

# 2010 Estate Tax Issue

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## 2010 Estate Tax Issues

First, I want to state that I believed today we would be covering the massive new federal income tax issues associated with the passage of the health care reform legislation. Obviously, that discussion will take place, if ever, on a much later day!

Instead, what I will talk about today is what I believed we would not be talking about at all, namely the repeal of the federal estate and generation skipping tax.

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## 2010 Estate Tax Issues

First and foremost it should be emphasized that a consensus seems to be growing that no new estate tax legislation will be passed this year. There are many reasons for this development. The reasons articulated for this are as follows:

1. No one, Republican or Democrat, wants to raise taxes in an election year;
2. The Republicans, fresh from their victory with Senator-Elect Brown, believe that they will have significant electoral gains in November and therefore will have a significantly stronger hand after that election;
3. The Democrats do not want to be seen giving the wealthy a substantial tax break (i.e., a \$3.5 million dollar exemption) in an election year; and
4. The Republicans appear to have been quite successful with their stall and delay tactics on legislation they do not like, i.e. health care.

## 2010 Estate Tax Issues

It would be a waste of our time, at this point, to review the many legislative alternatives available to Congress. Let's just deal with existing realities.

1. The federal estate and generation skipping tax is now repealed.
2. Beginning January 1, 2011 the exemption amount will again go to \$1,000,000 and the estate tax rate will go to 55%.
3. There is still a gift tax on all lifetime transfers in excess of \$1,000,000 but it will be taxed at 35% instead of 45%.
4. The heirs of decedents dying in 2010 will receive a carryover basis in lieu of the normal stepped up basis.

## 2010 Estate Tax Issues

Questions: May clients face problems as a consequence of the repeal of the federal estate and generation skipping tax?

Answer: Absolutely, and probably more than you can possibly imagine! Especially for those clients who are using standard formula clauses (i.e., Credit shelter trusts). Virtually every estate planning attorney used formula clauses to take full advantage of the maximum estate tax exemptions.

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## 2010 Estate Tax Issues

What other problems might be lying in wait?  
Please see the attached article from the  
Leimberg Information Systems.

Minto Law Group, LLC and the Wealth  
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**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1564**

**Date:** 21-Dec-09  
**From:** Steve Leimberg's Estate Planning Newsletter  
**Subject:** Akers: Questions & Answers on the Lapse of the Estate and GST Taxes in 2010

The estate planning bar hasn't stopped buzzing about an event some have described as the estate tax "breakdown." LISI's BlogWatch contains links to a number of articles that recount how we got to this point, so if anything, the buzz has only grown louder.

Last Thursday, LISI provided members with the insights of **Carlyn S. McCaffrey** and **Jonathan G. Blattmachr** regarding the impending repeal of estate and generation-skipping taxes, as well as the adoption of a carryover basis regime. See, [LISI Estate Planning Newsletter #1563](#).

Now, LISI provides members with commentary on this topic by another highly respected authority of the estate planning bar, **Steve Akers**. **Steve R. Akers** is a managing director at **Bessemer Trust**, where he directs the family estate and legacy planning practice for the Southwest Region.

Steve has lectured on a variety of estate planning, estate administration, and family business planning topics at national meetings of the American College of Trust and Estate Counsel; American Bar Association Real Property, Probate and Trust Law Annual CLE Meetings; the U.S.C. Tax Institute; the University of Miami Philip E. Heckerling Institute on Estate Planning; the Annual Notre Dame Tax and Estate Planning Institute and the

Southern Federal Tax Conference – among many others.

Here is Steve's commentary:

## **EXECUTIVE SUMMARY:**

As a consequence of the Economic Growth and Tax Relief Reconciliation Act of 2001(EGTRRA) the estate and GST taxes, but not the gift tax, are set to be repealed for one year beginning January 1, 2010. In addition, for decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death.

