

## **Tax and Trust Law Changes Warrant Review of Plans**

Federal estate and income tax rules have changed radically in 2010 and will change radically again in 2011 unless Congress passes new legislation. Similarly, Michigan law governing trusts, regardless of when they were established, will change quite dramatically beginning April 1<sup>st</sup> of this year. This article is intended to advise you of what has happened and encourage you to reevaluate your estate plan in light of same.

**2001 Tax Act.** In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) which provided for significant phased-in increases in the federal estate, gift and generation skipping tax (GST) exemptions and lower tax rates. EGTRRA provisions included:

- In 2009, the estate and GST exemptions increased to \$3.5 million per decedent, with a flat 45% estate and GST tax rate on any excess. The gift tax exemption was \$1.0 million, with tax rates from 41% to 45%. The recipients of a decedent's assets were entitled to a taxpayer friendly step up in basis for purposes of determining the gain or loss on their ultimate disposition of same.
- In 2010, the federal estate and GST taxes were repealed for one year. The gift tax \$1.0 million exemption remained, with a lower flat tax rate of 35%. The step up in basis rules were replaced with Treasury Department friendly adjusted carry-over basis rules. These new basis rules permit a step up in basis of up to \$1.3 million, plus an additional \$3.0 million for certain spousal transfers at death.
- On January 1, 2011, EGTRRA is scheduled to automatically expire, which, in light of the above provisions, will complete the following, chaotic picture: A \$3.5 million estate and GST exemption and flat 45% tax rate in 2009, no estate and GST tax in 2010, and a \$1.0 million estate exemption and tax rate up to 60% in 2011.

**What Happened in 2009?** Many estate planning practitioners expected Congress to take action to carry the 2009 rules into 2010. However, in December, the House failed to act on a one year extension and instead sent the Senate a bill to make the 2009 rules permanent. Because the Senate was focused on health care and there was broad disagreement in the Senate on what to do with estate taxes, Congress enacted no changes to EGTRRA's 2010 rules. Thus, effective as of January 1, 2010, there is no federal estate or GST tax.

**Planning in Chaos.** Congress's failure to adopt estate tax legislation in 2009 and the possibility that changes will not be adopted during 2010, radically change the estate planning considerations of many clients. For example, Congress has indicated that in 2010 about 6,000 decedents will benefit from the elimination of estate taxes, but over 70,000 heirs will pay higher income taxes because of the change in the income tax basis rules for assets received from decedents.

**2010 Changes.** The U.S. has an unpredictable planning environment in which any number of radically different changes might occur in 2010:

- Congress may do nothing in 2010, in which case there is an adjusted carryover basis, and no federal estate or generation skipping tax for people who die in 2010. Though you may not die in 2010, you still need to consider planning for that possibility, because not planning for these changes, if death occurs, can be disastrous. For example:
  - Formula clauses (e.g. terms that allocated your estate exemption to a "by-pass trust") in your planning documents could inadvertently disinherit some of your intended beneficiaries and/or create conflicts among family members on how your documents should be properly interpreted.
  - Conflicts could arise among your heirs and fiduciaries on asset basis issues.
  - Passing assets directly to your surviving spouse may result in higher estate taxes after 2010.
- Congress may adopt legislation to carry the 2009 rules over to 2010, retroactive to January 1, 2010. There is broad disagreement on whether a retroactive tax bill is constitutional. If a retroactive law is adopted, it will almost certainly be challenged as unconstitutional and it could take years for the Supreme Court to rule on the issue. Until such a ruling, uncertainty would be rampant. Those dying after the enactment should not have that uncertainty. In any event, your estate plan should contemplate dying both before or after a potential retroactive enactment, which may or may not be constitutional.
- If Congress acts in 2010 to address the estate tax issues, it could:
  - Adopt what would purport to be a permanent estate tax exemption, beginning in 2010 or 2011. If so, most prognostications call for estate tax exemptions to fall between \$2.0 - \$5.0 million and tax rates from 35% to 45%.
  - Adopt a temporary higher estate exemption.
  - Adopt rules to limit or eliminate valuation discounts.

2011 Changes. Unless Congress enacts new legislation in 2010, then on January 1, 2011, a number of automatic changes occur to the federal tax code, including:

- The estate tax exemption drops to \$1.0 million per decedent.
- The estate tax rate increases (e.g., 55% above \$3.0 million and 60% above \$10 million).
- The fair market value step up in basis returns for assets passing from a decedent.
- The top income tax rates go up by a least 4.6%, capital gain tax rates go up by up to 5% and dividend tax rates go up by up to 24.6%.

Higher Taxes. No matter what happens to the estate tax, substantial tax increases are likely. A \$12 trillion deficit is projected for the next decade. The Congressional Budget Office indicates that the social security trust fund will pay out more than it receives starting in 2011 or 2012. Taxes will have to increase across a broad range of Americans. Both the Washington Post and the New York Times have stated that the President will have to abandon his pledge to only increase taxes on taxpayers earning over \$250,000.00. Given the slow pace of the economic recovery and the fact that we are in a mid-term election year, the federal government will probably not increase taxes until sometime in 2011. While substantial tax increases are likely, we just don't know any details.

ROTH IRAs. In 2010, taxpayers can convert traditional IRAs to ROTH IRAs and can pay the income taxes due on such conversion in 2010 or equally in 2011 and 2012. There are significant benefits and traps for the unwary in making these decisions.

Effectively, unless Congress adopts new legislation, in 2010 the estate tax rules flip 180 degrees from where they were in 2009, and then flip 180 degrees again in 2011 - only the estate tax and income tax rules could be even worse than what we had in 2009. Uncertainty makes it difficult to plan, but waiting to see what happens next is not a good idea. The earlier you can implement flexible tax and estate planning to respond to these changes the better.

The Michigan Trust Code. The Michigan Trust Code (MTC) was signed into law by Gov. Jennifer Granholm on June 18, 2009 with an effective date of April 1, 2010. With limited exceptions the MTC applies to all trusts whether created before or after April 1, 2010. The MTC is a series of default rules which, with 15 exceptions, may be overridden by the terms of one's trust agreement. These rules, though they reaffirm many long-standing principles, depart from others and, also, address what, heretofore, have been matters not addressed by Michigan law. Examples of matters addressed by the MTC include the standard of capacity required for the valid execution of a trust, the validity of "no contest" clauses, statutes of limitations for contesting a trust, the duties of

trustees, the rights of various categories of beneficiaries, representation of interests by surrogates, and the relationships between a trustee and third party non-beneficiaries. The foregoing list is certainly not exhaustive. The breadth of the MTC and the implications of same in regard to trusts drafted prior to its effective date warrant careful reconsideration of the existing terms of those trust documents.

We strongly recommend that folks proceed to review and re-evaluate their estate plans and determine whether, given the far-reaching impact of the legal changes referenced above, their interests would be advanced by making any changes to same. If you would like us to assist you with a review and re-evaluation of your plan we invite you to contact us to schedule an appointment.