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2010 ESTATE & GENERATION SKIPPING TRANSFER TAX REPEAL

RAYMOND JAMES®

This white paper addresses financial planning challenges in view of the 2010 estate and carry-over basis planning uncertainty. It identifies opportunities and challenges, discusses issues, and offers solutions that best suit your needs.

This paper was prepared by Raymond James Wealth Solutions, Financial Planning Group, Raymond James Insurance Group, and Raymond James Trust N.A.

The principal author was Susan L. Hartman of the Financial Planning Group.

In addition, the following individuals contributed to this paper:

- Chip Bauder, Wealth Solutions
- Patrick Daxon, Financial Planning
- David Ness, RJ Trust N.A.
- James Swink, RJ Insurance Group

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Introduction

The unthinkable has happened. Now what? Since the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), virtually every serious estate planning practitioner and academic, as well as any number of Representatives and Senators, predicted Congress would never allow the federal estate and generation skipping transfer tax to vanish for a year in 2010 only to be restored in 2011 as if nothing had happened in the intervening decade. Congress did allow those laws to vanish, with the coincident introduction of "modified carry over basis." Estate and financial planning practitioners must now deal with the aftermath.

As this is written, just before the State of the Union address, estate planning is in an extraordinary state of flux and uncertainty. Estate planners have never been able to confidently predict the state of the law in the future. Estate planners have always had confidence in their understanding of the state of the law today. Estate planners have never had to seriously worry about the state of the law yesterday. Yet today we have to recognize Congress is discussing a retroactive change in the law dating back to January 1, 2010.

What will Congress do and when will Congress act? Nobody knows. Logically, Congress appears to have the following choices:

1) Do nothing and allow the law passed under EGTRRA to play out,
2) Retroactively restore the law to 2009 rules,
3) Retroactively impose a new or different set of estate and GSTT rates and exemptions,
4) Prospectively restore the 2009 rules,
5) Prospectively impose a new or different set of estate and GSTT rates and exemptions, or
6) Some combination of 2 through 5 with a taxpayer election.

In addition, for the last five options, Congress could impose those rules only for 2010 or the rules could be extended into 2011 and beyond.

When will all this happen? Again, nobody knows. There is considerable speculation, and perhaps wishful thinking, that Congress may act quickly, perhaps by the end of February or March, and end this estate planning nightmare. There are counterbalancing forces suggesting it may act later rather than sooner. These forces include an ambitious legislative agenda addressing healthcare, financial industry reform, budget issues, two wars, and other EGTRRA-created and expiring income tax rules. In addition, 2010 is an election year with a third of the Senate and the entire House up for re-election.

What should we advise clients to do? Addressing that question is among the purposes of this white paper. In addition to educating practitioners on the quagmire, this white paper will address planning opportunities. However, the extraordinarily complex and fluid nature of these new rules requires flexibility, careful legal and tax advice delivered by experienced lawyers and CPAs, caution, and willingness to take a certain level of tax risk.

Repeal!

Until January 1, 2010, almost everyone expected Congress to either (1) patch or (2) create permanent estate tax and generation skipping transfer (GST) tax legislation, and avoid the elimination of the "step-up" in basis. Many expected a simple patch to extend 2009 law into 2010. In 2009's cliffhanger of an ending, Congress instead offered no resolution at all, leaving taxpayers in a precarious situation – how to design a financial plan that best suits their needs in what is perhaps one of the most uncertain, confused and confounding planning environments in history.

A Brief Background

Until the early 19th century, the wealth transfer tax was not a primary revenue generator for the government. Since that time, Congress has passed a series of legislation that alternately increases, decreases, eliminates and reinstates the various transfer taxes.