EGTRRA also included a "sunset" provision that eliminates all of the changes the Act made (including the transfer tax changes) at the end of 2010. These developments have caused planners, and a number of confused clients, to ask difficult questions about the future of the transfer tax system.

## **COMMENT:**

**Question #1: What happens to the estate tax and GST tax if Congress does not pass something before December 31?**

**Answer:** It's important to look at closely at what happens in both 2010 and 2011. There is a \$3.5 million exemption and a 45% top rate for the estate and GST tax in 2009, but there will be dramatic changes in 2010 under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act"). The estate and GST tax- - but NOT the gift tax- - are set to be repealed for one year beginning January 1, 2010.

For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2).

Observe, that while no step-UP in basis is allowed, the basis of property can be stepped-DOWN. The Conference Report refers to this as the "modified carryover basis regime."

Determining the decedent's carryover basis may be a

formidable task for many assets. There are two exceptions from the carryover basis provisions: (1) The executor can allocate up to \$1.3 million (increased by unused losses and loss carryovers) to increase the basis of assets; and (2) the executor can also allocate up to \$3.0 million to increase the basis of assets passing to a surviving spouse, either outright or in a QTIP trust. This is an increased basis of \$1.3 and \$3.0 million, not assets having a value of \$1.3 or \$3.0 million, so the allocation process may get complicated.

Observe that there may be many estates impacted by the carryover basis provisions that did not have to file estate tax returns with a \$3.5 million estate tax exemption. House officials have estimated that an extension of the estate tax (with a \$3.5 million exemption, 45% rate) would have impacted 6,000 estates, but the new carryover basis provisions will affect more than 70,000.

As an example, for highly appreciated estates where there is not a surviving spouse to take advantage of the \$3.0 million basis increase, an estate valued at well below the \$3.5 million current estate tax exemption level may be subject to carryover basis on some of the estate assets if unrealized appreciation in the estate assets exceeds \$1.3 million. Persons who are subject to various "recapture" provisions are not off the hook in 2010.

For example, the QDOT tax (with respect to a qualified domestic trust created to obtain a marital deduction for amounts passing to a noncitizen spouse) on distributions continues for 10 years after the estate tax is repealed, but the QDOT tax that applies at the surviving spouse's subsequent death does not apply if the surviving spouse dies after 2009. Also, the recapture provisions for special use valuation, QFOBI deductions, §6166 installments, and qualified conservation easements continue to apply in 2010.

Section 2511(c) applies to gifts after December 31, 2009. It provides that except as provided in regulations, a transfer in trust is treated as a transfer by gift unless the trust is a wholly owned grantor trust as to the donor or the donor's spouse. This is a rather strange provision. Apparently, the purpose is to prevent an individual from making an "incomplete gift" to a non-grantor trust that avoids gift taxes but still takes advantage of the trust's lower income tax brackets.

However, the section might apply in other situations as well and raises many uncertainties. For example, the section could conceivably be interpreted to mean that transfers to the donor's wholly grantor trust will not be treated as gifts even though they otherwise would be treated as gifts under traditional principles.

Could the transfer avoid gift taxation as well as avoid estate inclusion if none of the estate tax inclusion sections are triggered? Obviously, this section will need a great deal of clarification by regulations if it is not repealed or revised sometime in 2010. The gift tax will continue in 2010, but at a 35% top rate rather than the current 45% top rate.

The estate and GST tax returns in 2011 with a \$1 million exemption (the GST exemption is \$1 million, indexed for inflation) and a 55% top rate (with an additional 5% surtax for certain large estates). The gift tax will return to the pre-2001 system (\$1 million exemption, 55% top rate) in 2011. The carryover basis provisions of §1022 would no longer apply after the estate tax returns in 2011.

Various other changes made in the 2001 Tax Act would also be eliminated when the estate tax returns in 2011. These include eliminating the conservation easement exclusion under §2031(c), restoring the QFOBI deduction under §2057, eliminating the changes to §6166 regarding installment payments of estate taxes with respect to closely held businesses (for example, the owner requirement to be "closely held" would revert to 15 instead of 45), and eliminating the very helpful provisions regarding the qualified severance rules for GST tax purposes.

