PSYCHIC NEEDED! HOW TO PLAN FOR YOUR ESTATE IN THE FACE OF UNCERTAINTY

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Over the last ten years, due to an increase in the amount of assets exempt from the federal estate tax, fewer and fewer estates have been subject to the estate tax. Effective January 1, 2010, the federal estate tax disappeared completely. However, if Congress does not act, the federal estate tax will come roaring back on January 1, 2011 and, individual estates over one million dollars ($1,000,000.00) will be subject to the tax at rates of up to 55%. There has been discussion about Congress enacting legislation that would exempt estates under three million five hundred thousand dollars ($3,500,000.00) from the estate tax and decrease the rate of tax to forty-five percent (45%) or thirty-five percent (35%); however, nothing has been introduced. This creates a lot of uncertainty for individuals trying to plan for their estates.

The current situation exists due to The Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") that was passed in 2001. EGTRRA gradually repealed the federal estate tax over a ten (10) year period. Because of legislative requirements (the inability to budget for the repeal beyond 10 years), EGTRRA included a "sunset" provision so that all of its provisions expire on December 31, 2010. Accordingly, unless Congress acts, the federal estate tax will return on January 1, 2011 as if EGTRRA had never been enacted. In addition, assets inherited from decedents who die during the one year repeal of the estate tax in 2010 are subject to different rules regarding the taxation of any built-in gain (any untaxed appreciation in the property at the date of death). As a result, individuals who have estates that may be subject to tax or who die during a year in which there is no estate tax must make sure that their documents adequately address the issues created by both the uncertainty with respect to the federal estate tax and the existence of two methods for taxing gain in assets held at death.

Impact of Estate Tax Uncertainty on Planning

Although the estate tax exemption amount and rates have changed over the last several years, individuals trying to plan at least knew what those changes would be. However, no one expected the estate tax repeal for 2010 to actually occur. There was a widely-held belief that Congress would enact a legislative compromise that would eliminate the year of repeal in exchange for a permanent estate tax exemption of $3.5M. The failure to enact such a compromise means that the estate tax will return with an exemption of $1M in 2011, but the specter of possible legislation will impede the ability to plan. This uncertainty has been with us since January 1, 2010 when the possibility of retroactive legislation was first discussed. While any legislation passed is unlikely to be retroactive to January 1, 2010, there is much speculation as to whether there will be legislation and what it would entail.

Before EGTRRA, any changes to the estate tax were not significant. Therefore, most wills and trusts that included estate tax planning used relatively uniform language to establish trusts based on what a person could pass to a non-spouse without incurring any federal estate tax. The passage of EGTRRA resulted in dispositions of assets under wills that may not have been intended by the individual. For example, depending on the language in the document, a decedent's spouse could have been inadvertently disinherited. As a result, in 2001 lawyers began drafting wills with the knowledge that both the exemption amount was changing and that the estate tax could be repealed when the individual died. Because this uncertainty continues to exist, any estate plans must take into consideration a possible change in the estate tax and how it could impact the ability to carry out a testator's intentions.

Impact of Modified Basis Regime on Planning

A person who sells property is subject to tax to the extent that the amount received exceeds the person's tax basis in the property. Generally, the tax basis of an asset is equal to its purchase price. Before the estate tax repeal, the tax basis of any assets that were held by a decedent were "stepped up" to their then current fair market value. For example, if a decedent's tax basis in property before his death was $100 and the fair market value of the asset on his date of death was equal to $200, then the tax basis of the asset was "stepped up" to $200. Therefore, a sale of the property after death for $200 would not result in any gain subject to tax. The policy behind the step-up was based on the inclusion of the asset in the decedent's estate. Because the asset was taxed in the estate at its fair market value, a second tax was not imposed at the time it was later sold on the gain that existed when the person died.

When the estate tax was repealed, the policy reason underlying a "step up" in basis no longer existed. Therefore, EGTRRA included provisions limiting the ability to step up the basis of assets held by someone who dies in 2010. Under the 2010 "modified carryover basis" provisions, only some of a decedent's assets may be stepped up to fair market value. Whether any of the assets retain the decedent's tax basis depends on how much built-in gain there is. As a result, even though none of a decedent's assets will be subject to a federal estate tax if he dies in 2010, a beneficiary may have to pay tax on a sale of the asset based on the decedent's tax basis. Using the earlier example, the beneficiary would have $100 in taxable gain on the sale of property worth $200 with a tax basis of $100. The difficulty in accurately identifying the tax basis of all of a decedent's assets complicates the modified basis regime.

