Year's Day Surprise – Estate Taxes are Repealed for 365 days!

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After burning the midnight oil in lengthy debate, arm twisting, and marathon sessions in an attempt to generate a massive overhaul of the nation's health care system, Congress retired for 2009 without coming to an agreement on the expiring estate tax. According to the **Tax Act of 2001**, known as the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the estate tax was set to gradually phase out. By taking no action, Congress effectively repealed the estate tax along with the Generation-Skipping Transfer Tax ("GSTT") on January 1, 2010—for the first time since 1915! In 2011, the estate tax is scheduled to return with a vengeance to pre-2001 levels.

As part of the compromise to repeal the estate tax, the "step-up" in cost basis, which had been applied to estate assets in previous years, is also curtailed under section 1014(a) of the Internal Revenue Code ("Code"). Under the new 2010 carryover cost basis rules, all estate assets with a date of death fair market value greater than the historical cost basis will not receive a step-up in basis. This means that the decedent's cost basis of any asset transferred will "carryover" to those who inherit his or her property. Estate assets with a date of death fair market value that is less than the historical cost basis from the decedent will receive a "step-down" in basis to the fair market value at death.

In short, a decedent's estate will not be required to pay an estate tax, generally due nine months from the date of death, but the heirs who receive assets may have to pay a capital gains tax when the asset is sold, with the decedent's cost basis used to calculate any potential gains. The new rules do provide estate executors with the option to allocate \$1.3 million of increased cost basis among the estate assets of their choice. An additional \$3 million may be used to step-up the basis of any assets which are passing directly to a surviving spouse or a qualified trust for their benefit.

Although there are no federal or generation-skipping taxes levied on a decedent's estate created in 2010, state death taxes may still be due. The credit for the state death tax, normally used as a credit against the payment of any federal estate tax, has also been eliminated and cannot be used as a deduction against income taxes. The gift tax still remains, but is reduced from a top tax rate of 45% down to 35%. Congress felt that a gift tax should remain to preclude family members from shifting assets between generations to take advantage of lower income tax brackets.

The 2001 Act also included a "sunset" provision that eliminates all of the changes the Act made (including the transfer tax changes) at the end of 2010. Unless the Code is changed, beginning in 2011, the estate tax exemption will drop to \$1 million; the top estate, gift and GST tax rate will become 55% as it was before the 2001 Act (and it can be 60% for some

estate and gift tax transfers); the estate and gift tax system will again be "unified"; the state death tax credit under section 2011 will be restored; and several other important provisions will again be as they were before EGTRRA.

The New Transfer Law: A Look at Three Scenarios

What does this mean and how do these changes affect your current estate and financial plan? The changes in the transfer tax law present extraordinary opportunities, along with significant potential dangers. Because of the possibility of retroactive legislation that reinstates the transfer tax system as it exists in 2009, there is risk that any action taken on the premise that the estate and GST taxes are gone for the year and that the gift tax rate will be only 35% could result in unexpected transfer taxes.

The following is a simplistic example to demonstrate the differences between the three different transfer tax systems for years 2009, 2010 and 2011. In all three examples, we assume that the decedent has a net worth of \$5 million and dies with no surviving spouse.

Scenario One: Decedent passes away in 2009

Net Worth = \$5MM
Lifetime Exemption = \$3.5MM
Taxable Estate = \$1.5MM
Estate tax (45%) = \$675,000

Scenario Two: Decedent passes away in 2010

Net Worth = \$5MM
Lifetime Exemption = 0 / Capital Gains step-up = \$1.3MM
Taxable Estate = \$3.7MM Gains
Capital Gains Tax (15%) = \$555,000

Scenario Three: Decedent passes away in 2011

Net Worth = \$5MM
Lifetime Exemption = \$1MM
Taxable Estate = \$4MM
Estate Tax (55%) = \$2,200,000

The difference is a whopping \$1.65 million between dying in 2010 versus dying in 2011.

Looking Toward the Future: Steps You Can Take

In spite of the recent repeal of the law, Congress has vowed that it will "fix" or "correct" the problem and implement some form of estate tax for 2010. Any Congressional action may be retroactive back to January 1, 2010, even though many legal practitioners say that retroactive changes can be challenged as unconstitutional. In light of possible reform, we do recommend that clients review their current planning documents with their advisor. Many gifts under wills and trusts are defined in terms of tax concepts. For example, many married couples divide their estates into two broad portions: one portion equal to the unused estate tax exemption (typically passing into a non-marital deduction trust often called a "credit shelter trust" for the benefit of the surviving spouse and descendants) and the other portion passing outright to a spouse or into a marital deduction trust for the spouse's benefit. In some cases, the bequest intended to qualify for the marital deduction is phrased as "the lesser of the maximum marital deduction allowable in my estate or minimum amount necessary to reduce my federal estate tax to zero."

In other cases, an individual, whether married or not, may have a portion of his or her estate equal to his or her "unused GST exemption" passed in a different way from the balance of his or her estate, such as to a trust for the benefit of his or her grandchildren and more remote descendants.

These formulas are used because they produce what appears to be the optimal division or disposition of a decedent's property. However, formulas have no meaning if the concepts used to define them are no longer part of the tax law. Before you run out to change these documents, check with your advisor.

Through careful planning, it is possible to use both the \$1.3 million per individual exemption for a "cost basis step-up" and the \$3 million exemption for transfers between spouses together to raise the total cost basis of assets transferred to the entire \$4.3 million, somewhat similar to using the previous "credit shelter" amount.

If, as part of your overall estate plan, you are considering making taxable gifts, either gifts outright or gifts to a trust (i.e., a Grantor Retained Annuity Trust or GRAT), the gift tax rates for 2010 are only 35%, much less than 2009's rate of 45%, and 2011's expected rate of 55%. Thus, it may make sense to implement those gifts in 2010 to take advantage of the lower rates.

Trying to determine the future direction of estate taxes and to make firm plans is, for now, somewhat like trying to predict the weather. The year 2010 presents clients and their advisors with many challenges and opportunities in estate planning. If Congress acts early this year to change the current system as it stands today, we recommend that clients, at a minimum, communicate with their advisors to determine how the current law impacts their plan and what changes should be made, if any, to update their estate planning documents. Please contact your Silver Bridge advisor for more information about these developments and to determine the best course of action for your specific situation. ■

This white paper is for informational and educational purposes only. Please consult with your tax advisor and estate planning attorney for more information and to determine the appropriate strategies to address your specific situation.

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