

## Estate planning amidst an uncertain future for transfer taxes

Nine years ago, a law was enacted to repeal the estate tax for 2010, technically, for individuals dying in 2010, and then bring it back in harsher terms for those dying after 2010. Many had thought that the current Congress would undo the impending repeal and permanently or temporarily keep the tax at 2009 levels (\$3.5 million per person exemption and 45% top rate), perhaps with inflation adjustments to the exemption amount. However, with the contentious fight over health care and the continuing recession taking priority, that has not happened. This leaves estate planning in a confused state. And it doesn't necessarily mean that taxes will be lowered for heirs of a decedent dying in 2010. That's because, estate tax repeal includes changes to the income tax basis rules for property acquired from a decedent. As a result of these income tax changes, some heirs could face higher combined estate and income tax costs if their loved one dies in 2010.

**History of repeal.** The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act) repealed the estate tax and the generation-skipping transfer (GST) tax for estates of individuals dying in 2010. However, the current transfer tax rules are in a state of flux as a result of changes made by the 2001 Act that have been gradually implemented. To comply with budgetary rules, the 2001 Act contained a so-called "sunset rule" under which the pre-2001 Act rules return after 2010 unless Congress provides otherwise at some future time.

Under pre-2001 Act law, there was no gift tax and no estate tax on the first \$675,000 of combined transfers during life or at death, for gifts made and individuals dying in 2001. These two taxes were tied together under a unified system having a top rate of 55%. However, there were and still are differences between the gift tax and the estate tax. One difference potentially affected the income tax of donees (recipients) of gifts and heirs of estates. A donee generally gets the donor's basis (usually cost) for a gift. As a result of this carryover basis, if there is a gift of appreciated stock, for example, the donee will have a taxable gain if he sells at the gift value. Property acquired from a decedent, however, generally gets a basis equal to its value at his death. This means that, on a later sale by the heir, he won't have to pay income tax on the appreciation in the property that occurred while it was held by the decedent.

The 2001 Act substantially increased the \$675,000 exemption in stages after 2001. For individuals dying in 2006 through 2008, the exemption was \$2 million. It rose to \$3.5 million for individuals dying in 2009.

The 2001 Act also changed the unified system so that the gift tax exemption amount remained at \$1 million for all years after 2001; the gift tax is not being repealed during 2010 as is the estate tax. Under the "sunset rule," the exemption will be \$1 million for both estate and gift tax purposes in 2011.

Under the 2001 Act, the top estate and gift tax rate was reduced in stages. It was 46% for individuals dying and gifts made in 2006, and it dropped to 45% for transfers in 2007 through 2009. In 2010, there is no estate tax and the top gift tax rate will be 35%. The top estate and gift tax rate would revert to 55% in 2011, under current laws.

For 2010, absent corrective Congressional action, the basis rules for inherited property will be changed to be similar to the gift tax rules but with many opportunities for heirs to get increases in basis. For example, it will be possible to increase the basis of assets

received from an individual dying in 2010 by \$1.3 million and by an additional \$3 million for assets going to a spouse. Under the sunset rule, the pre-2001 Act step-up in basis rules return for 2011.

**Winners under repeal.** If the repeal goes into effect, heirs of individuals dying in 2010 with very large estates will save a substantial amount of transfer tax. While they may also be exposed to some income tax under the modified carryover basis regime, the transfer tax savings would more than offset the increased income tax costs.

**Losers under repeal.** Heirs of many smaller estates could come out worse if repeal goes through and a step-up in basis is removed. That's because, while these individuals won't face transfer tax costs, they could face income tax costs. This situation is different from the plight of heirs of wealthier individuals because heirs of less wealthy individuals currently face neither income tax nor estate tax costs. However, in 2010 they could face income tax costs.

**Other uncertain rule changes.** The 2001 Act made other changes to the transfer tax rules that also are scheduled to sunset after 2010. For example, it repealed the State death tax credit and replaced it with a deduction. Under the sunset rules, the deduction would end and the credit would return in 2011.

The 2001 Act also repealed the qualified family-owned business deduction, which would return in 2011. It also made modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the GST tax. These modifications would terminate under the sunset rule.

**Some action seems likely.** Although Congress didn't address these transfer tax issues before year end, it seems likely that something will be done in 2010. On Dec. 3, 2009, the House, by a vote of 225 to 200, approved H.R. 4154, the "Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009." The bill would make permanent the present-law estate, gift, and generation skipping transfer (GST) tax laws in effect for 2009. The Senate has not acted on this measure or on a bill introduced in the Senate by on Nov. 19, 2009 by Senators Tom Carper (D-DE) and George V. Voinovich (R-OH) to permanently extend estate tax. Under that bill, the value of any estate above \$7 million per couple or \$3.5 million per individual would be taxed at a 45% rate.

Whether for or against repeal, most legislators would not want to see a return of the pre-2001 Act provisions under the sunset rules. Thus, it seems fair to assume that some kind of compromise will be reached in 2010. Whether that would involve a retroactive undoing of repeal to the beginning of this year and, if so, whether such legislation would pass muster if challenged, remains to be seen. What does seem likely is that the estate tax will continue sometime next year with a minimum exemption of \$3.5 million per person and a maximum top rate of 45%. It also seems likely that the step-up in basis rules will be preserved. Thus, notwithstanding the current state of uncertainty, estate planning should continue to be undertaken for clients with estates in these ranges.