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The Estate Tax Is Gone (For Now)

By Jeffrey Kolender

As most people know by now, the federal estate tax was repealed as of January 1, 2010. This actually was part of the much acclaimed "death tax" repeal enacted in 2001, but most tax experts never thought the repeal would make its way into law. They said the deficit is too great, the budget has to be balanced, tax revenues are needed to pay for TARP, etc. Congress had tried on several occasions to pass some sort of compromise bill, yet it never happened. What a surprise; politics got in the way of effective governing. Yet that's a topic for another day.

The estate tax is gone (for 2010), so everybody, other than the tax collector, must be happy, right? You'll be paying less tax and you don't need to do any estate tax planning. Is that really true, though? Let's look at some of the realities of the situation:

1. Capital gains tax: It's logical to conclude that "with the estate tax gone, my kids won't have to pay a tax upon my death." Well, that's true; no federal estate tax will be due if you die in 2010 (unless the law is changed sometime this year). However, one of the benefits of the pre-2010 estate tax laws was that your beneficiaries' cost basis in your assets was increased to the assets' date-of-death value. This resulted in significant income tax savings upon a subsequent sale of the assets. As an example, let's say your grandfather bought real estate for $100,000 in 1962, which was worth $1 million at the time of his death in 2009. The cost basis of the real estate was increased to $1 million upon his death, so if you turned around and sold the property for $1 million that same year, it would not result in any capital gains tax.

Under the new law, however, this increased cost basis (known as a "stepped up basis") will no longer occur. Instead, subject to certain exceptions, your beneficiaries will receive the same cost basis you had in your assets, potentially resulting in significantly higher capital gains taxes if you die owning property that's greatly appreciated in value. This new rule also brings up another problem; how do you figure out the cost basis in property that may have been purchased 40 or 50 years ago? Most people don't even know what they paid for some stock they bought five years ago, especially if you have reinvested dividends along the way.

2. State estate tax: Even if there is no federal estate tax due, your estate may have to pay state estate tax. Although Virginia doesn't have an estate tax, Maryland and D.C. both have estate taxes for anyone with an estate in excess of $1 million. In determining the value of your estate, you include life insurance proceeds, retirement plans, the value of your house and investment assets, or in other words, everything. So, even if you have no federal estate tax concerns, it is still advisable to make plans to reduce or eliminate the state estate tax.

3. Watch out for 2011: One of the real peculiarities of this new law is that the federal estate tax is scheduled to come back in 2011. Even worse, the estate tax exemption - the amount you can pass to your beneficiaries free of estate tax - will be only $1 million, and the estate tax rates will be as high as 55%, a far cry from the $3.5 million exemption and 45% rate in effect in 2009. So, absent a change in the law, here's the "price of progress": a person dying in 2011 may pay more estate taxes than someone who passed away in 2009.

4. More legislation from Congress: There is some talk that Congress may pass new legislation this year to take effect next year. For example, it could change the law for 2011 (and beyond), increasing the estate tax exemption to the pre-2010 amount and/or change the estate tax rates. Such legislation would keep a federal estate tax in place, but still exempt the great majority of Americans from having to pay it.

Alternatively, Congress could decide to change the law effective sometime this year. There is even speculation that it may change the law retroactive to January 1; assuming the retroactivity is constitutional, that would mean that, in effect, the repeal of the federal estate tax never happened!

Or due either to a preoccupation with health care and other concerns, or just plain politics, Congress may do nothing.

5. Generation-skipping transfers: One option that has become quite popular over the last several years is to place property (upon death) in trust for a child for the child's lifetime, with the property passing upon the child's death to his/her children. Commonly known as "generation-skipping Trusts," these provide significant estate tax and asset protection benefits for your descendants, and can even be structured to continue for many generations or in perpetuity.

Under both pre-2010 and post-2010 law, there are limitations on the amount that can be placed in generation-skipping Trusts, with a significant tax imposed if you exceed the limit. Since the generation-skipping tax is repealed for 2010 only, it would seem upon first blush that this is a perfect opportunity for people to take full advantage of this repeal, and create generation¬skipping Trusts for their descendants. However, due to the manner in which the repeal was structured, putting assets into a generation-skipping Trust in 2010 may ultimately result in the imposition of that same tax in future years, making for a somewhat illogical yet very possible scenario.

6. What should I do/does the new law impact my existing estate plan? Many people looking at the mess that is currently the estate tax laws might be inclined not to revisit their estate plan until Congress fixes the law. Their thinking is: Why change your estate plan if there is a good chance Congress will change the law sometime soon? However, not changing your estate plan can result in significant estate tax problems. For example, if your current Will creates an estate tax savings Trust (commonly referred to as a "By-Pass," "Family" or "Non-Marital Deduction" Trust) for your spouse's benefit, then under 2010 law the Trust may be overfunded or not funded at all, depending on the language of your will (or Revocable Trust, if applicable).

The same may be true if you create generation-skipping Trusts for your children – depending on how the Will is structured, all of your estate may be placed in the generation-skipping Trusts, or no portion of your estate will be placed in the Trusts.
In a similar vein, if your estate is divided in some manner among your spouse and children, depending on the exact wording of the will, the spouse could be totally disinherited - in which case your children would receive everything - or could receive your entire estate and your children would be shut out.

These are just some of the issues that may arise as a result of the 2010 law.

For the reasons cited above and many others, it's clear that some type of review is essential to determine if your assets will be distributed in the manner you want and to ensure that you will take full advantage of the available estate tax benefits. It may also be a good time to see if your estate planning documents are otherwise up-to-date. For example, are your Executor (Personal Representative),Trustee and Guardian designations still correct? Do you have current Powers of Attorney and Advance Medical Directives? Are the beneficiary designations for your life insurance policies and retirement plans coordinated with the rest of your estate plan? These are all issues you should review periodically, even when there are no changes in the estate tax laws.

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