

## The Holiday Surprise from Washington

Congress delivered a late-year surprise to everyone in the tax and estate planning world by opting to ignore a fast-approaching reality—the repeal of the Federal Estate Tax that goes into effect on New Year’s Day.

This story begins in 2001, when President Bush signed into law an extensive tax reform bill delivered by the Republican-controlled Congress. The legislation included a provision that: (a) gradually increased the Estate Tax exemption to the current level of \$3.5 million per person; (b) reduced the maximum tax rate to 45%; and (c) ultimately repealed the tax in 2010. Congress realized this repeal would have huge consequences on the long-term budget process, so a legislative “trick” was required to make the numbers work. This sleight of hand was a provision that reverses the repeal after only 12 months, and in 2011 returns us to the law as it stood in 2001, with an exemption of only \$1 million per person and a top rate of 55%.

Certainly, Congress expected to take action before now to avoid an actual, temporary repeal of the Estate Tax. Unfortunately, time caught up with them and no action has been taken. We are left to wonder what might happen next.

First, we need to understand the law as it will exist as of January 1<sup>st</sup>:

- The Federal Estate and Generation-Skipping Transfer Taxes are eliminated, albeit temporarily;
- The \$1 million lifetime exemption still exists for taxable gifts, but the Gift Tax rate drops from 45% to 35%; and
- Carryover basis applies to assets held at death; that is, assets held at death will no longer receive a “step-up” in basis to the date of death value, with the following exceptions:
  - Up to \$3 million passing to a surviving spouse, plus
  - The first \$1.3 million in the aggregate passing from the decedent to one or more persons, other than the surviving spouse.

Second, there are several questions that we cannot answer at this time:

- With everything on its plate (including finding common ground on health care reform), will Congress find the time and focus in 2010 to resolve this dilemma, agree on common ground, and pass legislation to eliminate the confusion surrounding the law?
- If Congress acts, will they make the new law retroactive to January 1, 2010 or will the law be effective at some later date?
- If the law is retroactive, will it survive Constitutional challenges that may arise? (Federal Courts have allowed retroactive tax law changes in the past, but the estates of decedents who die with substantial assets after January 1<sup>st</sup>, but before a reform bill is introduced in Committee, will have a compelling motivation to challenge the effective date of the law.)
- How will executors handle decisions regarding the liquidation of low basis holdings after death with no clarity on if or how the proceeds may be subject to Capital Gains Tax?
- Are there gifting opportunities that may arise under the law as it now stands that may be available only in the early part of next year?

Benjamin Franklin's often overused adage, "In this world nothing is certain but death and taxes," has lost a bit of its luster. As a result of the inaction and lack of bipartisan focus in Congress, the Estate Tax has never been so uncertain. Few, if any, commentators saw this peculiar result coming even a few months and weeks ago, and most assumed there would at least be a temporary extension of the 2009 law.

Today, our hope is for clear and decisive action in Washington soon after the holidays, but considering the behavior in the Congress over the past year – with nearly unprecedented partisanship – all we can do is hope. We, of course, will monitor this situation closely and keep our clients and friends informed as matters develop, with particular attention to the development of planning opportunities that may arise.

Best wishes for the New Year!

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