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Estate and Gift Tax Update - Changes in 2010 and Beyond

As of January 1, 2010, the future of each of the federal estate tax, generation-skipping transfer ("GST") tax and gift tax remains uncertain. In accordance with the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the federal estate tax and GST tax have been repealed for one year, beginning January 1, 2010. The federal gift tax remains in effect during 2010, but at a lower 35% rate. There continues to be a $1 million lifetime gift tax exemption and an annual gift tax exclusion of $13,000 per donee. Most importantly, EGTRRA also contains a "sunset" provision that, effective January 1, 2011, eliminates all of the exemption increases, rate decreases and other changes originally implemented by the act. Consequently, the federal estate tax and GST tax are scheduled to be reinstated in 2011, with a $1 million exemption and a maximum effective rate of 55%. The federal gift tax also rises in 2011 to a maximum marginal rate of 55%. Throughout this period, most states that impose an estate tax will continue to do so.

For the past eight and a half years, since the initial passage of EGTRRA in 2001, virtually all estate planners expected Congress to revise the federal transfer tax system at some point before the end of 2009. This did not happen, leaving the one-year repeal of the federal estate and GST taxes in effect. However, it is entirely possible that Congress still may enact legislation to reinstate these taxes in some form this year. Any new legislation also may apply retroactively to January 1, 2010, although the constitutionality of such a provision is unclear.

From a capital gains tax perspective, the tax treatment of inherited assets also has changed. For individuals dying during 2010, the former "step-up" in cost basis at death for assets acquired from a decedent has been repealed, and replaced with a modified "carryover basis" system. Prior to 2010, the cost basis for assets held by a decedent would step up (or down) to the fair market value of the asset on the decedent's date of death. This eliminated a capital gains tax on any pre-death appreciation. Under the carryover basis system, assets generally will receive a cost basis equal to the basis of the property in the hands of the decedent. This new carryover basis regime will, however, permit an executor to allocate up to $1.3 million of increased basis to the decedent's assets in general, and an additional $3 million for assets passing to a surviving spouse. Under current law, the prior step up in cost basis regime will return in 2011.

Where Do We Go From Here?

It is not clear what action, if any, members of Congress may take this year to address the current state of the law. They may successfully pass legislation effective as of January 1, 2010. They may pass legislation effective at the date of passage. As has been the case for the last eight and a half years, they may be unsuccessful in passing any legislation. In each case, the results would differ.

No matter what Congress does or does not do, many estate plans allocate assets among trusts or beneficiaries through the use of formulas that assume the existence of a federal estate tax. Plans prepared in the last several years may have anticipated the 2010 temporary repeal. In some cases there may be ambiguities caused by the current state of the law. This uncertainty arrives together with a severe financial upheaval which in and of itself may make a review of your plan a prudent exercise. Should you wish to determine how the current uncertainty or any realignment of your assets may impact your estate plan, please contact your attorney at Edwards Angell Palmer & Dodge LLP.