

TRUSTS & ESTATES **LAW ALERT**

As of January 1, 2010, there is no federal estate tax. This is no small event as the tax, originally enacted in 1916, has been with us for almost a century. In our Winter 2009 Alert, we summarized the federal estate tax system under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), outlining the law's scheduled one-year repeal of the estate tax in 2010, to be followed by its revival in 2011. To the surprise of many observers of federal tax law policy and legislation, Congress did not pass legislation in 2009 to keep the estate tax in place.

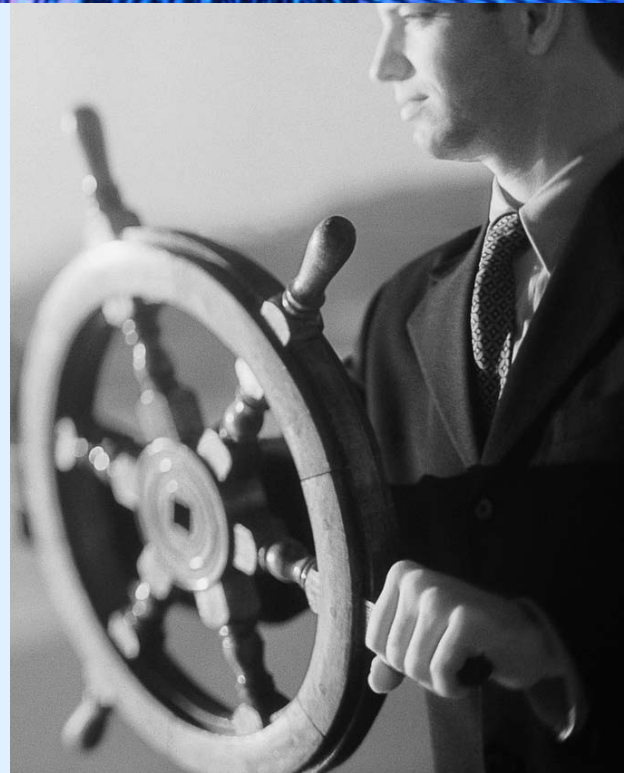
Federal Estate Tax 2009

For taxpayers dying in 2009, the law provided a \$3.5 million exemption from federal estate tax, with assets owned by a decedent above that amount subject to estate taxation, the highest marginal tax rate set at 45%. Assets given outright (or in certain qualifying trusts) by married taxpayers to a spouse

would qualify for the unlimited marital deduction from federal estate tax. The property acquired from the decedent was generally entitled to a full step-up in income tax basis equal to the fair market value of the property as of the date of death, rather than the decedent's basis (carryover basis).

2010

Pursuant to EGTRRA, the federal estate tax is repealed effective January 1, 2010. At the same time, however, the law provides that new and less favorable income tax basis rules become effective. The full basis step-up rule expires and instead, a modified carryover basis system is implemented. The basis of property transferred by a decedent will be equal to the fair market value of the asset at the decedent's death or the carryover basis, whichever is lower. However, a partial step-up to fair market value will be allowed in the aggregate amount of up to \$1.3 million. In addition, property



passing to a spouse may be entitled to an additional increase in basis of up to \$3 million. The adjustments to basis will be made in the executor's discretion to assets selected by the executor. It is likely that such a taxing regimen will prove complicated and problematic to administer.

Along with the repeal of the estate tax, the federal generation-skipping transfer tax is also repealed. Importantly, the federal gift tax remains in place, with the top marginal rate set at 35%.

2011

The federal estate tax repeal is short-lived, sunseting on December 31, 2010. The estate tax is to reappear on January 1, 2011, with the federal applicable exclusion amount reduced back to the pre-2001 level of \$1 million and the top marginal tax rate set at 55%.

Fortunately, with the return of the estate tax, the full step-up in income tax basis rules will be restored in 2011.

End of the Story for 2010?

It would be difficult to argue that the scheduled changes under existing law in store for 2010-2011 are good tax policy, if for no other reason than the uncertainty and planning challenges created by the dramatically shifting rules.

Perhaps worse, the confusing muddle appears to have not yet ended. The efforts expended by Congress in 2009 on legislative matters such as health care may have left other important policy issues unaddressed, but elected officials in Washington continue to have strong views about estate tax repeal.

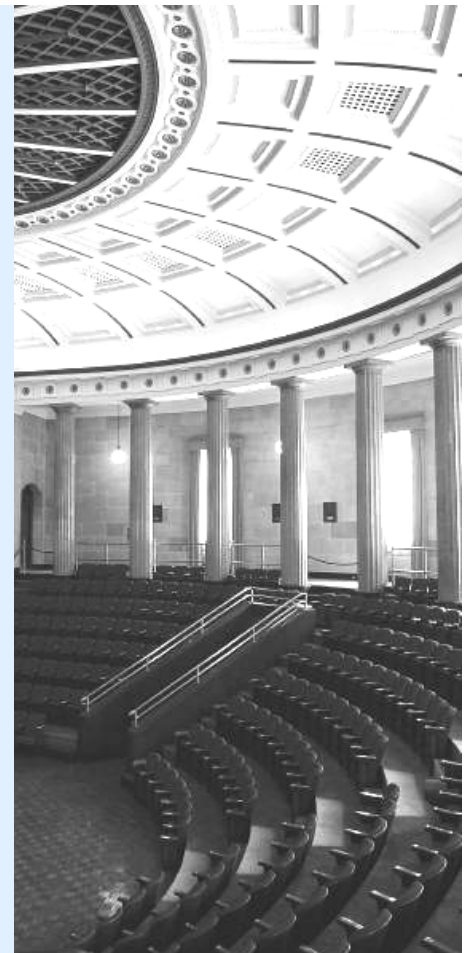
Congressional leaders appear determined to enact legislation in 2010 to reinstate the federal estate tax, making the reinstatement retroactive to the date of repeal.

Retroactive renewal of the estate tax may result in constitutional challenges to the law, the outcome of which will be the subject of lively legal debate.

On the other hand, the repeal of the estate tax may give rise to litigation due to the unintended operation of federal "credit shelter" formula clauses in Wills drafted in contemplation of reducing overall federal estate and generation-skipping transfer taxes.

Conclusion

The tax joke of recent years — don't die, hold out until 2010 — has lost its punch line. Stay tuned for what should prove to be an interesting year.



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