



# FITZPATRICK LENTZ & BUBBA

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Dear Client:

As you may have heard, the federal estate tax rules changed radically in 2010 and could change radically again in 2011 unless Congress passes new legislation. This letter is intended to advise you of what has happened and encourage you to consider reevaluating your estate plan.

**2001 Tax Act.** In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) which provided for significant phased-in increases in the federal estate, gift and generation skipping tax (GST) exemptions and lower tax rates. EGTRRA provisions included:

- In 2009, the estate and GST exemptions increased to \$3.5 million per decedent, with a flat 45% estate and GST tax rate on any excess. The gift tax exemption was \$1.0 million, with tax rates on any excess ranging from 41% to 45%.
- In 2010, the federal estate and GST taxes were repealed for one year. The gift tax \$1.0 million exemption remained, with a lower flat tax rate of 35%. Thus, you had to die or pay gift tax in 2010 to get the benefit of the change. The step up in basis rules (which gave a “fresh-start” fair market basis for most assets of a decedent) were replaced with an adjusted carry-over basis. These new basis rules permit a step up in basis at death of up to \$1.3 million, plus an additional \$3.0 million for certain spousal transfers.
- On January 1, 2011, EGTRRA will be automatically repealed, resulting in an odd situation: a \$3.5 million estate and GST exemption and flat 45% tax rate in 2009, no estate and GST tax in 2010, and a \$1.0 million estate exemption and tax rate up to 60% in 2011.

**What Happened in 2009?** Estate planning practitioners universally expected Congress to extend the 2009 estate tax rules into 2010 (both Representative Rangel as Chair of the House Ways and Means and Senator Baucus as Chair of the Senate Finance

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Committee said it would happen last fall). However, in December the House unexpectedly failed to act on a one year extension and instead sent the Senate a bill to make the 2009 rules permanent. Because the Senate was focused on health care and there was broad disagreement in the Senate on what to do with estate taxes, Congress enacted no changes to the EGTRRA's 2010 rules. Thus, effective as of January 1, 2010, there is no federal estate or GST tax.

**Planning in Chaos.** Congress's failures to adopt estate tax legislation in 2009, and the possibility that changes will not be adopted during 2010, radically change the estate planning considerations of many clients. For example, Congress has indicated that in 2010 about 6,000 decedents will benefit from the elimination of estate taxes, but over 70,000 heirs will pay higher income taxes because of the change in the income tax basis rules for assets received from decedents.

**2010 Changes.** The U.S. has an unpredictable planning environment in which any number of radically different changes may occur in 2010:

- Congress may do nothing in 2010, in which case there is an adjusted carryover basis, and no federal estate or generation skipping tax for people who die in 2010. While you probably will not die in 2010, you still need to consider planning for that possibility, because not planning for these changes, if death occurs, can be disastrous. For example:
  - Formula clauses (e.g. terms that allocated your estate exemption to a "by-pass or family trust") in your planning documents could inadvertently disinherit some heirs and/or your surviving spouse and/or create conflicts among family members as to how your documents should be interpreted.
  - Conflicts could arise among your heirs and fiduciaries on asset basis issues.
  - Inadvertent generation skipping taxes could be incurred after 2010.
  - Passing assets directly to your surviving spouse may result in higher estate taxes after 2010.
  - Inadvertent state taxes could be incurred from out of date terms in your documents.
- Congress may adopt legislation to carry the 2009 rules over to 2010, retroactive to January 1, 2010. There is broad disagreement on whether a retroactive tax bill is constitutional. If a retroactive law is adopted, it will probably be challenged as unconstitutional, and it could take years for the Supreme Court to rule on the issue. Until such a ruling, uncertainty will



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prevail. Those dying after the enactment should not have that uncertainty. In any event, your estate plan should contemplate dying both before or after a potential retroactive enactment, which may or may not be constitutional.

- If Congress acts in 2010 to address the estate tax issues, it could:
  - Adopt a permanent estate tax exemption, beginning in 2010 or 2011. If so, most commentators anticipate estate tax exemptions to fall between \$2 million and \$5 million and tax rates between 35% to 45%.
  - Adopt a temporary higher estate exemption.
  - Adopt rules to limit or eliminate valuation discounts and/or to eliminate short-term Grantor Retained Annuity Trusts.

