

Estate Tax Planning in 2010

When the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted in 2001, few believed that the estate tax would actually be repealed in 2010. Yet here we are, with no estate and generation skipping transfer taxes in place (though the lifetime gift tax exemption of \$1 million still applies). Conjecture continues, and it is unclear whether Congress will act retroactively this year or enact prospective legislation for 2011.

While we wait to see what happens, below is a summary of key issues to remain cognizant of.

Federal estate tax replaced by capital gains tax

For tax year 2010, a decedent's assets no longer receive a stepped-up basis to the fair market value (FMV) at the date of death or the alternate valuation date. Instead, the income tax basis is the lesser of the decedent's adjusted basis or the FMV on the date of death. This is a modified carry-over basis regime—while no step-up is allowed, the basis can be stepped down.

Once the new basis is determined, the decedent's executor may allocate up to \$1.3 million to increase the basis of property passing to beneficiaries and \$3 million to increase the basis of property passing outright or in a qualified terminable interest trust (QTIP) to the spouse. **Please note:** This is an allocation to increase basis up to \$1.3 million and \$3 million, not an increase in the basis of property valued at \$1.3 million and \$3 million.

- **Example 1:** Jane dies owning shares with a basis of \$1 million and an FMV of \$3 million. The nonspousal beneficiaries' basis in the shares remains at \$1 million (the lesser of the adjusted basis and the FMV). Note that the basis will not be stepped up to \$3 million. Jane's executor may allocate up to \$1.3 million to increase the basis of the shares to \$2.3 million.
- **Example 2:** Jim dies owning stock with basis determined to be \$2.5 million under the 2010 rules and an FMV of \$3 million. Jim's spouse is the beneficiary of his stock. Jim's executor may allocate \$500,000 to increase the basis of Jim's stock to \$3 million. The basis cannot be increased above FMV at the death. The executor may then use the remaining \$2.5 million allocation to increase the basis of other property transferring to Jim's spouse.

The Internal Revenue Code grants the power to the executor (or other qualified administrator) to allocate the basis exemption. Will and trust provisions should be reviewed to ensure that an appropriate party is named and fiduciary powers under both documents are defined clearly to reduce possible confusion and disagreement.

Generation skipping transfer tax repealed

The generation skipping transfer tax (GSTT) was a flat rate tax (45 percent in 2009) applied to transfers during life or at death to beneficiaries more than one generation below the taxpayer (e.g., grandchildren, great-grandchildren). The GSTT was imposed in addition to federal estate and gift taxes to try to curb the transfer of multigenerational gifts that sought to avoid estate and gift tax at every generational level.

In 2010, **multigenerational transfers are subject only to the gift tax rules**—meaning all transfers over the annual exclusion amount and above the \$1 million lifetime exemption amount are subject to 35-percent gift tax.

Trust tax planning provisions

Tax planning trusts (A/B trusts or credit shelter trusts). High-net-worth married clients may have trust provisions directing a division of estate assets into two portions:

- One portion equal to the estate tax exemption amount (\$3.5 million in 2009)
- One portion equal to the optimum marital deduction amount

With the repeal of the estate tax exemption and marital deduction, **assets may not pass under these formula provisions as intended**, possibly inadvertently disinherit a spouse or other beneficiaries, such as the children from a former marriage. Clients should have these provisions reviewed by their legal advisors to ensure that their planning goals have not been disrupted.

State-level estate tax still viable. Prior to EGTRRA, a majority of states had a “sponge” tax, which was equal to the amount of the federal credit allowable against federal estate tax. EGTRRA eliminated the federal credit, thereby eliminating a state’s ability to collect taxes under the “sponge” tax. A few states then enacted state-level estate tax regimes to recoup state-level estate tax. It does **not appear that these state tax provisions have been repealed** by the repeal of the federal estate tax for 2010.

Trusts with provisions that address state estate tax exemptions often tie these provisions to the trust’s federal estate tax provisions, which may result in a failure to allocate property appropriately to manage estate taxes at the state level. Clients should consider having their trusts reviewed by their legal advisors to be sure their state-level tax concerns are addressed.

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