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Foulston Sieffkin Issue Alert
Estate Planning

Unexpected Repeal of Federal Estate Tax

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This **Alert** is for the purpose of advising you of recent significant changes in the federal taxation of gifts and estates. Such taxes are often referred to as "transfer taxes."

Basic Changes

As you may well have heard in the media, effective January 1, 2010, the federal estate tax was repealed for a one year period. This repeal was pursuant to a "sunset provision" under the provisions of a tax law enacted in 2001. Such one year repeal also includes the federal generation-skipping transfer tax. This was a totally unexpected event. The vast majority of estate planners and political pundits had fully expected Congress would act to extend the federal estate tax beyond December 31, 2009, at an applicable exclusion amount at least equal to the $3.5 million amount that was in effect in 2009.

During this one year hiatus the federal gift tax remains in effect at the same $1.0 million lifetime exclusion amount in effect in 2009. Also remaining applicable is the 2009 annual gift tax exclusion amount of $13,000 and exclusions for gifts for certain health and education expenses. However, the gift tax rate for taxable gifts in excess of such $1.0 million lifetime exclusion amount is 35%, as opposed to the prior 2009 top gift tax rate of 45%.

In connection with the foregoing repeal of estate and generation-skipping taxes in 2010, there is a limitation imposed on the so-called "step-up" in income tax basis with respect to assets of decedents dying in 2010. With some exceptions (relating mostly to assets having unrecognized untaxed income such as qualified retirement plans and IRAS), prior to 2010, all assets includible in a decedent's estate for federal estate tax purposes (irrespective of whether the estate was large enough to be subject to estate taxation) normally received a new income tax basis equal to their fair market value at the time of the decedent's death. For decedents dying in 2010, however, there is now a limitation imposed on the overall "step-up" in basis. That limitation is $1.3 million of increased basis, with a possible additional $3.0 million increase in basis with respect to assets left in a certain type of trust for the benefit of a decedent's surviving spouse.

Possible Congressional Action in 2010

If Congress enacts any transfer tax legislation in 2010, it appears highly likely that it would generally impose the same transfer taxation laws in effect in 2009, with at least a $3.5 million estate tax applicable exclusion amount. However, it is uncertain whether any re-imposed estate tax would be imposed retroactively to decedents dying on or after January 1, 2010, as well as to all gifts and generation-skipping transfers (e.g., gifts to grandchildren and transfers from irrevocable trusts to grandchildren) made on or after that date and prior to the reenactment. Although such retroactivity once appeared likely, there presently appears to be a decided difference of opinion among Congressional leaders on this issue. If any transfer tax law enacted in 2010 is made retroactive, there is bound to be litigation on its legality, which litigation would be expected to eventually reach the US Supreme Court. The prevailing view among estate and gift tax scholars is that such retroactivity would be upheld as constitutional by the Court.

In the Interim

Even if the law is made retroactive, there is a real possibility that Congress will give taxpayers who die on or after January 1, 2010, and prior to the effective date of reenactment, or who made a taxable gift during such period, a choice as to whether to be taxed under the new law or under the current law. One possible situation where it might be advisable to be taxed under the current 2010 law prior to such reenactment would be the estate of a decedent who died during such interim period and did not have an estate large enough to be subject to federal estate taxation under the provisions of the reenacted law, but had more than $1.3 million of "built-in" gain which would be adversely affected by the limitation on the "step-up" in basis under current law. By agreeing to be taxed under the re-enacted estate tax, the taxpayer's estate would receive an unlimited "step up" in basis without being large enough to be subjected to any estate tax liability. Another situation would be a taxpayer who made a taxable gift during such interim period and did not wish to be taxed at a higher gift tax rate under the reenacted law.

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Effect if Congress Fails to Act in 2010

Unless Congress acts in 2010, the law in effect prior to 2001, not 2009, will once again govern estate, generation-skipping and gift taxation effective January 1, 2011. Given the highly partisan political atmosphere in Washington, it is certainly not beyond possibility during this election year that Congress will fail to act, as it failed to do with regard to extending the 2009 transfer tax rules. Although the 2010 limitations on the maximum "step-up" in income tax basis would go away if transfer taxation reverted to pre-2001 law in 2011, such prior law only had a $1.0 million lifetime applicable exclusion amount cumulatively for both estate and gift taxes and a high maximum transfer tax rate of 55%, as opposed to a maximum 45% rate applicable in 2009. Some other estate tax benefits enacted since 2000, such as a deduction for conservation easements, also would go by the wayside.

What Such Changes May Mean to You

The uncertainty posed by the foregoing changes and possible Congressional enactments this year is enormous. However, some general conclusions can be made. First, only a very small percentage of estates not subject to federal estate taxation will be affected by this period of uncertainty (although whether the value of estates impacted by federal estate taxation will be $3.5 million or $1.0 million is strictly dependent upon whether Congress acts this year). Secondly, a very clear majority of taxpayers having estates subject to federal estate taxation will see no need to make changes to their estate plan at least until the transfer tax laws are settled. Exceptions include: (1) those who wish to take advantage of the lower 35% gift tax rate this year and are willing to risk that they are not adversely affected by a retroactive enactment of the old gift tax rates; and (2) with respect to married persons who have a Family Trust/Marital Trust arrangement following their deaths under the provisions of their Wills or Revocable Trusts, who may wish to have such provisions revised to make their intent clear as to such division. There can be uncertainty in their interpretation should death occur under current law, for such division assumes there is an estate tax then in effect. The most likely problem scenario is when the primary beneficiary under the Family Trust portion is not the surviving spouse. Most, but certainly not all, other estate plans are not in need of attention during this current period of uncertainty. Nonetheless, it is an important reminder that any estate plan which has not been reviewed in the last two years should be reviewed to determine if modifications are in order for other reasons, e.g., as a result of intervening changes in the family situation, changes in estate planning law, or because the named fiduciaries or provisions for beneficiaries are no longer appropriate.

Summary

We felt it important to alert you of the foregoing transfer tax changes and possible legislation in a manner which brings them into proper perspective without causing any undue alarm. The bottom line is that the foregoing federal transfer tax changes and Congressional uncertainty will not cause many persons to change their estate plans or employ any estate planning techniques in this interim period prior to the transfer tax laws becoming more settled. However, the impact of such changes on any particular estate plan is very fact sensitive and thus no generalizations in this notice as to their impact on your estate should be relied upon. We suggest individuals currently having an estate of over $1.0 million, or who have a formula clause under the provisions of their Will or Revocable Trust dividing their estate into a Family Trust/Marital Trust type of arrangement, or who have bequests in their planning documents tied to the generation-skipping tax exemption, should at least have their estate plans reviewed to ensure that no implementation of any estate planning techniques or alterations to their estate planning documents are warranted in this interim period.

Should you have any questions with respect to the above discussion or desire to seek an appointment to review your estate plan, please feel free to contact our office.

For Further Information

Foulston Siefkin regularly counsels clients on issues relating to Estate Planning and Probate. If you are interested in additional information regarding these matters, please visit our website at **www.foulston.com** or if you would like to discuss specific ways in which Foulston Siefkin can help you, contact **Tim O'Sullivan** at (316) 291-9564, or at tosullivan@foulston.com, or **Stewart Weaver** at (316) 291-9736, or at sweaver@foulston.com.

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