

Estate Tax Repeal – Here Today, Gone Tomorrow

The **Economic Growth and Tax Relief Reconciliation Act of 2001** occupies 186 pages of text. For most wealthy Americans (and others subject to U.S. transfer taxes), the most critical provision in regard to estate taxes is the very last – the so-called “sunset” clause. It reads, in relevant part, as follows:

SEC. 901. SUNSET PROVISIONS OF ACT.

“All provisions of, and amendments made by, this Act shall not apply ... to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010. [The current laws] ... shall be applied ... to years, estates, gifts, and transfers [after December 31, 2010] ... as if the provisions and amendments described [herein] ... had never been enacted.”

In short, although the much-ballyhooed “repeal” occurs in 2010, the *current estate tax provisions automatically reappear on January 1, 2011, unless another Congress passes a new bill extending repeal beyond 2010 and a new President signs that bill into law*. Thus, for those who do not die prior to January 1, 2011, this entire transfer tax cut package may be essentially meaningless.¹

Key provisions of the law.

1. *Full repeal of both the estate tax and generation-skipping transfer tax is in effect only for decedents dying between January 1-December 31, 2010.* There is significant relief for the estates of individuals dying between January 1, 2002 and December 31, 2009, as well, with the benefits increasing over that period.
2. The unified credit remains a *credit equivalent* – not a true exemption as was proposed in previous versions of the legislation. The “applicable exclusion amount” for both gift and estate tax purposes goes to \$1,000,000 in 2002. *The gift tax exclusion amount remains frozen at \$1,000,000.* The estate tax exclusion amount goes to \$1.5 million in 2004, \$2 million in 2006, and \$3.5 million in 2009.² *The GST exemption amount tracks with the estate tax exclusion amount beginning in 2004.* The special exemption for qualified family-owned business interests (QFOBI) is repealed after 2003, when the estate tax exclusion amount goes to \$1.5 million.
3. *The Gift Tax is never repealed.* Even after total repeal of the estate and generation-skipping transfer taxes, the ability to make tax-free gifts is limited to the \$1 million

¹ JCT budget estimates in relation to an earlier, version of the bill put a price tag of \$1.3 trillion on a 10-year extension of repeal. Some estimates relating to the current bill place the cost around \$600 billion. To assume that repeal will hold beyond 2010 suggests that one can predict the economic realities facing the country and the political make-up of Congress and the White House in 2010.

² There appears to be no increase in the unified credit for nonresident aliens, which translates into an exclusion amount of \$60,000.

exclusion amount. For gifting in excess of \$1 million, a credit will be allowed for what would be the tax on first \$1 million of gifting. The **annual gift tax exclusion is unaffected by this bill.**

4. **Marginal gift and estate tax rates decrease** for gifts made and for decedents dying between 2002 and 2010. In addition, the 5% surtax on estates over \$10,000,000 – to phase out the benefit of the progressive rate structure and the unified credit – is repealed in 2002. The combination of increased exemption (for estate and GST purposes) and reduced gift, estate, and GST tax rates is shown on the following table.

Calendar Year	Estate and GST³ exemption	Highest estate, gift, and GST⁴ tax rates
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	Tax repealed	35% ⁵ on taxable gifts only
2011⁶	\$1 million	55%

5. The **state death tax credit is repealed** for decedents dying after 2004, with the maximum credit currently allowed being reduced by 25% in 2002; by 50% in 2003; and by 75% in 2004. It is then **replaced by a deduction** from the gross estate for state death taxes actually paid.
6. **Step-up in basis is repealed for decedents dying after December 31, 2009.** The recipient gets basis equal to the LESSER of decedent's adjusted basis in the asset or the fair market value of the asset at date of death. The decedent can pass on an aggregate \$1.3 million⁷ of basis increase to any heir, **plus** another \$3 million to a

³ The GST exemption stays at its current rate (\$1 million indexed for inflation) until 2004.

⁴ The GST tax is imposed at a flat rate equal to the highest estate tax rate in effect at the time of the transfer.

⁵ After 2009 the maximum gift tax rate will be the top individual income tax rate as established under this bill.

⁶ In the absence of an extension of the repeal provisions, the rates revert to what they would have been had this legislation never been enacted.

