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ESTATE TAX REPEAL

I have been looking forward to repeal for two reasons - no, not for political reasons nor because of some injustice in the idea of double taxing the money we've earned. I have been looking forward to the time when estate planning could be what it should be - the time when the transfer tax tail would quit wagging the dog. With a 55% estate tax, people could not afford to ignore the tax. The laws were so complex that the attorney's time was spent learning, understanding the law and then planning how to reduce its impact on our clients. You have to spend your time understanding the impact of the law and determining which course of action best reduces your tax without unduly compromising your objectives. In fact, you rarely had time to even consider your objectives. With the estate tax gone - we can focus on our real legacies - what we really want to pass on to our children - monetary and non-monetary. We can consider the impact of our monetary legacy and take the steps to ensure that it is consistent with and enhances our non-monetary legacies.

But before I celebrate, let me say that it is highly unlikely that the estate tax will ever actually be repealed. What, you say? Am I behind the times? Didn't I realize that Bush signed into law the repeal of the estate tax on June 7, 2001?

Estate Tax. The estate tax is phased out over a ten year period. The exemption and the estate tax rates are as follows:

Year	Exemption	Maximum Rate
2002	$1,000,000	50% *
2003	$1,000,000	49%*
2004	$1,500,000	48%
2005	$1,500,000	47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%
2009	$3,500,000	45%
2010	No estate tax - Limited step-up in basis	
2011	$1,000,000**	55%

* The 50% rate will be applied to amounts over $2.5 million. The 49% rate is the maximum rate applied to amounts over $2 million and 45% to the amounts between $1.5 and $2 million; thus, the maximum rate will be applied to amounts over $2 million since the 45% rate does not apply until the exemption has reached the 45% rate. Taxes can be determined after 2006 simply by subtracting the exemption and multiplying the remainder by 45% until the tax is repealed in 2010.

> The estate tax is repealed for 2010 and reinstated in its current form in 2011.

** Some commentators have interpreted the law to revert to the 2001 exemption of $675,000, but the more logical interpretation is to have the law revert to the law in effect today which increases the exemption to $1 million by 2006.

Gift Tax. The gift tax is retained to avoid having people give property to reduce the income taxes on the family. The gift tax exemption increases to $1 million in 2002, but does not increase after that point. The gift tax rate is the same as the estate tax rate as long as there is an estate tax. If there is no estate tax, then the gift tax rate is equal to the highest marginal income tax rate.

Gift taxes are retained at the top income tax rate after repeal of the estate taxes.

Generation-Skipping Tax. The generation-skipping exemption is increased to match the estate tax exemption. Generation-skipping taxes are repealed at the same time estate taxes are repealed.

Basis Adjustment on Death. Under current law, upon an individual's death, the basis of the assets included in the decedent's estate are adjusted ("stepped up") to be equal to the value of these assets as of the date of death. This provision provides not only significant income tax benefits but also provides relief for individuals who have not maintained records of the cost of their assets. Community property estates have an additional benefit in that both the deceased spouse's half of the community and the *surviving* spouse's half of the community receive a basis adjustment when the first spouse dies.

When the estate tax is repealed, the amount of the step-up in basis is limited.

Upon repeal of the estate tax, the basis of assets owned by a decedent at the time of death are no longer automatically stepped up.

A decedent's estate is entitled to step-up in basis of up to $1.3 million for assets held by the decedent. An additional adjustment in basis of up to $3 million is provided for assets left to the surviving spouse. Thus, if the decedent leaves all of his property to his/her surviving spouse, the decedent's estate will be entitled to a $4.3 million basis adjustment. The step up cannot increase the basis of assets above the value of the assets at the date of death. This basis adjustment can also be applied to the surviving spouse's one-half of the community property, but the total basis step up for all community assets cannot exceed $4.3 million. All of the decedent's and the surviving spouse's remaining community assets will have a basis equal to the lesser of the decedent's (or survivor's) basis or the value at date of death.

State Death Tax. Under current law, an estate is entitled to a credit for taxes paid to the state. This credit is reduced by half next year and is phased out by 2005. Texas has a "pick up credit" which means that Texas imposes an inheritance tax equal to the state death tax credit allowed by the federal government. With a repeal of the estate taxes and the state death tax

credit, Texas inheritance taxes will be eliminated. However, it is highly unlikely that Texas will simply cease to impose inheritance taxes, so expect Texas law to change to impose its own inheritance tax. After the state death tax credit is repealed, the new tax law allows a deduction for inheritance taxes paid to a state.

