TAX RELIEF AND THE CHANGES TO THE ESTATE AND GIFT LAWS

By Clark Blackman II and Ellen J. Boling

The prospect of the eventual estate tax repeal in 2010 seems to contain the promise of simplified estate planning, but the promise may be more illusion than reality. For the rest of the decade, the estate tax will be in constant flux, and complex planning for these intervening years may be necessary.

Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 ("the Act") on May 26, 2001. The Act represents the most significant tax cuts enacted into law since 1981.

Our Tax Strategies article in the August issue focused on the changes to individual income taxes and retirement savings alternatives ("Tax Relief: The New Act and What It Means for Individuals," August 2001 *AAII Journal*, available at AAII.com). Here, we address the changes to the estate and gift tax laws.

The future repeal of the estate tax is perhaps the most controversial aspect of the 2001 Act. Importantly, the Act contains a "sunset provision" that results in all of the Act's provisions being repealed as of December 31, 2010. As a result of the "sunset provision," the estate, gift, and generation-skipping transfer provisions in effect in 2001 will become the law once again on January 1, 2011, if Congress takes no intervening action.

TWO-STEP APPROACH

Beginning in 2002, the Act gradually will reduce the estate, gift, and generation-skipping transfer (GST) taxes, increase the "unified credit," and make a significant number of more technical changes. After repeal, the Act generally sets into place "carryover basis" rules for the taxation of inherited property. "Carryover basis," to an heir, results in inherited assets having a tax *cost* equal to the lesser of the decedent's basis or the fair market value of the asset at the time of death. This means that a capital gains tax may result when the heir sells the asset, even if the asset does not increase in value after death.

RATES AND UNIFIED CREDIT

The top estate and gift tax rates will slowly drop from 55% to 45% by 2007. The largest rate reduction comes in 2002, as both the 5% surtax applicable to transfers over $10 million and the estate and gift tax rates above 50% are repealed. Additionally, the unified credit exemption amount increases from $675,000 to $1 million in 2002, while the state death tax credit decreases to 75% of the current amount.

The highest estate and gift tax rates continue to drop by one percentage point a year through 2007. Once the rate reaches 45%, it will remain in effect until the estate tax is temporarily repealed in 2010. The gift tax will remain, but the maximum gift tax rate changes to 35% and the exemption is $1 million. In addition, any transfer in trust after 2009 will generally be deemed to be a taxable gift unless: (1) the trust is a grantor trust to the donor (or the donor's spouse), which causes the income (including any capital gains) to be taxable to the donor (or donor's spouse); or (2) the transfer is exempted from such treatment under regulations to be prescribed by the Treasury secretary.

Over the same phase-in period, the unified credit exemption amount for

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estate tax purposes increases from $675,000 to $3.5 million as follows:

- 2004—$1 million to $1.5 million,
- 2006—$2 million,
- 2009—$3.5 million.

The applicable gift tax exclusion amount is increased to $1 million in 2002 and remains there until 2010.

The generation-skipping transfer exemption will remain at its current amount ($1,060,000 for 2001, subject to increases for inflation in 2002 and 2003) until 2004, at which time it will increase to $1.5 million and will be the same amount as the estate tax exemption. It will continue to increase as the estate tax exemption increases. The generation-skipping transfer rate will be the same as the maximum estate tax rate (see Table 1).

CARRYOVER BASIS

The Tax Relief Act introduces new carryover basis rules. After the repeal of the estate tax in 2010, the decedent's tax basis in assets will transfer to the decedent's beneficiaries. The beneficiaries' tax basis for income tax purposes will be the decedent's tax basis, or the property's fair market value on the date of the decedent's death, whichever is less.

The Act does allow for some transfers to qualify for a "step-up" in basis to fair market value. An estate can increase the basis of assets transferred to one or more beneficiaries by a total of $1.3 million. The amount of a decedent's unused capital losses, net operating losses, and certain "built-in" losses may also increase the $1.3 million cap. An estate can also increase the basis of assets transferred to a surviving spouse by an additional $3 million. As a result, the step-up in basis for surviving spouses can total $4.3 million (even more if the aforementioned losses increase the step-up). In addition to qualifying for a basis step-up at the first spouse's death, property left outright to a surviving spouse will also qualify for the $1.3 million basis step-up provision in the surviving spouse's estate. However, property left to the surviving spouse in a marital deduction trust (either a general power of appointment trust or a qualified terminable interest property trust) would *not* be eligible for the step-up at the surviving spouse's death.

