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TO OUR CLIENTS AND FRIENDS:

Re: AS CERTAIN AS DEATH AND TAXES?

As you are undoubtedly aware, what was once considered inconceivable has happened – Congress adjourned for 2009 without addressing the question of Estate, Gift and Generation-Skipping Transfer Taxes, and we are now two months into 2010 without Congress having acted. As a result, under the terms of the law that was passed in 2001, at the moment there is no federal estate tax or generation-skipping transfer tax applicable to the estate of individuals dying in calendar 2010, or to generation-skipping transfers that occur this year. The gift tax continues, but at a reduced 35% tax rate. Also, in the case of 2010 estates, the rules for computing capital gain or loss for inherited assets are significantly revised, with the basic approach being a carry-over of the decedent's cost basis (rather than a step-up to the estate tax value of appreciated inherited assets, which was the prior rule), although certain basis adjustments will reduce the impact of the new rule in many cases.

While the provision making 2010 the year without federal estate tax has been part of the law since 2001 (long-time clients with good memories may recall that the newsletter we wrote when the 2001 Act was passed referred to this possibility), it's fair to say that almost until the end of this past December it was confidently (but, as it turns out, incorrectly) assumed that Congress would not permit the provisions in question to take effect. Indeed, whether the rules described in the preceding paragraph will actually apply for any part or all of 2010 remains an open question. Some in Congress want to reinstitute the 2009 rules (or some variation on those rules) with retroactive effect back to January 1, 2010.

That said, if Congress takes no action whatsoever (which is beginning to look quite possible if not necessarily probable), under the law currently on the books the estate, gift and generation-skipping transfer tax regime that existed prior to the 2001 tax act will be reinstituted on January 1, 2011 (meaning, among other things, that the estate and gift tax exemption will be only $1,000,000, the generation-skipping transfer tax exemption, which is subject to an inflation adjustment, will be about $1,340,000, and the top estate and gift tax rate, as well as the GST tax rate on transfers to which no exemption as been allocated, will be 55%). If Congress allows the estate, gift and generation-skipping transfer tax provisions to revert to pre-2001 law, there may be significant uncertainty as to the effect of actions taken between 2000 and 2010, although no back tax will be due.

Of course, Congress may ultimately choose to do something other than either retroactively reinstating the 2009 rules or complete inaction (with pre-2001 rules therefore coming back into effect in 2011). Some are predicting that some time this year Congress will prospectively reinstate the 2009 law (even possibly increasing exemptions and reducing rates beyond the 2009 level) and give the estates of individuals who die in 2010 before Congress acts the right to choose to be subject to the 2010 carry-over basis provisions or the reinstated estate, gift and generation-skipping tax law. But the plain truth is that no one knows what is going to happen, and it seems increasingly likely that it may be quite some time before a clear picture emerges.

In the meantime, an obvious question is whether you should be doing something about your current estate planning documents. In a small number of cases, formula clauses or other provisions that were tied to prior law could result in undesirable consequences if a client happens to die in calendar 2010 and the estate tax is not retroactively reimposed (or Congress attempts retroactive imposition of the estate tax and that action is ultimately held unconstitutional by the Courts). An example might be a formula provision that left the portion of the estate that is not subject to estate tax (an amount that would have been capped at no more than $3.5 million through the end of 2009) to or in trust for children, with the balance of the estate going to or in trust for the surviving spouse. In such a case the complete absence of the federal estate tax might result in the entire estate passing to the children, with nothing for the spouse, which may well be an undesirable result, depending on the circumstances of the particular case. Similarly, a formula provision creating a long term trust for descendants based on the amount of the testator's "GST exemption," with everything else passing outright to children, might result in the entire estate passing to the children, with nothing in a long term trust to save estate and generation-skipping transfer taxes if and when they are reinstituted.

It is probably the case that relatively few of our clients' Wills or revocable trusts present the possibility of such undesirable results in the event of a death in 2010. For example, if your Will provides that your entire estate goes to your surviving spouse or to trusts that benefit your surviving spouse, and otherwise to your children or more remote descendants, or if you are unmarried and the distribution of your estate is fixed among your desired beneficiaries, the uncertainty about federal estate tax is not likely to require any modification to your documents. Moreover, many of our clients who revisited their estate plans after the 2001 Tax Act have documents that contain a specific provision about how such formulas are to be interpreted in a year without estate tax or generation-skipping transfer tax. As mentioned above, however, there may be some clients for whom an unintended result of the current law could be a distortion of their intended estate plan, and there are likely other situations in which review of the estate plan and revisions to deal with the situation now facing us would be appropriate, because the new provisions may present planning opportunities.

This letter has touched on only a few highlights of the special tax rules applicable for 2010. Many of the ramifications of those rules are still not clearly understood, and the Internal Revenue Service has provided no significant guidance, undoubtedly because of what had been an almost universal belief that the rules would never take effect.

If you would like us to review your personal situation to make sure that a death this year will not create an untenable distortion of your estate plan, please let us know. We appreciate that it is not very satisfactory to say, as we have in effect said in this letter, that "there may or may not be a problem, and we may or may not be able to suggest an ideal solution," but that is the unfortunate situation in which we find ourselves. We will certainly write to you again when we know with more certainty what Congress intends to do or not to do, at which time we hope to be in a position to offer more concrete suggestions.

Sincerely yours,

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