WHAT'S UP WITH THE ESTATE TAX?

Kell, Alterman & Runstein, LLP

If you have not heard recently, Congress, through its action in 2001 and subsequent inaction, has done away with the federal estate tax and the generation skipping tax. This change is effective January 1, 2010 through December 31, 2010. After December 31, 2010, if Congress does nothing, the federal estate tax laws will revert to the rules prior to 2001.

In 2009, the federal estate tax was 45% for the amount of an estate in excess of $3.5 million. Several bills were presented in Congress during 2009 to avoid the repeal of the estate tax. To everyone's surprise, Congress was unable to agree on any proposals. These proposals even included a one page bill that would have simply extended the 2009 estate tax law for three months while issues were sorted out.

As a result of this inaction, the federal estate tax has been repealed due to the automatic repeal provisions in the 2001 laws. Nonetheless, the inheritance tax in the states of Oregon and Washington, among others, continues. The following is a brief synopsis of the new law now in effect, followed by scenarios that could occur, and finally some suggestions as to what the concerned citizen might do about this legal limbo.

The New Rules

With the repeal of the federal estate tax (and the generation-skipping tax) came a repeal of the rules allowing a step-up in basis in property acquired from a decedent. Basis in property is the acquisition cost for the property with certain adjustments. Under the pre-2010 laws, heirs and beneficiaries received a "stepped-up" basis, which meant that the basis value of an asset took on the fair market value of the asset as of the date of death (or alternate valuation date). This "step-up" meant that if heirs sold property acquired from a decedent immediately following death, no capital gains tax would need to be paid on the sale of the asset as there would be no reportable gain.

Under the new laws that went into effect January 1, 2010, the regime changed to a modified carry-over basis system in place of a federal estate tax. Under the modified carry-over basis system a step-up in basis will be allowed for up to $1.3 million with all remaining assets maintaining the original cost basis.[1]

[1] Under the new law, the assets acquired from a decedent are subject to a modified carry-over basis which is the lesser of: (a) the adjusted basis of the decedent, or (b) the fair market value of the property at the date of the decedent's death (but not the alternate valuation date). The decedent's personal representative (or executor) is allowed to step-up the basis of assets transferred in an estate by a total of $1.3 million dollars. This amount can be increased by the amount of unused capital losses, net operating losses and certain built-in losses of the decedent.

Kell, Alterman & Runstein, LLP
520 SW Yamhill #600
Portland, OR 97204
(503) 222-3531

For married couples, the basis of property transferred outright to the spouse or to a "QTIP" trust[2] for the benefit of the surviving spouse may be stepped-up by an additional $3.0 million.[3] Therefore, basis transferred to a spouse may be increased up to a total of $4.3 million with proper planning.[4] In order to take advantage of this additional $3.0 million in stepped-up basis, the assets must be left to a QTIP marital trust or as an outright transfer to a spouse under current law.[5] Again, these rules are the federal rules only. The state inheritance tax rules still apply as in place prior to January 1, 2010

It is very important to note that the federal gift tax was not repealed for gifts made after December 31, 2009. The maximum lifetime gifting exclusion is $1.0 million[6] with all gifts in excess of that amount currently taxed at 35%.[7] Further, a transfer to a trust (other than a grantor trust where the donor is the whole owner of the trust) will be defined as a gift. The ramifications of the code section defining this rule are not clear at the time of writing this article. Some commentators expect the Service or Congress to provide clarification soon.

As mentioned previously, some states such as Oregon and Washington have decoupled from the federal tax regime. In other words, despite the repeal of the federal estate tax, the state inheritance tax in many states continues. In Oregon, an estate under $1.0 million dollars is exempted from state inheritance tax. In Washington, up to $2.0 million dollars is exempted. Therefore, it is very important that any estate plan not only take into account the new federal rules but also the state tax differences.

Finally, the repeal of the estate tax could have unintended consequences to the distributive intent of an existing plan depending on the formula language and terms of the plan documents. Some plans anticipate funding several trusts at death based on the exemption amount of prior law. With no current exemption amount, one or more of the trusts may not be funded at the death which could exclude intended beneficiaries.

It is clear that there is considerable confusion about the repeal of the federal estate tax at the present time both in application and as it relates to what might happen. Some commentators believe that Congress will enact a retroactive law restoring the federal estate tax. Others believe Congress will do nothing and the law will automatically revert to pre-2001 status on January 1, 2011. It is also unclear whether a violation of the Constitution will occur if Congress attempts to re-enact a federal estate tax retroactively. As a result, the 1994 Supreme Court case of U.S. vs. Carlton[8] could be challenged or modified. In that case, the Supreme Court generally indicated that unlike the criminal

[2] Qualified Terminable Interest in Property
[3] IRC Sec. 1022(c)(2)(B).
[4] IRC Sec. 1022(c)(1).
[5] IRC Sec. 1022(c)(3).
[6] IRC Sec. 2505(a)(1).
[7] IRC Sec. 2502(a)(2).
[8] United States v. Carlton, 512 U.S. 26 (1994).

Kell, Alterman & Runstein, LLP
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code, Congress has considerable power to tax forwards and backwards without a due process violation.

Logical Outccomes

The following are logical options that could occur depending on the actions of Congress:

1. Congress re-enacts the federal estate tax and makes it retroactive to January 1, 2010 (using 2009 rates or other rates determined through Congressional negotiations)[9]. Constitutional challenges could result;

2. Congress re-enacts the federal estate tax and allows taxpayers the choice of applying the retroactive law or the law that existed at the time of death;

3. Congress re-enacts the federal estate tax effective the date the bill is signed into law (using 2009 rates or other negotiated rates);

4. Congress does nothing in which case the estate tax will return January 1, 2011 with a rate of 55% and only a $1 million dollar exemption.

What You Can Do Now

There are a multitude of options available to smart planners. One option, although not recommended, is to simply wait to see what Congress does, if anything. This option is not recommended as death is not a predictable event. With improper planning, a death in 2010 could leave an estate without the ability to take maximum advantage of the current laws. Furthermore, and more importantly, the estate may not be distributed as desired under some pre-2010 drafting techniques.

A better option would be to have your estate plan reviewed, even if recently completed, and consider installing a "patch" to your plan. A properly designed patch, whether in a will or trust context, can take into account the variety of logical outcomes above so that further amendments may not be necessary unless Congress does something completely unpredictable.

Concerned citizens should also consider writing to their Congressional representative and express the desire for certainty in this area of law very soon.

Finally, it is worthwhile to begin assembling basis information for existing assets. This information will be required in order to prove basis at death. Failure to assemble this information or have access to it following a death could cause unnecessary capital gains taxes to be paid in the event of a sale of an asset.

[9] This option could cause United States v. Carlton to be challenged or distinguished.

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To have your questions answered about the above law changes, create or update an estate plan or to determine whether an estate plan patch is right for you, please contact one of the lawyers at Kell, Alterman & Runstein, LLP. This article is for general informational purposes only and should not be relied upon in individual circumstances. Consulting with qualified tax advisors is recommended.

By Robert E. Kabacy

Kell, Alterman & Runstein, LLP
520 SW Yamhill #600
Portland, OR 97204
(503) 222-3531