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## When Estate Tax Repeal Isn't Repeal.

**"No man's life, liberty or fortune is safe when our legislature is in session."**

**- Benjamin Franklin**

Currently, the federal estate tax and the generation skipping tax (GST) have been repealed for 2010. However, the Congress has indicated that these taxes may be reinstated, possibly even retroactively to January 1<sup>st</sup>, at the applicable 2009 rates sometime later this year. The exemption from federal estate tax in 2009 was \$3.5 million and the maximum tax rate on amounts in excess of the exemption was 45%.

Also, under the current 2010 law, there will only be a limited step-up in the income-tax basis on assets that are transferred at death to a surviving spouse or the next generation. Generally, the federal income tax laws have previously allowed the beneficiaries of a deceased person to receive a full adjustment of the cost basis to the fair market value of many types of assets at the death of the owner. This eliminated, or at least reduced, capital gains taxes when the heirs subsequently sold those assets.

In 2010, if the estate tax remains repealed, a step-up in basis is limited to the first \$1.3 million for the overall estate, plus \$3 million for assets that are transferred to a surviving spouse. This means many more families that were never affected by federal estate taxes may now find themselves affected by this new income tax regime.

If Congress fails to act on estate tax reform in 2010, the federal estate tax on all estates over \$1 million returns in 2011, with estate tax rates up to 55%. Generation skipping transfers greater than \$1 million will again be taxed at a flat rate of 55%.

Congress did NOT repeal the federal gift tax. Currently, annual gifts are limited to \$13,000 per beneficiary. Beyond that, if any person makes taxable gifts (i.e., gifts in any year to a person in excess of \$13,000) of cumulatively more than \$1 million over his or her lifetime, he or she will use up the lifetime unified credit exemption equivalent and will be subject to gift tax. The gift tax will equal the highest individual federal income tax rate, currently 35% in 2010, but increasing in subsequent years.

Although the uncertainty of the federal estate taxes may lead some to inaction, the truth is, planning has become even more important in 2010.

First, your current estate planning documents, including your Will and trust, should be reviewed. In the past, one of the most common estate planning methods used to avoid or reduce the federal estate tax has included the use of Exemption and Survivor's Trusts. After the death of the first spouse, the Exemption Trust is usually funded under a formula equal to the current federal exemption (up to \$3.5 million last year, possibly only \$1 million in 2011 and beyond) and the Survivor's Trust generally receives the remainder. Unfortunately, with the federal estate

tax repeal, this means some estate plans will now fund all of the assets into the Survivor's Trust, and nothing into the Exemption trust, because currently the exemption amount is zero. Upon the death of the surviving spouse, post 2010, the estate will have only one exemption amount to shelter the estate from federal estate tax, instead of the exemption amounts of both spouses. It is wise to review your estate plan to ensure that your documents have the flexibility to minimize future estate taxes, and not inadvertently result in more tax liability than should be paid.

Even though you may be wary of undertaking additional planning during this time of uncertainty, this may be an opportunity to transfer assets while they have a reduced value due to the current economic climate. If you make a gift of an asset now, while the value is relatively low when compared to just a few years ago, when that asset recovers in value, the growth will have occurred after the gift was completed and outside of your estate. Thus the growth will not be subject to gift or estate taxes. This may be an excellent opportunity to enhance the value of a gifting strategy to leverage the value of both your \$13,000 annual gift exclusion and your lifetime exemption of \$1,000,000 per donor.

Additionally, if you are considering making gifts, you can still use discounting techniques. When an individual transfers an interest in a closely-held business entity or real estate during their lifetime or at death, the interest is valued at its fair market value on the transfer date. Some assets, such as a minority interest in a family business, or real estate, may qualify for two types of discounts: One for lack of control and another for lack of marketability. Congress has proposed eliminating some of these types of discounts, and there is potential for discounts to be addressed in the new federal estate tax bill, if and/or when it is acted upon. Because of this, now may be a good time to consider making a transfer where discounts are important.

There is also an opportunity to take advantage of reduced value in your retirement accounts to reduce your future income taxes. Effective January 1, 2010, you may convert all or part of your traditional IRAs to a Roth IRA, without any limitation on your earned income. Prior to 2010, if your modified adjusted gross income was greater than \$100,000 you were not eligible to make a Roth IRA conversion. That limitation has been removed.

The amount that you elect to convert to a Roth IRA is reported to you as taxable income, but there are no penalties due on the converted amount, only income taxes. Further, if you elect to make a conversion of an IRA to a Roth IRA in 2010, you can elect to report 1/2 of the income in 2011, and 1/2 in 2012, allowing you to defer payment of the taxes due on the converted amounts until you file your income tax returns for those years. The income on the conversion will not be reported to you as 2010 income. This option exists only for conversions that are completed in 2010.

This is an opportunity to convert IRA assets, which would ordinarily be taxable to you in retirement, into assets which are received completely free of income tax once you are age 59-1/2 or older. The market is still in a recovery phase and you could also benefit from converting when your account balances are lower and pay less income tax. If the assets then rebound in value as the recovery proceeds, that growth will also be exempt from income taxation once you have retired and begin to draw on the Roth IRA.

A Roth IRA conversion will not be appropriate for all people, but this is a rare opportunity, and merits an examination of your options. If the result is that a Roth IRA conversion would not work in your case, at least you have done your homework and made an informed decision.