

Memorandum Regarding 2010 Repeal of Estate and Generation-Skipping Transfer Taxes

As of January 1, 2010, the Federal estate and generation-skipping transfer (“GST”) taxes have been repealed and the top marginal Federal gift tax rate has been reduced from 45% to 35% for a one-year period. While many anticipate that Congress will reinstate the estate and GST taxes and the 45% top marginal gift tax rate retroactive to January 1, 2010, there is considerable uncertainty regarding how the legislative process will move forward. This memorandum briefly describes the state of the transfer tax laws and generally reviews how clients might approach their estate planning in light of the current situation.

Background

Up until January 1, 2010, each individual had a Federal “Estate Tax Exemption” and a Federal “GST Exemption” that he or she could use to transfer property at death to someone other than a charitable organization or spouse without the imposition of a transfer tax. The Estate Tax Exemption and the GST Exemption were both \$3.5 million in 2009. Gifts in excess of these exemptions were subject to a Federal estate tax or GST tax (and, in some instances, both taxes) at a top marginal rate of 45%.

The Federal estate and GST taxes were repealed as of January 1, 2010, and the “step-up” in basis rules, pursuant to which inherited assets received a new cost basis for income tax purposes equal to their fair market value at a decedent’s death, were replaced with a “carry-over” basis regime. Under the new carry-over basis rules, the basis in inherited assets for income tax purposes is the same as the decedent’s basis in the assets, except that the basis in the assets may be increased by up to \$1.3 million, with an additional \$3 million of basis increase permitted for assets passing to a surviving spouse or to a qualifying trust for a surviving spouse.

In addition to the Estate Tax Exemption and the GST Exemption, each individual has a Federal “Gift Tax Exemption” of \$1 million, which allows an individual to transfer property during life to someone other than a charitable organization or spouse without the imposition of a Federal gift tax. The Federal gift tax has not been repealed, and the Gift Tax Exemption remains at \$1 million. However, the Federal gift tax rate has been reduced from a top marginal rate of 45% to 35% for taxable gifts in excess of the Gift Tax Exemption.

If Congress fails to enact new legislation, the repeal of the Federal estate and GST taxes and the 35% gift tax rate will be in effect for one year only: under current law, as of January 1, 2011, the Estate and GST Tax Exemptions will return to \$1 million¹ and the Federal estate, GST and gift taxes will be imposed at a top marginal rate of 55% (with a 5% surcharge for adjusted taxable estates between \$10 million and \$17.184 million to recapture the benefits of the lower tax brackets and of the Estate Tax Exemption, resulting in a flat 55% tax for estates in excess of \$17.184 million).

As noted above, there is a possibility that legislation will reinstate retroactively the Federal estate and GST taxes and the 45% Federal gift tax rate. Nonetheless, it is conceivable that there will be a period during which there is no Federal estate or GST tax.

Effect of Legislation on Current Estate Plans

The estate plans of many married couples have been designed to eliminate any Federal estate tax on the death of the first spouse to die and to minimize the Federal estate tax imposed on the survivor's death by dividing the estate of the first spouse to die into two tax-free gifts: (i) a formula gift of the maximum amount that may pass tax-free by reason of the Estate Tax Exemption to a "by-pass" trust for the surviving spouse and children or directly to children and (ii) a gift of the balance of the estate to the surviving spouse or to a trust for the spouse's benefit, which passes tax-free by reason of the marital deduction. In some estate plans, each spouse makes a gift of his or her GST Exemption to a trust for children and grandchildren, with the balance of the estate passing to the surviving spouse or, if none, to children.

The gift of the Estate Tax Exemption or the GST Exemption is usually defined by a formula so that the amount of the gift adjusts automatically as the relevant exemption changes under the tax laws.

If a client were to die while no Federal estate tax or GST tax is in place (assuming that the estate and GST taxes are not reinstated on a retroactive basis), an issue may arise as to the effect of the formula gift. With respect to most of our clients' Wills, it is likely (though not certain) that the formula gift would fail since the gift refers to an exemption that no longer exists, and the entire estate would pass to the surviving spouse. From an estate planning perspective, this result may not be optimal, because the property passing to the surviving spouse may be subject to an estate tax on the spouse's subsequent death if the estate tax is eventually reinstated, as expected.

