

Planning without an estate tax

What few estate planners believed possible has come to pass: the federal estate tax has been repealed for deaths in 2010. While the repeal of the estate tax will benefit some, it may cause other estate's beneficiaries to incur unexpected income taxes and, regardless of the possible tax consequences, some estate plans may no longer work as intended. We are providing the following information about the current state of federal, Oregon and Washington tax laws which may affect estate planning. We encourage those with any questions they may have about these issues to contact one of our estate planning attorneys.

2009 Federal Rules:

Under the laws in effect in 2009, every individual could transfer up to \$3.5 million of assets at death and up to \$1 million during lifetime without incurring federal estate tax. All transfers over those amounts were taxed at a rate of 45%. The recipient of a gift during life generally would have the same – or “carried over” – income tax basis in the given assets as the person making the gift. However, the basis of appreciated assets transferred at death would be “stepped up” to fair market value at the time of death, thereby eliminating the income tax on the appreciation of the assets which occurred during the decedent's lifetime.

The 2009 rules benefitted estates under \$3.5 million and their beneficiaries the most. The smaller estates avoided paying federal estate tax entirely and the beneficiaries avoided income tax liability because of the step up basis rule.

2010 Federal Rules:

The estate tax is repealed, but only for 2010. The gift tax remains in effect under the 2009 rules, except that the tax rate is lowered to a flat 35% from the 45% rate for 2009. The step up basis rule is also repealed for transfers made at death. Heirs will take as their basis the decedent's basis, but an estate may elect to increase the decedent's basis in its assets by up to \$1.3 million toward fair market value. In addition, an estate may elect to increase the basis by up to \$3 million for property passing to a surviving spouse. The basis provisions in effect this year require attention to complicated allocation rules.

Ironically, the elimination of the estate tax shifts the tax burden from wealthier estates to smaller estates. To understand the shift, imagine that two widows - one worth \$10 million, the other one worth \$2 million - die tomorrow holding identical blocks of stock worth \$110,000 with a cost basis of \$10,000. Because the widows' basis carries over to the beneficiaries, the beneficiaries will pay \$15,000 in capital gains tax on the appreciation which accrued during the widows' lifetime. Last year, the beneficiaries of the poorer widow's estate would have had the benefit of the step up basis rule and paid little to no capital gains as well as no federal estate tax while the beneficiaries of the wealthier widow would have incurred nearly \$50,000 in federal estate tax on the same asset.

2011 Federal Rules:

If Congress does not act, the federal estate tax will return in 2011, but in modified form. The estate tax exemption will be reduced to \$1 million while the maximum estate tax rate will be increased to 55%. The gift tax will have the same rules as in 2009, except that the maximum tax rate will be increased to 55% as well. Carry-over basis continues to apply to lifetime gifts, but the step up basis rule will return for transfers made at death. With the return of the estate tax, the unlimited marital and charitable deductions will again be important estate planning tools.

2011's return to a lower exemption amount will cause a significantly greater number of estates to be potentially subject to federal estate tax, creating a greater need to do tax planning.

Retroactive reinstatement?

Some members of the Democratic leadership in Congress have expressed a desire to reinstate the federal estate tax sometime this year and to make it retroactive (in order to eliminate a period of effective repeal). If the federal estate tax is retroactively reinstated, it will face legal challenges based on claims of unconstitutionality. However, even if permitted, it's uncertain whether the Democratic leadership in Congress will be able to convince its colleagues to reinstate the tax retroactively.

As we discussed above, the reinstatement would benefit moderate sized estates compared with 2010 and would benefit all estates beginning January 1, 2011.

Oregon and Washington Rules:

The federal rules do not change Oregon's inheritance tax rules. Oregon's exemption amount continues to be \$1 million (and is not scheduled to change). The decedent's assets transferred at death receive a step up basis. Oregon charges a graduated inheritance tax on estates which have a total net value of more than \$1 million. However, Oregon does not impose the tax on qualified transfers to a surviving spouse or gifts to qualified charities. There is no Oregon gift tax.

The federal rules do not change Washington's estate tax rules either. The Washington exemption amount continues to be \$2 million (and is not scheduled to change). The decedent's assets transferred at death receive a step-up in basis and all community property receives a step-up in basis at the death of the first spouse to die. Washington charges a graduated estate tax on estates which have a total net value of more than \$2 million. However, Washington does not impose the tax on qualified transfers to a surviving spouse or gifts to qualified charities. There is no Washington gift tax.

Despite this confusing and complicated federal tax system, Congress may or may not act to fix the law this year. If Congress does act, we plan to update this page with any changes. Until that time, however, we recommend that everyone consider reviewing their estate plan in order to ensure that it

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matches their expectations. We would be happy to meet with any person to review their plan to ensure that it continues to meet their goals and needs this year and beyond.

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