

# “What keeps you up at night?”

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## Congress imposes more taxes on beneficiaries of estates! What hath Congress wrought?

By Robert H. Louis and Maurice D. Lee, III

After much political maneuvering and finger-pointing, the U.S. Congress did what nearly every estate planning professional had predicted (up until the middle of December) could not happen: it failed to amend the federal estate tax law before the end of the year. This means that the law enacted initially in 2001 will continue, resulting in the federal estate tax and the federal generation-skipping tax (GST) both *disappearing* for 2010. This crazy-quilt provides, however, that in 2011, the federal estate tax and the GST will spring to life again, but with higher rates and much lower exemptions:

2009: 45 percent rate and \$3,500,000 exemptions

2010: Zero percent rate and no exemptions

2011: maximum rate of 55 percent and \$1,000,000 exemptions

It is very possible that Congress will change the law early in 2010 to extend the 2009 rate and exemption. It may attempt to do so simply for the balance of 2010, or it may attempt to make the extension retroactive to January 1, 2010, but it's not clear that would work. There will surely be litigation attacking the constitutionality of such a retroactive change if that step is taken. That litigation could go on for years, potentially delaying indefinitely the settlement of any taxable estate of those decedents who die during the repeal period. More significantly, the repeal of the estate tax and GST may create unanswered questions about what happens if someone dies before the tax comes back into effect. Here's why: Many or perhaps most of the wills we write, especially for married couples, are based on the idea of minimizing federal estate and GST taxes. This results in the creation of trusts to take advantage of the exemptions against these taxes and the marital deduction. But if there is no estate tax or GST and no exemptions, how are these provisions to be interpreted? The trusts might not work as planned, and surviving spouses could receive much less than was intended.

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It's also important to remember that the federal gift tax (and the \$1,000,000 lifetime gift tax exemption) is not repealed for 2010, although the rate is reduced to 35 percent. So 2010 will not be a year when assets can be freely transferred to avoid future estate taxes.

But the headline of this Alert says that Congress has levied more taxes, and that is the result of the one-year repeal. That is because carryover basis is brought back into the law. If someone dies when the estate tax is in effect, the basis of his or her assets, for capital gain or loss purposes, is adjusted to their date of death values. This wipes out, potentially, a lifetime of capital gains and is a valuable tax benefit. But if there is no estate tax, there is no step-up, and estate beneficiaries take on the decedent's basis (certain smaller estates, however, will be effectively exempted from this result). Not only does this significantly increase the chance of beneficiaries and estates being hit with substantial taxes on capital gains, but it requires detailed record-keeping that many will find difficult to do. Some estimate that the loss of the step-up in basis will generate more in taxes than repealing the estate tax would save. With the return of carryover basis, far more people, and estates, will be adversely affected by the repeal of the estate tax than would have been the case had the estate tax continued in its 2009 form.

Make no mistake: The return of carryover basis is a nightmare waiting to happen. The executor of your estate is now going to be responsible for determining your historic cost basis in every asset you own (every stock and bond, every table and chair, every piece of real estate, and so on). How many of us could do that now, with respect to our own assets, while we're alive, much less foisting that problem on our executors after we're gone? Apparently our elected representatives are little concerned with the lessons of

history. Congress actually tried this once before, enacting a carryover basis law as part of the Tax Reform Act of 1976, and it was quickly repealed after about 18 months because they realized it was absolutely unworkable, for the reasons suggested above. And here we go again.

Because it is difficult to determine if any planning based on the temporary repeal of the estate tax will accomplish much, we are not generally recommending any immediate dramatic steps. If you are concerned about the effect of these unusual developments on your situation, particularly with respect to how these changes might impact the dispositive plans you have in your own wills or revocable trusts, please call us to discuss your options. Meanwhile, we will continue to monitor the situation and will advise you of further developments.

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