



**State Estate Planning Committee
of the California Society of Certified Public Accountants**

**ESTATE PLANNING AFTER TAX REFORM -
HOW DO WE GUIDE OUR CLIENTS NOW?**

Friday, November 9, 2001

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Tax Alert

FROM: Richard E. Gilbert
DATE: November 9, 2001
SUBJECT: Estate Planning After Tax Reform - How Do We Guide Our Clients Now?

On June 7, 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001. This legislation contains the most sweeping changes to the estate and gift tax since the unlimited marital deduction was created in 1982, but the changes do not reach their full force until 2010, and, even then, they are scheduled to last only one year. Congress will have to reenact the legislation to extend its life. This memo highlights the changes related to estate planning.

The Estate Tax

- Under prior law, the effective estate tax rate started at 37% and quickly reached 55%, and a surcharge applied to estates over \$10 million. Under the new legislation, the top rate drops to 50% in 2002 and continues to drop over the next five years as outlined in the following chart, and the large-estate surcharge is eliminated.
- Under prior law, each person could protect \$675,000 from the estate and gift tax. Under the new legislation, beginning in 2002 taxpayers can protect \$1 million from the estate tax, and that amount will increase over the next seven years as outlined in the following chart.
- Under the new legislation, there will be no estate tax for deaths occurring during 2010. However, the changes made by the new legislation automatically expire on December 31, 2010, at which time the top estate tax rate will revert to 55%, the large-estate surcharge will apply, and the amount that can be protected from estate taxes will drop to \$1 million.

The Gift Tax

- Under prior law, the gift tax operated in conjunction with the estate tax. As a result, the effective gift tax rate started at 37% and ranged up to 55%, and a surcharge applied to gifts over \$10 million. Under the new legislation, the gift tax will operate separately from the estate tax starting in 2002.
- Under the new legislation, the top gift tax rate drops to 50% in 2002 and continues to drop over the next eight years until it reaches 35% in 2010 as outlined in the following chart.

- Under prior law, each person had a unified credit against both the estate and gift taxes that protected \$675,000. Under the new legislation, beginning in 2002 taxpayers will have a \$1 million exemption from the gift tax, but this exemption will not increase over time. There is no change in the \$10,000 annual gift exclusion.
- The new legislation does not repeal the gift tax. As a result, the gift tax will be a stand-alone tax for gifts made during 2010.
- The changes made by the new legislation automatically expire on December 31, 2010, at which time the top gift tax rate will revert to 55% and the large-gift surcharge will apply. The amount that can be protected from gift (and estate) taxes will remain at \$1 million.

The Generation-Skipping Transfer Tax

- Under the existing rules, each person has a \$1 million exemption from the Generation-Skipping Transfer Tax ("GST"). The exemption is subject to upward adjustments based on inflation, and this year it protects \$1.06 million from GST. Under the new legislation, the GST exemption will continue to rise based on inflation adjustments until 2004, when it will jump to \$1.5 million. It then increases over the next five years as outlined in the following chart. Under the new legislation, taxpayers are required to allocate their GST exemption to lifetime transfers except under very specific circumstances.
- The GST tax rate is the top estate tax rate so the new legislation effectively reduces the top GST tax rate to 50% for 2002. Thereafter, the GST rate drops as the top estate tax rate drops.
- Under the new legislation, there will be no GST for generation-skipping transfers during 2010. However, as with the estate tax, the new law expires on December 31, 2010, at which time prior GST rules will be reinstated.

Year	Estate tax exemption	Top estate tax rate	GST exemption	Top GST tax rate	Lifetime gift exemption	Top gift tax rate
2002	\$1 million	50%	\$1.06+ million	50%	\$1 million	50%
2003	\$1 million	49%	\$1.06+ million	49%	\$1 million	49%
2004	\$1.5 million	48%	\$1.5 million	48%	\$1 million	48%
2005	\$1.5 million	47%	\$1.5 million	47%	\$1 million	47%
2006	\$2 million	46%	\$2 million	46%	\$1 million	46%
2007	\$2 million	45%	\$2 million	45%	\$1 million	45%
2008	\$2 million	45%	\$2 million	45%	\$1 million	45%
2009	\$3.5 million	45%	\$3.5 million	45%	\$1 million	45%
2010	N/A	N/A	N/A	N/A	\$1 million	35%
2011+	\$1 million	55%	\$1.06+ million	55%	\$1 million	55%

Capital Gains Tax on Inherited Assets

When an asset is sold, the owner owes capital gains on the profit. For these purposes, "profit" is the excess of the sales price over the owner's tax basis in the property. If the owner bought the property, his or her tax basis is generally equal to what he or she paid for it. Under the current rules, a beneficiary who inherits an asset is allowed to use the asset's value on the date the deceased owner died as his or her tax basis in the asset. Because of this "step up" in basis, only the post-death appreciation is subject to income tax if the beneficiary decides to sell the asset.