Year	Legislation
1797–1802	To cover expenses, a Federal Stamp Tax is imposed on certain estates. It remains in place until 1802.
1815	Congress debates an estate tax to finance the War of 1812.
1864–1870	Estate tax is introduced due to budgetary pressures from the Civil War.
1898–1902	After several attempts by Congress, an estate tax is introduced on estates greater or equal to $10,000.
1916	Estate tax is levied on estates over $50,000.
1924	Estate tax is increased to 40%. Gift tax is added.
1926	Gift tax is repealed.
1932	Gift tax is reinstated.
1934	Estate tax increases to 60% for estates over $10 million.
1948–1953	Various bills increase and decrease estate and gift taxes. Estate taxes rise as high as 77% and gift taxes rise as high as 57.75%.
1954	Most employer qualified plans are exempted from estate taxes. By 1982, this exclusion is reduced to only $100,000. It is repealed in 1988 and a 15% excise tax is imposed that remains in place until 1997.
1976	Major legislation combines estate and gift taxes into a unified rate.
1986	Generation skipping taxes at a flat 55% rate are imposed. Remain in place to this day.
2001	Congress votes to gradually decrease estate taxes.
2010	Estate and generation skipping transfer taxes are scheduled for repeal.
2011	Under current law all estate, gift and generation skipping transfer taxes are scheduled to be reinstated at their 2001 rates.

Source: AXA/Equitable Flyer titled *"Stop Ignoring Me. Estate Taxes Aren't Going Away." Catalog #137445 (9/09), http://tools.aimcoins.com/doclib/files/AIMCO/39765/AXA%20-%20Estate%20Tax%20Repeal%5B1%5D.pdf*

With economists of the time forecasting massive budget surpluses for the coming decade, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). EGTRRA phased in reductions to the estate and gift taxes, eventually eliminating both the estate tax and the GST effective January 1, 2010. EGTRRA also included a sunset provision.

Under the sunset provision, the law returns to where it would have been had EGTRRA not been enacted. On January 1, 2011, the law reverts to a graduated estate tax with a 55% top rate and a $1-million estate tax exemption amount, and a flat 55% GST tax with a $1-million GST tax exclusion amount.

Federal Transfer Tax Rates and Effective Exemptions, by Year of Transfer

Year	Estate Tax: Exemption (Millions of dollars)	Estate Tax: Rate (Percent) Bottom	Estate Tax: Rate (Percent) Top	Gift Tax: Exemption (Millions of dollars)	Gift Tax: Top Rate (Percent)	Federal Treatment of States' Wealth Transfer Taxes (Percent): Credit	Federal Treatment of States' Wealth Transfer Taxes (Percent): Deduction
2001	0.675	37	55 [a]	0.675	55 [a]	100	0
2002	1.0	41	50	1.0	50	75	25
2003	1.0	41	49	1.0	49	50	50
2004	1.5	43	48	1.0	48	25	75
2005	2.0	43	47	1.0	47	0	100
2006	2.0	45	46	1.0	46	0	100
2007	2.0	45	45	1.0	45	0	100
2008	2.0	45	45	1.0	45	0	100
2009	3.5	45	45	1.0	45	0	100
2010	Unlimited	Repealed	Repealed	1.0	35	0	100
2011 and Beyond	1.0	41	55 [a]	1.0	55 [a]	100	0

Source: Congressional Budget Office.

a. In 2001 and in years after 2010, a 5 percent surtax is imposed on wealth transfers between $10.0 million and $17.184 million. The surtax is designed to recapture the benefits of the graduated rate structure of the estate tax and results in an effective marginal tax rate of 60 percent on wealth transfers in that range.

Source: Congressional Budget Office in *Economic and Budget Issue Brief* (December 18, 2009), Table 1, http://www.cbo.gov/ftpdocs/108xx/doc10841/12-18-Estate_GiftTax_Brief.pdf

2009 and Step Up

Under the law as it stood in 2009:

- Estate tax: estates over the applicable exclusion amount of $3.5 million, or $7 million for couples, were taxed at a flat 45% rate.
- GST: decedents had a $3.5-million GST exclusion and a flat 45% GST rate.
- Gift tax: individuals were allowed to make an unlimited number of $13,000 (2009 and 2010) tax-free annual exclusion gifts and up to $1 million of the applicable exclusion amount could be applied to lifetime gifts. Excess gifts were taxable up to the 45% top rate.
- Basis: capital assets included in the estate received a step up/down in basis.

