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2010: A Year Without Estate Tax? What Clients Should Consider as a Result of Recent Congressional Inaction

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An event that many estate planning professionals thought was unlikely to occur has become a reality. Congress has failed to pass new legislation addressing a one-year gap in the application of estate and generation skipping transfer (GST) taxes for the calendar year of 2010, creating a difficult and uncertain situation for estate planning. This Paul Hastings client alert focuses on the uncertainty created by current congressional inaction with respect to the estate and GST taxes and the impact of such uncertainty on current estate plans.

The Estate and Generation Skipping Transfer Tax Laws in 2010 (Without Further Congressional Action)

In 2009, the exemptions for estate and GST taxes were $3.5 million per person with a maximum estate tax rate of 45%. As of January 1, 2010, however, the estate tax and the GST tax "shall not be applied" for the calendar year 2010 — allowing individuals who die this year to leave their entire estate tax-free to their heirs.

However, the estate and GST taxes will return, in 2011, to the onerous levels last seen in 2001. Thus, the estate of an individual dying in 2011 will be subject to a $1 million estate and GST tax exemption and a top tax rate of 55% (60% for some estate and gift tax transfers).

Senate leaders have vowed to address this one-year gap in the application of estate and GST taxes immediately upon their return this month. Senate Finance Committee Chair Max Baucus (D-Mont.) has stated that "the correct public policy is to achieve continuity with respect to the estate tax," and that "[w]e'll clearly work to do this retroactively." However, it is unclear whether or not reinstituting the estate and GST taxes retroactive to January 1, 2010 would be constitutional.

With the current state of the economy and the emphasis on other political issues, we must now consider the consequences of further Congressional inaction in 2010 and the return of the estate and GST taxes in 2011 to 2001 rates.

To access our January 2009 Client Alert discussing anticipated tax reform legislation in more depth, please visit: http://www.paulhastings.com/assets/publications/1130.pdf?wt.mc_ID=1130.pdf.

What Does the Gap in the Estate and Generation Skipping Transfer Tax Laws in 2010 Mean for Current Estate Planning?

Each estate plan is unique and general observations cannot be universally applied. A review of your estate plan is warranted in light of these changes.

Most estate plans have two components. The first component is a basic revocable will and/or trust plan that addresses the distribution of your estate at your death. The second component addresses lifetime gifts and other types of transfers to trusts, limited liability companies, qualified personal residence trusts, charitable trusts and the like in order to accomplish your goals for the distribution of your wealth and to reduce or avoid estate taxes at your death.

Although there are many variations to revocable will and/or trust plans, most fall within three categories: (1) plans that leave all assets in trust for the benefit of the surviving spouse or other individuals upon the first death, and the remainder in trust for the benefit of the children or other remaining beneficiaries upon the second death; (2) plans that leave a specific amount tied to the estate tax exemption in trust for the benefit of one group of beneficiaries and the remainder in trust for the benefit of another group of beneficiaries, at the first or second death; and (3) plans that leave a specific amount tied to the estate tax exemption in trust for the benefit of one group of beneficiaries and the remaining assets outright to the surviving spouse or other individuals.

If your estate plan involves the transfer of all assets in trust for the benefit of the surviving spouse or other individuals upon the first death, and the remainder in trust for the benefit of the children or other remaining beneficiaries upon the second death, you may not be significantly impacted by the 2010 rules.

However, if your estate plan involves the transfer of a specific amount tied to the estate tax exemption to one group of beneficiaries and the remainder to another group of beneficiaries, at the first or second death, or an outright transfer of assets to the surviving spouse upon the first death, you should have your plan reviewed immediately to avoid an inadvertent transfer.

For example, consider the estate plan which provides that, upon husband's death, his children from his first marriage are to receive an amount equal to his exemption from estate taxes and his remaining assets are to go to his second wife. If the husband dies in 2010, his children from his first marriage would receive nothing because, under the current law, there is no estate tax exemption for individuals dying in 2010. Instead, all of his estate would go to his second wife — clearly not the result he wanted.

