

## **Taxes— Estate Tax Repeal and Carryover Basis in 2010: Some Further Considerations**

By now, we know that Congress didn't get around to addressing transfer taxes in 2009. Consequently, as unlikely as it seems, the estate and generation-skipping transfer (GST) taxes have been repealed for 2010. Unless Congress acts this year, the 2001 estate and GST tax regimes will return. In 2001, the estate and GST exemptions were a mere \$1 million and the maximum rates were 55 percent.

In addition to the repeal of the Federal estate and GST taxes, 2010 marks the onset of a "modified carry-over basis" regime. Under the law as it stands today, for decedents dying in 2010, appreciated assets do not receive a step-up in basis to date of death value. Instead the beneficiary takes the decedent's adjusted basis in such assets. Consequently, sale of such assets will result in a taxable gain that includes both pre- and post-death appreciation. There are two exceptions to the carry-over basis approach:

- The basis of property passing to non-spousal beneficiaries can be increased by \$1.3 million; and
- Property passing to a surviving spouse or into a Qualified Terminable Interest Property (QTIP) trust for the benefit of the surviving spouse can be increased by an additional \$3 million.

### **What the Future Holds**

As Daniel Smith pointed out in his article last month, "The Estate Tax—What Now?" there are at least two scenarios that could play out on the legislative front:

- Congress will allow the repeal of the estate and GST tax (and imposition of carry-over basis) and reversion to the 2001 regime to stand (Play It Out scenario); or
- Congress will reinstate the federal estate and GST taxes retroactively for 2010 (probably extending 2009 rates and exemptions) and either continue 2009 law as is or with modification for tax years 2011 and beyond (Fix-It scenario).

This article expands on Daniel's article of last month, offering some additional considerations for advisors in this time of uncertainty.

## Play It Out

Clients who believe that the 2010 repeal will stand are faced with the specter of what some have called the “throw momma from the train” scenario. Unfortunately, for those families with elderly parents and/or grandparents in hospice or other “end of life” care, the potential return of the estate and GST tax at 2001 levels in 2011 is no joke. As callous as it sounds, discussions of *continuance of life* for older-generation family members versus *quality of life* for younger-generation family members are likely to take place in lawyer’s offices and hospital corridors. For better or worse, taxes are likely to play a role in determining how long some elderly patients will be kept alive.

Even clients not faced with this dire scenario should review their estate planning documents. For clients dying in 2010, when there is no estate tax, language in existing wills and trusts could lead to unintended consequences. Here’s why.

Nearly all affluent and high-net worth (HNW) clients have documents (either a will or a living trust) that divide their estates at death into family and marital shares. The family share is typically left to a “credit shelter” or “by pass trust,” while the marital share is typically left to a marital trust. In second marriage situations, the marital trust is often a QTIP trust. In first marriage situations, it is more likely to be a “life interest with general power of appointment” trust.

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Attorneys use a variety of formulas for dividing the estate into the two shares. A pecuniary formula funds a specific dollar amount. A fractional formula funds the marital and credit shelter trust proportionally with each asset. In addition, one type of pecuniary formula funds the marital trust first with the balance or residuary passing to the credit shelter trust. Another formula funds the credit shelter trust first with the balance of the estate going into the marital trust. The type of formula used affects whether capital gains taxes are payable upon funding and the ease of administration.

Let’s say a client’s will or living trust has a typical pecuniary formula that reads essentially as follows:

“I, Bill, leave all of my estate to my wife, Leslie, following the subtraction of that amount of my estate which is the minimum amount necessary to reduce my Federal estate tax to the lowest amount.”