⁷ A helpful provision in the new law increases this number by the value of any built-in loss that existed on the date of death. For example, if an individual's basis in Lucent stock was \$400,000 and the date of death value was \$100,000, the executor will be permitted to pass on a total of \$1.6 million of basis increase. This is more favorable than under current law, where the beneficiary of the stock would take the decedent's basis of \$100,000 and the tax loss would be wasted.

surviving spouse. There is only \$60,000 of basis increase allowed where the decedent is a *nonresident alien*. These amounts are indexed for inflation beginning in 2011, with the base year being 2009. Items of *Income in Respect of a Decedent (IRD)* are not subject to the basis increase allowance – this is also the case under current law.

Now let's look at some of the implications of these changes.

Estates of decedents dying between January 1, 2002 and December 31, 2010, will benefit most from the new law. The combined effect of the increased unified credit exclusion amount and the reduced rates could substantially decrease an estate's federal tax liability during this window. That's the good news. The bad news is that one has to die before 2011 in order to obtain these benefits. It would seem that the best planning opportunities might exist for the terminally ill and those currently on life support. Others may have to take into account the bleak possibility that they may survive until sunset.

The best quote we've heard to date on this aspect of the bill comes from well-known New York estate attorney Sanford J. Schlesinger: "We should have a new kind of living will: 'plug me in until repeal.'" Of course, as we approach 2011 this may change to: "Shoot me, please, on New Year's Eve."

What Congress did (or failed to do) in relation to gift taxes may be an indicator of how serious Congress is about repeal. It appears that the only positive changes that have been made in the gift tax are (1) a gradual reduction in the maximum rates from 55% to 35% (with no reductions in the lower brackets), and (2) an increase in the gift tax credit exclusion amount to \$1 million in 2002 rather than in 2006. In other words, estate and GST taxes may go away, but the gift tax is forever. Elimination of the gift tax – or significant expansion in the exclusion amount – would have permitted taxpayers to give away significant amounts of wealth during their lifetimes, thus avoiding estate and GST taxes at death. Instead, Congress has substantially limited gifting opportunities, thus ensuring that when the repeal sunsets on December 31, 2010, there will be plenty of assets remaining subject to the revived estate and GST taxes.

Accelerated gifting may be indicated for some taxpayers. For those who are willing to part with control over some assets, full utilization of the \$1 million⁸ gift tax credit exclusion amount in 2002 is available. This will ensure that the amount of the gift plus all the appreciation on that amount will be removed from the estate. The earlier the gift is made, the more appreciation may be removed from the estate. All other things being equal, the preference would be to gift cash, cash equivalents, or other high basis property. Otherwise, the gift will include a built-in taxable gain, and will thus fail to maximize the efficiency of the exclusion. If death occurs prior to repeal or after the sunset takes effect, low basis assets remaining in the estate will receive a stepped-up basis. If repeal is in effect at the time of the taxpayer's death, the estate will be able to allocate \$1.3 million of

⁸ The exclusion amount is per person. Thus, a married couple may collectively exclude \$2 million of gifts, through individual gifts or through gift-splitting.

basis (plus \$3 million of basis in the case of a surviving spouse) to the low-basis assets remaining in the estate.

For example, assume that you have a \$1 million investment portfolio with an aggregate cost basis of \$400,000 and thus \$600,000 of untaxed gain. If you gift the entire portfolio to your children in 2002 and they sell the stock thereafter, then under current tax law they will owe \$120,000 in federal capital gains taxes. (There may also be state taxes due.) You will have used your entire \$1 million exclusion amount to transfer, in effect, \$880,000 of assets. If you had given cash or high basis assets and kept the investment portfolio instead, you would have taken more complete advantage of the available exclusion. Moreover, if you die before 2010, your estate will receive a stepped-up basis in that \$1 million investment portfolio; if you die while repeal is in effect, your executor can allocate part of the \$1.3 million basis allowance to the \$600,000 gain.

Generation-skipping transfers offer long-term tax protection for wealthy taxpayers.

As the estate tax and GST tax exemptions increase over the next decade, so do the opportunities for wealth transfer. For those fortunate (?) enough to die in 2009, up to \$3.5 million may be left to a Dynasty Trust, where it may benefit descendants in perpetuity (depending on the situs of the trust) without being exposed to transfer taxes – regardless of whether repeal is made permanent. Those dying in 2010 may leave unlimited amounts to such a trust, with the only baggage being carryover basis. And you don't have to die to take advantage of the expanded opportunities. Under current law, gifts in excess of \$1,060,000 would attract both gift *and* GST taxes. Under the new law, generation-skipping gifts of up to \$1.5 million in 2004, up to \$2 million in 2006, and up to \$3.5 million in 2009 can be made with only a gift tax imposed. In 2010, unlimited generation-skipping gifts can be made subject only to gift tax. What this means is that even when the “repeal” sunsets in 2011, all such prior transfers will forever escape further estate, gift, and generation-skipping taxes.