Under the new legislation, this "step up" is greatly limited. For assets inherited during 2010, the beneficiary's basis will be the lesser of (1) the deceased's adjusted basis or (2) the asset's value on the date of death. The new basis could go down, as well as up. So if you paid \$1,000 for the asset originally, and it was worth \$500 on the date of your death, your heirs would inherit the asset with a \$500 cost basis ("stepped down").

To help offset the additional income (or capital gain) tax beneficiaries will pay, the new legislation gives the estate of every US citizen and resident a \$1.3 million "aggregate basis increase" to allocate among the deceased's assets. Estates of non-resident aliens are given only a \$60,000 basis increase. This increase can be allocated among assets in any way the deceased's personal representative decides, but no asset's basis can be increased above its date of death value. The basis increase cannot be applied to several types of assets, including, for example, assets in your retirement plan.

The estate of a married person receives an additional \$3 million basis increase to be allocated to property passing to or for the benefit of the surviving spouse. For non-resident aliens, this \$3 million additional basis increase is not available. The additional increase can be used in conjunction with the basic \$1.3 million increase, so that assets passing to a spouse are eligible for a \$4.3 million basis increase.

For purposes of this basis increase, a deceased spouse is deemed to own 100% of any community property that passes to the surviving spouse. That means that the surviving spouse's share of the community property may be stepped up as well, but the total basis increase is limited to \$4.3 million. In other words, the deceased spouse's interest in community property which is left to the surviving spouse and the survivor's community share would also be entitled to a step up in basis but the step up is limited to a total of \$4.3 million. This is a major change from the prior law, which allowed the entire community property to receive a new cost basis.

Here are examples of how this might work for a spouse or child:

- HUSBAND dies in 2010 (after the estate tax is fully repealed). The community property is worth \$10 million, and the original basis of the assets is \$1 million. The WIFE's share of the community property and HUSBAND's share left to WIFE would be entitled to a new basis of \$5.3 million (original \$1 million plus increase of \$4.3 million). WIFE would still have \$4.7 million of appreciation in the remaining assets, which would be taxed if she were to sell such assets. When WIFE dies in 2012, her assets would be eligible for an additional \$1.3 million in basis increase.
- If the same facts occurred and only the children were beneficiaries, then they would inherit their parents' \$10 million assets with a cost basis of \$2.3 million (\$1.0 million original

basis and a step up of \$1.3 million). If they sold the entire estate at that point, they would pay tax on the \$7.7 million increase.

Prudent taxpayers will start gathering basis information on all of their assets so that records will be available because lack of record-keeping can mean the deceased's basis must be treated as zero. This information will also help taxpayers make the best allocation of the basis increases. However, since the new law expires on December 31, 2010, this new approach applies only for deaths occurring in the year 2010. Although the estate tax may return in 2011, the repeal may very well be extended, which makes long-term planning more complex.

New Reporting Requirement

For deaths occurring in the year 2010, the basis increase described above will be allocated on a new IRS form which will contain information very similar to that required on the current estate tax return, plus basis information as described above. This new form must be filed by the deceased taxpayer's executor if the deceased was a US citizen or resident and the fair market value of his or her non-cash assets exceeded \$1.3 million (or exceeded \$60,000 for U.S. situs assets of non-resident aliens). The form is due when the taxpayer's final income tax return is due, and an executor who fails to file this return is subject to a \$10,000 fine.

ESTATE PLAN REVIEW

IN ADDITION, PLEASE REMEMBER THAT AN ESTATE PLAN IS CONTINUALLY EVOLVING AS WEALTH AND FAMILY CIRCUMSTANCES CHANGE AND SHOULD BE REVIEWED PERIODICALLY. PLEASE BE AWARE THAT DUE TO RECENT ACTIONS BY CONGRESS, THE ESTATE TAX LAW IS IN A STATE OF FLUX. WHILE THE ESTATE TAX IS SCHEDULED TO BE REPEALED EFFECTIVE JANUARY 1, 2010, THE REPEAL LASTS ONLY ONE YEAR. EFFECTIVE JANUARY 1, 2011, THE ESTATE AND GIFT TAX LAW AS IT EXISTED PRIOR TO THE NEW LAW RESURRECTS. THERE WILL BE SEVERAL CONGRESSIONAL ELECTIONS AND AT LEAST TWO PRESIDENTIAL ELECTIONS BETWEEN NOW AND 2010. I EXPECT FURTHER CHANGES IN THE LAW. YOUR ESTATE PLAN MAY HAVE TO BE ADJUSTED IN RESPONSE TO FURTHER CHANGES. IT WILL BE YOUR RESPONSIBILITY TO INITIATE THE REVIEW PROCESS BY SCHEDULING A TIME TO MEET WITH ME PERIODICALLY, BUT NO LESS FREQUENTLY THAN EVERY TWO YEARS.