

Dealing with the Chaos of Estate Tax Repeal

On January 1, 2010, we entered the final stage of the 10-year phase-out and repeal of the federal estate and generation-skipping transfer (GST) taxes put in motion by the Economic Growth and Tax Reconciliation Relief Act of 2001. That legislation increased the estate and GST tax exemptions from \$1 million to \$3.5 million over the period 2002-2009 and reduced the rates on those taxes over the same period from 55 percent to 45 percent. The legislation repealed the estate and GST taxes in 2010, and left the gift tax in place in 2010 with a reduced rate of 35 percent. This is for only one year, however. As of January 1, 2011 the estate and GST taxes are scheduled to be back in place along with the gift tax, but with the 2001 exemptions and rates. The likelihood that Congress will take some sort of action to reinstate the estate and GST taxes this year is very high, and any such action may be retroactive. At the moment, however, all we have is uncertainty.

Because we cannot predict the timing or content of further Congressional action, there are limits to the advice we can provide at this time. However, the uncertainty gives rise to certain short-term risks and opportunities that you may wish to discuss with us.

Risks:

- Many estate planning documents contain formula bequests that are based on estate and GST tax concepts. If those documents were to become operative at a time when those taxes were not in effect, the formulas could be difficult to construe, and in a small number of cases could direct that property be distributed in unanticipated and undesired ways. This is particularly likely to be the case where a decedent is survived by a spouse and bequests are made to children or grandchildren that are defined by the amount of available estate tax exemption or GST tax exemption.
- The trade-off for elimination of the estate tax is the introduction of carry-over basis. This means that assets held at death will no longer acquire a new cost basis for income tax purposes equal to fair market value at date of death, but will retain the cost basis they had in the hands of the decedent. The new rules—effective while the estate tax remains repealed—provide a limited basis step-up in the amount of \$1.3 million, plus an additional basis step-up of \$3 million for “qualified spousal property.” In many cases estate planning documents are structured in a way that will take full advantage of these limited step-up rules, though in some cases they may not be.
- The new carry-over basis rules will present a challenge in the administration of the estate of a person who dies this year before Congress acts to address estate tax repeal. Where a basis step up was available, an executor’s first step in administering an estate was often to sell appreciated securities, particularly where those securities were not diversified. With uncertainty about whether or not there is a basis step up, the decision to sell securities is a more difficult and riskier one.

Opportunities:

- Some clients may wish to take advantage of no GST tax and a gift tax at a reduced rate of 35 percent, to make substantial gifts to or for grandchildren or other family members. Unfortunately, if the GST tax were reenacted and the 45 percent gift tax restored retroactively, the opportunity would have

proved illusory. As a way of tempering this risk, it may be possible in appropriate circumstances to make a gift and retain the option for it to be effective currently as a gift for grandchildren or other family members (if current law stays unchanged) or as a nontaxable gift to a spouse (if the law is changed retroactively).

We would be happy to talk with you about how estate tax repeal may affect you, and whether there are planning opportunities that are appropriate to your situation. In many cases we are likely to advise that you do not need to make changes to your estate plan, but this would be a good time for at least an interim review.

If you have additional questions regarding the federal estate tax, please contact your Ropes & Gray advisor.