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Estate and GST Tax Repeal In 2010

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2010 may prove to be the exception to Benjamin Franklin's well known adage, "In this world nothing can be said to be certain, except death and taxes".

Beginning January 1, 2010 there are several sweeping changes in the estate and gift tax world. Both the federal estate tax and the generation-skipping transfer (GST) tax are temporarily repealed for one year. As a result of the repeal of the estate tax, the step-up-basis rules at death are now limited, so beneficiaries will generally receive what is referred to as "carry over basis". Although the gift tax exemption amount will remain at \$1 million for the year, the top gift tax rate will drop from 45 to 35 percent. These highly unexpected results are now in place for 2010. However, most pundits believe Congress will enact corrective legislation, retroactive to January 1, 2010.

The top federal estate tax rate at the end of 2009 was 45 percent with each individual receiving an exemption of \$3.5 million, potentially \$7 million for married couples. The Generation Skipping Transfer Tax, or GST, which generally applies to transfers to grandchildren, and more remote descendants, had a 45 percent top tax rate at the end of 2009 and a \$3.5 million exemption. The GST tax is in addition to the regular estate tax.

Legislative History and Developments

The 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) temporarily repeals the estate and GST taxes until January 1, 2011 when the Act's sunset provisions reinstate the \$1 million exemption and the 55 percent top tax rate from the year 2000. Under the Act, the estate and the GST tax are repealed for estates of decedents dying in 2010 and a modified carryover basis regime applies.

The new carryover basis provisions are an important change in determining the basis of inherited property. For 2010, the basis of inherited property will be the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. This rule does not allow the basis of the property to be "stepped-up" at the decedent's death, but does require the basis to be "stepped-down". Two basis carryover exceptions apply for 2010. The basis of assets received from an individual dying in 2010 are stepped-up by \$1.3 million for non-spousal beneficiaries and by an additional \$3 million for assets devised to a spouse.

Estate legislation was introduced this past year, but was not enacted. On December 3, 2009, the bill passed by the House would have extended permanently the 2009 top tax rate of 45 percent and the exemption of \$3.5 million (potentially \$7 million per couple) for estate and GST taxes. Congress failed to act on this legislation by year end. This important piece of unfinished legislative business has left estate and gift taxes in a state of limbo. Legislators do not want a return of the pre-2001 Act provisions, so some kind of compromise may be reached, further complicating estate and gift planning. 2010 planning is challenging, given the possibility and legality of retroactive legislation. Previous attempts to enact carryover basis were met with significant resistance, with the result that carryover basis was thwarted, even after it was initially enacted.

In addition to the fate of the estate tax, there could be other sweeping changes to estate planning if other estate tax reform proposals are enacted. These proposals include implementing a minimum term of 10 years for grantor retained annuity trusts (GRATs), disallowing valuation discounts for transfers of family-controlled businesses, and instituting a reporting requirement on donors and executors to provide the IRS and property recipients with accurate basis information.

Caution: Many states have their own estate and gift tax rules. It is essential to consider a decedent's resident and other probate states' rules as they may be impacted by federal rules applicable to 2010, and as such rules are again modified.

Planning Opportunities

Under the 2010 law, some will fair better than others. Some heirs could face higher combined income taxes if they inherit property in 2010. Heirs of individuals dying in 2010 with very large estates will save a substantial amount of estate tax. They may be subject to income tax under the modified carryover basis rules, but the estate tax savings would more than offset the increase in income tax. Heirs of many smaller taxable estates may fair worse in 2010 with the removal of the step-up in basis. These heirs will not face estate taxes, but they could face added income taxes.

Executors may also be challenged as they will now be required to allocate the \$1,300,000 stepped-up allowance between assets and different beneficiaries. They must also allocate the spousal \$3,000,000 step-up among all the assets devised to the surviving spouse. Gifts to grandchildren and more remote descendants in 2010 should be considered when there is no GST tax. Since the top gift tax rate is now 35 percent, individuals who are considering larger gifts should consider making them in 2010. GRATs and GST trusts are other planning opportunities to be considered. All these options could change with the passage of legislation during 2010 or later. If nothing is passed, the provisions in effect for 2000 will be the new law starting January 1, 2011.

Legislation is far from the only factor that affects estate and GST tax planning. Your planning should be revisited regularly as circumstances change. This is even more important as the tax laws affecting your planning change.

Source: Marcum, LLP