

Estate Tax Muddle Creates Challenges for Advisors and Clients

By Baird's Financial and Estate Planning Team

Beware! Rumors of the demise of the “death tax” have been greatly exaggerated. While we entered this year with no federal estate tax for the first time since 1916, the repeal of the estate tax will be rather short-lived. The levy on estates is scheduled to come back at the end of this year, and when it comes back, it may come back with a vengeance.

The source of all the confusion is the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Under EGTRRA, the federal estate tax exemption was gradually ratcheted up from \$1,000,000 in 2002 to an all time high of \$3,500,000 in 2009. Estates that are valued below the exemption amount are shielded from the estate tax.

In 2002, when the exemption amount was \$1,000,000, the exemption shielded all but approximately 100,000 estates from the estate tax. By 2009, when the exemption amount had risen to \$3,500,000, the exemption is estimated to have shielded all but about 6,000 estates from the estate tax.

In 2010, EGTRRA makes the estate tax exemption unlimited, meaning the estate tax is effectively repealed, but only for one year. Then in 2011, EGTRRA will sunset, or expire, and the exemption amount reverts back to \$1,000,000, where it is likely to again impact as many as 100,000 estates each year, indefinitely.

The content of this whitepaper was also the subject of a feature article written by Baird's Rich Behrendt in the February 2010 issue of *The Wealth Management Letter*, an online publication for Financial Advisors published by *Registered Rep* magazine.

Disturbing anecdotes have circulated about elderly millionaires being kept alive on feeding tubes last year until after December 31st when the estate tax was repealed, even though they had signed living wills expressly stating their desire not be kept alive in a vegetative state by artificial means. Morbid jokes abound about the temporary repeal of the estate tax making 2010 the year to “throw Mama from the train.”

It is difficult to defend a federal estate tax system that has so little year-over-year continuity that it impacts only 6,000 taxpayers in 2009, zero taxpayers in 2010, and 100,000 taxpayers in 2011. Apparently, Congress wanted to cut taxes in the worst way back in 2001, and that’s just what they did. They cut taxes in the worst way imaginable.

What many planners may not realize about EGTRRA’s temporary repeal of the estate tax in 2010 is that it will actually hurt far more families than it will help. This is because the law eliminated the automatic basis adjustment on assets passing from an estate. Prior to this year, most assets passing from a decedent received a new basis equal to the fair market value as of the decedent’s date of death. (A small category of assets, such as IRAs and 401(k)s, did not receive the automatic basis adjustment.) The intent of the automatic basis adjustment rule was to avoid the harsh double taxation of subjecting the same property to not only estate taxes, but also capital gains taxes when the decedent’s heirs

later sold their inherited property. To offset the lost revenue of the temporary repeal of the estate tax, Congress eliminated the automatic basis adjustment on all assets that heirs inherit from a decedent’s estate and replaced it with something called modified carryover basis.

Under the modified carryover basis rules, a decedent’s personal representative or executor may reset the basis of \$1,300,000 worth of property included in the decedent’s estate to the date of death value. But the basis of the rest of the property included in the estate is “carried over” from the decedent to his or her heirs. If the decedent is survived by a spouse, another \$3,000,000 worth of assets passing to the surviving spouse may also receive a new basis.

It is estimated that the heirs of approximately 70,000 estates will be subject to capital gains tax under the new, modified carryover basis system. Compare that to the estimated 6,000 estates that were subject to estate taxes in 2009 when the exemption amount was \$3,500,000.

Critics have also bemoaned the administrative burden of the modified carryover basis rules. Heirs will now be required to establish the original cost basis of assets the decedent may have acquired years ago, or even decades ago. Imagine having to determine the cost basis of a family farm that a parent acquired 50 or 60 years ago. What happens if the heirs are unable to produce credible evidence to support what

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they reasonably believe to be the decedent's original cost basis? The IRS will presume the basis is zero and the full amount of the sale price is subject to capital gains tax.

What are the chances that Congress will fix the federal estate tax mess anytime soon? Estate planners and advisors alike were stunned that Congress failed to act before the end of 2009. Senate lawmakers could eliminate all of these problems by approving a bill passed by the House of Representatives on December 3, 2009. H.R. 4154, the "Permanent Estate Tax Relief for Families, Farmers and Small Business Act of 2009" would restore the estate tax immediately with a \$3,500,000 exemption amount and eliminate the modified carryover rules. However, passing the House bill would require a 60 vote supermajority in the Senate, which seems out of reach after Republican Scott Brown's recent surprise victory in the Massachusetts special election.

Senate Republicans may be reluctant to vote in favor of H.R. 4154 this year for fear of being accused of raising taxes, even though the bill would have the long-term effect of reducing estate taxes for thousands of families by averting the devastating return to a \$1,000,000 exemption beginning next year. Senate Democrats, on the other hand,

may be tempted to withdraw their support for H.R. 4154 later this year if they perceive that the Republicans will only approve a version of the bill that takes effect after the one-year repeal for 2010. A partisan gambit of this nature may grind the political process into a stalemate where nothing gets done.

Cynical observers might even speculate that our Washington lawmakers secretly prefer having a dysfunctional tax system as we head into the November mid-term elections. Both sides of the political aisle will point fingers and blame the other side for creating the current mess, while families and their estate planning professionals struggle to figure out how to manage the contingencies and uncertainties.

What should advisors do in this period of uncertainty? High-net-worth clients should be advised to consult with a qualified estate planning attorney to review existing estate planning documents. Formula clauses designed to fund a credit shelter trust at the death of one spouse may have to be amended to provide for contingencies. Gifting programs and other wealth transfer techniques should continue to be implemented where appropriate because we are likely to have some form of the federal estate tax for the foreseeable future.

ABOUT THE AUTHOR

Richard A. Behrendt has been the senior estate planner on Baird's Financial and Estate Planning Team since 2006. Before that he spent 12 years working as an estate tax attorney with the Internal Revenue Service. For his work representing the government in several complex audits, Rich received the IRS's National Achievement Award in 2006. Rich is also an adjunct professor of law at the University of Wisconsin Law School, where he teaches a course in advanced estate planning.