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Expert Analysis

A Look at the Current Muddled State Of the Federal Estate Tax

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For the first time in almost 100 years, a federal estate tax does not exist. In 2001, President George W. Bush enacted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). Referred to by some as "Throw Momma From the Train" legislation, EGTRRA provided for the gradual phase-out of not only the federal estate tax but also the generation skipping transfer (GST) tax.

As a result of EGTRRA, the estate tax applicable exclusion and the GST tax exemption both increased from $1 million in 2002 to $3.5 million in 2009 (at an effective rate of 45 percent in 2009). On Jan. 1, the federal estate and GST taxes were eliminated, but only for one year. In 2011, the federal estate and GST taxes are scheduled to return with a $1 million applicable exclusion and a $1 million GST exemption, indexed for inflation, at a top rate of 55 percent.

It was widely anticipated that Congress would enact new legislation prior to the end of 2009 to prevent the repeal. Toward the end of the year, Democratic leaders in Congress, to no avail, attempted to extend the law applicable in 2009 for another year to avoid the repeal. Congress' failure to reach an agreement has left estate planners and tax advisers guessing as to what may happen this year. Congress may enact legislation that would retroactively restore the estate and GST taxes with specified exemption amounts effective as of Jan. 1; it may restore the taxes to be effective as of a later date; or even in a very improbable scenario in these current deficit times, it may make the repeal permanent.

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Alternatively, Congress could choose not to act—or it could fail to reach an agreement—which would mean that there would be no federal estate and GST taxes in 2010, and the sunset provisions would take effect in 2011 with $1 million exemptions as discussed above. Although changes in law normally allow for new planning opportunities, the current legislative uncertainty has left advisers with more questions than new opportunities.

Possible Scenarios

If Congress chooses to retroactively reinstate the federal estate and GST taxes to Jan. 1, the estate of a decedent with a taxable estate may make a constitutional challenge to the retroactive application of the taxes. Although it seems inherently unfair to enact such a retroactive application, existing case law suggests that a constitutional challenge may not be successful considering the relatively low threshold that Congress needs to overcome such a challenge in the context of retroactively applying a tax.

In an effort to recoup some of the loss of revenue as a result of the repeal, in 2010, EGTRRA replaces the federal estate and GST taxes with a modified carryover basis regime. If the current legislation is not changed and a decedent dies in 2010 when there is no federal estate tax, a decedent's beneficiaries receiving appreciated property will no longer receive a step-up in basis for income tax purposes. Under the law in effect prior to 2010 and again in 2011, the tax basis of inherited property generally increases to the date of death value.

In 2010 only, the modified carryover basis regime would apply so that the beneficiary of inherited property would generally take the decedent's basis in the property. If the fair market value of the inherited property is less than the

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decedent's basis, the beneficiary will take the property with the lower fair market value basis. This rule prevents the beneficiary from taking advantage of any built in loss of the inherited property.

The new carryover basis regime potentially increases the amount of gain, and, in turn, would increase the income tax liability when the property is subsequently sold. While paying capital gains tax at a reduced rate when compared to paying estate tax at a higher rate may be beneficial to some beneficiaries, others who would not have paid an estate tax due to high estate tax exclusion amounts may now be subject to capital gains tax as a result of this law, and therefore be worse off. The law allows for two modifications to the carryover basis rules. First, the basis of property passing to a beneficiary other than a spouse can be increased by $1.3 million, and second, property passing to a surviving spouse can be increased by an additional $3 million.

Avoiding the Unintended

In this uncertain legislative climate, it is vitally important to review existing estate planning documents to make sure unintended results do not occur. Oftentimes, the applicable exclusion amount in a taxpayer's will or living trust is created by a formula tied to statutes in the Internal Revenue Code. In the current repeal landscape, the formula may very well equal zero, which could be problematic, especially if the applicable exclusion amount was intended to benefit someone other than the decedent's spouse, such as the decedent's children, grandchildren, children from a different marriage, or any other beneficiary for that matter.

The same issues apply for formulas in wills or living trusts funding GST trusts for younger beneficiaries. If, as a result of the repeal, the formula produces an amount equal to zero, beneficiaries intended to receive assets under a decedent's will or living trust may not receive anything.

It is important to note that the repeal of the federal estate tax generally has no impact on the New York or New Jersey state estate taxes. New York imposes a separate estate tax on assets passing to someone other than a spouse or charity in excess of $1 million, while New Jersey is the same with a $675,000 threshold.

The New York and New Jersey estate taxes are taxed at a much lower rate (top rate of 16 percent) than the federal estate tax (45 percent in 2009). As mentioned above, however, the formula clauses in wills and living trusts need to be reviewed from a New York and New Jersey state estate tax perspective as well. For example, a formula, as a result of the repeal, may fund a trust passing to non-spouse beneficiaries in an amount that would trigger a significant New York or New Jersey estate tax. While perhaps that can be viewed to be a good deal because that amount would ultimately escape federal estate tax, this should be identified ahead of time so that all options are reviewed and discussed.

EGTRRA has generally left the federal gift tax intact with a $1 million lifetime exemption, although the effective tax rate has been reduced from 45 percent to 35 percent in 2010. One reason to retain the gift tax was to protect the integrity of the income tax by preventing an individual from gifting assets to a beneficiary in an effort to shift income to a lower tax bracket.

Conclusion

It was considered unthinkable that Congress would allow 2010 to arrive without enacting new legislation. The failure of Congress to act has even been referred to as "congressional malpractice." The repeal of the federal estate and the GST taxes—and the ensuing legislative uncertainty—has forced advisers to consider all possible alternatives in planning, and has them even attempting the impossible task of predicting the future.

There is widespread hope that Congress will act swiftly to eliminate this uncertainty. Congress needs to consider issues of fairness, whether a progressive estate tax system makes sense, and the need for revenue. Perhaps more important, Congress needs to consider how EGTRRA has affected taxpayers' behavior to the point where some individuals may be wishing for an early death of a wealthy family member or thinking about expediting the day of death by either withdrawing a terminally ill relative's life-sustaining treatment or even—we hope not—throwing "Momma From the train."