January 29, 2010

What the New Federal Estate Tax Law Means

As you have probably read, the federal estate tax and the federal generation-skipping transfer tax have been repealed for estates of decedents dying in 2010?- although both taxes are scheduled to return in 2011. In addition, there is no longer an increase in the cost basis of assets to market value at death in calculating capital gains tax on property inherited in 2010. All estate planning documents need to be reviewed to determine if any changes are warranted, and, for married couples, ownership of assets needs to be reviewed to determine if any rebalancing is warranted.

What is the current law?

For 2010, the federal estate and generation skipping transfer ("GST") taxes have been repealed. At the same time, the automatic "step-up" in basis for assets owned by a person who dies in 2010 has been eliminated and replaced with a "carryover basis" system for capital gains tax purposes. With carryover basis, beneficiaries inherit property with the same cost basis in the property as the decedent. The executor of an estate can, however, allocate up to $1,300,000 of basis increase (plus, in general, unused built-in losses and loss carryovers) to any property in an estate and another $3,000,000 of basis increase to property passing to a surviving spouse either outright or in qualifying trusts. Thus, although in 2010 estates will escape federal estate tax, the potential capital gains liability for heirs could be even more than what the estate tax would have been.

The federal gift tax remains in place, but with a reduced 35 percent tax rate, down from 45 percent.

But will it stick?

Congress may attempt to reinstate the estate and GST taxes retroactively to January 1, 2010 (the House in fact passed legislation extending the 2009 tax rates, but the Senate never took up the bill). Whether Congress will pass legislation retroactively or prospectively and what form the legislation will take are still uncertain.

What happens in 2011?

Unless Congress provides otherwise, on January 1, 2011, the federal estate, GST and gift tax laws return to what they were in 2001. Thus, there will be a federal estate and gift tax with an exemption of $1,000,000 and a top tax rate of 55 percent (plus a 5 percent surtax on estates from $10 million to $17 million). There will also be a GST tax with an exemption of about $1,340,000 and a tax rate of 55 percent.

Is that it?

State estate taxes in many jurisdictions, including Connecticut, Massachusetts, New Jersey and New York, continue to apply. Even if an estate is not subject to federal estate tax, it may be subject to state estate tax in the state of residence and all other states in which there is real estate or certain other property.

What should you do?

Your estate planning documents should be reviewed to ensure that they will operate effectively even if there is no federal estate tax and the new capital gains tax rules apply. Many estate planning documents refer to the federal estate tax or GST tax in establishing, for example, the size of a marital or family trust or of a bequest. Our concern is that your documents may be interpreted, and your assets distributed, in a different manner than you intend. Some of these documents will need to be changed to ensure that repeal does not create an ambiguity that could defeat your wishes.

Married couples should also review the way they have divided their assets to maximize the use of both state estate tax exemptions and federal basis increase, regardless of who dies first. In some cases, holding property as tenants in common will be an efficient way to meet both objectives.

The repeal of the GST tax for 2010 also creates an opportunity to make gifts in trust to children or grandchildren that may escape transfer taxes for future generations. Gifts of this kind must be carefully considered, however, in light of the possibility of retroactive reinstatement of the GST tax.