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## ***Estate, Gift and GST Taxes – The Latest!***

### **Dear Clients and Friends:**

You may have heard that hope for estate tax legislation before the end of 2009 apparently died in the Senate the night of December 16th – although there is one report this morning that there may be another last ditch effort before the end of the year. Some people think, “Oh, good, no estate taxes in 2010,” but it is not quite that simple. In the following paragraphs we summarize what the estate, gift and generation-skipping transfer (GST) taxes under current law (if not changed by Congress) will be for 2010 and 2011 and the uncertainties presented for 2010, including possible retroactive legislative enactment. Then we saved the good news for the end where we outline some planning opportunities now available for a small window which we think will be the first few months of 2010 (assuming there is no legislation by December 31, 2009).

First, a summary of the tax laws for 2009, 2010 and 2011 under current law:

Year	Federal Estate Tax		California Estate Tax	Federal GST Tax		Federal Gift Tax		Step-Up in Basis for Estates
	Exclusion	Rate		Exclusion	Rate	Exclusion	Rate	
2009	\$3,500,000	45%	None	\$ 3,500,000	45%	\$1,000,000	45%	All estate assets, including surviving spouse's share of community property
2010	None	None	None	None	None	\$1,000,000	35%	\$ 1,300,000, plus an additional \$ 3,000,000 for assets going to a spouse
2011	\$1,000,000	55%	Amount of Federal Credit	\$ 1,340,000 plus 2011 inflation	55%	\$1,000,000	55%	All estate assets, including surviving spouse's share of community property

To explain the chart, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA or the 2001 Act) increased the speed of a graduated increase in the exemption for estate and GST taxes while decreasing the tax rate. Both taxes are then repealed for calendar year 2010. However, the 2001 Act is to “sunset” after 2010, meaning that for 2011 the estate and GST tax provisions return to what they would be otherwise under prior law. For gift taxes, both under the 2001 Act and prior law, the lifetime exemption is \$1 million, gift taxes are not repealed in 2010, and the tax rate shifts each year. **Take note of the very low 35% gift tax rate for 2010.**

California has no GST or gift taxes, and the state’s estate tax is only in the form of collecting whatever credit the federal government allows for state death taxes. The 2001 Act had phased out that credit, so with the sunset of the 2001 Act the credit will return in 2011. However, the total estate tax (state and federal) is the same as this state tax credit only shifts tax money from the IRS to the state.

Another aspect of the 2001 Act is that as of 2010 the “step-up” in income tax basis of assets in a decedent’s estate is eliminated. Instead, the decedent’s tax basis “carries over” to those who receive the assets, but subject to special rules. So in broad terms, when an asset received from a decedent is sold, the then-owner will be liable for gain from the decedent’s income tax basis. However, there are provisions for some increase in a decedent’s basis: an executor will have the ability to allocate approximately \$1.3 million to increase the basis up to fair market value, and assets going to a surviving spouse can get an additional \$3 million in assets at a stepped-up basis. Practically speaking, family members will need to keep every scrap of paper they can find when someone dies in order to try to determine the basis of each and every asset of a decedent’s estate (from a home to a car to a refrigerator to a diamond ring to the clock on the wall). **We recommend that everyone gather documentation of the amounts paid for all your assets to prove what the basis is, and keep this information with your valuable papers.** This “carry-over basis” provision has been discussed many times in Congress and it is possible that Congress may implement this beyond 2010.

**We have read estimates that while about 6,000 estates in 2010 will avoid estate taxes, between 61,000 and 70,000 taxpayers will have new capital-gains liability to be paid when the property inherited from a decedent who died in 2010 is later sold. Also consider that the long-term capital gain rate is presently scheduled to increase from 15% to 20% as of January 1, 2011.**

Interestingly, in May of 2006 researchers in Australia studied the effects of Australia’s 1979 repeal of federal inheritance taxes, and found that the week prior to the effective date of the repeal resulted in a significant reduction in the number of deaths, which were presumably picked up by an increase in the number of deaths the week after the effective date of the repeal. The Australian researchers posited that the U.S. may see similar statistics the week before and after December 31, 2009, when the U.S. estate tax is repealed.

