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The Repeal of the Federal Estate Tax: Nothing's Certain

By: Neil V. Birkhoff

A. **Introduction.** On June 7, 2001, President Bush signed into law Pub. L. 107-16, 107th Cong., 1st Sess. (2001), "The Economic Growth and Tax Relief Reconciliation Act of 2001" ("the Tax Act of 2001 "), which made significant changes to the estate, gift, and generation skipping transfer (GST) taxes (the "transfer taxes"), increased the available exemptions, and then provided for the repeal of the estate and GST taxes in 2010.

B. **The Big News: The Repeal of the Estate and Generation-Skipping Transfer Taxes.** A decade later and Congress has done nothing to change the estate tax and GST tax provisions of the Tax Act of 2001. Therefore, Section 501(a) of the Tax Act of 2001 repeals the estate and GST taxes with respect to estates of decedents dying after December 31, 2009, and to other generation-skipping transfers made after December 31, 2009. Tax Act of 2001 §§ 501(a), 501(b); IRC §§ 2210(a), 2664.

(1) **But is the Estate Tax Gone Entirely?** Dispositions of property, after December 31, 2009, for which the estate of a decedent who died before January 1, 2010, was allowed the tax benefits of special use valuation (Section 2032A), the deduction for interests in qualified family owned businesses (Section 2057), or deferral of estate taxes attributable to a business interest (Section 6166), will continue to result in the recapture of the previous estate tax benefits, to the extent provided under present law. These recapture taxes are not repealed. See H. Conf. Rpt. 107-84, 107th Cong., 1st Sess., 147 Cong. Rec. H2773-H2774 (May 25, 2001). Likewise, the estate tax will continue to be imposed after 2009 in certain cases with respect to qualified domestic trusts (QDOTs) created for the benefit of a non-citizen surviving spouse, where the spouse whose will or trust created the QDOT died before January 1, 2010. Tax Act of 2001§ 501(a); IRC § 2210(b). The estate tax will be assessed on any distribution after December 31, 2009, and before January 1, 2021, from a QDOT, before the date of the death of the non-citizen surviving spouse. Further, the estate tax will be imposed on the value of the property remaining in a QDOT on the date of death of the non-citizen surviving spouse if such surviving spouse dies before January 1, 2010.

(2) **What about the Gift Tax?** The Tax Act of 2001 does not repeal the gift tax.

a. The 2001 Tax Act, however, reduces the highest gift tax rate in 2010 to the highest individual income tax rate, meaning that gifts made after December 31, 2009 are subject to a flat 35 percent gift tax rate.

b. After the repeal of the estate and GST taxes, "a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under" the grantor trust rules. Tax Act of 2001, § 51l(e), IRC § 2511(c). Thus, a transfer to a trust will be a completed gift unless the transfer is incomplete for income tax purposes.

C. **Congress Giveth and Congress Taketh Away: The New Basis Rules.**

(1) **General Rule.** Under the Tax Act of 2001, a person who receives property from a decedent who dies after December 31, 2009, has an adjusted basis in the property equal to the lesser of the fair market value of the property on the date of the decedent's death, or the adjusted basis of the property in the hands of the

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decedent. Tax Act of 2001 §§ 541, 542; IRC §§ 1014(f), 1022. Thus, the step-down in basis under present law for loss assets received from a decedent is retained, but the step-up in basis for appreciated assets is eliminated. Tax Act of 2001 §§ 541, 542; IRC §§ 1014(f), 1022(a).

(2) A Little Basis Relief. The Tax Act of 2001 does allow the executor of a decedent's estate to allocate some additional basis to and among a decedent's assets. The two basis adjustments under the Act are the $1.3 million "aggregate basis increase" and the $3 million "spousal property basis increase."

a. The aggregate basis increase (generally limited to $1.3 million) is allocated by the executor on an asset-by-asset basis, and cannot raise the basis of any asset above its fair market value on the date of the decedent's death. The allocation can be changed only as permitted by the Secretary of the Treasury. Tax Act of 2001 § 542(a); IRC § 1022(b)(3)(B).

b. The $1.3 million limitation on the aggregate basis increase may be increased by certain unused losses. The executor is allowed to add to the $1.3 million aggregate basis increase the sum of the amount of any capital loss carryover (under Section 1212(b)), and the amount of any net operating loss carryover (under Section 172), which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of- the decedent. Further, the executor is allowed to add to the $1.3 million aggregate basis increase the sum of the amount of any losses that would have been allowable (under Section 165) had the property acquired from the decedent been sold at fair market value immediately before the decedent's death. Tax Act of 2001 § 542(a); IRC § 1022(b)(2)(C).

c. The spousal property basis increase permits the executor of a decedent's estate to increase the basis of property acquired from the decedent by the decedent's surviving spouse by $3 million, in addition to any adjustments made by the $1.3 million aggregate basis increase. Tax Act of 2001 § 542(a); IRC § 1022(c).

