

Death and Taxes - Not So Certain After All: Important News About the Federal Estate Tax

January 2010

At midnight on December 31, 2009, certain provisions of the Internal Revenue Code imposing the federal estate tax and the generation-skipping transfer tax expired. While this constitutes a "repeal" of the federal estate and generation-skipping transfer taxes, very few observers expect this change in the law to last, as Congressional Democratic leaders have stated their intent to reinstate the taxes through retroactive legislation to be adopted early this year. There is, of course, considerable uncertainty for tax and estate planning purposes at this point. As explained in more detail below, clients may wish to have their estate plans reviewed for the individual impact on their situations.

The repeal of the federal estate tax and generation-skipping tax is, by its terms, only scheduled to last for calendar year 2010. The federal gift tax was not similarly affected, and the lifetime exemption per person for taxable gifts (i.e., the lifetime total of taxable gifts one person may make without a gift tax being imposed) remains at \$1,000,000. The top marginal rate for gift tax was lowered to 35% from the previous top rate of 45%. Unless Congress acts to the contrary, in 2011 the estate, gift and generation-skipping taxes will be revert to 2001 levels, with a \$1,000,000 lifetime exemption and a 55% top rate.

A further important aspect of the new law is that, for persons dying in 2010, the rule which allows the adjustment of cost basis for income tax purposes of all assets passing to heirs at death to the fair market value of the assets at death (known as the "step-up in basis") also expired. This rule had the effect of erasing most unrealized capital gain in a decedent's estate. The new law does provide for a basis step-up of \$3,000,000 allocable to assets passing to a spouse, and \$1.3 million of additional basis on other assets. Consequently, for deaths in 2010, assets passed at death where gains exceed those

additional basis amounts will have a carryover basis – that is, the cost basis in the hands of the decedent immediately prior to death.

Almost no federal tax policy experts anticipated that these changes would take effect, despite the fact that the limited repeal has been "on the books" since 2001, and as noted, legislation to reverse them has been in the works. One likely approach may be the enactment of a provision indefinitely extending the estate, gift, and generation-skipping taxes (as well as the exemption amounts and rates) and the cost basis rules that were in effect on December 31, 2009, retroactive to January 1, 2010. There are other possible outcomes as well, and it is possible that there will be a period where the modified carryover basis regime will be in effect, resulting in a "Repeal Window."

For this and for other planning reasons, it will be desirable for many clients to have a review of their estate plans and asset configurations which may require the addition of previously unnecessary provisions or changes in assets. It is of course possible, and perhaps even probable, that an extension of the pre-2010 estate tax will be challenged on the basis that making the former tax or tax rates retroactive is unfair, and the federal courts would have to rule on that. While some legal theorists have ventured the opinion that precedent supports upholding retroactivity, it is impossible to predict the final result.

Unfortunately, that puts persons in the position of having possibly obsolete plans, or those who wish to possibly take action in order to take advantage of a Repeal Window, at a disadvantage, because we may not know if any Repeal Window will be upheld or disallowed until long after the Window is closed. That element of risk and uncertainty impacts decisions which only our clients can

make; as lawyers we can only advise as to factors which might be relevant.

We make the following recommendations to deal with this uncertainty:

First, we suggest that all clients increase the attention they give to maintaining cost basis information.

Second, you may wish to consider taking no action at this time since there may be no Repeal Window or only a brief Repeal Window, and proper actions to deal with the Repeal Window may entail considerable cost and effort. However, inaction may mean assuming the risk of sub-optimal tax results, either in terms of the dispositive scheme of the estate plan or the inefficient use of the basis step up. For some clients, inaction is not necessarily the most beneficial course of action, and some clients may already be aware of circumstances suggesting immediate review is necessary. This may be particularly true for clients residing in states with no state estate tax, such as Florida or New Hampshire.

Third, unless you decide to take the risk of inaction, we recommend that you consult with your B&L attorney to decide whether to take the risk and what changes may be necessary to eliminate the risk. Since whatever the outcome, the estate and gift tax rules are likely to change, this may be a good time to review estate planning goals so as to be prepared for the new world. As always, we will strive to conduct any review, and implement any changes, in the most efficient and economic way possible.

Finally, a comment. There is no one tax regime that will be of benefit to all clients. If you think a world without an estate tax seems like something that should be on your wish list, consider that for many, if not most people, the modified carryover basis world could well end up costing the heirs more in

capital gains tax than an estate tax. An unmarried person's estate of \$3,500,000 paid no estate tax in 2009; however, the same estate in the modified carryover basis world may pay up to \$330,000 in future capital gains taxes at 2009 rates (and more at 2010 scheduled rates). Therefore, "be careful what you wish for," because we are now in uncharted waters in an area of the law where predictability is a priority.

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