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Temporary Estate and GST Tax Repeal Expected in 2010

The highly unexpected result — repeal of the federal estate tax in 2010 in accordance with Bush era tax cuts — now seems a likely reality, at least temporarily.

Currently, the top federal estate tax rate is 45 percent, with each individual entitled to a $3.5 million exemption (allowing married couples to shield up to $7 million from the estate tax with proper planning). Under 2001 tax legislation, however, the federal estate tax will be repealed in 2010. Absent subsequent legislation, the federal estate tax will be reinstated in 2011, at a maximum rate of 55%, with a $1 million exemption. During this time, the gift tax will remain in place with the lifetime gift tax exemption fixed at $1 million; however, in 2010, the top gift tax rate will drop from 45 to 35 percent.

The generation-skipping transfer, or GST, tax, which applies generally to transfers to grandchildren and more remote descendants at a flat rate of 45%, also is scheduled for repeal beginning on January 1, 2010. Similar to the estate tax, if Congress does not act, the GST tax will be restored in 2011 at the top federal estate tax rate of 55%, with a $1 million exemption (the GST tax exemption currently is $3.5 million).

Upon repeal of the estate tax in 2010, inherited property will receive what is referred to as a "carry over basis." In essence, beneficiaries will receive the decedent's cost basis in the property and pay a capital gains tax on any appreciation when the inherited items are sold. Carry over basis generally will apply to all inherited property, provided that the Executor may increase the basis of one or more estate assets up to $1.3 million (and an additional $3 million with respect to assets passing to a surviving spouse, either outright or in a qualifying trust). By comparison, except for the change that applies for 2010, the basis of most inherited property is reset to fair market value (at date of death).

Earlier this month, the House passed a bill that, if enacted, would have extended permanently the 2009 top rate of 45 percent and the exemption of $3.5 million for the estate (and GST) taxes. It was anticipated that the Senate would, at the least, pass legislation for a short-term extension of the estate tax, giving Congress additional time to work out a more permanent resolution.

Nevertheless, the Senate has failed to agree on a temporary measure, which practically ensures that estate tax repeal will take effect in 2010.

Some Democrats have vowed to pass retroactive legislation so that the estate tax is reinstated in 2010; however, given the split on this issue in the Senate, it is not certain that such legislation will pass. Furthermore, any retroactive legislation undoubtedly will be subject to litigation on constitutional grounds. What is certain, is that the estate tax law will remain in a state of flux for the foreseeable future.

We believe that it is an important time to review and perhaps update your estate plan to deal with the current uncertainty. In addition, in light of the repeal of the GST tax and reduced gift tax rate (of 35%) in 2010, there may be opportunities to make estate planning transfers (taking into account the possibility of retroactive legislation).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions or wish to discuss your particular situation, please call John J. O’Neil (212-373-3379), Alan Halperin (212-373-3313) or Andrea Sanft (212-373-3256).