

Understanding the 2010 Estate Tax Repeal

The start of a new year often signals a time for change--especially when it comes to taxes, and 2010 has brought some major changes. As of January 1, the federal estate and generation-skipping transfer (GST) taxes are repealed, and the step-up in basis rule is modified for 2010. While it's possible (and some believe very likely) that Congress will reinstate these taxes, until that time, it's important to understand these significant federal tax law changes and how they might affect you.

FEDERAL ESTATE TAX REPEAL

In 2009, the top estate tax rate was 45%, and estates received an exclusion of \$3.5 million (meaning that up to \$3.5 million of assets were exempt from estate tax). However, as part of the tax cuts initiated in 2001, the estate tax is repealed for 2010 but is scheduled to return in 2011, albeit with a reduced \$1 million exclusion and an increased top tax rate of 55%.

It's possible Congress may reinstate the estate tax retroactively, that is, back to January 1, 2010, in which case heirs who already received their inheritance may have to reimburse the estate to enable it to pay the reinstated estate tax. On the other hand, heirs who haven't received their inheritance may have to wait for their gifts until the likely challenges to the constitutionality of instituting the estate tax retroactively have been resolved in the courts. In any case, until these issues have been cleared up, it may be wise for executors and trustees of estates in 2010 to retain sufficient assets in the estate to pay a potential estate tax.

What should you be doing about the estate tax? Review and, if necessary, revise your estate planning documents, like wills and trusts. For example, many wills and trusts drafted with an estate tax in mind leave an amount of assets up to the applicable exclusion amount to children, with the balance going to the surviving spouse. However, in 2010, since there is no estate tax, there also is no exclusion. Depending on how documents are worded, this could create a situation where all of the assets pass to the children with nothing going to the surviving spouse, or vice versa. Thus, it's important that your estate planning documents be reviewed to ensure that your intentions are actually carried out.

GENERATION-SKIPPING TRANSFER TAX REPEAL

The generation-skipping transfer tax is a federal tax on transfers of property made, either during life or at death, to an individual who is more than one generation below you, such as your grandchild. The tax, also repealed for 2010, had a \$3.5 million exemption in 2009 and a top tax rate of 45%. However, like the estate tax, the GST tax is also scheduled to be reintroduced in 2011, with a \$1 million exemption and top tax rate of 55%.

What should you do about the GST tax in 2010? The repeal of the generation-skipping transfer tax in 2010 means the elimination (albeit temporarily) of one of the taxes on gifts made during life. The other applicable tax is the gift tax, which provides a \$1 million lifetime exemption and a top tax rate of 35% in 2010. The gift tax rate is scheduled to increase in 2011 to 45%. Thus, assets can be gifted in 2010, either directly or through a trust, to grandchildren and younger generations while accounting only for the gift tax, unless, of course, the GST tax is reinstated, retroactively or otherwise.

STEP-UP IN BASIS REPEAL

Along with the 2010 repeal of the estate tax and GST tax is the partial elimination of the step-up in basis rule. In 2009, the tax basis of property in a decedent's estate was generally increased, or stepped up, to the asset's fair market value as of the decedent's date of death. However, in 2010, the cost basis of estate assets is equal to the lesser of the decedent's adjusted cost basis or the fair market value of the assets on the date of the decedent's death. This means that estate assets likely will retain the decedent's cost basis. Absent Congressional action to the contrary, the modification of the step-up in basis rule is temporary, with the full step-up in basis rule scheduled to return in 2011.

The law does allow estates to exempt up to \$1.3 million of gain (generally, the difference between the decedent's cost basis in property and its date-of-death fair market value), which executors and trustees may allocate among estate assets. Also, an additional \$3 million of gain may be exempted for assets passing to a surviving spouse. This means that estates in 2010 may be able to increase the cost basis of assets up to \$4.3 million.

The modification of step-up in basis can lead to some issues for estate administrators. For example, executors or trustees of estates larger than \$1.3 million will have to figure out which assets should receive the step-up in basis. This is especially important for heirs and beneficiaries other than a surviving spouse.

In addition, heirs who want to sell inherited assets not covered by the step-up in basis will have to try to figure out the decedent's cost basis in order to calculate potential capital gain. For example, assume you inherit shares of XYZ Company stock in 2010. You sell them and now have to determine whether you owe a capital gains tax. First, you need to know if any of the \$1.3 million step-up in basis applies to these shares. If your XYZ stock didn't receive a basis step-up, you'll have to figure out the cost basis of your inherited stock. Arriving at the cost basis of inherited property may prove difficult, if not impossible, especially if the decedent didn't keep accurate purchase records, or if the stock split over the years, or if the decedent received some of the stock by gift or inheritance.

WHAT'S NEXT?

Most observers believe Congress will restore these taxes retroactively sometime in 2010. There are a number of proposals under consideration and exactly what plan will be adopted and when are important questions that remain unanswered.

Another potential issue surrounds the constitutionality of Congress reinstating the estate tax and/or GST tax retroactive to January 1, 2010. Congress has imposed taxes retroactively in the past and when

challenged, taxpayers have lost the majority of the time. Whether Congressional reinstatement retroactive to January 1 will withstand a challenge is conjecture at this point since Congress has yet to act, but the possibility of reinstatement of either or both taxes further adds to the estate planning conundrum in 2010.

And don't forget to consider possible state taxes. Currently, 16 states plus the District of Columbia impose their own estate and/or inheritance tax, separate from any federal estate tax.

Despite all of this uncertainty, do not put off making or reviewing your estate plan. Not having an estate plan, or having an outdated plan, could mean your intentions aren't carried out and could cost your surviving spouse and heirs.

Year	Estate tax	Generation-skipping transfer tax	Step-up in basis	Gift tax
2009	\$3.5 million exemption 45% top tax rate	\$3.5 million exemption 45% top tax rate	Full step-up in basis	\$1 million lifetime exemption 45% top tax rate
2010	Repealed	Repealed	First \$1.3 million gets step-up Assets to spouse get added \$3 million step-up	\$1 million lifetime exemption 35% top tax rate
2011	\$1.5 million exemption 55% top tax rate	\$1.5 million exemption 55% top tax rate	Full step-up in basis	\$1 million lifetime exemption 45% top tax rate

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