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Temporary Repeal of Federal Estate Tax and Generation-Skipping Tax

- Beginning January 1, 2010, the federal estate tax and generation-skipping tax are repealed for one year (or until earlier Congressional action).
- Gift tax is not repealed and will be 35%; consider making gifts in early 2010.
- Reinstatement of the estate tax is likely during 2010, but timing is uncertain and constitutional issues may prevent retroactivity.
- While there is no estate tax, estates of decedents dying after January 1, 2010, are subject to complicated carry-over basis rules.
- Existing estate plans should be reviewed, particularly if division of assets among beneficiaries is driven by a tax-based formula.
- If you are a risk taker, there may be a short window of time to make gifts to grandchildren free of generation-skipping tax. Importantly, we recommend you consult your estate planning attorney.

January, 2010—This has been an extremely busy fall and early winter for Congress—especially with the debate over health care reform. Amidst it all, the repeal and reinstatement of the federal estate tax was whispered through the halls but received only sporadic attention.

Because Congress failed to address the estate tax prior to January 1, 2010, the federal estate tax and generation-skipping tax are repealed for one year. This repeal may last for all of 2010, or may be halted by Congressional action at any time during the year. There will likely be an attempt to reinstate the 2009 tax rates and exemptions, but there is no certainty any such reinstatement will be retroactive to January 1.

We expect Congress will reinstate the estate tax sometime after the first quarter of 2010, but the timing depends entirely upon (1) other issues before Congress and (2) legislators' perception of how this will impact the November mid-term elections. The odds are high some legislators will fight to make the new estate tax retroactive for all estates of decedents dying after January 1, 2010. Thus, such estates will need to reserve sufficient funds to pay estate tax until Congress decides not to make the tax retroactive, or until all court challenges to retroactivity are exhausted. The court challenges will be based upon significant constitutional issues. Of note, John Buckley, the Chief Tax Counsel of the House Ways and Means Committee, expressed he believes retroactivity is unconstitutional.

We believe Congress will act (though, virtually no one thought matters would go this far). Failure to act during 2010 means that in 2011, the estate and gift tax rate jumps to 55% and the exemption amount falls to $1,000,000. The mid-term elections will almost certainly be the catalyst forcing some resolution before the end of the summer. For more background on how we got to this point, and what estate tax reform might look like in the future, see the article in Glenmede's Fall 2009 *Perspectives*, "The Sunset May Not be Pretty."

What Happens To Decedents' Estates Created After January 1, 2010, but Before January 1, 2011 (or earlier reinstatement of the tax)?

There is no federal estate tax or generation-skipping tax to pay. State death tax may still be due. Although the federal estate tax is repealed, estates of decedents dying after January 1, 2010, also lose the step-up in cost basis formerly applied to estate assets.

Under pre-2010 law, most assets in an estate get a new tax cost basis equal to the asset's fair market value on the date of death. Capital gains realized after death are computed from the date of death value. Under the new 2010 rules, there is no comparable automatic step-up in cost basis. However, at the date of death, any asset with a fair market value less than the tax cost of the asset will have a cost basis step-down.

To ease the burden of unrelenting capital gain, the executor is deemed to have (1) a fund of $1,300,000 which he may use to step-up the basis of the assets chosen by him and (2) a second supplementary fund of $3,000,000 which he may use to step-up the basis of any assets passing directly to a surviving spouse, or a qualified trust for the spouse's benefit.

New carry-over basis rules will apply broadly to all estates, not just the large estates previously touched by the estate tax. We expect that the complexity caused by these new carry-over basis rules will cause hardship.

Should You Be Concerned About Your Current Estate Planning?

Yes and no. You may be elated there is no estate tax but, does its elimination change the distribution of your estate? The estates which may be most significantly impacted are those which rely upon a tax-based formula to split the estate amongst beneficiaries.

The most common estate planning creates a Marital Trust and a Residuary Trust (often called a bypass trust, a family trust or an exemption trust). In its simplest terms, the tax-based formula tells the executor or trustee to fund the Residuary Trust with the largest amount that can pass free of estate tax (*i.e.*, the "exemption amount," $3,500,000 in 2009) and the remaining estate passes to the surviving spouse (or Marital Trust). Estate planners have used this formula instead of a fixed amount because the "exemption amount" has varied over the years and most families choose to both minimize and postpone tax for the longest possible time by taking advantage of the marital deduction. But this formula no longer works if there is no "exemption amount." In the example given, with no "exemption amount," all estate assets will pass to the Residuary Trust and none to the Marital Trust. Depending on your estate planning goals, this may or may not be a good result for your family.

If your estate plan uses a tax-based formula, you may want to consult with your estate planning attorney. Similarly, you may want to revisit this if your estate plan includes charitable provisions largely meant to take advantage of favorable tax provisions. Consulting your estate planning attorney is particularly necessary if you or a family member is ill, or if there is concern of high mortality risk in 2010.

What Estate Planning Opportunities Exist with This Temporary Hiatus?

Planning opportunities will exist only to the extent that Congress is unsuccessful making the new estate, generation-skipping and gift tax retroactive to January 1, 2010. With this in mind, if you are a risk taker, there may indeed be some opportunity.

If you previously fully used your gift tax exemption (currently $1,000,000) and you plan to make year-end taxable gifts despite the gift tax (45% prior to 2010), then postponing these gifts is wise. Similarly, if you had not contemplated making taxable gifts, you may want to consider doing so early in 2010. While you must still pay gift tax even after the estate tax is repealed, the rate for 2010 is only 35%. If the new estate and gift tax is retroactive, the risk is that you may be required to pay a higher gift tax rate. There is also a risk that, even if a higher tax rate does not apply, any new estate tax might introduce modifications that later tax your remaining assets at a higher rate to compensate for the fact that you paid less gift tax in 2010.

The case for making gifts to grandchildren during the estate tax hiatus is particularly appealing since the generation-skipping tax is also temporarily repealed. You should consider making outright gifts to your grandchildren to fully utilize your remaining $1,000,000 gift tax exemption, or even tacking a GST trust onto a GRAT.

We note that the annual exclusion amount of $13,000 for gifts to individuals remains unchanged throughout the year. As always, we advise that you make these gifts, particularly if you have estate assets valued at or greater than $3,500,000 (or $7,000,000 per couple).

What Will Happen If Congress Takes No Action in 2010?

If Congress does not enact new estate tax legislation in 2010, the estate tax reappears much the same as before the 2001 legislation. We will have a $1,000,000 exemption amount for both estate tax and gift tax, the generation-skipping tax will be reinstituted and the highest tax rate will be 55%. Special provisions enacted after 2001 for conservation easements, installment payments for estate tax on some closely held businesses, and other targeted provisions will not re-appear.

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