2010 and Carryover Basis

The 2010 law as of January 1, 2010:

- Estate tax: repealed.
- GST: repealed.
- Gift tax: individuals may make an unlimited number of $13,000 tax-free annual exclusion gifts and up to $1 million of the applicable exclusion amount can be applied to lifetime gifts. Excess gifts are taxable with a 35% top rate.
- Basis: the deceased's basis in assets carries over (in a modified fashion as discussed below) in the hands of the heirs.

2011 and Step Up

In 2011 the law reverts to the 2001 rules:

- Estate tax: estates over the applicable exclusion amount of $1 million, or $2 million for couples, will be taxed at graduated rates up to a top rate of 55%.*
- GST: decedents will have a $1-million GST exclusion amount and a flat 55%* GST rate.
- Gift tax: individuals may make an unlimited number of $13,000 tax-free annual exclusion gifts and up to $1 million of the applicable exclusion amount can be applied to lifetime gifts. Excess gifts will be taxable.

- Basis: capital assets included in the estate will receive a step up/down in basis.

* 60% for some estates in excess of $10 million but less than $17.184 million due to certain surcharges.

2010 Considerations

The 2010 implementation of carryover basis and estate tax repeal certainly created one of the most difficult planning environments in many years. Depending on the language in estate planning documents and the composition of the estate, an entire financial plan could be jeopardized.

There is a possibility that the law we began the year with will not be the law at the end of the year. Now the task is more complicated than simply planning for a year without an estate tax. How do you plan without knowing if the law will change? What if the change is retroactive to the first of the year? What if the change is prospective? What if the change allows for a choice of laws from January 1 through the date the law is enacted? Choose between (1) paying no estate tax and using carryover basis or (2) paying an estate tax and getting the old, familiar "step-up?" What if Congress simply enacts a national inheritance tax?

Prudence, in view of the uncertainty of change, suggests that all planners should be at least aware of the modified Carryover Basis rules and other estate planning considerations. This section reviews the basics and provides examples and strategies for:

- Traditional Estate Planning and
- Carryover Basis Planning.

Traditional Estate Planning

The repeal of the estate tax leaves us with real uncertainty as to the effectiveness of existing estate planning documents. Consider that there are two estate planning systems – one for informed/engaged individuals and the other for uninformed/inactive individuals. To plan effectively, tax payers must become informed and act!

Popular Strategies – The United States imposes three types of taxes on wealth transfers:

1. Estate Tax,
2. Gift Tax and
3. Generation Skipping Transfer (GST) Tax.

The estate tax is assessed on the net value of assets transferred when a person dies. The gift tax is assessed on the net value of assets one person transfers to another. The GST tax is assessed on the net value of some transfers of wealth to grandchildren and certain other individuals during life or at death. Other than a decrease in the top gift tax rate from 45% to 35%, the gift tax rules remain in place for 2010. The 2010 vanishing – and perhaps reappearing – estate and GST taxes are more significant.

Prior to 2010, there were several strategies for reducing wealth transfer taxes. In our experience, only one or two strategies were commonly used in keeping with the general rule: In planning to meet the overriding goals, keep it as simple as possible. The fewer moving pieces, the lower the risk of failure. More complicated goals and larger estates, however, often incorporated a combination of strategies.

Many of these strategies involved some form of an irrevocable gift, transfer in trust or charitable giving including the very common:

- Lifetime Giving,
- Irrevocable Life Insurance Trust ("ILIT") and
- Charitable Trust.

Lifetime Giving

Outright gifts during life to friends and family are an important planning tool. To protect the integrity of the income tax system, the gift tax remains almost entirely intact for 2010.

