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GRADUAL ELIMINATION OF ESTATE TAX

The following is an explanation of how estate planning may be affected by the 2001 Tax Act. This new 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 This means the estate tax is repealed only for those who die in 2010.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 is 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 are tied together under a unified system having a top rate of 55%. However, there are differences between the gift tax and the estate tax. One difference potentially affects the income tax of donees (recipients) of gifts and heirs of estates. A donee generally gets the donor's basis (usually cost) for a gift. As a result, if there is a gift of appreciated stock, for example, the donee will have a taxable gain if the gift is sold at the gift value. Property acquired from a decedent, however, generally gets a basis equal to its value at date of death. This means that, on a later sale by the heir, income tax won't have to be paid on the appreciation of the property that occurred while it was held by the decedent.

EXEMPTION INCREASES AND RATE REDUCTIONS

The new law substantially increases the $675,000 exemption after 2001. It rises 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. There is also a change to the unified system. The gift tax exemption amount remains at $1 million for all years after 2001, and the gift tax is not being repealed during 2010 as the estate tax is. Only the estate tax exemption amount will rise to more than $1 million. Under the Sunset Rule, the exemption will go down to $1 million for both estate and gift tax purposes in 2011.

The top estate and gift tax rate drops to 50% in 2002, 49% in 2003, 48% in 2004, 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%. The top estate and gift tax rate reverts to 55% in 2011.

CHANGE TO BASIS RULES

When 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 will be possible to increase the basis of assets received from an individual dying in 2010 to $1.3 million and to $3 million for assets going to a spouse. Under the Sunset Rule, the step-up in basis rules return for 2011.

OTHER CHANGES

The 2001 Act contains a number of other changes, some of which are retroactive. On the positive side, it simplifies, reduces and in 2010 repeals the generation-skipping transfer 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., grandfather transferring to grandson rather than to son). It also improves the exemption for conservation easements and the provision which allows deferral of estate tax on a closely held business. It even creates a retroactive refund opportunity for some estates which had farms that were valued based on actual use rather than highest and best use. On the negative side, it eliminates the family-owned business deduction for individuals dying after 2003.

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. Also, the way the law works, when income tax costs are factored in, some heirs will face higher tax costs if their benefactor dies in 2010 when the estate tax is 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 their assets will pass as they desire and 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 increasing exemption amount (or the $1 million amount which will apply for 2011 after estate tax is restored one year after it is repealed) should make annual exclusion gifts each year. The gift tax annual exclusion allows you to give $10,000 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 and placing one's residence in a special type of trust.

SPECIAL FACTORS FOR MARRIED COUPLES

Married couples should make sure each spouse has sufficient assets to take advantage of the increasing exemption. Also, their wills should establish a so-called bypass or credit-shelter trust. Such a trust is funded with an amount equal to the exemption. 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 to retain all records of cost or other basis. For a purchased item, this means a receipt or statement showing the amount paid for it. For an item 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.