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# Mind the Tax Gap

## *The Estate Tax is Dead (for now)*

As you may know, Congress has yet to deal with the expiring estate tax and the sunset of the expiration next year. So currently, as of January 1, 2010, there is no federal estate or generation-skipping transfer tax. The gift tax remains in effect and the rate is now 35% (for lifetime gifts in excess of \$1 million, and over \$13k per person in any one year). Next year in 2011, this one year repeal automatically expires, and the old pre-2001 estate tax comes back, with only a \$1 million estate tax exemption and a 55% top rate (formerly \$3.5 million and 45%, in 2009).

### **State Estate Taxes Still**

#### **Matter**

Most states decoupled from this crazy federal scheme shortly after it was passed in 2001. Currently, many states have an estate tax after a smaller exemption, such as \$1 million in New York and Massachusetts. Rates range typically from about 6% up to 16% for very large estates. Some states, like Wyoming, Florida and Texas currently do not have estate taxes. Other states (like New Hampshire) that had repealed estate taxes are bringing them back to fight deficits from the current economic debacle.

### **What Should a Concerned Citizen Do Right Now?**

So we have a short period of no federal estate tax on the books. Many people believe that the estate tax in some form will be retroactively reinstated in 2010 by Congress when the second half of the current session resumes, perhaps by late spring. However, not everyone agrees that the retroactive reinstatement of taxes is constitutional. The courts have allowed retroactive rate increases, but this may be the first retroactive reinstatement of a tax itself.

#### **Bad planning:**

Obviously no one is going to volunteer to avoid the estate tax by dying between Jan. 1, 2010 and before the estate tax is reinstated.

#### **Good planning:**

However, for people who live through this period, are there wise things to do? One thing to consider is the impact of the generation-skipping tax (GST). This tax applies when you try to wisely skip the taxable estates of your kids through a good plan that will eventually pass wealth tax-free to future generations. Previously, you could do this only to the extent of your GST exemption, which was the same as the estate tax exemption (\$3.5 million in 2009). Everything above that must either be taxed in the children's estates, or before future generations can inherit, it is subject to the GST tax (at the maximum estate tax rate).

**MIND THE TAX GAP**

*(Continued inside right)*

## WHY LAVELLE & FINN IS YOUR BEST ALLY

Ask about our one year complimentary follow-up for sophisticated estate plans. If you are concerned that anything you do now to fix your estate plan will be promptly undone by Congress this year, worry no more. Lavelle & Finn, LLP offers a complimentary fix if Congress passes new legislation that wrecks your shiny new estate plan - for up to one year later. Most of the time we try to anticipate changes and provide for them in the plan. This time, however, the possibilities are endless. So no need to sit on the sidelines with a dangerously unplanned estate or out-dated plan - act now and Lavelle & Finn, LLP will have you covered!



**GIVE US A BUZZ  
518-869-6227**

## Married With Wills: The Good, the Bad and the Ugly

The federal "no estate tax gap" of early 2010 can have many unusual implications, even for married people who actually have wills. Perhaps after a child or two has been born, many responsible adults will finally bite the bullet and get *something* in place, if not a complete estate plan. Even these basic documents can be adversely affected by this unprecedented time of no federal estate tax, followed by a renewed estate tax, no later than January 1, 2011, if Congress does not act.

**The good.** At least with any competent will, you have a basic plan for your assets in the event of your death, or worse, the death of you and your spouse. So you named a trustworthy person to serve as Executor, and you named respectable substitute parents as the guardians of your minor children. And if you were really well advised, you might have even named trustees and designed proper trusts to avoid your children losing their inheritance to divorce, lawsuits, bankruptcy, nursing homes or other risks.

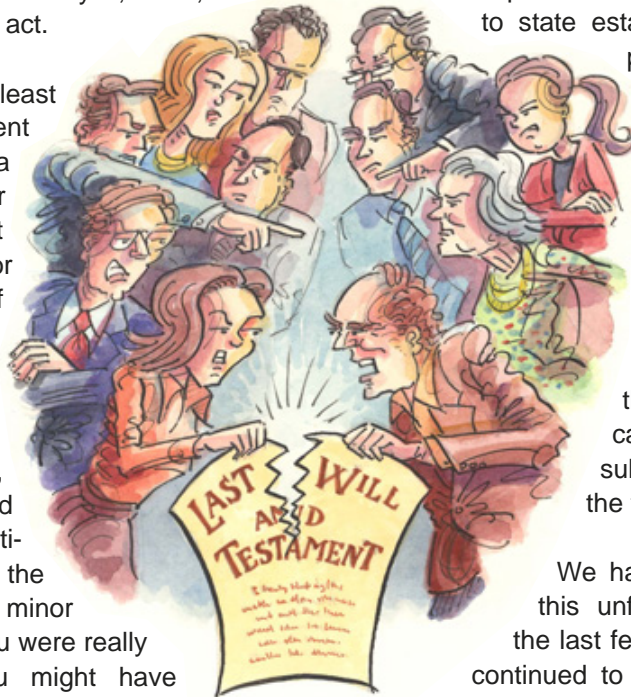
**The bad.** Perhaps you were foresighted enough to not merely do wills, but to prepare a fully loaded estate plan, including tax sensitive provisions to reduce your family's exposure to estate taxes. Most planners use complicated formula clauses to set up tax-saving trusts at the death of the first spouse to die. These formulas assume that a federal estate tax exists. What happens when there is no estate tax for your documents to work with? Bad things happen - at least, no one knows for sure. If you have tax-oriented trusts in your will, and perhaps the kids share in one and your surviving

spouse in another, this current "no tax zone" can cause really bad results - including unintentional disinheritances.

