The Current State of the Federal Estate Tax

A Basis for Concern: How it Impacts Your Estate and Life Insurance Plans

On January 1, 2010, the U.S. Congress allowed what caught many people, even estate planning pundits, by surprise. What few predicted would happen actually did happen – a repeal of the estate tax. As of the date of this publication, Congress has failed to pass any bicameral legislation whatsoever addressing the estate tax. Most legal and tax advisors assumed that Congress would extend the estate tax before it expired at the end of 2009. While the House of Representative did approve a bill (H.R. 4154) on December 3, 2009, the bill failed to win the support in the Senate. So we start 2010 with the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) intact.

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What is the reaction to Congress' inaction?

Estate and Generation-Skipping Transfer Taxes

As of January 1, 2010, federal estate and generation-skipping transfer (GST) taxes are temporarily repealed. In addition, transfers during life are now subject to a 35% gift tax (with the $1 million lifetime gift tax exemption still in place). If no legislation is passed to address the estate tax, EGTRRA calls for the reinstatement of the estate and GST tax in 2011 at 2001 estate tax rate levels. The following chart summarizes the current state of the law:

Year	Estate Tax Exemption	Highest Estate/ GST Tax Rate	GST Tax Exemption	Gift Tax Exemption	Highest Gift Tax Rate
2010	$0 - Federal Estate Tax Repealed	0%	$0 - GST Tax Repealed	$1,000,000	35%
2011 (and beyond)	$1,000,000	55%	$1,120,000[1]	$1,000,000	55%

Impacts on Income Tax Basis

Before 2010, a decedent's (eligible) assets received a cost basis equal to the asset's fair market value on the date of the person's death. If the recipient sold the inherited asset shortly after receiving it, the step-up in basis rules would result in little or no capital gains tax (depending on the amount of appreciation after death).

In 2010, EGTRRA repealed the step-up in basis rules and replaced them with a modified carryover basis regime. For persons dying in 2010, the basis of property is the **lesser** of the decedent's basis or the fair market value of the property on the date of death. Instead of a full step-up in basis, the executor of the estate is allowed to allocate $1.3 million to increase the basis of assets. In addition, the executor of the estate may allocate another $3 million to increase the basis of assets passing to the surviving spouse.

By way of example, Kyle's father, Jack, died on January 1, 2009, and left Kyle with 500 shares of XYZ Inc. stock. At the time of his death, Jack had a basis of $10 per share and each share had a fair market value of $100 (i.e., $90 of gain per share of stock). Therefore, under a step-up regime, Kyle's basis per share will step-up to the value on the date of Jack's death – $100 per share. Assuming no further appreciation in the value of the stock prior to sale, when Kyle sells the stock he avoids tax on $90 per share in capital gains. Under a carryover basis regime, assuming the $1.3 million basis allocation is not available, Jack's basis of $10 per share would become Kyle's basis. Thus, Kyle would pay tax on the $90 of gain (per share) when he sells the shares.

1 Indexed for inflation.

Will there be any future estate tax legislation?[2]

We are presently in unchartered waters. It is unclear when (or whether) Congress will enact future legislation to address the estate tax repeal. Regardless of Congressional action (or lack thereof), the estate tax probably will return, whether it be this year (2010) or later. The estate tax repeal is scheduled to expire on December 31, 2010.

If Congress does not act this year, the estate tax will return on January 1, 2011 at a much higher rate ($1,000,000 estate tax exemption amount and maximum 55% tax rate). It is vital to implement an estate plan that continues to address an individual's needs and that is independent of what lawmakers may (or may not) do.

Planning in Spite of the "Repeal" of the Federal Estate Tax

Here are ten things to remember when implementing your estate plans in light of the 2010 estate tax repeal:

1. **"They're back"… If Congress does nothing this year, that is.**
   EGTRRA provides for a one-year repeal of the estate and GST tax to decedents dying in 2010. If Congress does not address the estate tax law, EGTRRA will "sunset" on January 1, 2011. In other words, assuming no Congressional action, on January 1, 2011, the applicable exclusion amount for estate and gift taxes will be $1 million. The GST tax exemption will be $1 million indexed for inflation. The highest marginal estate and gift tax rate will be 55% plus a 5% surcharge to phase out the benefit of the unified credit on estates between $10 million and $17,184,000.

