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ESTATE TAX REPEAL?

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In a move widely criticized by estate planning professionals, Congress adjourned for the 2009 year without taking any action on the scheduled repeal of estate taxes in 2010. Instead, Congressional leaders stated that they plan on passing legislation in 2010 to maintain the 2009 estate tax exclusion amount of \$3,500,000. This legislation would be made retroactive to January 1, 2010.

Many commentators have concluded that a retroactive imposition of a \$3,500,000 estate tax exclusion amount would be unconstitutional. These opinions are speculative and it is uncertain how the courts would rule on this issue. That means there is no way to know what the applicable estate tax exclusion amount will be for someone dying in 2010 before a retroactive estate tax bill is passed (assuming Congress ever passes such a bill). Furthermore, even if the repeal of estate taxes is deemed effective for certain decedents, their heirs may be subject to income taxes on certain assets for which no income tax liability would have existed had the estate tax repeal not come into effect (see *article on Page 2 regarding stepped-up income tax basis*). Despite the foregoing, most of these concerns are immaterial if a retroactive imposition of a \$3,500,000 estate tax exclusion amount is deemed constitutional. *Don't worry if this sounds extremely confusing, because it is!*

If Congress re-imposes a \$3,500,000 estate tax exclusion it would provide clarity with respect to the estate tax laws (at least for those persons dying after the enactment of such legislation). Unfortunately, this could be more of a wish than reality. Throughout 2009, Congress assured the estate planning industry that it would be enacting estate tax legislation prior to the end of 2009 to eliminate the uncertainty surrounding the scheduled repeal of estate taxes. Because Congress failed to deliver on their previous promise, it might not be wise to take their current promise as fact.

In the event Congress fails to resolve the estate tax conundrum during the 2010 tax year, the consequences will be severe. Under current law, the repeal of estate taxes in 2010 is followed by a re-imposition of an estate tax exclusion in the amount of \$1,000,000 in 2011. This would affect a greater number of estates than the \$3,500,000 exclusion amount that was in place in 2009.

It is hard to provide clear estate planning guidance to taxpayers in the midst of such confusion and uncertainty in the federal estate tax laws. Although each person's situation is unique and requires special planning, the following guidelines are provided in an attempt to provide general guidance (the following guidelines are for people with existing estate planning documents and are based upon current assumptions and expectations): (1) taxpayers with assets less than \$1,000,000 in assets should not have to worry about the imposition of estate taxes regardless of what Congress does; (2) if both spouses are healthy, taxpayers with assets between \$1,000,000 and \$3,500,000 might want to

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HIDDEN COST OF ESTATE TAX REFORM

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The "Estate Tax Repeal" article reports that the tax is not in effect for 2010 since Congress has been unable to pass an amendment to reverse the sunset provisions in a prior reform bill. What many taxpayers do not realize is that there is a trade-off for the lack of an Estate Tax in the form of a limited "step up in basis" for the property included in the decedent's taxable estate. The result is a higher capital gains tax upon the sale of appreciated property that is included in larger estates.

For years under the Estate Tax, upon the death of a taxpayer, all of the property that was included in the decedent's taxable estate was revalued for income tax purposes at the fair market value of the property on the date of death, or if the alternate valuation date was elected, upon the alternate valuation date. Tax basis is the measure against which gains are calculated. The amount of gain that is taxable upon a sale of property is the amount realized less the adjusted basis of the property. Adjusted basis is typically the cost of the property, plus the cost of improvements to the property, less depreciation or amortization. The amount realized is typically the sales price of the property.

For example, if a decedent purchased IBM stock in 1960 for \$500,000 and died on December 31, 2009 owning the same stock when it was worth \$2,000,000, under the old law, the stock would acquire a step up in basis to \$2,000,000. If the stock was then sold on February 1, 2010 for \$2,100,000, the devisees would only pay income tax on gain of \$100,000 (\$2,100,000 - \$2,000,000).

Under the 2010 rules, the step up in basis is limited depending on the circumstances. Under §1022, the estate's executor or representative is allowed to assign up to \$1,300,000 in basis increase (not to exceed fair market value) to specific estate assets of U.S. citizen and U.S.-resident decedents. Thus, if the same decedent died on January 1, 2010, and the basis increase is allocated to the IBM stock, the basis would be increased to only \$1,800,000. On the subsequent sale on February 1st, the devisees would pay income tax on gain of \$400,000.