The Act provides that any increase in basis is to be allocated asset by asset; however, in no circumstance may an asset have a basis of more than its fair market value. It also specifies that *executors* will elect which assets take a step-up, and by how much. The basis step-up limitations will be adjusted for inflation annually after 2010.

To prevent possible income tax avoidance, the Act will not allow a basis increase on the following assets:

- Property acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death;
- Property constituting a right to receive income in respect of a decedent;
- Stock or securities of a foreign personal holding company;
- Stock of a domestic international sales corporation (or former domestic international sales corporation);
- Stock of a foreign investment company; and
- Stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

In addition, property over which the decedent held a "power of appointment" (whether general or limited) would not be eligible for the basis step-up. (A power of appointment is typically assigned to you through a trust document; you'll usually know when you have one.)

The carryover basis rules were included in the Act to ensure that taxpayers do not hoard appreciating assets until death to escape federal taxation of their income. These rules, however, virtually assure that Congress will be forced to revisit the estate tax and carryover basis issue in the future. Twice before (in the 1920s and late 1970s), Congress enacted carryover basis rules and twice these rules were repealed because their complexity made them difficult to administer. Often, individuals themselves do not know their basis in assets. Asking an heir to figure out the decedent's basis in a large portfolio of holdings including privately traded stocks, real estate, artwork, antiques, and self-constructed assets will present real administrative challenges. Congress and the Internal Revenue Service (IRS) will have to address these issues before carryover basis takes effect.

TABLE 1. EXEMPTIONS AND RATES UNDER THE 2001 TAX ACT

Calendar Year	Estate and GST Exemption ($ Mil)	Highest Estate and Gift Tax Rates (%)
2002	1.0	50
2003	1.0	49
2004	1.5	48
2005	1.5	47
2006	2.0	46
2007	2.0	45
2008	2.0	45
2009	3.5	45
2010	repeal	35*

**Applies to gift tax only.*

NEW REPORTING RULES

New rules now require more extensive reporting of certain types of gifts and transfers made at death, and impose costly penalties for non-compliance. Generally, these rules require donors or executors (or the trustee of a revocable trust) to report the following information to the IRS:

- Name and taxpayer identification number of the recipient;
- A description of the property;
- The adjusted basis of the property in the hands of the donor or decedent and, in the case of transfers at death, the property's fair market value;
- The donor or decedent's holding period for such property;
- Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;
- In the case of transfers at death, the amount of basis increase allotted to the property; and
- Any other information the Treasury secretary may prescribe.

These new reporting guidelines are mandatory for lifetime gifts required to be shown on a gift tax return, non-cash transfers at death in excess of $1.3 million, and certain transfers of appreciated property by the decedent within three years of death.

In respect to transfers at death, the required information must be attached to the last individual income tax return of the decedent (or at such later date as may be prescribed by the regulations). The required information with respect to lifetime transfers must be included in the gift tax return for the year in which the transfer takes place. Similar information must be furnished in writing to recipients of the property. Additionally, the recipients must be provided with the name, address, and phone number of the person required to provide the information. This information must be furnished to the recipients within 30 days after the date the information is required to be provided to the IRS.

The penalty for failing to report the transfers at death of non-cash assets over $1.3 million is $10,000. For failing to provide other reports to the IRS the penalty is $500, while the penalty for failing to report required information to beneficiaries is $50 for each violation. Similar penalties apply for failure to furnish the information regarding lifetime gifts. The IRS will not impose penalties if the failure to file is due to reasonable cause; however, intentional disregard of the rules results in a penalty equal to 5% of the fair market value of the property in question, determined as of the date of death or gift.

TAX RECAPTURE PROVISIONS

Estates may continue to claim a variety of benefits that are subject to recapture or lapse if certain conditions are not satisfied over time. These include use of qualified conservation easements, special-use valuations, qualified family-owned business deductions, and installment payments of estate tax for closely held businesses.

The Tax Relief Act continues the existing recapture rules beyond the date of repeal in 2010.

OTHER PROVISIONS

The rules for estate taxation of distributions from marital trusts for non-U.S. citizen spouses have also been modified by the 2001 Act. These distributions would not be subject to tax if the trusts were established by an individual dying after 2009. If the individual dies prior to 2010, distributions from the trust would only be subject to tax if made before 2021.

Any gain or loss on the transfer of property in satisfaction of monetary bequests after 2009 would be recognized only to the extent that the property's fair market value at the time of the transfer differs from the fair market value on the date of death (not the carryover basis).

