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**CLIENT AND FRIENDS UPDATE: 2010 SUSPENSION OF U.S. ESTATE AND
GENERATION SKIPPING TRANSFER TAXES – SOME OBSERVATIONS**

By Jonathan Davis

As is well known from the news media, the U.S. estate tax has been suspended for deaths occurring in calendar year 2010 – but it is also currently scheduled to again be effective for deaths occurring after calendar year 2010, this time with an “exemption” that is equivalent to \$1,000,000 of assets plus a small cost of living increase. Whether Congress and the President will amend the Internal Revenue Code to reinstitute the U.S. estate tax prospectively for the rest of 2010, or retroactively for all of 2010, or whether Congress and the President will not do anything - is anyone’s guess.

Meanwhile, the U.S. gift tax continues in effect for lifetime gifts (even if made in 2010), with the familiar \$1,000,000 exemption for aggregate taxable gifts over a person’s lifetime, with the familiar “annual exclusion” for small direct gifts of up to \$13,000 per recipient per year, and with the familiar exemption for direct gifts of tuition payments and direct gifts of health expenses.

Meanwhile, also, Massachusetts continues to impose its own estate tax regardless of what the U.S. Internal Revenue Code provides as to deaths in 2010. (Massachusetts does not impose a gift tax.)

For **estates of unmarried individuals** who die in 2010, the suspension of U.S. estate tax should not require much change to written estate plan documents. (NOTE - Same sex married couples are considered unmarried for purposes of the U.S. estate tax and its suspension, even though they are considered married for purposes of the Massachusetts estate tax).

For **married individuals**, most (although not all) estate plans use documents that, at the first spouse’s death, funnel an amount of assets equal to the U.S. estate tax “exemption” to a trust, and allocate the balance of the estate’s assets either directly to the surviving spouse or to another trust that is intended to benefit only the surviving spouse (during the surviving spouse’s life). Assets directed outright to the surviving spouse or directed into a trust for the surviving spouse generally qualify for what is called the “marital deduction”. Marital deduction assets do not attract a U.S. estate tax when the first spouse dies (although they may attract an estate tax later, at the surviving spouse’s death).

This common pattern is aimed at preventing the imposition of U.S. estate tax at the first spouse’s death, thereby leaving the surviving spouse’s “inheritance” undiminished by U.S. estate tax and delaying U.S. estate tax until the surviving spouse’s death.

For **estates of married individuals who die in 2010**, the suspension of U.S. estate tax may, under the typical pattern of estate planning documents, cause virtually all of the assets to be funneled into the “exemption” trust, and little or nothing funneled outright to the surviving spouse or to a “marital deduction” trust for the surviving spouse. This may not be a major problem if the “exemption” trust is written in the same pattern as if it were a “marital deduction” trust – namely, no current beneficiary other than the surviving spouse (until his/her death), all income must be paid to the surviving spouse, and generous provisions for distributions of principal to the surviving spouse while she/he remains alive.

However, if the “exemption” trust does not follow a “marital deduction” trust pattern, and if there are other potential beneficiaries of the “exemption” trust while the surviving spouse is alive – for example, if there are children or grandchildren who are also beneficiaries of the “exemption” trust at the same time as the surviving spouse – then there is a risk, triggered by the suspension of the U.S. estate tax, that the combination of all or most estate assets being funneled into the “exemption” trust + extensive distributions from the “exemption” trust to non-spouse beneficiaries may leave the surviving spouse short of funds.

Worse yet, if the surviving spouse is **not** a beneficiary **at all** of the “exemption” trust, the suspension of the U.S. estate tax may cause the funneling of all or most assets to the “exemption” trust where they cannot be used to benefit the surviving spouse. (It would not be surprising to find this pattern in the case of a remarriage where there are children from a previous marriage.)

Usually, there will be two exemption trusts for each couple. Married couples should check their estate planning documents to determine whether the pattern of both of their “exemption” trusts which is to remain in effect for the life of the surviving spouse provides (a) generous principal distributions to the surviving spouse, alone, and also requires payment of all income only to the surviving spouse, or, instead, (b) permits distributions to both the surviving spouse and also other persons while the surviving spouse lives, or, instead, (c) permits distributions only to persons who are not the surviving spouse.

Couples who answer (b) or (c) as to even one of their exemption trusts should make it a priority to immediately consult estate planning counsel.

Couples who answer (a) for both of their exemption trusts probably ought to touch base with estate planning counsel but the need may be less urgent. However, even for couples who answer “(a)” for both exemption trusts – if one of the couple is seriously ill, or if one of the couple is “old old”, then, the couple should also make it a priority to consult estate planning counsel.

