January 2010 brought many changes to the world of estate taxation and planning.

Contrary to the expectations of most observers, Congress failed to stop the scheduled repeal of the Federal estate and generation-skipping taxes for the year 2010. If Congress remains silent on estate taxation issues this year, the estate and generation-skipping taxes will return next year, with the lowest estate tax exemption since 2003 ($1,000,000 per person) and highest tax rates since 2001 (up to 55 percent).

Adding to the complexity of estate planning, the current estate tax law for 2010 and 2011 is not set in stone. Congress could at any time change the law for 2010 and/or subsequent years. Although the final provisions of the estate tax law for 2010 and the future are still unknown, you may take certain steps now to protect your estate and ensure your wishes are respected regardless of the shifts in estate tax law.

Temporary repeal of estate and generation-skipping taxes

The Economic Growth and Tax Relief Reconciliation Act of 2001 reduced in the Federal estate tax rates and increased the exemption from Federal estate tax (that is, the tax-free amount that an individual can leave to beneficiaries other than a spouse or charity). These changes were phased in over a period of several years, culminating in the repeal of Federal estate and generation-skipping transfer taxes beginning Jan. 1, 2010. In order to comply with rules relating to the Federal budget, however, the repeal is only effective for one year. Beginning Jan. 1, 2011, the Federal estate and generation-skipping transfer taxes will return, with an estate tax exemption of only $1,000,000 per person, and tax rates as high as 55 percent for most estates (or 60 percent for portions of very large estates).

Most observers predicted that Congress would enact new legislation to prevent the temporary repeal of the estate tax, and perhaps revise the laws on the books for 2011 by providing a more generous exemption and/or lower tax rates. Indeed, the House of Representatives passed a bill in December 2009 that provided for the permanent extension of 2009's estate and generation-skipping tax exemption amount of $3,500,000 and tax rate of 45%. The Senate, however, failed to pass any legislation addressing the estate tax.

Some members of Congress have said that they intend to pass laws this year, retroactive to January 1st, to reinstate the estate and generation-skipping taxes. Whether or not any such legislation is enacted, and whether a retroactive reinstatement of the taxes is Constitutional, remains to be seen.

Examine your existing estate plan

While we wait and watch for Congressional action, it is important to review existing estate plans in light of the current laws and the anticipated changes in the law. Even in this time of uncertainty, it is possible to incorporate flexibility in your estate plan to ensure the best possible tax outcome while ensuring your assets are distributed according to your wishes.

The shifting tax laws should not be a reason to delay a review of your existing estate plan or implementation of estate planning, if you haven't already done so. In fact, it is more important than ever to turn your attention to this essential, personal matter.

For many years prior to this extraordinary estate tax situation, most Wills and Trusts for married individuals with taxable estates (and for some single individuals who were charitably inclined) incorporated “formula” language to minimize estate taxes. Generally, the formulas would ensure that any property not exempt from estate tax would pass to a surviving spouse (to obtain maximum deferral of estate tax) or to charity (to escape estate tax altogether). It is still appropriate to use such formulas in many situations, but it is important to be aware of the consequences of the formula under current law and, if necessary, make adjustments for the possibility of death during the period of estate tax repeal. If your Will or revocable Trust refers to the “federal estate tax,” the “maximum marital deduction,” the “taxable estate,” the “unified credit” or similar concepts, you should have your documents reviewed to be sure your wishes would be carried out in the event of your death during 2010.
Carryover basis system

The modified carryover basis rules currently in effect for property inherited during 2010 represent a fundamental, if temporary, shift in the taxation of inherited property. Rather than taxing the transfer of property from a decedent, like the estate tax, the carryover basis rules affect the capital gains tax on the subsequent sale of property by the person who inherits it.

In the past, property inherited from a decedent received a new basis, equal to the property's value at the decedent's date of death, in the hands of the recipient. Thus, recipients generally wouldn't incur significant capital gains liability if they sold inherited property soon after the original owner's death.

Property inherited from someone who dies in 2010, however, won't receive a new basis at the owner's death. Instead, the decedent's basis in the property (generally, what the decedent paid for the property) will carry over to the recipient, who will be liable for capital gains tax on the increase in the property's value while it was owned by the decedent, as well as any increase after the decedent's death, when he or she sells the property.

