Chaos Created By the 2010 Repeal of the Federal Estate Tax & Generation Skipping Transfer Tax

Trusts & Estates Practice Group
Foster Swift Estate Planning Bulletin
January 2010

PRACTICE AREAS
Estate Planning

To the surprise of most estate planning attorneys, Congress failed to redress the repeal in 2010 of the federal estate tax and generation-skipping transfer tax before adjourning the 2009 session. Consequently, the beginning of 2010 marked the first time in 94 years that the United States has been without a federal estate tax. It is important for you to be aware of the current status of federal transfer tax law and the scheduled changes for 2011, and to act quickly to minimize any negative impact on your estate plan or take advantage of planning opportunities that may not exist for long.

Federal transfer taxes consist of a gift tax (imposed on transfers during the donor's lifetime), an estate tax (imposed on the value of a decedent's taxable estate at the decedent's death), and a generation-skipping transfer tax (imposed in addition to the gift tax or estate tax on transfers to individuals who are two or more generations below the transferor). In 2009, the highest marginal rate for each of these three transfer taxes was 45%.

QUESTION

What does it mean that the federal estate tax is "repealed" for decedents dying in 2010?

ANSWER

The federal estate tax has been effectively repealed for decedent's dying in 2010. This means that, unless new legislation is enacted, **there is no federal estate tax for individuals dying in 2010**. Although some states have a state estate tax, Michigan does not currently have an operable estate tax. Thus, under current law, no estate tax liability will be imposed as a result of the death of a Michigan resident who dies in 2010.

QUESTION

Before 2010, how did the federal estate tax operate?

ANSWER

Before 2010, the federal estate tax law allowed each individual to transfer a certain value of property at death free from federal estate tax. This amount is commonly referred to as the "estate tax exclusion amount." Any property transferred in excess of the estate tax exclusion amount was subject to federal estate tax. In 2009, the federal estate tax rate was a flat rate of 45%; however, the federal estate tax has had a marginal rate of as high as 77%.

QUESTION

How was the federal estate tax repealed in 2010?

ANSWER

In 2001, Congress passed legislation that increased the estate tax exclusion amount in stages from $675,000 in 2001 to $3.5 million in 2009 and lowered the highest marginal federal estate tax rate from 55% in 2001 to 45% in 2009. Ultimately, the same federal legislation called for the federal estate tax to not apply to decedent's dying in 2010. Due to a "sunset" provision, the federal estate tax will return in 2011 with an estate tax exclusion amount of $1 million and tax rate of 55% (see **Table 1**). The "sunset" provision was designed to sidestep a Congressional budgetary rule that allows Senators to block legislation that purports to increase the federal deficit beyond a 10-year term.

Transfer occurring/Decedent dying in:

Estate tax exclusion amount

Gift tax exclusion amount

GST exemption

Highest estate GST, and gift tax rate

2009

$3.5 million

$1 million

$3.5 million

45%

2010

N/A (estate tax repealed)

$1 million

N/A (GST tax repealed)

35% (gift tax only)

2011

$1 million

$1 million

$1 million + (adjusted for inflation)

55%

The repeal of the federal estate tax in 2010 and its return in 2011 is irrational from a policy perspective. If a decedent died December 31, 2009 with a $5 million estate, only $1.5 million would be subject to federal estate tax. Assuming no deductions applied, at a 45% tax rate the estate tax liability would be $675,000. If that same decedent died one day later on January 1, 2010, there would be no estate tax liability.

The discrepancy worsens when the federal estate tax is reinstated in 2011. A decedent dying with a $5 million estate on December 31, 2010 would incur no estate tax liability. If that same decedent instead died one day later on January 1, 2011, $4 million would be subject to estate tax. At a rate of 55%, the estate tax liability would be $2.2 million.

Many commentators expected Congress to pass new federal estate tax legislation before 2010 eliminating this one-year gap in the federal estate tax, and possibly increasing the estate tax exclusion amount for 2011 and beyond. In early December 2009, the House of Representatives passed a bill permanently extending federal estate taxes at the 2009 level; however, the Senate adjourned the 2009 session without passing the bill. As a result, the federal estate tax repeal went into effect January 1, 2010.

QUESTION

Does the 2010 repeal of the federal estate tax affect my estate plan?