Gain is *not* recognized at death for a transfer of property that is subject to a liability that is greater than the decedent's basis. Similarly, the estate would recognize no gain on the distribution of such property to a beneficiary by reason of the liability. However, neither of these provisions applies if the property passes to a tax-exempt beneficiary.

The existing rules with respect to recognition of gain on transfers to foreign trusts and estates have been modified in two ways. First, the exception to existing rules requiring the recognition of capital gain on the transfer of appreciated property to non-resident trusts or estates is limited to circumstances in which a U.S. person is treated as the grantor for U.S income tax purposes. Second, gain must be recognized on testamentary transfers to non-resident individuals as well as non-resident estates and trusts.

Effective date: The Act repeals the estate and generation-skipping transfer taxes and sets into place carryover basis rules for estates of individuals dying, and transfers made, after 2009.

INTERIM CHANGES

Conservation Easements

The Act expands the availability of qualified conservation easements to any property within the United States or possession of the United States that meets the requirements of a conservation easement. The date for determining the easement's compliance is the date the donation is made.

Effective date: Change applies to estates of individuals dying after 2000.

Closely Held Businesses and Estate Tax Installment Payments

The Act expands the availability of estate tax installment payments by broadening the definition of an interest in a closely held business. A partnership or corporation with 45 or fewer partners or shareholders qualifies as a closely held business,

allowing the estate to make installment payments. Formerly, the entity had to have 15 or fewer partners or shareholders.

Effective date: Change is effective for individuals dying after 2001.

GENERATION-SKIPPING TRANSFERS

Prior to the enactment of the 2001 Act, a generation-skipping transfer tax was imposed on certain transfers that may have resulted in estate tax avoidance by transferring property to a generation more than one generation below the transferor. For example, the tax would apply to a transfer to a trust for the benefit of the transferor's grandchildren and great-grandchildren. The generation-skipping transfer rules provided a $1 million-per-transferor exemption.

The rules governing the allocation of the generation-skipping transfer exemption amount have created traps for the unwary and have led to unnecessary taxation of transfers. The 2001 Act modifies a number of the rules related to the allocation of the generation-skipping transfer exemption amount to ensure that transferors can achieve the greatest benefit from the exclusion.

Transfers to Generation-Skipping Transfer Trusts

A person can make a generation-skipping transfer that is considered either a direct or indirect skip to grandchildren and other lower-generation beneficiaries. The transfer is a direct skip if no one in the first generation (e.g., a child) has any interest in the property. If someone in the first generation does have an interest, then the transfer is an indirect skip. For transferors making certain indirect skips, the Act removes the burden of affirmatively allocating the generation-skipping transfer exemption to the transferred property. The new allocation rule creates greater parity between the methods for allocating the generation-skipping transfer exemption to direct and indirect skips. Now, those making both direct and certain indirect skips are protected by an automatic allocation of any unused generation-skipping transfer exemption—to the extent necessary to make the property exempt from the generation-skipping transfer tax. Individuals making direct or certain indirect skips may elect out of the automatic allocation rules.

Effective date: The new allocation rules apply to transfers made after 2000, and to estate tax inclusion periods ending after 2000.

Seeking Relief for Late Elections

Those who inadvertently failed to make timely elections to allocate the generation-skipping transfer exemption can now seek relief from the Treasury. The Act authorizes and directs the Treasury secretary to grant extensions of time to make the election, and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief were granted, then the gift tax or estate tax value of the transfer would be used for determining the generation-skipping transfer tax exemption allocation.

Effective date: The Act applies to requests for relief pending on, or filed after, December 31, 2000.

Retroactive Allocation of Generation-Skipping Transfer Exemption

In cases in which there is an unnatural order of death—for example, a donor's child dies before the donor—the Act allows retroactive allocation of the generation-skipping transfer exemption (on a chronological basis) to certain trusts of which the deceased child was a beneficiary.

Effective date: The retroactive allocation applies to deaths of non-skip beneficiaries occurring after 2000.

POST-ESTATE TAX ERA

Even after 2009, beneficiaries of certain large estates should not expect that their slates will be clean of all taxes. Indeed, the Act may hold some surprises for the nation's largest taxable estates—those often described as falling in the highest one percent of estates.

