



estate tax "repeal"

MSK Client Alert

February 2010

Ben Franklin only got it partly right. As it turns out, nothing is as certain as death. Not even taxes.

Effective January 1, 2010, the federal estate tax and generation-skipping transfer ("GST") tax have been temporarily repealed. Many related rules also have significantly changed. All are scheduled to considerably change again in 2011.

The purpose of this notice is to help you begin to evaluate what, if anything, these changes may mean for your estate plan.

The Lay of the Land

Despite the confusion Congress has created, a few things appear clear as of the date of this notice:

1. The federal estate tax does not apply to estates of decedents passing away this year;
2. The "step-up" in income tax basis of a decedent's assets is generally limited to \$1.3 million (plus an additional \$3 million for transfers to a spouse) with respect to persons who die this year;
3. The GST tax does not apply to "generation-skipping transfers" that occur this year;
4. The top federal gift tax rate is 35% for gifts made this year (still with a \$1 million exemption); and
5. ***These rules only apply during 2010.*** Starting in 2011, they change back to the 2001 rules, such as an estate tax exemption of only \$1 million and a maximum tax rate of 55% (60% in some cases).

It is uncertain whether - or when - Congress will change any of these rules (and, if so, what the new rules would be, and whether they would be retroactive to January 1, 2010). Based on what we have seen during the past year, this

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legislation appears to be more difficult to predict than to enact.

Primary Concerns

Your planning may be subject to the rules currently applicable for 2010 if:

1. You pass away (or make certain gifts) this year; and
2. Congress does not retroactively change the rules.

It might seem that the temporary elimination of the estate tax would be a good thing for all clients. Unfortunately, this is not necessarily so. The 2010 rules may significantly change the allocation of your assets among your beneficiaries, contrary to what you expected when you executed your planning documents.

Everyone's estate plan is different. The potential impact of the 2010 rules to you can be determined only by reviewing your circumstances and the specific language of your estate planning documents. The following are key issues for you to keep in mind when considering whether you would like us to review your planning.

Generally, it is less likely your planning will be adversely affected by the current 2010 estate tax rules if:

1. You are single and all of the gifts upon your death are stated either in terms of specific dollar amounts or percentages of your assets; or
2. You are married, and when the first spouse passes away, all of that spouse's assets are held solely for the surviving spouse during the survivor's lifetime, all of the income from those assets is distributed for the survivor's benefit (which is not the case in many plans) and, at the second spouse's death, all of the assets are distributed outright to children both spouses have together.

In contrast, if your estate plan allocates your assets among different beneficiaries with reference to the estate tax (or GST tax), including the exemptions and marital deduction, the current 2010 rules are likely to significantly affect the amounts your beneficiaries may receive.

As but one illustration, an estate plan for married clients commonly provides that, upon the death of the first spouse, the deceased spouse's assets are allocated between two trusts: a "Marital Trust" for the benefit of the surviving spouse and an "Exemption Trust." The value of the deceased spouse's assets allocated to each of these trusts generally is determined by a formula based on some aspect of the estate tax rules.

For example, the trust agreement may allocate to the Exemption Trust assets equal to the deceased spouse's exemption from estate tax. However, when there is no estate tax, does the Exemption Trust receive *all* of the decedent's assets (because none of the deceased spouse's assets are subject to estate tax) or *none* of the assets (because there cannot be an estate tax exemption when the estate tax does not exist)?



It is highly unlikely that the deceased spouse intended this "all or nothing" allocation. This is particularly true if persons other than the surviving spouse (such as the decedent's children from a prior marriage) are beneficiaries of the Exemption Trust. The situation may become even more difficult if the surviving spouse (from a different marriage) is the trustee in charge of making the allocation. You can begin to appreciate the potential problems.

Similar issues can arise with respect to formulas that define other gifts to beneficiaries, including charitable organizations.

Charting the Course

We do not know what, if anything, Congress will do. We may see proposed legislation within a few weeks. Then again, it is possible that nothing may be enacted. If the current rules are changed retroactively, one can expect challenges to their legality and applicability for years to come.

In the midst of confusion, it is key to focus on your goal: your estate plan should implement your intentions. If you are concerned that (or are not clear whether) the 2010 rules in their present form may cause your estate plan to allocate your assets in a way you do not intend, we recommend that your estate plan be reviewed and, if appropriate, amended.

Some clients also may consider proactive planning to attempt to capture potential benefits of the current 2010 rules, in case any changes may not be retroactively effective. For example, in light of the current maximum 35% gift tax rate, clients who otherwise anticipate making a taxable gift might consider doing so as soon as possible. However, this planning may not be as desirable for clients who otherwise would not have incurred gift taxes.

No Contest Clauses

Please also note that California law regarding disinheritance provisions (also known as "no contest" clauses) has changed since most of our clients last executed their estate planning documents. The new rules significantly limit the types of acts that may constitute a "contest" of a will or trust. Amendments you request to your estate plan to reflect the 2010 federal tax rules also will include amendments to reflect the changes to the "no contest" laws.

The disinheritance and related provisions are of particular concern to a number of our clients. At times, terms of estate plans are specifically crafted based on these provisions. If this may be your situation, or if you have a particular concern regarding the effect of these provisions in your estate plan, consider asking us to review and, if appropriate, amend your documents (even if you do not wish to amend in light of the 2010 federal tax laws).

Conversion Into Roth IRA

You also should be aware of a potential retirement plan opportunity. Effective January 1, 2010, you can roll over amounts from traditional IRAs to Roth IRAs regardless of your adjusted gross income. This can have significant benefits, including, generally, that subsequent withdrawals from the Roth IRA may not be subject to income tax, and lifetime "minimum distributions" are not required to begin when you turn 70-1/2.



The trade-off is that generally you will be subject to income tax on the amount you roll over, except to the extent the IRA assets are attributable to after-tax employee contributions. Generally, the income tax cost is payable currently. However, for rollovers in 2010, you can elect to spread the taxable income between 2011 and 2012.

Whether rolling over to a Roth IRA is appropriate depends on many factors, including (1) the availability of funds outside of the Roth IRA to pay the current income tax cost of the rollover and continue your desired lifestyle (so that the amount in the Roth IRA can continue to grow tax-deferred) and (2) whether you expect to be in higher income tax brackets in the future.

Conclusion

We commiserate with you that our legislators have put you in this confusing position. Please call if you would like us to review your planning or otherwise discuss your alternatives. We will do our best to keep our fees and costs as low as we can.