

ESTATE TAXES...WHAT A MESS

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CURRENT LAW

As the law now stands, there is no estate tax on individuals dying in 2010, the generation skipping transfer (GST) tax has been repealed for 2010 and the basis rules have changed for 2010, subjecting heirs to the possibility of capital gains tax on the appreciation in the value of inherited assets. The gift tax exemption remains at \$1 million, however, the rate of tax on gifts in excess of the exemption amount has decreased to 35% (in 2009 the rate was 45%).

It is unknown whether a legislative "fix" will be enacted before the end of 2010. On December 3, 2009, the House of Representatives passed the Permanent Estate Tax Relief for Families, Farmers and Small Businesses Bill of 2009 (H.R. 4154), which would have permanently extended the \$3.5 million exemption (\$7 million for a married couple) with a flat estate tax rate of 45%. The bill failed to win support in the Senate. Technically, Congress has a nine-month window to change the estate tax regime or extend the 2009 estate tax regime retroactively to January 1, 2010 before the estates of decedents dying on January 1, 2010 would be required to file an estate tax return.

To sum up, we are now in a very strange place with no federal estate tax on those who happen to die this year and a confiscatory tax looming over those who happen to die after December 31, 2010. This bizarre situation will continue until the law changes, which everyone seems to think it will (keep in mind those same people also said that Congress would fix this before January 1, 2010).

BACKGROUND

2009 Estate & Gift Tax Limits		2010 Estate & Gift Tax Limits		2011 Estate & Gift Tax Limits	
Lifetime gift tax exemption:	\$1 million	Lifetime gift tax exemption:	\$1 million	Lifetime gift tax exemption:	\$1 million
Federal estate tax exemption:	\$3.5 million	Federal estate tax exemption:	No Tax	Federal estate tax exemption:	\$1 million
Generation skipping exemption:	3.5 million	Generation skipping exemption:	No Tax	Generation skipping exemption:	\$1 million
Maximum gift and estate tax rate:	45%	Maximum gift tax rate:	35%	Maximum gift and estate tax rate:	55%

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed the estate tax and the generation skipping transfer (GST) tax for estates of individuals dying in 2010. EGTRRA substantially increased the estate tax exemption in stages after 2001 from \$675,000 to \$3.5 million in 2009. The gift tax is not being repealed during 2010 as is the estate tax.

FEDERAL ESTATE TAX

Until recently, the estate tax was irrelevant to the overwhelming majority of individuals because only a small percentage of individuals, under the estate tax rules that were in effect for 2009, had assets worth more than \$3.5 million (\$7.0 million for a married couple), the levels below which estates were entirely exempt from the tax. Amounts above those thresholds were taxed at a 45% rate. The one-year repeal of the estate tax has been a part of the law since the Bush tax cuts were enacted in 2001. In 2011, when those tax cuts expire, a greater percentage of individuals will be subject to the federal estate tax since the estate tax will come roaring back to life with a \$1 million exemption for individuals (\$2 million for a married couple) and amounts above those thresholds will be taxed at a 55% rate.

MODIFIED CARRYOVER BASIS REGIME

Effective for individuals dying in 2010, EGTRRA repeals the stepped-up basis rules and replaces them with a modified carryover basis regime. The modified carryover basis rules provide that the basis of assets inherited will be the lower of the fair market value on the date of death or the decedent's original basis in the asset. Thus, the income tax basis of property acquired from a decedent's estate holding significant appreciated property generally must be carried over from the decedent under this repeal.

EGTRRA allows executors to partially increase the basis of inherited property by up to \$1.3 million (only \$60,000 for nonresident aliens) and an additional \$3 million in the case of property passing to a U.S. citizen surviving spouse. Further appreciation will be subject to tax when the asset is sold.

This rule leaves the inherited property's gain being taxed upon its sale by either the estate or the beneficiaries at the maximum capital gains tax rate. EGTRRA does not allow for a "fresh-start rule," whereby an asset's basis would be stepped up to the fair market value as of the date of death ("stepped-up basis"). As a result, the first \$1.3 million of unrealized capital gains in an estate is exempt (only \$60,000 for nonresident aliens) and an additional \$3 million in capital gains is exempt if those assets go to the surviving spouse).

