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Client Alert

To Our Clients and Friends:

Well, they said it could never happen but the federal estate tax has been repealed (at least for now).

How did that happen? Congress amended the estate tax in 2001 to provide for a phase in of a reduction of the top estate tax rate (from 55% to 45%) and an increase of the estate tax exemption from \$1,000,000 to \$3,500,000. The 2001 legislation further provided for repeal of the estate tax in 2010, followed by a return of the tax in 2011....at the rates and exemptions in effect in 2001. Clearly an illogical piece of legislation which we assumed would be fixed before 2010. Unfortunately, Congress, despite having almost 9 years to figure out how to deal with the estate tax after 2009, failed to do so.

So, for the year 2010, here is the state of the law:

- For persons dying in 2010, there is no federal estate tax.
- The New York estate tax is still in effect (with an exemption of \$1,000,000 – although some commentators have reasoned that the exemption is *zero* by reason of the repeal of the federal estate tax) with a top rate of 16%. The estate tax laws of most other states also remain in effect.
- The federal generation skipping transfer tax (“GST”) has been repealed.
- The federal gift tax is still applicable, with a lifetime exemption of \$1,000,000 and a 35% maximum rate.
- The so-called “step up in basis” rule - which adjusted the tax cost of an asset received from a decedent to its fair market value at the time of the deceased’s death – has been repealed. Instead, inherited assets will have a basis (for purposes of computing capital

gains tax) of the *lower* of the decedent's basis or the fair market value at death, subject to certain adjustments.

If Congress does not act, then in 2011 and beyond:

- The federal estate tax will return with a maximum rate of 55% and an exemption of \$1,000,000.
- The GST tax will also return with a maximum rate of 55% and an exemption of about \$1,300,000.
- The federal gift tax will continue in effect with a \$1,000,000 exemption, but with a top rate of 55%.
- The "step up in basis rule" will be restored for assets received from a decedent.

If Congress does act and the estate tax and GST tax are restored (possibly to the same levels as in 2009) and made retroactive to January 1, 2010, there is likely to be a constitutional challenge by the heirs of anyone who dies before enactment of the new legislation. The outcome of such a challenge is uncertain.

What to do now:

1. Many wills contain a formula bequest of the amount that can pass free of federal estate tax to a "credit shelter trust" or directly to children or other beneficiaries, with the balance of the estate passing to the surviving spouse. If death occurred in 2009, that formula bequest would have been \$3,500,000. With the repeal of the federal estate tax, the formula could result in the unintended consequence of allocating the entire estate to the credit shelter bequest and disinheriting the surviving spouse. Note, most if not all wills prepared by our office do not have that formula; but rather a modified version of that formula which would result in a credit shelter bequest of zero and the entire residuary estate passing to the surviving spouse. In all events, this language in wills should be checked carefully.
2. Given the uncertainty of both the estate tax and the timing of when death will occur, consideration should be given to drafting "flexible" wills that will maximize the opportunity for heirs to take advantage of tax planning opportunities available at the time of a decedent's death.
3. The reality is that while 2010 may turn out to be a good year to die (at least from the perspective of saving estate taxes), most of us will live to 2011 and beyond. With the

return of the estate tax in 2011, either at 2001 rates/exemptions or at some other level set by Congress, the focus on estate planning and implementing strategies that shift wealth to younger generations should continue. Consider acting sooner rather than later, since it is possible that estate tax legislation will include eliminating or reducing the benefits of strategies that are currently available.

We will be following developments in Congress carefully over the coming weeks and months. Hopefully, there will be legislation that clarifies the future of the estate tax. In the meantime, if you have any questions about your will or estate plan, or seek our advice on any of these or related matters, please do not hesitate to contact us.

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