

WEALTH TRANSFER IN A RISING TAX ENVIRONMENT: THE STATE OF THE ESTATE TAX

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The estate tax is in a state of great flux. In a stunning development that has even veteran Washington observers shaking their heads, Congress failed to act before the end of 2009 to prevent the temporary repeal of the estate tax in 2010.

Thus, as of January 1, the estate tax was repealed — along with, for most assets, a “stepped-up” basis at death. As one beltway insider told *The Washington Post*, “Nobody who was in the know thought Congress would be this irresponsible in dealing with a situation that they had on the horizon for nine years.”

Democratic leaders have said they will move expeditiously to reinstitute the 2009 rules for 2010, and to apply those rules retroactively to January 1. But it remains to be seen whether the Republicans will accommodate that objective and whether retroactive legislation can survive a court challenge.

This paper discusses the current — and possible future — status of the estate tax, and provides some strategies for investors to minimize future taxes in this fluid environment.

The Current Structure of the Estate Tax

In 2001, Congress adopted an estate tax reform bill. That bill provided for a one-year repeal of the estate tax nine years hence, in 2010. At the time, everyone believed Congress would act before 2010 to avoid that happening. But because Congress failed to act, the rules provided in the 2001 act went into effect.

In 2009, an individual at death was permitted to pass on assets with aggregate value of up to \$3.5 million without imposition of estate tax. An individual also was permitted to leave unlimited assets to a surviving spouse without imposition of tax. To the extent assets passed to non-spouse beneficiaries exceeded \$3.5 million in value, a 45% estate tax was imposed. Assets passed on at death received a “stepped up” basis, which meant that heirs did not pay capital gains tax on appreciation that occurred during the deceased’s life when the heirs later sold the inherited assets.

For 2010, unless Congress acts to reinstitute it, the estate tax has been repealed. But, in large part, stepped-up basis at death has been repealed as well. Thus, an estate tax on the deceased has been replaced by a capital gains tax on heirs. Tax authorities estimate that the number of estates paying tax in 2010 will increase tenfold, as estates that previously were exempt from estate tax now will be forced to pay capital gains tax on assets sold.

Repeal is scheduled to expire at the end of 2010. As the law is currently written, in 2011 the estate tax will be reinstated with a \$1 million exemption and a 55% tax rate. Stepped up basis will be reinstated then as well.

The rules can be summarized as follows:

- **2009:**
 - \$3.5 million estate tax exemption, 45% tax rate
 - Stepped-up basis
 - \$1 million gift tax exemption, 45% tax rate
- **2010:**
 - No estate tax or generation skipping tax (GST)
 - Carryover basis (\$1.3M total step-up plus \$3M spousal step-up)
 - \$1 million gift tax exemption, 35% tax rate
- **2011:**
 - \$1 million estate unified tax and gift exemption, 55% tax rate

The New Carryover Basis Rules

As noted above, unless Congress changes the law, in 2010 heirs cannot claim a stepped-up basis in inherited assets. Instead, heirs receiving property in 2010 (and only in 2010) may be required to pay capital gains tax when they sell inherited assets.

The 2010 rules provide for a modified carryover basis at death. Under these rules, an heir’s basis in inherited

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property is the lesser of (i) the deceased's basis in that property and (ii) the fair market value of the property on the date of death. The executor then can choose to increase the basis of inherited property by a total of \$1.3 million, plus an additional \$3 million for property passing to a spouse. The executor allocates this increase among inherited assets at his discretion, but an asset's total basis cannot exceed that asset's fair market value. The executor can choose to use the \$1.3 million general increase on assets passing to the spouse, in which case the spouse's asset basis can be increased by a total of \$4.3 million.

Where an heir takes an asset with a basis equal to the deceased's basis (that is, where the basis of the asset is not a lower fair market value at death and the basis is not increased by the executor), the heir's holding period for that asset includes the deceased's holding period for purposes of determining whether the sale of the asset produces long-term gain.

Administratively, this system is something of a mess. Kids and grandkids won't know what their parents and grandparents paid for assets (think of the family home held for 20 years), and so will have difficulty reporting the gain. And the IRS will have the same difficulty auditing the returns.

