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## Repeal of the Estate and Generation-Skipping Tax: Living and Dying in a State of Confusion

In 2001, Congress enacted estate tax legislation that increased the estate tax exemption from \$1,000,000 to \$3,500,000 and decreased the estate tax rates from 55% to 45% over a span of ten years, leading up to a full repeal of the estate tax in 2010. However, this estate tax legislation also included a “sunset” provision that causes the estate tax law to revert back to the older limits and rates beginning in 2011, unless Congress did something to prevent that from happening. Similar changes were enacted for the generation-skipping tax.

Everyone expected Congress to act in 2009 to retain the estate tax in some form and to avoid the repeal provisions, and everybody was wrong. Some now expect Congress to act swiftly in the first quarter of 2010, to resurrect the estate tax in some form and to apply it retroactively to the beginning of the year, but in an election year will they be wrong again?

### What's the Law Now? — Effective January 1, 2010

1. The estate tax and the generation-skipping tax is repealed for one year;
2. The gift tax is retained, with the \$13,000 annual per donee gift tax exclusion and the \$1,000,000 lifetime exclusion remaining intact, but with a lower tax rate of 35%; and
3. The estates of decedent's dying in 2010 will be subject to a carryover basis regime (in lieu of the step-up basis regime that was applied before 2010), with limited exceptions.

### What Will Be the Law Beginning in 2011? — Under Current Law

1. The estate tax is reinstated with a maximum rate of 55% (up from 45% applicable in 2009). The exemption amount is reduced to \$1,000,000 (decreased from \$3,500,000 available in 2009);
2. The generation-skipping tax is reinstated at a flat rate of 55% (up from 45% applicable in 2009). The exemption returns to an inflation-adjusted amount of approximately \$1,300,000 (decreased from \$3,500,000 available in 2009);
3. The gift tax is retained but the maximum tax rate increases from 35% to 55%; and
4. The step-up basis regime that was applied prior to 2010 is reinstated, thus allowing the income tax basis of a decedent's assets to be adjusted to the value of the assets at the date of death.

## What Does All This Mean?

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The good news for those unfortunate to pass away in 2010 while the estate tax is repealed is that their estates may not be subject to estate and generation-skipping tax unless, of course, Congress reenacts the taxes and applies the new law retroactively. The bad news for the survivors of such decedents is that the absence of an estate tax and a generation-skipping tax may, in certain situations, cause the decedent's estate plan to be greatly disrupted and to unintentionally benefit or prejudice different classes of beneficiaries.

Many estate plans drafted since 1976 include formula bequests which are designed to create and fund distributions or trusts to avoid, minimize or defer estate tax and generation-skipping tax. Such formula bequests are based upon the estate tax and generation-skipping tax concepts applicable at the time of a decedent's death.

For example, the classic Trust A/Trust B plan for a married couple generally includes a formula bequest causing Trust B to be created in an amount equal to the then applicable estate tax exemption, with the balance of the estate passing to Trust A. A \$5,000,000 estate of a decedent dying in 2001, when the exemption was \$1,000,000, would have been allocated pursuant to such formula bequest \$1,000,000 to Trust B and \$4,000,000 to Trust A. The same estate of a decedent dying in 2009 with such a formula bequest would be allocated \$3,500,000 to Trust B and \$1,500,000 to Trust A. In 2010, in the absence of an estate tax, such a plan would result in a \$5,000,000 Trust B and no Trust A.

Where the beneficiary of such trusts is the same, *i.e.*, a surviving spouse, this adjustment to the size of the trusts created may be inconsequential. However, where there are different beneficiaries under Trust A and Trust B, *i.e.*, a spouse as a beneficiary of Trust A and children as beneficiaries of Trust B, these tax law changes may result in material, unintended modifications of the decedent's dispositive plan.

The formula bequest is not present in those estate plans for a married couple which provide for an outright bequest to a surviving spouse, but permit the creation of a trust by the "disclaimer" of the surviving spouse or which utilize a single trust for the spouse.

For those decedent's with more complicated generation-skipping tax plans, where different generations are beneficiaries of separate trusts created under a formula based upon the generation-skipping tax exemption, these tax law changes may also result in material modifications of the dispositive plan, including in 2010 the complete disinheritance of the grandchildren.

## What to Do: Check Your Estate Plan

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1. If you are married and believe you have a formula bequest creating multiple trusts at your death, but your spouse is the beneficiary of those trusts, there is likely nothing you need to do immediately. When the status of the estate tax is finally determined, you may wish to review your estate plan with us to determine whether your plan should be modified.

2. If you believe you have a formula bequest creating trusts for different beneficiaries, including generation-skipping trusts for children and grandchildren, or formula bequests to charity, you should review your estate plan with us now to consider modifying it to prevent disruption of your dispositive plan under current law. In the likelihood that Congress will act to reinstate the estate tax and generation-skipping tax similar to 2009 rates and limits, you may wish to amend your estate plan in such a way that the change would only apply if your death occurs in 2010 when the current rules are still in effect.
  
3. If you are uncertain about the type of plan you have, or if you have questions concerning the issues discussed in this newsletter, please contact us and we will be glad to review your plan or discuss these matters with you.

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