i. An allocation of the spousal property basis increase cannot increase the basis received from the decedent above the fair market value of the property on the date of the decedent's death.

ii. The spousal property basis increase is allowed only for property passing to a surviving spouse outright or in a qualified terminable interest property ("QTIP") trust. Tax Act of 2001 § 542(a); IRC § 1022(c).

iii. A decedent is not deemed to own property merely because the decedent holds a general power of appointment over that property. Tax Act of 2001 § 542(a); IRC § 1022(d)(1)(B)(iii). Thus, the use of a "tax basis trust," under which one spouse creates a trust to hold appreciated assets, and gives the other spouse a general power of appointment over the trust, with the intent of obtaining a basis increase when the other spouse dies, will not be effective to take advantage of the spousal property basis increase.

d. The aggregate basis increase or spousal property basis increase cannot be allocated to the following types of assets:

i. items of income in respect of a decedent (Section 691); or

ii. property acquired by the decedent by lifetime transfer for less than adequate and full consideration in money or money's worth, during the three-year period ending on the date of death, other than property acquired by gift from the decedent's spouse.

(3) Basis Reporting Requirements.

a. The executor of the estate of a decedent who dies after December 31, 2009, is required to file a return with basis information. Tax Act of 2001 § 542(b); IRC §§ 6018, 6019, 6716. The aggregate basis increase and spousal property basis increase are allocated on this return.

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i. The executor will be required to report the basis and character (capital gains or ordinary income) of all property acquired from a decedent, if the total fair market value of the property acquired from a decedent's estate (other than cash) exceeds the $1.3 million aggregate basis adjustment (determined without regard to losses and loss carryovers that are otherwise added to the $1.3 million figure for purposes of allocating the aggregate basis increase). Tax Act of 2001 § 542(b); IRC § 6018(b).

ii. The executor must also report on the return appreciated property with a value of more than $25,000 that was acquired from a decedent, but that was ineligible for allocation of any portion of the aggregate basis increase because it was acquired by the decedent by transfer for less than adequate and full consideration within three years of the decedent's death, and was required to be included on a gift tax return.

iii. The decedent's executor will be required to include on this return:

1. the name and taxpayer identification number of the recipient of such property;

2. an accurate description of such property;

3. the adjusted basis of such property in the hands of the decedent and its fair market value at the time of death;

4. the decedent's holding period for such property;

5. sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;

6. the amount of aggregate basis increase and additional basis increase for property acquired by a spouse, allocated to each asset; and

7. such other information as the Secretary may by regulations prescribe.

b. The executor will also be required to report to the recipient of the property, the name, address, and telephone number of the executor, and the information provided to the IRS regarding the asset acquired by this recipient. These basis information returns must be filed with the decedent's income tax return for the decedent's last taxable year.

c. The Tax Act of 2001 imposes a penalty of $10,000 for each failure to report to the IRS transfers at death of non-cash assets in excess of $1.3 million in value, and a penalty of $500 for each failure to report to the IRS the receipt by a decedent of appreciated property valued in excess of $25,000 within three years of death. A $50 penalty is imposed for each failure to provide the required information to a beneficiary. Tax Act of 2001 § 542(b)(4); I.R.C. § 6716.

D. **Sunset Provisions.** All of the estate, gift, and GST tax provisions of the Tax Act of 2001 will expire on December 31, 2010.

(1) **Budget Act.** This sunset is necessary to comply with the Congressional Budget Acts of 1974 and 1990, which require a vote of 60 senators to pass a bill that would decrease revenues for a fiscal year more than ten years after the present fiscal year.

(2) **Result.** The sunset provision means that unless Congress takes further action, the estate and GST taxes will be repealed only with respect to estates of decedents and taxable events in 2010, and the estate, gift, and GST tax laws will be restored to their pre-Tax Act of 2001 status on January 1, 2011.

E. **Wills and Trusts Need to be Reviewed Now.** You need to consider the effect of the estate and GST tax repeal on your estate plan if your documents create a unified credit share and a marital share, particularly if these shares are held for the benefit of different beneficiaries.

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a. Such divisions are usually based on a formula that creates a non-marital share equal to the greatest amount that can pass free of tax because of the decedent's applicable exclusion amount.

   i. The client who executed such a will or revocable trust before 2001 reasonably expected that it would produce a non-marital share equal to $675,000 in 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million after 2005. IRC § 2010(c).
   ii. The client did not anticipate that it would produce an exemption (unified credit) share equal to $1.5 million in 2004, $2 million in 2006, or $3.5 million in 2009.

b. The increased applicable exclusion amount may not require the revision of a will or revocable trust that creates separate marital and non-marital shares, if the two shares pass to similar trusts for the lifetime benefit of the surviving spouse.

c. The increases in the applicable exemption amount and the GST exemption may create a serious problem, however, if the marital and non-marital shares do not benefit the same persons, or benefit different beneficiaries in substantially different ways.