2011 Changes. Unless Congress enacts new legislation in 2010, then on January 1, 2011, a number of automatic changes occur to the federal tax code, including:

- The estate tax exemption drops to \$1.0 million per decedent.
- The estate tax rate increases (e.g., 55% above \$3.0 million and 60% above \$10 million).
- States which remain “coupled” to the federal estate tax will have their state death taxes restored. Thus, if you own property in one of these coupled states, you could have new exposure to a state estate tax.
- The fair market value step up in basis returns for assets passing from a decedent.
- The top income tax rates go up by at least 4.6%, capital gain tax rates increase by up to 5% and dividend tax rates increase by up to 24.6%.

Higher Taxes. No matter what happens to the estate tax, substantial tax increases are looming. A \$12 trillion deficit is projected for the next decade. The Congressional Budget Office indicates that the social security trust fund will pay out more than it receives starting in 2011 and 2012. Taxes will have to increase across a broad range of Americans. Both The Washington Post and The New York Times have stated that the President will have to abandon his pledge to increase taxes only on taxpayers earning over \$250,000. Given slow economic recovery and the fact that we are in a mid-term election year, the federal government will probably not increase taxes until 2011. While substantial tax increases are likely, we just don’t know any details. We do plan to send our clients another letter if and when we have some certainty on the federal estate and gift tax laws.



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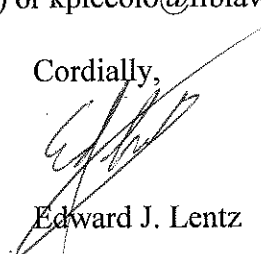
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ROTH IRAs/Haiti. In 2010, all taxpayers can convert traditional IRAs to ROTH IRAs and can pay the income taxes due on such conversion in 2010 or equally in 2011 and 2012. There are significant benefits and traps for the unwary in making these decisions. Legislation was also recently passed giving taxpayers the option of deducting pre-March 1, 2010 cash contributions to help Haiti recover from the recent earthquake on their 2009 (or 2010) tax returns.

Effectively, unless Congress adopts new legislation, in 2010 the estate tax rules rotate 180 degrees from where they were in 2009, and then rotate 180 degrees again in 2011. Unfortunately, in 2011, the estate tax and income tax rules could be even worse than what we had in 2009. Uncertainty makes it difficult to plan, but waiting to see what happens next may not be a good idea (although many of our clients have made a practical decision to take a "wait and see" approach). The earlier you can implement flexible tax and estate planning to respond to these changes the better.

Please call us to schedule a time to meet, go over your current estate plan and determine what changes need to be made to your current plan to minimize taxes and to reduce the possibility of family conflicts in these uncertain times. Unless we hear that you want to engage us to review your existing plan, we will not begin that process. We will also not begin the process until you complete and return our Estate Planning Information Form so that we can be sure we are up to date on your current family and financial situation. Our form is available upon request by calling or e-mailing Kathy Piccolo at 610-797-9000 (Ext. 309) or [kpiccoco@flblaw.com](mailto:kpiccoco@flblaw.com).

Cordially,



Edward J. Lentz

EJL:kp

P.S. The taxation of Pennsylvania residents at their deaths has not changed and is not in a state of flux. A summary of the current laws in that regard is enclosed.

## PENNSYLVANIA INHERITANCE TAX

While this death tax on Pennsylvania residents (and on non-residents as to their Pennsylvania real estate) may not be as burdensome as the Federal Estate Tax when the latter is in effect, it applies to nearly every estate in view of the fact that there is no exempt amount or credit against the tax (like the \$3,500,000 exemption equivalent in effect in 2009 in connection with the Federal Estate Tax). The Pennsylvania Inheritance Tax rate is 0% on transfers to a spouse<sup>1</sup> and 4.5% on transfers to other close family members -- your children, stepchildren, grandchildren and parents (unless the decedent is 21 or younger, a special case where a transfer to a parent is exempt). Transfers to siblings will be taxed at 12%, and transfers to other non-family members will be taxed at 15% unless property passes to charity (in which case the transfer is exempt). Most gifts made within a year of the donor's death are included in the donor's estate for purposes of the Pennsylvania Inheritance Tax. However, life insurance is always exempt from Pennsylvania Inheritance Tax. Funeral expenses and other deductions are also available in order to reduce the value of the estate subject to tax.

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<sup>1</sup> In 1995, the Pennsylvania Inheritance Tax law was amended to eliminate the tax on transfers to (or for the exclusive benefit of) a surviving spouse. Trusts for a spouse qualify for the Pennsylvania "marital deduction" in their entirety only if they are for the spouse's sole use during his or her lifetime.