



March 31, 2010

Re: Estate, Gift, and GST Taxes in 2010

Dear Client:

It is remarkable that as we enter the second quarter there is still no real certainty regarding the application of the federal wealth transfer taxes in 2010 and beyond. In this letter, we review the circumstances surrounding this uncertainty and consider various possible outcomes.

### **The Law in Effect Prior to 2010**

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 – sometimes referred to as “EGTRRA” – the highest estate, gift, and generation-skipping transfer (“GST”) tax rates generally were 55%. Individuals were entitled to an aggregate “exemption” from estate and gift taxes of up to \$675,000, with different exemptions available for GST taxes. With the passage of EGTRRA, however, the impact of these taxes was greatly reduced over the next eight years, so that by 2009, the following rates were in effect:

<b>Tax</b>	<b>2009 Maximum Tax Rate</b>	<b>2009 Exemption Amount</b>
Estate	45%	\$3.5 million
Gift	45%	\$1.0 million
GST	45%	\$3.5 million

### **The Current Law as It Stands in 2010**

Under EGTRRA, the above provisions have changed dramatically for 2010. The main highlights are as follows.

- There is **no** federal estate tax for persons dying in 2010.
- The gift tax remains in effect, but the rate has dropped to 35%. The exemption amount is unchanged at \$1 million.
- There is **no** GST tax in 2010 on generation-skipping transfers (such as gifts to grandchildren or distributions from trusts to grandchildren).

Thus, at least for 2010, the federal estate and GST taxes have been repealed, and the gift tax has been reduced. Yet, there is a hidden cost associated with these changes. Specifically, **new basis-adjustment rules now apply.**

- Heirs now generally inherit assets at the decedent’s tax basis, commonly known as a “carryover basis.” In the past, they benefitted from a “stepped-up” basis equal to the assets’ fair market value at the time of death.
- Since this change may generate large capital gains taxes, Congress offered limited relief as follows:
  - Up to \$1.3 million in cost-basis increases for assets owned by decedents; and
  - Up to an additional \$3 million in cost-basis increases if the assets pass outright to a surviving spouse or through certain qualifying trusts.

<b>Tax</b>	<b>2010 Maximum Tax Rate</b>	<b>2010 Exemption Amount</b>
Estate	repealed	repealed
Gift	35%	\$1.0 million
GST	repealed	repealed

### **The Current Law as It Would Apply in 2011 and Beyond**

Also included in EGTRRA is a “sunset” provision. Under this provision, without action from Congress, in 2011 the estate and GST taxes will be restored; the top rates of tax will be increased back to 55%; and the exemption amounts will be reinstated at levels substantially lower than their 2009 levels:

<b>Tax</b>	<b>2011 Maximum Tax Rate</b>	<b>2011 Exemption Amount</b>
Estate	55%	\$1.0 million
Gift	55%	\$1.0 million
GST	55%	\$1.0 million (inflation adjusted)

Additionally, a 5% surtax will apply to estate and gift transfers between \$10 million and \$17,184,000, and the new carryover-basis rules described above will be replaced with the former date-of-death basis step-up rules.

### **Some Consequences of the Temporary Estate Tax Repeal**

For the first time since 1915, there is no federal estate tax currently in place. There is also no GST tax for the first time since 1976. It would be natural to assume that the temporary repeal of the estate and GST taxes will, in all cases, be a positive development. Yet, it actually may disrupt many carefully crafted estate plans.

Some estate plans, for example, contain formula provisions that automatically transfer assets into “credit shelter,” “marital,” and other trusts by reference to the expected application of the estate tax. For many years, these provisions have been a popular mechanism for reducing estate taxes. With the temporary elimination of the estate tax, however, individuals who die during 2010 may now have their assets pass disproportionately to certain trusts in a manner that was never intended.

Moreover, the implementation of the new carryover-basis rules during 2010 has the potential to reduce the benefits otherwise offered by the repeal of the estate tax. Some have estimated that 70,000 people could be affected by the carryover-basis rule this year, compared to the 6,000 who would have paid estate tax under the old law. The imposition of the carryover-basis rule could also lead to increased recordkeeping burdens associated with determining the proper cost basis of assets that passed from the decedent.

It should also be noted that the uncertainty surrounding the federal estate tax may be compounded by the application of various state-level estate taxes. It is therefore important to reconsider the implications of your current plan in conjunction with your state's estate tax (if any).

### **Possible Outcomes**

Many are speculating as to the eventual resolution of the uncertainty surrounding the estate, gift, and GST taxes. Several members of Congress have expressed a desire to extend the 2009 tax rates and exemption levels retroactively to January 1, 2010. Congress could also reenact an estate and GST tax at some point during 2010, making the law effective upon enactment rather than applying it retroactively. It is also possible that Congress will not act on this issue in 2010 and that EGTRRA will "sunset" as planned, resulting in the reinstatement of estate, gift, and GST taxes similar to those of 2001. Of course, there are many possible variations of these outcomes, and we must carefully monitor the activity (or inactivity) of Congress this year.

For estates created in 2010, the uncertainty of how Congress will act and whether it will impose laws retroactively creates numerous issues with the estate administration process. For example, administrators will be required to grapple with issues such as how much liquidity to generate for estate taxes and how to allocate the cost-basis increases described above to the various assets within the estate.

In light of the current state of the law, we recommend that you consider having your estate planning documents reviewed. In the meantime, if you have any questions about this or any other matter, please contact your financial counselor.

Very truly yours,



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