One important benefit of lifetime giving is that it leverages the difference between the 2010 35% gift tax rate and a 45% (if reinstated) or higher estate tax rate.

Example: Assume the estate tax is reinstated at 45% for 2010. Mike has a taxable estate and $100,000 earmarked for his brother, Joe. But, Mike does not want to be out-of-pocket for the tax on the transfer. He has two options:

1. Die and leave Joe $100,000. Mike's estate pays an estate tax of $45,000, or 45%. Joe receives a net $55,000. In summary, $100,000 – $45,000 = $55,000 for Joe at some future date; or
2. Make a taxable gift to Joe in 2010. Mike gives Joe $74,100 and pays a gift tax of $25,900, or 35%. The result here is that $100,000 – $25,900 = $74,100 for Joe today.

There are still four types of outright gifts:

1. *Annual exclusion gifts.* Every taxpayer may currently give up to $13,000 (2009 and 2010) to as many individuals as desired without any tax consequence. Annual exclusion gifts are frequently used to fund UGMA/UTMAs, 529 accounts and irrevocable life insurance trusts (ILITs").
2. *Medical/tuition gifts.* Every taxpayer may give an unlimited amount to any individual for medical and tuition expenses. One caveat here is that the check must be payable to the service provider, like the orthodontist or the educational institution (e.g., "State College of Engineering").
3. *Lifetime exclusion gifts.* Every taxpayer may give up to an aggregate total of $1 million (2009 and 2010) to any individual(s) during their lifetimes without any out-of-pocket tax consequences. Lifetime exclusion gifts may be made in cash or other assets or may be used to fund a trust such as a qualified personal residence trust ("QPRT").
4. *Taxable gifts.* Gifts that cannot be claimed as one of the above are taxed at a flat rate of 35% in 2010 (45% in 2009; will be 55% in 2011).

Planning Tip: If a taxable gift is to be made in 2010, make it early so there is a better chance that it will be taxed at the flat 35%, rather than a reinstated 45%, or even 2011's 55% rate.

Planning Tip: Congress is also considering dramatic changes limiting the valuation rules in certain situations. Any new legislation could include those changes. Gifts for which a valuation is advisable, say shares of a family limited partnership ("FLP"), should be made sooner rather than later to potentially avoid being snared by new valuation rules.

Irrevocable Life Insurance Trust ("ILIT")

Traditionally, cash gifts are used to fund irrevocable trusts designed to hold life insurance ("ILIT"). So that the gift to the ILIT will qualify as an annual exclusion gift, the ILIT allows the trust creator the discretion to grant each beneficiary a Crummey power: the right to withdraw the gift from the trust.

The 2010 law is unclear as to whether these Crummey gifts still qualify for the annual exclusion. This may not have been an intended result. Until clarifying guidance is issued, however, trust creators should consult with their estate planning advisors before granting any ILIT beneficiary a Crummey power or withdrawal right.

Planning Tip: Grant a Crummey power and incur the risk the beneficiary will withdraw the gift from the ILIT. Verify that the annual exclusion is still available for the gift before granting the Crummey power and bearing that risk of withdrawal.

Generation Skipping Transfers ("GSTs")

Pre-2010, taxable gifts to individuals more than one generation apart, such as grandchildren, were also subject to the generation skipping transfer tax. As with the estate tax, the GST tax is also repealed for

2010 and is similarly subject to reinstatement. Still, consider gifts that skip a generation or two, especially where confidence is high that the GST tax will not be reinstated.

Non-Generation Skipping Transfer ("Non-GSTs") Trusts

Assets in a non-GST trust are exposed to the GST tax in the year in which the assets are distributed from the trust. There is a real risk that the GST tax will be reinstated retroactively. One proposed technique for avoiding any reinstatement of the GST tax is to run the non-GST trust distribution through a second trust, which then distributes outright to the skip person. This technique requires careful drafting and implementation. An estate planning advisor's assistance will be required to successfully avoid any reinstated GST tax.

