

Gradual elimination of estate tax

Dear Reader:

I am writing this letter to explain to clients how their estate planning may be affected by the 2001 Tax Act. This law gradually eliminates the estate tax by increasing the amount that is exempt from the tax over several years, reducing the top rate over several years, and finally repealing the estate tax for individuals dying after 2009. But there is a quirk in the law. To comply with budgetary rules, the 2001 Act contains a so-called sunset rule under which the pre-2001 Act rules return after 2010 unless Congress provides otherwise at some future time. This means that the estate tax is repealed only for those who die in 2010. The changes are quite complicated and will require most estate plans to be reevaluated.

Background. Under pre-2001 Act law, there was no gift tax, and no estate tax on the first \$675,000 of combined transfers during life or at death, for gifts made and individuals dying in 2001. These two taxes were tied together under a unified system having a top rate of 55%. However, there were differences between the gift tax and the estate tax. One difference potentially affected the income tax of donees (recipients) of gifts and heirs of estates. A donee generally got the donor's basis (usually cost) for a gift. As a result, if there was a gift of appreciated stock, for example, the donee had a taxable gain if he sold at the gift value. Property acquired from a decedent, however, generally got a basis equal to its value at his death. This meant that, on a later sale by the heir, he didn't have to pay income tax on the appreciation in the property that occurred while it was held by the decedent.

Exemption increases and rate reductions. The 2001 Act increased the exemption from \$675,000 for 2001 to \$1 million for 2002 and 2003, \$1.5 million for 2004 and 2005, \$2 million for 2006 through 2008, and \$3.5 million in 2009. But only the estate tax exemption amounts rose to more than \$1 million. The gift tax exemption amount remains at \$1 million for all years after 2001, and the gift tax is not being repealed during 2010, as the estate tax is currently scheduled to be. Thus, there is a modified unified estate and gift system in 2009, and no unified system in 2010. Under the sunset rule, the estate and gift system would be re-unified in 2011, with the exemption going down to \$1 million for both estate and gift tax purposes.

The top estate and gift tax rate dropped to 50% in 2002, 49% in 2003, 48% in 2004, and 47% in 2005, 46% in 2006, and 45% in 2007 through 2009. In 2010, there will be no estate tax, and the top gift tax rate will be 35%. Under the sunset rule, the top estate and gift tax rate would revert to 55% in 2011.

Change to basis rules. If the estate tax is repealed in 2010, the basis rules will be changed to be similar to the gift tax rules but with many opportunities for heirs to get increases in basis. For example, it would be possible to increase the basis of assets received from an individual dying in 2010 by \$1.3 million and by an additional \$3 million for assets going to a spouse. Under the sunset rule, the step-up in basis rules would return for 2011.

Other changes. The 2001 Act contained a number of other changes, some of which are retroactive. It simplified and reduced the generation-skipping transfer (GST) tax, which is a special tax that's designed to prevent individuals from avoiding the estate tax by transferring assets to a generation below the next one (e.g., grandparent transferring to grandchild rather than to child). The 2001 Act also improved the exemption for conservation easements and the provision that allows deferral of estate tax on a closely

held business. It even created a retroactive refund opportunity for some estates that had farms that were valued based on actual use rather than highest and best use.

The 2001 Act eliminated the family-owned business deduction for individuals dying after 2003. (The amount of this deduction was coordinated with the exemption amount, and the *combined* amounts could not exceed \$1.3 million. As noted above, after 2003, the exemption amount alone exceeds \$1.3 million.)

Uncertain impact on planning. The uncertainty of whether the sunset provision will ever come into play and whether an individual will die during a period of increasing exemption amounts makes planning difficult. Moreover, because of the way the law works, when income tax costs are factored in, some heirs would face higher tax costs if their benefactor dies in 2010, when the estate tax is scheduled to be repealed, than they would if he died before 2010.

What to do now. Individuals should continue to write wills and develop estate plans to ensure that their assets will pass as they desire and that special needs of particular heirs will be properly addressed. This is so even if there is a good chance of survival until a year when estate tax won't be owed because of the increasing exemption or repeal. Individuals who may have an estate larger than the \$3.5 million exemption amount that applies in 2009—or the \$1 million amount that is currently scheduled to apply for 2011 (when the estate tax is scheduled to be restored one year after it is repealed)—should make annual exclusion gifts each year. The gift tax annual exclusion allows you to give \$13,000 to an unlimited number of donees each year without paying gift tax. By doing this, you remove the gift amounts from your estate and save estate tax. In addition, you remove the post-transfer growth in the gifts from your estate. Other steps to reduce estate tax include setting up a life insurance trust, establishing a grantor retained annuity trust (GRAT), and placing one's residence in a special type of trust called a qualified personal residence trust (QPRT).

Special factors for married couples. Married couples should make sure that each spouse has sufficient assets in his or her own name to take advantage of the increased exemption. In addition, their wills should establish a so-called bypass or credit-shelter trust. Such a trust is funded with an amount equal to the exemption from estate tax. The survivor gets income from the trust and the assets in the trust pass to the children free of estate tax on the survivor's death. Assets above the exempt amount can be given outright to the surviving spouse or placed in a special marital trust for him or her. This approach may have to be altered depending on the year involved and the size of the estates.

Record retention. With the scheduled change to a modified carryover basis system in 2010, it is essential that you retain all records of cost or other basis. For purchased items, this means receipts and statements showing the amount you paid for it. For items inherited before 2010, basis ordinarily is the date-of-death value of the item. For property acquired by gift, the donee's basis usually is the same as the donor's. For depreciable property, basis is reduced to reflect allowable depreciation.

New look at plan. While the 2001 Act may well save estate tax to the benefit of your heirs, it has added many new planning complications. I invite you to contact our office to set up an appointment so that we can properly reexamine your estate plan to help to keep your estate tax, and income tax for your heirs, to a minimum.

