Wealth Management Update

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Estate and GST Taxes Repealed for 2010; and Gift Tax Rate Will Drop

In 2009, the estate and generation-skipping transfer ("GST") tax exemptions were $3.5 million per person, and the estate and GST tax rates were 45%. In 2001, Congress passed changes to the estate, GST and gift tax rules that take effect in 2010. Those changes call for the estate and GST taxes to be repealed for 2010 and for the gift tax rate to be equal to the highest income tax rate in 2010, which is 35%.

Assuming Congress does not change the law, on January 1, 2011, the estate, GST and gift tax laws that existed on January 1, 2001 would be reinstated; that is, the estate and gift tax exemptions would be reunified again at $1 million and the GST exemption would be $1 million, indexed for inflation. The estate and gift tax rates would range from 39% to 55% depending on the taxable gift or estate with taxable transfers in excess of $3 million taxed at the top rate. For taxable transfers between $10 million and $17,184,000, there would be a 5% additional tax imposed to bring the tax to 60% (the effect of the 5% surcharge is to phase out the decedent's estate tax exemption). In 2011, the GST tax rate would be 55%, the highest estate tax rate.

Even though almost everyone thought that Congress would act before 2010 so that repeal of the estate and GST taxes would never actually take place, Congress did not have time to act – and 2010 began without an estate tax applicable to people who die during 2010. However, Congress has indicated that it will attempt to pass an estate tax bill that is retroactive, so that there is no repeal of the estate and GST taxes. Whether retroactive taxation is constitutional is far from certain and time will tell regarding its viability.

With this confusion regarding the estate, gift and GST tax rules, we thought it would be helpful if we provided a summary of the current status of the law and what might happen if Congress changes that law. That summary appears below:

Law Applicable Before 2010

The rules that applied before 2010 are:

1. Estates of more than $3.5 million were subject to estate tax at a 45% rate.

2. Gifts that exceeded the amount of the annual gift tax exclusion ($13,000 for 2009) were taxed at a 45% rate once those gifts exceeded the individual's $ 1 million lifetime gift tax exemption.

3. To the extent a person's lifetime gift tax exemption was used up, that person's exemption from estate tax was reduced.

4. When someone died, that person's heirs inherited their property with an income tax basis equal to fair market value at the time of that person's death. (The result is that the heirs can generally sell the inherited property without income tax consequences.)

5. During life a person could gift up to $3.5 million to grandchildren (or other individuals two or more generations below their own) without incurring GST tax. To the extent not used during life, that $3.5 million GST tax exemption was available for use at death.

Generation-skipping transfers that exceed the GST exemption were subject to GST tax at a 45% rate.

The following example illustrates how the rules applicable before 2010 worked:

Example 1

Assume a father made gifts to his son in 2009 that totaled $1,013,001. $13,000 of that gift used his annual exclusion for his son. $1 million used up his lifetime exemption against gift tax. The last $1 was subject to gift tax at a 45% rate.

Now assume that the father died in 2009 with a $7 million estate which will be distributed to a trust for his son, and that the father's property had a zero basis. Because the father had already used $1 million (forget about the $1 for purposes of this example!) of his $3.5 million estate tax exemption, he had $2.5 million remaining to be used at his death. Therefore, of the father's $7 million estate, $2.5 million escaped estate tax – and a tax of 45% was imposed on the balance; the estate tax due was $2,025,000.

Son's trust received the $7 million property with a $7 million basis. If the trust sold that property for $7 million, there is no gain and no income tax due.

Father made no gifts to grandchildren during his lifetime, so he had $3.5 million of GST exemption to allocate to the trust for his son. That allocation will help avoid tax when the son dies and the assets in the son's trust pass to son's children (father's grandchildren).

Law Applicable During 2010

The rules that apply during 2010 are:

1. There is no estate tax.

2. The gift tax rate drops to 35%. The gift tax exemptions remain unchanged. Therefore, gifts that exceed the amount of the annual gift tax exclusion ($13,000) are taxed at a 35% rate once those gifts exceed the individual's $ 1 million lifetime gift tax exemption.

