January 2010

Dear Reader,

The economy and action/inaction of Congress have created more than the usual upheaval with respect to tax planning moving forward into 2010. There are three primary concerns and the inside report will focus on just one. First, there are numerous temporary tax provisions that lapsed at the end of 2009. These include (1) the deduction for state and local sales taxes, (2) the additional standard deduction for non-itemizers for certain state and local real property taxes, (3) the deduction for qualified higher education expenses, (4) the deduction for teacher's classroom expenses, and (5) the allowance of tax-free charitable contributions from an IRA up to $100,000 for individuals who have reached age 70 ½.

The House of Representatives passed the Tax Extenders Act (HR 4123) in December, but some in the Senate did not like the revenue offset provisions. The Health Care legislation consumed most of its time before the holiday recess and the Senate did not create an alternative extenders bill. This extenders legislation was passed retroactively in the past, but this makes planning potentially tax-advantaged expenditures impossible until the legislation is enacted. A notable exclusion from the House bill was the alternative minimum tax (AMT) relief that may be handled in new legislation with perhaps some significant reform. The state of the economy and the federal deficit will certainly make any tax legislation more controversial than normal.

Second, the health care legislation will require some movement, probably by the House of Representatives for passage early this year. The Senate version, The Patient Protection and Affordable Care Act, was passed 60 to 39 on Christmas Eve. In bill language form, it's over 2400 pages. We'll provide you with a detailed summary of the tax provisions if the bill makes it to the President's desk for enactment.

Finally, the federal estate and generation-skipping transfer (GST) taxes lapsed (for one year) at the end of 2009. This has generated some controversial discussion in the media and Congress will have to address this sometime this year. Read the inside report for a discussion of the possibilities.

Cordially,

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Estate Tax Planning with Repeal or Reform?

When EGTRRA was passed in 2001, the federal estate and generation-skipping transfer (GST) taxes were gradually reduced from 2001 to 2009 and scheduled for repeal (for one year only) in 2010. The law reverts in 2011 to the 2001 rules leaving a federal estate-tax exemption of $1 million and marginal rates that reach as high as 60 percent for 2011 and thereafter. Virtually all estate-planning professionals and politicos predicted that the repeal would never occur and that a tax-reform package would provide some certainty to the future of estate planning. The House of Representatives passed a simplified bill (The Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009 (HR 4154)) in December. The bill (amazingly, less than two pages) would make permanent the $3.5 million exemption for estate taxes and the maximum 45 percent rate. The Senate was unable to reach a quick agreement to garner the 60 votes needed to minimize debate and the bill was not further addressed.

Due to the failure to pass this measure, the federal estate and GST taxes are technically repealed at this time. The federal gift tax continues with the rules enacted in 2001. In addition, assets included in the estates of decedents dying after 2009 will not receive an adjustment in the income-tax basis of such assets to date of death value (i.e., the so-called carryover basis rules have taken effect). Some in Congress have promised to take this matter up quickly this month and provide for retroactive re-enactment of these taxes. There has been some discussion of the possible challenge of a retroactively imposed tax based on Constitutional grounds.

In August 1993, President Clinton signed a bill that extended an additional 5-percent surcharge to the federal estate and GST taxes and made the provision retroactive to January 1 of that year. There was a Constitutional challenge to that provision that was ultimately denied, but the court's decision was based on the plaintiff's standing to bring the suit, not on the Constitutional issue (*National Taxpayers Union, Inc. v. United States,* 95-2 USTC 60,219). Certainly, there would be a decedent's estate from a death early this year that would become subject to a retroactive estate tax that would satisfy the standing requirements to bring a similar suit. Ultimately, political compromise will be necessary to resolve this issue but, this is an election year. The health care debate has proven how difficult this can become. It does seem unlikely that a Democratic President would go along with a permanent repeal of the estate tax.

The Possibilities for the Federal Estate Tax

Retroactive Re-enactment of the Estate Tax

This approach (assuming the Constitutional issue can be resolved) has the appeal of simplicity and providing certainty for estate planning. It is likely that some form of this approach will be introduced as legislation in the House of Representatives by the time some of you are reading this. The amount of the exemption and the maximum tax rate are certainly going to be subject to debate and the Senate will probably push for a higher exemption and lower maximum rate. There have been several alternatives proposed in the previous few years, with exemptions ranging from $2 to $5 million and rates from as low as 15 percent up to 55 percent in one proposal. However, there are other potential modifications to the wealth transfer tax that might work their way into legislation. We'll discuss these below.

Reintroduction of Graduated Marginal Estate Tax Rates

Due to the size of the exemption amount and the current rate table, the estate tax has been imposed at 45 percent for the last few years. The effective rate actually paid is far lower due to the exemption and other estate-tax reduction planning techniques. One recent proposal contained graduated rates above the exemption amount with the highest marginal rate of 55 percent effective for estate amounts over $10 million. This type of proposal adds some complexity, but unless the deficit concerns become paramount in the eyes of the legislators, it is unlikely that the estate-tax rate will be increased above the 2009 level.