Couples who are uncertain what category their exemption trusts fall into should make it a priority to immediately consult estate planning counsel.

There's More – Income Tax “Basis”

Along with eliminating the U.S. estate tax for deaths in 2010, the current law also makes income tax changes. Before 2010, if a person died directly or indirectly owning an asset, then, usually, the estate, heirs or other successors would take the asset with a new basis, and the new basis would be the same as the asset's value at death. Often this basis change at death could eliminate or minimize subsequent income tax if the estate, heir or other successor promptly sold the asset – the sale price being equal or close to the new “date of death” basis. Now, however, for deaths occurring in 2010, assets belonging to the deceased person generally (with some exceptions) either retain the decedent's basis in the asset, or, if the asset's date of death value is less than the decedent's basis the asset takes a “basis step-down” to the lower date of death value.

However, there are some exceptions to the new basis rule. For deaths in 2010 a deceased person's executor or administrator may add up to an additional \$1,300,000 to the “carryover basis” of assets (although no asset may have its basis increased beyond the asset's value at death). Generally, such assets are similar to the kinds of assets that would have been entitled to a basis change at death - for example, assets held in living trusts; assets that the decedent had transferred into a trust that the decedent had retained the right to change; and certain jointly owned assets. There appears to be a major exception, however, for assets the decedent transferred into a trust where the decedent only retained the right to receive the trust's income (for example, certain kinds of personal residence trusts). There also appears to be a major exception for assets that the decedent does not own but as to which the decedent held a so-called “general power of appointment” (i.e., the right to cause the asset to be transferred to him/herself, to his/her estate, to his/her creditors, or to the creditors of his/her estate). (NOTE – The \$1,300,000 maximum basis increase only applies in the case of decedents who are either U.S. citizens or U.S. residents; for assets of deceased non-resident aliens the maximum basis increase is limited to \$60,000.)

There is another major exception to the new basis rule. In addition to the \$1,300,000 maximum basis increase, in the case of assets passing to the decedent's surviving spouse there can be an additional basis increase of up to an additional \$3,000,000 (although no asset may have its basis increased beyond the asset's value at death). Generally, assets that would have qualified for the pre-2010 “marital deduction” will also be entitled to this additional \$3,000,000 maximum basis increase: that includes assets passing directly to the surviving spouse, and, also, assets passing to or held in a trust for the surviving spouse that pays all income to the surviving spouse and no person who is other than the surviving spouse may receive trust principal while the surviving spouse is living. (NOTE - Same sex married couples are considered unmarried for purposes of the U.S. estate tax and its suspension, even though they are considered married for purposes of the Massachusetts estate tax).

If Congress and the President do not revoke the estate tax suspension, the new basis rules portend considerable work for the executors and administrators of persons who die in

2010, since executors and administrators will have to decide the best allocation of basis increase among eligible assets.

As to Massachusetts income tax, in the case of deaths occurring in 2010, it appears that the basis of assets taken by the deceased person's estate, heirs or successors will follow the new U.S. basis rules; and, usually, there will not be a difference between Massachusetts and U.S. income tax bases. (However, in the case of same sex married couples, it is not clear whether, for deaths occurring in 2010, the Mass. Dept. of Revenue will act to place surviving same sex spouses in the same position for Massachusetts income tax basis purposes as if the marriage had been an opposite sex marriage.)

Still More – “Disclaimers”

The unintended and unanticipated “funneling” of assets caused by the suspension of the U.S. estate tax, and the new income tax basis rules, may put a premium on post-death tax planning by means of disclaimers. (“Disclaimers” are a technique for recipients of assets, or for certain trust beneficiaries, to refuse to accept assets or trust interests.) In certain cases, disclaimers may be used to produce a better outcome than the estate planning documents provide.

Unfortunately, it becomes difficult to use disclaimers if the intended recipient of assets or an intended trust beneficiary receives a benefit from the asset or trust before trying to disclaim. Also unfortunately, there is a short time limit in which to make disclaimers.

Because the disclaimer tool is likely to be useful for deaths in 2010 (unless the U.S. estate tax suspension and carryover income tax basis are repealed), **survivors of a deceased person should make it a priority to contact probate or tax counsel very soon after the death has occurred, to try to preserve the availability of disclaimers.**

This Update is intended only to provide generalized information. It is not intended to provide information or advice with respect to specific situations. To address real life, specific situations you should obtain appropriate professional assistance.

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