

# LOWENSTEIN SANDLER PC CLIENT ALERT

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### FEDERAL ESTATE TAX REPEAL: ON THE VERGE OF REALITY

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**In June 2001, President George W. Bush signed a law that gradually reduced and ultimately repealed the federal estate and generation-skipping transfer ("GST") taxes. The repeal was made effective only for one year – 2010 – after which the original 2001 estate and GST tax laws were to return. Until now, conventional wisdom has been that a more permanent law change would occur before 2010 – perhaps a permanent repeal (as supported by President Bush) or a permanent tax at a fixed exemption and rate level (as supported by President Obama). After numerous failed attempts at such changes – and contrary to virtually everyone's expectations – we now face the prospect of an estate tax and GST-tax free 2010.**

The tax landscape remains extremely uncertain; indeed, we cannot rule out the prospect of a last-minute or even *retroactive* legislative change. However, based on what we know at this moment, this alert reviews several important federal tax considerations that may affect your estate plan in 2010 and beyond.

#### The Law as of January 1... Maybe

The basic changes scheduled to occur in 2010 (and 2011) have dramatic effects for estate, GST, gift, and income tax purposes.

- No federal estate tax — but only for 2010. For individuals who die during 2009, the federal estate tax is imposed at a flat 45% rate, subject to a maximum exemption of \$3,500,000 (which in turn is subject to reduction for certain lifetime gifts). For individuals who die during 2010, the federal estate tax will not apply, regardless of the magnitude of the estate. For individuals who die after 2010, the federal estate tax is scheduled to return with a \$1,000,000 maximum exemption (again subject to reduction for certain lifetime gifts) and a graduated tax with a maximum rate of 55%.
  - To illustrate, let's assume that Frustrated Taxpayer (who has a \$10,000,000 net taxable estate and has not made any lifetime gifts) suffers a heart attack in December 2009 upon becoming aggravated with Congress. If Frustrated Taxpayer dies on or before December 31, 2009, his estate will be liable for federal estate

tax of \$2,925,000. If Frustrated Taxpayer manages to hang on until January 1, 2010 and then dies, his estate will not be subject to federal estate tax at all. However, if Frustrated Taxpayer lingers until January 1, 2011, his estate will be liable for federal estate tax of \$4,795,000.

- No federal GST tax — but only for 2010. Presently, the GST tax (effectively, a second level of estate or gift tax) applies to any transfer benefiting one or more "skip persons," e.g., grandchildren or subsequent generations and/or trusts for their benefit. For 2009, the maximum GST exemption and tax rate are the same as the estate tax exemption and rate: \$3,500,000 and 45%. As with the estate tax, the GST tax is set to be repealed for any generation-skipping transfer occurring in 2010 — and to return in 2011 with a maximum rate of 55%. However, unlike the estate tax exemption, the GST exemption is indexed for inflation from 1998 — starting from a base of \$1,000,000 and based on current

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forecasts, we anticipate that the 2011 maximum GST exemption will be approximately \$1,350,000.

- Federal gift tax remains in effect for 2010. Unfortunately, the only way to take full advantage of the 2010 transfer tax repeal is to die. The federal gift tax, which applies to lifetime gifts beyond a per-donee annual exclusion and a per-donor lifetime exemption, will remain in effect during 2010 and beyond. The annual exclusion (presently \$13,000 per donee in both 2009 and 2010) will continue to be indexed for inflation, while the lifetime exemption is set to remain \$1,000,000 per donor indefinitely. The only scheduled change is to the maximum gift tax rate, which is set to drop to 35% for 2010 and then to increase to 55% for 2011.
- Income Tax Basis Step-Up. Even when Congress giveth, it tendeth to taketh away. Under current law, the tax basis of any asset owned by taxpayer is adjusted ("stepped-up," in the case of an appreciated asset) at the taxpayer's death to equal the asset's fair market value at that time. This basis "step-up" eliminates built-in capital gains, which typically results in tax savings regardless of whether the taxpayer's estate is subject to estate tax. For taxpayers who die in 2010, the basis step-up at death is eliminated, subject only to exceptions generally applicable to the first \$1,300,000 of gain in a taxpayer's estate and an additional \$3,000,000 of gain on assets bequeathed to (or in a qualifying trust for) a surviving spouse. On the other hand, the basis "step-down" at death for assets with built-in losses will remain in effect for 2010. For some taxpayers, the tax costs of

losing the basis step-up at death can exceed the savings afforded by estate tax repeal!

