PUBLICATION

Navigating the Uncharted Waters of Estate Tax Repeal

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Congress adjourned for 2009 without addressing the repeal of both the federal estate tax and generation-skipping transfer (GST) tax effective January 1, 2010, unleashing a storm of uncertainty that engulfs both existing estate plans and future estate planning. The federal gift tax continues in 2010 at a reduced 35% rate, adding to the turbulence produced by Congress's inaction.

The origins of the storm lie in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA offered eight years of favorable climate for estate planning, incrementally increasing the estate and GST tax exemptions to a peak of $3.5 million in 2009, while simultaneously reducing the tax rate to 45%. But EGTRRA culminates with two years of dramatic systemic changes to the estate and gift taxes. First, on January 1, 2010, EGTRRA repealed the estate and GST taxes and the basis step-up on appreciated property owned by a decedent at death, replacing them with a modified carry-over basis regime. Then, on January 1, 2011, EGTRRA sunsets and the estate and gift tax system returns to its pre-2001 condition that includes a $1 million estate, gift, and GST exemption with a 55% tax rate and an additional 5% surtax on certain large estates, and a return of the basis step-up.

Effects of Estate Tax Repeal

Important effects of Congressional failure to prevent repeal of the estate tax include the following:

Modified Carryover Basis. The modified carryover basis regime took effect on January 1, 2010, and provides that the basis of property acquired from a decedent who dies in 2010 is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. Thus, when appreciated property inherited from a decedent is sold by the heirs or beneficiaries, the taxable gain will include both the appreciation of property during the decedent's lifetime and appreciation after the decedent's death. Determining the decedent's basis in property so the gain can be measured will often be extremely difficult, particularly when the property has been held for a long time or has been depreciated or amortized.

There are two exceptions to the carryover basis. First, every decedent is eligible for a $1.3 million basis step up. Second, assets passing to a surviving spouse or a QTIP trust for the surviving spouse's benefit are eligible for an additional $3 million basis increase. Both such basis increases shall be allocated by the executor of the decedent's estate. Executors will face difficult decisions involving the allocation of the basis increases and such allocations will likely be a major source of dispute.

Existing Formula Provisions. Many existing wills and trusts include formula marital bequest provisions that are tied to the estate and GST tax exemptions, so the repeal of the estate tax may change the manner in which property passes under an existing will or trust.

What Will Congress Do Next?

Congress debated numerous proposals over the last eight years but ultimately took no action to avoid the inevitable tumult created by a one year estate and GST tax repeal. Congressional leadership has promised to react to the estate and GST tax repeal in early 2010, but Congress's specific reactions remain unclear. Proposed options include:

- a one-year extension of the 2009 $3.5 million estate and GST tax exemption and 45% rate, with a comprehensive revision of the estate and gift tax later in 2010; and
- a permanent extension of the 2009 estate and GST tax $3.5 million exemption and 45% rate (which the House passed on December 3, 2009, but which was not considered by the Senate before it adjourned for the year in 2009).

Whether a retroactive reinstatement of the estate tax and GST effective January 1, 2010 will survive constitutional challenge remains a subject of fierce disagreement, and if attempted, will certainly result in litigation. However, Congress will be under strong pressure to avoid a one-year repeal and to bring some resolution to the current climate of uncertainty, so it is likely that the estate tax will be high on Congress's agenda early this year. The estate tax is a politically sensitive issue on both sides of the aisle, and pressures of the 2010 mid-term elections could frustrate attempts to reach a compromise. The only prediction about the estate tax that can be made with certainty at this point is that it will be a hotly-debated issue in the first quarter of 2010.

What Should You Do Now?

Now more than ever, professional guidance is essential to assess the impact of estate tax repeal on your existing estate plans, recognize opportunities presented by this climate of uncertainty, and navigate your estate plan through the uncharted waters ahead.

We recommend that you arrange for a careful review to consider whether your plan is affected by the repeal of the estate and GST taxes, the reduced gift tax rate, and the imposition of the modified carryover basis regime. When a person dies in 2010, major tax consequences can result, so you should also review documents involving health care and end-of-life decisions (living wills, health care proxies, advance directives, etc.). While evaluating the impact that changes in estate and gift tax law will have on your estate planning, we recommend that you also review other changes in your assets or your family situation that may call for revision of your estate plan, as we explained in our December 2009 alert.

If any of the issues outlined above trigger questions or a concern that you would like to discuss further, please contact any of the attorneys in our Tax Department.