

THE ODD FUTURE OF THE ESTATE TAX: GONE IN 2010: BACK IN 2011?



Introduction:

ESTATE TAX is imposed upon any transfer of property from a Decedent and planning to minimize that tax is one of the most vital aspects of estate planning. Such planning has become increasingly difficult due to the inability of Congress to amend by January 1, 2010 a law passed ten years ago which was always intended to be altered before this deadline. The result...NO estate tax in 2010...but the stepped up basis that existed for inheriting appreciated property from a Decedent also disappears. AND...as the law is now written, in 2011 the old rates from ten years ago...suddenly reappear!

Thus as the law now stands...no estate tax for 2010...and massive estate tax beginning January 1, 2011. With stepped up basis for capital gains gone for this coming year...and back the next?

The United States cannot afford this huge cut in taxes for a year...and when Congress passed the law a decade ago, the concept was that before this year arrived, a new compromise tax would be created. Little did Congress back then realize the remarkable divisions in the present Congress which seem to make intelligent planning impossible.

So, what does this all mean? Read on...

THE HISTORY:

As Congress left the law in 2001, it resulted in an estate tax slowly, ever so slowly, being reduced between 2002-2009 ending with it being *entirely eliminated in 2010...BUT then entirely reimposed at the 2001 rate on January 1, 2011*. Thus, what could cost you zero in estate taxes on December 31, 2010 could cost you a million dollars a day later! (Recall estate tax is at 55% in 2011 and zero in 2010!)

Why was such an odd law passed in which a tax was slowly removed only to reappear entirely overnight? Most observers state that Congress wanted the credit of appearing to reduce taxes but knew very well that the USA could not possibly afford the loss of so much revenue. By reducing it for ten

years...then having it come back...the bad news would be saved for another Congress while the credit was enjoyed by the Congress of 2001.

Less cynical persons argue that Congress simply assumed that in the ten years the following Congresses would work to craft a more intelligent and balanced estate tax system and gave themselves plenty of time to do that. The problem-they have not done so and Congress is more divided than ever.

So, what is the law?

THE DISAPPEARING TAX BREAK...

In June of 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 ("ACT") and the portion of it relating to estate and gift tax is the subject of this article.

The Act phases out and repeals by 2010 the FEDERAL ESTATE TAX and repeals the federal generation-skipping transfer tax; retains the federal gift tax in modified form with new reporting requirements; and substantially eliminates the step up in basis at death for income tax purposes in favor of a modified carry over basis.

The current tax laws are reinstated in full, however, on January 1, 2011. In other words, the new law that repeals the estate tax and the generation skipping transfer tax is, itself, eliminated in 2011 by a "sunset" provision and, unless there is further legislation, in 2011 we will be right back where we were in 2001. Put another way, unless you are "lucky" enough to die in 2010, you could end up with a disastrous estate plan.

Graphically, it works like this:

The estate and gift tax law in 2001 had a \$675,000 exemption (unified for estate and gift tax) which means you can give away up to \$675,000 over your life and by your death before taxes are due. Thereafter, the rates begin and they top out at 55%.

The new law provides as follows

YEAR	EXEMPTION	HIGHEST RATE
2004	1.5 MILLION	48%
2005	1.5 MILLION	47%
2006	2 MILLION	46%
2007	2 MILLION	45%
2008	2 MILLION	45%
2009	3.5 MILLION	45%

2010

NO TAX

**TOP INDIVIDUAL INCOME TAX
RATE FOR GIFT TAX ONLY**

2011

1 MILLION?

55%?

Study the figures above and you will quickly determine why it is increasingly difficult to make intelligent tax planning for estates and trusts. An estate worth ten million dollars will pay no taxes in 2010 and could easily pay four million dollars in taxes a week into 2011. Complex plans to cut that make perfect sense for 2011 but may distort the wishes of the family and cost tens of thousands of dollars...for nothing...in 2010!



Most experts predict that in 2010 the Legislature will have to pass a new bill and the "experts" predict a new law providing for the basic rates and structure seen in 2009. Democrats have already pushed for that solution. Republicans want to up the exemption from \$3.5 million to five million or more. The usual deadlock has arisen.

And note that the income tax advantage of the estate tax law...the stepped up basis for property (if you inherit, the capital gains basis gets a new value based on fair market value as of date of death) also is modified and reduced. The cynics predict that this benefit will be left to die while the estate tax is allowed to come back.

Note also that GIFT TAX is not repealed and its top rate, in 2010, is the top income tax rate at that time. The gift tax exemption is frozen at one million dollars from 2002 forward. Generally, any transfer to a trust will be considered a taxable gift unless it is, essentially, revocable (thus of little use for estate tax planning.)

WHAT TO DO?

1. The fact that you are reading this newsletter means you already have one weapon: you know what is going to happen until 2011. Most people do not and while there was some initial outcry when this law passed, the sad fact is that Americans think in short term increments and 2011 seems a long time away.

2. But the plan you must make to protect your family is NOW, not in 2011 since the underlying truth of estate planning is that when the documents become effective you are no longer there to change them...right?

3. So NOW is the time to ponder what to do and to do it with good tax and legal advice. What does that mean?

a. Compute, or have your CPA compute, what your estate tax would be if you die before 2011...and after. Find out how much money we are talking about. Be sure to plan for both your own death...and the simultaneous death of you and your spouse. (Unless you are quite elderly, the chances are you and your spouse will die together in an accident so do not ignore that very real danger.)

b. If the Tax is significant, taking into account inflation of real property in your area, create TWO estate plans...and make the plans now how to integrate them so that you can transition back and forth quickly should the law change...or not change. Make no plan that does not allow such flexibility. (For example, permanent gifts to lower your estate to avoid the danger of 2011 permanently eliminate your access to assets that may be vital for you if the economy goes badly...and cannot be retrieved without gift tax being paid once again!)

c. Do not expect your plan to be elegant or perfect. You are doing what you can but until we get closer to 2011 we will not know for sure what the situation is likely to be. This is a compromise solution.

d. Do NOT distort your family situation assuming either the good times of 2010 or the disaster of 2011 is likely. We simply do not know. Seek flexibility in your structure, know that such flexibility may have some tax cost, and be ready to switch from one plan to the other as the situation clarifies.

e. Watch Congress. Follow the changes in the law...if any. Keep in touch with your CPA and attorney and know this: more than half your wealth depends on your understanding the current "flim flam" of the law and if you wish to protect your family this is a task you must undertake seriously.



One wag commented that if they do not change the estate tax by December 31, 2010, a lot of people are going to die before January 1, 2011. Given the massive taxes that a single day's delay in death can create, the unfairness of this law is manifest. Whether Congress can at last act in a responsible manner is another question, of course...We shall see...

