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Federal Estate Tax Repealed Effective January 1, 2010

Congress Allows the Estate Tax to Disappear Into the Sunset – At Least Temporarily

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The specter of federal estate tax repeal on January 1, 2010 has been looming since the enactment of the Economic Growth and Tax Reconciliation Act of 2001 (“EGTRA”). Despite numerous legislative efforts on both sides of the aisle during the intervening years to deal with EGTRA’s peculiar estate tax repeal provisions, the United States Congress unexpectedly allowed the federal estate tax repeal to take effect under EGTRA’s sunset provisions. Consequently, estates of individuals who die after December 31, 2009 will not be subject to federal estate tax. Nevertheless, if Congress continues to take no action, under EGTRA the estate tax automatically will be reinstated at 2001 levels on January 1, 2011. As a result of this incongruous outcome, members of Congress have promised to take up the issue of estate tax early in 2010.

Background of EGTRA’s Repeal Provisions

EGTRA’s extraordinary one-year repeal of the estate tax and of the lesser-discussed generation skipping transfer tax (“GST tax”) during 2010 resulted from a mixture of the economic and political climate that existed in 2001 and congressional rules that prohibited measures from impacting budgets in remote years. Specifically, EGTRA provided for:

A phased increase in the lifetime exemption from estate tax and GST tax from their 2001 level of \$1 million per person to \$3.5 million per person in 2009;

A phased decrease in the top estate tax and GST tax rates from their 2001 level of 55% to 45% in 2007 and thereafter;

Repeal of the estate tax and the GST tax in their entirety on January 1, 2010; and

Reinstitution of the estate tax and GST tax at their 2001 levels (\$1 million per person exemption and 55% top rate) as of January 1, 2011.

Other provisions of EGTRA that will take effect on January 1, 2010 have significance:

- The federal gift tax remains intact, but at a reduced rate of 35% and with a \$1 million lifetime exemption; and
- Subject to certain exceptions described below, property acquired from a decedent will retain the decedent's income tax basis in the hands of the recipient.

Current Status – No Estate Tax, but Carryover Income Tax Basis

Prior to January 1, 2010, property acquired from a decedent as a bequest or inheritance received a new basis for income tax purposes. The value of the property as of the date of the decedent's death (commonly referred to as "stepped-up basis") became the new basis of the property in the hands of the beneficiary. Assuming that the value of the inherited property had increased from the time that the decedent acquired the property, the stepped-up basis was advantageous to beneficiaries who wished to sell the inherited property. The beneficiary could use the stepped-up basis for income tax purposes, thereby generating little, if any, gain on the subsequent sale of the property.

As of January 1, 2010, however, EGTRA mandates that property acquired from a decedent generally will retain the income tax basis that the property had in the hands of the decedent at the time of the decedent's death (commonly referred to as "carryover basis"). The new requirement to use the carryover basis is detrimental to beneficiaries who wish to sell inherited property that had increased in value between the decedent's acquisition of the property and the decedent's death. The adverse effects of the carryover basis may be ameliorated to some extent by the provisions in EGTRA that allow for an increase of up to \$1.3 million in the basis of certain assets of the decedent selected by the decedent's executor, plus an increase of up to an additional \$3 million in the basis (up to fair market value) of property passing to the decedent's surviving spouse, either outright or in a qualified trust. Generally, these provisions provide a decedent's executor with an opportunity to avoid capital gain tax by increasing the basis of those assets (up to the allowable basis limits) that the beneficiary most likely will sell.

Interestingly, there are expected to be many estates that would not have been required to file estate tax returns if the estate tax had remained in place with a \$3.5 million exclusion that will be adversely impacted by the new carryover basis provisions. It has been estimated that only 6,000 estates would have been impacted in 2010 by a continuation of the estate tax at its 2009 levels, but that the new carryover basis provisions will affect more than 71,000 estates.

Moreover, the change in the basis regime has resulted in increased recordkeeping burdens on taxpayers who now will need to retain or obtain cost and basis-adjustment information pertaining to inherited assets. It now will be incumbent on taxpayers to seek out information about the decedent's basis in inherited property. Unless the beneficiaries can provide information about the decedent's basis in the assets, the presumption is that the basis of such assets is zero dollars.

Congressional Action in 2010 – Retroactivity Issues

On December 3, 2009, the United States House of Representatives passed H.R. 4154 in an effort to avoid the repeal of the estate and GST taxes in 2010. That bill provided for the permanent extension of the estate and GST taxes at 2009 levels. Although the bill was sent to the Senate, it was not acted on, in part, because of the Senate's preoccupation with its debate over healthcare reform legislation. Senate Democrats have vowed to initiate discussions regarding estate tax legislation early in 2010. If Congress is successful in passing legislation in 2010, will such legislation be implemented retroactively to January 1, 2010? Although there is some legal precedent for retroactive application of tax laws, there is considerable uncertainty about whether reimposition of the estate and GST taxes on a retroactive basis would be constitutional. Court challenges to a retroactively applied statute certainly would be expected, and those challenges might take several years to resolve. This will cause a conundrum for the estates of decedents who die in 2010 before the enactment of a new estate tax regime.

Congressional Action – Possible Options for Debate

Recently, many estate tax-related issues have been debated in Congress. It is likely that many of these issues will surface again if and when the estate tax is debated in Congress in 2010. Some of these matters, and others, might find their way into final estate tax legislation:

Estate tax rate – 2009 level (45%) versus some lower rate (e.g., 35% or the capital gain tax rate).

Estate tax exemption amount – 2009 level (\$3.5 million per person) versus some higher amount (e.g., \$5 million or more per person).

Indexing of the estate tax exemption for inflation.

Portability of estate tax exemption between spouses – this would allow the unused portion of the exemption of a deceased spouse with little of his or her own assets to be used by the surviving spouse at his or her death.

Reunification of the lifetime gift tax exclusion and the lifetime estate tax exemption by increasing the gift tax exclusion to an amount equal to the estate tax exemption.

Reduction in tax benefit of Grantor Retained Annuity Trusts (GRATs) by limiting the term of a GRAT to a maximum of ten years.

Elimination of discounts for decedent's interests in family-controlled entities, such as family limited partnerships (FLPs).

Conclusion

There remains a great deal of uncertainty surrounding the future of the federal estate tax. It is unclear whether a permanent estate tax at 2009 levels can be agreed upon, or whether a compromise with regard to the tax rate and exemption amount can be forged. President Obama's first budget proposal in February 2009 presumed a permanent estate tax at 2009 levels. Therefore, it also remains uncertain with what amount of deviation the President will be comfortable. Given the significant level of uncertainty, it is difficult, at best, for individuals to plan their estates effectively without guidance from their professional advisors.

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