The 2001 Act postpones and greatly reduces the taxation of appreciated assets passed on to beneficiaries of these estates, but some tax exposure remains. Instead of taxing the appreciation of transferred assets at death, beneficiaries of larger estates will pay capital gains tax on the appreciation when the assets are sold at some later date. Capital gains tax, while lower than taxes owed under the pre-repeal estate tax regime, remain significant, especially for estates with highly appreciated assets. Under the Act, some estates will be in a more adverse tax situation than they faced under prior law due to the subsequent capital gains tax paid by beneficiaries.

Suppose, for example, a surviving spouse inherits $9.325 million from the decedent's $10 million taxable estate, with the remaining $675,000 of assets passing to their child. Under current law, the estate would have no estate tax liability, and the surviving spouse would receive a step-up in basis for all assets received. An immediate sale of the inherited assets by the surviving spouse would result in no gain or loss since the surviving spouse's basis equals fair market value. Of course, the spouse's bequest of these assets to the next generation would trigger a substantial tax.

If the estate tax repeal were fully in place today, the estate would still have no tax liability. But the surviving spouse would receive a limited step-up in basis—only up to $4.3 million of fair market value—while the remaining assets of just over $5 million would have carryover basis.

Assume that the spouse inherited a closely held business, which the employees wanted to purchase. Also assume that the asset had a carryover basis of zero (the worst-case scenario). An immediate sale of the business would result in a capital gains tax of $1,005,000, using a

20% rate. So, while the spouse has no liability for either estate tax or capital gains under current law, disposing of the business would result in taxes in excess of $1 million when the repeal is completely effective. Even if the business had a greater carryover basis, the spouse would still owe more taxes under the repeal than under the current law. The spouse, however, would never owe capital gains tax if the assets were held and passed on through his or her estate, so timing of the sale has an impact on whether the estate is better or worse off under the repeal.

Complexity and New Reporting Requirements

Under the Act, capital gains may not be the only surprise. Beneficiaries of large estates will face new complexities for determining the basis of inherited assets and will need to comply with new reporting requirements.

Executors will have to elect which assets are to receive the step-up in basis, while also determining the extent to which each asset receives an increase. Some property will be ineligible for step-up, including certain assets the decedent acquired by gift.

Determining carryover basis for other assets could be difficult, especially for assets held by decedents for a number of years, or assets that were purchased through reinvestment programs over the course of the decedent's life. In these cases, obtaining documentation to determine the decedent's basis is often onerous and sometimes impossible.

Impact on States

Most people have focused primarily on how repeal of the estate tax is expected to affect federal revenues or personal estate tax liabilities, while the potential impact on state taxes has largely been ignored. A surprising fact is that the federal estate tax generates over $4 billion a year in state government revenues, and this amount is expected to fall sharply both during the phase-in period and the period following the repeal.

Sixteen states now have their own inheritance or estate tax systems and have at least some structure in place to continue to collect revenues following a federal repeal. But the remaining states rely on a so-called "pickup tax," in which the states typically receive estate taxes based on the federal credit provided for state death taxes. The states pick up tax revenue equal to the death credit, so, in essence, the credit shifts federal revenues to the states.

"Pickup" states face the prospect of dwindling revenues beginning in 2002, unless they restructure their own systems in time to preserve collections. Without question, opponents in these states will resist new taxes.

The End of Estate Planning?

The prospect of eventual estate tax repeal seems to contain the promise of simplified estate planning. Unfortunately, the promise may be more illusion than reality. For the rest of the decade, the estate tax will be in constant flux. Since no one is guaranteed the privilege of living until full repeal is in effect, some complex planning for the intervening years may be necessary.

During the phase-in period of the new estate rates, special care should be taken in drafting wills and trusts. If estate documents include formulas that shift the maximum amount to children without generating estate tax, less may go to the spouse than intended (i.e., $3.5 million would transfer to children if decedent dies in 2009).

Having to maintain multiple sets of estate plans will add complexity and cost. For example, estate plans should address the possibility of the decedent's death taking place during periods when the estate death tax credit is changing—such as after the credit is repealed, but before the outright repeal of the estate tax.

After the repeal of the estate tax, estate planners will have to address the effect of basis step-up and the continuation of the gift tax that Congress and the Treasury designed to prevent erosion of the income tax base through intergenerational transfers.

CONCLUSION

This article was designed to describe the impact that the changes of the 2001 Act may have on lowering the tax liability on the assets that individuals have accumulated over their lives. Consult your professional tax or financial planning advisor to ensure that you understand how the new Act impacts you. ✥

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