ANSWER

If your estate plan was designed to reduce or avoid federal estate tax, then the 2010 repeal of the federal estate tax could impact formulas utilized in your revocable trust, thereby causing unintended consequences.

For example, in disposing of trust assets upon the death of the settlor, some revocable trusts include a formula to create a share equal to the federal estate tax exclusion amount of the settlor (the "credit shelter share"). This credit shelter share typically is used to fund a "Family Trust" or is given outright to children. The remainder of the trust estate is typically then distributed to the surviving spouse, outright or in trust.

Under certain formulas used, the 2010 repeal of the federal estate tax could unintentionally cause the entire trust estate to be allocated to the credit shelter share, thereby leaving nothing to pass to the surviving spouse. This could be a problem if the credit shelter share passes outright to children or passes to a Family Trust of which the surviving spouse is not a beneficiary, especially if the surviving spouse does not have substantial assets of his or her own.

> For example, a husband and wife with an estate of $10 million may have separate trusts, each trust funded with $5 million. If the husband had died in 2009, a Family Trust would have been established with approximately $3.5 million, the 2009 federal estate tax exclusion amount. The remaining $1.5 million would have been distributed to the surviving spouse, outright or in trust.
>
> If the husband instead dies in 2010 with the same estate plan, the entire $5 million would be distributed to the Family Trust and none would pass to the surviving spouse. The husband may have intended that at least a portion of his estate would go to his wife.

Another situation that may be adversely impacted by the 2010 repeal of the federal estate tax is that of a widow or widower who leaves the credit shelter share to children and the remaining assets to charity. Depending on the nature of the formula used in the trust to effectuate this dispositive plan, the federal estate tax repeal could cause (a) the entire trust estate to pass to the children, with nothing passing to charity, or (b) the entire trust estate to pass to charity, with nothing to passing to the children.

QUESTION

Are there any other federal tax law changes affecting decedents dying in 2010?

ANSWER

The legislation passed by Congress in 2001 also made changes to basis rules for assets passing upon the death of a decedent dying in 2010. This may impact the income tax owed on capital gains upon the eventual sale of the property, and may affect far more individuals than the 2010 repeal of the federal estate tax.

Before 2010, the basis of assets passing upon the death of a decedent would "step-up" (or "step-down") to the asset’s fair market value as of the date of the decedent’s death. For example, a decedent may have purchased a house many years ago for $100,000 and the fair market value of the house may now be $300,000. Assuming the absence of improvements or depreciation, the decedent’s basis of the house would be the original purchase price, $100,000. If the decedent had died in 2009, the person receiving the house from the decedent would have a basis equal to the fair market value of the house, $300,000.

Appreciated assets passing upon the death of a decedent dying in 2010 **may not receive a step-up in basis**. Instead, assets received from a decedent dying in 2010 will have a basis equal to the *lower* of (a) the decedent's basis, or (b) the fair market value of the asset. This is referred to as "carry-over basis."

Continuing with the above example, if the decedent instead died in 2010, the person receiving the house from the decedent would retain the decedent's basis of $100,000. Thus, if the house was later sold, the seller would recognize a capital gain equal to the difference between the fair market value and basis, or $200,000. Long-term capital gains are taxed as income at a current maximum rate of 15%, so this would result in income tax of $30,000.

QUESTION

Are there any exceptions to carry-over basis?

ANSWER

Yes. The current tax law provides for two exceptions:

1. The personal representative of an estate may allocate up to $1.3 million (increased by unused losses or loss carryovers) in basis increases; and
2. The personal representative can allocate up to an additional $3 million in basis increases for certain transfers to or in trust for the surviving spouse.

QUESTION

Do I need to amend my estate plan to utilize this carry-over basis?

ANSWER

No, the law allows your personal representative or the successor trustee of your revocable trust to allocate the basis adjustments among specific assets following your death. However, this may present the personal representative or successor trustee with difficult choices or even a conflict in making basis allocations. An amendment to your estate plan may provide your personal representative or successor trustee with specific direction or guidance in making basis allocations. You might also consider waiving conflicts of interest by the personal representative or successor trustee in allocating basis or exonerating the personal representative or successor from liability in making allocation determinations.

QUESTION

Is the federal gift tax repealed in 2010?