3. When someone dies, the basis step-up at death is eliminated – except for the first $1.3 million that passes to someone other than a decedent's spouse and the first $3 million that passes to a decedent's spouse.

4. There is no GST tax.

The following example illustrates how the rules applicable during 2010 work:

Example 2

Assume a father makes gifts to his son in 2010 that total $1,013,001. $13,000 of that gift uses his gift tax annual exclusion for his son. $1 million uses up his lifetime exemption against gift tax. The last $1 is subject to gift tax at a 35% rate.

Now assume that the father dies in 2010 with a $7 million estate which will be distributed to a trust for his son, and that the father's property had a zero basis. No estate tax is imposed.

Because father is not married, only $1.3 million of the basis can be stepped up for the $7 million property. Therefore, son's trust receives the $7 million property with a $1.3 million basis. If the trust sells that property for $7 million, there is $5,700,000 of capital gain, which will be taxed at the capital gains rate. Assuming that the rate is 25%, the income tax due is $1,425,000.

Note: because there is no GST tax during 2010, father could leave whatever he wanted to his grandchildren without imposition of GST tax. Depending on the law at the time when the son dies will dictate whether GST tax will be imposed at that time.

Law Applicable After 2010

The rules that apply after 2010 are:

1. The estate tax exemption is $1 million. Taxable estates in excess of $1 million are subject to estate tax at rates ranging from 39% to 55%, depending on the amount. The top rate of 55% is imposed on taxable estates in excess of $3 million. There is an additional 5% surcharge for estates that exceed $10 million and are less than $17,184,000.

2. The gift tax exemption is also $1 million. Similar to taxable estates, taxable gifts in excess of $1 million are subject to gift tax at rates ranging from 39% to 55%, depending on the amount. The top rate of 55% is imposed on taxable gifts in excess of $3 million.

3. To the extent a person's lifetime gift tax exemption is used up, that person's exemption from estate tax is reduced.

4. When someone dies, that person's heirs inherit their property with an income tax basis equal to fair market value at the time that person's death. (The result is that the heirs can generally sell the inherited property without income tax consequences.)

5. During life a person can gift up to $1 million (as indexed for inflation) to grandchildren (or other individuals two or more generations below their own) without incurring GST tax. To the extent not used during life, that $1 million GST tax exemption is available for use at death.

6. Generation-skipping transfers that exceed the GST exemption are subject to GST tax at a 55% rate.

The following example illustrates how the rules applicable after 2010 work:

Example 3

Assume a father makes gifts to his son in 2011 that total $1,013,001. $13,000 of that gift uses his annual exclusion for his son. $1 million uses up his lifetime gift tax exemption. The last $1 is subject to gift tax at a 39% rate (with graduated rates for future gifts that are taxed at rates between 39% and 55%).

Now assume that the father dies in 2011 with a $7 million estate which will be distributed to a trust for his son, and that the father's property had a zero basis. Because the father has already used his $1 million gift tax exemption (forget about the $1 for purposes of this example!), he has no exemption remaining to be used at his death. Therefore, the father's entire $7 million estate is subject to estate tax. Based on graduated tax rates, $3,057,000 of estate tax is due.

Son's trust receives the $7 million property with a $7 million basis. If the trust sells that property for $7 million, there is no gain and no income tax due.

Father made no gifts to grandchildren during his lifetime, so he has $1 million of GST exemption to allocate to the trust for his son. That allocation will help avoid tax when the son dies and the assets in the son's trust pass to son's children (father's grandchildren).

WILL CONGRESS ACT RETROACTIVELY?

There is talk in Congress about passing a retroactive estate tax bill in 2010, which would eliminate the repeal so that estates of persons dying in 2010 would be subject to estate tax. Presumably, the GST tax would also be reinstated retroactively and the higher gift tax rate of 45% would also be reinstated retroactively.

