The Wealth Advisor

No Estate Tax in 2010: What Does this Mean to You?

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What a mess Congress has created! We are now in a year where there is no federal estate tax - but hold the cheers. Congress has substituted another method of taxation that will collect more taxes from many of our clients and families than the estate tax. Additionally, as has been reported in the local and national media, including the Wall Street Journal and New York Times[1], these changes will, for some, greatly alter the planned for and anticipated distributions among family members and heirs.

These changes impact people of all levels of wealth, and the new tax will impact an estimated ten times more Americans than the estate tax.

How Did We Get Here?

A brief review of the law will help explain why this is so significant. The much-heralded 2001 tax act, signed into law by President George W. Bush, gradually reduced the maximum rate of the federal estate tax (and the equally onerous generation-skipping transfer tax on transfers to grandchildren) from 55% to 45%. Over time, it dramatically increased the amount of property that you could pass free of federal estate tax from $675,000 per person in 2001 to $3.5 million per person in 2009. That means that with basic estate planning, a married couple could pass up to $7 million free of federal estate tax if they both died in 2009.

Then, ***in 2010 only***, the 2001 tax act *repeals* the estate tax. Poof! It's gone. But like a horror film character who just won't die, under the existing law the estate tax *returns again* on January 1, 2011 - only at a much lower $1 million exemption and a higher maximum 55% tax rate! This strange "now it's gone, no it isn't" effect is the result of a rule in Congress that attempts to limit budget deficits.

A New Tax Replaces the Estate Tax

To pay for this one-year vacation from the estate tax, Congress replaced the estate tax with an increased income tax. Here's how it works: Before 2010, any assets that pass to someone when you die would be valued at fair market value at the date of death. Thus after death, when a surviving spouse or heirs sold any assets (like securities or a home) that had increased in value, they would not have to pay income tax (capital gains tax) on any of that growth that occurred during your life. (This is referred to as a "*step-up in basis*.") For many heirs this means huge income tax savings, oftentimes tens of thousands of dollars or more.

But in 2010 property that passes at death does not automatically receive this step-up in basis. Instead, each decedent has a limited amount of his or her property that can be "stepped-up" in value at the time of death. Property that does not receive this step-up value will be subject to tax on the total increase in value from the date the decedent first acquired the property until the date the property is sold. This means that the property could be exposed to tens of thousands of dollars of income tax liability for your heirs!

Not surprisingly, these rules are convoluted and in many cases very different from the old law. In fact, Congress attempted to institute a similar tax structure in the 1970s and then repealed it retroactively because it was too difficult to administer. Because of past experience as well as the anticipated difficulties in calculating such a tax, the common belief was that Congress would not allow the new carryover basis regime to occur and would change the law before January 1, 2010. But Congress didn't do that.

What Should We Expect from Congress Now?

No one knows what Congress will do next; everyone assumed that Congress would act before December 31, 2009 to avoid the situation we're in now. But Congress was preoccupied by the health-care debate then, and it is very possible that Congress will continue to focus on health care and other pressing matters up to the time of the mid-term elections in early November.

In fact, some cynics have suggested that Congress will not act until the end of 2010 or later because Congressional members up for re-election will make repeal of the death tax a campaign issue. These same cynics argue that both Republicans and Democrats will blame the other for this mess, with neither wanting to fix it. If that happens, we may not see anything from Congress regarding the estate tax until 2011, at the earliest.

How Are You Affected?

This law can affect you in several ways. For married couples as well as single clients, we need to first make sure that your estate plan divides and distributes your property according to your desires, and not by the provisions dictated by Congress. For more than 50 years it has been common in estate planning documents to use a written mathematical formula to divide the assets of a married couple when the first spouse dies to maximize estate tax savings.

Similar formulas have been used to provide funds for charitable causes and to benefit family and friends. But in 2010, when there is no estate tax, these formulas might not work in the way they were intended. If a spouse is not your sole beneficiary (for example, if you have children from a prior marriage), the existing formula could result in the complete disinheritance or substantial reduction of resources provided for the surviving spouse.

What Should You Do?

We encourage you to meet with us as soon as possible to review your estate plan and make any changes that are necessary for this law. We need to ensure that your property is positioned to receive *the maximum step-up in basis increase available under current law*. This is a time that demands a new approach to your planning with new thinking, building in flexibility to make certain that your wishes are fulfilled no matter what Congress will throw at us this year or next. We have solutions that will meet your planning objectives with the least amount of tax impact.

See Estate-Tax Repeal Means Some Spouses Are Left Out, January 2, 2010 Wall Street Journal, and A Bizarre Year for the Estate Tax Will Require Extra Planning, January 8, 2010 New York Times

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