There are a number of approaches that may be taken in light of the

¹ The GST Exemption, but not the Estate or Gift Tax Exemption, would be indexed for inflation.

uncertainty surrounding Federal transfer tax legislation. Many clients may decide to take a wait and see approach. Hopefully, over the next few months, the legislative uncertainty will be resolved and steps can be taken at that time to adjust the estate plan if appropriate. For clients who would prefer to revise their estate plans to specifically provide how their property should be disposed of if there is no Federal estate tax in effect at the time of their deaths, there are several alternative approaches that may be considered. Some of these options are briefly outlined below:

- A client may wish to provide that, if no Federal estate tax is in effect, a fixed amount or percentage of the estate will pass directly to children (or to trusts for their benefit), thereby reducing the share passing to the surviving spouse.
- A client may wish to provide that, if no Federal estate tax is in effect, any property that would otherwise pass outright to his or her spouse will pass instead to a trust for the primary benefit of the surviving spouse. In this way, depending on future legislation, it may be possible for assets passing to children on the surviving spouse's subsequent death to escape the application of a reinstated estate tax.
- A client may wish to provide that, if no Federal GST tax is in effect, any property that would otherwise pass outright to a child will pass instead to a trust for the child. In this way, depending on future legislation, it may be possible for assets passing to grandchildren (or more remote issue) on the child's subsequent death to escape the application of a reinstated GST tax.

A number of states, including New York, New Jersey and Connecticut, have retained their estate tax, and any revision of a current estate plan should be made after taking into account the relevant state estate tax laws.

A client's age, health and family circumstances, as well as the client's current estate plan, will all need to be considered in determining the appropriate steps to take in reaction to this temporary repeal of the Federal estate and GST taxes.

Effect of Legislation on Lifetime Planning

We recommend that clients continue to pursue planning techniques designed to reduce the size of their estates in light of the likelihood that the Federal estate and GST taxes will be reinstated. Thus, annual exclusion gifts should continue to be made. The annual exclusion is \$13,000 (or \$26,000 for a married couple that splits gifts) per donee in 2010. Grantor retained annuity trusts ("GRATs") and other estate planning techniques designed to

shift the future value of assets to lower generations are also useful mechanisms for reducing the potential cost of reinstated Federal estate and GST taxes.²

Some clients may also be interested in making gifts intended to take advantage of the temporary repeal of the GST tax and reduction of the gift tax rate to 35%. Below are some gift strategies that might be considered:

- A client could make a gift of the client's \$1 million Gift Tax Exemption (\$2 million for a married couple) to a trust for children and grandchildren. If the GST tax is not reinstated retroactively, such a gift may have the benefit of passing additional funds to grandchildren without reducing the donor's available GST Exemption.
- A client could make gifts to children in excess of the Gift Tax Exemption in order to take advantage of the 35% gift tax rate. Such a gift should not be made unless the client is willing to pay a 45% gift tax if the 45% rate is reinstated retroactively, although it may be possible to structure such a gift to adult children so that they can disclaim the gift in favor of a spouse if the 45% rate is reinstated.
- A client could make a gift to a trust for the client's spouse that would qualify for the marital deduction at the election of the client (a "QTIP election"). If the GST tax is not reinstated retroactively, such a trust may, depending on future legislation, be permanently exempt from the GST tax. Further, if the 35% gift tax rate remains in effect for 2010, the client may decide not to make the QTIP election and instead pay a 35% gift tax on the gift to the trust, thereby potentially avoiding a higher estate tax on the death of the spouse. Because it would not be necessary to make the QTIP election until 2011, it is possible that the client would be able to delay a decision as to whether to make the election (and pay the gift tax) until final legislation has been enacted.

In considering whether to use any giving techniques such as those described above, clients should keep in mind that these gifts might have minimal or no benefit if, as many expect, new legislation is applied retroactively. Clients nonetheless interested in any of these strategies should contact us to review them in further detail.

* * * *

² In a prior memorandum, we described the potential tax benefits of gifts to GRATs and charitable lead trusts and of intrafamily loans. See our prior memorandum dated November 19, 2008 entitled "Memorandum Regarding Estate Planning Techniques in a Low-Interest Rate Environment" available at www.clearygottlieb.com in the Private Clients practice area.

If you wish to discuss how these changes affect your estate plan, please call one of the attorneys in our Private Clients and Charitable Organizations Practice Group.

Steven M. Loeb
(212) 225-2620
sloeb@cgsh.com

Judith Kassel
(212) 225-2062
jkassel@cgsh.com

Heide H. Ilgenfritz
(212) 225-2358
hilgenfritz@cgsh.com

Catherine A. Borneo
(212) 225-2292
cborneo@cgsh.com

Ruth Z. Plave
(212) 225-2094
rplave@cgsh.com

Amanda T. Oberg
(212) 225-2388
aoberg@cgsh.com

Elana S. Feuer
(212) 225-2617
efeuer@cgsh.com

Michele Leibson
(212) 225-2166
mleibson@cgsh.com

CLEARY GOTTLIEB STEEN & HAMILTON LLP

* * * *

U.S. Treasury Circular 230 Notice

Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties.

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS

12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS

Rue de la Loi, 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW

Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow 115054, Russia
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE

Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME

Piazza di Spagna, 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN

Via San Paolo, 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING

Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax