

**2010 ESTATE TAX PITFALL  
ILLUSTRATIONS**  
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In my 6-3-10 Blog post I identified potential problems with some estate plans if a spouse should pass away in 2010. The crux of the problem lies in trust language that is designed to transfer the maximum exempt amount to an irrevocable Decedent's Trust upon the death of the first spouse. While this strategy worked well in 2009, it could be disastrous in 2010. This article illustrates two examples of these which are too voluminous for a blog post.

**Background:**

For over 30 years, we have operated under several basic estate and gift tax concepts:

- 1) No inheritance taxes
- 2) Estate and gift taxes apply to the decedent/donor
- 3) The unified credit of various amounts ranging from \$600,000 to \$3.5 million
- 4) The unlimited marital deduction wherein no tax applies upon the death of the first spouse and an unlimited amount can be transferred to the surviving spouse
- 5) The "step up in basis" wherein the tax basis of property owned at the time one spouse passes away steps up (or down) to fair market value on the date of death.

The unified credit grew from \$600,000 to \$3.5 million peaking in 2009.

**A little history from 2001 to 2009:**

In 2001 there was significant pressure in congress to eliminate the estate tax. Rather than eliminate the estate tax, congress passed a law that gradually increased the unified credit to \$3.5 million in 2009; then eliminated the estate tax altogether in 2010. This law "sunsetting" in 2010 meaning it was temporary. Congress was going to study the effects of the change then enact permanent legislation sometime before 2010 either making the repeal permanent or, as most of us expected, reenact the estate tax at some level.

Congress did not act. Therefore in 2010 the rules are completely different than in previous years...but only for 2010. In 2011, due to the "sunset" provision, the law reverts back to what it was in 2001.

Very few estate planning professionals expected this to happen!

### What changes in 2010?

- 1) No estate tax
- 2) Basis step-up limited to \$1,300,000 per estate (bequests to non-spouse heirs)
- 3) Additional basis step-up limited to \$3,000,000 for transfers to the surviving spouse.
- 4) No unified credit

### What happens in 2011?

We revert back to 2001 rules where the unified credit will be \$1 million and step up in basis will occur upon the date of death.

These illustrations demonstrate what can happen when one spouse of a married couple passes away in 2010 with estate tax plans and documents drafted for use under prior (and future, post 2010) rules.

*For both examples, presume the trust language instructs the trustee upon the first death to transfer the maximum amount of assets exempt from estate tax at the time of the first spouse's death from the Living Trust into a Decedent's Trust and the balance to a Survivor's Trust under the unlimited marital deduction. This is fairly typical.*

### Case 1: Illustration of the Step Up In Basis vs. Carryover Basis problem

Husband and Wife (Joe and Mary) have cash of \$100,000, life insurance proceeds received when Mary passed away of \$50,000 and two rental properties worth \$3 million each with an adjusted tax basis of \$200,000 each:

#### A. Assume Mary passed away in 2009:

<u>Item</u>	<u>Fair Market Value</u>	<u>Transfers at Stepped Up Tax Basis</u>	
		<u>In Decedent's Trust</u>	<u>Survivor</u>
Cash	\$ 150,000		\$ 150,000
Rental Property #1	3,000,000	\$ 2,000,000	
Rental Property #2	<u>3,000,000</u>	<u>1,500,000</u>	<u>2,500,000</u>
TOTAL ESTATE	\$ <u>6,150,000</u>	\$ <u>3,500,000</u>	\$ <u>2,650,000</u>

The assets placed in The Decedent's Trust will never again be subject to estate tax. Since they are no longer in the survivor's estate, they will not step up to fair market value again when the survivor passes away.

The assets that pass to the survivor can be bought or sold, consumed, etc by the survivor during his lifetime or when the survivor passes away. These assets will step up to fair market value again (unless in 2010).

**B. Assume Mary passes away in 2010:**

<u>Item</u>	<u>Fair Market Value</u>	<u>Adjusted Basis</u>	
		<u>In Decedent's Trust</u>	<u>Survivor</u>
Cash	\$ 150,000	\$ 150,000	0
Rental Properties	<u>6,000,000</u>	<u>4,300,000</u>	0
TOTAL ESTATE	\$ <u>6,150,000</u>	\$ 4,450,000	0

Per instructions in the trust document, all property goes to the decedent's trust thus removing it from Joe's estate. Usually in accordance with Decedent's Trust language, Joe has the right to all the income from these assets for the rest of his life; when he passes away, his two children (the beneficiaries of the Decedent's Trust) inherit the property.

Assuming the children wish to sell the rental properties after their dad passes away in 2011:

Selling Price	\$ 6,000,000
Tax Basis	<u>4,300,000</u>
Taxable Gain	\$ 2,300,000

Likely Federal and State Income Tax at 38%      \$ 874,000

What would this look like if Mary passed away in 2011?

