

December 31, 2009

Re: 2010 Estate Tax Repeal

INTRODUCTION: Federal legislation enacted in 2001 enacted many changes to the transfer tax system. That legislation gave us the current estate and generation-skipping transfer (GST) exemptions of \$3.5 million, and a marginal tax rate of 45%. Most famously, the 2001 legislation repealed the estate and GST taxes (but not the gift tax) for 2010. The 2001 legislation, however, also included a "sunset" provision eliminating all of these transfer tax changes at the end of 2010. Unless Congress acts, the estate tax exemption will drop to \$1 million in 2011, and the top estate, gift and GST tax rate will return to 55% (60% for some transfers subject to tax).

In December 2009 the House of Representatives passed H.R. 4154, permanently extending the 2009 estate and GST tax rates and exemption amounts. The more closely divided Senate did not act, proving yet again that the House is nearly irrelevant to wealth transfer tax reform. The one-year repeal originally enacted by Congress in 2001 begins on January 1st and the two taxes will hibernate in 2010. In an election year, hardly a Representative or Senator up for re-election wants to go on record as having voted to re-institute a tax. The ultimate irony may be that if Congress fails to act, the estate tax will return automatically in 2011 to a 55% rate and \$1 million exemption.

COMMENT: If history offers any lessons, rumors of the demise of the estate tax are greatly exaggerated. The first estate and generation-skipping transfer tax returns for 2010 decedents will be due next October (April 2011 if an estate takes a six-month extension or the GST tax is reportable on a gift tax return). Congress could restore these taxes retroactively by acting at any time before then. Alternately, it could restore the tax prospectively and allow some transfers to escape tax free.

The sooner Congress acts the more likely it is that any change would be retroactive. As 2010 progresses, the chances increase that Congress will make prospective changes only. Taxpayers are likely to know the result before any 2010 estate or GST tax return is filed. In most cases, few decisions involving either tax will be required before 2011. Congress may make noise all year that it will pass a retroactive fix, just to discourage those who would "push Momma from the train."

A third possibility exists that Congress will do nothing (except talk) in 2010 and allow the 2001 estate and GST taxes to return in 2011. That inaction will raise taxes, which the Democrats will seek to blame on Republicans who blocked the December 2009 legislation.

Carryover Basis Considerations. The income tax bases of assets acquired from an individual who dies in 2010 will not equal their estate tax values. Instead, the bases of these assets will "carryover" to those who inherit the property. Estates of decedents who die in 2010

may need to deal with carryover basis as the price they pay for non-payment of any estate tax, if Congress does not retroactively fix the one year repeal.

There are two "exceptions" to the carryover basis rule that will provide some relief to the beneficiaries who receive these assets. First, the decedent's personal representative may increase the bases of assets up to a \$1,300,000 limitation. The basis of an asset with this increase, however, may not exceed its fair market value on the date of death. Second, the personal representative may increase the bases of assets that the surviving spouse receives outright or through a QTIP trust (called "qualified spousal property") up to a \$3,000,000 limitation.

Few personal representatives will need to worry about carryover basis until they sell assets and then file the first income tax return for the estate (for many that will not occur before April 15, 2011). All that personal representatives will need to do in 2010 is compile records that provide evidence of the decedent's historic income tax basis. Caution should be exercised in choosing assets to sell or realizing gain on a partial distribution of property in kind. Otherwise, carryover basis does not require immediate attention.

CONCLUSION: The elimination of the estate and GST taxes and the introduction of carryover basis for those dying in 2010 is an extraordinary event. Is there a clear avenue for action today? Generally the answer is no. Most taxpayers will benefit from patience, waiting until senatorial politicians stop squeezing maximum campaign funding gold from the goose of wealth transfer tax uncertainty. This wealth tax uncertainty should not distract you from current financial and planning concerns, such as completing estate planning documents to reflect your current intent for the disposition of your property.

Best wishes for a Happy New Year.

Very truly yours,

JOHN A. HARTOG, INC.