“May you live in interesting times” *

This ancient curse was quoted in the American Society of International Law Proceedings vol. 33 (1939).

For those of us who care about estate taxes, the interesting times are now. Saying that the state of the law is uncertain is an understatement. In this Special Report, I’ll try to explain the current situation and make some “fearless forecasts” for the future.

Estate Tax “Repealed.” In a Statute commonly known as “EGGTRA,” enacted in 2001, Congress raised the estate tax exemption in several steps, from $1MM to the 2009 level of $3.5MM. EGGTRA provided for “repeal” (actually a moratorium) in 2010. If Congress does not act, the estate tax will come roaring back in 2011 with the pre-2001 exemption of $1MM.

Some of you may recall my fearless forecast of last year: That Congress will do nothing and let the tax “expire” on December 1, 2009. The second half of the forecast was that, if the Democrats continue to have a majority in Congress through 2010, we may be back to a $1MM exemption. The first forecast came true. I hope that the second will not, but we have to plan today, to the extent that we can, for what might be the law tomorrow,

Where we are Right Now. For the present, there is no Federal estate tax. But there are two reasons not to celebrate yet. First, the estate tax is being replaced by a moratorium on “stepped up basis at death.” Secondly, there is a possibility that Congress may reinstate the tax retroactively.

Taxation of Accrued Capital Gains. Until this year, with the exception of Income in Respect of a Decedent, annuities, and certain other items, assets passing at death took on a new basis equal to their date of death value. This is sometimes optimistically called “stepped up basis at death.” As long as we do not have an estate tax, stepped up basis is being replaced by “carryover basis.” The basis of assets passing at death will be the decedent’s basis, subject to some adjustments.

Basis Adjustments. There is a $1.3 MM general basis adjustment and a $3 MM adjustment for assets passing to a surviving spouse. For those whose capital gains exceed the adjustments,

allocation of basis may get complicated, particularly for assets other than securities and real estate, where there may be scanty, or no, records. Collections, furniture and art may pose expensive problems to determine their adjusted basis.

In addition, the Statute provides in part for basis to be the lesser of the decedent's adjusted basis or fair market value at death. This provision is similar to, but not exactly the same as, Section 1015 dealing with the basis of assets acquired by gift.

> **How repeal can hurt.** Some people will be better off with no estate tax and carryover basis, but others can face increased taxes. EXAMPLE: Bachelor Bjax started a business in his garage with a few thousand dollars and a lot of hope. Business boomed and Bjax became rich. His small investment is now worth $2.5 MM. If he had died in 2009, his entire estate would have passed free of estate and capital gains taxes. In 2010, $1.2 MM of potential gain will be passed on to his heirs. [$2.5 MM minus the $1.3 MM adjustment]. With a 15% Federal rate (for now) and a 5% Connecticut rate, that's $240M of tax. It may not be payable at death, but if the system stays in place, it will be payable someday.

Retroactive re-enactment of the Estate Tax. The Federal estate tax may not be dead. It may be only in suspended animation. It's likely that Congress will try to resurrect the tax, possibly retroactive to January 1st. This would mean that the estate of someone who died while the tax was "sleeping" would be subject to the new levy.

There is scant judicial authority on retroactive transfer tax changes. Some lawyers cite ***United States v. Carlton**, **512 U.S. 26 (1994)*** as an example of the Court's allowing a retroactive estate tax law change.

Carlton dealt with the deduction under former Sec. 2057 for the sale of securities to an ESOP. The statute was retroactively amended more than a year after the decedent's death to provide that only securities directly owned immediately prior to death would qualify for the deduction. Since the securities in question had been bought by the executor, the "new" statute would not permit the deduction. The Court held that retroactive application of the statute was constitutional because it was not unreasonable and was rationally related to its legitimate purpose, and only reached back for slightly longer than one year.

Carlton May not Apply. A law professor once remarked: "Change the facts and change the result." The statute in question in ***Carlton*** was corrective, enacted to fix a drafting error in the original provision. The Supreme Court noted:

> "There is little doubt that the 1987 amendment to §2057 was adopted as a curative measure. As enacted in October 1986, §2057 contained no requirement that the decedent have owned the stock in question to qualify for the ESOP proceeds deduction. As a result, any estate could claim the deduction simply by buying stock in the market and immediately reselling it to an ESOP, thereby obtaining a potentially dramatic reduction in (or even elimination of) the estate tax obligation."

Congress passed EGGTRA in 2001. Its provisions, including the 2010 moratorium, are clear. An attempt to impose a tax on the estate of someone who died while the tax was effectively repealed is not "corrective." It is the imposition of a tax on a (generally) involuntary act occurring when the tax was not in effect.

The only certainty is that efforts at retroactive legislation will be strongly resisted. Someone with a large enough estate will die while the tax is in limbo and that there will be protracted litigation.

Important Action Step. Many estate plans provide that, in the estate of the first spouse to die, assets equal to his or her estate tax exemption will be allocated to trust for the benefit of his or her surviving spouse. These trusts are called "bypass" trusts because the trust assets are available to the survivor but "bypass" his or her estate for estate tax purposes. Bypass trusts allow both spouses to take maximum advantage of each of their exemptions.

Formula Clauses. Lawyers often used language designed to make sure that the bypass trust was set up in the exact proper amount. These provisions are called "formula clauses." There could be issues of interpretation because the formulas make reference to concepts, such as the estate tax exemption which are no longer part of the law after "repeal."

Because we do not currently have an estate tax, these "formula clauses" can sometimes cause serious problems.

The majority of our firm's documents drafted after 2002 deal with the effect of potential estate tax repeal on formula clauses. Our earlier

documents, and many more recent ones done by other practitioners, do not.

Need for Flexibility. Estate planning documents must be able to deal with reasonably anticipated legislative outcomes. **EXAMPLE:** Congress could do nothing. The Federal exemption would then be $1MM. They could decide to make the $3.5 MM exemption permanent. The Connecticut exemption could remain at its current $3.5 MM level or the Legislature could reduce it to $2 MM.

If you are unsure of what your clients' documents provide, you should consult with a competent estate and trust lawyer in your state.

* PLEASE NOTE: This is meant to provide a brief overview of the recent estate tax changes. It is not meant to be, and should not be relied upon as, professional advice.