ANSWER

No. **There is no repeal of the federal gift tax in 2010**. However, in 2010 a donor can still gift up to $13,000 per donee (the annual gift tax exclusion amount) free of federal gift tax liability and without any requirement to file a federal gift tax return. In addition, a donor still retains the ability to make aggregate lifetime gifts of up to $1 million under the "lifetime" gift tax exemption. The donor only pays gift tax on gifts exceeding the donor's $1 million lifetime gift tax exemption.

In 2010, the maximum federal gift tax rate is 35%. The maximum federal gift tax rate is scheduled to increase to 55% in 2011. Therefore, now may be a good opportunity to make large gifts at the lower 35% federal gift tax rate currently in effect in 2010.

QUESTION

Is the federal generation-skipping transfer tax also repealed in 2010?

ANSWER

Yes. This means that, unless Congress enacts new legislation, **there is no generation-skipping transfer tax** for transfers to individuals two or more generations below the donor (i.e., grandchildren) in 2010.

QUESTION

How can I take advantage of the repeal of the federal generation-skipping transfer tax?

ANSWER

If you intend to transfer large amounts to your grandchildren as part of your estate plan, 2010 may be a good time to consider outright gifts to grandchildren because such transfers are currently not subject to the generation-skipping transfer tax. It may also be possible to fund a trust for grandchildren without incurring generation-skipping transfer tax. Keep in mind, however, that the federal gift tax still applies to any gifts to grandchildren or others.

For trustees or beneficiaries of trusts that may be subject to generation-skipping transfer tax upon a distribution to a grandchild, now may be a good time to make such a distribution and avoid generation-skipping transfer tax.

As discussed below, Congress may attempt to reinstate the generation-skipping transfer tax retroactive to January 1, 2010. Prior to making any distributions, you should discuss the potential benefits and risks of such a distribution with your estate planning attorney.

QUESTION

What happens to federal transfer taxes in 2011?

ANSWER

Unless Congress passes new legislation, in 2011 the federal estate tax is reinstated with an estate tax exclusion amount of $1 million and a maximum estate tax rate of 55%. The step-up in basis returns, so all assets passing because of a decedent's death in 2011 will have a basis equal to the fair market value of the asset as of the decedent's date of death. The federal generation-skipping transfer tax also returns, with an exemption of $1 million (indexed for inflation) and a maximum rate of 55%. The federal gift tax continues to have a $1 million lifetime gift tax exemption, but the maximum gift tax rate will be increased to 55%.

QUESTION

Will Congress do something to resolve the chaos it created in the federal transfer tax system?

ANSWER

We cannot be sure what Congress may do. At this time, there appear to be two likely courses for Congress:

1. First, Congress could pass new legislation in 2010 to permanently or temporarily restore the federal estate tax and generation-skipping transfer tax, which would likely be under the following general parameters:
    a. An estate tax exclusion amount (and corresponding generation-skipping transfer tax exclusion amount) between $3.5 million and $5 million;
    b. A maximum estate tax rate, generation-skipping transfer tax rate, and gift tax rate between 35% and 45%; and
    c. An effective date anytime between January 1, 2010 and January 1, 2011. If Congress attempts to make the effective date retroactive from the date of enactment, then the retroactivity will, inevitably, be challenged on constitutional grounds. It is unclear whether or not such a challenge would be successful.
2. Alternatively, Congress could simply take no action, and thereby allow the restoration of the federal estate tax in 2011 with a $1 million exclusion amount and 55% highest marginal tax rate. Although this was not considered a significant possibility as recently as one year ago, it has now become a more viable scenario because of (a) the need to address historical federal budget deficits, and (b) the reluctance to vote on controversial matters in an election year. The current Congress may attempt to attribute this "tax increase" to the actions of the 2001 Congress and distance itself from responsibility.

TABLE 1

Transfer occurring/Decedent dying in:	Estate tax exclusion amount	Gift tax exclusion amount	GST exemption	Highest estate GST, and gift tax rate
2009	$3.5 million	$1 million	$3.5 million	45%
2010	N/A (estate tax repealed)	$1 million	N/A (GST tax repealed)	35% (gift tax only)
2011	$1 million	$1 million	$1 million + (adjusted for inflation)	55%