

You have probably heard that Congress has repealed the estate tax as part of the 2001 Tax Relief Act. Those of you with estate plans currently in place may be wondering what effect, if any, this will have on your estate plan, which was prepared at a time when estate tax repeal seemed unlikely. This tip is intended to provide you with the details of estate tax repeal.

Estate Tax Repeal

The 2001 Act repeals the estate tax, but repeal will not be effective until January 1, 2010. Although the proponents of repeal had hoped for more immediate action, budgetary constraints delayed outright repeal for more than eight years. Budget rules also required that the Act provide for the reinstatement of the estate tax starting in 2011. It is unlikely, however, that a reinstatement of the tax will take place if repeal actually occurs.

Although repeal lies well in the future, the 2001 Act reduces the estate tax on the estates of those who die during the transitional period. It does this in two ways. First, in a provision that benefits all estates, it steadily increases the individual exemption amount (set at \$675,000 for 2001) so that it will be \$1.0 million in 2002 and 2003; \$1.5 million in 2004 and 2005; \$2.0 million in 2006, 2007, and 2008; and \$3.5 million in 2009, the final year before repeal. Married couples, with effective planning, are able to take advantage of two exemptions in their estates. Thus, as early as 2002, a married couple with a \$2.0 million estate will no longer be subject to the estate tax.

The second tax-saving feature during the transitional period is a reduction in the top estate and gift tax rates, currently set at 55% and 53%. This change will help only wealthier taxpayers, since these top rates affect only estates of more than \$2.5 million. Effective January 1, 2002, the top rates of 53% and 55% are eliminated and replaced with a rate of 50% on taxable estates in excess of \$2.5 million. The top rate is then further reduced by 1% a year until 2007, when it will be 45%, and it remains at that level until the estate tax is repealed at the end of 2009.

Retention of the Gift Tax

To the surprise of many, the 2001 Act did not repeal the gift tax. Even after estate tax repeal, the gift tax will continue to be imposed on gifts in excess of the individual exemption amount. Congress was less than generous in setting the lifetime exemption amount for gift tax purposes. Like the estate tax exemption, the gift tax exemption increases to \$1.0 million in 2002, but receives no further increases. Thereafter, it will remain at \$1.0 million.

In 2010, the maximum gift tax rate will drop to 35%, equal to the top income tax rate for individuals. There is good reason for this linking of the top gift tax and income tax rates. Congress decided to retain the gift tax due to concerns that lack of a gift tax would encourage taxpayers to make tax-free gifts of income-producing property to family members in lower income tax brackets. Such transfers would be an easy way to reduce the overall income tax burden on the family. Although it will still be possible to make such transfers after estate tax repeal, the reduced gift tax will act as a "toll charge" for taxpayers engaging in this type of planning.

Loss of Basis Step-Up at Death

The quid pro quo for repeal of the estate tax was the loss of step-up in income tax basis at death. Currently, all property owned by a decedent for estate tax purposes receives a date-of-death basis for income tax purposes. Effective for persons dying after December 31, 2009, property acquired from a decedent will retain the decedent's tax basis. This is known as "carryover" basis. When the recipient of the property eventually sells it, he or she will be compelled to compute the gain using the decedent's adjusted basis. In most cases, the decedent's basis will be less than the date-of-death value, resulting in an increased capital gains tax.

The legislation contains a major exceptions to carryover basis. The estate of every decedent who is a U.S. citizen or resident will be entitled to increase the basis of the decedent's property by up to \$1.3 million, although no item of property may have its basis increased above its fair market value on the date-of-death. If the estate is valued at \$1.3 million or less, each asset will automatically receive a basis equal to its date-of-death value. If the estate is larger than \$1.3 million, the estate must file a return allocating the basis increase to specific assets.

If the decedent was married, the estate is entitled to an additional basis increase of up to \$3.0 million for property passing to the surviving spouse.

Planning Considerations During the Transition Period

Because the estate tax remains in effect until the end of 2009, it is not recommended that you immediately revise your estate plan to take advantage of its repeal. Since we all have a chance of dying before repeal takes place, it is necessary to have an estate plan that is designed to minimize the estate tax. Estate tax repeal will do little good for the individual who dies on or before December 31, 2009, when the tax is still in effect.

Because of the phased-in increase in the unified credit that takes place during the transitional period, it is important that your current estate plan be reviewed to ensure that it takes advantage of this increase. If your plan uses a "formula clause" that allocates a portion of your estate to a credit shelter trust that is equal to the amount of the unified credit on the date of death, it will be able to take advantage of the increased credit. If, however, it refers to a specific dollar amount, it needs to be revised if you wish to use the increased credit.