



Date: June 6, 2001

MEMORANDUM

To: All Estate Planning Clients
From: Robert E. Madden, Esquire
Re: Estate and Gift Tax Changes

As many of you have read in the newspapers, Congress has passed, and President Bush is expected to sign, legislation which makes significant changes in the estate and gift tax provisions of the Internal Revenue Code. These changes will affect the estate plans of most of our clients over the next decade. The purpose of this memorandum is to alert you to these changes so that they ultimately can be reviewed in conjunction with your own estate plan.

I. Introduction

Although most newspaper accounts speak in terms of estate tax “repeal,” that designation is quite misleading. In truth, Congress has passed a phase-out of the estate and generation-skipping transfer tax (“GST”) provisions, which gradually increases the exclusions from these taxes, decreases the highest marginal estate and gift tax rates, and will ultimately repeal the estate and GST tax by calendar year 2010. It should be noted, however, that most practitioners are skeptical that the repeal provisions will ever take effect. If the political composition of Congress and/or the White House changes, as it inevitably will over the next decade, or if there is a need for revenue as budget surpluses disappear, it is highly likely that the ultimate repeal of the estate tax or some of the subsequent phase-down provisions will be eliminated. In addition, the “sunset” provisions of the bill make everything inapplicable for years beginning after December 31, 2010 – thereby requiring Congressional action for the “repeal” to last more than one year. Thus, estate and gift taxes will be with us for at least the next 9 years, and it is highly likely they will affect estates for much longer.

II. Specific Changes to the Estate Tax Provisions

As noted above, the new law will essentially increase the estate tax and GST tax exclusions and lower the highest marginal estate and gift tax rates under the following table.

Estate and Gift Tax Rates and Unified Credit Exemption Amount

Calendar year	Estate and GST tax deathtime transfer exemption	Highest estate and gift tax rates
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%



2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	N/A (taxes repealed)	Top individual rate under the bill (gift tax only)

Accordingly, under the legislation as will be effective in 2010, the estate and generation-skipping transfer taxes are repealed. It should be noted, however, that the gift taxes will not be repealed so that beginning in 2010, the top gift tax rate will be the highest individual income tax rate as provided under the tax bill. The law also provides that, except as provided in regulations, a transfer to a trust will be treated as a taxable gift unless the trust is treated as wholly-owned by the donor or the donor's spouse under the grantor trust provisions of the Internal Revenue Code. The fact that the gift tax provisions have not been repealed (so as to retain the gift tax on lifetime transfers of assets) increases the skepticism of most practitioners that the estate tax will be completely repealed. By keeping the gift tax in place, the law will prevent individuals from transferring most of their assets to heirs during their lifetime in the event that the estate tax provisions were to be re-implemented.

After the repeal of the estate and generation-skipping transfer tax in 2010, the present step-up in basis rules for property acquired from a decedent will be repealed. The step-up in basis rules generally provide that property acquired from a decedent will receive an income tax cost basis equal to the value at which they are included in a decedent's taxable estate. Thus, for example, under the present rules, if someone bought stock for \$10 a share and upon his or her death the stock was valued at \$100 per share, its new income tax basis would be \$100. This means that the heirs could sell the stock and only be taxed on any gain in excess of the \$100 basis. Under the rules that will take effect in 2010, the step-up would largely be eliminated so that the cost basis would remain at \$10 per share. Although there are some modifications to this rule, the net effect of this change will mean that significant income tax costs will replace estate tax costs as a burden to heirs.

In addition, under the conference agreement, the state death tax credits (which are given for inheritance taxes paid to the various states) will be reduced and will be repealed by the year 2005, after which there will be a deduction for state death taxes. It should be noted that the tax bill does not, and indeed cannot, repeal the inheritance taxes imposed by various states. These taxes, in most states, have had little or no effect on decedents in the past, since they typically equaled the federal credit. This meant that the taxes were either paid to the federal government or the states, but that the state inheritance tax imposed little or no burden on decedents. The effect of the federal estate tax repeal will be that state death taxes become a more prominent and significant item for most decedents.

III. What does this mean?

In general, the changes that will take effect will be beneficial in that exclusions will increase and the top estate tax rates will decrease. If the phase-out in 2010 takes effect (although I do not personally believe that it will), it will be a significant benefit for most individuals. Although this is a positive development, each of you should keep in mind the following points:



- Estate taxes are not repealed until 2010. Unless each of us is assured of living until that time, estate tax planning remains a significant item in all estate plans.
- Non-tax reasons for planning remain. For example, holding assets in trust for younger children (or older children, for that matter), naming of guardians for minors, asset protection issues, protecting assets go to children from a prior marriage, or providing for professional management of assets remain. Liquidity issues and the need for insurance will continue in many instances.
- Aggressive gifting may be appropriate for larger estates to take advantage of increased exclusions.
- Income tax issues will become more critical as the step-up in basis rules are eliminated.
- State inheritance taxes will become a prominent planning concern as the federal law is phased out.
- Other changes, such as the modification to the generation-skipping transfer tax rules or the expanded rules relating to conservation easements will affect many individuals.

IV. Planning action items.

As these changes begin to take effect in 2002 most individuals, particularly those whose total estates are at or above the present exclusion level of \$675,000 should have their estate plan professionally reviewed in light of current circumstances. Most of the wills or revocable trusts drafted for married couples which provide for by-pass or credit shelter trusts, have provisions which automatically track the federal estate tax exclusion. This generally means that there will be allocated to the credit shelter trust an amount equal to the exclusion. For larger estates, this is likely to be a desirable course of action. For those estates which are at or near the exclusion levels, it may mean that too much will be allocated to the credit shelter trust. In addition, the specific wording of the formula provisions may have to change based on the precise legislative language (which is not yet available). Accordingly, we strongly urge most of our clients to have their estate situation reviewed at least by 2002 as a result of these changes.

Although this memorandum was prepared in advance of the actual legislative language being available to us, it does highlight the most significant changes. There may be other changes which impact on any individual situation after we have had a chance to study the bill in depth. Please feel free to call us with any questions that you have, or to have your estate plan reviewed by us.

REM/jll