The provisions of such a retroactive law – if it comes to pass – are not now determinable. The House has passed a bill keeping the rules as they are in 2009. The Senate has not passed a bill – though some Senators have been pushing for a $5 million exemption from estate tax and a 35% maximum rate. One compromise suggested was to keep the 2009 rules in force but to allow the $3.5 million exemption to grow with inflation.

One can only speculate as to what – if anything – Congress might do this year. The ability of Congress to act retroactively is also an issue; there are some cases that suggest retroactive action would be constitutional, but one can certainly expect a constitutionality challenge from the estate of a wealthy individual who dies after 2009 but prior to any 2010 retroactive legislation or an individual who makes a gift to his grandchildren in early 2010 prior to any retroactive legislation expecting to pay gift tax at a 35% rate and no GST tax!

PLANNING SUGGESTIONS FOR THE EXPECTED "INTERIM" PERIOD BETWEEN 2010 AND EXPECTED CONGRESSIONAL ACTION

Anyone who says they "know" what will happen with the estate tax is lying – NO ONE KNOWS WHAT CONGRESS WILL DO (if anything)! However, since we have entered 2010 without an estate or GST tax, there are a number of planning ideas that taxpayers might consider.

Examples of this type of planning follows:

- A grandparent might make a gift of $1 million to a trust for grandchildren in early January. That gift would use the grandparent's lifetime exemption against gift tax (or be subject to gift tax at a rate of 35% to the extent the grandparent has used his exemption), but since there is no GST tax, the gift would be free of GST tax. The remainder beneficiaries of the trust could be a trust for the grandparent's spouse and/or children.

  If Congress passes a law that is not retroactive, the gift to the trust would have been completed without using any portion of the grandparent's GST tax exemption.

  If Congress passes a law (before the date, which is nine months from the date of the gift) making the GST tax retroactive and applicable to the gift grandparent made to the trust, this opportunity would be eliminated. At that time, the grandchildren could disclaim their interest in the trust so that it passes to the trust for the grandparent's spouse and/or children. The disclaimer would be a "qualified" disclaimer (made within nine months of the gift and satisfying all the other requirements of such a disclaimer), so that the grandchildren would not be treated as having made a gift to the trust for the grandparent's spouse and/or children.

  Furthermore, if the grandparent does not want to use any portion of his gift tax exemption (or pay any gift tax if he had already used his gift tax exemption), the children could also disclaim the gift. In this case, assuming that the spouse had a "qualifying income interest" in the trust and it otherwise would qualify as a marital QTIP trust, the gift would be treated as coming directly from the grandparent to the grandparent's spouse – qualifying for the marital deduction so no gift tax would be due. Grandparent would be in the same position from a tax perspective as he would have been in if he hadn't done anything.

- Husband can make a significant gift to a trust for his wife that requires her to receive all of the trust income currently. Wife and children can be named discretionary distributees of trust principal. To the extent that the gift exceeds husband's $1 million lifetime exemption, gift tax will be imposed at the new 35% rate (down from 45%).

  If Congress passes a bill that returns the rules to those applicable in 2009, but is not retroactive to the date of husband's gift, a 10% reduction in the gift tax rate for the amounts transferred to the trust will have been achieved.

  If Congress passes a bill that makes the 45% gift tax rate retroactive to the date of husband's gift to the trust, the children can disclaim (in the form of a "qualified" disclaimer) their rights to receive discretionary distributions of principal from the trust. Husband can then make a QTIP election for the trust qualifying his gift for the marital deduction, so that no gift tax is due. As long as the disclaimer is "qualified" (made within nine months of the gift and satisfying all the other requirements of such a disclaimer), the children won't be treated as having made a gift either. If wife receives a distribution of principal from the QTIP trust in termination thereof, husband and wife are in the same position as if they hadn't even attempted to save the 10% rate differential.

The Personal Planning Department of Proskauer can tailor an effective plan to reduce estate, gift and GST taxes during this uncertain period – and we are ready to answer your questions concerning this changing situation.

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