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THE ESTATE TAX IN 2010: THE YEAR OF UNCERTAINTY IN DEATH AND TAXES

By: Dorothy L. Korszen
January 2010



According to Benjamin Franklin, "Nothing can be said to be certain, except death and taxes." This year, however, we can expect much uncertainty regarding both death and taxes. For the first time since Congress passed the 1916 federal estate tax, there is currently no federal estate tax in effect for calendar year 2010. The Economic Growth and Tax Relief Reconciliation Act of 2001, among other provisions, increased the estate tax exemption amount from \$675,000 in 2001 to \$3.5 million in 2009, then called for no estate or generation skipping transfer (GST) tax in 2010, with all provisions of the Act "sunsetting" after that. As a result, the estate, gift and GST taxes that applied in 2001 will again apply in 2001. In the absence of further legislation, the estate, GST and gift tax exemption amounts effective on January 1, 2011, will again be \$1 million, and the maximum estate and gift tax rate of 55% reinstated.

It was generally assumed that Congress would not let 2009 pass without enacting an estate tax. Much to the surprise of estate planning professionals, 2009 ended with no new estate tax legislation. Although the House passed a bill to permanently extend the 2009 estate tax laws, the Senate did not address this bill. Many people expect Congress to address these issues later in 2010, and perhaps to make legislation retroactive so that an estate or GST tax enacted later in the year will apply to persons who died after January 1, 2010. Commentators are already voicing opinions on whether such retroactive legislation will be constitutional.

Modified Carryover Basis. Under prior estate tax law, those who inherited property generally received a stepped-up basis so that their new basis in inherited property would be the date of death fair market value of the property. If he or she sold the property at that value, he or she may not have realized a gain and therefore avoid paying capital gains taxes. However, for those passing away in 2010, the basis of inherited property is the "modified carryover basis," which will be the lesser of the decedent's adjusted basis or the fair market value of the property on the date of death. This means there will be no step-up in basis, but there can be a step-down. There are two exceptions which may provide some relief. The personal representative of an estate may allocate up to \$1.3 million (with some adjustments allowed) to increase the basis of assets, and up to \$3 million for a surviving spouse.

To illustrate, assume that the decedent purchased property for \$100,000, and that property was worth \$1 million at the date of death. Under the prior law, a beneficiary would inherit the property with a stepped-up basis of the fair market value at the date of death, that is, \$1 million, so would not pay capital gains tax upon the sale of the property if sold for \$1 million. Under the law in effect today, the beneficiary's basis would be \$100,000. If the beneficiary sold the property for \$1 million then the beneficiary would pay either short term capital gains tax of up to \$315,000, or long term capital gains tax of \$135,000 if the beneficiary waits at least a year to sell the property, unless the personal representative is able to allocate basis to this asset.



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As we often see today, the decedent may have paid \$1 million for property that was later worth \$300,000 at his date of death. In that case, the beneficiary would receive a stepped-down basis of \$300,000, which would be the less of the decedent's basis or the fair market value on the date of death.

Gift Tax. The gift tax will continue in 2010 with a \$1 million exemption and a 35% top tax rate. The top gift tax rate in 2009 was 45%. Donors who wish to make taxable gifts may elect to do so in 2010 instead of in 2011 when the top tax rate may be 55%. The \$13,000 annual exclusion still applies in 2010.

GST. The generation skipping transfer tax is a tax imposed on certain transfers of assets from a donor to a related person younger than one generation from the donor and certain transfers to unrelated persons more than 37-1/2 years younger than the donor. These are known as "skip" persons. With no GST tax in 2010, donors may consider making gifts to grandchildren and younger persons. However, the risk of retroactive application of a subsequently enacted GST must be considered.

Trusts. As part of their estate planning, married couples often use trusts which provide that upon the death of the first spouse a portion of the assets are used to fund a credit shelter trust with the remaining assets passing to the surviving spouse outright or in trust. Often, the estate tax exemption amount is used to fund the credit shelter trust with the intent of removing these assets from the surviving spouse's taxable estate. If there is no estate tax in 2010, and the terms of the trust state that the exemption amount will pass to the credit shelter trust, then all of the deceased spouse's assets may pass to the credit shelter trust with no assets passing to the surviving spouse. If a person has left his or her credit shelter trust to his or her children, then the children could receive the entire estate to the exclusion of the spouse. Estate planning documents could be reviewed to determine whether changes should be made due to the possible impact of no estate tax.

This year one should keep advised of estate tax legislation so that plans can be prepared to minimize estate, GST and gift taxes due and take advantage of any opportunities to transfer assets under this new more advantageous tax regime. There is presently great uncertainty about what the tax system will be in 2011, and even the state of the current tax system, considering the possibility of retroactive changes.

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