

## 2010: The Year of Death Tax Repeal or Not?

*Background.* Legislation enacted in 2001 gradually increased the estate tax and generation-skipping transfer ("GST") exemptions and decreased tax rates (at all times, the lifetime gift tax exemption remained constant at \$1 million). In 2009, the estate and GST exemptions reached a peak of \$3.5 million and tax rates reached a low of 45%. In 2010, the 2001 legislation calls for a one-year repeal of the estate and GST taxes, a 35% gift tax rate (at least initially) and no "step-up" in basis (all discussed below). However, the 2001 legislation is scheduled to "sunset" on December 31, 2010, causing the pre-2001 law to become law again. Most estate planning practitioners believed Congress would act to extend the 2001 legislation. The House of Representatives did pass legislation to make permanent the 2009 exemption and tax rate levels; however, the Senate, being focused on health care reform, could not reach an agreement.

*2010 Tax Law.* The result is an uncertain new year for taxpayers. Beginning January 1, 2010, there is no estate or GST tax. The lifetime gift tax exemption remains at \$1 million, but the gift tax rate is 35% (it is tied to the top income tax rate, so if income tax rates change the gift tax rate may change). The news is not all good, however. Although estates of individuals passing in 2010 will not be subject to estate or GST tax, the beneficiaries of those estates will face complex rules regarding the income tax basis of property received by the beneficiaries from the decedent (income tax basis is used to determine gain when the property is sold). Prior to 2010, a beneficiary received inherited property with an income tax basis equal to the fair market value of the property at the decedent's date of death (generally, a "step-up" in basis). In 2010, the beneficiary, generally, will receive inherited property with an income tax basis equal to the decedent's income tax basis in the property (a "carry-over" basis). This will cause the beneficiary to inherit the built-in capital gains and resulting tax obligation if the property is sold. This may have unexpected and severe tax income tax consequences, and will most certainly affect more taxpayers than the estate tax system previously touched. The 2010 law does provide some relief by allowing for a \$1.3 million increase in the basis of appreciated assets and an additional \$3.0 million increase in basis of appreciated assets for certain transfers to a surviving spouse. However, estate plans may have to be changed to fully utilize those provisions.

*2011 Tax Law.* The estate tax repeal is, at most, a temporary event which ends abruptly on December 31, 2010. As of January 1, 2011, the law in effect prior to the 2001 legislation snaps back into place. The 2011 estate and gift tax exemptions will be \$1 million (the GST exemption also is \$1 million but indexed for inflation) with a top tax rate of 55% (plus a 5% surcharge on estates over \$10 million). The income tax basis for inherited property will revert back to prior law as well, with beneficiaries receiving property with a basis equal to the date-of-death fair market value of the property.

*What should you do now?* A myriad of proposals have been posited by members of Congress on this issue, including passing legislation retroactive to January 1, 2010, which would eliminate laws discussed above. We cannot be certain of any particular legislative action at this point. We recommend that clients consider the following:

- We strongly encourage you to contact us to discuss whether your estate plan should be updated to incorporate the necessary provisions to account for the new income tax basis rules. In addition, most estate plans will divide your assets upon your death based on formulas intended to minimize the estate tax liability. Because there is no estate tax in 2010, these formulas may operate to allocate your assets in a manner inconsistent with your wishes.
- Lifetime gifts to grandchildren may be more attractive in 2010. Because of the elimination of the GST tax, you can make direct gifts to your grandchildren (or to certain trusts for the benefit of your grandchildren) without incurring GST tax consequences, if GST tax is not retroactively reinstated.
- Estate-freezing techniques, such as grantor retained annuity trusts ("GRATs") and installment sales, may be attractive as well due to the lower gift tax rate and elimination of the GST tax, particularly in the current low interest rate environment.

Please contact an attorney with the Thompson Coburn LLP Private Client Practice Area to discuss these issues and to provide assistance in your estate planning matters. Note that planning for gifts and estate-freezing techniques briefly described above may be very time sensitive, and action may need to be taken before legislation is enacted in 2010.

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