

The Changing State of the Federal Estate Tax

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On November 13, 1789, Benjamin Franklin wrote one of his more famous lines, "But in this world nothing can be said to be certain, except death and taxes."

Two hundred and twenty years later, Congress and the President have proven him wrong.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") has repealed the estate tax and generation skipping tax ("GST"), but not the gift tax, in 2010.

In 2009, a \$3.5 million federal estate tax and GST exemption applied to each individual. With proper planning, a husband and wife could exempt \$7 million from federal estate tax and from GST. A \$1 million gift tax exemption also applied to each individual for taxable gifts made during their lifetime.

The gift tax exemption continues during 2010, but starting Jan. 1, 2011, the estate tax and GST regime returns with a vengeance, allowing only a \$1 million exemption with a 55 percent top tax rate (compared to 2009's \$3.5 million exemption with a 45 percent top rate).

There was a prior concept of a "step up" in basis of property acquired from a decedent. This means that the fair market value of the decedent's property as of the date of the decedent's death became the new basis in the property to the heirs. Therefore, inherited property sold shortly after a decedent's death usually resulted in very little taxable capital gains.

Under EGTRRA, for those dying in 2010, the basis of property acquired from a decedent would be the **lesser** of the decedent's adjusted basis in the property (usually its cost) or its fair market value upon the decedent's death, subject to limited adjustments.

Consider the case of a decedent who acquired an asset 40 years ago with a basis of \$1,000. The asset had a fair market value of \$10,000 at the time of death. The basis of that property acquired from the decedent would be only \$1,000, generating a taxable gain of \$9,000 if you could sell the asset shortly after inheriting it.

Additionally, accounting fees would be incurred to determine the stock's basis after stock splits, reorganizations, mergers, etc. Had the death occurred in 2009, however, the taxable gain could have been zero.

A \$1 million gift tax exemption currently is applicable to each individual during that person's lifetime. To the extent you utilize some or all of this exemption during your lifetime, the federal estate tax exemption applicable to your estate is reduced by that amount. For the 2010 calendar year and thereafter, the gift tax exemption remains at \$1 million.

While the maximum gift tax rate was 45 percent in 2009, the maximum rate has **decreased** to 35 percent for the 2010 calendar year, but is scheduled to **increase** to 55 percent for the 2011 calendar year and thereafter.

While the U.S. House of Representatives passed a bill to permanently extend the 2009 estate and gift tax and GST regime (including the \$3.5 million exemption and 45 percent maximum rate), the Senate did not pass any such legislation before the winter recess.

Several senators announced their intention to enact legislation in early 2010, with a retroactive effect, providing that the same rules in effect for 2009 would continue for 2010 and thereafter.

Unfortunately, there is a strong difference of opinion among members of Congress as to whether, in fact, the rules can be made retroactive or not. Congressional inaction has resulted in confusion as to the viability of your estate plan.

Many people have estate plans that were prepared under the false assumption that a federal estate tax always would exist. They never realized that if they die in 2010, their estate actually could be distributed in a manner contrary to their wishes, due to the tax formulas in their estate planning documents.

Now is the time to review your estate plan to ensure that it accomplishes your goals... during times with and without a federal estate tax.

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