   If we assume Congress takes no action with regards to the estate tax in 2010, the estate and GST transfer tax will return in 2011. For individuals with estates greater than $1 million (or married couples with estates exceeding $2 million), estate planning will be necessary if, among other things, individuals want to ensure their assets are transferred in the most efficient manner. Using life insurance may enable individuals to maximize the wealth transferred to their heirs and also provide the necessary estate tax[3] liquidity when the need arises. Therefore, regardless of the current 2010 repeal, it is prudent to plan in light of the likelihood that estate taxes will return – either some time in 2010 and thereafter – at rates anywhere from $1 million to $5 million. Given this possibility, individuals should consult their financial and legal advisors to review their current plans and consider new opportunities in light of the repeal.

2 Due to the uncertain and complex nature of the estate tax issue, please consult your tax and legal advisors as to what effect the repeal of federal estate taxes in 2010 and their reinstatement in 2011, or any new federal estate tax legislation, may have on your estate plans.

3 As of January 1, 2010, the federal estate tax is repealed until December 31, 2010. Also, over the same time period, the rules regarding step-up in basis for property transferred at death were replaced with a modified carryover basis at death rule. Congress continues to consider legislation that, if passed, may change current federal estate tax law. Please consult with your tax and legal advisors as to what effect the repeal of federal estate taxes in 2010 and their reinstatement in 2011, or any new federal estate tax legislation, may have on your estate plans.

2. Step aside "step-up in basis." Make room for the "carryover basis" rules.

Remember, for decedents dying in 2010, the basis of property acquired is the lesser of the decedent's basis or the fair market value of the property at the decedent's death.[4] That change has a significant income and capital gains tax impact.

a. *Potential Higher Capital Gains Tax:* The elimination of the step-up in basis rules in 2010 may significantly impact estates and/or heirs that, prior to 2010, had little or no capital gains liability. In fact, under the modified carryover basis system, recipients of assets may be subject to capital gains once gains in the estate exceed $1.3 million (with an extra $3 million for property passing to a surviving spouse). According to some estimates, an extension of the estate tax (with a $3.5 million exemption and 45% tax rate) would have impacted 6,000 estates; but, the new carryover basis provisions will affect more than 70,000 estates.[5]

b. *The Importance of Record Keeping:* Under the 2010 carryover basis system, the executor of the decedent's estate is allowed to partially increase the basis of property by a certain amount ($1.3 million with an extra $3 million for property passing to a surviving spouse). Any further appreciation will be subject to taxation when the asset is sold. This rule leaves open the possibility that the property's gain will be subject to taxation when it is either sold by the decedent's estate or the beneficiaries at the maximum capital gains tax rate (currently 15% in 2010; scheduled to increase to 20% in 2011).

   Given the importance of the decedent's basis, the estate's executor should have proper documentation so as to be able to properly compute and allocate the basis of the assets at the decedent's death. Likewise, the executor should be empowered to determine which assets are to receive the basis increase and send beneficiaries statements notifying them of the adjusted basis in the assets they are to receive. Failure to maintain such records may make it more difficult to accurately compute an asset's basis, making it more of a chore to determine the correct basis. This, in turn, may make the executor's job more difficult, time consuming and costly.

4 IRC Sec. 1022(a)(2).
5 "Estate Planning in Light of One-Year 'Repeal' Of Estate and GST Tax in 2010," S. R. Akers, January 2010.

3. Re-Examine the Marital Trust and B-Trust Formula

Many estate planning documents are drafted so as to maximize the first-to-die spouse's unused estate tax exemption amount by creating at least two trusts. This is generally accomplished by including a formula in the couple's estate planning documents that creates a marital trust and a B-Trust (also known as a credit shelter trust or a bypass trust). The formula generally funds the B-Trust with the maximum amount of assets that can pass free from federal estate tax; all remaining assets are placed in the marital trust and pass without estate taxes via the unlimited marital deduction.

