

DREW & MERSEREAU, P.C.
COUNSELLORS AT LAW
47 WEST MAIN STREET
AVON, CONNECTICUT 06001-4706
WWW.DREWMERS.COM

JOHN E. DREW
PAUL E. MERSEREAU
CHRISTOPHER S. DREW *

GREGORY D. SMITH

* ALSO A MEMBER OF MASSACHUSETTS BAR

TELEPHONE (860) 677-1974
FAX (860) 677-9143
JDrewLaw@aol.com
PaulMers@aol.com
CDrew@drewmers.com
GSmith@drewmers.com

DREW & MERSEREAU, P.C. ADVISORY MEMORANDUM

CURRENT STATUS (AS OF JANUARY 15, 2010)
OF 2010 FEDERAL AND CONNECTICUT ESTATE TAX LAWS

As we write this Memo the Federal and Connecticut estate tax laws are in a state of flux. This Memo reviews the current estate tax on both the Federal and Connecticut level, along with examples of specific situations that may impact your clients. While it is possible that Congress may reinstate the Federal estate tax retroactively to January 1, 2010, we want you to have a full understanding of the current situation.

1. Federal Estate Taxes

a. Rules for 2009

In 2009, an individual could pass up to \$3.5 million free of the Federal estate tax upon his death. Any assets exceeding \$3.5 million were subject to a maximum tax rate of 45%. All transferred assets received a step-up (or step-down) in cost basis based on the fair market value of the asset as of the date of the decedent's death (or the alternate valuation date, which is the date six months after the date of the decedent's death, if the executor so elects). In addition, a person can give \$1 million during his life without having to pay any gift tax.

b. Rules for 2010

Soon after Congress passed legislation in 2001 eliminating the Federal estate tax for one year in 2010 most commentators believed that Congress would pass new legislation before the end of 2009 to avert the repeal of the estate tax. The primary concern was that the carryover basis system proposed for 2010 had been tried in the 1970s but had proven unworkable because of the difficulty in determining the cost basis for assets after people died.

This fall the House of Representatives passed legislation to continue the Federal estate tax rules for 2009 in 2010. The Senate, however, did not pass any legislation regarding the Federal estate tax and allowed the Federal estate tax to lapse for 2010. Consequently, there is no Federal estate tax or generation-skipping transfer tax as of January 1, 2010. The gift tax threshold remains at \$1 million and the maximum gift tax rate is 35% for aggregate lifetime gifts in excess of \$1 million.

With the elimination of the Federal estate tax, transferred assets no longer automatically receive a step-up (or step-down) in cost basis based on the fair market value of the asset as of the date of the decedent's death (or the alternate valuation date). Rather, transferred assets are now subject to carry-over basis with a limited step-up in basis given to heirs and the spouse of decedents. When the heirs of a decedent sell assets they inherited, they will need to use the same cost basis as the decedent would have used unless the executor elected to increase the cost basis for the asset being sold. Any gains would be subject to the Federal capital gains tax. The new law allows an "aggregate basis increase" of \$1.3 million among inherited assets. A spouse may receive an increase in basis of \$3 million, in addition to the \$1.3 million basis increase allowed for decedents.

c. Carry-over Basis Examples

The executor of an estate may allocate the \$1.3 million basis increase to whatever assets he sees fit, on an asset-by-asset basis. In this example, the executor may allocate the \$1.3 million basis increase among the four assets and the decedent's heirs may sell all of the assets without realizing any gain.

<u>Asset</u>	<u>Basis</u>	<u>Value at Date of Death</u>
ExxonMobil Stock	\$ 300,000	\$1,000,000
Microsoft Stock	\$ 500,000	\$ 750,000
Residence	\$ 400,000	\$ 500,000
Partnership Interest	\$ 500,000	\$ 750,000
Total	\$1,700,000	\$3,000,000

A spouse may receive an increase in basis of \$3 million, in addition to the \$1.3 million basis increase allocated to decedents. The following is an example where a decedent dies with a surviving spouse and heirs:

<u>Asset</u>	<u>Basis</u>	<u>Value at Date of Death</u>
ExxonMobil Stock	\$ 300,000	\$3,000,000
Microsoft Stock	\$ 500,000	\$1,000,000
Residence	\$ 400,000	\$2,000,000
Partnership Interest	\$ 500,000	\$1,000,000
Total	\$1,700,000	\$7,000,000

The executor may allocate the basis to the assets on a case-by-case basis. In this example, the executor chose to utilize the spousal basis increase of \$3 million for the ExxonMobil Stock and Microsoft Stock and the \$1.3 million aggregate basis increase for the Residence. The remaining difference of \$1.3 million will be taxed as a capital gain, paid by the beneficiaries of the assets when the assets are sold.

