

Sample Client Letter

Estate and Tax Planning for 2010 & 2011

National Association of Estate Planners & Councils

January 26, 2010

***Using this Letter:** The NAEPC has produced this letter as an informational form for the clients of members of affiliated local estate planning councils. You may adjust it to meet your particular client needs and any local issues which you believe should be addressed. Fax, email and/or mail the letter to your estate planning clients. Post the letter on your website. Maintain a list of who you sent this letter to and do follow-up calls and emails to your clients. Please note that the NAEPC waives any copyright protections to the letter.*

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 reevaluate your estate plan as soon as possible.

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 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- In 2010, the federal estate and GST taxes were repealed for one year.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 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) was replaced with an adjusted carry-over basis. These new basis rules permit a step up in basis of up to \$1.3 million, plus an additional \$3.0 million for certain spousal transfers at death.
- On January 1, 2011, EGTRRA was automatically repealed, resulting in an odd situation: A \$3.5 million estate and GST exemption and flat 45% tax rate in 2009, no estate and GST tax in 2010, and a \$1.0 million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 carry the 2009 estate tax rules across 2010 (both Representative Rangel as Chair of the House Ways and Means and Senator Baucus as Chair of the Senate Finance Committee said it would happen earlier last fall). However, unexpectedly in December the House 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 failure 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 trust") in your planning documents could inadvertently disinherit some heirs and/or your surviving spouse and/or create conflicts among family members on how your documents should be properly 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 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 be challenged as unconstitutional and it could take years for the Supreme Court to rule on the issue. Until such a ruling, uncertainty will 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 permanent estate tax exemption, beginning in 2010 or 2011. If so, most commentators anticipate estate tax exemptions to fall between \$2-5.0 million and tax rates 35% to 45%.
 - Adopt a temporary higher estate exemption.
 - Adopt rules to limit or eliminate valuation discounts.

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 go up by up to 5% and dividend tax rates go up 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 or 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 only increase taxes 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 sometime in 2011. While substantial tax increases are likely, we just don't know any details.

ROTH IRAs. In 2010, 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.

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 – only 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 is not a good idea. 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 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 future family conflicts in these chaotic times. Unless we otherwise hear that you want to engage us to review your existing plan, we will not begin that process.

Sincerely,