Re-unification of the Estate and Gift Tax

The 2009 level of exemption for estate was $3.5 million while lifetime taxable gifts are only exempt up to a cumulative total of $1 million. For 2010, the gift tax rate is 35 percent (absent any retroactive changes). There have been proposals to unify the exemption amounts. It seems unlikely that the estate-tax exemption will be lowered to as little as $1 million even though current law would have the estate-tax exemption at this level in 2011 and thereafter. It certainly would be helpful for the succession planning for the owners of family businesses and farms if the gift-tax exemption was increased commensurate with the estate-tax exemption. However, it is also very difficult to forecast the revenue loss for this type of tax reduction.

Portability of Estate-Tax Exemption to a Surviving Spouse

One proposal contained in some prior reform bills that did not pass would allow a surviving spouse to use the estate-tax exemption of a deceased spouse who did not use his or her full exemption at the time of death. This provision would simplify the estate planning for some couples since it would eliminate the need to create a formula will or living trust that create an exemption trust at the first death. It would also

eliminate the need for some couples to re-title or separate assets from joint ownership. For example, assume a married couple has $7 million (assume the exemption will be re-instated at $3.5 million) owned jointly with rights of survivorship. When the first spouse dies, the $3.5 million exemption amount of the decedent will not be used since the surviving spouse receives the whole estate by operation of law and the transfer is completely deductible as a result of the estate-tax marital deduction. However, the surviving spouse would have a $7 million exemption at the second death.

This type of change has merit, but will result in tax revenue loss because the current planning techniques to use both exemptions are often ignored or inappropriate in many scenarios. However, if this provision is enacted, the traditional techniques may still be indicated in many estates for both personal and tax-planning reasons.

State Estate or Inheritance Taxes

The state death tax credit was phased out by EGGTRA in 2001. Some states continue to collect this tax even without the federal estate tax credit (the so-called decoupled states) and other states have an unlinked estate or inheritance tax. In 2009, the state death taxes paid were allowable as a deduction from the federal estate tax base. It seems unlikely that any reform will re-enact the state death tax credit because this would shift federal tax dollars directly to the states. However, most of the prior attempts to reform the estate tax would have kept the deduction for state estate or inheritance tax paid by the estate.

Other Miscellaneous Reform Issues

The Treasury generally is asked to produce items that are potential revenue raisers when reform is proposed. Hopefully, these items also coincide with goals of fairness and simplicity. It’s worth mentioning a few changes that have been discussed by Congress. First, family limited partnerships (FLPs) could be limited in providing valuation discounts for gift or estate tax purposes. The discussion has primarily focused on entities formed without any business activities where the entity holds only investment assets.

A second possibility is requiring a minimum time period (e.g., 10 years) for grantor-retained-annuity trusts (GRATs). Actuarial principles used to value the gift component of a GRAT combined with appropriate investment yield have resulted in transfer-tax free wealth transfers in some circumstances for short-term GRATs. Finally, reform might place a greater compliance burden on an estate’s personal representative for reporting income-tax basis to heirs who inherit property.

No New Reform Legislation

This would seem to make the least sense. For deaths in 2010, there would be no estate taxation. However, the heirs would take property with a modified carryover basis. Under Sec. 1022, the executor is allowed to

add $1.3 million to the basis of estate assets. An additional $3 million of basis can be added to the assets inherited by a surviving spouse. Certain assets, such as previously untaxed monies in retirement plans or IRAs, cannot receive any of the discretionary basis increase. Hence, the wealth transfer tax is replaced by a long-term capital gain tax (currently imposed at no greater than 15 percent) and the tax is only imposed when the estate or the heirs sell the property. The executor has the requirement to file a return, that has not yet been developed, to report the adjusted income-tax basis of estate assets to the IRS and the heirs.

Under the current law, this carryover basis is gone after 2010 and, as we discussed above, the federal estate tax would return with rules from 2001. This would limit the estate exemption to $1 million and have a maximum rate of 55 percent (with an additional 5 percent surcharge to some large estates).

Obviously, having a new tax compliance requirement in place for one-year only followed by a substantial estate-tax increase would seem to be politically infeasible. On the other hand, there have been greater surprises in the past.

Planning Implications

For those concerned with planning an estate, stay abreast of the legislative proposals and be prepared to react. Professional advice is essential and it will be important to get this advice at the time any legislation appears headed to passage (or existing law seems certain due to inaction). The taxes that might be imposed on an estate are potentially enormous and mistakes cannot be cured in many instances. Here are a few pieces of advice we'd like to pass along:

- Absent a deathbed scenario, do not rush to take action or unwind prior planning.

- Estate planning goals should be the same regardless of tax burdens. The dispositive goals should drive the plan and the estate owner should answer the "Who", "How", and "When" questions with the assistance of an advisory team. The tax minimization techniques should be applied only after the primary goals have been determined.

- Prior estate plans may be fine or may just require a small tune-up. A good estate plan should have been designed to be valid for the indefinite future. There may be great dispositive reasons to keep existing trust structures in place. Trusts are formed for many reasons other than taxes. Assets

placed in irrevocable trusts, such as a life insurance policy, have investment and asset security value irrespective of the form of the wealth transfer tax.

- Expect more change to taxation in the future. The previous version of the wealth transfer tax began over 30 years ago. It is unlikely with rapid shifts in the political climate and a large national debt that anything enacted this year will have the same stab

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