### Potential 2010 Planning Concerns

Because virtually no one believed that the 2010 tax changes would come to pass (at least in temporary form), virtually no one has an estate plan that specifically addresses the issues raised by those changes. While your plan may not be implicated by those changes – or you may simply be willing to take the chance that you will live longer than those changes remain in effect – you should at least consider a review of your plan based on the following concerns:

- Maximum estate tax exemption amount passes to descendants, not spouse. If you are married and your plan provides that the maximum federal estate tax exemption amount will pass to your children or other descendants, your estate plan arguably will disinherit your spouse if you die while the estate tax repeal is effective (since your entire estate will be exempt from federal estate tax). This is especially likely for couples who have children from prior relationships. Although state laws protect most spouses from disinheritance to a limited degree, it is virtually always a good idea to make more specific provisions in your will (and/or revocable trust) that spell out your intention.
- Carryover basis problems. We recommend that you consider amending your will (and revocable trust, if any) to include special language to take advantage of the \$1,300,000 basis step-up exception. If you are married,

you also may wish to reconfigure the allocation of your assets and/or the bequests to the surviving spouse to ensure full use of both the \$1,300,000 exception and the \$3,000,000 exception. In any case, you should carefully review your financial records to ensure that you have accurate tax basis information — a good idea even under current law, but essential in the event the step-up rule ceases to apply.

- GST planning. We recommend a review if your plan presently provides for GST planning at death — either direct gifts to grandchildren (or more remote descendants) or "Lifetime Trusts" for your children that are not subject to estate tax at their deaths. To the extent those GST gifts are based on the amount of your remaining GST exemption, those gifts may not be made if you die while the GST tax is not in effect.

### Potential 2010 LIFETIME Planning Opportunities

Despite the continued uncertainty associated with estate, gift, and GST tax laws for 2010 and beyond, several attractive lifetime planning opportunities seem to be presenting themselves while (if?) the repeal remains in effect.

- Taxable gifts. The 35% federal gift tax rate slated for 2010 is historically low. If you believe that estate tax rates ultimately will rise sharply (back to 45% or even to 55%) before your demise and you want to transfer meaningful wealth to your descendants, 2010 may be the time to do that, even at a gift tax cost.

- **GST gifting.** If the repeal occurs as scheduled, the GST tax will no longer apply to either transfers at death or lifetime transfers. Consequently, 2010 may present a window within which not only to make significant gifts to grandchildren, but to create and fund perpetual "dynasty trusts." While these gifts may be subject to gift tax at a reduced 35% rate, they may never again be subject to gift, estate, or GST tax!
- **GRATs, CLATs, QPRTs, and grantor trust sales.** Congress has not yet restricted these creative lifetime "freeze" techniques. Interest rates remain exceptionally low, enhancing the effectiveness of GRATs, CLATs, and grantor trust sales (though not QPRTs, which still may be beneficial in light of low housing prices and the reduced gift tax rate). To the extent you have assets that demonstrate meaningful appreciation potential, 2010 could be a good time to consider one or more of these tax planning techniques. Indeed, while the issue remains unclear, it may be possible during 2010 to create GST-exempt GRATs, CLATs, and QPRTs, which would allow for tax-free (or discounted, in the case of QPRTs) funding of perpetual trusts.

### **The Catch: Possibility of Retroactive Change.**

Congress has been working on "fixing" the estate, gift and GST tax system virtually since the passage of the 2001 Act. President Obama has expressed support for permanently preserving the basic rules in place for 2009. Democratic leaders in both houses of Congress have sharply criticized their colleagues for failing to pass estate tax reform legislation, which would eliminate the scheduled repeal and other special 2010 rules discussed above. Those leaders have vowed to take up such legislation as soon as possible during 2010. It is certainly possible that such legislation could pass. Indeed, it is not beyond the realm of possibility that such legislation could "repeal the repeal" retroactively, which could dramatically affect those making taxable gifts and the heirs of decedents who die in 2010. While there is arguably a constitutional basis for such retroactive tax changes, high-stakes court challenges are almost certain to occur, which will only exacerbate the uncertainty.

If you find all of this baffling and aggravating, please rest assured that you are in good company. Indeed, the landscape may have changed by the time you finish reading this alert.

The one clear piece of advice we can give you at this point is that you should contact one of the Lowenstein Sandler attorneys listed below to discuss how all of these changes may affect your estate plan. We cannot forecast with certainty what Congress and the President will do, but we will do our best to navigate you safely through these dark waters.

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