The impact of repeal of the state death tax credit. The vast majority of states impose a “sponge tax” on the estates of decedents who are residents or own property in those states. This means that the tax imposed is simply equal to the credit for state death taxes that the federal government allows against the federal estate tax. For estates subject to taxes in a sponge tax state, repeal of this credit may be a non-event: it simply means that instead of sending two checks (one to the IRS and one to the state treasury), the executor will send all the money to Washington.

There is one advantage that may accrue to the estates of decedents dying before 2011 with significant items of IRD (Income in Respect of a Decedent). This includes IRAs, pension plans, 401(k) plans, 403(b) annuities, non-qualified deferred compensation plans, death benefit only plans, and deferred annuities, to name some of the most common. §691(c) of the Internal Revenue Code permits the recipients of these amounts to take an income tax deduction equal to the *federal* estate taxes paid that were attributable to those items of IRD. To the extent that a larger percentage of the entire estate tax bill will be payable to the federal (rather than the state) government beginning in 2002, there will be a increased income tax deduction available for the heirs.

However, repeal of the state death tax credit may have serious financial repercussions for the states themselves. Repeal of the state death tax credit may effectively repeal the state death tax itself. Many states derive significant revenues from the sponge tax, and the pressure will be on as early as 2002 to develop alternative sources of revenue. To the extent that states de-couple their estate taxes from the federal scheme and enact freestanding taxes, individual estates may experience a net increase in the total amount of taxes due, as a deduction is less valuable than a credit of the same dollar amount.

Step-up or carryover basis: life insurance works either way. For estates large enough to be subject to estate taxes, policies owned outside the insured's estate will continue to provide liquidity to pay taxes or to offset the estate shrinkage resulting from taxes of any kind. In 2010 (and thereafter, if repeal is extended) there will be limitations (described above) on the value of assets that can be passed with increased basis. In that case, even personally owned life insurance will avoid all federal taxes, since the death benefit is received income tax-free with no basis step-up needed.

Note that there is no tax – capital gains or otherwise – triggered on appreciated assets at the death of the estate owner. Rather, the *tax is imposed on the subsequent sale or liquidation* of the asset by the beneficiary. It should also be kept in mind that there is no guarantee that the income taxes imposed on these items will be at capital gains rates, or that those rates will be the same as, or lower than, they are today.

Record keeping issues – carryover basis. One of the more difficult practical concerns with the carryover basis regime is the tracking of basis in various assets. For some wealthy individuals it would be a project to reconstruct cost basis *today*, let alone at some point many years into the future. We can expect Treasury Regulations at some point detailing the level of evidence that might be required and the consequences of failure to provide that evidence. It might turn out to be like getting on a toll road and then losing your ticket: even if you've traveled only one exit, you'll be charged as if you had driven the entire length of the toll road to your current exit point.

If repeal ever becomes a reality, what taxes will still have to be paid? As described above, there is the tax on appreciated assets that heirs must pay when they dispose of those assets, to the extent that the \$1.3 million (or spousal) basis increase allotments have been exceeded. And there is the possibility that various states will enact estate or inheritance taxes not related to a federal estate tax scheme. A third, and much more insidious, tax increase relates to the IRD income tax deduction discussed earlier (see page 4, above).

Example. Assume that Joseph Mallory, a widower, dies in 2001 with a \$10 million estate, including \$4 million of pension and IRA accumulations. Assume further that there is no state death tax, so that the federal estate tax attributable to these assets is \$2.2 million. Mr. Mallory's heirs will be entitled to a \$2.2 million IRD income tax deduction: instead of paying taxes on \$4 million of income, they will pay taxes on only \$1.8 million.

However, repeal of the estate tax would eliminate this deduction, thereby dramatically increasing their income tax liability.

