

Frequently Asked Questions About 2010—Estate Tax, Gift Tax, GST Tax, and Carryover Basis

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*Updates forthcoming regarding the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

What's so important about calendar year 2010 for my estate plan?

- Federal estate tax 'repealed' for a death in 2010
- Federal GST tax 'repealed' for a generation-skipping transfer in 2010
- Federal gift tax rate drops to 35 percent for taxable gifts in 2010
- 'Carryover basis' applies to assets received from a person who dies in 2010
- These federal tax law changes may negatively impact the distributions under a will or revocable trust for a death in 2010

At the end of December 2009, Congress unexpectedly allowed the federal estate tax and federal GST tax to expire for calendar year 2010 only. Some estate plans aren't impacted by these 2010 federal tax law changes. However, provisions in wills and trusts linked to federal estate tax and federal GST tax concepts may cause unintended results in 2010. In some cases, distributions to the surviving spouse, to charities, or to others may be significantly changed or even eliminated. Contact your Gray Plant Mooty attorney and ask if the 2010 federal tax law changes impact your estate plan.

Is Congress going to act in 2010 to change the federal transfer tax laws or carryover basis?

We don't know yet, but we're watching Congress closely. On December 3, 2009, the House of Representatives passed H.R. 4154 to repeal carryover basis and to extend the calendar year 2009 federal estate tax, gift tax, and GST tax laws into calendar year 2010 and beyond. As of February 11, 2010, the Senate hadn't yet passed this bill. In addition to H.R. 4154, Congress is considering many different tax law proposals for 2010 and beyond. Some senators and representatives have stated that they plan to reinstate the federal estate tax and GST tax in early 2010, and the new legislation might apply retroactively to January 1, 2010. However, it's unclear if Congress will pass any federal transfer tax legislation in 2010.

What federal transfer tax laws will change for 2011, unless Congress acts?

Unless Congress acts, the federal transfer tax laws will change again in calendar year 2011. The 2011 federal estate tax applicable exclusion amount will be \$1 million (this amount was \$3.5 million in 2009), and the maximum tax rate will be 55 percent plus a 5 percent surtax applicable to estates over \$10 million (the maximum tax rate was 45 percent in 2009). The 2011 federal gift tax exclusion amount will be \$1 million (this amount was \$1 million in 2009 and 2010), and the maximum tax rate will be 55 percent (the maximum tax rate was 45 percent in 2009 and 35 percent in 2010). The 2011 federal GST exemption amount will be \$1 million plus an inflation adjustment (this amount was \$3.5 million in 2009), and the tax rate will be a flat 55 percent (the tax rate was a flat 45 percent in 2009).

In addition, there are uncertainties about future capital gain taxes and future GST taxes in 2011 and beyond. Under the 2001 tax bill, known as the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), Congress changed the federal transfer tax laws to lower tax rates and increase the exclusions that sheltered most families from paying federal estate tax and GST tax. However, there is a problem with EGTRRA—when Congress passed the bill in 2001, the bill didn't receive the 60 votes in the Senate necessary to make the new law permanent. Because of this, all provisions of EGTRRA expire or 'sunset' on December 31, 2010. In addition, starting January 1, 2011, federal tax laws are applied and administered as if Congress had never enacted EGTRRA. At this point, it isn't clear how this will impact taxes in 2011 and beyond. For example, from 2004 to 2009, EGTRRA gradually increased the GST exemption to \$3.5 million. It isn't clear whether a trust that received an allocation of this increased GST exemption will continue to be exempt after December 31, 2010. In

addition, EGTRRA permits selected assets passing from a person who dies in 2010 to receive an income tax basis improvement. It isn't clear whether an asset that received a basis improvement will continue to have that increased basis after December 31, 2010.

Is there a federal gift tax in effect for 2010?

Yes, the federal gift tax is still in effect for calendar year 2010. For gifts made in 2010 by a donor, the federal gift tax annual exclusion amount is \$13,000 per donee. For gifts made in 2010 that exceed the annual exclusion amount, each donor has a lifetime gift exclusion amount of \$1 million, reduced by prior taxable gifts. For gifts made in 2010 that exceed the \$1 million lifetime gift exclusion amount, the tax rate is a flat 35 percent.

Is there a Minnesota estate tax in effect for 2010?

Yes, Minnesota still has a state estate tax in effect for a death in calendar year 2010. Minnesota's estate tax generally applies to estates with a net value of \$1 million or more. Currently, 19 states and the District of Columbia have an estate tax, an inheritance tax, or both in effect for a death in calendar year 2010.

