

Avoid the Estate Tax (Or Die Trying)?

2010 is new in a variety of respects, but taxes are high on my list. For the first time in more than 90 years, we don't have a federal estate tax! Yes, that's right. Way back in 2001, Congress enacted a number of tax changes, some immediate, some not.

Famously, the 2001 legislation repealed the estate tax (but not the gift tax) for 2010 only. The legislation made it clear that there was a sunset provision eliminating this repeal at the end of 2010.

That means as you read this, if you die, there is no federal estate tax. On the other hand, if you die one year from now in early 2011, the top estate tax rate will be 55 percent (or even 60 percent in some cases), with only \$1 million being exempt from tax. If you died in 2009, your exemption was \$3.5 million, and the top rate was 45 percent.

That can make dying in 2010 a rare and once-in-a-lifetime (tax) opportunity. It has even been suggested that aged clients might want to orchestrate their own death. You can imagine how the blogs are buzzing! Some ultra-wealthy people are probably eyeing all of this with a suspicious eye, and ringing their estate planners to try to take advantage of it. Trust and estate lawyers are very busy thinking through what to do with specific clients, and what to do more generally.



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Don't get me wrong. I'm not suggesting that anyone should plan to die in 2010, whether for tax reasons or otherwise. Indeed, most observers seem to recognize that even if you were to die tomorrow, if you have a substantial estate, you will almost certainly end up paying estate tax. Why?

A retroactive tax, that's why. Most tax professionals (myself included) believed throughout the last decade that Congress would act with "plenty" of time before the estate tax was nominally scheduled to come to a brief and ignominious end on New Year's Eve, Dec. 31, 2009. But we were wrong.

Of course, when you use "retroactive" and "tax" in the same sentence, get ready for the tax protesters. There's something downright unsettling about hearing that Congress is levying a tax retroactively. Didn't our Founding Fathers guard against this, after all?

I'll spare you the constitutional diatribe about whether a retroactive tax law should or should not be upheld. But I believe most observers think that, at least in this case, a retroactive estate tax will be upheld if it is ever challenged in the courts. Of course, the sooner something happens in Congress, the less retroactive the legislation will need to be, which means it will more likely be upheld (although I think virtually any retroactivity on this point is likely to pass constitutional muster).

As its name suggests, the generation-skipping transfer tax applies when someone transfers property to a grandchild, not a child. It is a separate tax designed to help thwart the wealthy from skipping a generation where the middle generation simply doesn't need the money. It's more complicated than this, of course, but it is worth noting that the biggest opportunity presented by this 2010 (bizarre) estate tax repeal may lie in generation-skipping taxes.

What should be done when estate planning for clients or for yourself? In all likelihood, we will soon have an estate tax and a generation-skipping tax very similar to what we had under the 2001 legislation. In all likelihood, the exemption amount (which you can transfer without running afoul of the tax) will be \$3.5 million or so per person. If that happens, it will mean that a married couple dying in a common accident will probably be able to pass along up to \$7 million of property free of federal estate (or generation-skipping) tax.

Of course, I'm only guessing, but everyone understands the concept of tax basis in some fashion. Thus, if you pay \$100 for a share of stock and sell it five years later for \$500, you have a gain of \$400. The same is true for basis in a residence or other assets that might be transferred on death. Under our (now repealed) estate

tax system, you normally got an increase in (or "step-up" in) basis to the current value of the asset on the date of death.

Here's how a step up works. If the decedent's house was worth \$1 million on death, the \$1 million would be included in his estate. The estate tax would or would not be assessed depending upon how much other property the decedent had (again, \$3.5 million generally being a "free" allowance). Whether tax was or was not paid, though, the value of the house in the hands of the person who inherits it would be \$1 million. If the heir sells the property shortly thereafter, there should be little or no gain to be subject to income tax. The idea is a dovetail between income and estate tax. But right now - with no estate tax - this step-up in basis rule was also repealed. That means the income tax basis of an asset acquired from someone who dies in 2010 will not be stepped up. If a parent dies in 2010 with a very small basis in a house, that same small tax basis will carry over to the child who inherits it. When the child sells it, there will be income tax, and there's no \$3.5 million exemption from income tax.

And this brings us back to the likely retroactivity of the tax, and what might happen. A key test of retroactivity might involve a person dying with a big estate today, and expecting to pass assets tax free to heirs. Let's say because of declining market conditions, the value of the family property is equal to its tax basis. In other words, from an income tax perspective, if the property were all sold, there would be no gain to tax. Then suppose six months from now Congress enacts an estate tax, along with the traditional step up in basis, applying it retroactively to this decedent's estate. Would such a retroactive tax pass muster? This decedent and her heirs would get no benefit from the step up in basis, because the value of the property on death is the same as market value. That could make an interesting Constitutional challenge.

This also illustrates the difficulties faced by families and their estate planners. There's no easy answer, and it's appropriate to have several contingency plans. This isn't a good time to buy an online will kit and whip up an estate plan at home.

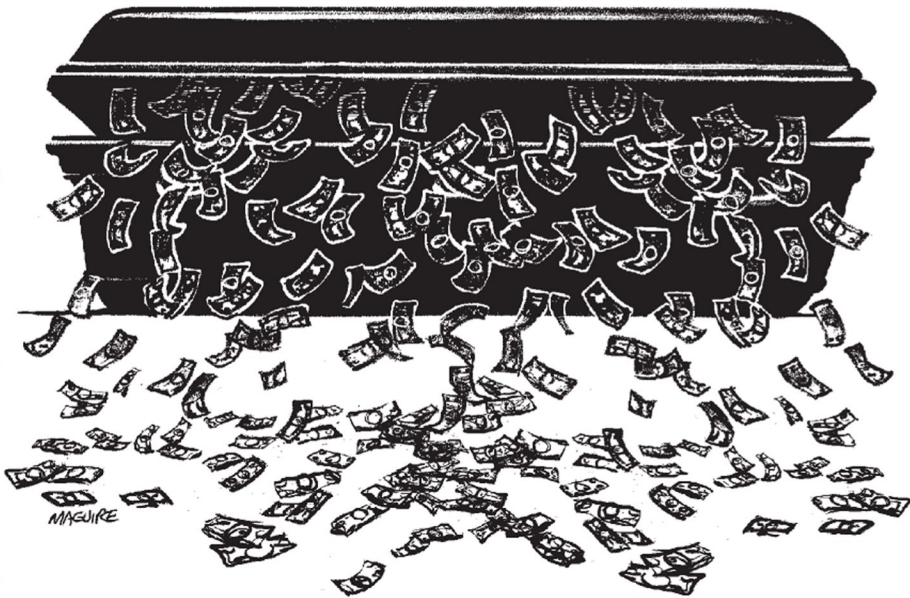
As you can see, there are many nuances and traps here. That's especially true for persons dying or near death during this estate tax hiatus, and the family members inheriting from them.

All in all, for a whole variety of reasons, it is probably best if the estate tax is re-enacted retroactively in the near future. Political commentators can quibble over whether there should be a \$3.5 million or \$5 million exemption (or some other figure). It might be good to completely repeal the estate tax. Yet, if that is done, it needs to be cautiously pursued given the number of tentacles the estate tax has into various other parts of the tax law.

Regardless of how much you love to save taxes, I would not book my passage to the great beyond just yet.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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