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Now most people do not want to be thinking about taxes when a loved one is not doing very well or in a medical crisis. However, as a tax lawyer, it needs to be said that for anyone with an estate over \$3.5 million (or \$7 million for husband and wife), **the best tax planning is for them to be sure to live past Midnight and into January 1, 2010.**

***So what happened to the expected change in the law to avoid the 2010 repeal?***

Between 2002 and now there have been multiple measures introduced in Congress, many adopted by either the House or Senate, but none by both houses. This year's 111th Congress saw several bills introduced. HR 4154, a short, one-page bill, finally was passed by the House and sent to the Senate on December 3, 2009. HR 4154 would have made permanent the 2009 estate tax top rate of 45% and the \$3.5 million estate tax exemption. However, it was anticipated to have an uphill battle in the Senate, and that is what happened. On December 16th, the Senate could not pass this bill nor amendments to make it effective for only a few months to buy more time for another bill. Now discussion on estate taxes has been tabled by the Senate until some time next year.

The Washington tax "insiders" we follow have anticipated that we could come to 2010 without a tax bill, and in the past they have consistently opined that surely Congress will then pass legislation in 2010 which would then be retroactive to January 1, 2010. Several news articles have said the same. In the past we have relied on these opinions, but now we are re-evaluating what might happen.

First, consider the political climate, the multiple issues Congress is now dealing with, and the little attention estate taxes has garnered on a national level in recent months. Also, consider the fact that 2010 is an election year so estate taxes will surely become an election issue.

Next, consider the almost certain litigation over any legislation enacted later in 2010 with retroactive application to January 1, 2010. The U.S. Supreme Court has upheld the constitutionality of certain retroactive tax laws. However, there are exceptions. Although many think that a constitutional challenge to a retroactive estate tax bill adopted in 2010 would not have a chance before the Supreme Court, others disagree. One of the strong arguments for possible success comes from a precedent concerning gift taxes which, by nature, is determined during annual periods. In this particular gift tax case, the Supreme Court would not apply the retroactive tax because the gifts had been made and completed prior to the adoption of the new law. On the other hand, there was another case dealing with a retroactive increase in the estate tax rate from 50% to 55% and a federal appellate court allowed the retroactive increase to apply to the estate of a decedent who had died prior to enactment of the legislation. In that case the U.S. Supreme Court chose to let the appellate ruling stand. But note that this latter estate case only dealt with a change in the tax rate, where the prior gift tax case dealt with the imposition of a new gift tax. In 2010, the estate tax has been repealed entirely so it can be argued that later legislation seeking a retroactive application is seeking to apply a "new" tax to the estate of a person who died early in 2010 when there was no estate tax at all.

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So we are considering that the odds of a constitutional challenge to retroactive estate tax legislation in 2010 are good, which would tie up the legislation in courts for a few years until the Supreme Court might rule. We are also hearing more people consider that Congress may prefer to avoid that prospect by not having any retroactive component to estate tax legislation which might be later adopted.

Assuming, therefore, that any estate tax legislation for 2009 did indeed die in the Senate on December 16th, and in light of the above serious questions about any future retroactive legislation, this presents us with both uncertainties and opportunities.

***Uncertainties.*** Most wills and trusts have generally anticipated updated legislation to continue the estate tax in a form similar to what it is in 2009, **albeit with some possible changes in the numbers**, and so the trust funding formulas and estate tax planning are typically based on these current tax laws with the funding formulas able to handle changes in the numbers. (Although very old documents, especially prior to about 1998, could have more problems.) Even today, no one can predict what will finally apply to calendar year 2010 or 2011. The uncertainties, therefore, include how the funding formulas might be interpreted on any particular date after January 1, 2010, i.e., depending on future legislation and any legal challenges to such legislation, or by assertions of differing interpretations brought by beneficiaries who might attempt to seek personal advantage by one interpretation or another. One of these beneficiary challenges arises from the formula language sometimes used for gifts to a spouse (where the formula wants to maximize estate tax savings and minimize capital gain treatment) where it might be possible for remainder beneficiaries to assert that a surviving spouse is not entitled to anything from a deceased spouse – again, depending on the language and depending on the assertiveness of other beneficiaries during this 2010 year of uncertainty (this goes away in 2011 under present law).

