



# IN BRIEF

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## ESTATE TAX REPEAL...?

In late May, Congress passed the Economic Growth and Tax Relief Act of 2001, and on June 7 President Bush signed it into law. The Act made significant changes to the federal estate and gift taxes. This article will address some issues that should be considered in reviewing estate plans in the context of the new law.

### ESTATE TAX EXEMPTION AMOUNT

Although the new Act has often been described as repealing the estate tax, there is some question as to whether repeal will actually take place. In general, the estate tax will be phased out over the next 10 years, so that persons dying in 2010 will pay no estate tax. However, the entire bill will expire on December 31, 2010 and, if future Congresses do not extend the provisions of the Act, persons dying in 2011 will be subject to the law as it existed prior to the Act. In other words, the estate tax might be reenacted automatically in 2011. Also effective in 2010 only, the income tax stepped-up basis rules are changed so that capital gains will no longer be completely forgiven at death.

The new Act increases the current \$675,000 estate tax exemption amount to \$1,000,000 on January 1, 2002, and in future years as follows:

Year of Death	Exemption Amount
2002	\$1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000

2009	3,500,000
2010	No estate tax

### CHANGES IN ESTATE TAX RATES

The new Act also reduces the estate tax rates. Under current law, the maximum rate for very large estates is 55 percent. Beginning on January 1, 2002, the maximum rate will slowly decrease, as follows:

Year of Death	Maximum Rate
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007 through 2009	45%
2010	No Estate Tax

After 2010, the Unified Credit will revert to \$1,000,000, and the maximum estate tax rate will revert to 55 percent, unless a future Congress passes legislation to extend or otherwise modify the Act.

### GIFT TAX AND GENERATION-SKIPPING TAX CHANGES

The new Act also makes significant changes to the gift tax and the generation-skipping transfer tax. The \$10,000 annual exclusion for gifts will remain in place and will be adjusted for inflation, as under prior law. The maximum gift tax rate will decrease according to the rate schedule for estate taxes (except in 2010, when the maximum gift tax rate will be 35 percent), while the estate tax will be eliminated entirely. The exemption amount for gift taxes will increase from its current level of \$675,000 to \$1,000,000 on January 1, 2002, but unlike the exemption amount for estate tax it will not increase

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further. Thus the gift tax will remain in place after the estate tax is phased out, and the gift tax exemption will remain at \$1,000,000 indefinitely. In addition, all transfers to irrevocable trusts after 2009 will be taxable gifts. As a result, the \$10,000 annual exclusion will no longer be available for gifts to irrevocable trusts for minor children.

The current \$1,060,000 exemption for generation-skipping transfers will increase as follows:

2001 through 2003	\$1,060,000
2004 and 2005	\$1,500,000
2006 through 2008	\$2,000,000
2009	\$3,500,000
2010	No generation-skipping tax

The changes to the gift tax and the generation-skipping tax are also complicated by the fact that the entire Act will expire in 2011. The gift tax rates will then return to their former level and the generation-skipping tax exemption will also return to its former level unless a future Congress extends the Act or makes other changes. In the meantime, estate planning will need to take all of these contingencies into account.

### **INCOME TAX BASIS**

The income tax provisions of the new Act are also very significant. Under present law, most assets passing at death receive a new stepped-up income tax basis equal to the value of the asset on the date of the decedent's death. As a result, the income taxation of capital gains accrued prior to death is generally forgiven. Under the new Act, after the estate tax is repealed on January 1, 2010 the increase in basis available under the old law will no longer be available. Instead, assets will pass to the heirs with the decedent's original cost basis. As a result, the heirs will eventually be required to pay capital gains taxes on the capital gains that accrued during the decedent's lifetime, although those capital gains taxes will generally not be due until the heirs sell the assets. However, the new Act does allow the executor of a taxpayer's estate to increase the cost basis of some of the decedent's property so that the capital gains accrued on those particular assets during the decedent's life will be forgiven. The amount of increased basis will be limited to \$1,300,000. In the case of transfers to a surviving spouse, an additional basis increase of \$3,000,000 will be allowed, but only on assets passing to the spouse or to certain trusts

for the benefit of the spouse.

The new Act contains numerous other provisions, but the provisions discussed here are the primary provisions that affect estate planning. The consensus appears to be that the repeal of the estate tax will not stand, at least not in its current form, but at this time no one knows whether future Congresses will act to ensure that the estate tax will disappear permanently in 2010.

### **FORMULA BEQUESTS**

In this section we discuss some (but not all) of the estate planning issues that arise as a result of the 2001 legislation.

The scheduled increase in the estate tax exemption amount may require the review of existing wills and trusts utilizing a "bypass" or "credit shelter" formula. Under the new law, the formula will result in a decrease in the amount passing to the residuary beneficiary. This may be particularly relevant for clients whose exemption amount will pass to children or others rather than in trust for the surviving spouse. For example, suppose a client with an estate of \$2,000,000 decides to give his \$675,000 exemption amount to his children and leave the rest, \$1,325,000, to his wife. As is usual, the bequest to children is expressed in the form of a formula based on the exemption amount existing as of the year of death. However, with the increase in the exemption amount to \$1,000,000 in 2002, \$1,500,000 in 2004, \$2,000,000 in 2006 and \$3,500,000 in 2009, the formula may result in the client's wife receiving significantly less than the client envisioned – and possibly nothing. Formula bequests need to be reviewed to ensure that they will produce the intended bequest to the surviving spouse regardless of the year of death. Alternative plans might be considered involving "disclaimer" wills or trusts or the possible use of partial Qualified Terminable Interest Property ("QTIP") elections.

### **ADDITIONAL GIFTING OPPORTUNITY**

Some clients make lifetime gifts of assets that are expected to appreciate significantly in value so as to remove that future appreciation from their taxable estates. With the increase in the gift tax exemption to \$1,000,000 in 2002, an opportunity exists for making additional gifts for these reasons without the imposition of gift tax. Again, however, unlike the

estate tax exemption amount, the gift tax exemption is not scheduled to increase after 2002. Due to the current uncertainty about the future nature or existence of the estate and gift taxes, practitioners should be wary about recommending strategies that result in imposition of gift taxes (or premature imposition of estate taxes).

### **POWERS OF PERSONAL REPRESENTATIVE/TRUSTEE**

If the basis allocation rules actually take effect in 2010, it may be wise to add provisions to estate planning documents specifically empowering the personal representative or trustee with discretion to allocate basis among assets regardless of whether or not this allocation has the effect of discriminating among beneficiaries.

### **ASSETS NEEDED FOR AN EFFECTIVE ESTATE PLAN**

After January 1, 2002, married clients should make an effort to each control \$1,000,000 of the family's assets in order to fully utilize their exemption amounts, and in subsequent years that amount should increase in accordance with the schedule shown above.

### **RECORD KEEPING**

Under current law, death cleanses the past sins of poor record keeping by giving a new date of death value to most assets. If, in fact, the partial elimination of the step-up in income tax basis at death comes to pass, it will be even more crucial than before that clients retain records reflecting the amount they paid for their assets.

To put it mildly, the 2001 tax act has left a number of uncertainties for estate planners. What *seems* clear is that the estate and gift taxes will remain with us at least through 2009. Due to the likely further changes in this area in the future, practitioners are well advised to exercise increased diligence in monitoring legislative developments that could impact their clients' estate plans.

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