What About Lifetime Gifts and Sophisticated Estate Planning?

If Congress takes no action on the estate tax this year, it will be back with a vengeance in 2011. It is also quite possible that if Congress does enact legislation this year reinstating the estate tax, it will be made retroactive to January 1. As a result, lifetime gifting and sophisticated estate planning tools (such as dynasty trusts, family limited liability companies, qualified personal residence trusts, and charitable trusts) remain essential to achieving many clients' estate planning goals.

Although current law eliminates the estate and GST taxes in 2010, the gift tax continues with a lifetime exemption of $1 million per person (but with a reduced 35% top rate rather than the former

45%). As a result, once an individual's total lifetime gifts have exceeded $1 million (subject to certain other exclusions), he or she must pay gift tax on any additional lifetime gifts.

Further, in 2011, the unified estate and gift tax system will be reinstated. In other words, a person's future estate tax exemption (for years following 2010) will be reduced to the extent such person utilized the $1 million gift tax exemption amount during his or her life. For example, if a person makes $500,000 in gifts in 2010 and then dies in 2011, when the estate tax exemption reverts back to $1 million per person, that person may leave only $500,000 at their death free of the estate tax. This is because the earlier use of $500,000 of gift tax exemption is deducted from the person's $1 million estate tax exemption.

Certain gifts continue to be excluded from the $1 million lifetime gift tax exemption. The annual exclusion from gift tax will remain at $13,000 per person per donee. This will enable individuals to continue to gift $13,000 ($26,000 for a married couple) each year to an unlimited number of donees without such gifts reducing their $1 million lifetime gift tax exemption. Annual exclusion gifts are often used for gifts into irrevocable lifetime insurance trusts and trusts for children and grandchildren.

Payments for tuition and medical expenses made directly to educational and medical institutions on behalf of individuals such as children and grandchildren continue to be excluded from the $1 million lifetime gift tax exemption. Similarly, gifts to charitable organizations can be made in unlimited amounts without reducing the gift tax exemption.

In addition, given the current low interest rate environment and the depressed valuation of most assets, it is an unusually opportune time to implement intrafamily loans, grantor retained annuity trusts (GRATs), sales to grantor trusts, charitable lead annuity trusts (CLATs) and, in some cases, qualified personal residence trusts (QPRTs).

To access our June 2008 Client Alert discussing wealth transfer opportunities in a low interest rate environment, please visit: http://www.paulhastings.com/publicationdetail.aspx?publicationId=934.

What Happens to the Estate of a Person who Dies in 2010?

For the estate of a person who dies in 2010, although there is no estate tax under current law, a modified carryover basis rule takes the place of the estate tax. This modified carryover basis rule presents some of the most complicated planning estate practitioners have seen in decades.

For individuals dying in 2010 (married or single), under Internal Revenue Code Section 1022, the tax basis of assets will carry over to those who succeed to such property on the decedent's death. Thus, beneficiaries will not receive a benefit from a stepped up basis and may be exposed to capital gains taxes to the extent that the inherited estate consists of property with unrealized gains in excess of $1.3 million.

Carryover basis for 2010 is defined as the lesser of (i) the adjusted basis or (ii) the fair market value of the property as of the decedent's death. Many clients have not kept detailed records on the basis of their assets which will likely make the calculation of carryover basis difficult.

The 2010 rules allow for two small exceptions from the modified carryover basis rules. First, Section 1022(b) allows an executor to allocate up to $1.3 million to increase the basis of assets with unrealized gains. Second, the basis of property which is directed to a spouse outright or in a qualified terminable interest property trust (QTIP trust) can be increased by an additional $3,000,000. The

executor must apply these allocations on an information return to the IRS according to Section 1022(d) and once the executor's allocation is made, it can only be changed with the consent of the IRS.

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