Example without allocating basis increase	Example allocating basis increase
<p>Example 1: Parent died on January 2, 2010 and left Child 1,000 shares of ABC Co. stock. At the time of Parent's death, Parent had a basis of \$1 million and the fair market value of the shares is \$5 million.</p> <p><u>Carryover basis regime:</u> Child's basis in the stock will be carried over and remain \$1 million. Assuming Child sells the stock the next day at fair market value (\$5 million), Child will have to pay tax on \$4 million in capital gain upon the sale of the stock.</p> <p><u>Stepped-up basis regime:</u> Child's basis per share will step up to its date of death value of \$5 million. Assuming Child sells the stock the next day at fair market value (\$5 million), Child pays no tax upon the sale of the stock.</p>	<p>Example 2: Parent died on January 2, 2010 and left Child investment real property. At the time of Parent's death, Parent had a basis of \$1 million and the fair market value of the property is \$5 million.</p> <p><u>Carryover basis regime:</u> Child's basis in the property will be carried over and remain \$1 million. Up to \$1.3 million can be allocated to increase the basis in the inherited property. Assuming the entire \$1.3 million is allocated to this asset and Child sells the property the next day at fair market value (\$5 million), Child will have to pay tax on \$2.7 million in capital gain upon the sale of the property.</p> <p><u>Stepped-up basis regime:</u> Child's basis in the property will step up to its date of death value of \$5 million. Assuming Child sells the property the next day at fair market value (\$5 million), Child pays no tax upon the sale of the property.</p>

As a result, in 2010 beneficiaries will have to deal with any capital gains incurred from the sale of their inherited property, and those taxes will be based on the assets' original value when purchased by the deceased, rather than the value upon transfer, known as stepped-up basis.

Nearly all large estates would face new administrative burdens since their owners would have to know the original purchase price of every asset in the estate in order to calculate their capital gains tax liability. Previously, all assets in an estate were simply valued at fair market value on the date of the decedent's death.

GIFT TAX

Under EGTRRA, the gift tax is retained despite the repeal of the estate and GST taxes in 2010. The federal gift tax is imposed on the fair market value of gifts made during the donor's (the person giving the gift) life. The gift tax is applicable only to the value of the gift or gifts given to any particular person during a calendar year that exceeds the annual gift tax exclusion amount. The annual gift tax exclusion amount, which is inflation indexed, is \$13,000 for 2009 and 2010. If a donor elects to split gifts with his or her spouse, the first \$26,000 of gifts to a particular individual during a calendar

year is excluded from the gift tax. In 2010, to the extent the value of a gift exceeds \$13,000 (\$26,000 for a married couple) it is subject to gift tax at the 35% rate.

Year	Top Gift Tax Rate	Exemption Amount
2009	45%	\$1 million
2010	35%	\$1 million
2011	55%	\$1 million

GENERATION SKIPPING TRANSFER (GST) TAX

The GST tax ensures that the transfer of wealth will be taxed on each generation. The GST tax is imposed on taxable terminations, taxable distributions and direct skips (a skip person may be a natural person who is one or two generations below that of the transferor).

Normally, when you give assets directly to your grandchildren or set up a trust to do so, you need to plan for the GST tax. The GST tax is in addition to the estate and gift tax.

For purposes of determining the GST tax, each individual is entitled to a lifetime GST exemption. The lifetime GST exemption is equal to the amount that is excludable from the estate tax. For 2009, the GST exemption was \$3.5 million. In 2010, there is no GST tax and for 2011, the GST exemption is \$1 million.

Example 1	Example 2
<p>Grandparent makes a lifetime taxable gift to Grandson of \$1.5 million in 2009.</p> <p>Grandparent has the ability to allocate \$1.5 million of the \$3.5 million lifetime GST tax exemption to this gift. As a result, no GST tax would be due as a result of the gift.</p>	<p>Grandparent makes a lifetime taxable gift to Grandson of \$1.5 million in 2011.</p> <p>Grandparent allocates \$1 million of the \$1 million lifetime GST tax exemption to this gift. Grandparent will have to pay a GST tax on the \$500,000 excess.</p>

CAN CONGRESS PASS A RETROACTIVE ESTATE TAX LATER IN 2010?

Many expect that Congress will bring the estate tax back from limbo before long, probably making it retroactive to the start of 2010. There have been many instances where Congress has changed tax laws retroactively. That is not to say that there will not be any lawsuits challenging the constitutionality of a retroactive estate tax. If the stakes are high enough, beneficiaries will challenge it and there will be lawsuits.

WHAT CAN YOU DO?

Option 1: Nothing. The one-year repeal of the estate tax has been a part of the law since 2001. Congress had nine years to do something about it but here we are, in 2010, with no estate tax.

Option 2: Change your existing estate planning documents based on the law as it exists as of January 1, 2010. You may need to change your estate plan later if Congress reinstates the estate tax retroactive to January 1, 2010.

Berliner Cohen will continue to monitor the activities of Congress relating to this and will update as necessary. In the meantime, if you have any questions regarding your estate plan, please contact your Berliner Cohen attorney or any member of the Estate Planning group:

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