

The 2010 Estate Tax Gap

Anyway you cut it, the current state of Federal estate tax and transfer tax law is a mess. A more polite way to put it is that we are in the midst of a gap, following expiration of the estate tax, while awaiting the reinstatement of this tax in one form or another. This situation challenges families, business owners and their advisors to confront the resulting uncertainty as they try to sort out the best planning approach at this particular moment.

Current Law

Since January 1, 2010, there has been no Federal Estate Tax. Under current law, the estate of a person who dies during calendar year 2010 will not owe any Estate Tax, regardless of the size of that estate. The Federal Generation Skipping Estate Tax is also abolished at this time. The gift tax remains in effect. The gift tax rate is reduced to 35% and the \$1 million exemption from this tax is preserved.

This is an unusual situation. The current version of the Federal Estate Tax has been in force in one form or another since the Revenue Act of 1916, which also imposed the income tax shortly after the Constitutional amendment permitting that levy was passed. As noted in next section, the Estate Tax is scheduled for reinstatement in 2011.

Expiration of the Estate Tax abolishes the step-up in tax basis heirs enjoyed under previous law. This step-up was almost always beneficial to heirs, as it enabled them to avoid capital gains taxes on the “built-in gains” that were usually experienced on appreciated assets. It is also very difficult to determine the predecessors’ cost basis in appreciated property. The current tax regime will thus force an estate’s heirs to pay capital gains taxes on the appreciated gains when they sell property received from the estate. Current law grants some relief from this hardship by authorizing two separate exceptions to the cost-basis rule: the \$3 million exemption for a surviving spouse and a \$1.3 million exemption for all other heirs.

Where the Law is Headed

There are few certainties in Federal Estate Tax law at this point. We know there is no Estate Tax in effect right now, and that the Estate Tax will be automatically reinstated at more unfavorable levels on January 1, 2011 if Congress fails to pass corrective legislation this year.

Possible Scenarios. Prognostication on this topic has become much more difficult due to recent events. Most observers did not believe that the U.S. Congress would actually allow this gap in the Estate Tax law to occur, but it has. We can glean the following possibilities from existing law and previous proposals in Congress (including during 2009):

Continue 2009 Tax Levels. Many expect that Congress will pass a bill which retains the tax rate and exemption levels that applied in 2009: estate and gift tax rates that vary from 15% to a maximum rate of 45% and a \$3.5 million exemption for each decedent (which married couples can double to \$7 million for their joint estate). There have been several bills introduced to fix the Estate Tax rates and law at these levels, but none were enacted.

No Action-Reinstate 2001 Tax Levels: Congress could fail to act in 2010. That inaction automatically reinstates the Estate and Generation Skipping Taxes on January 2, 2011. Exemptions from Estate Taxes would be \$1 million per individual and the tax rates would gradually rise to a 55% maximum rate. The generation skipping tax would also be reinstated at similar levels.

Adjusted rates and exemptions: Congress could enact a new law that looks a lot like the old law, but imposes different exemption amounts and rates.

New law: Congress could enact a new law which imposes an entirely distinct and new tax regimen on estates and gifts.

Estate tax repeal: The estate tax could be repealed.

The Wild Card of Retroactivity. To add to this air of uncertainty, Congress could elect to impose any of the new tax regimes retroactively. The “no action” reinstatement would not, however, have any retroactive effect. This factor is discussed further in the next section.

Our Prognostication. In our estimation, the most likely scenario is that Congress will reinstate the 2009 tax levels and make that Estate Tax regimen retroactive to January 1, 2010. Several bills were introduced to this effect in 2009 (and in earlier years) but were not passed for a variety of reasons that appear to be distinct from the merits of this legislation.

The second most likely scenario is that Congress will not act and will thus effectively reinstate the 2001 taxation levels. This scenario has gained considerable “momentum” given the lack of action – in the face of considerable pressure to act – so far.

Unfortunately, we are all left to guess at what the estate and gift tax law will look like at some point during 2010 or at the beginning of 2011. The Federal government has presented very little in the way of actions or projections that identify the likely course of events. As of the date of this writing, there has been no notable congressional action; the 2011 Budget anticipates the continuation of “estate and gift” taxes from 2010-2020, but does not specify the proposed tax rates in the more notable summaries.