> **Example:** Years ago, Jimmy funded a non-GST trust for his grandchildren. Today, the grandchildren are responsible adults and, to avoid the GST tax on the distributions, Jimmy would like to distribute the non-GST trust assets in 2010.
>
> Jimmy's estate planning advisor creates a "second trust" for the benefit of Jimmy's grandchildren. The assets from the old non-GST trust are distributed into "second trust" and subsequently distributed to the grandchildren.

Formulas: Marital, Family, GST, Charitable, State QTIP, Etc.

Prior to 2010, a popular wealth transfer technique was to use estate planning documents (wills, trusts, etc.) with one or more formulas to direct assets to a bypass (also referred to as a credit shelter or family trust), generation skipping transfer (GST) or other trust, and/or a charity in order to minimize estate tax exposure. The idea was to take maximum advantage of estate tax breaks including applicable exclusion amount, GST tax exemption amount and the charitable deduction for estates.

With the repeal of the estate tax, how much will pass to the bypass trust? The generation skipping trust? The charity? Will there even be anything left to fund the marital share? And, after all that, will the bypass trust even qualify for the special adjustment (the $1.3-million basis increase as discussed in detail below)?

> **Example:** Tom's estate planning documents contain language that any asset which does not qualify for the marital deduction falls into a family trust. In 2010, there is no estate tax and, therefore, no marital deduction. So no asset could qualify for the marital deduction. Does everything then flow into the family trust, leaving the marital share unfunded?

All documents containing formulas should be closely reviewed. It is important to understand the planning goals and special considerations. Is the goal to provide minimum or maximum funding to one particular share? Will the existing formula be interpreted to achieve that goal?

There is concern that any state probate or other court interpretation may not be respected by the IRS or stand up in tax court. In addition, no guidance has been issued as to how to interpret word formulas that refer specifically to the applicable exclusion amount, or federal estate and GST taxes.

> **Example:** Ben passes away in 2010 leaving behind a second wife, Lisa, and children from his first marriage. His net estate is in excess of $20 million and his estate planning documents were drawn up at a time when the applicable exclusion amount was $3.5 million. The formula in Ben's will provides that the family trust be funded with the largest amount possible without incurring any estate tax. The family trust provides only for Ben's children with his first wife, Jane. Did Ben really intend to impoverish his second wife?

In determining Ben's intent, the court must consider all the evidence available, including evidence outside the four corners of the document, such as other documents or writings.

Planning Tip: Until existing estate planning documents can be reviewed and updated, take a few minutes to "evidence" client intent in writing. This writing and other evidence of intentions will be considered by the probate court in applying formulas and other provisions in any estate planning documents.

Review Formula Clauses

Documents that do not address the possibility of no federal estate tax and carryover basis should probably be restated or amended. Those whose estate plans utilize "formula clauses" should have those formulas reviewed. States continue to address amending their probate codes to provide interpretative guidance for inoperative formula clauses. Nonetheless, the ideal situation is for documents to lay out exactly what is to happen in a year with no estate tax and carryover basis.

Flexibility Gets Complicated

Regardless of where the estate and GST taxes eventually settle, planning should be designed with a significant amount of flexibility. Increasing flexibility, however, leads directly to more challenging drafting and perhaps an increased risk that the plan will fail.

Consider that, pre-2010, one popular strategy for maximizing estate planning efficiencies was to name the surviving spouse as primary beneficiary on retirement accounts and insurance policies. In post-death planning, if it maximized estate and income tax efficiencies for the family unit as a whole, the estate planning advisor would have the survivor disclaim the asset, letting it fall to the contingent beneficiary, generally the children. This strategy relied in large part on the ability of the spouse to actually make that disclaimer. The risk is the survivor would not or could not disclaim because the survivor had already exercised too much control over the assets.

