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Estate tax fiasco

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What was once unthinkable has now become reality for estate planners and their clients. A bizarre sequence of see-sawing transfer tax law that was never intended to actually occur is now the law.

Estate tax reform and attempts to repeal it completely began in earnest in 2001 when Congress passed the 2001 Tax Act. The 2001 act also made the estate and generation-skipping transfer (GST) taxes inapplicable for one year, 2010. Finally, the 2001 act provided that all its provisions would expire on Jan. 1, 2011, as if never enacted, thus reinstating retroactively the harsher estate tax law in effect in 2001 before the 2001 act.

These weird "now we have estate tax, now we don't" provisions were due to budget and procedural rules that limited the tax reduction in the 2001 act to a 10-year period. Proponents of repeal hoped that the one-year repeal would be extended, possibly year by year, or made permanent at some point during the phase-in period.

By fall 2005 it was clear to knowledgeable estate planners that estate tax repeal was no longer likely. However, they also assumed that Congress would never allow a one-year estate tax gap followed by reinstatement of a harsher estate tax and that permanent legislation would be enacted long before the end of 2009. A one-year gap with reinstatement would create a mess for gap transfers and trusts, particularly in the application of the GST tax. This also would result in wildly different estate tax treatment for taxpayers who died on Dec. 31, 2009, compared to Jan. 1, 2010, and well as those who died on Dec. 31, 2010, compared to Jan. 1, 2011. Nothing at all like this had ever happened before in the transfer-tax area, and so expectations were understandable that it would not happen here.

However, Congress has in fact allowed 2009 to expire without any transfer-tax legislation. Regardless of whether one supports repeal or not, the result of failing to act in 2009 is chaos for taxpayers and their advisers.

Stability is essential in the transfer-tax laws, and changes in transfer-tax laws when made previously have allowed reasonable and even lengthy phase-in periods for taxpayers to have time to conform their wills and trusts. Sophisticated estate plans have complex formulas tied to estate and GST tax results that adjust for changes in assets and tax laws within certain parameters. However, because few thought that the gap and reinstatement would actually occur, many trusts and wills do not address this possibility. For decedents who die during any gap, property may pass to trusts or beneficiaries much differently than what likely would have been intended, and, for some, only litigation will resolve how these formulas work.

Some members of Congress have vowed to act early this year to reinstate the 2009 tax law retroactive to Jan. 1, 2010. But Congress' failure late in 2009 to delay the 2010 gap for 60 days to allow further legislation to occur makes it uncertain that retroactive legislation can be passed. Given that 2010 is an election year, it is possible that nothing will be done until after the elections. A retroactive reinstatement of the estate and GST taxes will be controversial and, if it occurs, challenges to its constitutionality will cause uncertainty for years to come.

PARALYZING UNCERTAINTY

Uncertainty as to what is or will be the law during the gap is paralyzing. Taxpayers may not know whether they should go to the expense and trouble of revising their estate plans. Executors and trustees who administer the

assets of taxpayers who die in 2010 will not know, maybe for months, whether they owe estate tax. When making investment decisions, executors and trustees will not know if they will incur capital gain when selling assets because different basis rules also apply while there is no estate tax in 2010.

Under 2009 law, decedents were not required to file an estate tax return if the estate was less than $3.5 million. For 2010 decedents, the basis provisions require a return for estates of more than $1.3 million and may also result in greater capital gain taxes owed on the sale of assets compared to the 2009 law. Thus, by failing to act, Congress has burdened a far greater number of taxpayers with filing a return, with valuing assets and, in many cases, with more tax than under the 2009 tax law.

Whatever Congress decides is the appropriate tax system, it is particularly important for estate tax laws, or the lack thereof, to be stable and predictable. The failure of Congress to address permanent estate tax policy in the years since 2001, let alone in 2009, has created uncertainty and unfairness and is not sound tax policy. Taxpayers are likely to incur needless expense and inconvenience by having to change their estate plan to cover any gap in 2010. They cannot plan properly for their families and businesses when the application of the estate tax is so unpredictable. Congress should address the situation immediately.

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