Assuming death in 2010, the problem with this type of formula may be that the marital trust will not be funded at all and the B-Trust will be overfunded. In other words, if the first spouse dies in 2010 with no estate taxes, this general formula may cause the unintentional underfunding of the marital trust. Given the potential severity of the outcome, it is vital to review the estate planning documents (and the formulas contained within these documents) to make sure the documents continue to meet the individual's needs and objectives. A thorough review, evaluation and modification of these documents may help make certain there are assets available to the surviving spouse.

4. Don't give away the farm! Estate Tax Repeal Does Not Apply to Gifting

Although Congress' inaction (thus far) has opened the door for estate tax relief in 2010, it has had little impact on gift taxes. In fact, the gift tax will continue in 2010 but at a lower, 35% top rate (rather than a 45% top rate in 2009). The annual exclusion amount also continues to be $13,000 (indexed for inflation).[6] Thus, individuals are still able to utilize both their lifetime gift tax exemption amount[7] and annual exclusion gifting with little gift tax impact. In fact, if a person makes a taxable gift in 2010, the lower gift tax rate (35% in 2010 versus 45% in 2009) means the gift is exposed to a lower gift tax liability. Individuals who are utilizing their gifting capacity and are interested in making further gifts may do so at a lower gift tax liability. If these same individuals wait until 2011 and no further legislation is enacted, the gift tax rate increases to 55% thereby making it more costly from a gift tax perspective.

6 *Annual exclusion gifting: In 2010, any person is allowed to give to any other person gifts in a calendar year that have an aggregate amount of up to $13,000 indexed for inflation.*

7 *Lifetime gift tax exemption amount: During a person's lifetime, he or she is able to gift up to $1,000,000 without incurring any federal gift taxes because of the lifetime gift tax exemption amount (transfer to a U.S. citizen or resident spouse are exempt from gift tax because of the unlimited marital deduction) .*

5. **Don't Skip the Transfers to "Skip Persons"**

   Prior to 2010, the GST tax applied to transfers made during life and at death to persons two or more generations younger than you, such as grandchildren or great grandchildren (i.e., "skip persons"). The GST tax exemption amount ($3,500,000 in 2009) allowed individuals to give or leave a certain amount of assets to skip persons without imposing this additional transfer tax. In 2010, the GST tax is repealed; this means that individuals wishing to make transfers to skip persons in 2010 may currently do so without the imposition of the GST tax. It is important to remember, however, that a gift tax may still be imposed if the gift to the skip person exceeds the $1,000,000 lifetime gift tax exemption amount or the $13,000 annual exclusion amount. This is the case because the gift tax is a tax that is imposed in addition to the GST tax (if any). It is also important to remember that in 2011, the GST tax returns with an exemption of $1,120,000 and a higher, 55% maximum tax rate.

6. **Feeling Philanthropic, Look to Low Basis Assets**

   For individuals who are charitably inclined, the 2010 estate tax repeal did not impact the charitable deduction rules.[8] Given that the estate tax has been repealed in 2010, individuals may donate to charities more for income tax deductions than to obtain a charitable estate tax deduction. Many individuals will continue to incorporate charitable giving into their estate planning in support of their philanthropic wishes and the desire to eliminate capital gains tax on certain appreciated assets. Given the potential negative impact of the carryover basis system in place in 2010, charitable gifts of low basis assets to, for example, a charitable remainder trust (CRT), may be one way to minimize or defer the capital gains taxes associated with the sale of such assets. This type of strategy, coupled with life insurance inside of a wealth replacement trust, may help replace the wealth "lost" to heirs when the grantors transfer the asset to the CRT.[9]

7. **Reduce the Gift Tax Bite with Gift-Minimizing Strategies**

   Given that there continues to be a gift tax in 2010, techniques that enable individuals to minimize or eliminate gifting may be beneficial to transfer wealth to heirs. These techniques include, but are not limited to, grantor retained annuity trusts (GRATs), sales to intentionally defective grantor trusts (IDIT sales) and qualified personal residence trusts (QPRTs).[10] For instance, with a GRAT, the individual's contribution to the GRAT may be valued at close to zero for gift tax purposes if the GRAT is structured as a zeroed-out GRAT. With a zeroed-out GRAT, the individual's gift to the beneficiaries is close to zero because the value of the individual's retained interest is almost equal to the value of the property the individual transferred to the GRAT.

