

private client services update

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UNCERTAINTY SURROUNDS IMMINENT ESTATE TAX REPEAL

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While it may be true that in this world nothing is certain, except death and taxes, uncertainty dominates the future of federal estate taxes after Congress's apparent failure to enact legislation before year end. The failure to enact legislation means that the federal estate tax, which yields approximately \$25 billion annually in taxes, will be repealed at midnight, December 31, 2009. The repeal of the estate tax may, at first blush, appear to be a victory for those that have fought to get rid of the tax and a welcome simplification for many taxpayers who have long been frustrated by the complexity of the laws. The victory, however, may be hollow as the repeal creates even more uncertainty due to the less often cited repeal of the current "stepped-up basis" rules, the likelihood that the repeal will be short-lived and the problems that could arise if Congress attempts to retroactively reenact the estate tax next year. Faced with this uncertainty, planners and clients, especially those with health issues, must ensure that estate plans are structured to address these changes. Similarly, fiduciaries administering estates with decedent's dying in 2010 must be aware of the changes and plan for the possibility of a retroactive reenactment.

Current Law – EGTRRA

Although the issues surrounding the impending repeal have garnered little attention from the press until recently, Congress has known about the repeal and the potential confusion it could create since the current estate tax laws were enacted during the Bush administration as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Under EGTRRA, the estate tax and generation skipping transfer (GST) tax exemption amounts have gradually increased to their current \$3.5 million exemption and estate and gift tax rates have gradually declined to their current 45% rate. This means each individual can pass \$3.5 million free of federal estate tax to someone other than a spouse or charity. (There is an unlimited deduction allowed for assets passing to a spouse or charity). Any amount in excess of the \$3.5 million is subject to the 45% tax. In addition, if more than \$3.5 million passes to someone more than one generation removed from the decedent or donor (e.g. a grandchild or great grandchild) an additional 45% GST tax would be imposed on such transfers.

EGTRRA has always provided for a one year repeal of the federal estate tax in 2010. Proponents of the law would have liked to make the repeal permanent, but to reduce the cost a sunset provision was added to EGTRRA. Under the sunset provision, the repeal will only be effective for 2010. After that the estate and gift tax laws revert back to the laws in effect before EGTRRA. Accordingly, the estate and GST tax exemptions will be reduced to \$1 million and the tax rate will be 55% for most estates. Below is a summary of the EGTRRA:

Current Estate and Gift Tax Laws Under EGTRRA			
	2009	2010	2011
Federal Estate Tax Exemption	\$3.5M	Repealed	\$1M
Top Federal Estate Tax Rate	45%	N/A	55% and 5% surtax on estates between \$10M and \$17.184 M
Stepped up Tax Basis	Yes	Limited to \$1.3M for non-spouse and \$3M for spouse	Yes
Federal GST Tax Exemption	\$3.5M	Repealed	\$1M

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Top Federal GST Tax Rate	45%	N/A	55%
Federal Gift Tax Exemption	\$1M	\$1M	\$1M
Top Federal Gift Tax Rate	45%	35%	55%
Annual Gift Tax Exclusion	\$13,000	\$13,000 (indexed)	\$13,000 (indexed)
Long Term Capital Gains Rate	15%	15%	20%

Practical Effect of Repeal

While estate planners have dealt with the uncertainty created by the potential repeal, most felt Congress would surely enact some form of legislation before 2010. Even though healthcare has dominated the Congressional agenda this fall, there appeared to be momentum for estate tax reform as the year drew to an end. On December 3, 2009, the House passed a bill permanently extending the current \$3.5 million estate tax exemption and 45% estate tax rate. The House and Senate have since adjourned and are not scheduled to reconvene until next year. Thus, we are left to address the practical effects of an imminent repeal.

Estate and GST Tax. The repeal of the estate and GST tax would appear to permit those dying in 2010 to pass an unlimited amount of assets free of federal estate tax and GST tax. Although the possibility of an estate tax free year has caused Representative Richard E. Neal to lament "If you are at the checkout counter, you might want to expedite things," reliance on the repeal should be cautioned. Indeed, Senate Finance Committee Chairman Max Baucus said he will try next year to pass retroactive legislation ensuring no lapse in the estate tax. Moreover, the potential nightmare (discussed below) that could accompany the corresponding repeal of the stepped-up basis rules may force Congress to support retroactive application.

