ESTATE TAX ALERT –
2010 ESTATE TAX REPEAL

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REPORT FROM COUNSEL

2010 FEDERAL ESTATE TAX AND GENERATION SKIPPING TAX

Beginning January 1, 2010 there was the temporary repeal of the federal estate tax and generation skipping tax for one year. There is much uncertainty as to what will happen with the estate and gift taxes by the end of this year. The alternatives are as follows: 1) the 2010 estate tax repeal will be repealed; 2) the 2010 repeal remains and the estate and gift tax rules return to the previous 2001 rules in 2011 with a $1 million exemption; 3) the 2010 estate tax repeal will be repealed retroactively; or 4) anything far and between.

There is uncertainty as to what the new scheme would be and whether it would apply retroactively to all death time and lifetime transfers made in 2010. Otherwise, under the new rules, it may be highly beneficial to *download* an estate through gifting and especially to younger generations. However, there is a risk in that these transfers may be susceptible to a

retroactive tax. Whether this risk is enough to dissuade taking advantage of the 2010 law depends on the particular and specific characteristics of each client.

Current Law:

On January 1, 2010 the federal estate tax and generation skipping tax ("GST") were repealed for one year, the gift tax transfer marginal rate was capped at a maximum of 35%, and there are new special limited carryover basis provisions for property transferred at death.

After 2010 the federal transfer taxes revert back to the 2001 rules where the estate tax and GST are reinstated and 1) the unified lifetime wealth transfer tax exemption is limited to $1 million; 2) the maximum marginal gift and estate tax rate is 55%; and 3) estates over $10 million will be charged a surtax of 5% between $10,000,000 and $17,184,000.

The take away from this is that the rules in year 2010 allow for much more room to minimize wealth transfer taxes. In calendar year 2010 if a person dies with a large estate, there will be no estate tax or GST consequences. For example, if someone had a $13.5 million net estate and died in 2009 (with the unified credit equal to a $3.5 million exemption) $4.5 million in federal estate taxes ($10 million * 45%) would be due at death and $9 million ($13.5 million - $9 million) would pass at death. In 2010 with the estate tax repealed, there would be no estate tax and the entire $13.5 million passes tax free at death.

However, this comes with a caveat. In years other than 2010 all property received by a beneficiary received a step up in basis to the fair market value of the property received as of the date of death of the testator. Thus, if the $13.5 million in assets had a tax basis of zero and $9 million was transferred after taxes, the beneficiary receives $9 million in property with a tax basis of $9 million. In 2010, there is an appreciation step up basis limitation of $1.3 million, so while the full $13.5 million is transferred; it only has a basis of $1.3 million. Thus, on a sale by the beneficiary, there is a sizable taxable gain for income purposes.

As a general rule, it may be more beneficial to make gifts in 2010 than in other years. There is a reduced maximum marginal gift tax rate of 35%. In 2011 this marginal gift tax rate will revert to the 2001 level of 55%. This means that for every dollar taxed at the 2001 maximum 55% gift tax rate, in 2010 there is a 36% (20%/55%) reduction in taxes for gifts transferred in 2010 versus 2011. Further, with the GST repeal, one could transfer assets to grandchildren without incurring a second level of tax. Generally, if assets are transferred to grandchildren a second layer of tax applies hypothetically as if the funds were transferred to the child and then retransferred to the grandchild. The current rules avoid this hypothetical second set of taxes.

Once again, starting in 2011, the federal estate and gift tax scheme would return to the 2001 tax scheme with only a $1 million federal exemption. This would mean that transfers above $1 million whether by way of a lifetime gift or at death would be taxed at the applicable higher 2001 estate and gift tax rates. The highest marginal tax rate for both estate and gift tax purposes will return to 55% from the 2009 level of 45%, and for estates over $10

million there will be a surcharge tax of 5% to recapture benefits from the $1 million exemption benefit.

Thus, if the current law remains in place throughout the year or any changes are not retroactive, there are much better estate and gift tax planning techniques in 2010 than 2011.