Nonetheless, examples of desirable flexibilities include the flexibility to:

- "Unwind" irrevocable gifts in the event of repeal for all of 2010,
- At least partially unwind irrevocable gifts in the event of partial or full reinstatement of the estate and GST taxes, and
- Allow a trustee, or the trust protector, to make unequal distributions and discretionary distributions using a non-ascertainable standard.

Formal Document Review Highly Recommended

As of January 1, 2010, virtually every estate planning document – will or trust – written for clients in the middle class or above in the last 20 years or more refers to a tax system that no longer exists. The law today, and perhaps tomorrow, is so different from prior law, that every estate planning document should be reviewed by an estate planning advisor:

- Even if life expectancy is anticipated to reach well beyond 2010, "the number 13 bus" could be around the next corner.
- Even if the individual who created the estate planning document – will or trust – dies in 2010, it is possible to obtain a court order construing the estate planning documents including a last will, pre- and post-nuptial agreements, trust documents, and even beneficiary designation forms for insurance and retirement plan accounts.

Carryover Basis

Prior to 2010, the imbedded gain in inherited assets was potentially subject to double taxation: estate tax and, upon sale, capital gains tax. To avoid this heavy taxation, the law allowed for an adjustment in basis – a step up/down – to the fair market value ("FMV") at which the capital asset was taxed in the deceased's estate.

Repealing the estate tax eliminated the potential for double-taxation. So, for 2010, the step up has been replaced with a modified carryover basis (MCB). When current law reinstates the estate tax in 2011, the step up/down in basis also returns. Until then, plan for MCB.

MCB Defined

The general rule is that the heirs' basis in the property will remain the same as the deceased's basis in the property, unless the FMV at death was less than the deceased's basis. Then, the heirs' basis would be lowered to the FMV at date of death.

> **Example:** Steve's estate consists of an equity portfolio with a FMV of $750,000. His basis in the portfolio is $1 million. The adjusted basis in the hands of his son and heir, John, is the lesser of Steve's basis and the FMV on the date of death, or $750,000.
>
> Because the asset was depressed, Steve should have considered not owning the portfolio at death. One possible strategy would be to gift the asset during life. While a taxable gift would have to be evaluated further, simply using his annual exclusion and $1-million lifetime gift allowances may have preserved his higher basis for John. Later, when the capital asset has appreciated and been sold, John will pay a lower capital gains tax. Another strategy for capital loss carryovers is discussed later in the section titled "Losses Increase Special Adjustment above $1.3 Million."

There are two modifications to this rule. First, each estate is entitled to a basis increase of up to $1.3 million. Second, capital assets passing to a surviving spouse may be entitled to an additional $3-million basis increase. Estates able to fully utilize both modifications will realize a maximum $4.3-million increase in basis (1.3 + 3). A married couple could realize a combined maximum $5.6-million increase in basis (1.3 + 3 + 1.3).

Special Adjustment – $1.3 Million

The first modification provides all estates with a limited basis increase. The basis of appreciated assets may be increased to their FMV as of the deceased's date of death. Total increases may not exceed $1.3 million.

Losses Increase Special Adjustment Amount above $1.3 Million

The $1.3-million special adjustment is increased by some:

- Capital Loss Carryovers,
- Net Operating Loss (NOL) Carryovers,
- Theft Losses and
- Worthless Securities.

Additionally, these losses need not be allocated to the asset which generated the loss.

> **Example:** Warren is a shareholder in ABC Company, a closely held C corporation. The value of his shares in 2010 is $2.5 million. His basis is $100,000. Warren's unused NOL carryovers are $50,000. If Warren passes away in 2010, his special adjustment would total $1.35 million (1.3 + .05).
>
> **Example:** James owed two assets at his death in 2010: 14,285 shares of XYZ Company and his home, Wheatland. His basis in the stock was $1 million and its FMV at his death $0. His basis in Wheatland was $500,000 and its FMV at his death $3 million. As James never married, he left his

entire estate to his niece, Harriet. The total special adjustment basis increase available to Harriet is $2.3 million (base $1.3 special adjustment increase by $1-million loss in worthless securities). The entire basis increase may be allocated to Wheatland, giving Harriet a basis of $2.8 million.

