

# Financial Crisis Management Alert



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## Death And Taxes, Sure. Death Tax – Not So Fast

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If you were hoping that President Obama would talk about the estate tax in his State of the Union speech on Wednesday, you were disappointed. He didn't touch it. And by now, we've had a full month without a federal estate tax -- the first time that has happened in almost a century.

The problem is not necessarily that there currently is no federal estate tax, it is the uncertainty of the situation. Will Congress re-impose the estate tax this year? If so, will it do so retroactively? If it does do that, would that be constitutional? If there is a gap year, or part of a gap year, what happens next year? What should bankers and other fiduciaries do for clients right now?

First, a little background.

### Setting The Stage: The 2001 Tax Act

Under the provisions of a Bush-era tax-cut bill enacted in 2001, the estate tax over the past 10 years or so has taken less and less of a bite out of estates. The 2001 tax act accomplished this by raising the value of the exemption and fiddling with the tax rate. Thus, for example, in 2001, the estate tax exemption was \$675,000, and the estate tax rate was 55 percent. In 2005, the numbers were \$1.5 million and 47 percent. By 2009, the exemption was \$3.5 million, meaning

that only estates valued at more than \$3.5 million were subject to an estate tax, and the tax rate had fallen to 45 percent.

So far so good.

Congress, in its infinite wisdom, decided in the 2001 tax act that there would be *no* estate tax for 2010. That amounted to a remarkable political victory for those who had characterized the estate tax as a “death tax” and sought to eliminate it. But that victory came at a price: it messed up federal budget and deficit projections. So, Congress, in its infinite wisdom (sorry for repeating that, but it is the only phrase that works), decided in the 2001 tax act that the estate tax would be resurrected in 2011 -- on estates with a value of \$1 million and higher (going back to what it was in the first year after the 2001 tax act), and at a tax rate of 55 percent (the rate before the 2001 tax act took effect).

Since the 2001 tax act became law, it has been expected that Congress would “fix” the 2010 problem and enact an estate tax for 2010, and probably even increase the estate tax exemption for 2011 (and future years) from \$1 million to at least \$3.5 million, while dropping the tax rate from 55 percent.

Years passed. Congress did not act. More years passed. Congress still did not act. Not to worry. Congress wouldn’t fail to deal with this, would it? It would certainly extend the estate tax.

In early December 2009, the House of Representatives passed a bill, H.R. 4154, to do just that. The Senate had all month to act, but, incredibly, it failed to do so. And now, another month has passed -- still no Senate action.

### **Wait! There’s More!**

Oh, there’s something else that needs to be mentioned. Not only did the estate tax disappear, but a provision in the tax law known as “step-up” in basis has dropped out, too.

Before January 1, 2010, property inherited from a decedent was valued at its fair market value at the time of the decedent’s death, notwithstanding its value at the time the decedent had acquired it. Because of that, no capital gains tax typically was triggered when inherited assets were sold.

That “step-up” rule also was eliminated as of January 1, except that the basis in inherited assets can be increased by up to \$1.3 million, and except that a surviving spouse can increase basis by an additional \$3 million.

These new rules, by the way, exist only for 2010; if Congress does nothing, the prior step-up rules go back into effect next year.

The implications of this change can be significant. Suppose a bank customer dies this year, leaving to his only child a million-dollar family home that had been purchased decades ago and a million dollars in stocks that had been purchased over the years. Generally speaking, before 2010, the child would pay no capital gains tax upon selling the house or the stocks. Now, however, a capital gains tax

would be due, and the value of the family home and stocks would have to be determined as of the date the assets had been acquired; that would likely be a costly endeavor, as well as a logistical and documentation nightmare.

### **Well, Congress Is Going to Act, Right?**

Notwithstanding the failure of Congress to act over the years, and in December, optimists believe that Congress is going pass a law that puts 2009's rules back in effect for 2010, and makes them applicable for future years, too.

Realists know that it is not certain that Congress will do so. It very well may be that the more time that passes without action, and the closer the November elections come, the less likely Congress will be willing to enact a "death tax." And even if Congress were to act, as pointed out above, there may be some fascinating (at least to tax lawyers) legal and constitutional issues that would have to be resolved.

### **The Implications**

In many instances, estate plans created after the 2001 tax act was enacted contain provisions tied to the federal estate tax, and that can be a real problem. For example, an estate plan that contains a marital and family trust may not attain the testator's goals in the absence of a federal estate tax, which means that someone may be unintentionally disinherited. (Some states, including Virginia and Maryland, are thinking about changing their laws so that these estate plan provisions will be interpreted as if the federal rules as of December 31, 2009, are in effect.)

As a result, it is important to speak with clients and suggest that they undertake a simple review of their plans to determine whether they need to be revised for this year, and possibly for next year.

Moreover, banks that administer trusts and estates should carefully consider the implications of the elimination of the "step-up" rules. For now, they may be faced with the problem of choosing the assets that will benefit from the \$1.3 million step-up in basis, and which will not. At the least, this can be a significant administrative problem. It also can set up a battle between or among beneficiaries. How to handle this has to be carefully considered.

Finally, it is important to let elected officials in Washington know that this situation must be addressed, and soon.