Given the potential amounts at stake, some estates with decedents who die after repeal but before new legislation is passed may seek the aid of the courts in attempting to prevent retroactive application. There is, however, some precedent that would support retroactive application of a new estate tax law. Specifically, when Congress raised the estate tax rate in August 1993 to 55% and made the raise retroactive to January, the estates of two taxpayers who died in the spring of 1993 filed suit challenging Congress's ability to make the law retroactive and lost. Although next year's battle would be over the retroactive application of the law itself (assuming it is passed retroactively), rather than the rate, only time will tell whether this distinction will make a difference in the eyes of the courts.

Gift Tax. Unlike the estate and GST taxes, gift tax is not repealed under EGTRRA in 2010. The gift tax rate, however, is reduced from 45% to 35%. The lower rate should facilitate more taxable giving, but again, the possibility of retroactive reform could nullify the apparent benefits of the rate decrease. Anyone considering making a taxable gift in 2010, should consult with their advisors early in the year to take advantage of any potential tax breaks.

Stepped-Up Basis and Capital Gains Tax. While the repeal of the estate tax and GST tax would likely only affect a relatively small segment of taxpayers, the repeal of the current stepped-up basis rules could affect an enormous number of taxpayers. Under the current step-up rules, whenever someone inherits property, his or her tax basis becomes the fair market value at the decedent's date of death (or the value six months after the date of death in limited circumstances). Thus no capital gains tax is paid on the appreciation that occurred during the decedent's lifetime under the current law. In 2010, these rules will be replaced with a modified carryover basis rule under section 1022 of the Internal Revenue Code. Under these new rules, a recipient's basis in the inherited property will be the lesser of the adjusted basis in the property or the fair market value the date of death. The executor of each estate will be permitted to increase the basis of assets owned by the decedent and transferred at death by \$1.3 million. Assets left to a spouse may receive an additional \$3 million basis increase, producing the potential to protect a combined \$4.3 million. Importantly, however, the spousal property basis increase is allowed only

for property passing to a surviving spouse outright or in a qualified terminable interest property (QTIP) trust. Thus property passing to a typical credit shelter trust may not qualify for the additional \$3 million spousal basis increase. The carryover basis rules are set to sunset along with the other EGTRRA provisions in 2011.

Not only does the repeal of the stepped-up basis rule affect more taxpayers, the implementation of the rules may be a nightmare for executors. First, executors will be required to determine and report to the IRS the decedent's adjusted basis in each of the decedent's assets. For assets that have been owned for decades, this could be a daunting task unless the decedent kept meticulous records. Second, the executor must decide how to allocate the potential \$4.3 million in basis adjustments. As few estate planning documents have been drafted to provide specific guidance on allocation of basis adjustments, this too may prove challenging for executors. Another challenge executors may face is balancing the carryover basis rules with the need to sell assets to raise cash to cover estate expenses and the debts of the decedent, the need to reallocate assets to ensure the assets are invested prudently and the need to fund trusts, all of which can trigger capital gains tax.

Planning During Uncertainty

While it is apparent that the federal estate tax, GST tax and stepped-up basis rules will be repealed on January 1, we do not know how long the repeal will last. Conventional wisdom suggests that sometime next year Congress will reenact the estate and GST taxes with an exemption amount in the neighborhood of the \$3.5 million exemption, perhaps indexed for inflation, adopt a tax rate somewhere in the 35-45% range and reenact the stepped-up basis rules. Perhaps greater questions remain regarding whether some or all of the components – estate tax, GST tax, tax rate, and step-up rules – will be applied retroactively. Regardless, estate planning clients, particularly those in poor health, should ensure that their documents are flexible and structured to account for the upcoming changes, such as ensuring that their plan permits full utilization of the \$4.3 million increase in basis.

Likewise, executors of estates of decedents dying in 2010 should be mindful of the impending changes. In particular, executors should be familiar with the modified carryover basis rules to ensure any potential basis increases are maximized and properly allocated among the decedent's assets and to prevent the unnecessary triggering of capital gains taxes. Executors should also be mindful of potential repeal when distributing assets and consider withholding sufficient assets to pay any potential estate taxes.



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