CHANGES IN ESTATE, GIFT & GENERATION SKIPPING TRANSFER TAX RULES

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Current Rules

The current law imposes three federal taxes on transfers of assets from one person to another. A gift tax is payable by the giver ("donor") of a lifetime gift. An estate tax is imposed on the estate of a decedent based on the value of the estate's assets. A generation-skipping transfer (GST) tax applies to lifetime or death-time transfers to a member of a generation younger than the person making the transfer.

The estate and gifts taxes are unified so that a single graduated tax rate schedule, ranging from 18% to 55% applies. The GST tax is imposed at a flat rate of 55% and may be owed in addition to other transfer taxes.

A "unified credit" is available to offset gift and estate taxes. For 2007, the unified credit effectively exempts $2,000,000 in cumulative lifetime and death-time transfers. This effective exemption amount is scheduled to increase in steps so that it will be $3.5 million in 2009. The GST tax has a separate exemption for cumulative generation-skipping transfers of up to $2,000,000 (in 2006; subject to future inflation adjustments).

The current law also allows a 100% gift-tax and estate-tax marital deduction for qualifying transfers between spouses. (A special rule applies if the recipient-spouse is not a U.S. citizen.)

Under present law, if the recipient of a gift later sells the gift property, he or she generally uses the donor's tax basis in determining gain or loss. Thus, essentially, the donor's basis is "carried over" to the recipient. On the other hand, property passing from a decedent's estate generally receives a "stepped-up" basis. This basis of the assets becomes the fair market value of the asset as of the date of death. This stepped-up basis allows a beneficiary of an estate who sells the property to avoid tax on any appreciation in the value of the property that occurred before the decedent's death.

The new law overhauls the transfer tax system. Among the changes are a phaseout and eventual repeal of the estate and GST taxes, revision of the gift-tax rates, and a change in the way the tax basis of inherited assets is figured.

Transfer Tax Changes – 2001 Tax Act

Your estate planning is likely to be affected by the 2001 Tax Act. Among other changes, this new law gradually eliminates the estate tax by increasing the amount that is exempt from the tax over several years, reducing the top rate over several years, and finally repealing the estate tax for individuals dying after 2009. But there is a quirk in the law. To comply with budgetary rules, the 2001 Act contains a so-called sunset rule under which the pre-2001 Act rules return after 2010 unless Congress provides otherwise at some future time. This means that the estate tax is repealed only for those who die in 2010. For those who die after 2010, the estate tax comes back in force. The changes are quite complicated and will require most estate plans to be reevaluated.

Exemption Increases

The new law substantially increases the $675,000 exemption after 2001. It rises to $1 million for 2002 and 2003, $1.5 million for 2004 and 2005, $2 million for 2006 through 2008, and $3.5 million in 2009. There is also a change to the unified system. The gift tax exemption amount remains at $1 million for all years after 2001, and the gift tax is not being repealed during 2010 as the estate tax is. Only the estate tax exemption amount will rise to more than $1 million. Under the sunset rule, the exemption will go down to $1 million for both estate and gift tax purposes in 2011.

Charts Showing Estate Tax Costs over Next Several Years

Estate Tax Costs for the $1 million Taxable Estate

Year	Estate Tax
2001	$125,250
2002 and later years	- $0 -

Estate Tax Costs for the $2 million Taxable Estate

Year	Estate Tax
2001	$560,250
2002	435,000
2003	435,000
2004	225,000
2005	225,000
2006-2010	- $0 -
2011	435,000

Gift Tax

The current gift tax rates range from 18% to 55% in 2001 (the same as the estate tax rates). In 2002, the Act reduces the top gift tax rate to 50%, 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006, 45% in 2007-2009 and 35% in 2010. The top gift tax rate drops to 35% in 2010 when the estate tax is repealed for the year. In 2011, the rate returns to 55%. The following table illustrates the gift tax table for the year 2010:

Gift Tax Table
(2010)

Value of Estate		Tax on	Rate on
From	**To**	**Col. 1**	**Excess**
$0	$10,000	$0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	---------	155,800	35%

There is currently an estate and gift tax unified credit which protects up to $675,000 from estate and gift tax in 2001. The Act increases this protection for gift tax purposes to $1,000,000 until the year 2010 but does not repeal the tax (a specific difference between the new estate and gift tax systems).

