What a mess Congress has created! We are now in a year where there is no federal estate tax - but hold the cheers. Congress has substituted another method of taxation that will collect more taxes from many of our clients than the estate tax. Additionally, as has been reported in the local and national press, these changes will, for some, greatly alter the distributions of the estate among family members and heirs.

A brief review of the law will help explain why this is so significant. The 2001 tax act, signed into law by President George W. Bush, gradually reduced the maximum rate of the federal estate tax (and the equally onerous generation-skipping transfer tax on transfers to grandchildren) from 55% to 45%. It also gradually increased the amount of property that you could pass free of federal estate tax from $675,000 per person in 2001 to $3,500,000 per person in 2009. **Then, in 2010 only, the 2001 tax act repeals the estate tax. But, under the existing law, the estate tax returns again on January 1, 2011 - only at a much lower $1,000,000 exemption and a higher maximum 55% tax rate!**

Paying for Estate Tax Repeal

To pay for this one (1) year vacation from the estate tax, Congress replaced the estate tax with an increased income tax. Before 2010, any assets that pass to someone when you die would be valued at fair market value at the date of death. Thus after death, when a surviving spouse or heirs sold any assets (like securities or a home) that had increased in value; they would not have to pay income tax on any of that growth that occurred during your life (this is referred to as a “step-up in basis”). For many heirs this means huge income tax savings, oftentimes tens of thousands of dollars or more.

In 2010, property that passes at death does not automatically receive this step-up in basis. Instead, each individual has a limited amount of property that can be “stepped-up” in value at the time of death ($1,300,000; plus $3,000,000 additional to a surviving spouse). Property that does not receive this step-upvalue will be subject to tax on all increase in value *from the date you first acquired the property*. This means that the property could be exposed to tens of thousands of dollars of income tax liability for your heirs!

Like the tax and estate planning community at large, we expected that Congress would amend the tax laws before the end of 2009 to prevent this result. Unfortunately, now that 2010 has come without Congressional action, some wills and trusts contain tax-related clauses that do not work as intended under the law as it presently exists.

Do My Documents Need to Be Changed?

Because there is a possibility that the estate tax may not apply in 2010 and a possibility that the estate tax exclusion in 2011 will revert to $1,000,000, we recommend that you review your will or trust immediately. Even though we consider both possibilities unlikely, we suggest that you contact us to discuss your will or trust if any division or distribution of assets depends on the marital deduction, the federal estate tax, the unified credit, the “applicable exclusion amount” for the estate tax, and/or the generation-skipping transfer tax.

How You Are Affected?

This new law can have a negative impact on your current estate plan in many key areas. Here are only a few examples:

1. For married couples, we need to first make sure that your property will be divided among your beneficiaries according to your desires. For more than 50 years, it has been common to use a written mathematical formula to divide the assets of a married couple when the first spouse dies to maximize estate tax savings. Likewise formulas have been used to provide funds for charitable causes and to benefit family and friends. Most of these formulas were tied to either the estate tax exemption or to the marital deduction. Now, in 2010 when there is no estate tax, these formulas will not work the way they were intended. If a spouse is not your sole beneficiary (for example, if you have children from a prior marriage), **the existing formula could result in the disinheritance or substantial reduction of resources provided for the surviving spouse.**

2. For married couples, as well as single clients, your estate plan needs to be amended to provide for "carryover basis" and the $1,300,000 of assets that can be stepped up to fair market value on your death. **We need to decide how this basis step up amount will be allocated among all of your assets, and who has the discretion and the authority to make that allocation.** In other words, if you have an estate of $2,000,000, only $1,300,000 of assets will get a new basis, and $700,000 will retain the old cost basis. So, which assets get stepped up, the ones passing to Beneficiary A, or the ones passing to Beneficiaries B and C?

3. With the repeal of the generation skipping transfer tax, there may be formulas in your Will or Trust that need to be amended that allocate and divide your estate between your children and your grandchildren. Under the old law, only $3,500,000 could be passed to grandchildren without incurring another substantial tax called a "generation skipping tax" (GST tax). This tax is in addition to the normal estate tax. You may have a formula that says give the maximum amount to my grandchildren without creating a GST tax, and give the remainder to my children. Under the old law, if you had an estate of $10,000,000 then $3,500,000 would have gone to the grandchildren and $6,500,000 would go to your children. Now, under the new law, all of it would go to the grandchildren (because there is no GST tax) and your children would be disinherited.

In short, if tax clauses or tax-related formulas make a difference as to who gets what, leaving your trust unmodified may have significant unintended consequences. The greatest potential for unintended consequences exists when each spouse or partner has different beneficiaries and assets are allocated based on a tax-based formula. The problems can be amplified when the one spouse or partner has significant separate property.

Opportunities Under the New Law

Before deciding if you want to make changes to your will or trust, you need to answer these questions: (1) how would I plan my estate if there were no estate tax and no GST tax? (2) How would my planning change if the law is re-enacted with a $1,000,000 exclusion for both of those taxes? (3) How would my planning change if the law is re-enacted with a $3,500,000 (or larger) exclusion for both of those taxes? (4) How does my current plan compare with what I really want?

2010 Planning Opportunities?

The current tax law, including the 35% gift tax rate and the lack of a GST tax, combined with recession-reduced asset values, may provide a once-in-a-lifetime gift-planning opportunity. We will be happy to discuss potential tax-planning techniques under 2010 law, but if you choose to rely on current law, you will be assuming the risk that the law could be changed retroactively.

What Should You Do?

We encourage you to to review your estate plan and make any changes that are necessary for this law to prevent any of your beneficiaries from being unintentionally disinherited. We have solutions that will meet your planning objectives with the least amount of tax impact.

This is a time that demands a new approach to your Estate Plan with new thinking and building in flexibility to see that your wishes are fulfilled no matter what Congress will throw at us this year or next.

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