

LAWS OF UNINTENDED CONSEQUENCES: THE UNCERTAIN STATE OF THE ESTATE TAX

It's been almost nine years since the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) called for the federal estate tax to be repealed in 2010 — and reinstated in 2011. The one-year repeal was a political compromise required to get the bill passed, so most observers assumed that Congress would intervene either to extend the tax or to make the repeal permanent. But 2009 came and went with no new estate tax legislation.

The temporary nature of the repeal, together with uncertainty over what Congress will do next, has created an estate planning quagmire. In addition to the repeal itself, EGTRRA made several other significant changes — for 2010 only — that make long-term planning a challenge. These include a new tax code provision, Section 2511(c), which imposes gift tax on transfers to certain trusts that previously wouldn't have been taxable.

Until recently, Sec. 2511(c) received little attention. After all, few thought it would ever see the light of day. Once it was clear that the estate tax repeal would become a reality, estate planning advisors began to take a closer look and, to many, the provision's ambiguous language suggested tax consequences that Congress arguably didn't intend. On Feb. 16, the IRS published Notice 2010-19 to clear up the confusion. Unfortunately, the Notice itself highlights unintended consequences of the law.

WHERE THINGS STAND NOW

During the last nine years, EGTRRA gradually reduced the federal gift, estate and generation skipping transfer (GST) tax rates and increased the amounts of wealth that were exempt from tax. In 2009, the top transfer tax rates stood at 45%, the estate and GST tax exemptions at \$3.5 million and the lifetime gift tax exemption at \$1 million.

This year, the estate and GST taxes have disappeared, the gift tax rate has dropped to 35% and the gift tax exemption remains at \$1 million. Next year, the tax rates and exemption amounts revert to the levels prescribed by pre-EGTRRA law. That means that in 2011, absent new legislation, all three transfer taxes will apply at a top rate of 55%, with an exemption amount of \$1 million (though the GST exemption will be indexed for inflation).

Going hand-in-hand with the 2010 repeal is a significant change related to income tax on inherited assets. Until 2009, inherited property generally received a "stepped-up" income tax basis equal to its fair market value on the date of death. This allowed recipients to sell the property immediately without triggering capital gains taxes.

Under EGTRRA, in 2010 only, the automatic step-up in basis is eliminated. Instead, estates are permitted to allocate up to \$1.3 million to step up the basis of certain assets plus an additional \$3 million for assets left to a spouse.

AN UNCERTAIN FUTURE

In addition to estate tax repeal, EGTRRA made several other significant changes - for 2010 only - that make long-term planning a challenge. One such change is where gift tax will be imposed on transfers to certain trusts that previously wouldn't have been taxable. So, things are in a challenging mode right now.

An effective estate plan depends on predictable estate and income tax rules. It's difficult to plan for the transfer of wealth in the most tax-efficient manner if those rules change dramatically from year to year.

As things stand now, strategies that worked in 2009 may be ineffective — or even counterproductive — in 2010. For example, wills and trusts that use formulas tied to the applicable exemption amount may produce unexpected (and unwelcome) results in 2010. And strategies that make sense in 2010 may be inappropriate in 2011.

Making matters worse, Congress is likely to change the rules again, but we don't know how or when that will happen. For example, Congress might:

- Do nothing, allowing the one-year repeal to stand and the pre-EGTRRA tax regime to return in 2011,
- Reinstating the 2009 tax regime (with or without modifications) *retroactively* to Jan. 1, 2010, or
- Reinstating the 2009 tax regime (with or without modifications) *prospectively*.

Retroactive reinstatement likely would result in litigation over its constitutionality, which could lead to years of uncertainty about the tax treatment of 2010 transfers made before such legislation is signed into law.

BE PREPARED

Given the uncertainty over the future of the estate tax, review your plan with your advisors to determine the impact of the repeal. You should also discuss strategies that can help you adapt your plan to the changes that are sure to come.

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