To Our Clients and Friends **January 15, 2010**

2010: The Year of No Federal Estate Tax (Maybe?)

Back in 2001, when the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act") became law, we estate planners were confident that the law would be changed before 2010 when, absent a change, the estate tax would be repealed. So much for our crystal ball! 2009 came and went without any change being enacted, despite numerous attempts and a bill passed by the House (but not the Senate) in December 2009 that would have kept in place the estate tax rules of 2009. Accordingly, the repeal of the estate tax became effective on January 1, 2010.

Of course, legislation could be passed during 2010 to reinstate the estate tax. It is not uncommon for legislation to provide for a retroactive effective date and there is some debate regarding whether a retroactive reinstatement of the estate tax would be constitutional.

If Congress does not act to change the law during 2010, the federal estate tax comes back in 2011, with a top rate of 55% and a lifetime exemption amount of $1,000,000 (as well as all the other rules that were in effect before the 2001 Act). Compare this with the estate tax in 2009, which had a top rate of 45% and an exemption amount of $3,500,000.

Most clients are not enamored of death as a tax-savings technique (certainly, we do not recommend it!). But what if death does occur in 2010?

Should You Immediately Re-Do Your Will?

It is hard to get excited about writing a whole new will for 2010, when you might need another new will soon thereafter, given the (at least reasonable) possibility of a change in law. Many wills prepared after 2001 contain certain flexibility for post-death planning through the use of disclaimers. A disclaimer is a post-death action that can sometimes be used to change the distribution of assets among beneficiaries in order to produce a better tax result.

However, if your will has an unlimited "formula" clause that leaves to your heirs other than your spouse the maximum amount that can pass free of federal estate tax, it may be advisable to change (or at least cap) the formula. If your will divides your assets among your beneficiaries based upon the "federal estate tax exclusion (or exemption or credit) amount," the "generation skipping transfer tax exemption amount," or other such terms from the now-repealed federal estate tax law, your will may need to be revised to avoid unintended consequences.

Elimination of the Unlimited Basis Step-Up

If there is no estate tax, then there is no "step-up" in the basis of a decedent's assets, based on the value of the assets at the date of death. Rather, the basis step-up rule is replaced by a "carryover" basis rule. This means that the beneficiaries of the estate will need to establish the decedent's basis, no matter how long ago the decedent acquired the assets owned at death (so don't throw away those old records!). Upon a sale of the asset, the beneficiary will owe income tax on the gain computed by reference to the decedent's basis.

However, a limited basis step-up of $1.3 million is allowed, with an additional allowance of $3 million of basis for property passing either outright to a surviving spouse or to a marital ("QTIP") trust for the spouse's benefit. The executor of the decedent's estate is given the discretion to allocate the basis increase among the decedent's assets.

In the case of encumbered property, the elimination of the unlimited basis step-up can produce a significant disadvantage, particularly if the net value of the property is modest and the income tax basis is low. The decedent's heirs receive the encumbered property with a carryover basis (increased by any portion of the limited step-up allocated by the decedent's executor to the property) and, therefore, succeed to the inherent income tax liability upon the disposition of the property. Depending upon the facts, the inherent income tax liability can exceed what the estate tax liability would have been in 2009.

The Gift and Generation-Skipping Transfer Taxes

The 2001 Act did not repeal the gift tax, which remains in effect with a $1 million lifetime exemption amount and a new (for 2010) lower 35% top rate. However, the generation skipping transfer tax (GST) is repealed -- for 2010 -- like the estate tax. For those focused on transferring wealth to grandchildren, early 2010 may be an opportunity to do so at the lower (35%) gift tax rate. Although such a gift is fraught with uncertainty, it may be worth considering in a particular case.

Stay Tuned

We will of course be watching legislative developments very carefully. If you have concerns about your own will or estate plan, or would like further information on the current state of the law, please contact any member of our Estate Planning Practice Team:

Stuart J. Gross	(212) 903-8723
Mark David Rozen	(212) 903-8743
Quincy Cotton	(212) 903-8739
JoAnn Luehring	(212) 903-8731
Sanford H. Goldberg	(212) 903-8745
Lionel Etra	(212) 903-8721
Debra G. Kosakoff	(212) 903-8735