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FEDERAL ESTATE TAXES IN FLUX

By: William C. Hussey, II

As of January 1, 2010, the federal estate tax and its companion federal transfer tax, the Generation Skipping Transfer Tax (GST), have been temporarily repealed for one year. While at first blush this may appear to be a windfall or a planning opportunity for some wealthy individuals, the uncertainty surrounding the status of the two taxes in Congress makes planning in the current environment highly uncertain.

Under federal budgetary rules, the changes made to the estate and GST taxes in 2001 under the Economic Growth and Tax Relief Reconciliation Act will cause the estate and GST tax regimes that were previously in effect to be fully reinstated in 2011. Thus, the estate and GST tax exemptions will revert to \$1 million (subject to indexing for inflation in the case of the GST tax), and the top tax rates will return to 55% with a 5% surcharge on taxable estates over \$10 million. The federal gift tax remains in full force and effect with a \$1 million lifetime exemption, but taxable gifts made in 2010 in excess of such exemption would only be subject to a reduced gift tax rate of 35%. Moreover, during the temporary repeal period in 2010, the basis step-up rules, which would permit the basis of any assets includable in a decedent's estate to be increased to fair market value, are modified so that only a limited number of assets will benefit from such adjustments.

For a limited class of individuals, the temporary repeal of the federal death taxes can cause a larger problem with their estate plans. Many Wills or Living Trusts employ a formula provision that essentially distributes the decedent's estate into a so-called "Credit Shelter Trust" that is designed to hold assets up to the amount of the federal estate tax exemption amount, and the balance is given outright to, or placed in, a separate trust for the benefit of a surviving spouse. In some cases, the Credit Shelter Trust may be designed so that the surviving spouse has no interest in such trust as the marital gift or trust would be

expected to provide sufficient assets to sustain the surviving spouse during his or her remaining lifetime. In the absence of a federal estate tax, however, such formula clauses could cause the decedent's entire estate to be funded into the Credit Shelter Trust. Thus, the surviving spouse would be effectively disinherited (albeit unintentionally). Accordingly, we encourage every person to review his or her Will and Trusts to ensure that such a result will not occur under their estate plan.

The burning question, of course, is what will Congress do to fix the situation? On December 3, 2009, the House of Representatives voted to permanently extend the estate and GST taxes as they existed in 2009 – *i.e.*, a \$3.5 million estate and GST exemption level and a tax rate equal to 45% of the excess. Due to disagreement with the "take it or leave it" nature of such House Bill, the Senate never considered its adoption. As a result, there is a general consensus among estate and tax professionals that there are now three possible outcomes to the current situation.

The most likely result, based on Congressional rhetoric, is a permanent extension of the 2009 tax rates and exemption levels, including a reinstatement of the basis step-up rules with all of the taxes, rates, and accompanying rules being retroactively reinstated to January 1 of this year. Many commentators have pointed out that such retroactive reinstatement may raise a constitutionality argument regarding its "*ex post facto*" nature. However, U.S. Supreme Court precedent suggests that such retroactivity would pass constitutional muster. Thus, individuals who engage in gift transfers or other transactions to take advantage of what most professionals believe to be a temporary situation may find themselves in protracted litigation with the IRS in order to sustain those transfers in the event Congress retroactively reinstates the prior transfer-tax rules.

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Alternatively, Congress may decide to simply reinstate the transfer-tax rules effective as of the date the legislation is passed into law. While this would avoid the constitutional concerns mentioned above, it would likely also require that the basis step-up rules be retroactively reinstated in order to avoid the problems inherent with such a basis-adjustment regime. If the basis step-up rules were merely reinstated at the time the legislation is passed, a limited number of decedents' estates would in fact receive a windfall from the temporary repeal of the estate and GST taxes. Given current deficit concerns and policy issues, this result seems less likely to be adopted – particularly since recent deficit-spending legislation has suggested that the law will be retroactively reinstated.

Finally, if Congress fails to come to an agreement, the temporary repeal could remain in effect for 2010 and the tax regimes in effect prior to 2001 could simply be allowed to return in 2011 without further action. Since neither major political party is in favor of a return to such prior tax regime, it appears unlikely that Congress will allow this to transpire.

In summary, the status of the federal estate and GST taxes has caused even greater uncertainty due to Congress' failure to address the issue in full. While we expect the taxes to be reinstated during the current year, the exact form and content of any legislation is still in doubt. Therefore, every individual should review his or her estate plan to ensure that the outcomes possible under those documents is consistent with his or her wishes for the disposition of the estate upon his or her death, and notwithstanding the ultimate resolution of this tax quandary.

If you would like to discuss how any of these changes may affect your business or tax planning, or have any other tax or estate planning questions, please contact Bill Hussey (see contact info in sidebar) or Scott Borsack (215.864.7048; borsacks@whiteandwilliams.com).

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