Stonefield Josephson Academy

Tax Alert

January 2010

Estate Tax Repeal—Benefit or "Death Trap"?

As Congress has failed to pass any Estate tax reform, there is now at least some time during 2010 when there will be NO federal Estate and Generation-Skipping Transfer (GST) taxes. How long that may be, and whether or not Congress can retroactively reinstate the Estate and GST taxes to January 1, 2010, no one knows for sure. During this time of uncertainty, what should you do to protect your assets, avoid potential "death traps", and position your estate plan for whatever the future brings?

Estate Plans Need to be Reviewed:

Most estate plans need to be reviewed and updated to reflect the changes discussed further below, particularly if allocations to trusts will be made to a surviving spouse or children from a prior marriage. As most estate plans use an allocation based upon the exemption amount, some intended beneficiaries may receive nothing if death occurs during repeal in 2010.

Example: Estate plan provides for a "family trust" and a "marital trust" upon the death of the first spouse. To avoid estate taxes, the family trust is to receive the exemption amount with the remainder to the marital trust. If the family trust is primarily for the benefit of the children (especially those from a prior marriage), after the survivor's death, the children may receive nothing if there is no estate tax and thus, no exemption amount.

Note: Many plans provide that the marital trust is to receive the Estate tax exemption amount with the remainder to the family trust. In that case, the surviving spouse may receive nothing if there is no estate tax and thus, no exemption amount. A similar problem occurs if the Estate tax exemption is high enough (ex. $3.5 million, as in 2009) to including most or all of the estate, a loved one receives little or nothing.

Generation Skipping Benefit of Repeal:

Other than the absence of an Estate and GST tax, a benefit of repeal is that an unlimited amount can be left to grandchildren (skipping the children's generation) at death. If an estate plan is drafted properly, a long-term "dynasty trust" could be created that would effectively eliminate Estate and GST taxes and benefit children and grandchildren for many generations.

Potential "Death Traps" due to Repeal:

A benefit of having an Estate tax was that the basis of the property in an estate was generally increased ("stepped-up") to the fair market value (FMV) at the date of death. Under repeal, however, only a limited "step-up" in basis of $1.3 million (plus $3 million, for a spouse) is allowed using a complicated *Carryover Basis regime*. While there may be no Estate or GST tax, this may significantly increase federal capital gains taxes and state income taxes.

Example 1: If a single person or surviving spouse died in 2009, they could leave property with no basis and valued at $3.5 million Estate and GST tax free to their loved ones, children or grandchildren, who could shortly thereafter sell the property with little or no capital gains or income taxes due to the FMV basis "step-up" rule. If a single person or surviving spouse dies in 2010 during repeal, however, the heirs will only receive a $1.3 million "step-up" in basis and may owe capital gains and income taxes of $550,000 on the sale [$3.5 million - $1.3 million = $2.2 million x 25% (15%, federal capital gains tax, plus 10%, state income tax)].

Example 2: If a married person died in 2009, they could have left an unlimited amount for the benefit of their surviving spouse, Estate and GST Tax free, plus property with no basis and valued at $3.5 million for the benefit of their children and grandchildren, who could then sell the property with little or no capital gains or income taxes. If they die in 2010 during repeal, however, the family will only have a $1.3 million "step-up" in basis and an additional $3 million "step-up" for property distributed outright to the surviving spouse (or in a carefully drafted trust primarily for the benefit of the surviving spouse). Therefore, a sale of $5 million in property after the death of the first spouse in 2010 could result in additional capital gains and income taxes of $175,000 ($5M - $1.3M - $3M x 25%) whereas no taxes would have been owed if they had died in 2009 and sold the property shortly thereafter.

In addition to the difficulties illustrated above, the absence of a FMV basis "step-up" rule will require taxpayers to determine the decedent's basis in the property transferred. For property owned by the decedent for many years, such as a home or stocks, this challenge may be costly and even insurmountable. Another potential death trap during repeal is that *transfers to trusts* will generally be *treated as completed (taxable) gifts*. Therefore, only $1 million may be transferred to a "dynasty trust", unless the trust is carefully drafted so that the income is taxable to the creator of the trust.

What's Next?

Although many influential commentators believe that Congress will be able to retroactively reinstate the Estate and GST taxes to January 1, 2010, others believe they cannot and there will be a period of time during which no Estate or GST tax is applicable. So if Congress re-enacts the Estate and GST taxes retroactively, expect court challenges!

If no effective changes are made in 2010, the Estate, GST and Gift tax exemption in 2011 will be only $1 million and the highest tax rate will again be 55%. For *Californians* (and decedents in many other states), there may also be an additional state Estate Tax owed, due to the potential reinstatement of the *state death tax credit*.

To develop an effective estate plan or have a review of your estate plan, in light of these significant changes, please call or email Brent D. Rose, MPAcc(Tax), JD at (949) 428-3177 or brose@sjaccounting.com or your principal contact at Stonefield Josephson.

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