Risk of Congressional Retroactive Legislation:

At first blush, it may seem intuitive to suddenly gift as much as possible outside of the estate tax exemption to children and grandchildren in 2010 or at least before any possible change in legislation; however, it is not so simple. Many tax professionals, accountants, and attorneys believe that the 2010 temporary rules will likely be repealed and repealed retroactively. For example, if Congress votes to replace the 2010 rules with the 2009 or 2011 schemes and this is applied retroactively, then the gifts made in hopes of being under the 2010 repeal rules may turn out to be major mistakes and blunders in an estate plan. However, it has been debated among professionals that a retroactive enactment of a new tax may not be constitutional. Congress may not have the taxing authority and power to reinstate and enact a "new" estate tax and GST retroactively. Thus, on a theoretical legal basis, even if legislation is passed, it may be rejected by the Supreme Court.

In summary, there are four possible scenarios: 1) the current rules remain unchanged; 2) the rules are amended retroactively and this is constitutional; 3) the rules are amended retroactively but the retroactive provisions are disallowed by the U.S. Supreme Court as unconstitutional; or 4) Congress simply passes non-retroactive changes. Under scenarios 1, 3, and 4, other than in the odd chance of dying in 2010, it would be most beneficial to gift assets and property over the estate exemption before any such possible Congressional legislation. However, this is done at the possible risk that scenario 2 could happen. Whether this risk should be taken or not depends on the particular facts and circumstances of each client.

What the New Scheme Could Look Like:

Outside of whether the legislation is retroactive or not, there is speculation as to what an amended 2010 scheme would look like. While no one can be certain what legislation would be passed, considering that all Congressional bills are usually a complex amalgamation of differing political interests, there are certain schemes that tax professionals believe are more likely than others.

Some believe Congress will extend one or more of the 2002-2009 rules indefinitely. Others believe that Congress will just accelerate the 2011 rules under the current law so they are effective in 2010. There could also be anything far and between or above or below if Congress decides to make major changes to the most recent estate tax scheme. There is so much uncertainty.

What Steps to Take and Other Considerations:

To combat this, some high net worth individuals are making complex contingent wills

and trusts for different scenarios. For instance, a person may provide that if he dies in 2010 under the current law, some or even all of his assets [assuming his spouse and children are self-sufficient] would go directly to a trust for the grandchildren since there are no estate or GST consequences. If the person dies outside of 2010 or they die after the 2010 rules are amended, then the Will would provide that if this happens some assets can be diverted to a trust for a spouse to take advantage of the spouse's estate tax marital deduction and diverted away from grandchildren to avoid unnecessary GST consequences. Drafting a will that adapts to the different possible circumstances may be the only way to provide certainty and flexibility to fully take advantage of the current tax rules.

There may also be certain other circumstances where it may still be beneficial to gift. For example, if someone planned on gifting above the $1 million lifetime gift exemption within the next couple years for personal reasons, this is the time to do it. If the person makes the gift now, he will have the lower marginal tax rate and favorable GST treatment, but if the rules change, he may not be any worse off than if he waited a year or two. An example is if someone has a substantial amount of assets to make transfers to his children and grandchildren and still have enough too fully use an estate tax unified credit at death, he can make a transfer this year that may possibly be taxed at the lower 35% gift tax rate. If there is a retroactive change and it is taxed at the higher marginal tax rate, there is less risk for this individual in that it would have been taxed at the higher rate at his death. If the assets are appreciable or income producing, the benefit is having the appreciation and/or income out of his gross estate partially offsets any possible risk of retroactive tax treatment.

There are a number of other different scenarios where it would be beneficial to gift this year that may lead to a "win-not loses" situation. It depends on each client's unique facts and personal financial circumstances.

In summary, the possible changes in wealth transfer rules may be somewhat perplexing; however, after taking a step back, it is just another layer of uncertainty to deal with in the estate planning process. It is a fact specific evaluation where each client has his own subjective preferences which may be partially outside of the federal tax law. Taken together, it may be possible to plan against this uncertainty.

If anyone has any questions or inquiries concerning this subject matter, do not hesitate to contact us. Feel free to email us your questions or comments concerning this newsletter.

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