

US Estate Tax Repeal

The US Congress allowed the federal estate tax to expire on January 1, 2010. The estate tax scheduled to come back into effect on January 1, 2011 contains the higher 2001 rates (up to 55 percent) and lower exemption amount (\$1 million). It is still open to Congress to pass legislation during 2010 to change those amounts. Further compounding the uncertainty, Congress may even attempt to retroactively reinstate the estate tax for 2010. Practitioners with cross-border clients should review existing estate plans to determine whether any action needs to be taken to address the repeal.

Although the 2010 estate tax repeal was on the books for several years, practitioners, commentators, and even lawmakers had worked under the assumption that Congress would act before the end of 2009 to renew the tax. As a result, most US estate plans put into place before 2010 do not contemplate the possibility of repeal, a practice that may now produce unintended consequences. Particularly problematic are the wills of married people whose estates exceed \$1 million. Typically, such wills contain formulas designed to minimize federal estate tax, most often by reference to “the minimum amount that will reduce the US federal estate tax to the lowest possible amount.” This flexible formula automatically adjusted itself to the US estate tax exemption, which rose steadily over the last 15 years, and thus allowed the clients’ wills to remain effective without constant modification.

However, the estate tax repeal may cause such a formula not to operate as intended: in some situations, the formula may produce disastrous results. Assume that a wife’s will bequeaths to her husband the amount necessary to reduce her US 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, her children would have received \$3.5 million (reflecting the then current exemption amount) less taxes and non-deductible expenses, and the husband would have received the balance of the estate. However, if the wife dies during 2010, her entire gross estate goes to her children and nothing goes to her husband, because the amount needed to “reduce the US federal estate tax to the lowest possible amount” is nil.

Other commonly used formulas may also produce undesirable consequences. Assume that a client, wishing to contribute to his grandchildren’s college educations, funds a trust under his will with an amount equal to his “otherwise unused generation-skipping transfer tax exemption.” His will provides that the balance of his estate passes to his wife. Because the generation-skipping transfer tax also expired on January 1, 2010, it is unclear whether the phrase “otherwise unused generation-skipping transfer tax exemption” has any meaning. A prudent executor will request a court construction before making distributions from the estate, resulting in a delayed distribution of estate assets and increased estate administration costs.

A practitioner with cross-border clients should examine existing estate plans to determine whether a will contains a formula that no longer functions as intended. If a client is married, the practitioner should review the estate plan and assess whether a formula will result in a gift of a substantial portion of the estate to someone other than the surviving spouse or a trust for his or her benefit. Estate plans should also be reviewed for formulas that give a substantial amount of assets to charity or that refer to an amount of “generation-skipping transfer tax exemption” or use similar wording.

Because the estate tax will likely be reinstated on January 1, 2011 (if not earlier), some clients may decide to ride out the uncertainty and do nothing. If a client chooses to act immediately, the existing estate plan can be patched with a relatively simple codicil or revocable trust amendment that addresses asset distribution if the client dies while the repeal is in effect.