From the time this legislation system was put into motion in the 2001 Tax Act, most planners believed that Congress would revise the estate and GST tax before 2010 to avoid the one-year estate and GST tax repeal with carryover basis, and return to the pre-2001 system in 2011.

**Question #2: Will Congress act before December 31 to avoid the one-year repeal of the estate and GST tax?**

**Answer:** It appears likely that Congress will not act in time. The House of Representatives passed H.R. 4154 to

permanently extend the 2009 system (\$3.5 million exemption, 45% rate) on December 3, 2009. The permanent extension passed the House without a single Republican vote — the Republicans are holding out for a larger exemption and lower rates; one proposal is for a \$5 million exemption and a 35% rate.

It appears that the Senate will not act before the end of the year. A number of senators oppose the permanent extension, hoping to get more favorable provisions (such as a \$5 million exemption with a 35% top rate). When it became apparent that the Senate would not approve the permanent extension of the 2009 system, Democratic leaders in the Senate proposed several potential compromises, including extensions of the 2009 system for as short as two months to as long as two years.

They proposed attaching those to the 2010 Defense appropriations bill, but at least one Democratic senator plans to oppose that bill. So far, Democrats reportedly have not been able to locate any Republican senator who would support an estate tax extension, and it now appears that the Senate probably will not act on the estate and GST tax before December 31.

Even if the Senate did act, any differences between what it passed and the House bill would then have to be ironed out in conference, and the compromise between both bills then brought back to the House and Senate to be passed again as approved by the conference committee. Since the House is planning to adjourn soon for the balance of the year, there does not appear to be time to avert the lapse of the estate and generation-skipping taxes on January 1st.

### **Question #3: What should clients do in the waning days of 2009 in light of this confusion?**

**Answer:** Some respected planners have suggested to their clients who want to create GST exempt trusts that they should do so before December 31, because there will not be a system in place after January 1 to allocate GST exemption, and there is no certainty that a later reenactment of the GST tax will "grandfather" trusts created before the effective date of the reenactment. However, many planners believe that trusts created in early 2010 when there is no GST tax would

not later become subject to the GST tax or - - at the very least - that there would be provisions permitting late allocation of GST exemption to trusts established in the gap period.

Clients who are considering funding grantor retained annuity trusts ("GRATs") but who really want to have the remainder after the GRAT period continue in trust for grandchildren may want to hold off until after January 1. There is the possibility that a GRAT created in 2010 before the expected reenactment of the estate tax and the GST tax will not be subject to the GST tax; if so, the GRAT and any trust into which GRAT assets pass would not be subject to the GST tax regime.

Under the current GST rules that apply to GRATs, by contrast, no GST exemption can be allocated to a GRAT until the end of the GRAT term, when the assets would pass to long-term trusts for descendants. At that point, substantial GST exemption may be needed to exempt the trust from the GST tax in the future.

Similarly, clients who are considering making large gifts that would require the payment of gift tax may want to wait until 2010, when the gift tax rate would be reduced to 35% (if there is no Congressional action before December 31 to change that result). Also, installment sales where there is a possible gift element if the IRS should determine that the transferred value exceeds the note amount could benefit from a similar delay to 2010.

Remember, that the gift tax is being reduced to a maximum 35% rate, but that it will still exist for all transfers over the \$1 million exemption and \$13,000 annual exclusions, so there are limited tax-free ways to transfer assets during life, even next year.

**Question #4: Will the estate and GST tax be reenacted next year?**

**Answer:** At this point, there is "massive, massive confusion" in the words of Senate Finance Committee Chairman, Max Baucus. Some Republicans and conservative Democrats view the one-year repeal as creating leverage to insist on larger exemptions and lower rates (such as the \$5 million exemption, 35% rate proposal).

