

Tax Insights

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Estate tax repeal in 2010 raises transfer tax issues

The estate tax officially disappeared on Jan. 1, 2010. This temporary estate tax repeal was signed into law 10 years ago as part of *Economic Growth and Tax Relief Reconciliation Act of 2001*, which included several other important transfer tax changes for 2010.

In addition, beginning for one year on Jan. 1, 2010, the gift tax is reduced to 35 percent, the generation-skipping transfer (GST) tax is repealed and the step-up-basis rules at death are severely limited.

This drastic and temporary change in transfer tax rules raises many issues for taxpayers with carefully crafted estate plans. Opportunities and concerns are magnified by the scheduled return to 2000 transfer tax rules beginning in 2011. The outlook is also complicated by the prospect of congressional action to change the 2010 rules — action that could be retroactive to Jan. 1, 2010, and extended into 2011 and beyond. Before making any decisions, taxpayers should understand the current rules and political outlook, and consult an estate planning professional.

Current law

In 2009, the exemptions for the estate tax and GST tax reached \$3.5 million per spouse, and the top rate of each was reduced to 45 percent. The gift tax exemption in 2009 remained at \$1 million, while the top rate was reduced to 45 percent. In 2010, the estate and GST taxes both disappear completely, while the gift tax (with the \$1 million exemption) is reduced to 35 percent.

In 2011, the transfer taxes are scheduled to revert to the law in place before 2001. That means the gift, estate and GST taxes will be reunified with top rates of 55 percent and an exemption of just \$1 million. Only the GST exemption will be indexed for inflation. (See table 1).

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Table 1 Estate, gift, and generation-skipping tax rates and exemptions under current law						
	Estate tax		Gift tax		GST tax	
	Exemption	Top rate	Exemption	Top rate	Exemption	Top rate
2009	\$3,500,000	45%	\$1,000,000	45%	\$3,500,000	45%
2010	Estate tax repealed	Estate tax repealed	\$1,000,000	35%	GST tax repealed	GST tax repealed
2011+	\$1,000,000	55%	\$1,000,000	55%	\$1,000,000 (+inflation adjustment)	55%

Besides the exemptions and rates, there are several other transfer tax rules that will change over the next two years. In 2011 the state death tax credit, which was repealed for several years, will return. 2010 also includes several one-year changes. New Section 2511(c) is effective for gifts made after Dec. 31, 2009, but sunsets after 2010. It could limit some estate planning techniques involving grantor trusts as it treats transfers to trusts as a gift unless the trust is wholly owned by the donor or the donor's spouse.

Most importantly, the automatic step-up in basis at death disappears in 2010. Previously, heirs were allowed to "step-up" the basis of inherited property to the property's value at the time of the decedent's death. The basis of property inherited in 2010 will be limited to the lesser of its basis in the hands of the decedent or its value at the time of death. Estates will be able to allocate just \$1.3 million in basis to increase the bases of assets up to their value at the time of death, while another \$3 million can be used to increase the bases of assets given to a surviving spouse.

Political outlook

Democratic lawmakers have announced their intention to reinstate the estate and GST tax for 2010 and possibly make this change retroactive so that it applies to the entire year. This effort could run into political and legal challenges, but it is important to remember that it is possible a retroactive change could be enacted and upheld by the courts.

It is also possible that Congress will enact a purely prospective change to the estate tax for 2010, or the retroactive portion of the tax could be struck down by courts. If Congress proposes a prospective change to the estate, gift and GST tax for part of 2010, lawmakers are likely to use an effective date of the day the bill is introduced. This would prevent a rash of gifts being made as taxpayers scramble to take advantage of the time between a bill's introduction and its enactment.

Most Democrats support extending 2009 transfer tax rules permanently to prevent both estate tax repeal in 2010 and the return to 2000 law in 2011. The House in 2009 voted 225 to 200 in favor of an estate tax bill (H.R. 4154) that would permanently extend the 2009

exemption of \$3.5 million and top rate of 45 percent. This bill did not index the exemption for inflation.

With a slimmer Democratic majority and several conservative Democrats, Senate leaders will have a more difficult time passing an estate bill. They may be forced to compromise with Republicans, who would be trading the temporary repeal in 2010 for better permanent rates and exemptions. Sens. Jon Kyl, R-Ariz., and Blanche Lincoln, D-Ark., have proposed a compromise with a \$5 million exemption and top rate of 35 percent, which could also be phased in gradually.

Table 2 Estate tax reform options for 2011 and beyond		
	Per spouse exemption	Top rate
Current law	\$1 million	55%
House bill (H.R. 4154)	\$3.5 million	45%
Kyl/Lincoln compromise	\$5 million	35%

Democrats could attempt a short-term fix that covers only 2010 and possibly 2011 — and then return to the issue later. It is unclear whether any estate tax legislation will address issues besides the rates and exemptions, such as the return of the state death tax credit and Section 2511(c). Many observers believe it is likely that any legislation will retroactively restore the basis “step-up” rules for all decedents’ estates in 2010, even if the estate tax itself is not retroactively reinstated for the entire year.

Implications

The current, future and potential changes in the law present an excellent opportunity for taxpayers to consult with their estate planning professionals. In many instances, estate planning documents may need to be revised to plan for these changes. In addition, other potential opportunities presented by these changes in the law should be explored.

The potential swings in the exemptions and rates from year to year (or even month to month depending on legislation) also could have implications for many estate planning techniques that use formulas based on rates and exemptions to divide and dispose of an estate. The potential for rule changes in basis step-up and Section 2511(c) — if left in place for 2010 — could also affect planning strategies. Contact an estate planning professional for advice about dealing with your specific situation.

Any transfers or estate planning techniques based on the current repeal of the GST tax and a gift tax rate of 35 percent should be considered with care, due to the possibility of retroactive reinstatement of the GST tax and a retroactive increase in the gift tax rate. If you are considering such a strategy, it will be important to contact an estate planning professional to examine all the possible scenarios.

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