

## WHAT IS THE STATUS OF THE FEDERAL ESTATE TAX, REALLY?

2010 is the final year of a federal estate tax phase-out passed by Congress during the Bush Administration. There has been ongoing speculation about what Congress may do to change the law (and the House of Representatives actually did pass a bill in early December, 2009) but as of early February 2010, the phase-out legislation remains in force. The highlights of the current law are as follows:

- **No estate tax and no generation skipping tax.** No federal estate tax will be imposed upon the estates of individuals who die after January 1, 2010. The previous tax placed on transfers to people such as grandchildren has been eliminated.
- **Modified carry over basis rules apply.** Under prior law certain assets to which the capital gains tax applied, including most importantly real property, received a “stepped-up tax basis” upon the death of the owner to fair market value, without limitation. Under those rules, if a person had purchased a house for \$100,000.00 that was worth \$200,000.00 at the time of his death, his heirs could sell the house after his death without any income tax liability. Those rules are subject to new limitations, and heirs who sell inherited appreciated property may face a capital gains tax.
- **Gift Tax remains, with a 35% rate.** The gift tax provisions of prior law remain in effect. There is a \$1 million lifetime exclusion, and the annual gift tax exclusion also remains, but the gift tax rate has dropped from 45% to 35%. The gift tax rate is on non-excluded transfers.

What’s going to happen next? It now appears that one of three things may happen.

**1) Retroactive imposition of the estate tax and GST.** Congress could enact legislation which reimposes the estate tax rules in effect in 2009, retroactive to January 1. It would be expected that such legislation would include either the previous \$3.5 million lifetime exemption, or perhaps a greater sum up to \$5 million. It could also include a provision allowing a surviving spouse to receive the benefit of any unused exclusion in the estate of the first spouse to die. The imposition of a retroactive tax would raise some significant constitutional questions however, which could tie up affected estates in the courts for literally years.

**2) Prospective imposition of the estate tax and GST.** Congress might decide to avoid the constitutionality issues by simply passing new estate tax legislation with no retroactive effect. When that might be accomplished is anybody’s guess. Since it would be an amendment to an existing income tax and not a new tax, retroactive amendment of the stepped-up basis rules could still be on the table.

**3) Do nothing.** If Congress were to take no action, the estate tax phase-out legislation will sunset on December 31, 2010, and we will return to the rules in effect in 2001. That will mean a top estate, gift and GST tax rate of 55%, a 5% surcharge on taxable estates over \$10 million, a \$1 million estate and gift tax exclusion, a \$1 million GST exemption indexed for inflation, and the basis adjustment rules.

**Bottom Line.** The bottom line is that well designed estate plans will eliminate “formula provisions” with respect to credit shelter trust creation. Wills and trusts containing formula clauses could cause the transfer of either all or none of a decedent’s estate into a separate trust, thereby defeating a primary goal of the entire plan. Estate planners should be taking every opportunity to employ language that maximizes flexibility for the client in these uncertain times. Individuals would be well advised to have an estate planning document “check-up” with a competent attorney, as a failure to do so could cause negative consequences for surviving family members.

Feel free to call us at 541-386-2221 for more details about the Federal estate tax.