**C. Assume Mary passes away in 2011:**

<u>Item</u>	<u>Fair Market Value</u>	<u>Stepped Up Basis</u>	
		<u>In Decedent's Trust</u>	<u>Survivor</u>
Cash	\$ 150,000		\$ 150,000
Rental Property #1	3,000,000	\$ 1,000,000	1,000,000
Rental Property #2	<u>3,000,000</u>	<u>0</u>	<u>2,000,000</u>
TOTAL ESTATE	\$ <u>6,150,000</u>	\$ <u>1,000,000</u>	\$ <u>3,150,000</u>

Again, following the instructions in the trust, the maximum amount of value not subject to estate tax is transferred to the Decedent's Trust. When Joe passes away, assuming no significant increase in market value, when his children wish to sell the two rental properties:

Selling Price	\$ 6,000,000
Tax Basis	<u>6,000,000</u>

**Taxable Gain**      \$ 0

**Income Tax**      \$ 0

**The difference is almost \$900,000 in income taxes!**

What is needed now to protect the estate from the negative consequences illustrated above if one spouse should pass away in 2010?

Joe and Mary should have their estate attorney draft an emergency provision that gives the trustee the leeway to fund the Decedent's Trust based on the existing law and circumstances applicable upon the first death. This way, if the highly appreciated assets are in Joe's estate when he passes away after 2010, the assets will step up in basis to Fair Market Value. Most experts believe the estate tax exemption will eventually be made permanent at \$3.5 million, the 2009 level.

**Case #2: Illustration of the Different Beneficiary Problem**

Facts: Jack and Jill have \$500,000 in cash and two rental properties worth approximately \$3.5 million each.

Under the terms of the Living Trust, upon the first death the maximum amount exempt from estate tax (\$3.5 million in 2009) is to fund the Decedent's Trust and the balance is to remain in The Survivor's Trust.

Jack and Jill's two children do not get along with each other so in an attempt to eliminate future problems between their children, Jack and Jill made their son George the sole beneficiary of the Decedent's Trust and left the residue (what is left) of the estate to their daughter Andrea. Furthermore, they resigned as trustees and appointed National Trust Company as a professional trustee to manage the trust assets to "distance" management of the estate from the family.

**Assume Jill dies in 2010:**

All assets go to the Decedent's Trust. Jack is entitled to the income it generates for the rest of his life then the assets go to George. Andrea will receive nothing. If Jack had remained trustee, he could have failed to fund the Decedent's Trust and take his chances with his son. However, the professional fiduciary (National Trust Company) would be duty-bound to follow the trust document or face a lawsuit!

In this situation, litigation is likely. Also, similar tax issues to Case #1 would apply because all assets not in Jack's estate when he passed away would not step up in basis (there is an exception to this but beyond the scope of this example).

**Assume Jill dies in 2011:**

The Decedent's Trust would be funded with \$1 million. Most estate planners believe that when congress finally acts, the exempt amount will increase to 2009 levels for 2011 and beyond.

**Distribution of Trust Assets When Jill Passes Away Illustrated**

	<u>2009<sup>(1)</sup></u>	<u>2010<sup>(2)</sup></u>	<u>2011<sup>(3)</sup></u>
Assets transfer to Decedent's Trust (George is Beneficiary)	\$3.5 Million	\$7.5 Million	\$1 Million
Assets to Jack (survivor) & Andrea (daughter)	<u>\$4 Million</u>	<u>\$ 0</u>	<u>\$6.5 Million</u>
TOTAL ESTATE:	<u>\$7.5 Million</u>	<u>\$7.5 Million</u>	<u>\$7.5 Million</u>

**Notes:**

- 1) If Jill passed away in 2009, the funding would be fairly equal and Jack could "fine tune" the distribution to George with a codicil or trust amendment. The property left in Jack's estate would step up to Fair Market value on Jill's death.
- 2) If Jill passed away in 2010, without an amendment to the trust, no assets would pass to Jack as surviving spouse, no assets would step up in basis when Jack passes away after 2010 and Andrea would receive nothing. Since the assets are out of Jack's estate, upon Jill's death, he cannot fix the distribution with an amendment after she passes away.
- 3) Assuming present law, if Jill passes away in 2011, a \$1 million undivided interest would go to the Decedent's trust and step up to Fair Market Value. The balance of the estate would step up to Fair Market Value and remain with the survivor therefore Jack would still have the ability to square things up between his kids with an amendment to his trust before he passes away.

Again, to avoid these pitfalls, an emergency provision for 2010 should be considered to ensure that Jack and Jill's desires can be achieved. We recommend you contact your estate attorney to inquire regarding the necessity of a revision to your estate planning documents.