What Will Happen?

Democratic leaders have said they will move expeditiously this year to extend the 2009 rules to 2010, and to apply those rules retroactively to January 1. But it remains to be seen whether the Republicans will accommodate that objective or instead will continue to block Democratic efforts to reinstitute an estate tax.

What happened at year-end 2009 may be indicative. In December 2009, the House dutifully passed a bill to make the 2009 rules permanent. Recognizing that the Senate might not be ready to address permanent rules, House leaders expressed a willingness to extend the 2009 rules for one year — or even just two months — to give Congress time to consider permanent legislation. But Senate Republicans — distressed that health care reform was being forced on them in a year-end rush and believing it would be difficult for the Democrats to reinstate the estate tax once it had been repealed — blocked the passage of any estate tax changes. Thus, the repeal went into effect.

Republicans now may push to increase the estate tax exemption, perhaps to \$5 million from last year's \$3.5 million. The longer the Republicans wait, though, the weaker their position becomes, as the automatic reinstatement of the tax in 2011 with an unpalatable \$1 million exemption looms closer. Thus, the parties seem poised to engage in a game of "chicken" with the estate tax — and taxpayers' ability to plan for death — hanging in the balance.

If Congress does reinstate the tax retroactively to January 1, 2010, look for a court challenge. The Supreme Court has typically — but not always — upheld Congress's ability to

change taxes retroactively. But the attempt to impose a new tax on someone who has died before the tax was in effect should, at a minimum, make for a lively debate.

In any event, Congress must act, if it acts at all, within the first nine months of 2010. At that point, executors must file returns for people dying at the beginning of the year and need to know what to do.

What Else Might Congress Do?

Most Washington observers believe Congress will consider a major tax reform bill this year. Congress must address other tax issues, such as the expiration of the Bush income tax cuts at the end of 2010. The estate tax could be part of that bill if Congress fails to deal with it expeditiously at the beginning of the year. A tax reform bill also might address other elements of the estate tax, including:

■ Should the exemption be indexed for inflation?

Historically, the estate tax exemption (\$3.5 million in 2009) has not been indexed for inflation. This has required Congress periodically to pass legislation to raise the amount. Most observers believe that indexing the exemption for inflation is appropriate. However, doing so causes a revenue loss for the government as more assets escape estate tax over time. Given the current record-high budget deficits, it is uncertain whether Congress ultimately will decide to provide for indexing.

■ Should the gift tax exemption be reunified with the estate tax exemption?

Until recent years, the gift tax exemption — the amount a person can give away during life — was the same as the estate tax exemption. Thus an individual could choose to give away his tax-free asset amount during his life or at his death. (Any exemption used during life reduces the exemption available at death.) The gift tax exemption remained at \$1 million, however, when the estate tax exemption rose above that amount. Many observers believe it would be appropriate to increase the gift tax exemption to an amount equal the estate tax exemption (assuming Congress adopts an exemption greater than \$1 million in 2011).

Raising the gift tax exemption would result in a significant revenue loss for the government. A typical gifting technique has a donor, as early in his life as possible, put in trust for heirs assets equal to the exemption amount. These assets can then appreciate over the remainder of the donor's life outside of his estate (that is, free from estate tax). If the gift tax exemption is raised, significantly more asset appreciation would escape estate tax. For that reason, Congress may choose not to reunify the exemptions.

■ Will the exemption be simplified for spouses?

Some bills introduced are proposing a sensible provision referred to as "portability of the exemption between spouses." This provision would work as follows: Suppose everybody may pass on \$3½ million tax free at death. A wife dies with \$2 million. Her husband then could pass on

\$5 million tax free — his \$3½ million plus the \$1½ million exemption his wife did not use. This rule would eliminate in many cases the need for complicated trusts currently used to accomplish this task.

■ Will Congress cut down on tax minimization techniques?

