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NEWSLETTER

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ESTATE TAX CHAOS

As our prior newsletters have mentioned, in 2001, Congress passed and President Bush signed the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), which gradually increased the estate tax exemption and generation-skipping transfer ("GST") tax exemption, and then repealed both of those taxes as of January 1, 2010. However, EGTRRA "sunset" by its terms January 1, 2011, and prior law will then apply. This craziness was apparently adopted to keep within the Congressional budget rules in effect at the time. Most practitioners thought that Congress would take action before this all happened, to provide taxpayers and tax advisors with more certainty. Unfortunately, that did not occur. To be fair, the U.S. House of Representatives passed a bill in December to keep in effect the laws in place in 2009, but the Senate was stalemated and took no action (and still has not taken any action).

WHAT WE KNOW

2009 Law. For decedents dying or gifts made in 2009, the following rules apply: The estate tax and GST tax exemptions were \$3.5 million and the tax rate for transfers in excess of that amount was 45%. Most assets included in a decedent's gross estate for estate tax purposes received a new basis equal to fair market value on date of death (or the alternate valuation date, if applicable). This "step up in basis" (or step down) did not apply to "Income in Respect of Decedent" or IRD assets such as tax-deferred annuities, IRAs and 401(k)s. The gift tax exemption for gifts in excess of the \$13,000 annual exclusion was \$1 million, and the top tax rate was 45%.

2010 Law. The following rules are in effect unless and until Congress takes action: The estate tax and GST tax are repealed. The gift tax is still in effect with the same \$1 million exemption, but the top tax rate is reduced to 35%. The step

up in basis is more limited: generally, there is a "carryover" basis of the decedent's basis to the estate and beneficiaries, except for a limited step up of \$1.3 million. This step up is increased to \$3 million for assets passing to a surviving spouse or QTIP trust for a spouse.

2011 Law. If Congress takes no action, the law in effect prior to EGTRRA will apply as of January 1, 2011. The estate tax exemption will be \$1 million. The GST exemption is also \$1 million but indexed for inflation since 1999, so it will probably be more than that. The top estate tax rate (same as GST rate) will be 55% plus an additional surcharge of 5% for estates between \$10 million and \$17,184,000. The gift tax exemption will be \$1 million with a top rate the same as the estate tax rate. The step up in basis will apply. The Colorado estate tax equal to the state death tax credit allowed on the federal return will also probably reappear.

WHAT WE DO NOT KNOW

Congress' Actions. We do not know what action Congress may take, and if it will be retroactive to January 1, 2010. We also do not know whether a retroactive bill will be constitutional, although the U.S. Supreme Court has approved retroactive tax rate changes in the past. One case took seven years to wind its way through the system to check the constitutionality of such a change.

Gifts Before Congress Acts. Taxpayers might want to make large gifts to take advantage of the lower 35% gift tax rate, but Congress could change this retroactively. GST transfers are problematic: there is no GST tax right now, so a large gift to grandchildren looks tempting. However, Congress could reinstate the tax retroactively, so there is a great deal of risk associated with such a gift. In addition, there is no GST exemption right now, and no automatic allocation rules that would allocate GST exemption to gifts to a trust. If a large gift is made to a GST trust now, then in