**The ugly.** Another ugly possibility remains. State estate taxes are probably not going anywhere even with the "temporary" federal repeal, and these same formula trusts can cause trouble here too. Generally, without attention, what could happen is 100% of the first spouse's estate could be subject to state estate tax, at rates approaching 16%. Normally, this exposure is controlled by limiting taxes under the formula to the amount needed to maximize federal savings. One consequence of the federal no tax period is that the formula may cause everything to be subject to state tax at the first death.

We have been anticipating this unfortunate situation in the last few years as Congress continued to do nothing. By adjusting our trust funding formulas so that the surviving spouse as executor can "elect" how to treat things at the first death, these problems can be avoided. For most people this elective trust provision works well to maintain automatic trust protection from creditors and predators, while maintaining control over the tax planning.

If your estate plan was prepared under different assumptions, you should revisit your documents soon. We do not know how soon or even whether Congress will address this matter, and all indications are that Congress will only put a one year patch on it. This means that similar urgent issues will be presented this time next year when the federal estate tax is scheduled to return with a mere \$1 million exemption and a 55% top rate. **LF**



## Mind the Tax Gap *(continued from cover)*

Some experts are suggesting that in any period after Jan 1, 2010 in which there is no estate or GST tax, it would be smart to make GST transfers (to things like GRATs) which would presumably be exempt from GST forever. The argument is that retroactively applying GST to GRAT type transfers might be too much for the courts to swallow. Gift tax still applies, so you need a good strategy.

Since we happen to be in a low value, low interest rate era as well, this allows taxpayers to make very effective estate planning transfers, with the added bonus that perhaps no estate or GST taxes will ever apply to these transfers if the tax is not retroactively reinstated, or if it is, the courts disallow it as unconstitutional. So in addition to being a great time to do your normal estate planning, you may have a freebie from Congress as well. **Call Lavelle & Finn** to see if you should take advantage of this temporary tax gap. 518-869-6227. **LF**

## Massive Tax Increase Coupled with Federal Estate Tax Repeal

Now you know Congress would not repeal a tax like the estate tax, that only applies to a very small part of the population, without replacing it with a tax that applies to many more people. So that's just what they did. Starting January 1, 2010, the federal estate tax has been replaced with a capital gains tax on inherited property.

For all of its 90+ year history, a benefit of the now repealed federal estate tax system was that beneficiaries of the estate generally got a fresh start with the income tax system. So that stock that grandma received from her father 40 years before she died would be marked to market at the date of her death. Grandma's beneficiaries would inherit the stock with a tax basis equal to its date of death value, and could sell it without any tax on the 40 years of gain.

Not anymore. The new rule is that all property, subject to a couple of exemptions, will carry over its tax basis from the decedent. In the case above, Grandma's beneficiaries would have to figure out what Grandma's father paid for the stock before he gave it to her. That cost, say \$1 a share, would have been Grandma's tax basis, and that "carries over" to the beneficiaries. The beneficiaries, when they sell the stock at \$1,000 a share, would have a capital gain of \$999 per share, taxed at whatever the current capital gains tax rate is. The current rate is 15%, but this is scheduled to change as well on January 1, 2011.

The two exemptions are: Property of up to \$1.3 million can be valued at date of death values for tax purposes, and if married, a first deceased spouse's assets can be marked to market a further \$3 million if passing to a surviving spouse.

For assets retained by the spouse, of course, this "extra" \$3 million mark-up is no longer available when the surviving spouse dies and the carry over process starts again. Further, if the trust provisions of the wills are not reviewed and changed prior to a death while the federal estate tax repeal is in effect (January 1, 2010 to ?), only property passing directly to a spouse or to a specially designed marital trust qualifies for the extra \$3 million. So planners may have to choose between 100% estate tax free inheritance coupled with capital gains tax potential for everything over \$1.3 million, lesser estate tax savings to avoid more capital gains tax, or losing some or all of the \$3 million mark-up.

Since the capital gains tax impact on estates over \$1.3 million would apply to many tens of thousands of families each year that do not benefit from the federal estate tax repeal, this is a real tax increase that needs urgent attention. Although "carry over" basis was tried once before in 1976 and repealed retroactively, there is no reason to believe this will happen again. Call for a review of your situation today. **LF**



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