

CLIENT ALERT

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Repeal of Federal Estate Tax

January 4, 2010

Effective January 1, 2010, the federal estate and generation-skipping transfer (“GST”) taxes have been repealed. While this sounds dramatic, the repeal lasts only until December 31, 2010, according to the laws as currently written. The federal estate and GST taxes are scheduled to return on January 1, 2011. Further, it is widely believed that Congress will look to enact legislation in early 2010 which will likely “repeal the repeal”, and seek to reinstate the estate and GST taxes as of January 1, 2010.

However, Congress has had over eight years to address this issue, and has failed to do so. It was eight years ago, in 2001, that a law was enacted to repeal the estate tax for 2010, for individuals dying in 2010, and then return to the federal estate tax for those dying after 2010. Most people thought that the current Congress would undo the impending repeal well before its arrival on January 1, 2010, and perhaps temporarily keep the tax at 2009 levels (\$3.5 million per person exemption and 45% top estate tax rate), and maybe include inflation adjustments to the exemption amount. Incredibly, notwithstanding the introduction of proposed legislation on Capitol Hill over the past several years, nothing has been enacted to avoid the repeal. This leaves estate planning in a discombobulated state.

Though the concept of “repeal” sounds attractive, it doesn't necessarily mean that tax burdens will be eliminated for heirs of a decedent dying in 2010. This is because estate tax repeal includes a simultaneous repeal of the “step-up” in basis rules for income tax purposes. Prior to January 1, 2010, the death of a taxpayer caused most of his or her assets to have a “tax basis” equal to the value at the date of death, thus causing all unrealized appreciation to escape income taxes (i.e., capital gain taxes). The primary exceptions to the basis step-up rules were qualified retirement accounts, such as 401(k)s and IRAs, and annuities. Under the new rules effective January 1, 2010, surviving spouses will receive a step-up in basis up to \$3.0 million, while other heirs, including trusts, would receive a step-up in basis to \$1.3 million (sometimes referred to as “step-up exemptions”).

As a result of these income tax changes, new income taxes will replace the estate taxes, and some heirs may face higher combined estate and income tax costs if their loved one dies in 2010 rather than under 2009 federal estate tax rules (particularly for estates between roughly \$1 million and \$5 million).

As indicated above, the estate and GST taxes will return on January 1, 2011. At that time, an individual will be given a \$1 million exemption from federal estate and GST taxes (with the GST tax exemption adjusted for inflation), and the top federal estate tax rate will become 55%. The federal gift tax exemption would remain at \$1 million. This represents a significant change from the estate and GST taxes that existed in 2009, under which taxpayers had a \$3.5 million exemption from both the estate tax and the GST tax, and a top federal estate tax rate of 45%.

So what happens to the estates of decedents dying in 2010? Heirs of individuals dying in 2010 with larger estates (roughly \$5 million or more in assets) should save a substantial amount of taxes. On the other hand, heirs of smaller estates that would not have been subject to federal estate tax before 2010 may now have to pay income taxes that would not have been imposed prior to 2010.

Congress has intimated that, sometime during 2010, it will enact legislation to “repeal the repeal,” and make it retroactively effective as of January 1, 2010. On December 3, 2009, the House approved H.R. 4154, the “Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009.” The bill would make permanent the estate, gift, and GST tax laws in effect during 2009. The Senate has not acted on this measure or on a bill introduced in the Senate on November 19, 2009 to permanently extend estate tax. Under the Senate bill, the value of any estate above \$7 million per couple or \$3.5 million per individual would be taxed at a 45% rate (similar to the House bill). However, given Congress’ inability to address these issues prior to January 1, 2010, we are skeptical as to whether Congress will take any action prior to 2011.

Heirs of decedents with larger estates, who die before the President would sign any retroactive legislation, will likely look to challenge the constitutionality of any such legislation. There is U.S. Supreme Court precedent to support the constitutionality of retroactive estate tax legislation, most notably Carlton v. U.S., 512 U.S. 26 (1994), but the scope of the retroactive change in that decision was much narrower. Of course, heirs of smaller estates may conversely look to support the constitutionality of a retroactive change.

What should people be considering in the face of these developments?

Reviewing of Estate Plans – We believe everyone should consider revisiting their estate plans so that they are in the best position to maximize both the step-up exemptions as well as their federal estate tax exemptions. To maximize those exemptions, the most likely actions to be taken are the possible updating of Wills (and Revocable Trusts, if applicable) and the possible re-titling of assets between spouses.

Updating of Wills (and Revocable Trusts) – We think it is certainly advisable for people to review their estate plans in the light of these developments. This is particularly true for those with larger estates whose Wills or Revocable Trusts may contain “formula” divisions of an estate of a predeceasing spouse based on the federal estate tax (e.g., federal estate tax exemption in trust for the surviving spouse, and the rest outright to the surviving spouse). The same goes for formula divisions between charitable and non-charitable beneficiaries (e.g., federal estate tax exemption to children, and the rest to charitable organization), or which may be based on the use of the GST tax exemption. In certain of those situations, it may be advisable to make a technical update to the Will or Revocable Trust to address the possibility of a death during this repeal period, and maximize the use of step-up exemptions, yet at the same time be in the position to utilize federal estate tax exemptions when the federal estate tax comes back into effect.

Re-Titling of Assets – In many cases, we expect that a married couple’s titling of assets may not put them in the best position to take advantage of both the step-up exemptions and the federal estate tax exemption. While there will be limits in most cases as to how much can be done to get the best of both worlds, it is likely that some planning can be accomplished.

Gifts During 2010 – While the federal estate tax and GST taxes have been repealed, the federal gift tax remains in place ostensibly to avoid large scale shifting of income.

Annual Exclusion Gifting. Those who have been utilizing annual exclusion gifts (i.e., \$13,000 per year per person) to reduce their estates should continue such plans. This includes the use of such annual exclusion gifts with irrevocable life insurance trusts. Since it is generally believed that the repeal will be temporary at best, it seems inappropriate to abandon such giving, and certainly inappropriate to undo life insurance coverage that may be helpful in dealing with federal estate tax. The potential exception may be annual exclusion gifts where there is an intention to allocate some GST tax exemption.

Gifts to Utilize Lifetime Gift Tax Exemption. For those with larger estates, it has generally been advisable to make lifetime gifts to absorb the \$1 million lifetime exemption from the federal gift tax, and move future appreciation of the gifted assets out of the donor's federally taxable estate. This is often done via an irrevocable trust. There is a provision in the federal gift tax rules that became effective on January 1, 2010, which creates a potential planning opportunity for gifts to certain types of trusts. This planning opportunity is particularly attractive for those who still have their \$1 million lifetime gift tax exemption available, and who are willing and able to give away that amount of money or other property without compromising their personal financial security.

Transfers to Grantor Retained Annuity Trusts. During the repeal, the benefits of a transfer to a grantor retained annuity trust ("GRAT") are a bit uncertain, due to changes to the gift tax rules taking effect on January 1, 2010. Caution should be exercised in using a GRAT.

Gifts to Utilize GST Tax Exemption. Because there is no GST tax in 2010, there is also no GST tax exemption in 2010. As a result, transfers that are intended to be GST tax free, both now and in the future, need to be handled with care. The law as written creates some significant ambiguities in this area.

If you would like to discuss how these developments may affect you, please do not hesitate to contact a member of our Tax & Estates practice group.

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