8 *For more information on the charitable deduction rules, please refer to Pacific Life's pocket guide titled "Charitable Remainder and Lead Trusts with Life Insurance."*

9 *For more information on this strategy, please refer to Pacific Life's point-of-sale brochure titled "Charitable Remainder Trust Using a Wealth Replacement Strategy with Life Insurance."*

10 *For more information on the charitable deduction rules, please refer to Pacific Life's pocket guide titled "Advanced Estate Planning Techniques and Life Insurance for the Ultra Wealthy."*

8. **Turning Back the Clock: The Retroactivity Debate**

Another looming question in the estate tax debate is: If Congress makes changes to the estate tax laws in 2010, will they attempt to make the changes retroactive to January 1, 2010? Some legislators have commented that they support retroactivity, while others believe it is unfair to individuals who either die prior to retroactivity or who make gifts thinking they are subject to a 35% (rather than a 45%) tax rate. Additionally, some legal experts doubt whether retroactivity is constitutional. While it is unclear whether retroactivity is constitutional, it seems likely that there will be some litigation if Congress does decide to retroactively apply the estate and GST tax back to January 1, 2010. Individuals should consult with their legal and tax advisors to address this and other issues relating to the estate and GST tax legislation.

9. **Look Into Your Crystal Ball: Features of Potential Future Legislation**

Perhaps the single most frequently asked question regarding the estate tax is "What happens now?" Few predicted the current estate tax situation would come to fruition. It is presently unclear what the features of any future estate tax legislation may encompass. If the past is any indication of what the future may hold, we can look to the recent discussions that lawmakers have had.

Estate tax exemption amount. Various legislators have suggested they support an estate tax exemption amount of $3.5 million, $5 million or $1 million.

Portability. There have been discussions regarding the inclusion of "portability" of the estate tax exemption amount in future legislation. Portability refers to the idea that when the first spouse dies, his or her unused estate tax exemption amount is transferred to the surviving spouse; the surviving spouse is then able to use that entire amount at his or her death. In other words, the surviving spouse would have both spouses' unused federal estate tax exemptions (if any).

Reunification. In the past, the gift and estate tax exemption amounts were unified (i.e., the same amount) and could be used to offset both lifetime gifts and bequests at death. As of 2009, the gift and estate tax exemption amount were different ($1 million and $3.5 million, respectively). This mismatch may have discouraged substantial lifetime gifting because gifts in excess of $1 million may have subject the grantor to gift taxation. Recently, legislators have expressed support for reunifying the gift and estate tax exemption amounts. Depending on the estate tax exemption amount, if reunification is enacted, this may simplify and enhance an individual's ability to make tax-free gifts during one's lifetime.

Indexing for inflation. Finally, another feature that may be included in future estate tax legislation is indexing the estate tax exemption amount for inflation. This potential feature may, if included, adjust the estate tax exemption amount to reflect the rate of inflation – as is currently the case with the annual exclusion amount and the GST tax amount.

10. Life Insurance Continues to be an Invaluable Planning Tool

During this time of estate tax uncertainty, remember that the estate tax repeal is likely to be temporary. Working with their legal and tax advisors, individuals should incorporate flexibility into their planning so as to anticipate changes in the estate tax laws should and when such changes take place. These individuals should also have their estate planning documents reviewed to determine if they continue to meet their goals and objectives.

Indeed, life insurance remains a valuable planning resource. Under a carryover basis regime, estates with little liquidity and highly appreciated assets may face significant income tax burdens if they need to sell assets to generate liquid funds. Life insurance may help provide the funds needed to address the income tax burden or generate the liquid funds needed. Unlike other assets, the life insurance death benefit proceeds are income tax-free.[11]

Finally, unless an estate tax repeal is made permanent, wealthy individuals that have an estate tax liability will likely continue to have an estate tax liability in the coming years regardless of what Congress does. The need for life insurance for estate tax liquidity may be essential in order to address this potential liability. Additionally, life insurance will continue to be invaluable in various non-estate tax contexts such as business succession planning, blended family planning, wealth replacement planning for charitably inclined donors and retirement planning.

11 *For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

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