



Alerts

Congress Allows Temporary Repeal of Federal Estate Tax – Immediate Review of Estate Planning Documents Critical

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Estate tax planning is an important part of estate planning. Because Congress has allowed the federal estate tax to be repealed, the estate tax planning environment is now in turmoil.

The federal estate tax and the federal generation-skipping tax (GST) were repealed on December 31, 2009—for one calendar year. Both taxes will become effective again, automatically, on January 1, 2011. During the one-year gap, a new tax regime is in place. The estate planning documents of those who have them may not fully contemplate all of the possible ramifications of these tax changes. Following below are some of the issues should be considered, and possible courses of action which should be taken now.

2010 Tax Planning: How Much Needs to Be Done for One Year?

Should one die in 2010, his or her beneficiaries will receive the property bequeathed tax-free. However, the beneficiaries will inherit the decedent's income tax basis related to such property. This means that a large capital gain may be passed on to the beneficiaries. Fortunately, each taxpayer may avoid up to \$1.3 million of capital gains by using a special "step up" allowance under Internal Revenue Code Section 1022. A married individual may avoid an additional \$3 million of capital gains related to property transferred directly to his or her spouse. Transfers to spouses must be outright or subject to a special qualified terminable interest trust, for the \$3 million basis step up rule to apply.

Married persons whose estate planning documents do not anticipate the estate tax repeal should review those documents as soon as possible. If one has a typical "A/B" trust, i.e., a trust which may split into a marital trust and a credit shelter trust upon one's death, all of the trust's assets may be allocated to the credit shelter trust should he or she die in 2010. As a result, such an individual may fail to fully utilize the basis step up opportunities should he or she die in 2010. Further, such an individual's marital trust as currently drafted may not meet the rules to allow for the \$3 million step up.

Both married and single persons therefore need to document the basis in their assets. This should be done as soon as possible because locating the relevant information is often difficult and time-consuming.

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2011 and Future Estate Tax Planning

As mentioned, the federal estate tax and the GST will automatically become effective again on January 1, 2011. Both taxes will become permanent at that point. Unfortunately, each taxpayer will then only be allowed to transfer up to \$1 million tax-free, and life insurance proceeds are included in this amount. Estate tax rates will be raised to 55 percent for large estates. Therefore, the federal government is on track to take a larger portion of estates than one might have imagined. The reduction of the tax-free amount from \$3.5 million in 2009 to \$1 million in 2011 may result in a significantly higher tax burden and a dramatic increase in the number of taxable estates.

The current estate planning documents of those who are single and die in 2011 may be adequate to deal with the changes set to take place in 2011, provided that those documents were adequate before the tax law changes. (If the documents were inadequate before the tax law changes, they will remain so until the ramifications of the changes are dealt with.) Married persons, however, need to closely look at their documents to ensure that their estate planning goals can still be met. Additionally, business transition and cash flow planning will become even more important in 2011 and future years for those who are business owners or real estate owners.

Most estate planners expect Congress to restore the federal estate tax and the GST retroactively. That said, Congress seems to have lost its footing of late, and no action appears imminent. Further, most estate planners never expected the estate tax repeal to become effective. One cannot rely on conventional wisdom when so much is at stake. Individuals therefore need to review their situations with a qualified estate tax planning advisor immediately.

Federal Gift Tax Remains in Effect

The federal gift tax still applies to all lifetime transfers. It applies in 2010, 2011 and thereafter. Each taxpayer is limited to taxable lifetime transfers totaling \$1 million before a tax is actually imposed. However, taxable transfers must be reported annually. Exclusions for annual exclusion gifts (currently \$13,000 per year per donee), medical gifts and tuition gifts remain in place. If the federal estate tax tax-free limit returns to \$1 million in 2011, gifting will become even more important from a tax perspective than it has been in the last few years. Persons whose taxable estate will exceed \$1 million in 2011 should consider developing a formal gifting plan now in anticipation of the 2011 estate tax law changes.

Necessary Action Steps

1. Individuals need to review their estate planning documents with a qualified estate planning attorney to determine what actions, if any, need to be taken now.
2. The documents needed to prove the income tax basis for each of an individual's assets should be collected immediately.