Special Adjustment Basis Increases Not Automatic

The special adjustment ($1.3 million) basis increase is not automatic. The deceased's executor must make an affirmative election to take advantage of the increase, allocate the increase among the deceased's eligible assets and report accordingly to the IRS. Executors are encouraged to obtain well-documented valuations for difficult-to-value items such as ownership interests in small family businesses and collectibles. Because it may be many years before the basis increase of any particular item is challenged by the IRS, it is wise to retain copies of valuations and other appraisal information, and the IRS filings reporting the allocation of the basis increase.

Example: John dies in 2010 leaving his only asset, Peacefields (his farm), to his son, John Jr. John's basis in Peacefields was $8 million. At the time of John's death, Peacefields' FMV was $9 million. John's executor allocates $1 million of the $1.3 special adjustment to Peacefields. John Jr.'s basis in Peacefields is $9 million.

Assume John Jr. later sells Peacefield. Because the executor elected to make use of the special adjustment, John Jr. will not have to pay capital gains tax on the pre-death appreciation.

Spousal Adjustment – $3 Million

The second modification allows for an additional basis increase of up to $3 million on property passing to a surviving spouse. As with the special basis adjustment, basis of appreciated assets may be increased to their FMV as of the deceased's date of death and the total increases may not exceed $3 million.

Increase Restricted to Outright and Certain Trust Transfers

Eligible assets are restricted to assets passing to the surviving spouse outright or in certain trusts. An outright transfer is generally a transfer that is free and clear of trust or any other "strings." At the death of the surviving spouse, assets transferred outright to the spouse are eligible for another basis increase: special or spousal adjustment, as applicable. Capital assets held in certain types of trusts are not eligible for another basis adjustment.

The spousal adjustment is automatic; the executor is not required to make an affirmative election to use it.

Carryover Basis in a Nutshell

Carryover basis is simply the *lesser* of the:

- Deceased's adjusted basis or
- FMV on date of death.

Modifications

Additionally, a limited increase in basis is available on certain transfers. An increase, or step up, of up to:

- $1.3 million ("special adjustment") is available to every estate.
  A reduced adjustment applies to non-resident, non-citizen heirs.
- <u>Plus</u> an additional $3 million ("spousal adjustment") is available on outright transfers to a surviving spouse.
  Restricted to transfers outright (free of trust) and certain trust transfers.

Assets Not Eligible for the Basis Increase

There are restrictions as to which assets may receive a basis increase.

No increase is permitted for:

- Interests in certain foreign corporations and
- Property the deceased received as a gift within three years of death.
  Transfers between spouses are exempt unless the giving spouse received the assets as a gift within three years prior to the deceased's death.

Income in respect of a decedent ("IRD") is not eligible for basis increase. IRD includes:

- Individual Retirement Accounts ("IRAs"),
- Employer-Sponsored Qualified Retirement Plans ("QRPs") and
- Net Unrealized Appreciation ("NUA") in Qualified Employer Securities.

Powers of Appointment ("POAs")

Including a power of appointment ("POA") in any estate plan gives the beneficiary or other power holder the right to make changes to the estate plan. POAs come in several different types and are of varying degrees of utility. They are, though, a convenient planning tool in that they allow for changes to be made any time: during life, during incapacity and post-death. And, a POA may be general – very broad in scope – or limited.

As of January 1, 2010, the consequences of holding or exercising a POA changed. Pre-2010, assets in a marital trust subject to a general power of appointment may have been included in the surviving spouse's estate at death, thus making them eligible for a second step-up. In 2010, the deceased is not treated as owning any property simply because he or she has a general POA over that property. So, marital trust assets subject to a general POA are not included in the estate of the survivor and, therefore, are not eligible for a second basis increase.

