The 2010 Estate Tax Repeal

On June 7th, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. Among the many changes to the tax law was estate tax repeal effective for the year 2010. At the time, the common consensus was that this complete repeal of the estate tax would never come to fruition. In an attempt to avoid the 2010 estate tax repeal, the House of Representatives passed H.R. 4154 to permanently extend the 2009 system ($3.5 million exemption, 45% tax rate) on December 3rd. However, this system, as well as various other proposals and compromises, failed to pass in the Senate.

On December 31st, Congressional staff members from the House Ways and Means and Senate Finance committees confirmed that an expected joint letter would not be issued. This letter, regarding how Congress intends to approach the 2010 estate tax repeal, was not issued because Congress could not agree on how to approach it. This failure to act prior to year end effectuated what few believed would ever happen - effective January 1st, 2010, estate taxes and generation-skipping taxes have been repealed for the current year, and a Congressional response remains uncertain.

Any eventual law passed will most likely attempt to be retroactive in effect to January 1, 2010. The most probable solution will be structured similar to the 2009 system: a $3.5 million exemption, a 45% tax rate, and the gift tax will remain disjointed from the estate tax exemption ($1 million versus the $3.5 million estate tax exemption). A retroactive reenactment of the estate tax effective January 1st may or may not be valid. Although there is substantial precedent (including Supreme Court cases) upholding the constitutionality of retroactive tax legislation, most of such legislation relates to changes in rates, not reinstatement of prior law no longer in effect.

The retroactive application of the potential law is not certain, in part, due to strict scrutiny that the Supreme Court emphasizes in constitutional review of retroactive tax legislation coupled with the difficulty of retroactively instituting an estate tax when no system currently exists. Furthermore, there is always the very real possibility that Congress will be unable to come to an agreement, and 2010 will pass without further legislation. In the absence of legislation, the estate tax is resurrected in 2011 with a $1 million exemption and a 55% maximum rate.

Impact of 2010 Estate Tax Repeal

One consequence of the repeal of the estate tax is that the meaning of formula provisions in existing wills and trusts becomes difficult to define. These provisions are phrased in terms of tax concepts, such as marital deduction and estate tax exemption amount, which are meaningless without an estate tax system in place. Since these tax concepts are not in the law as of now, the meaning of existing documents may be difficult to ascertain, which could adversely affect the eventual disposition of assets. Along those lines, these ambiguities could yield a number of will and trust construction suits over the coming years.

Even if the literal meaning of a formula clause is clear, application of a formula in a circumstance where no estate tax is currently in place could be drastically inconsistent with the intent of the testator. A typical estate plan for married individuals would include a provision designed to leave as much as possible to trusts or individuals other than the surviving spouse without generating any federal tax. In order to accomplish this, under traditional formulas, the maximum estate tax free amount (an amount equal to the deceased spouse's unused exemption amount) is transferred to descendents or other family members and the remainder of the estate is left to the surviving spouse.

Depending on the specific wording and interpretation of the formula bequests, this could have drastically adverse consequences. Considering the term exemption amount is not currently defined in law; it is very possible that the amount transferred to those other than the surviving spouse would be unlimited, effectively excluding the surviving spouse from the estate entirely. A similar result could obtain when dealing with exempt and non-exempt generation-skipping tax trusts. This will most likely also result in costly litigation regarding construction of the subject provisions in light of the client's intent, as well as intra-family litigation regarding the spouse's elective share of the estate and compliance with premarital agreements.

Action Steps

In light of these current uncertainties regarding the 2010 estate tax laws, it is recommended that you consider the careful review of current estate plans to alleviate or mitigate any of the risks described above. The most adequate solution to these risks may be to implement a stop-gap provision in either controlling wills or trusts to limit the allocation to descendents or mandate an allocation to the surviving spouse or children, as the case may be.

For example, the provision might provide generally that if the testator dies in 2010 at the time when the estate tax does not apply to the estate and the taxes are not retroactively reinstated prior to December 31, 2010, it shall be presumed that the relevant sections of the tax code as in effect on December 31, 2009 are in effect at the time of the client's death. Such a stop-gap provision should be tailored to the specific intentions of the testator.

Conclusion

The best course of action at this time remains unclear. It is important, however, to identify potential pitfalls and risks which have been created by the current failure of Congressional action. Please **contact us** in the event you wish to discuss these issues or identify potential problems in your estate plan.

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HANDLER THAYER, LLP

ATTORNEYS AND COUNSELORS AT LAW

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