UNINTENDED EFFECTS OF THE FEDERAL ESTATE TAX REPEAL

Estates & Trusts Alert
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Despite predictions that common sense would prevail, Congress allowed the federal estate tax to expire on January 1, 2010, creating massive confusion and unpredictability for millions of taxpayers. The New York estate tax, which taxes estates in excess of $1 million, remains in effect.

The federal estate tax is scheduled to come back on January 1, 2011, with 2001's higher rates (55%) and lower exemption ($1 million). Compounding the current uncertainty, Congress may very well pass legislation in 2010 that changes these amounts. Even President Obama's 2011 budget proposal assumes that Congress will act during 2010, returning the estate tax to the 2009 rate (45%) and exemption amount ($3.5 million).

While no estate tax may sound like good news, even for only one year, the current confusion and uncertainty is not good news. Will someone who died on January 2, 2010, really be able to leave millions to children with no estate tax? How will the basis of the assets received by the next generation be determined? Will Congress reinstate the tax retroactive to January 1? Would that be constitutional? The answer — and therefore whether estates of people who die in 2010 are subject to estate tax or not — may not be known until the Supreme Court makes a final decision in three or four years. Given that uncertainty, what should the executor of a 2010 estate do?

Perhaps even more important is the effect of estate tax repeal on existing estate plans. Typically, the wills of married people with estates over $1 million contain formulas designed to minimize federal estate tax. A vast majority of these wills contain a formula giving the surviving spouse (or a trust for the surviving spouse's benefit) "the minimum amount that will reduce the federal estate tax to the lowest possible amount." This flexible formula automatically adjusts to an increase in the estate tax exemption, which has been steadily increasing over the last 15 years, allowing our clients' wills to remain effective without constant modification. But the formula may now have unintended-and potentially highly disruptive-effects on anyone who has a surviving spouse and who dies while no federal estate tax is in effect.

The following examples illustrate some potential issues:

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Example 1: A husband and wife have wills that include a formula gift to the surviving spouse. The wife's will gives her husband the amount necessary to reduce her federal estate tax to zero. The balance of her estate is given to her children from her first marriage. If the wife had died in 2009, the wife's children would have received $3.5 million less taxes and non-deductible expenses, and the husband would have received everything else. However, if the wife dies during 2010, her entire estate will go to her children, and nothing will go to her husband. This result is likely very far from what the wife intends or the husband needs. It may even result in litigation if the husband decides his only recourse is to exercise his statutory right to elect against the will.

Example 2: A husband and wife, both New York residents, have wills that include a formula gift to the surviving spouse. As with example 1, the wife's will gives her husband the amount necessary to reduce her federal estate tax to zero. The balance of her estate passes to a family trust for the benefit of her husband and children. If the wife dies during 2010, her entire estate will pass to the family trust. This distribution of assets may be satisfactory, but it may also cause her estate to owe New York estate tax. If wife has an estate of $2 million, roughly $100,000 of New York estate tax will be due on her death. If a different formula were used, this New York estate tax could be deferred and possibly avoided altogether, depending on the husband's assets and residence at his death.

Example 3: An individual has a will signed in 2009 that leaves an amount equal to the federal estate tax exemption to his children and the balance to charity. If he had died in 2009, $3.5 million would have passed to his children, and everything else to charity. If he dies during 2010, it is unclear what portion of his estate will pass to charity and what portion will pass to his children, and the Executor may have to obtain a court order directing how the estate should be distributed.

Example 4: A husband wants to establish a trust under his will to pay for his grandchildren's college educations, with the balance of the estate passing to the wife. The will creates a trust with an amount equal to "my otherwise unused generation-skipping transfer tax exemption." The balance of the estate passes to the wife, either outright or in trust. Because the generation-skipping transfer tax also expired on January 1, 2010, a court would probably have to decide whether the phrase "my otherwise unused generation-skipping transfer tax exemption" has any continuing meaning. Nothing could be paid for a grandchild's college tuition until the court made its decision.

A review of your current estate plan is crucial if any of the following describes you:

- You are married, and your will contains a formula clause that leaves a substantial share of your assets to someone other than your spouse or to a trust of which your spouse is not a beneficiary
- Your will contains a formula clause that leaves a substantial share of your assets to charity
- Your will contains a formula clause referring to an amount of "generation-skipping transfer tax exemption" or a similar phrase

If you think any of these examples comes close to your situation, a review and update of your current estate plan may be crucial. Please contact a member of our Estates & Trusts Practice Group if you have any questions on the state of the estate tax or if you would like to discuss updating your current estate plan.

To contact a member of our Estates & Trusts Practice Group, click on his or her name below:
Thomas R. Hyde, Richard F. Campbell, John Catterson, Katherine E. Cauley, Paul R. Comeau, Catherine B. Eberl, Carol A. Fitzsimmons, Kevin K. Gluc, Alice A. Joseffer, Todd M. Joseph, Margaret E. Lehman, Leslie R. Kellogg, Britta L. Lukomski, Thomas W. Nelson, Mario J. Papa, Timothy Sawers, James M. Wadsworth