

Estate and Financial Planning News You Can Use

January 2010

ESTATE AND GENERATION SKIPPING TRANSFER TAX LAWS – POSSIBLE OPPORTUNITIES AND PITFALLS

Brian K. Janowsky, Esq.

In 2009, there was significant attention provided regarding the scheduled 2010 repeal of the federal estate tax laws. This issue was addressed in our July 2009 and December 2009 newsletters, “Estate and Financial Planning News You Can Use.” Practitioners and commentators nationwide expected that Congress and the President would act prior to 2010 to prevent the scheduled repeal, especially in light of the current fiscal challenges facing the federal government. Congress and the President, however, were unable to take collective action. Therefore, the repeal is a reality.

(1) Is there really no estate tax? What about GST tax and gift tax?

(A) Estate Tax

As of January 1, 2010, the estate tax laws have been repealed. However, the repeal is scheduled only to apply to deaths occurring in the year 2010. Without further legislation, the federal estate tax is scheduled to be reinstated in 2011, at a tax rate of 55% and with only a \$1 million exemption per person. That rate and exemption are less favorable than the levels of 2009, which included a 45% tax rate and a \$3.5 million exemption. The repeal also brings a significant change in the income tax basis rules for property received from a decedent. (See (4) and (5) below.)

(B) GST Tax

The application of the Generation Skipping Transfer (“GST”) tax has been suspended in 2010. The GST tax normally applies to a transfer which “skips” a generation. The GST tax will continue to apply to certain transfers made prior to 2010.

(C) Gift Tax

The gift tax has not been repealed. The \$1 million lifetime exemption still applies. However, in 2010 the gift tax rate is 35%, compared to a 2009 gift tax rate of 45%.

(2) If I am married, what is the potential impact of the repeal on my estate plan?

Estate plans for married couples often involve a division of the first spouse’s assets into two parts. The first part is funded with property equal in value to the estate tax exemption in effect in the year of the first spouse’s death, and the second part consists of the balance. The first part is sheltered from tax at the death of both spouses. The second part is not taxed until the surviving spouse’s death. This division is often accomplished through the use of a formula that references concepts and terms provided within the estate tax laws. In 2010, these concepts and terms do not technically exist because of the repeal. Therefore, the formula could result in all of the property being allocated to the first part, or the second part (depending on the formula). That allocation may be contrary to your intentions.

Likewise, the repeal could also affect a charitable bequest funded by a formula or percentage that relies on concepts and terms of the estate tax law.

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(3) If I am single, what is the potential impact of the repeal on my estate plan?

If a single individual's estate plan creates a bequest at death (whether charitable or non-charitable) that is funded by a formula or percentage, the repeal could undermine the intended funding of the bequest in a fashion similar to that described in (2), above.

(4) Why should I be concerned with income tax basis? Isn't the repeal only for estate tax?

Prior to the repeal, a beneficiary's "basis" for the purpose of calculating capital gain in property received at a transferor's death "stepped up" to the date of death value of the asset. Accordingly, an immediate sale of the property by the beneficiary resulted in little to no taxable gain.

In 2010, subject to the exceptions described below, "carryover" basis applies to property received by death related transfer. That is, the basis of appreciated property received by a beneficiary is not increased to date of death value, but rather, equals the decedent's basis. Further, the basis of property which has a value at death that is less than the decedent's basis is reduced to that depreciated value, thus reducing the deductible loss on a subsequent sale.

(5) Are there any exceptions to the carryover basis rules?

The above carryover basis rules are modified with two exceptions in 2010. The first is a special basis adjustment which allows a decedent's basis in appreciated property to be increased by \$1.3 million, not to exceed the property's fair market value. The second exception applies specifically to property passing in a qualifying manner to a surviving spouse, by providing a \$3 million increase in basis.

In order to maximize the potential benefits of these new basis rules, additional planning may be necessary based on your specific situation.

(6) What possible legislative steps could be taken in 2010?