Impact on estate planning documents. Many wills and trusts contain so-called “formula” marital deduction clauses to take maximum advantage of the unified credit and other credits that have been in the Code for decades. One approach divides the estate into two portions: an amount equal to the unified credit is allocated to a trust (the “Credit Shelter Trust”) for the benefit of spouse and children, with the balance of the estate going to the spouse outright or in trust (the “Marital Trust”). Another approach directs to the spouse or Marital Trust the *smallest* amount that will qualify for the marital deduction and, after taking into account the unified credit (and other credits and deductions), will result in the smallest federal estate tax being paid. Generally, the spouse has fewer rights in the Credit Shelter Trust, since the objective is to protect these assets from estate taxes in both estates.

Imagine the results in the following cases:

1. Husband dies in 2001 with a \$2 million estate and a will that was drafted last year with a formula marital deduction clause similar to one of the above examples. Because the unified credit is now \$675,000, his spouse will receive \$1.325 million as a marital bequest, while the balance goes to the Credit Shelter Trust.
2. Same facts, only Husband dies in 2006. Because the unified credit is now \$2 million, *nothing* goes to the marital trust.

Although Husband and Wife might not object to the above disposition, it was probably not what they contemplated when their wills were drafted in 2000. What this means is that all wills drafted with formula marital deduction provisions before this legislation will need to be reviewed by competent counsel to determine whether they still accomplish their intended objectives.

For those who believe that repeal is here to stay. Income tax planning becomes even more critical than transfer tax planning. These individuals should take maximum advantage of income tax deduction and deferral opportunities. First on the list must be *contributions to qualified retirement plans*, the opportunities for which have been greatly enhanced by the new tax law – at least through 2010. Absent a concern about estate tax inclusion of proceeds, the purchase of *life insurance within the retirement plan* becomes an even more attractive option: the premiums are paid with tax deductible contributions and the proceeds are received free of all federal taxes. The *Super IRA Legacy* strategy should be incorporated with the expanded use of qualified retirement plans to maintain the deferral of income taxes as long as possible. Both lifetime and testamentary⁹ *charitable gifting strategies* remain attractive under estate tax repeal, in

⁹ Ideally, it is the estate beneficiary who initiates the charitable gift of low basis property, using the income tax deduction to purchase life insurance to replace the value of the assets going to the charity.

particular those approaches that involve outright or deferred gifts of appreciated property to charity.

For those who believe that repeal is illusory. While the above strategies are viable even in the face of the estate tax, most people of means will continue to use the planning techniques that were in play prior to the passage of the tax bill: discounted gifting and other estate reduction techniques; life insurance trusts; and generation-skipping transfers.

For those who don't know what to believe. *Flexibility* is the watchword here: plan for the worst and be prepared to change direction on short notice. In the financial services world the call will be for those products and concepts that most effectively keep the client's options open. Strategies that have both transfer tax *and* income tax advantages will be preferred; survivorship policies that can easily be split into single life policies and single life policies that can be designed to pay survivorship benefits will enjoy a huge advantage.

Implications for the estate planning community. Several months ago, the very quotable Sanford J. Schlesinger, Esq. (quoted earlier) wrote: "I am learning a second language so I can become a New York City cab driver if repeal occurs." Now Mr. Schlesinger may need to hire some of those multi-lingual cab drivers to help him do all the estate planning work that will be required to keep his clients ahead of the curve. He will now have to take into account an increased variety of scenarios in drafting wills and trusts so that these documents can handle a variety of circumstances smoothly. They will have to account for the likelihood of increased estate tax exclusion amounts, depending upon the year of death; the possibility of complete repeal in 2010 (or in some other year); and the threat of sunset, i.e., the return of the current transfer tax system in all its glory. As has so often happened in the past, this is yet another Full Employment Opportunity Act for tax and estate planning professionals.

Can we count on certainty through 2010? There will be four more congressional elections and two more presidential elections between now and November of 2010. In the past, Congress has not been bashful about tweaking arrangements that their predecessors have put in place. Generally the concern is budgetary, and the stock in trade of a Congress concerned about finances is to delay the effective dates of phased-in revenue-losing provisions.

Example: In 1981, Congress passed ERTA, which contained a number of serious transfer tax reforms, including the 100% marital deduction. Included in the legislation was a four-year phase-down of the top estate and gift tax rate from 70% to 50%. In 1984, a new Congress passed TRA'84, which froze the top rate at 55% for three years. The Revenue Act of 1987 froze the top rate at 55% for an additional five years. Finally, OBRA '93 set the top rate at 55% "permanently." (Until the new law goes into effect.)

As we say in Vermont: "Don't bet the farm on it."

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