In addition, §1022 permits the estate's executor or representative to assign up to an additional \$3,000,000 (not to exceed fair market value) of basis increase to certain property devised to the surviving spouse, regardless of whether the decedent is a U.S. citizen or resident. The additional \$3,000,000 step-up only applies to property left to a surviving spouse either outright or as "qualified terminable interest property" (QTIP). Therefore, property left to a surviving spouse in either a power of appointment trust (Family Trust) or in a survivor's trust (Marital Trust) will NOT qualify.

"Tax basis is the measure against which gains are calculated."

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wait and see what Congress does, if anything, before taking any action; and (3) it appears likely, no matter what Congress ends up doing, estates in excess of \$3.5 million will require planning to avoid estate taxes. Therefore, taxpayers with estates over \$3,500,000 should take advantage of the planning options that are currently available to reduce their taxable estates. Finally, wills and trusts that utilize formula clauses to fund marital and family trusts should be reviewed to make sure the repeal of estate taxes that is currently in effect does not result in an unintended distribution of assets into one trust at the exclusion of the other trust.

“Many strategies currently exist to reduce the potential estate tax burden on estates...”

It should also be noted that many strategies currently exist to reduce the potential estate tax burden on estates; however, some of these options may not last very long. A bill introduced during the 2009 Congressional session proposed to eliminate the use of discounts for gifts of closely-held family entities (eg., family limited partnerships and family LLCs). This was part of the bill to extend the \$3,500,000 estate tax exemption that was never acted upon by Congress during the 2009 Congressional session. Therefore, if Congress decides to retroactively reinstate the \$3,500,000 estate tax exemption in 2010, they could include the elimination of family discounts in the legislation as well.

Grantor Retained Annuity Trusts (“GRATs”) are another commonly used technique to reduce estate taxes. With a GRAT, a donor transfers assets to a trust in exchange for a stream of payments from the trust for a fixed term. Any balance remaining in the GRAT at the expiration of the payment stream to the donor passes to the donor’s heirs free of estate tax. The goal is to transfer highly appreciating assets to the GRAT that will appreciate at a faster rate than the discount rate used to calculate payments to the donor. For example, if assets contributed to a GRAT, appreciate by 12% per year but the interest rate used to calculate payments from the GRAT to the donor is only 3%, the donor is able to transfer 9% of the value of the assets out his estate per year. In order to maximize the amount of potential appreciation in the GRAT assets, many GRATs are created as short-term trusts (2 year terms) that are rolled over once the term is complete. This allows a donor to lock-in large upswings in short-term appreciation by eliminating the averaging of gains in asset values over a long period of time. Donors are also currently able to use zeroed-out GRATs (i.e., the donor does not incur any gift taxes when transferring assets to the GRAT). With zeroed-out GRATs, the donor does not use up any of his or her estate tax exemption. Therefore, even if no net appreciation occurs, the only risk to the donor is the payment of fees to set up and administer the GRAT. In March 2010, a bill was passed by the U.S. House of Representatives that would eliminate the use of zeroed-out GRATs and require that GRATs be set up for a minimum term of 10 years. This means that whenever a donor transfers assets to a GRAT, he or she will use up part of their estate tax exemption amount even if there is no net appreciation in the assets over the term of the GRAT. Furthermore, the use of 10 year GRATs reduces the ability to transfer high amounts of appreciation out of a donor’s estate because it averages the appreciation over a long period of time. If the Senate passes the House bill, it is likely that it will be signed by President Obama.

Given the foregoing, immediate action may be warranted for persons desiring to reduce potential estate taxes. Feel free to contact our offices if you have any questions about how these issues affect your estate plan or if you require assistance with your estate planning needs.

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FIRM NEWS

Bankruptcy Filings

Mallgren & Ferrell, P.C. is available to prepare Chapter 7 and Chapter 13 bankruptcy filings.

Personnel Changes

Mary Babcock, after working with Mallgren & Ferrell for 8-1/2 years, decided it was time to retire. We wish her the best.

Ann Marie Dinkel, a Colorado native, has joined our staff. She was born and raised in Pueblo where she obtained her Associates Degree at Pueblo Community College. She has 15+ years' experience in the legal field. Ann Marie has experience in the areas of mechanics liens, construction defect, entity formation, family law, criminal law, probate and personal injury. Her hobbies include competing in green chili and salsa cook-offs. We welcome Ann Marie to our firm.

Going Green

In doing our part to help the environment, we are offering our newsletter via e-mail. If you would prefer the newsletter delivered electronically, please send an e-mail to ehughes@mallgrenferrell.com and write "Subscribe" in the Subject line. We will still offer the newsletter via hard copy to those of you who prefer that method.