If my will or revocable trust uses a formula to distribute assets, should I update my estate planning documents?

Probably, if your will or revocable trust uses a formula based on federal estate tax or GST tax concepts. Contact your Gray Plant Mooty attorney and ask if the 2010 federal tax law change impacts your estate plan. These tax law changes don't affect all formulas. You may want to amend your estate planning documents to clarify your intent for 2010, especially if Congress doesn't act soon.

Should I wait until Congress acts before I update my estate planning documents?

Probably not, because amending your will or revocable trust can clarify what happens if you die in 2010. This is especially important for wills and revocable trusts that use formulas based on federal estate tax or federal GST tax concepts. For estate planning documents that are affected by the 2010 federal tax law change, a short amendment document may be all that is needed to clarify what happens if you die in 2010.

How often should I update my estate plan?

Normally, you should contact your Gray Plant Mooty estate planning attorney every two or three years to review your estate plan. Also contact your Gray Plant Mooty estate planning attorney if you have had a significant change in your life, including getting married or divorced, having a child, moving to another state, buying real estate in another state, starting a business, changing jobs, experiencing a significant change in your income, retiring, etc.

Is it possible to update a person's estate plan if the person is incapacitated?

Yes, in Minnesota, an incapacitated person's guardian may ask permission of the court to update the person's estate plan. Contact a Gray Plant Mooty attorney to ask for more details about this process.

Should I make a contribution to an irrevocable trust in 2010, including paying a premium on a life insurance policy owned by an irrevocable trust?

Ask your Gray Plant Mooty attorney first. For an irrevocable trust that is exempt from federal GST tax, it isn't clear yet whether a contribution to the trust in calendar year 2010 (including personally paying a premium on a life insurance policy owned by the trustee of an irrevocable trust) will cause the trust to lose its GST tax-exempt status. If there is no GST exemption amount to allocate to the contribution to the trust in 2010, future distributions from the trust may be subject to federal GST tax. Contact your Gray Plant Mooty attorney and ask about the planning options we have for contributions to a GST tax-exempt trust in 2010 and for premium payments on life insurance policies owned by a GST tax-exempt trust in 2010.

Should I make gifts to my grandchildren in 2010?

Ask your Gray Plant Mooty attorney first. For gifts to grandchildren (or other gifts that might skip a generation) in calendar year 2010, it isn't clear yet whether the gift will be subject to federal GST tax. Although it's possible that gifts to grandchildren in 2010 will be exempt from federal GST tax, Congress may retroactively change the 2010 federal tax laws. In general, a gift made directly to a grandchild that doesn't exceed the \$13,000 federal gift tax annual exclusion amount isn't subject to federal GST tax, so these gifts aren't affected in 2010.

However, a gift in 2010 to an irrevocable trust for the benefit of a grandchild or a gift to a Uniform Transfers to Minors Act account may be subject to federal GST tax after 2010 when the money is distributed out of the trust or UTMA account to the grandchild. Contact your Gray Plant Mooty attorney for more information on making gifts to grandchildren (or other gifts that might skip a generation) in 2010.

Are there unique estate planning opportunities for 2010 before Congress acts?

Yes, but Congress may retroactively change the 2010 federal tax laws. Because the federal gift tax rate drops to 35 percent for 2010 (the maximum federal gift tax rate was 45 percent in 2009 and is scheduled to increase to 55 percent in 2011), there may be opportunity for making taxable gifts in 2010 and paying the tax at a lower rate. Other estate planning opportunities include making gifts to family members or to charities without paying federal gift tax (using the gift tax annual exclusion, the lifetime gift tax exclusion amount, the marital deduction, or the charitable deduction). Contact your Gray Plant Mooty estate planning attorney if you are interested in gifting opportunities and other estate planning opportunities for 2010.

What's 'carryover basis'?

The 'carryover basis' system is the short name for a new set of income tax rules that apply to assets received from a person who dies in calendar year 2010. To explain carryover basis, we need to describe the capital gains tax system briefly.

When you sell or exchange an asset, the IRS generally collects an income tax on the profit or 'gains' that you receive. For example, Penny Saver buys 100 shares of stock in XYZ Company for \$10/share (total: \$1,000). If Penny sells her 100 shares later for \$12/share (total: \$1,200), Penny received a profit of \$200. The IRS taxes Penny on that \$200 of profit as a capital gain.