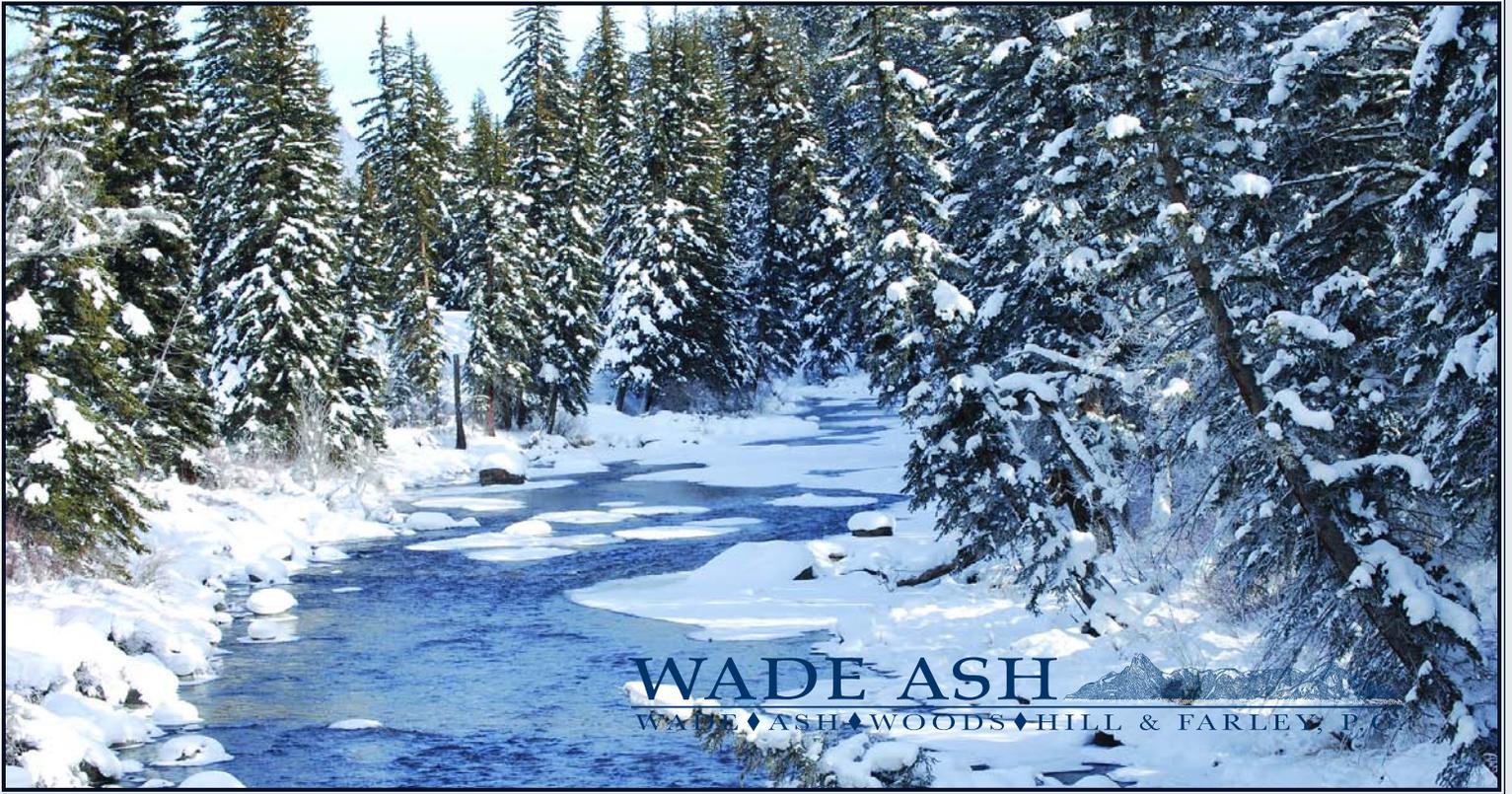
2011, with no exemption having been allocated to that gift, the trust may no longer be wholly GST exempt. A safer course might be a direct gift to grandchildren outside a trust. With no GST tax in effect, no GST exemption should have to be allocated to a direct gift. But no one really knows how such gifts will be treated.

Formula Clauses. We do not know exactly how either a marital deduction formula or a GST formula will be interpreted for a decedent dying in 2010 if the formula did not specifically address how assets should be allocated if there were no estate or GST tax. Some states are considering a statutory rule of construction (and Colorado is one), but such a general rule may or may not yield the best result in a particular case.

WHAT YOU SHOULD DO

Review your documents to see if changes are needed to any formulas dividing between a Marital Trust and Family Trust, or dividing into GST exempt and nonexempt shares. Contact us if you would like to schedule a meeting to review your estate plan in light of these unexpected changes. Even though since 2001 we included a sentence in many of our formula clauses addressing the issue of no federal estate tax, that "guess" at the time your documents were prepared may or may not be the best course now. Because Congress' inaction is unexpected, and the current chaos is not a result of our actions, we will charge our usual hourly rates for our time spent on reviews and preparation of any necessary amendments to estate planning documents.

IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice included in this written or electronic communication was not intended or written to be used, and it cannot be used by the taxpayer, for the purpose of avoiding any penalties that may be imposed on the taxpayer by any governmental taxing authority or agency.



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