Estate Tax and Generation-Skipping Transfer Tax Law

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State of the Law

The failure of Congress to reform or extend the transfer tax law as it existed in 2009 has triggered a one-year repeal of the federal estate tax and the generation-skipping transfer tax. If Congressional inaction continues, the estate tax will return next January 1 with an exclusion of only $1 million rather than the 2009 exclusion of $3.5 million, and with a top estate tax bracket of 55% rather than the 2009 rate of 45%. The generation-skipping transfer tax will also return with a reduced exemption and increased rate.

The federal gift tax remains in effect for 2010 with a reduced top rate of 35%. The annual exclusion of $13,000 and the lifetime exclusion amount of $1 million remain.

In addition to the transfer tax changes, a dramatic income tax change has resulted from the repeal of the law that conferred a step up in basis for assets acquired from a decedent. Instead of the basis of an asset increasing to fair market value as of the decedent's date of death, the basis in the hands of a beneficiary will be the lesser of the decedent's basis or the fair market value of the asset, resulting in a capital gains tax on sale of the asset. The law does permit an aggregate increase in basis of $1.3 million for assets passing to a non-spouse and of $3 million for assets passing in a qualifying manner to a surviving spouse.

Congress may reinstate the estate tax, the generation-skipping transfer tax and the step up in basis for assets acquired from a decedent; and Congress may seek to have reinstatement retroactive to January 1, 2010. Retroactivity is likely to be challenged on constitutional grounds, and Congress may make any reinstatement prospective only. In the meantime, the existing gap in the transfer tax laws creates both potential problems under estate plans and potential opportunities for those who can tolerate risk. Primarily, however, great uncertainty and confusion have been created.

Problem Areas

It is very common for a revocable Trust or Will to dispose of assets by means of a tax-related formula provision based on the maximum amount that "can pass free of estate tax" or "free of generation-skipping transfer tax." With the repeal of those taxes, the amount covered by the formula may be the entire estate. Such a disposition would create a problem if the formula was intended to limit the amount going to particular beneficiaries to the tax-based formula amount. For example, some plans provide for a gift of the estate tax exclusion amount ($3.5 million under prior law) to go to children and the balance of the estate to go to the surviving spouse. Also, some plans provide for the generation-skipping transfer tax exemption amount (also $3.5 million under prior law) to go to grandchildren and the residue to children. The result now may be an unintended distribution of the entire estate to the children if the surviving spouse is not the beneficiary (or one of the beneficiaries) of the estate tax exclusion amount, and distribution of the entire residue to grandchildren if the children are not potential lifetime beneficiaries of the generation-skipping transfer tax exemption amount.

With respect to carryover basis, planning may be required if a person's assets include appreciation (not value, but appreciation) of more than $1.3 million to qualify for the additional $3 million basis increase for assets passing to a surviving spouse.

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