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E-Report on the Estate Tax "Mess"

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Last week it became apparent that Congress will not take any action before the end of 2009 to prevent the scheduled dramatic changes in the federal gift tax, estate tax and generation-skipping transfer tax from taking effect. It is possible, indeed we think probable, that there will be legislative action in 2010, effective either for the period after Congress acts, or, more likely, retroactive to January 1, 2010.

In the meantime, however, there is a possibility that for at least some of 2010, beginning January 1—

- Federal gift tax rates will be 35%, rather than 45% (the 2009 rate) after the $1,000,000 exemption is used;
- There will be NO federal estate tax on estates of individuals who die during this period, rather than a 45% tax on the portion of an individual's assets in excess $3.5 million (the 2009 rate and exemption);
- The income tax basis of assets owned by individuals who die during this period will equal the individual's pre-death income tax basis of the same assets (if lower than date of death value), subject to some specific adjustments (such as a general $1.3 million basis increase, and a $3 million additional increase in the case of some gifts to spouses), rather than their value at death (the 2009 rule); and
- There will be NO generation-skipping transfer tax (GST tax) on transfers to grandchildren or others in their generation or in lower generations, rather than a 45% tax on such transfers, except to the extent that a $3.5 million GST exemption protects such transfers from tax (the 2009 rule). (The gift tax will, however, continue to apply to lifetime transfers to grandchildren if no exclusion applies and the $1,000,000 exemption has been used.)

In the unlikely event that Congressional inaction continues into 2011, beginning January 1, 2011,

- Federal gift tax rates will be graduated beginning at 41% (after the $1,000,000 exemption) and rising to 55%;
- The federal estate tax will apply to estates of individuals who die in 2011 or after and such estates will be subject to rates equal to the gift tax rates (or temporarily to

60% for some larger estates) once the combination of taxable gifts and the estate exceed $1,000,000;

- The income tax basis of assets owned by individuals who die during this period will equal their value at death (step-up in basis); and
- GST tax will be imposed at a flat rate of 55% on direct or indirect transfers (including through trusts) to grandchildren or others in their generation or in lower generations, except to the extent that the transfer is protected from tax by allocation of the GST exemption to the transfer which will be limited to $1,000,000, adjusted for inflation.

Probably more detail than you wanted or needed. The question then becomes: will Congress act after the new year to reinstate the taxes and, if so, will the reinstated taxes be retroactive to January 1? The answers to these questions are unknown. Unfortunately, in our opinion there is little one can do to take advantage of the situation because Congress could make legislation retroactive in which case you could end up with a substantial gift tax and possibly generation-skipping transfer tax to pay.

If Congress acts, it is likely that it will extend the 2009 law or perhaps increase the exemption and reduce the rates. It is also possible, although we believe less likely, that Congress will reduce the exemption (say to $2,000,000) or increase the rates (perhaps on a graduated basis). Moreover, there is some chance that whatever change is ultimately made will be accomplished by so-called "loophole closing" amendments that restrict or eliminate estate planning possibilities from techniques such as GRATs and family partnerships.

In summary, we believe this is a wait and see proposition as it is impossible to know if Congress will act retroactively. Finally, if it begins to look like the estate and generation-skipping taxes will be eliminated for a significant period of time, your will should be examined to make sure that it accomplishes your non-tax objectives.

~Clare