<u>Asset</u>	<u>Carry-over Basis</u>	<u>Basis Increase</u>	<u>New Total Basis</u>
ExxonMobil Stock	\$ 300,000	\$2,700,000	\$3,000,000
Microsoft Stock	\$ 500,000	\$ 300,000	\$ 800,000
Residence	\$ 400,000	\$1,300,000	\$1,700,000
P'ship Interest	\$ 500,000	\$ 0	\$ 500,000
Total	\$1,700,000	\$4,300,000	\$6,000,000

d. Rules for 2011

In 2011, the Federal estate tax is scheduled to revert back to its 2001 level. The exemption amount for individuals will be \$1 million and the maximum estate tax rate increases to 55% (with an additional 5% tax on estates that exceed \$10 million). The gift tax exemption remains at \$1 million, but the gift tax rate increases to 55% for aggregate lifetime gifts in excess of \$1 million. Beneficiaries will once again receive a step-up in cost basis on all inherited property and the unlimited marital deduction returns. Finally, the generation-skipping transfer tax exemption will return and increase to an inflation adjusted amount of \$1.13 million with a maximum tax rate of 55%.

e. Issues with the Repeal and Subsequent Reinstatement of Estate Taxes

Multiple issues arise with the repeal of the estate tax in 2010 and its reinstatement in 2011:

1. Many executors will find it difficult to determine the original cost basis for assets that have been in the possession of the decedent for many years.

2. Beneficiaries of decedents with estates that contain assets that have greatly appreciated will face increased capital gains taxes. For example, spouses of decedents with assets that appreciated more than \$4.3 million will face an increase in potential capital gains taxes as they sell assets because the 2010 tax laws eliminate the unlimited marital deduction. The amount of assets that has appreciated more than \$4.3 million will be taxed at the capital gain rate when the assets are sold.

3. Many commentators believe that Congress will retroactively reinstate the estate tax for 2010 later this year because of the issues stated above. However, the constitutionality of Congress changing the Federal estate tax on a retroactive basis may be challenged, leading to further confusion in this area of law. While it is unlikely that Congress will permit the Federal estate tax to return with an exemption of \$1 million in 2011, it remains a possibility because very few commentators thought that Congress would not have solved this problem by now.

2. Connecticut Estate Taxes

Connecticut has also seen its share of trials and tribulations with the Connecticut estate tax.

a. Rules for 2009

In 2009, an estate or gift valued at \$2 million or less was not taxed under the Connecticut estate tax. An estate or gift valued at \$2,000,001 or more was taxed under the Connecticut estate tax and the full value of the entire estate or gift (including the first \$2 million) was taxable. Under this law there was a "cliff" in which a \$1 increase in the value of a gift or estate from \$2,000,000 to \$2,000,001 increased Connecticut estate tax liability from zero to \$101,700. Many commentators felt that this "cliff" provision was unfair.

b. Rules for 2010

When Connecticut passed the budget bill in September, 2009, the legislation included a provision to raise the estate tax threshold from \$2 million to \$3.5 million starting with deaths occurring and gifts made on or after January 1, 2010. The bill also eliminated the much-maligned "cliff" provision by applying the tax only against the marginal value of the assets over the \$3.5 million threshold. The legislation also reduced the rate of the Connecticut estate tax by 25%.

In December, 2009 the Connecticut estate tax issue was back in the news. Unfortunately, Connecticut is facing an increasing deficit. As part of the deficit mitigation plan adopted by the legislature, the implementation of the increase in the Connecticut estate tax threshold to \$3.5 million would be delayed for two years. The bill would have reduced the estate tax threshold from \$3.5 million to \$2 million starting with deaths occurring and gifts made on or after January 1, 2010. The rules for 2010 would be very similar to the rules for 2009, except that the "cliff" provision was removed to be consistent with the legislation passed in September.

Governor Rell vetoed the legislature's deficit mitigation plan, and it does not appear that the legislature has the votes to override the veto. Meanwhile, Connecticut continues to have significant financial concerns and the legislature will be back in session in February. The issue of whether the increase in the Connecticut estate tax threshold to \$3.5 million will be changed will certainly be on the table as part of the negotiations to address the budget deficit.

3. Conclusion

The uncertainty created by Congress' lack of action and Connecticut's flip-flopping creates difficulty for planners. We hope that this Memo brings you up-to-date with the current laws and will help you advise your clients through this uncertain time. Please do not hesitate to contact us if you have any additional questions regarding these issues.

DREW & MERSEREAU, P.C.
JANUARY 15, 2010