

2010 ESTATE TAX LAW

As you may have heard, the federal estate tax rules changed radically in 2010, and could change radically again in 2011 unless Congress passes new legislation. This article is intended to advise you of what has happened and encourage you to reevaluate your estate plan as soon as possible.

2001 Tax Act. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (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%.
- In 2010, the federal estate and GST taxes were repealed for one year.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%. Thus, you have to die or pay gift tax to get the benefit of the change. The step-up in basis rules (which gave a "fresh-start" fair market basis for most assets of a decedent) was replaced with an adjusted carry-over basis. 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- On January 1, 2011, EGTRRA is automatically repealed, resulting in an odd situation: A \$3.5 million estate and GST exemption and flat 45% estate tax rate in 2009, no estate or GST tax in 2010, and a \$1.0 million estate exemption and tax rate of up to 60% in 2011.

What Happened in 2009? Estate planning practitioners almost universally expected Congress to carry the 2009 estate tax rules through 2010. However, unexpectedly 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 may occur in 2010:

Congress may do nothing in 2010, in which case there is an adjusted carryover basis, and no federal estate or GST tax for people who die in 2010. While you probably will 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 (so called Marital/Family or A/B Trusts) could inadvertently disinherit some heirs and/or your surviving spouse 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.
- Inadvertent GST taxes could be incurred after 2010.
- Passing assets directly to your surviving spouse may result in higher estate taxes after 2010.
- Inadvertent state taxes could be incurred from out of date terms in your documents.
- Congress may adopt legislation to carry the 2009 rules over 2010, retroactive to January 1, 2010. There is broad disagreement on whether a retroactive tax bill would be constitutional. If a retroactive law it adopted, it will be challenged as unconstitutional and it could take years for the Supreme Court to rule on the issue. Until such a ruling, uncertainty will prevail. Those dying after any 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 permanent estate tax exemption, beginning in 2010 or 2011. If so, most commentators anticipate estate tax exemptions to fall between \$2-5 million and tax rates 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).
- States which remain "coupled" to the federal estate tax will have their state death taxes restored. Thus, if you own property in one of these coupled states, you could have new exposure to a state estate tax.
- The fair market value step up in basis returns for assets passing from a decedent.
- The top income tax rates go up by at least 4.6%, capital gain tax rates go up by up to 5% and dividend tax rates go up by up to 24.6%.

What Should You Do? 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. Please call us to schedule a time to go over your current estate plan and determine what changes need to be made to your current plan to minimize taxes and to reduce the possibility of future family conflicts in these chaotic times.