Capital Gains Tax

Starting in 2010, the new law repeals the old stepped-up basis rule for death-time transfers and replaces it with a modified carry-over basis rule. In general, the basis of property received from a decedent will be the lesser of (1) the decedent's adjusted basis in the property, or (2) the property's fair market value on the date of death.

Starting in 2010, the new law allows an executor or personal representative of an estate to increase (step up) the basis of assets acquired by the beneficiaries at the decedent's death, within certain limits. Each estate will generally be permitted to increase the basis of assets transferred up to $1.3 million. Plus, the basis of property transferred to a surviving spouse may be increased by an additional $3 million, so the total step-up for assets transferred to a surviving spouse will be as much as $4.3 million. Both the $1.3 million and $3 million figures will be adjusted for inflation.

The planning challenge in 2010 for individuals leaving over $1.3 million to beneficiaries (other than to a spouse) will be which assets receive the step-up and which assets do not.

Generation-Skipping Transfer Tax Changes

The 2001 Act simplifies and reduces the generation-skipping transfer (GST) tax, which is a special tax that's designed to prevent individuals from avoiding the estate tax by transferring assets to a generation below the next one (e.g. grandfather transferring to grandson rather than to son). It also repeals the GST tax for those dying in 2010 but the tax returns under the sunset rule in 2011. The following table illustrates the scheduled increases in the generation-skipping transfer tax exemption through 2011:

GST Tax Exemption

Year	**Exemption**
2001-2003	$1,060,000
2004-2005	1,500,000
2006-2008	2,000,000
2009	3,500,000
2010	NA
2011	1,060,000

Uncertain Impact on Planning

The uncertainties of whether the sunset provision will ever come into play, and whether an individual will die during a period of increasing exemption amounts, while the estate tax is repealed or after it is reinstated, makes planning difficult. Also, the way the law works, when the capital gains tax costs are factored in, some heirs will face higher tax costs if their benefactor dies in 2010 when the estate tax is repealed then they would if he died before 2010.

Example: Mary, a widow, dies in 2009 with assets worth $3.5 million and having a basis of $500,000. There is no estate tax (because of the $3.5 million exemption for that year) and her heirs can immediately sell the assets without any capital gains tax gain because of the step-up rule. Now assume Mary dies in 2010. Again, there is no estate tax (because of repeal) but now her heirs would get a basis of $1.8 million ($500,000 carryover basis and $1.3 million increase). So if they sold the inherited assets for $3.5 million they would have an capital gains tax gain of $1.7 million.

What to Do Now

Individuals should continue to write wills and develop estate plans to ensure that their assets will pass as they desire and that special needs of particular heirs will be properly addressed. This is so even if there is a good chance of survival until a year when estate tax won't be owed because of the increasing exemption or repeal. Individuals who may have an estate larger than the increasing exemption should make annual exclusion gifts each year. The gift tax annual exclusion allows you to give $10,000 ($20,000 for gifts from a married couple) to an unlimited number of donees each year without paying gift tax. By doing this, you remove the gift amounts from you estate and save estate tax. In addition, you remove the growth in the gifts from your estate.

Married couples should make sure that each spouse has sufficient assets to take advantage of the increasing exemption. Also, their estate plans should establish a so-called by-pass or credit shelter trust. Such a trust is funded with an amount no greater than the exemption amount. The survivor gets income from the trust and the assets in the trust pass to the children free of estate tax on the survivor's death. Assets above the exempt amount can be given outright to the surviving spouse. This approach may have to be altered depending on the year involved and the size of the estates.

Example: Wife has $200,000 and Husband has $2 million when he dies in 2006. Under his estate plan, he leave the exemption amount outright to his children from a previous marriage and the remainder to his Wife. If Husband died in 2001, that would mean $675,000 (the current exemption amount) would pass to his children and the remainder, $1,325,000, would pass to his spouse. Since he died in 2006, this plan results in 2 million passing outright to the children (the exemption amount in 2006) and $0 passing to the Wife.

With the scheduled change to a modified carry-over basis system in 2010, it is essential to retain all records of cost or other basis. For a purchased item, this means a receipt or statement showing the amount paid for it. For an item inherited before 2010, basis ordinarily is the date of death value of the item. For property acquired by gift, the donee's basis usually is the same as the donor's. For depreciable property, basis is reduced to reflect allowable deductions.