

ESTATE TAX LAPSE: Crisis, Chaos and Disarray

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Published by the Hanson Bridgett Trust & Estates Litigation Group

HANSONBRIDGETT.COM

Congress' failure to reinstate the federal estate tax which lapsed at the end of 2009 has created a series of thorny issues for estate planners as well as clients, beneficiaries, trustees, executors, and the courts. This article explains how we got to this point and explores some of the issues we expect to see as trust and estate litigators.

A State of Confusion

The U.S. Congress enacted the 2001 Tax Act which was thought to be an attempt at estate tax reform. It made estate and generation-skipping transfer (GST) taxes inapplicable for one year, namely, 2010, and further provided that all of its provisions would completely expire by 2011, reverting to the state of affairs prior to its enactment in 2001. While the 2001 Tax Act provided for an exclusion from estate taxes of \$3.5 million and a top estate tax bracket of 45%, the previous rules had an exclusion of only \$1 million and a top bracket of 55%.

These strange provisions made some sense at the time but only because it was expected that additional legislation would follow. Throughout the last 10 years, those following this issue had assumed that Congress would do something — anything — to extend the 2001 Act or enact further reforms. But that did not happen, leading to the current situation wherein there are no estate taxes in 2010, but in 2011 the same estate taxes that existed in 2000 will be in effect. In addition to a present lack of estate and GST taxes, the 2001 Tax Act leaves us in 2010 with an incongruity in calculating capital gains taxes. Instead of the basis of an asset increasing to fair market value as of the decedent's date of death (as has existed from 2001 through 2009), the basis this year will be the lesser of the decedent's basis or the fair market value of the asset.

Many believe that Congress will act shortly to rectify this situation. But in this election year, who knows what they may do, if anything? If Congress waits until after elections to act, we will be left with uncertainty for most of the year.

The Host of Horribles

What all this means is a huge amount of uncertainty for planners, their clients, the courts, and litigators. As but one example, it is very common for a revocable Trust or Will to dispose of assets by means of a tax-related formula provision which distributes the maximum amount which "can pass free of estate tax" or words to this effect to a certain beneficiary such as a child, while the balance of the estate would go to a surviving spouse. But under the current state as we find it in 2010, such a disposition would find the entire estate going to the child with the spouse taking nothing, something we can safely assume that neither the decedent nor her estate planning attorney anticipated or desired.

If a settlor purchased real property in 1980 which passed by his death in 2010 to his beneficiary, when the beneficiary sells the property, he must calculate the basis as of 1980 when the settlor acquired it rather than 2010 when he acquired it. If the settlor had died in 2009, the basis would be calculated from 2009 instead.

If Congress does act to address this situation, it is assumed that the "fix" would be retroactive to January 1, 2010. But that raises constitutional issues as to enforceability of a retroactive tax. Challenges (and there are sure to be legal challenges) to such an attempted fix would tie up the issue in the courts for years. Alternatively, if the "fix" is not retroactive, there will be enormous inequalities between the estates of those who die in tax-free 2010, as opposed to those who died in 2009 or die in 2011. This would seem yet another fertile ground for litigation based on constitutional grounds.

Meanwhile, a trustee or executor administering a trust or estate of someone who dies in 2010 is faced with even more uncertainty. Should he or she distribute the estate without taking taxes into account or assume there will be an attempted "fix" at some point and hold enough in reserve to pay those taxes? Will the beneficiaries cooperate with this approach or demand full distribution under the terms of the trust instrument or will? If there is full distribution under the current tax structure (or lack of it) but a retroactive tax is enacted and subsequently upheld by the courts, who bears the responsibility of paying those taxes from the distributed estate?

Similarly, a trustee or executor making investment or liquidation decisions would be at a loss to know which capital gains taxes might attach to the sale of estate property in 2010 or whether they should wait until 2011 to sell under different rules.

Should planners contact each of their clients and attempt to update their plans to accommodate this uncertain state of events? Would they face personal liability for failing to do so? Will clients want to incur the expense of updating their plans or take a risk that they will outlive Congress' current inaction on this important issue?

Estate planners and their clients need certainty in preparing estate plans and in administering trusts and probates. These scenarios only demonstrate some of the issues we can expect to see as the year progresses and we are plagued by a lack of stability in the transfer-tax laws.

Interim Solutions?

There are no easy answers for anyone dealing with any aspect of this. We have heard stories of planners drafting stand-alone amendments that can be revoked as needed based on further developments in Washington D.C.

Meanwhile, we are expecting to see executors and trustees take advantage of the forgiving nature of the Probate Code and a large increase in Notices of Proposed Action and Petitions for Instruction.

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