

IS THE HOLIDAY OVER FOR ESTATE PLANNING?

This year's estate tax hiatus may end up causing more problems than it solves for families trying to transfer wealth. Time to get to work.

When Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001, it appeared to spell the end of the estate tax—or at least the beginning of the end. Under the law, estate taxes and generation-skipping transfer (GST) taxes would be whittled away until they disappeared in 2010. There was a catch, though. The statute had an expiration date of Dec. 31, 2010, after which the estate tax would revert to its pre-2001 form unless further action were taken. Still, Congress had almost a decade to make the repeal permanent or to reach a compromise that would retain the tax but at levels affecting far fewer families.

It has been able to do neither. Nine years later, the mood in Congress is not exactly conducive to compromise, and legislators have been busy debating what to do about health care, energy policy and a recovering but still frail economy. Fixing the estate tax has been far down on the agenda—and the clock is ticking.

The impending termination of the inheritance tax holiday has complicated estate planning for wealthy families, and things are only going to get trickier next January. Without a new law, the tax will return with just a \$1 million exemption—the amount an individual may pass along tax-free—and a top tax rate of 55% on nonexempt assets with a 5% surtax for estates valued at more than \$10 million. That's a far cry from the \$3.5 million exemp-

tion and 45% top estate tax rate of 2009. And because we don't yet know what will happen, families potentially subject to the tax—in whatever form it may take at the time of a death—may need to adjust their estate plans to anticipate multiple scenarios.

NO MORE "STEP UP"

Even 2010, widely viewed as an unprecedented boon for families that are transferring their wealth, has ushered in several significant and immediate challenges for many estates. Until this year, inheritors got a major income tax break on assets that had gained

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value. The cost basis of inherited investments, which is used to determine possible capital gains taxes when assets are sold, was "stepped up" to its market value on the day the assets' owner died, explains Gideon Rothschild, a partner in the New York City law firm Moses & Singer. But that tax advantage has been replaced with a new rule that carries over the original cost basis of inherited property. So if you inherit stock that your grandfather bought

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in 1940, your cost basis for capital gains tax purposes will be the same as his was. If the investment's value has multiplied over the years, you could face a steep income tax bill when you sell.

Could, but not necessarily *will*. This year's rules allow an executor to increase the cost basis of assets in the estate by up to \$1.3 million, with an additional \$3 million increase allowable for assets passing to a spouse or a qualified spousal trust. Larger gains will be taxable, however, and everyone will have the added difficulty of trying to determine just how much was paid for investments that in many cases were made decades ago.

Adding to the confusion, the federal gift tax remains in effect in 2010, with a \$1 million lifetime exemption and a top rate of 35% (down from 45% in 2009). Meanwhile, most—but not all—state gift and GST tax rates remain unchanged. “My clients are in a total state of limbo,” Rothschild says. Still, there are several steps that most families can take now to see to it that their estate plans continue to reflect their original intentions, he says.

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WATCH YOUR LEGAL LANGUAGE

The federal estate tax exemption actually started rising even before the 2001 law was passed. Gradual increases during the late 1990s prompted most estate planners to recommend using a formula, rather than a fixed number, in wills and trust documents, to capture the full advantage of shifting estate and GST tax credits, says Vinay Navani, a partner with Wilkin & Guttenplan, an accounting and consulting firm in East Brunswick, N.J. That way plans wouldn't have to be rewritten every time the exemption inched upward.

For example, a husband in his second marriage could stipulate that the full tax-exempt amount in effect at the time of his death go to fund a trust for children from his first marriage, with all remaining assets passing to his current spouse. (A spouse can inherit an unlimited amount from a deceased spouse without estate tax liability.) But if the husband died this year, that formula could send everything to the children's trust, leaving nothing for the spouse—or it could leave everything to the spouse and nothing for the children, depending

on how the formula is worded. Conversely, if he died in 2011 and the law hadn't been changed, the kids would get just \$1 million—compared with \$3.5 million if he had died in 2009.

Rothschild has a different point of view and says that if any part of your estate plan uses formulas to determine the distribution of your assets, you're almost guaranteed that your wealth won't be disbursed as you intend. To solve the problem, he recommends working with your attorney to revise your will and trust documents back to a fixed number, at least until Congress chooses a final form for the estate tax. “A fixed number is only one option,” Rothschild says, “and if you do that, you will need to revise again next year. Each client situation will likely require a different fix.”

LIMITED-TIME OPPORTUNITIES

According to Scott Cooper, Managing Director, Wealth Structuring Group for Bank of America Merrill Lynch, 2010 could be your last best chance to use a popular estate planning

vehicle—the grantor-retained annuity trust, or GRAT—to transfer wealth to future generations. A GRAT is an irrevocable trust into which you transfer assets while retaining the right to receive annuity payments for a predetermined number of years. At the time you set up a GRAT, you may owe gift tax on the assets you move into the trust, but the amount of the tax is determined by

the projected value of the assets at the end of the GRAT's term, at which point the money goes to the trust's beneficiaries tax-free. The projected value of the GRAT is based on the size of the annuity payments and a standard IRS-determined rate of appreciation in effect when the trust is set up, even if the actual rate of appreciation of the assets inside the trust ends up being much, much higher.

Under current law, you can structure a GRAT so that the taxable gift is ultimately close to zero, an outcome that today's low (3.2% as of mid March) IRS rate of appreciation makes relatively easy to achieve. But, Cooper notes, legislation has been introduced in Congress that would effectively end the ability to “zero out” a GRAT and would set a 10-year minimum for terms—changes that could make these trusts far less attractive. “The zeroed-out GRAT can be a wonderful estate planning strategy for certain clients,” says Cooper. “Unfortunately, it's not unusual for clients to have little or no appreciation of the planning tools currently available—until after they're legislated away. They just don't know what they have until it's gone.”

This year may also offer an unusually good opportunity to move money out of your estate through a substantial gift. While there is still a \$1 million limit on tax-free lifetime gifts by an individual (\$2 million if you include your spouse), this year's 35% federal tax rate on gifts that exceed your exemption is much lower than it has been—or is slated to be in the future. In 2011, barring changes in the law, the rate will shoot up to 55%. What's more, because there is no federal GST tax this year, you can give unlimited amounts, outright or in trust, to grandchildren or later descendants, Cooper says. A final advantage of giving during 2010 is that the value of assets you give away may have been reduced during the market downturn—which increases the potential worth of what you give now, before prices fully recover.

AN ESTATE TAX CLAWBACK?

If Congress does reach a compromise on the estate tax at some point in the year—perhaps establishing a permanent tax with 2009's \$3.5 million exemption and 45% tax rate—it could attempt to apply the new tax law retroactively. That could leave the estates of those who die in 2010 hanging in the void, Navani says, particularly if a retroactive provision prompted constitutional challenges in the courts. "This is the time to have your estate attorney revisit your will and other estate documents, and you may have to do it again in 2011...and then again in 2012," he says. "I hate to say it, but the further we go into 2010 without any legislation, the stronger the chance that we will revert to the rules before the 2001 law." It should be interesting. ■

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