Congress and the President could take several actions, four of which are:

- (A) No action, which would result in no estate or GST tax in 2010, with a return to the higher rates in 2011, as explained above.
- (B) Reinstate the federal estate and GST tax laws during 2010, to be applied from the time of enactment. This could be a temporary extension until 2011, or a permanent fix going forward.
- (C) Reinstate the federal estate and GST tax laws during 2010, and apply the reactivation retroactively to January 1, 2010.
- (D) Permanent repeal of both the estate and GST tax laws.

(7) Is there any indication of what action will be taken?

It is unclear which action Congress and the President will take, however, it is our belief that steps will be taken to reinstate the estate and GST taxes in the current year, which may even be applied retroactively. If that is the case, an estate currently scheduled to be free from federal estate and GST tax could nonetheless be subject to those taxes at whatever levels Congress and the President approve. While there may be legal challenges to a retroactive application, the outcome is uncertain and the resolution of any challenge would not occur for some time. At this point, there is no way to predict what rates and exemption amounts would be applied.

(8) Are there positive planning opportunities because of the repeal?

(A) Direct Gifts

As stated above, although the estate tax is repealed and the GST tax is suspended, the gift tax is still effective at the \$1 million lifetime exemption level. However, unlike the 2009 gift tax rate of 45%, the gift tax rate in 2010 is only 35%. Individuals who wish to take aggressive action may consider making taxable gifts, and, if Congress and the President do not act, or they enact legislation with an effective date after the date of the gift, the tax rate would only be 35%. This would generate \$100,000 of savings on a \$1,000,000 taxable gift.

(B) Transfers That Skip A Generation

In 2010, an individual may be able to make various transfers that skip a generation without the application of GST tax. Such a transfer could be outright or in trust. In addition, if a trust is currently in existence, a transfer or distribution from the trust that skips a generation may also not be subject to GST tax. Further, if an individual is unlikely to survive 2010, he/she may consider creating a trust that skips a generation as part of his/her testamentary plan. Such a testamentary trust may be exempt from the application of GST tax after death.

(9) **If I am not comfortable with risk, are these opportunities appropriate for me?**

While opportunities may exist, individuals should beware of making taxable gifts and “skip” transfers during 2010. As discussed above, the passage of retroactive legislation could subject gifts to a tax rate of 45% or higher depending on the law, and impose a retroactive GST tax to transfers that skip a generation.

(10) **What steps should I take? Should I act quickly?**

Because of the uncertainty of the law and the manner in which the current law may affect your particular plan, we suggest you contact your attorney to review your estate plan. If planning opportunities exist in your particular situation, quick action is advisable.

The foregoing is only intended to provide a general discussion and, therefore, should not be relied upon for your estate planning needs. However, if you have any questions about this memorandum, or its application to your specific situation, please contact any of the members of our Estates and Financial Planning Practice Group listed below.

In Central New York, call 315-218-8000 or e-mail:

Joseph A. Greenman	jgreenman@bsk.com
Brian K. Haynes	bhaynes@bsk.com
Brian K. Janowsky	bjanowsky@bsk.com
James E. Mackin	jmackin@bsk.com
Elizabeth L. Perry	eperry@bsk.com
William J. Rubenstein	wrubenstein@bsk.com
Martin A. Schwab	mschwab@bsk.com
James N. Seeley	jseeley@bsk.com

In the Capital District, call 518-533-3000 or e-mail:

John R. Aldrich	jaldrich@bsk.com
Frank C. Mayer	fmayer@bsk.com

In Northern New York, call 315-343-9116 or e-mail:

Scott J. DelConte	sdelconte@bsk.com
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In Southwest Florida, call 239-659-3800

Dennis C. Brown	dbrown@bsk.com
Curtis B. Cassner	ccassner@bsk.com
James D. Dati	jdati@bsk.com
David L. Dawson	ddawson@bsk.com
Michael D. Gentzle	mgentzle@bsk.com
Adam C. Kerlek	akerlek@bsk.com
F. Joseph McMackin, III	jmcmackin@bsk.com
David N. Sexton	dsexton@bsk.com
Robert C. Zundel, Jr.	czundel@bsk.com

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