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Created: 12/8/2011 4:43 PM

URL: <http://www.csqmag.com/issues/Q12010/adv-estatelaw.html>

Estate Law Repeal

Upheaval & Opportunities

The unthinkable has occurred. Unpredictably, the U.S. Congress has allowed the federal estate tax to expire and fade into tax history – again – for a mere 12 months...unless, of course, Congress decides to change its mind before the end of the year. As of January 1, 2010 and lasting until December 31, 2010, a person who passes away can leave his or her property to anyone he or she chooses without payment of transfer tax (known as “estate tax”). Good news, right? Well, maybe. It depends on what you own, how you own it, and, to a certain extent, if you have adult grandchildren.

With the repeal of the estate tax, two other tax rules were also repealed. Before the repeal, beneficiaries of an estate received the inherited assets with a new, stepped-up, tax basis equal to the fair market value of the asset on the day the decedent died. That meant any unrecognized capital gain in the asset was erased as of the date of death. The inheriting beneficiary could sell the asset and compute any gain from the new “stepped-up” basis, unlike a lifetime gift where the gift recipient receives the gifted asset with the donor’s original tax basis. There was, and is, no basis step-up on gifts.

Under the current tax scheme, the estate tax (and step-up in basis) returns on January 1, 2011, and it will return at year-2001 levels (i.e., a \$1 million exemption and a top tax rate of 55%). Even if Congress acts early in 2010 and attempts to make any changes retroactive to the beginning of 2010, there will undoubtedly be legal challenges in court as to the constitutionality of making the tax fix retroactive to January 1 of this year.

Some believe that Congress, some time in this first quarter of 2010, will pass a retroactive law to reinstate the estate tax and step-up in basis. Others believe that Congress will kick the can down the road until late summer and again try to make it retroactive. Still others believe Congress will do nothing and leave the problem for

the next Congress which will convene in January 2011.

Besides forcing everyone who has a will or a trust to do a review with legal counsel to see what amendments or changes are required by this upheaval in the law, the new set of rules creates a few special opportunities for those who can take advantage.

Opportunity No. 1

The repeal of the estate tax also means there is no generation-skipping tax (the flat 50% excise tax imposed on top of estate and gift taxes on large gifts to grandchildren and later generations). Since there is no generation-skipping tax, grandparents can make substantial outright gifts to grandchildren just for the cost of the gift tax. In 2010, the gift tax is a flat 35% - the lowest rate in living memory. Gifts of limited partnership interests or closely held company stock are ideal for this type of gift. This low-rate flat gift tax also makes Qualified Personal Residence Trusts ("QPRTs") even more attractive as an effective way to transfer and preserve family wealth.

Opportunity No. 2

Even though there is no generation-skipping tax ("GST"), there is also no generation-skipping tax exemption to apply to gifts in trust for grandchildren. When the estate and GST taxes come back in 2011 (or sooner depending on Congress), any gifts in trust for grandchildren will be subject to GST tax in the future when distributions from the trust are made to or for the benefit of the grandchildren (under a concept known as "taxable distributions" or "taxable terminations"). Now a grandparent can make substantial gifts, subject only to the 35% gift tax, to a special type of trust for children, grandchildren, and later generations that acts as a private family bank -- never making distributions to the beneficiaries but rather, creating limited liability companies with the children and grandchildren and investing in those business ventures or deals so as to facilitate generations of family members becoming self-sufficient, self-reliant, and successful in their own right. The special trust will have to end no later than 90 years after its creation (if created in California), and the distributions at termination of the trust to those later generations may be subject to some type of generation-skipping tax then, but family wealth will have been preserved for nearly a century and many generations of children will have the financial ability to get into business and establish their own fortunes.

Meet with your estate planning counsel as soon as possible to protect your wealth and capture opportunities during this turbulent tax change...before the window of opportunity closes.