Coordinate/Use Both Modifications: Special and Spousal

In prior years, it was important to do advance planning for estates of a certain size, say an FMV in excess of $3.5 million for 2009. Now, the emphasis is on the need to plan for estates with appreciation in excess of certain thresholds: $1.3 and $3 million (both indexed for inflation).

Estates with Less than $1.3 Million in Appreciation

Couples with less-appreciated estates may choose to ignore the $1.3-million special adjustment at the first death and simply apply the spousal adjustment. In this case, they would make certain the estate of the first to die holds up to $3 million in appreciation – not FMV – and have the deceased's assets pass to the surviving spouse outright or in a special trust for his or her benefit. This takes full advantage of the $3-million spousal adjustment at the first death. The $1.3-million special adjustment is available to the surviving spouse's estate.

Example: Adam and Florence's combined estate has a $10-million FMV. Their basis is $5.7 million. Adam is on his deathbed and they would like to take full advantage of the $3-million spousal adjustment and the $1.3-million special adjustment. They transfer all the assets into Adam's name. He leaves his entire estate outright to Florence. The adjusted basis in the inherited assets is $10 million.

Although they have achieved their goal and made full use of the spousal adjustment, there were no assets left to transfer to any heir other than the surviving spouse.

At Florence's death, any appreciated inherited assets would be eligible for a special or spousal adjustment, as applicable.

Of course, family considerations may warrant funding a family, or by-pass, trust at the first death – with up to $1.3 million in appreciation – and passing the remaining assets to the surviving spouse outright. The family trust may be funded by formula or the surviving spouse's disclaimer.

Example: Teddy loves his wife, Olivia, and knows that after his death she will have sufficient assets to maintain her standard of living. Teddy also loves his child by his first wife, Alice, but he knows that Alice will need some financial assistance before Olivia passes away. Olivia is not likely to help Alice. Teddy knows that assets left to a marital trust are only available for Olivia's benefit during her lifetime. So, Teddy decides to fund a by-pass trust for the benefit of both Olivia and Alice with up to $1.3 million in appreciated assets at this death. The remaining assets he leaves outright to Olivia.

Estates with Greater than $1.3 Million in Appreciation

Couples whose estates have, or are anticipated to, experience greater levels of appreciation must similarly plan to obtain the maximum basis increase available at the first death. At a minimum, they will divide assets to ensure that at least $4.3 million of appreciation is included in the estate of the first to die. The surviving spouse will be entitled to another $1.3-million special adjustment at death.

Example: John is expected to die first. He and his wife, Julia, arrange their affairs so that John's estate will receive both special and spousal adjustments: a $1.3-million basis increase on assets left to John's family trust and a $3-million basis increase on asset left outright to Julia, his surviving spouse. John's estate receives a total basis increase of $4.3 million (1.3 + 3). Julia's estate is also entitled to a $1.3-special adjustment basis increase. Their combined basis increase is $5.6 million (Julia's 1.3 + John's 4.3).

Concluding Comments

The practice of financial planning was significantly altered on January 1, 2010, with the "repeal" of the estate and gift taxes. Yet, Congress may act to change the situation, perhaps with a retroactive extension of 2009 law through 2010.

While experts debate the legality of such a retroactive tax increase, the longer Congress takes to act, the less likely any change will be retroactive. One "outside the box" solution suggested is that Congress will implement a choice of laws available for decedents dying between January 1, 2010, and the time a new law is enacted: 2009 with its step-up in basis or 2010 with its carry-over basis. While much remains undetermined, it is clear that these are interesting times rife with planning opportunities.

Action Items

1. Obtain a formal review of all existing estate planning documents by your attorney, paying particular attention to any formula clauses employed.
2. Use the meeting with the attorney to update the estate plan to reflect changes in the family, changes in wealth, changes in goals or changes in fiduciary appointments.
3. Compile and share with your financial advisor a complete list of assets, including how the asset is owned (jointly, in trust, etc.), acquisition date and cost basis.