Congress could act quickly, but we do not expect any decisive action within the next 90 days. The best chance for legislative action early this year was on a pending bill from 2009, and that did not occur as scheduled.

The Outlook for Retroactive Reinstatement

The retroactive imposition of taxes is of course subject to constitutional challenge. Much of the case law in which such challenges were upheld, however, date back to the 1920s and predate the Roosevelt administration. Successful challenges to government power were upheld much more frequently in that era. Without getting into the nuts and bolts of the law, the essential legal test is whether retroactivity is a “rational means” of furthering “a legitimate legislative purpose.” The latest case on this topic suggests that Congress should be able to craft a law which will withstand any such constitutional challenge.

The bottom line is that the estate planner should anticipate retroactivity in any estate planning performed in 2010. Even if retroactivity is challenged in the Federal courts, it could take years for such a case (or cases) to be resolved.

Planning Documents Problems

If you have already signed a Will and/or Trust, this gap in the law could decimate the intended distribution of your assets upon the death of you and/or your spouse. Many estate planning documents (primarily Wills and Trusts) refer to previous Federal law when making property distributions to a decedent's heirs. For example, your Trust may have a bypass (or credit shelter) trust formula that allocates the maximum amount exempt from Federal Estate Tax to your spouse (or alternatively to the bypass trust). The Trust is drafted to allocate figures as high as \$3.5 million (the 2009 exemption) to the Family Trust or spouse.

Under the law at this precise point in time, the tax exemption amount is reduced to zero. Now these carefully crafted clauses will in many cases cause the surviving spouse to be bypassed, and the entire estate will be allocated to the Family Trust (the beneficiaries are usually children). The spouse is not cut out altogether, since bypass trust terms frequently state that the surviving spouse must be cared for "in the manner accustomed" (or words to that effect). The surviving spouse is frequently the sole recipient of the Family Trust income and can even receive principal distributions from that Trust. Nonetheless, the surviving spouse might still be shocked to not receive any "free and clear" distribution from his or her deceased spouse. This controversy will become particularly acute if the surviving spouse is not the Trustee making the decisions as to when and what to distribute.

This problem is compounded even further if the Trust links distribution amounts to the "unified credit" or "marital deduction." These commonly used phrases under previous law are no longer in effect, and may be thrown out by a court interpreting a Trust.

These same interpretative problems can arise in much the same manner with respect to any provisions in a generation skipping trust clause, since there currently is no generation skipping tax, nor any exemptions to that tax.

General Advice – Review and Be Flexible

As noted above, there are many possible resolutions to the current chaos imposed by Congress. The conscientious estate planner has many options in reaction to this legal chaos, but generally speaking they fall within the following choices:

1. Sit tight and wait for the change in law
2. Amend the estate plan to allow for all predictable changes in the law
3. Take advantage of the current low tax rates

Option #3 is risky due to the spectre of retroactivity. There are ways to avoid getting ambushed by a retroactive change in law; for example, the recipient of a specially timed gift could disclaim the gift if and when it becomes apparent that the higher tax rates have been

reinstated. Nonetheless, only those who present special circumstances or have formidable risk tolerance should approach this topic with anything but caution.

Most people should elect between the first and second categories noted above. For those with an estate plan in place, the first step is to review the distributive clauses of his or her Trust (and perhaps the Will) to determine if a change is necessary to conform to current law. If the property distribution is not dependent upon the estate tax, or the clauses anticipated that there may not be an estate tax, the grantor can just sit tight.

In the more likely case that the distributions were crafted around the prior Estate Tax law, the prudent person will sign a brief amendment to the Trust to allow for distributions according to his or her wishes without reference to any tax. Such clauses can be drafted flexibly (e.g., alternatively) so as to allow for distributions with or without the presence of an Estate Tax.

Anyone who does not have a Will or Trust should not “just sit tight” and wait out the law. As noted in the previous paragraph, the estate plan can be drafted so as to provide for distributions with and without an estate tax. The prudent planner need not and should not risk going without an estate plan just because Congress has as of yet proven unable to make the choices that must be made at some point.

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