The amount of basis step-up that an estate is entitled to depends on who is receiving the assets. The basis of assets that are transferred to a surviving spouse may be stepped up by up to three million dollars ($3,000,000.00). In addition, the basis of assets passing to a non-spouse beneficiary can be increased by up to one million three hundred thousand dollars ($1,300,000.00). It is the responsibility of the personal representative of the estate to adjust the basis appropriately by allocating the amount of the allowed "step-up" among each of the assets.

There are tax consequences to the beneficiaries if the difference between the fair market value of all of a decedent's assets and their tax basis as of death is greater than the amount that can be stepped up by a personal representative. In the event that there are multiple beneficiaries, it is possible that unequal allocations among the beneficiaries will create different income tax liabilities and could result in claims against the personal representative.

For example, assume that a decedent leaves all of his assets which are valued at $3.3M to his 2 children equally. At the time of his death, the decedent's basis in the assets is $100,000. Pursuant to his will, each child is distributed assets equal to $1.65M. Because the untaxed gain at the decedent's death exceeded $1.3M, only a portion of the assets would be stepped up to their fair market value. Therefore, a sale of the assets that did not get a step up would result in tax of approximately $285,000. If one of the children receives more of the assets that got stepped up than the other one, there is effectively an unequal distribution which is not what the decedent intended. If the built-in-gain in assets in an estate is under one million three hundred thousand dollars ($1,300,000.00), this is not an issue.

In addition, the personal representative has certain reporting responsibilities if the fair market value of the decedent's property (other than cash) exceeds one million three hundred thousand dollars ($1,300,000.00). There are penalties for failing to report the necessary information.

Further, as with the estate tax rules, the specter of possible legislation looms over the modified carry over basis regime. A similar rule regarding carry-over basis was in place for only two years in the 70's. Congress repealed the rules after the difficulty of trying to comply with them became clear. Therefore, it is always possible that Congress will similarly repeal the carry over basis rules with respect to assets inherited in 2010.

What Can You Do?

Estate planning lawyers have developed language that can be used to address the uncertainty, but how it applies to your estate planning depends on your goals and whether you are subject to a state estate tax (like in Maryland).

For example, a will can be drafted so that your heirs and fiduciaries have discretion at the time of your death to determine how your assets are distributed. This technique involves a "disclaimer" of assets by a recipient. Although disclaimers can be done without special language in your will, to insure that the assets are distributed in accordance with your wishes, your will should specify what happens to disclaimed assets.

Another planning technique that may be used where the amount that is exempt from federal estate tax is greater than the amount that is exempt from state estate tax involves the use of elections for certain trusts for state estate tax purposes only. Again, although the election can be made without special language in your will, only certain trusts qualify for the election. Therefore, if that is a possible planning technique, you should ensure that the applicable trust under your will satisfies the requirements.

In addition, many wills fund trusts based on the amount that is exempt from federal estate tax with the remainder going to the surviving spouse or a trust for the surviving spouse. That type of disposition might be exactly what the decedent wants in the event that $1M can pass free of estate tax, but if his estate is equal to $3M and $3.5M can pass free of estate tax, that might result in a division that is not what the testator intended. This can be addressed in a will in a number of different ways. The important point is that the issue is considered at the time the will is drafted.

Finally, even though the modified carry over basis regime only applies to assets of a decedent who dies in 2010, your will should address the issues raised by it. Your will should include instructions for how to allocate any basis adjustments among property and how any adjustments affect the disposition of the assets. It should also specifically shield the personal representative from any liability with respect to allocations. Even if you survive past December 31, 2010, you may want to include the language in your will. Based on our recent experience, you never know if a carry over basis regime will return.

It is always recommended that you review your will every few years in the event that the law or your circumstances have changed. If you have not reviewed your will recently, you should undertake that process now in light of the current situation. Further, if your will does not currently address these issues, you should consider changes to ensure that your wishes are accomplished on your death.

If you have any questions about these recent developments concerning the federal estate tax, please contact Stuart Rombro (410-727-8646 or srombro@rosenbergmartin.com), Jessica Lubar (410-649-4992 or jlubar@rosenbergmartin.com) or Zachary Conjeski at (410-649-1240 or zconjeski@rosenbergmartin.com) .