

**2001 Tax Act.** In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which provided for significant phased-in increases in the federal estate, gift and generation skipping tax (GST) exemptions and lower tax rates. EGTRRA provisions included:

- ◆ In 2009, the estate and GST exemptions increased to \$3.5 million per decedent, with a flat 45% estate and GST tax rate on any excess. The gift tax exemption was \$1.0 million, with tax rates from 41% to 45%.
- ◆ In 2010, the federal estate and GST taxes were repealed for one year. The gift tax \$1.0 million exemption remained, with a lower flat tax rate of 35%. Thus, you would have to die or pay gift tax to get the benefit of the change. The step-up in basis rules (which gave a "fresh-start" fair market basis for most assets of a decedent) were replaced with an adjusted carry-over basis. These new basis rules permit a step-up in basis of up to \$1.3 million, plus an additional \$3.0 million for certain spousal transfers at death.
- ◆ On January 1, 2011, EGTRRA was automatically repealed, resulting in an odd situation: A \$3.5 million estate and GST exemption and flat 45% estate tax rate in 2009, no estate or GST tax in 2010, and a \$1.0 million estate exemption and tax rate of up to 60% in 2011.

**What Happened in 2009?** Estate planning practitioners almost universally expected Congress to carry the same 2009 estate tax rules across 2010 (both Representative Rangel as Chair of the House Ways and Means and Senator Baucus as Chair of the Senate Finance Committee said it would happen earlier last fall). However, unexpectedly in December, the House failed to act on a one-year extension and instead sent the Senate a bill to make the 2009 rules permanent. Because the Senate was focused on health care and since there was already a broad disagreement on what to do with estate taxes, Congress enacted no changes to EGTRRA's 2010 rules. Thus, effective as of January 1, 2010, there is no federal estate or GST tax.

**Planning in Chaos.** Congress' failure to adopt estate tax legislation in 2009 and the possibility that changes will not be adopted during 2010, radically change the estate planning considerations for many of our clients. For example, Congress has indicated that in 2010 about 6,000 decedents will benefit from the elimination of estate taxes, but over 70,000 heirs will pay higher income taxes because of the change in the income tax basis rules for assets received from decedents.

**2010 Changes.** The U.S. has an unpredictable planning environment in which any number of radically different changes may occur in 2010: Congress may do nothing in 2010, in which case there is an adjusted carryover basis, and no federal estate or GST tax for people who die in 2010. While you probably will not die in 2010, you still need to consider planning for that possibility, because not planning for these changes, if death occurs, can be disastrous for your heirs. For example:

- ◆ Formula clauses (e.g. terms that allocated your estate exemption to a "by-pass trust") in your planning documents could inadvertently disinherit some heirs and/or your surviving spouse and/or create conflicts among family members on how your documents should be properly interpreted.
- ◆ Conflicts could arise among your heirs and fiduciaries on asset basis issues.
- ◆ Inadvertent GST taxes could be incurred after 2010.
- ◆ Passing assets directly to your surviving spouse may result in higher estate taxes after 2010.
- ◆ Inadvertent state taxes could be incurred from out of date terms in your documents.

Another possibility is that Congress may adopt legislation to carry the 2009 rules over 2010, retroactive to January 1, 2010. There is broad disagreement on whether a retroactive tax bill would be constitutional. If a retroactive law is adopted, it will be challenged as unconstitutional and it could take years for the Supreme Court to rule on the issue. Until such a ruling, uncertainty will prevail. Those dying after any enactment should not have that uncertainty. In any event, your estate plan

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# 2010 Changes to Federal Estate Tax Rules

should have provisions about dying both before or after a potential retroactive enactment which may or may not be deemed constitutional.

If Congress acts in 2010 to address the estate tax issues, it could:

- ◆ Adopt permanent estate tax exemption, beginning in 2010 or 2011. If so, most experts anticipate estate tax exemptions to fall between \$2 to 5 million and tax rates of 35% to 45%.
- ◆ Adopt a temporary higher estate exemption.
- ◆ Adopt rules to limit or eliminate valuation discounts.

**2011 Changes.** Unless Congress enacts new legislation in 2010, then on January 1, 2011, a number of automatic changes occur to the federal tax code, including:

- ◆ The estate tax exemption drops to \$1.0 million per decedent.
- ◆ The estate tax rate increases (e.g., 55% above \$3 million and 60% above \$10 million).
- ◆ States which remain "coupled" to the federal estate tax will have their state death taxes restored. Thus, if you own property in one of these coupled states, you could have new exposure to a state estate tax.
- ◆ The fair market value step-up in basis returns for assets passing from a decedent.
- ◆ The top income tax rates go up by at least 4.6%, capital gain tax rates go up by up to 5% and dividend tax rates go up by up to 24.6%.

**Virginia Pending Legislation.** Currently before the Virginia legislature is a bill (HB 755) that would adopt a rule of construction for interpreting formula clauses in wills and trusts for decedents who die in 2010 stating that these formulas are to be construed as if the decedent died in 2009. However, the bill does not address all the issues, including the maximization of the limited step-up

in basis. Of course, it only affects our Virginia clients.

**Higher Taxes.** No matter what happens to the estate tax, substantial tax increases are looming. A \$12 trillion deficit is projected for the next decade. The Congressional Budget Office indicates that the Social Security Trust Fund will pay out more than it receives starting in 2011 or 2012. Taxes will have to increase across a broad range of Americans. Both the Washington Post and the New York Times have stated that the President will have to abandon his pledge to only increase taxes on taxpayers earning over \$250,000. Given slow economic recovery and the fact that we are in a mid-term election year, the federal government will probably not increase taxes until sometime in 2011. While substantial tax increases are likely, we just don't know any details.

**ROTH IRAs.** In 2010, taxpayers can convert traditional IRAs to ROTH IRAs and can pay the income taxes due on such conversion in 2010 or equally in 2011 and 2012. There are significant benefits and traps for the unwary in making these decisions. Effectively, unless Congress adopts new legislation, in 2010 the estate tax rules rotate 180 degrees from where they were in 2009, and then rotate 180 degrees again in 2011 – only the estate tax and income tax rules could be even worse than what we had in 2009. Uncertainty makes it difficult to plan, but waiting to see what happens next is not a good idea. The earlier you can implement flexible tax and estate planning to respond to these changes the better.

Please feel free to contact us with any questions or feel free to pass this on to a friend or family member who you think might benefit from our help.

We encourage you to call and schedule a time to go over your current estate plan and determine what changes need to be made in order to minimize taxes and to reduce the possibility of future family conflicts in these chaotic times.