d. Consider a cap on the amount of the non-marital share to prevent the non-marital share from growing to the full size of the applicable exclusion amount.

   i. The amount of this cap will depend upon the goals of the client, the needs of the surviving spouse, and whether the surviving spouse is to receive any of the benefit of the non-marital trust.

   ii. The cap on the non-marital share can be drafted as a fractional share of the total residuary estate, or as a specific dollar amount.

e. An arbitrary cap on the non-marital share, of course, will increase the surviving spouse's taxable estate, by increasing the marital share.

   i. This increase could cause the surviving spouse's estate to be subject to estate taxes, if the combination of the surviving spouse's separate assets and the enlarged marital share exceed the surviving spouse's applicable exclusion amount.

   ii. This estate tax can be avoided if the excess of the first spouse's applicable exclusion amount over the arbitrary cap on the non-marital trust is held in a second non-marital trust, for the exclusive benefit of the surviving spouse.

f. You must consider the effect of the possible repeal of the estate tax on formula clauses that create a marital and a non-marital share. A formula that leaves to the non-marital share the largest amount that can pass without estate taxes will create a 100 percent non-marital disposition with no marital share, if the estate tax is repealed.

g. A formula clause that leaves the non-marital share an amount equal to the decedent's applicable exclusion amount could create a 100 percent marital disposition and no non-marital share, if the estate tax (including the applicable exclusion amount) is repealed.

h. The $3 million spousal property basis increase means that, even after repeal of the estate tax in 2010, estate planners will need to draft wills and revocable trusts creating a marital share sufficient to attract the full basis adjustment, in appropriate circumstances.

   i. Some clients will want to create a non-marital share with property that represents $1.3 million in appreciation, and then create a marital residue. Such planning will assure that the maximum amount of appreciation is sheltered by the two basis increases.

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ii. For clients with estates large enough that there is more than $4.3 million in appreciation in assets to which these basis increases can be allocated, estate planners may want to leave the remaining assets, after satisfying the marital and non-marital shares sufficiently to take advantage of both basis increases, to whomever the client chooses, without special tax considerations.

i. Take note that property left to a surviving spouse in a QTIP martial trust will qualify for the $3 million spousal property basis increase in the estate of the first spouse to die, but will not be treated as an asset of the surviving spouse at his or her later death. Thus, QTIP trusts will create new basis allocation planning challenges.

F. **Post Mortem Estate Planning.** Post mortem estate planning is likely to become even more important because of the Tax Act of 2001. The carryover basis rules that become applicable when the estate tax is repealed January 1, 2010, grant the executor broad discretion to allocate the decedent's $1.3 million aggregate basis increase and $3 million spousal property basis increase among assets.

a. The executor will need to pay careful attention to the precise assets to which these increases are allocated, unless the governing instrument dictates how these basis increases are to be allocated.

b. The executor has a fiduciary duty to treat all beneficiaries fairly and equally. The executor should, therefore, allocate the available basis increases fairly, so that each beneficiary receives a proportionate share of these increases.

c. There is a distinct advantage to allocating the aggregate basis increase to assets that will produce ordinary income when sold, such as property that would be held by the beneficiary for sale to customers in the ordinary course of business.

d. Allocating more basis increase to these assets would produce the greatest total tax savings, but the savings would inure to one beneficiary, rather than equally to all beneficiaries.

G. **Summary.** A well-known tax law professor referred to this estate tax repeal by congressional inaction as "congressional malpractice" in an article in the December 30, 2009 edition of the Wall Street Journal. Unfortunately, as with almost all congressional missteps, Congress will not pay, but individuals with estates large enough to be concerned with the estate tax will pay, one way or another, for this uncertainty in the tax law.

Woods Rogers Tax Group:

NEIL V. BIRKHOFF, Chair
540.983.7699
birkhoff@woodsrogers.com

BRIAN MICHAEL BROWN
804.343.5023
bbrown@woodsrogers.com

CLAUDE D. CARTER
540.983.7588
ccarter@woodsrogers.com

NICHOLAS C. CONTE
540.983.7630
conte@woodsrogers.com

R. NEAL KEESEE, JR.
540.983.7627
keesee@woodsrogers.com

TALFOURD H. KEMPER
540.983.7622
kemper@woodsrogers.com

TALFOURD H. KEMPER, JR.
540.983.7552
fkemper@woodsrogers.com

ALTON L. KNIGHTON, JR.
540.983.7632
knighton@woodsrogers.com

J. LEE E. OSBORNE
540.983.7516
losborne@woodsrogers.com

ALEXANDER I. SAUNDERS
540.983.7607
saunders@woodsrogers.com

CHRISTINE FRENTZ UNDERWOOD
540.983.7512
cunderwood@woodsrogers.com

JOSHUA C. WYKLE
540.983.7562
jwykle@woodsrogers.com