May 2010 **[Forward to a Friend]**

The Twilight Series: Part Two

Are you aware that the estate tax has been repealed this year? Do you know how it happened and what it may mean for you? If not, read on.

Last month's newsletter introduced the uncertainties surrounding the estate tax in 2010. As I mentioned, this year is the "twilight" year for estate planners: attractive and potentially dangerous. The attractive part is easy: the estate tax has been repealed this year. No estate tax sounds good, right? The dangerous part is more complicated and far reaching: instead of an estate tax, there is a new capital gains tax on assets that you inherit this year. Why is this capital gains tax more far reaching than the estate tax?

Last year's estate tax only affected about 15,000 estates. This is because it was imposed only on estates worth more than $7 million for married couples or $3.5 million per individual. By contrast, the new capital gains taxes in 2010 will affect the heirs of more than 50,000 people who die this year. So, although the estate tax is *kaput* this year, more people will be subject to federal tax at death.

What are these new capital gains taxes and what do they mean for you?

New Rules for Calculating Capital Gains at Death

When you buy an asset, the purchase price is your "cost basis." If you later sell that asset, you will have to pay a capital gains tax on the appreciation - that is, on the difference between the sales price and your cost basis. For example, if grandma bought a house in 1960 for $100,000 and sold it in 2009 for $1,500,000, she would have had to pay a capital gains tax on $1,400,000. If federal and state capital gains taxes were approximately 20%, she would have owed close to $280,000 in taxes - a pretty hefty sum.

For decades, there was an exception to this general rules for those who*inherited* property from someone who died. Under this exception, if you inherited an asset from someone who died, you got a *new* tax basis. Instead of inheriting the cost basis of the person who died, you got a new (and usually higher) tax basis equal to the value of the asset on the date of death. In our example, if you inherited grandma's house in 2009, you would have received a new tax basis of $1,500,000 - the value of the house on her date of death. If you then sold the house for $1,500,000 soon after her death, you would have owed *zero* capital gains tax on that sale. (Contrast this to the $280,000 capital gains tax that grandma would have owed had she lived and sold the property herself!) This was an unlimited tax break for heirs. You got that "step up" in basis on all of the assets you inherited from someone who died.

In 2010, these "step-up" in basis rules were significantly modified. This year, each person is limited to $1.3 million worth of a stepped-up basis. In other words, if a person dies in 2010, his or her executor must decide to allocate the $1.3 million to particular assets, like a house. So, if the cost basis of grandma's house is $100,000 and her executor decides to allocate the entire $1.3 million permitted step-up to the house, as opposed to other of grandma's assets, you as the heir of that house would receive a stepped-up basis of $1,400,000 ($1.3 million plus the original cost basis). If the executor decides not to allocate any of the $1.3 million to the house, then grandma's cost basis of $100,000 would carry over to you. This means significant capital gains taxes when you sell. There is also a $3 million step-up available to surviving spouses for appreciated assets. Other than these two exceptions, all other assets must be valued at their original value. Here's an example that highlights the dangers of these new "carryover" basis rules:

Hypothetical: Dad Dies With Two Kids

Assume that Dad is a widower with two college-aged kids and that he dies in 2010 with an estate of $3.5 million. Assume also that his cost basis in all his assets is $500,000. Because the estate tax is repealed this year, his estate will pay no estate tax. However, his children will have to pay approximately $340,000 in capital gains tax when they sell Dad's property this year. Why? Dad's cost basis ($500,000), increased by the $1,3 million aggregate increase permitted under the legislation (total of $1.8 million), carries over to the kids. Dad's assets in 2010 (valued at $3.5 million) minus the modified cost basis ($1.8 million) equals $1.7 million taxable appreciation. If the federal and state capital gains tax is approximately 20%, the kids are left with a tab of approximately $340,000 in capital gains tax.

Now contrast this capital gains tax to what would have happened if Dad died last year. Under the law in 2009, Dad would have had a $3.5 million exemption and the traditional step-up in basis rules would have applied. The result? There would have been no federal estate tax (because Dad's estate did not exceed the exemption amount) and there would have been no capital gains tax (because the kids would have received a step-up in basis to $3.5 million, the date of death value of the assets). So, in 2010, the year of the estate tax repeal, the kids pay $340,000. In 2009, when the estate tax existed, the kids would have paid nothing.

What About You?

Estate planning for 2010 has been complicated because of Congress' inaction and the uncertain state of the federal estate tax and capital gains rules. It is possible that Congress will enact new legislation this year or next to reinstate the estate tax. If new legislation is passed, it could be made retroactive to the beginning of this year (thereby eliminating the repeal). However, the constitutionality of such retroactive legislation would likely be challenged.

In this uncertain environment, it is more important than ever that executors and trustees of estates in 2010 retain sufficient assets in the estate to pay potential estate taxes. It is also important for heirs to locate accurate purchase records if they inherit assets in 2010 that do not receive a modified step-up in basis. Most of all, it is critical that you contact your estate planning attorney to discuss the impact, if any, of the estate tax repeal and new capital gains rules on your family's estate plan.

In next month's newsletter, the final part in this three-part *Twilight* series, I will discuss the new gift tax and generation-skipping transfer tax rules and how they might work in your favor this year.

Stay tuned . . .

Estate Tax Timeline: Summary

	2009	2010	2011 & beyond
Estate Tax	•45 % top tax rate •$3.5mm exemption	•Completely repealed •Carryover basis rules (instead of traditional step-up in basis rules) Two Exceptions: - $1.3mm aggregate increase - $3mm spousal increase	•55 % top tax rate •$1mm exemption
Generation Skipping Transfer Tax	•45% top tax rate •$3.5mm exemption	•Completely repealed	•55 % top tax rate •$1.34mm exemption (indexed for inflation)
Gift Tax	•45% top tax rate •$1mm exemption	•35 % top tax rate •$1mm exemption	•55 % top tax rate •$1mm exemption

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