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THE ESTATE TAX – A LEGISLATIVE DILEMMA!

by Aspen Family Business Group, LLC

In an act that pundits have describes as legislative malpractice, the Senate refused to address estate tax legislation before January 1, 2010. On December 3, 2009, the House had passed what effectively would have been a continuation of the 2009 rules - $3.5 million per person lifetime exemption, a 45% maximum tax rate. The step up in basis and generation-skipping tax would have continued as in previous years.

However that bill was not agreed to by the Senate nor was any other bill agreed upon so we have the following dilemmas:

- No estate tax
- No step up in basis (otherwise known as carry-over basis)
- No generation skipping tax
- 35% gift tax with a $1.0M exemption

There are many embedded issues as we delve into the details of the law, not the least of which is “what will congress do” when they finally address the estate tax. There are at least four alternative courses of action and no one knows which is most likely. The alternatives are:

- Keep the law as it is
  - No estate tax
  - Carry-over basis for capital gains
  - No generations skipping tax
- Allow the law to follow its course in which case, January 1, 2011, the exemption amount will be $1.0M and the maximum tax 55% plus a 5% premium for certain estates (a repeat of the Bush tax cut)
- Continue the 2009 limits - $3.5M exemption per person, 45% maximum tax rate, and retain the step-up in basis rules from the date of enactment
- Same as the previous scenario but make the limits retroactive to January 1,2010

There are of course other alternatives such as raising or lowering the exemption

amounts and the maximum tax rate.

Lawyers are questioning the constitutionality of making the estate tax law retroactive to January 1, 2010. There are those who argue that there are past precedent setting cases for the retroactive application of the tax law. However there are others that believe that the precedent setting cases are so dissimilar as to not be applicable.

What you can count on is court battles between estates and the IRS of epic proportions. Last year it was estimated that 5500 estates in excess of $3.5 million or $7.0 million were probated. At the same rate in 2010, by the end of March some 1400 plus will have died without knowing exactly what the rules are. Foregoing political commentary, this a classic case of irresponsibility by those charged with passing our laws.

Exacerbating the complexity, some 24 States have State estate tax laws - most with exemption amounts considerably lower than the 2009 $3.5M per person exemption. These are decoupled from the federal estate tax and with their own poor economic condition, you can be sure they will aggressively pursue collection.

Another difficult issue is the carry over basis rules. Formerly, when a descendent passed the basis in the property to heirs, they would receive a step-up to fair market value at date of death. A sale of property after death would only need to report the value increase from date of death for capital gains purposes.

As the law now stands, the property's basis is carried over to the heirs with some exempted amounts. Property passing to a spouse receives a $3.0M step-up in basis. Property passed to other heirs receives a $1.3M step up in basis. But who receives the step up? How will it be allocated to certain properties passing to certain heirs? What is the basis? How many people keep accurate records of basis change? And how about the stock that Aunt Millie gifted 60 years ago that has split, re split etc?!?! Even the IRS does not want this can of worms to attempt to track and litigate.

Lastly, and this is the pivotal message for all of us, our current wills and trusts often contain formulas for the allocation of assets between trusts or heirs at death. The current rules could cause some unexpected and undesirable results. An example: a husband passes away March 5, 2010 with an estate of $10 million, he is married to a second spouse, has one child by her and three children from his previous marriage.

His trust documents allocate an amount equal to the unified credit (formerly $3.5M in 2009) to the children of his first marriage, the balance to his current spouse and of course their child, not an unusual design in those circumstances. But what are the results today? Is the exemption unlimited with all assets going in trust for the children of the first marriage thereby disinheriting his current spouse? Since there is no "exemption amount", do all assets go to the current spouse, disinheriting the children of the first marriage? What is absolutely evident is that all of us need to contact our estate planning attorney and ask them if any changes to documents are needed. We encourage all to have this discussion now before it is too late.