So some post-death planning may be needed in 2010, such as use of disclaimers. **Alternatively, some clients may desire to update their wills or trusts as of January 1, 2010, to change the funding formulas to cover different anticipated contingencies.** But even in the legal and tax community, there are great uncertainties about what is likely to be finally adopted by Congress and it just may not be possible to match all the different possibilities.

With the various uncertainties about 2010 legislation, litigation (both as to the law or as to interpretation of instruments), and what challenges might be raised to the new “carry-over basis” for income tax gain on assets from decedents who died in 2010, estate beneficiaries really might not actually know for years how much they are actually inheriting and what all the tax consequences are for years! That is the bad news.

***Opportunities – now for the good news!*** Prudent planning would seek to take advantage of the current tax laws effective as of January 1, 2010, but to do transactions which would be completed prior to any subsequent legislation from Congress which either might not apply retroactively or to increase the odds that it might not apply to those particular transactions if any

retroactive law were challenged in court. Another prudent planning step would be to plan for a contingency to somehow “unwind” a transaction if legislation is later enacted reducing or eliminating any tax savings from the transaction.

So we think there is a window of opportunity early in 2010 prior to when Congress might enact estate tax legislation – possible for January and February, perhaps March – and these are some of the opportunities:

1. With the low 35% gift tax rate in 2010 (after a person uses up all of the \$1 million lifetime gift tax exemption), making large gifts that pay gift tax at the 35% rate could save considerable future tax from the estate and gift tax 55% rate for 2011 if Congress does not act. If Congress does act, so far the discussions of the tax rate have ranged between 35% and 55% so some savings should likely still be realized.

2. Taking advantage of no GST tax for 2010. You still have to consider gift tax implications, but you can avoid this additional GST tax. No GST tax means that gifts made directly to grandchildren will not incur GST taxes. Grandparents, think of future planning for college! Another application is making gifts into a trust for children, grandchildren and great-grandchildren, all of which can be exempt both from future GST and estate taxes (under current law), meaning that all trust assets will pass free of both estate and GST taxes down to each generation planned for in the trust. (But, again, you still do have to consider any gift tax implications.) Currently our GST tax planning is limited to the GST exemption amount but during this window of opportunity, there is no limit because there is no GST tax. There may even be an opportunity to clean up any problem trusts which have uncertainties as to GST exemption status, or may not be fully exempt from GST taxes as to all assets and future appreciation.

3. Another strategy for gifts that could be “unwound” depending on what Congress does later in 2010 is to make gifts to Grantor Retained Annuity Trusts (GRATs) which could then be “unwound” if all remainder beneficiaries of the GRAT disclaimed any interest within nine (9) months of the gift to the GRAT.

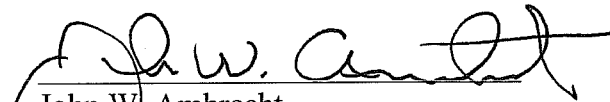
4. Planning to avoid uncertainties about trust funding language or beneficiary disputes over the language could be in the form of establishing a lifetime QTIP trust for a spouse, or modifying trust provisions to change the funding formula clauses consistent with present estate tax law for years 2010 and 2011 (although the uncertainty of future legislation cannot be eliminated entirely).


5. In light of the fact that in 2011 the long-term capital gain rate is set to increase to 20%, one might prefer to make a sale or do some other event which triggers recognition of gain in 2010 while the rate is still at 15%.

As a last note, we have prepared a memo of the different kinds of strategies available to minimize estate taxes and if you have not yet seen it, feel free to call the office and we will be happy to send one to you at no charge.

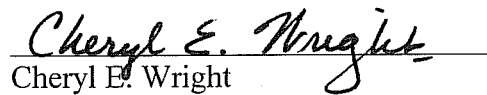
Wishing you joy and prosperity this holiday season and into the New Year!

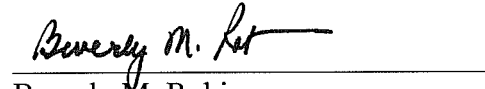
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