Suppose Penny dies before selling her 100 shares of stock in XYZ Company, and her will gives this stock to her son Buck. If Buck sells the stock, he needs to determine his basis in the stock so he can compute whether he receives any profit and owes the IRS any capital gains tax. Buck will have a different basis in the stock depending on Penny's year of death—one set of rules applies for a death in 2010 (carryover basis) and a different set of rules apply for a death before or after 2010.

For Penny's death before or after 2010, the stock that Buck receives from Penny has a new basis. The new basis generally equals the fair market value of the stock on the date of Penny's death. Buck doesn't need to know when Penny purchased the stock or how much she paid for it. If the fair market value of XYZ Company on Penny's death was \$15/share (total: \$1,500), then Buck's basis in the stock is also \$15/share. If Buck sells the stock later for \$18/share (total: \$1,800), Buck receives a profit of \$300 ($\$1,800 - \$1,500 = \300). This is the result even though Penny only paid \$10/share for the stock. The IRS taxes Buck on that \$300 as a capital gain.

For Penny's death in 2010, the carryover basis system applies. Generally, the stock that Buck receives from Penny has the same basis as it did before Penny's death—the basis "carries over" from Penny to Buck. So, Buck needs to know when Penny purchased the stock and how much she paid for it. It may be very difficult or even impossible for Buck to prove the purchase date and price, unless Penny kept good records. Here, Buck's basis in the stock is \$10/share, which is what Penny paid for the stock when she purchased it. In our example, the fair market value of XYZ Company on Penny's death was \$15/share, which exceeds the \$10/share that Penny paid for the stock. If the fair market value on Penny's death was lower than what she paid for it, Buck's basis in the stock would be reduced to that lower fair market value. Under the new carryover basis system, the executor of Penny's estate may increase the basis of selected assets by up to \$1.3 million. Penny's executor also may increase the basis of selected assets passing directly to or in a qualified trust for a surviving spouse by an additional \$3 million. However, Penny's executor can't increase the basis of any asset beyond the asset's fair market value. If Penny's executor doesn't elect to increase the basis of the stock passing to Buck,

Buck's basis in the stock remains at \$10/share, which is what Penny paid for the stock. If Buck sells the stock later for \$18/share (total: \$1,800), Buck receives a profit of \$800 (\$1,800 - \$1,000 = \$800). The IRS taxes Buck on that \$800 as a capital gain.

There are more rules that apply in determining the carryover basis for a death in calendar year 2010. These carryover basis rules are complicated and may require filing a special tax return for a death in 2010. Worst of all, the current tax code imposes the carryover basis income tax system for a death in calendar year 2010 only, and it's unclear whether these income tax basis rules, including the \$1.3 million or \$3 million basis increase amounts for assets passing from a person dying in 2010, will apply if an asset is sold in 2011 or beyond. Hopefully, Congress will clarify these federal tax laws soon.

What are the historical, current, and future federal estate, gift, and GST tax rates and exclusion amounts?

Federal Transfer Tax Law as of February 2010

Year	Estate Tax		Gift Tax		GST Tax	
	Exclusion	Top Rate	Exclusion	Top Rate	Exemption	Top Rate
2001	\$675,000	55%	\$675,000	55%	\$1,060,000	55%
2002	\$1,000,000	50%	\$1,000,000	50%	\$1,100,000	50%
2003	\$1,000,000	49%	\$1,000,000	49%	\$1,120,000	49%
2004	\$1,500,000	48%	\$1,000,000	48%	\$1,500,000	48%
2005	\$1,500,000	47%	\$1,000,000	47%	\$1,500,000	47%
2006	\$2,000,000	46%	\$1,000,000	46%	\$2,000,000	46%
2007	\$2,000,000	45%	\$1,000,000	45%	\$2,000,000	45%
2008	\$2,000,000	45%	\$1,000,000	45%	\$2,000,000	45%
2009	\$3,500,000	45%	\$1,000,000	45%	\$3,500,000	45%
2010	Repeal	Repeal	\$1,000,000	35%	Repeal	Repeal
2011	\$1,000,000	55%	\$1,000,000	55%	\$1,000,000	55%
					+ CPI adj.	

Gray Plant Mooty's Trust, Estate, and Charitable Planning practice group is closely monitoring the proposed transfer tax legislation in Congress, and we hope Congress will clarify these federal tax laws soon. If you have any questions about your estate plan or the latest federal tax proposals in Congress, please contact your Gray Plant Mooty attorney.

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