



THE RACK LAW FIRM, P.C.  
A PROFESSIONAL LAW CORPORATION

*Now What?*  
*Planning During Estate Tax Repeal*

We have known since the 2001 Tax Act that the federal estate tax was scheduled for a one-year repeal beginning January 1, 2010, but few of us believed we would ever see the repeal take effect. Beginning on January 1, 2011, the estate tax will return with a vengeance, since the current law provides for an exemption amount of \$1 million per taxpayer (this same exemption in 2009 was \$3.5 million). Although most experts were confident that Congress would act before that date to prevent the estate tax from phasing out completely, they failed to do so. As we live and breathe, there is currently no estate tax on the estates of persons dying in 2010; however, there is still uncertainty in the air due to notions of Congress enacting some form of retroactive legislation. Meanwhile, during this rare period of a repealed estate tax, the rules of the game have changed dramatically. Accordingly, citizens must become familiar with those new rules and take action to implement an updated estate plan designed to avoid unintended, and possibly severe, financial consequences. Consider the following as a syllabus for **Estate Tax Repeal 101**:

*Chapter 1: Modified Carryover Basis*

Before January 1 of this year, subject to limited exceptions, appreciated assets owned at one's death received a "step-up" in basis from the adjusted cost of the asset to the fair market value on the date of death. In other words, if a citizen died owning stock purchased many years ago for a fraction of the current value, the taxable capital gain would be eliminated upon death as the asset passes to the beneficiaries. The result is that the heirs could sell the stock soon after the owner's death and pay little or no income tax, since the capital gains tax is assessed on the difference between the sale price and the fair market value on the date of death. Of course, the value of the stock would be included in the decedent's gross estate for estate tax purposes, but this would only impact the heirs if the estate value was in excess of the estate tax exemption of \$3.5 million.

Beginning January 1, 2010, the foregoing does not apply. Now, a beneficiary who receives appreciated property from a deceased person receives it with an adjusted basis equal to the lesser of the decedent's basis or the asset's fair market value on the decedent's date of death. Gone is the automatic basis "step-up" to the value on date of death (although the basis "step-down" for depreciating assets is preserved). Significantly, this modified carryover basis system will affect far more people than the estate tax ever would! One estimate puts the number of people who will be impacted in 2010 by this tax legislation at 70,000, compared to the 5,500 decedents each year whose estates paid the "old" estate tax.

The Internal Revenue Code also preserves a limited step-up by enabling the person in charge of the decedent's property (usually, the executor) to allocate, on an asset-by-asset basis, a \$1.3 million "aggregate basis increase" up to the fair market value of the selected asset(s) at the date of the decedent's death. Assets left to a spouse may receive an additional \$3 million "spousal property basis increase," also asset-by-asset, up to the fair market value of the selected asset(s) at the date of the decedent's death.

*For example: In 1930, taxpayer purchases 1,000 shares of stock for \$100. During her life, the stock splits numerous times and significantly increases in value. When she dies in 2010, she owns 15,000 shares of stock which are worth \$1.5 million, and leaves all the stock to her two children. Her executor may "allocate" an artificial step-up basis to the stock of up to \$1.3 million, enabling the children to take a \$1,300,100 basis in the stock, and thereby minimizing the capital gains tax incurred when the children sell the stock in the future.*

In order to be eligible for either limited step-up, the property must be owned by the decedent at death. For purposes of the \$3 million spousal property basis increase, the property must be left to the surviving spouse alone, either outright or in a special trust known as a Qualified Terminable Interest Property ("QTIP") Trust ([click for more information](#)). This means that appreciated assets passing to a surviving spouse by way of a general power of appointment marital trust, or even to a survivor's trust in a joint revocable trust, may not qualify. Thus, absent written amendments to a trust document could meet these requirements, many spousal trusts in existence simply will not qualify, causing the loss of the \$3 million basis increase. This may set up the marital trust (and subsequently the surviving spouse) to incur a significant tax liability for assets sold in the future.