Assuming Bill dies in 2010, one interpretation of the formula is that the entire estate passes to Leslie, inasmuch as the minimum amount necessary to reduce a non-existent estate tax to zero is zero. If the estate tax returns in 2011 and Leslie dies in that year or later, the unintended consequence of this reading of the formula is that Bill and Leslie's combined estates will be taxable at Leslie's death. No part of Bill's estate (and appreciation thereon) will be sheltered from tax in the family trust. Furthermore, non-spousal beneficiaries will be effectively disinherited at Bill's death. None of this is what Bill expected or intended when his estate planning documents were drafted.

*One caveat to the "mega-funded" credit shelter trust approach is this: If federal estate and gift taxes return with a vengeance in 2011 and the client survives until then, it will be necessary to revisit the documents again to avoid overfunding of the credit shelter trust and underutilization of the marital share.*

Let's say the formula reads a little differently. It says that the credit shelter trust will be funded first with the largest amount that can pass free of estate taxes with the residuary estate passing to the marital share. One interpretation is that because the entire estate passes free of estate taxes in 2010, the entire trust passes to the family. The surviving spouse, much to his or her chagrin, is left standing at the curb, so to speak. Again, this is probably not the result the decedent intended.

Another possibility in both situations is potentially even more troubling. Disgruntled heirs could challenge the documents in court, arguing that repeal of the estate and GST taxes effectively revokes the will or trust or at least the formula clause. If the will or trust is considered revoked, presumably the decedent's estate will be distributed

based on the applicable law of intestacy. In general, such a disposition of the assets will be far from the decedent's intent and will not result in the most tax-efficient approach.

At a minimum, this suggests that clients who believe in the Play it Out scenario should add a codicil to their wills and/or amend their living trusts to make it clear that it is not their intent that repeal of the estate and GST taxes revokes their documents.

Beyond this, as Daniel Smith suggested last month, clients may wish to consider modifying documents to maximize the benefit of the 2010 repeal should they die in this year. Essentially, this would involve leaving the entire estate of the first spouse to die to heirs in a manner that does not qualify for the marital deduction, while at the same time providing the surviving spouse with sufficient income and limited power over principal that he or she is adequately cared for. The potential is to create a "mega-funded" credit shelter trust that transfers much more than the current \$3.5 million exemption amount (and future appreciation thereon) entirely outside of the transfer tax system.

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revisit the documents again to avoid overfunding of the credit shelter trust and underutilization of the marital share.

This concern can be alleviated by the use of a trust with QTIP provisions in conjunction with or in lieu of a credit shelter trust. Such a trust would provide all income to the surviving spouse for life with non-spousal beneficiaries receiving the remainder interest. Because the QTIP election isn't made until after death, the determination of how much of the trust, if any, to qualify for the marital deduction can be delayed. Furthermore, the election can be exercised pursuant to a formula to obtain the most tax-efficient results.

A further caveat to the "mega-funded" credit shelter trust approach relates to the modified carry-over basis rules. Assets not passing directly to the surviving spouse or into a QTIP will have a carryover basis subject to increase of only \$1.3 million. Thus, while leaving everything to non-spousal beneficiaries could make sense from an estate and GST tax perspective, it could trigger capital gains taxes if it is necessary to sell appreciated assets to generate liquidity and/or income for survivors.

### **Fix It**

Given the polarization within Congress, it is difficult to predict whether legislation to make the estate and GST tax retroactive will be enacted or not. However, even for clients who believe this scenario likely, it makes sense for them to review their documents and perhaps add a codicil or amend a trust document to hedge against the possibility of the repeal remaining permanent. If a client were to die in 2010 and repeal stuck, the unintended consequences described above could come to pass.

Rather than place their estates in the hands of Congress, clients and their estate planning attorneys may wish to take affirmative action.

### **Bottom Line**

Chances are your clients have received (or will be receiving shortly) letters from their estate planning attorneys advising them to have their documents revised. As their advisor, they may turn to you for insight on what to expect from such a review. Be prepared to discuss the alternatives. Help clients understand that the 2010 repeal is just for one year, even if it stands, and that a relatively small lawyer's fee to modify their existing documents could save big dollars in the long run.

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