



What Estate Tax?

Now that our income tax returns have been carefully prepared and timely filed (or at least put off for another six months), let's take a look at the state of the federal estate tax.

As of January 1, 2010, the thing we never expected to happen actually did. Congress let 2010 arrive without making any changes to the estate tax, which resulted in its repeal effective January 1. This means that hypothetically, the estates of those who die in 2010 will not be subject to any estate tax. Or will they?

Let's take a look back to see where we've been, and then we'll discuss the possibilities that may lie ahead.

In 2001, Congress passed a new tax act that resulted in gradually increasing estate tax exemptions and the ultimate repeal of the estate tax in 2010. In 2009, the estate tax applicable exemption was \$3.5 million, meaning that taxpayers who died in 2009 with an estate of less than \$3.5 million were not subject to estate taxes. Those with an estate of more than \$3.5 million were subject to a tax of 45% on the excess.

As 2010 approached, we all expected that Congress would take action to at least prevent repeal from coming into effect. The most commonly expected proposal involved making the 2009 law permanent at least for the next year. But because Congress didn't act, repeal is here.

So we can all breathe easy, right? Not so fast.

Following are a few scenarios that might play out, depending on whether Congress decides to take action and what action it chooses to take.

1. Congress could still act to reinstate the estate tax at 2009 (or similar) levels and make it retroactive to January 1 – effectively removing the repeal. Such an act could be in the form of a “quick fix” that lasts through 2010 or maybe 2011, thereby requiring Congress to take action again soon (and still leaving us all scratching our heads as to future years). Or they could make a more permanent change that we could rely upon for the foreseeable future – or at least until Congress decided to take up the issue again. The chatter in estate planning circles is that the farther we get into 2010, the more unlikely it becomes that Congress will pass a law that is retroactive.
2. Congress could allow the repeal for 2010 to stand and enact new legislation to take effect in 2011. Again, commonly heard proposals include reinstating the tax at 2009 or similar levels.
3. If Congress takes no action whatsoever, then we will have one year of repeal, but in 2011, the estate tax returns at an exemption level of \$1 million. By not acting, Congress would be effectively pulling millions of Americans back within the estate tax's reach. Because a decedent's gross estate includes the death benefit on life insurance policies



owned by the decedent, a \$1 million exemption level could even end up taxing otherwise smaller estates that perhaps include a larger life insurance policy.

Another issue to keep in mind for 2010 is the trade that Congress made when it crafted the 2010 estate tax repeal back in 2001. We have become used to the concept of “step-up in basis at death,” which in essence means that beneficiaries who inherited assets from a deceased person’s trust or estate received a “step-up” in the income tax basis of the asset equal to the fair market value of the asset at the decedent’s death. If the beneficiary sold the asset shortly after the decedent’s death, there was little to no capital gain to report. With the repeal of the estate tax in 2010 also came the loss of the step-up. This means that beneficiaries will also inherit the decedent’s basis in an asset (called the “carry-over basis”) and the built-in gain that may come with it. (Alternatively, in 2010, if the asset is worth less than the decedent’s basis, then the beneficiaries will get a “step-down.” The inherited basis is the lesser of the decedent’s basis or the fair market value of the asset at death.) A simple example: Mom and Dad bought a house in 1975 for \$150,000. Dad died several years ago, and Mom dies in 2010 when the house is worth \$400,000. If the Children of Mom and Dad sell the house for \$400,000, they will have a \$250,000 capital gain to report and a potential capital gains tax liability to pay. If there had been a basis step-up, the gain would have been zero. Tracking and determining the basis of a decedent’s property purchased years ago will be an administrative nightmare for taxpayers, but the good news is that the estate can allocate \$1.3 million of basis to appreciated assets, thereby reducing or eliminating much of the tax burden. (Assets that a decedent leaves to a surviving spouse, either outright or through a QTIP trust, are allowed an additional \$3 million step-up, for a total possible step-up of \$4.3 million.)

So what is the bottom line for YOU?

Total up the value of all of your assets, including the assets of your spouse if you are married, and including the death benefit on all life insurance policies that you own. If that total is:

1. Less than \$1 million: No need to worry about estate taxes at this time.
2. More than \$1 million but less than \$3.5 million: You may have an estate tax issue in 2011 depending on what Congress does...or better put, doesn’t do. Please contact me to discuss your estate plan and the options available to you.
3. More than \$3.5 million: You likely already have estate tax planning in your documents (or you should!), but they may need to be adjusted to take into account the 2010 repeal and the new basis allocation rules. Please contact me to discuss your estate plan and the options available to you.

For all of my existing clients, I’m happy to schedule a complimentary one hour conference to review your estate plan and determine if we should take further action in light of these uncertain tax times. And please remember that taking the “wait-and-see what Congress will do” approach, while tempting, may leave you and your family facing unintended consequences, including tax liabilities that could otherwise be avoided or reduced.

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