> If the exemption were raised to $5 million (covering virtually all the family farms and businesses Congress says it wants to protect), less than 2/10 of 1% of the people in the U.S. would be subject to the estate tax.

What Will Really Happen? In 2010 there is no estate tax. In 2011 the estate tax law automatically reverts to current law unless Congress votes to change the law again. Voting to keep the estate tax out depends on an economic and political climate in 2009 favoring repeal. No action not only means no repeal, it means we will not even be able to retain the increased exemptions. Only after the 10 years will we begin to see the impact of the drop in revenue. In addition, the gloss of the "repeal the estate tax" campaign is likely to have faded and be replaced with a counter campaign to reinstate the estate tax. On this last issue, a review of the repeal process and the impact of the estate tax is helpful. An article in *USA Today* in May of this year had some interesting information in this regard. A small minority of the people were in favor of repealing the estate tax, a somewhat larger percentage in favor of repealing the inheritance tax and a whopping 75% in favor of repealing the "death tax". Hence, the estate tax was referred to in the campaigns as the "death tax." Only 2% of the people in the U.S. have estates large enough to owe any estate tax. If the exemption were raised to $5 million (covering virtually all the family farms and businesses we want to protect), less than 2/10 of 1% of the people in the U.S. would be subject to the estate tax. Estate tax repeal may never go into effect. Reinstatement of the current estate tax structure may never be effective. A reasonably likely result is that we will retain the $3.5 million exemption and the 45% top estate tax bracket. However, we must work with the law as it is currently structured.

So let's enjoy the benefits - if there are any. We hope that the tax will be repealed - but we can see there are no guarantees. Is there any action we should affirmatively take in light of the new law? What are some guidelines in this "limbo" period?

- **Don't do anything for tax reasons alone**. But you shouldn't be anyway. The estate planning I do is motivated by taxes. However, after we begin the process and structure the action, it is always helpful to stop and ask - if we eliminated all the tax benefits from this transaction, would you still do it? The answer should be yes. If the answer is no, then the transaction needs to be restructured, since it means the tax tail is wagging the dog. The planning should enhance some part of our lives. It should enhance some broader objective that we have.

- **Review your Will**. Most Wills do not need to be revised due to the changes which will go into effect from 2002 to 2009. However, the structure of some Wills results in a total shift in the estate plan. Let's look at some examples.

  Example #1. Let's assume an individual has an all community estate of $5 million. The Will leaves the amount which is exempt from tax to a Bypass Trust. All property over the exempt amount is left in one or more Marital Trusts for the spouse. The spouse is either the sole or primary beneficiary of the Bypass Trust. Upon the spouse's death, the property is distributed to the children either outright or in trusts of which each child is the primary beneficiary of his/her trust (to the extent of the generation skipping exemption). Under the new law, the amount held in the Bypass Trust will increase and so will the amount held in the Generation-Skipping Trusts for the children.

  ...in this situation, as the exemption increases, the surviving spouse is cut out of the Will!

  However, no changes need to be made to this plan, since the individuals to whom the property is given do not change. The surviving spouse continues to be the beneficiary of all the trusts upon the deceased spouse's death. More of the spouse's share is held in the Bypass Trust, but the spouse is also the sole or primary beneficiary of the Bypass Trust. The children continue to receive the same amount of property, but a larger portion of the property will be held in the Generation Skipping Trusts.

  Example #2. The Will is structured in the same manner as the one in Example 1 with the Bypass Trust and the Marital Trusts created on the first spouse's death and with the property all passing to the children either in trust or outright. However, in this example, the surviving spouse is not a beneficiary of the Bypass Trust, only the children are beneficiaries. (This plan is common when there are children of a prior marriage.) As the exemption increases, the surviving spouse is cut out of the Will! This result will be even more devastating if the entire estate of the couple is the separate property of the deceased spouse, since in that situation the survivor will not have any property available for her support. The Will should be revised.

  ...you should review your estate plan if your plan is over five years old *or* if you have any questions as to the possible impact of the new law.

  Example #3. The Will is structured in the same manner as

the one in Example 1 except that the generation-skipping exemption amount is given to the grandchildren rather than the children. This Will should be revised, since the children will be cut out of the Will as the generation skipping exemption amount increases.

