

Congressional Chaos? Despite Pleading From the Estate Planning Community, Congress Fails to Fix Estate Tax

What are the affluent supposed to do? We are in the midst of unprecedented estate planning chaos, since Congress was unable either to permanently repeal the estate tax or establish temporary or permanent estate tax reform. Planners are stunned that Congress did not fix a problem that has been brewing since 2001.

Most people know that the federal government (and many states) have imposed an estate tax on decedent's estates. From 1981 to 1997, the estate tax exemption was \$600,000 (so only those individuals with estates over that amount had to be concerned with the tax). Over the same time period the maximum tax rate was 55%.

In 1997, Congress passed a bill to slowly increase the exemption to \$1 million by 2006. Then in 2001, Congress passed a law to "repeal the death tax", increasing the exemption to \$1 million and providing for full repeal of the tax on January 1, 2010. Under 2001 law, the exemption continued to increase up to \$3.5 million in 2009, and the maximum rate was lowered to 45%. The problem though, was that the pro-repeal legislators did not have enough votes to make the repeal permanent, so the repeal "sunset" on January 1, 2011. In other words, if Congress does not act before then, the tax is resurrected with a dramatically reduced exemption of \$1 million and a much higher rate of 55%.

In addition to there being no estate tax in 2010, there are other significant aspects of the 2010 repeal. First, the generation-skipping transfer (GST) tax is also repealed. The GST tax is a separate tax imposed with respect to certain transfers that will not be subject to estate tax in the next generation's estates (hence the term "generation-skipping"). GST planning is a powerful tool for transferring family wealth, but the amount of such transfers is generally limited (to \$3.5 million in 2009).

Second, the gift tax is retained with a \$1 million exemption but the rate is lowered to 35%. Third, the repeal switches income tax basis for inherited assets from "step-up" to "carryover". Historically, an heir's income tax basis in an inherited asset is "stepped up" to the fair market value of that asset at the date of death. As a result of the legislation to repeal the estate tax, the "step up" has been eliminated, and a decedent's basis now "carries over" to heirs. This generally means having to go back and determine what the decedent paid for an asset perhaps many decades ago.

In light of the pending "repeal of the repeal" of the estate tax beginning next January (with a \$1 million exemption and a maximum 55% rate),

Congressional leaders pledged to reconvene early this year and pass a bill to reimpose the estate tax retroactively to January 1, 2010. This possibility creates confusion and uncertainty for many families. In fact, our firm has had at least one client pass away this year who would have had a taxable estate just a few days earlier in 2009. When the client passed away in January, it appeared that the family would not owe any estate tax, but we will not know the real answer for some time. If Congress retroactively reinstates the estate tax, the stakes may be high enough for some estates to litigate the constitutionality of retroactive estate tax legislation.



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Another challenge will be interpreting older estate planning documents that do not contemplate tax repeal. Consider a married couple whose documents create two shares, one to a "family" or "credit shelter" trust and the other to the surviving spouse or to a marital trust for the spouse. Another example would be a plan that divides an estate based on the applicable GST exemption (when there is no GST tax). A third example would be the division of an estate by formula between family members and charity. In all of these cases, existing tax law could cause great ambiguity as to whether the entire estate would go to one share or to the other.

Although we hope that Congress will take action soon to provide stability and certainty, individuals should contact their estate planning attorneys as soon as possible to determine whether their plans need modification. In addition, although beyond the scope of this article, there are numerous planning opportunities presented by the current economic and legislative environment that may be worth considering before Congress or economic recovery makes them unavailable.

Congressional leaders have promised to address permanent estate tax reform in the near future. For updates on this and other related topics of interest, please visit Carruthers & Roth's new legal blog at www.NorthCarolinaWealthLawCounselor.com.

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