There is some relief for recipients of property under the carryover basis system, but the new system will still affect many estates that would not have been taxable in recent years (such as estates with a value of between $1,300,000 and $3,500,000). A special tax form will be due for estates that include property (other than cash) with a value of $1,300,000 or above. The personal representative (executor) of each estate may use that form to allocate a “basis increase” to property inherited from the decedent. The maximum basis increase for property passing to any person is $1,300,000, with an additional basis increase of up to $3,000,000 for property passing to a surviving spouse.

As an example, a person who dies in 2010 with a residence valued at $1,200,000 (with a basis of $200,000), securities worth $2,500,000 (with a combined basis of $1,000,000), and miscellaneous other assets worth $800,000 (with a combined basis of $500,000) would have a total estate worth $4,500,000. If all of those assets passed to the decedent's surviving spouse, the executor could allocate $1,000,000 of basis increase to the residence, $1,500,000 of basis increase to the securities, and $300,000 of basis increase to the other property (all allocated on an asset-by-asset basis), so that the surviving spouse's basis in the inherited property is equal to the value at the decedent's date of death. The results would not be as good for an heir other than the surviving spouse, however. Using the same figures as the previous example, assume that the decedent bequeaths all of her property to her son. The executor could allocate no more than $1,300,000 of basis increase to the property (for example, $1,000,000 to the residence and $300,000 to the miscellaneous assets), so the son will be responsible for capital gains taxes on $1,500,000 worth of appreciation that occurred during his mother's lifetime.

It is important to plan for the allocation of the basis increase during 2010. If possible, you should consider leaving an adequate amount of property to your spouse to take advantage of the $3,000,000 spousal basis increase. You should also consider whether your executor will be placed in an awkward position by exercising his or her power to allocate basis increase, which might benefit some beneficiaries more than others, and consider naming co-executors and/or providing protection for the executors from any potentially disgruntled beneficiaries.

Opportunities for making gifts; caution for certain gifts in trust

As noted above, the maximum Federal gift tax rate has been reduced to 35 percent for 2010 only. You may already be making annual exclusion gifts (that is, gifts of no more than $13,000, or $26,000 from a married person whose spouse consents to “split” the gifts, per recipient, per year) and/or payments of tuition or medical expenses directly to the providers on behalf of your children, grandchildren or other beneficiaries. Such gifts are sometimes referred to as nontaxable gifts. In addition to nontaxable gifts, you may make gifts of cash or other property worth up to $1,000,000 during your lifetime without incurring Federal estate tax. In many situations, transferring property by taxable gift is preferable to transferring property at death. Many people, particularly those with assets in excess of $3,500,000, should consider making taxable gifts during 2010, because the reinstated estate tax rates in 2011 and beyond (even if Congress acts to extend the 2009 exemption and rates) probably will exceed the 35 percent gift tax rate for 2010. On the other hand, consider the possibility that Congress might retroactively raise the gift tax rate for 2010 to something higher than 35 percent.

In planning your gifts for 2010, be aware that gifts to a trust that ultimately may benefit grandchildren or their descendants may be subject to generation-skipping transfer tax at a later date, even though the generation-skipping transfer tax has been repealed for 2010. Contact your estate planner, accountant or other financial adviser before making gifts to a trust this year. Outright transfers to grandchildren or other recipients this year (assuming the generation-skipping transfer tax is not reinstated) are not subject to those concerns.

Planning flexibility for the future

While planning for the unique circumstances of the year 2010 is essential, it is important not to lose sight of the probable reinstatement of estate tax and generation-skipping tax in 2011 and later years. Fortunately, it is possible to implement a flexible estate plan that takes into account both the unusual estate tax laws for this year and the anticipated changes in the future. While there is no “one size fits all” solution to the exceptional challenges presented by the current estate tax laws, we have developed strategies for minimizing estate tax exposure while maintaining maximum flexibility for the future. For most people with existing estate plans, a brief review of your documents and reconsideration of your estate planning goals will allow you to make fairly simple changes to bring your documents up to
date, prevent unintended consequences and prepare for the future.

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