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Tax Law Changes in Estate Planning in 2010- EGTRRA- Planning for the unknown

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In 2001, Congress enacted the Economic Growth and Tax Reform Reconciliation Act (EGTRRA). This was a breakthrough piece of legislation that dealt with issues from job creation to retirement funding to estate taxes. For purposes of this article, I will touch briefly on some of the glaring and cumbersome issues that have befallen upon estate and tax planners in 2010.

Estate and GST Taxes

Both the estate tax and the GST tax were repealed at the end of 2009 and are scheduled to return at unfavorable rates in 2011.

EGTRRA provided for a graduated increase in the federal estate tax exemption amounts from 2003 through 2009 along with a reduction in the federal estate tax rate from 55% to 45%. In 2009, the estate tax exemption amount was \$3.5M with a 45% tax rate. In 2010, the estate tax was repealed and in 2011 the exemption amount will be reduced to \$1M with a 55% tax rate on amounts over the \$1M.

Gift Taxes

Under Internal Revenue Code (IRC) Section 2503, any person is allowed to gift up to the applicable annual exclusion amount (\$13,000 in 2009 and 2010) to as many persons as he or she chooses. Any amount over that is considered a taxable transfer. However, any one person is also allowed to give away \$1M during their lifetime without paying any gift tax on the transfer, however, a gift tax return should be filed. For any transfers over this exemption amount a tax on the gift is due. The gift tax remains in place but has been reduced from 45% to 35% (which is also the highest income tax rate). However, under current law, in 2011 the gift tax will increase to 55%.

Finally, it is important to note that when we use the lifetime exclusion, the taxable gifts over the annual exclusion amount are added back to the taxable estate at death. You don't get both exclusion amounts.

Modified Carry Over

One of the major changes to the income tax code that affects estate planning deals with the basis of property transferred as a result of a person's death. Last year, under IRC Section 1014, property belonging to the decedent received a full step up in basis on the entire amount of the property. This step up in basis was also automatic. In other words, on the death of X, all property that X owned at that time had a basis equal to the fair market value as of the date of X's death.

This year, under (IRC) Section 1022, the executor of the decedent's estate can elect a step up in basis up to \$1.3M¹ by filing an estate tax return for property distributed to any heirs or beneficiaries. In addition to the \$1.3M step up in basis, a spouse can receive an additional \$3M in step up in basis but it must pass outright or in trust to the surviving spouse and if in trust it must in a qualified terminable interest (QTIP) type trust.

¹ For decedent's who are non-resident aliens the step up in basis available is reduced to \$60,000 and the additional spousal property basis increase is also not available.

Example

X dies owning a home. X's basis in the home was \$500K and it was valued at \$2M at X's death. Z (a non-spouse beneficiary) inherits the property from X and sells it for \$2.2M.

Under previous law, the basis in the property Z received would have received a full step up so Z's basis in the property would be \$2M. Since the sale price was \$200K more than Z's basis in the property, she would have to pay capital gains tax on the \$200K amount.

Under current law (assuming the executor allocated the available \$1.3 step up to this specific property), Z would be responsible for capital gains on \$400K, the difference between the basis (\$500k + \$1.3M) and the sale price (\$2.2M).

This is obviously a very simplified example but it illustrates some of the issues under the new tax regime. Some of the issues become more complicated when dealing with multiple beneficiaries and multiple properties with different basis when the executor is trying to allocate the step up and distribute the assets in a manner that feels fair to all.

Conclusion

It has been and will continue to be difficult to anticipate what will happen in Congress and how to plan. We expect that the estate tax exemption will be reinstated by Congress by the end of this year. We will keep you posted on the developments. At this point, all we can do is make our clients' estate plans flexible enough so that our clients will be taken care of in the unknown.

TABLE OF RATES- BASED ON CURRENT LAW

Calendar Year	Estate Tax Applicable Exclusion Amount	Gift Tax Applicable Exclusion Amount	Highest Estate and Gift Tax Rates
2008	\$2M	\$1M	45%
2009	\$3.5M	\$1M	45%
2010	Repealed	\$1M	Gift tax only 35% (which is equal to top individual income tax rate)
2011 & Beyond	\$1M	\$1M (adjusted for inflation)	55%