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PRIVATE CLIENT SERVICES
>> ALERT

ESTATE TAX SET TO EXPIRE ON NEW YEAR'S DAY

The federal estate tax law in effect since 2001 is set to expire on January 1, 2010. In mid-December, Congressional leaders announced they were unable to reach an agreement on a new law extending the estate tax. This has surprised observers, and could be a boon to some wealthy families during 2010. However, there is legal precedent for a retroactive tax law and Congress may act during 2010. Also, if Congress takes no action during 2010, then on January 1, 2011, the estate tax will reappear with just a $1 million exemption and higher rates than we are used to.

BACKGROUND

Through the end of 2009, the federal estate tax is imposed on estates in excess of $3.5 million, and the tax is calculated at a top rate of 45%. Bequests to charities and to husbands or wives are free from the tax, and estates are entitled to a valuable income tax benefit: all assets included in an estate take a "stepped-up" basis equal to the value of the assets on the date of death. This is an income tax concept that often allows families to sell inherited property after the death of a loved one without incurring capital gains tax on the sale. Also through 2009, the federal gift tax is imposed on gifts in excess of the lifetime exemption amount of $1 million. Gifts of less than $13,000 in any year, to an unlimited number of different donees, do not count against the lifetime exemption. The gift tax is imposed at a top rate of 45%.

WHAT ABOUT 2010?

In mid-December 2009, Congress announced that it was giving up trying to pass an estate tax law for 2010. As a result, the estate tax will be allowed to expire, in accordance with the law in effect since 2001. If there really is no federal estate tax in 2010, families will be able to pass an unlimited amount of wealth at death. While the gift tax will not go away, the top rate will fall from 45% to 35%. The gift tax lifetime exemption remains at $1 million. The policy reason for keeping the gift tax during a period when there is no estate tax relates to the income tax: without a gift tax, owners of valuable income-producing property could give that property to their children who are in lower income tax brackets. As a result, the family in the aggregate would pay less in income tax than if the donor retained the income producing property.

Are there any downsides to having no estate tax? Without an estate tax, estates will lose the income tax benefit of the stepped-up basis. Instead, inherited property will keep the same income tax basis it had in the hands of the decedent.

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THE BOTTOM LINE

The estate tax continues to be a moving target. At this time, it is nearly impossible to predict what the law will be during 2010 and beyond. We will send another Alert as this situation unfolds.

This means that family members will pay more in capital gains if they choose to sell inherited property. This will only impact relatively wealthy families, however, as the executor of every estate will be able to allocate up to $1.3 million in basis to property passing to any beneficiaries, and an additional $3 million in basis to property passing to husbands and wives. Another potential downside is that individuals may be less likely to leave a portion of their estates to charity. Historically, the charitable deduction against the estate tax has been a motivating factor in charitable bequests for some people.

Could there be a retroactive law passed during 2010? In a word, yes. Most constitutional law experts believe that the 1994 U.S. Supreme Court case of *U.S. v. Carlton* gives Congress the authority to make a tax law effective retroactively. Democrats in Congress are on the record stating that they will do just that early in 2010. The question is whether such an effort would be challenged in the courts. On the one hand, *U.S. v. Carlton* was a unanimous decision of the U.S. Supreme Court, of which Justice Scalia later remarked, "The reasoning the Court appl[ied]. . . guarantees that all retroactive tax laws will henceforth be valid." On the other hand, observers have taken note that *Carlton* may only apply to a retroactive change to an existing tax—as opposed to a retroactive effort to revive an expired tax.

WHAT ABOUT 2011?

Under the law in effect since 2001, the estate tax will only be gone for one year. In 2011 the tax comes roaring back at levels not seen for years: a mere $1 million exemption and a top marginal rate of up to 60%. The reason that the repeal of the tax only lasts one year is that the Congress that passed the 2001 law was not willing to raise other taxes or cut spending enough to pay for a truly permanent repeal of the tax. Therefore, even if there is no tax during 2010, Congress will have to act prospectively or the situation will worsen drastically in a year.

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