Even if it appears that the new law will not affect your plan, you should review your estate plan if your plan is over five years old *or* if you have any questions as to the possible impact of the new law.

...In ...529 Education Plans...the funds accrue tax-free and under the new law can be withdrawn tax-free.

- **Don't Count On Estate Tax Repeal**. As stated above, it is highly unlikely that the estate tax repeal will even go into effect in 2010. Tax savings planning continues to be important.

- **Don't Count on Step-Up in Basis**. Although it is highly unlikely that the estate tax will be repealed and that we will lose the step-up in basis, keep complete and meticulous records of your basis in all of your assets so that if the estate tax is repealed, you will have the necessary records. This information should be kept in a manner which is accessible to and understandable by your heirs.

- **Use 529 Education Plans for your Children and/or Grandchildren.** 529 Plans are not new. They have been around for several years but got an extra boost in the new tax law. These plans have been the best kept secret in the tax law. You can give money to your children or grandchildren, even making gifts of your $10,000 annual exclusion *in advance* for five years, the assets are invested in a variety of mutual funds sponsored by the plan, many plans allow the funds to be used at *any* post-secondary educational institution (public and private), the funds accrue tax-free and under the new law can be withdrawn tax-free. These plans are so beneficial I will be sending out a separate newsletter on them in the next several months.

With a Roth IRA, provide your children with a $1.7 million inheritance at age 59 ½ with as little as $2,000 a year.

- **Set up a Roth IRA for your Working Children and/or Grandchildren**. Funding a Roth IRA is an excellent way to give to your children and grandchildren. For example, let's assume you contribute $2,000 to a Roth IRA for your child beginning at age 19 and continue doing so until he/she is age 59. If the funds are invested at 12%, the child will have $1.7 million in the Roth IRA at age 59. These funds can be taken out over his/her lifetime tax-free. If the

funds continue to be invested at 12%, he/she can withdraw about $220,000 per year tax free for the remainder of his life expectancy. If the investment is changed to a more conservative return of 8%, the child can withdraw $160,000 tax-free for the remainder of his/her life expectancy. Under prior law, the contribution to a Roth IRA provided no income tax relief to the participant. Under the new law, if your child or grandchild has limited income, he/she will be eligible for a tax credit of 10%-50% of the first $2,000 of the contribution, depending on the amount of the child's income. The credits are phased out for a single person making $25,000 or more, a head of household making $37,500 or more, and a married couple filing jointly making over $50,000. The contribution limits will be increased to $3,000 in 2002, $4,000 in 2003 and $5,000 in 2005. With the increased limits, the impact of compounding can provide significant benefits if the maximum contribution is made from ages 19 to 29. Note that $5,000 invested for 10 years at 12% is worth $87,744 at the end of ten years. If that amount is reinvested at 12% for 30 more years (ages 29-59), the account will have a value of $2.6 million when the child reaches age 59.

- **Take this Opportunity to Consider Your True Legacy.** Estate planning is so driven by estate taxes that we rarely consider the legacy we would really like to leave our children. Money is a facilitator, an aid to accomplishment of our true legacy. We hope to open doors for our children, provide them with the opportunity to develop their unique talents, broaden their experience and/or enrich their lives. Take the opportunity to fantasize about what you would really like to give your children if tax were not a consideration. Would you give your children property now, during your lifetime? If the legacy is intangible like those mentioned above, how can money be used to help accomplish these non-monetary legacies?

To assist you in "rethinking your legacy" we will send out several newsletters over the next year. Some of them will consider estate planning techniques which provide many benefits in addition to taxes, and some of them will focus entirely on the non-monetary aspects of your legacy.

We have also considered different ways to provide our clients with assistance in a review of their estate plans in light of the new tax law, and perhaps in light of changes in their own personal situations. I will provide a seminar for all of our clients on estate planning now and as impacted by the new law. If you would like to bring your current Will (or Revocable Living Trust), attorneys in our office will be available to review your documents following the seminar and to

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discuss the impact of the law on your documents. The seminar and the review will provide you with the information concerning the impact of the new law on your plan and will help you determine if you should change your Will in light of the new law. This review will also provide a broad overview of changes which would be advisable in light of increases in the size of your estate.

If you are interested in attending a seminar on the new tax law, please contact Jamie Rohde at our office (214.373.7195). Please let her know if you would prefer weekday, evening or weekend. We will then contact you with the available times.

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