## ***Chapter 2: Marital Formula Funding Clauses***

Married couples who establish estate plans for estate tax protection typically create separate revocable "living" trusts which apply a funding formula to divide the decedent spouse's property into an estate tax exemption trust (sometimes known as a "Family Trust") and a marital deduction trust. The two formulas, known as either a fractional share or pecuniary amount, are used to maximize the amount that will pass to the couples' heirs at the second death free of estate tax. If the estate plan was drafted without considering the possibility of estate tax repeal, these common funding formulas generally will cause one of two problems:

First: If the typical fractional share formula is used, death during estate tax repeal may force the trustee to transfer all or nearly all of the decedent's assets into the estate tax exemption trust. This results in a marital trust with little or no assets from the decedent and forfeiture of the special basis adjustment options under the modified carryover basis rules, as discussed above.

Second: If the amount that is to pass to the Family Trust is pegged to the estate tax exemption amount applicable at the date of death, the opposite result could obtain, leaving the trustee unable to fund the Family Trust at all. Imagine the disastrous effects when the federal estate tax later returns, the surviving spouse dies, and the entire marital

estate is subject to taxation (particularly if the exemption amount goes downward from the 2009 amount of \$3.5 million to the 2011 amount of \$1 million) ([click for document](#)).

In either case, if the estate tax exemption and marital trusts contain identical beneficiaries and dispositive provisions, an over or underfunding problem will not have much impact on beneficiary distributions. However, if the estate tax exemption and marital trusts contain different beneficiaries or different dispositive provisions (such as in second marriage situations, especially where there are children from a prior marriage), an over-or under-funding will effectively disinherit the beneficiaries of one trust and overprovide for the beneficiaries of the other trust.

### ***Chapter 3: What Should Taxpayers Do Now?***

Since most advisors did not anticipate that Congress would allow the estate tax to be repealed in 2010, virtually all estate plans fail to take into consideration the absence of estate tax and its replacement, the modified carryover basis rules. Many who are aware of the estate tax repeal will naturally assume that the result for them and their families will be positive or, at worst, neutral. Unless forewarned, they would not suspect that failing to address updates to their estate plans could mean that more tax will be paid after their death. Moreover, the amount and nature of the assets that they intended to go to their spouse, family, friends and charities may be dramatically altered under these new rules.

In order to guard against these unintended consequences, and depending upon each client's specific circumstance, we generally suggest either a "Back-and-Forth" funding formula or a "Spousal Disclaimer" funding formula. The Back-and-Forth approach uses the modified carry-over basis rules to fund the estate tax exemption trust using the \$1.3 million basis allocation amount, then moves back to fund the marital trust with the remaining assets, thus preserving the \$3 million spousal basis allocation amount for appreciated assets. The Spousal Disclaimer approach distributes all assets to the surviving spouse but provides her with the opportunity to select which assets will benefit from the \$1.3 million basis allocation, thereby funding the estate tax exemption trust and Epilogue allowing her to retain the remaining property outright.

#### Epilogue

The key to successful tax planning in this fluctuating estate tax environment is to respond as best as once can to future legislation. Everyone should meet with their counsel this year to evaluate their current estate planning documents in this tenuous time of temporary tax repeal. Herein endeth the lesson

~ Kevin B. Rack  
~ Nathan R. Olansen

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***Fun Facts***  
***(at least for people with a nominal social life)***

\* Career Cast has compiled a list of the Top 200 jobs for 2010, based on the following five factors: Physical Demands, Work Environment, income, Stress and Hiring Outlook. The #1 job is Actuary (what was that about social life?). Lawyers ranked #80, just below Stockbrokers #77 and just above Tax Examiners/Collectors #82! – We're not sure why, because we love our jobs!

\* Good and bad news if you are a tax cheat. The IRS examined only 1.03% of all individual income tax returns and only .58% of all business income tax returns in 2009. For those unlucky few who did get caught up in a criminal prosecution, the IRS convicted 87.2% of the time.

**Pardon our mistake:** in our December 30 e-legal "Reflections at Year's End" we stated that upon election, the 2010 income tax liability triggered by a 2010 Roth IRA conversion, is due in two installments: the first, due on April 15, 2011, and the second, due on April 15, 2012. The due dates for payment of the tax are actually April 15, 2012 and April 15, 2013. Thanks to Chris Beale at UBS Financial Services for catching the error. Rest assured we flogged the staff appropriately to prevent future errors.                   **- Editor**