

## WHAT'S GOING ON WITH FEDERAL ESTATE TAXES? Should You Care and What Should You Do

For the year 2010 only, the federal estate tax been repealed. Since this is the first time since 1916 that there has been no estate tax, it may seem like a good thing. For many, however, the repeal may cause more problems than it solves. And even though the repeal is only for one year (since estate tax will apply again in 2011), it requires most people to consider whether their wills and trusts operate as planned or instead leave unintended consequences. This article describes the new uncertain estate tax landscape so clients can consider what steps, if any, they may want to take.

### A Little History

Gifts and estates are taxed by the federal government and by many states (including Minnesota). However, there is an exemption allowing estates under a certain amount to be transferred tax-free. For many years the exemption from federal tax was \$1,000,000. In 2001, Congress passed legislation that gradually increased the amount that would be exempt from federal estate tax, with the exemption peaking at \$3,500,000 in 2009. The maximum federal tax rate gradually decreased to 45%. Then in 2010 the estate tax (and the generation skipping tax (GST)) disappeared. However, the law will “sunset” in 2011 with the reinstatement of an exemption of \$1,000,000 and a top estate tax rate of 55%. It was assumed Congress would find a permanent fix by 2010, but they did not.

Even though the federal estate tax and GST do not apply in 2010, there is still a tax on lifetime gifts. A gift tax is imposed on lifetime gifts that exceed the annual exclusion amount (\$13,000/donee/year in 2010) and the lifetime gift exclusion amount (\$1 million). However, the 2010 gift tax rate is 35% (a decrease from 45% in 2009).

Minnesota imposes an additional estate tax. Since changes in federal tax law are not automatically applicable in Minnesota, it is unlikely that Minnesota, with its budgetary concerns, will eliminate its estate tax in 2010. Therefore, even though there is no federal estate or GST tax in 2010, there is still a Minnesota estate tax on decedent's estates exceeding \$1 million in value (at rates that are much higher for the first \$1 million (starting at 38%) and then from 10% to 16% after \$2 million). Minnesota has no gift tax on lifetime transfers.

### Should You Care

Significantly, although there is no federal estate (or GST) tax in 2010, death may cause an increase in capital gains tax to heirs. Under prior law, heirs received a “step-up” in basis equal to the value at death. However, in 2010 assets will retain the same basis they had in the hands of the decedent (carry-over basis), which is generally lower than the value at death. This increase in the value of the assets held by a decedent will, under 2010 law, generally be subject to capital gains tax upon the sale of the assets by the heirs. The new basis rules, however, do allow for a \$1.3 million “step-up” in basis for assets

passing to non-spousal heirs, and a \$3 million “step-up” in basis for assets passing to a surviving spouse (or trust for surviving spouse). However, assets that need to be sold by the estate for liquidity purposes to pay debts and taxes may produce capital gains tax to the estate. Without proper documentation by the decedent, it may be difficult to determine the cost basis plus improvements in the property (do you know what your parents paid for that stock they’ve held for the last 20 years that has split several times?). Even the allocation of the “step-up” basis allowance may produce disagreement among heirs when the personal representative allocates it to assets passing to certain heirs but not to others. And in order for a trust for the surviving spouse to qualify for the surviving spouse’s “step-up” in basis, the spouse must be the only income beneficiary of the trust, which may not be the case in your current will or trust.

On the positive side, the year 2010 could be a good time to consider taxable gifts while the top gift tax rate is only 35%, asset values remain depressed due to the weak economy, and interest rates are low. For example, gifting the family cabin to children may be something to consider this year. However, making large taxable gifts is not without problems as Congress may decide to make estate tax repeal permanent, or conversely Congress could decide to impose a gift tax rate higher than 35% that is retroactive to January 1, 2010. Anyone considering lifetime gifts in reliance on the 2010 rules should first consult with their legal advisor to discuss and understand the risks involved with such planning.

It is unknown whether Congress will pass legislation to reinstate the federal estate tax in 2010. There are some suggestions that Congress may try to make the tax retroactive to January 1, 2010, which will most likely result in constitutional challenges and further uncertainty for 2010 while any such litigation works its way through the courts. If Congress does not act in 2010, the federal estate tax and GST will automatically come back on January 1, 2011, with an exemption of only \$1,000,000 (versus \$3.5 million in 2009) and a federal estate and gift tax rate as high as 55%.

### What Should You Do

Most current estate planning documents have been prepared contemplating the existence of the federal estate tax, and some with two-part marital planning use formulas to minimize federal estate tax. These estate plans may be affected in ways that would be less than optimal. Therefore, the cautious course of action would be for every estate plan to be reviewed to insure that it achieves the intended result.

Here are guidelines to assist you in determining whether your will or revocable trust may have unintended results under the 2010 rules. (These guidelines apply to documents that have been prepared by our firm; if they were prepared by another firm or attorney, there may be other issues in addition to those outlined below.)

- A plan that makes gifts, including charitable gifts, in reference to “the gross estate” or the “taxable estate,” or in reference to an amount that will eliminate federal estate taxes.

- A two-part plan with a formula where the numerator (marital share) is the smallest amount necessary to eliminate federal estate tax. (Many wills/trusts determine the numerator based on the state estate tax – that approach remains valid under the 2010 rules since Minnesota retains a state estate tax with a \$1 million exemption.) (Our firm’s letter initially sending your prepared documents indicates if you have a two-part plan.)
- A plan with a QTIP marital trust. The Minnesota Revenue Dept has taken the position that since no federal QTIP election can be made under current law, assets passing to a QTIP trust will not be eligible for the marital deduction, therefore subjecting this amount to Minnesota estate tax at the death of the first spouse.
- A plan with GST tax planning that makes a gift in reference to the “available GST exemption.”
- An estate plan in which the exemption (or family) trust or the disclaimer trust does not require that all income must be distributed to the surviving spouse. (Our firm’s letter initially sending your prepared documents refers to this as “sprinkling” from the trust.) These documents should be amended to optimize the basis adjustments under the 2010 rules.
- An estate plan in which the surviving spouse is not the sole lifetime beneficiary of the exemption (or family) trust or disclaimer trust. These documents should also be amended to optimize the basis adjustments under the 2010 rules.

While it is anticipated that Congress may act sometime this year to reinstate the pre-2010 rules, this is not a certainty. Absent exigent health circumstances or other reasons, many people will wait before changing their estate plan in light of the uncertainty with the 2010 rules. Most firms, like ours, do not undertake a duty to advise clients of changes in the law that affect their situation given the impracticality of that task due to the volume of documents and regular changes in the law. Therefore, it is recommended that you review your estate plan and give consideration to consulting with your estate planning attorney to ensure that your documents continue to reflect your estate planning wishes.

The information in this website is not intended as legal advice. For legal advice, please consult an attorney.