There is a movement in Congress and the Administration to curb the use of sophisticated techniques taxpayers use to reduce gift and estate tax. For instance, Congress is considering limiting the use of “minority discounts.” These discounts are often used in conjunction with “family limited partnerships,” which work as follows: An individual puts his assets in a partnership and gives away 49% (or less) of that partnership to his children. For purposes of valuing the gift, the donor takes the position that the partnership interest transferred is not worth 49% as the children have only a minority interest; that is, the children can’t control what the partnership does. Thus, the donor values their interest at less, perhaps 35%. Although the children still get 49% of actual partnership asset value, the lower minority valuation reduces or eliminates the gift tax. Congress is concerned that in many cases these minority discounts artificially deflate the value of gifts and inappropriately reduce gift taxes.

Other proposals would curtail the use of “grantor retained annuity trusts” (GRATs), a sophisticated technique where a donor avoids gift tax by putting assets in trust and having the trust pay back to him the nominal value of those assets over time. If the assets appreciate more than the nominal value, the appreciation passes to heirs without tax. The president’s 2009 budget request proposes that GRATs be required to have a minimum term of 10 years. Alternatively (or in addition), Congress might eliminate these “zeroed out” GRATs by requiring the arrangement encompass some minimum gift to beneficiaries.

What Should You Do?

First, individuals should review their current estate planning documents with their advisors to ensure that the division of assets to beneficiaries will take place as intended were death to occur in 2010. A typical plan splits the estate into two trusts, a “credit shelter trust” for the children in an amount equal to the exemption amount (\$3.5 million in 2009), and a “marital trust” for the spouse with the remaining assets. In the absence of an estate tax, however, the estate planning document, depending on its wording, might place all the assets in the children’s trust (disinheriting the spouse) or in the spouse’s trust (disinheriting the children). Individuals need to make sure the asset disposition comports with their wishes.

Also, although the state of the estate tax in 2010 is up in the air, one thing is clear: **The estate tax has not been repealed permanently. It will be back, perhaps on more onerous terms.** Therefore, it remains more important than ever for individuals to discuss their financial situation with their advisors quickly and take action to minimize taxes they will face in the future.

For instance, individuals might consider gifting assets in 2010, perhaps to an irrevocable trust for the benefit of future generations. By gifting assets to a trust, the transferred assets — **and all future appreciation** — are removed from the taxable estate.

There are a number of reasons why gifting makes particular sense in 2010:

- Gifting arrangements work best when asset values and interest rates are low. Lower values reduce — or even eliminate — the gift tax imposed on transferred assets. Low interest rates enhance the value of gifting techniques that require the payment of interest. Thus, the current economic conditions are ideal for gifting.
- Gifts made this year in excess of the \$1 million lifetime exemption will be taxed at a lower rate (35%) than in other years, assuming no change in law. Moreover, with the one-year repeal, assets can be transferred to grandchildren without a generation skipping tax.
- Congress is poised to consider changes that could curtail or eliminate some of the tax-reducing gifting strategies currently available. Gifts made prior to the effective date of such legislation presumably would not be affected by this change (although this cannot be assured).

The fact that children or grandchildren are young need not dissuade individuals from taking advantage of this favourable environment for gifting. In many cases it is advisable to place gifts in trust for children and grandchildren, rather than giving the gifts outright. A trust can keep children from squandering assets until they have reached an age where they can responsibly handle them. A trust can also influence behaviour by providing for distribution of assets upon the occurrence of a particular event (such as graduation from college).

Assets placed in trust can grow free from estate tax. Individuals establishing trusts should retain a qualified professional fiduciary to assist in managing and administering the trust and directing the investment of trust assets. Because the rules are complex, it is critical to consult with a qualified estate planning attorney when establishing a trust, gifting assets, or considering any wealth transfer plan.

In short, simply staying put may not be the best option in this unprecedented environment. Instead, individuals should discuss with their financial advisors as soon as possible whether — and to what extent — actions such as gifting might make sense, before current economic conditions or the governing laws change.

¹ Assets given outright to grandchildren in 2010 will escape GST (assuming no change in law). Assets placed in trust for grandchildren in 2010 also will escape GST when transferred to the trust, but the trust’s later distribution of those assets to the grandchildren may be subject to GST if the GST is in effect in the year of distribution.

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