

Estate Tax Update

Since the enactment of The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), most estate planners have believed that there would be estate tax legislation preventing the 2010 repeal, and providing for meaningful estate tax reform. With just days remaining in 2009, Congress had not been able to agree on any of the estate tax reform proposals that have come forth in the last few years. Legislation was not enacted before the scheduled repeal of the estate and GST taxes on January 1, 2010.

You will recall that with regard to estate taxes, EGTRRA gradually reduced the maximum estate tax rate, as well as increased the estate tax exemption, from 2001 through 2009. In 2009, the maximum rate is 45% and the federal estate exemption is \$3.5 million. The EGTRRA provisions for 2010 become effective January 1, repealing the estate tax for decedents dying in 2010. However, even that is not completely reliable because it is possible that estate tax legislation will be passed in the coming year. Democratic Senate leaders have said that in 2010 they will seek to restore the 2009 estate tax rules. If new legislation is passed, it will likely reinstate the estate tax, and could make it retroactive to the beginning of the year. If there is no new legislation passed in 2010, the EGTRRA sunset provision provides that beginning in 2011, the estate tax would revert to a top rate of 55% and an exemption of only \$1 million.

To add further complexity to the issue, EGTRRA also provides for a form of "carryover basis" for decedents dying in 2010. Under current law, assets passing to beneficiaries upon a decedent's death are generally eligible to receive a new tax basis equal to their value on the date of death - the so-called "step-up basis" - eliminating the recognition of income on any appreciation that occurred prior to the date of death. Property transferred by a lifetime gift generally keeps the same basis as in the hands of the donor, known as a carryover basis. Under the EGTRRA rules for 2010, property passing to a beneficiary at death will be treated in a similar manner as if transferred by gift. The tax basis of property acquired from a decedent will generally be the decedent's basis, with two exceptions. The tax basis of property owned by the decedent and passing to beneficiaries will be increased to its date of death value, up to an aggregate of \$1.3 million. Property passing outright or in a qualifying trust for the surviving spouse will have its tax basis increased up to \$3 million. While the carryover basis rules may only be in effect during 2010, it is important that clients keep detailed records of the cost basis of assets. Under current law, in 2011 these carryover basis provisions will be eliminated, and there will be a return to the traditional step-up basis rules for inherited property.

In addition to repealing the estate tax, EGTRRA contains a provision which completely repeals the estate and generation skipping transfer ("GST") taxes. However, the gift tax exemption remains at \$1 million with a reduced top rate of 35%. As with the estate tax, the gift and GST taxes for 2010 may be changed by new legislation. In the absence of new legislation, the gift and GST taxes will revert to pre-EGTRRA law in 2011. Traditional lifetime gifting in order to reduce one's estate at death remains a viable planning technique because it is unlikely that the zero estate tax rules of 2010 will be made permanent. In fact, lifetime gifts may have increased advantage when the estate tax rates return to 55% in 2011.

While many of us hoped that 2010 would bring clarity to the estate tax rules we are faced with continued uncertainty in the area of estate, gift and GST tax laws, as well as the dealing with the 2010 carryover basis rules. This current uncertainty requires vigilance in drafting. We need to build in the flexibility required if the estate tax repeal and carryover

basis remain in force for deaths occurring in 2010. Particular attention needs to be paid to formulas and related provisions dividing any estate into credit-shelter/family trust and marital bequest/trust portions. Documents should clearly instruct executors and trustees how the estate is to be distributed if there is no federal estate tax at death, and contain provisions addressing any carryover basis rules in effect at death. Effective estate planning takes into account current laws and builds in the flexibility needed to address future changes in those laws.

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