

# **Is It Gone?**

**or:**

## **The Non-Repeal of the Estate Tax**

### **I. Introduction**

So, it's finally happened. After years of overcoming opposition in Congress and a Presidential veto, the estate tax has been repealed. On June 7, 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001, called EGTRRA (pronounced "Egg Tray"). The bill makes major changes to the United States' tax system, changing the income tax, gift tax, capital gains tax, and repealing the estate tax. So, now, or at least soon, we won't have to worry about estate planning, right? Let's talk about the current estate tax system, and the changes EGTRRA will bring.

### **II. Changes to the Estate Tax and Gift Tax**

Currently, any gifts you make during your lifetime and any property you pass on your death is subject to the unified gift and estate tax. Your estate tax is determined by totaling the value of everything you owned, less anything going to your spouse, and calculating a tentative tax based on estate tax rates from 18% to 55%. Then, your fiduciary (trustee or executor) reduces your estate tax by the unified credit amount (also called a "Coupon"). The current amount of the credit is designed to yield a \$0 estate tax on a \$675,000 estate.

Another credit that is available is the State Death Tax Credit. Any amount you pay to a state or D.C. for death taxes reduces your Federal Estate Tax dollar for dollar, up to certain limits. In most states (including Virginia), there is an estate tax that is equal to the maximum credit available. This is called a "pickup tax". So, basically, you calculate your estate tax, then figure out how much goes to your state capital (the maximum state death tax credit) and how much goes to Washington (the rest). Please keep in mind that this is only a summary and your taxes may be adjusted by other credits and deductions.

Now – the changes. The changes to the estate tax include:

1. Gradual reductions in the top tax rate;

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2. Increases in the unified credit; and
3. A reduction in the size of the State death tax credit and eventually changing it to a deduction;

This table summarizes some of the changes we will see.

| Year | Estate Tax Exemption | Top Rate            | Gift Tax Exemption | State Death Tax Credit | Other   |
|------|----------------------|---------------------|--------------------|------------------------|---|
| 2002 | \$1,000,000          | 50%                 | \$1,000,000        | Reduced 25%            | 5% "Bubble" (on estates over \$10 million) eliminated |
| 2003 | \$1,000,000          | 49%                 | \$1,000,000        | Reduced 50%            |   |
| 2004 | \$1,500,000          | 48%                 | \$1,000,000        | Reduced 75%            |   |
| 2005 | \$1,500,000          | 47%                 | \$1,000,000        | Changed to deduction   |   |
| 2006 | \$2,000,000          | 46%                 | \$1,000,000        | Changed to deduction   |   |
| 2007 | \$2,000,000          | 45%                 | \$1,000,000        | Changed to deduction   |   |
| 2008 | \$2,000,000          | 45%                 | \$1,000,000        | Changed to deduction   |   |
| 2009 | \$3,500,000          | 45%                 | \$1,000,000        | Changed to deduction   |   |
| 2010 | Estate Tax Repealed  | 35% (Gift Tax only) | \$1,000,000        | Changed to deduction   | Full step-up in basis repealed.                       |
| 2011 | \$1,000,000          | 55%                 | \$1,000,000        | Full Credit            | Full step-up in basis and 5% bubble restored.         |

As you can see, the repeal does not last very long. In 2011, we wind up right back where we would be without EGTRRA. This result is because of the sunset rule, which makes it very difficult to get large tax cuts or spending increases more than 10

years out. It also helped keep the cost of the bill within the \$1.35 trillion agreed upon by Congress and the President some time ago.

Even while the estate tax is repealed, there will still be a gift tax. Also, while the estate tax exemption amount goes up, the gift tax exemption remains at \$1 million. This is due to Congress realizing the amount of mayhem we tax attorneys could cause by using gifts to reduce income taxes.

### III. Changes to the Step Up in Basis

Currently, when you sell a capital asset (such as a house or an investment), you pay capital gains tax. This tax is at a lower rate than normal income taxes, but can cause great tax pain, because it might be very large in a single year. Much tax planning is designed to avoid paying capital gains taxes, or to time them for minimum impact on your financial goals. The advantage of an IRA, for example, is that you don't pay capital gains taxes until you withdraw the funds from the account.

The amount of your capital gain when you sell a piece of property is what you received for it, less your basis (for simplicity, what you paid for it). So, if you bought a mutual fund share for \$10 in 1985 and sold it for \$50 in 2001, you would have a capital gain of \$40 in 2001. Your capital gains tax would be based your tax bracket, but would definitely be less than the tax you pay on regular wages.

One of the advantages of dying is that the basis of any property you inherit is not what the decedent (the person who died) paid for it, but its value on the date the decedent died. In the above example, if you inherited that mutual fund share in 2001 when it was worth \$50, your basis is \$50. If you sell it while it is still \$50, then you have no gain, and therefore, no capital gains tax! The downside is that if the decedent paid \$50 for it and it's now worth \$10 (think internet start-ups), you get a "step-down" to the value on the date of death of the decedent.

With the demise of the estate tax, the feds thought that the step-up was too big a tax shelter and would cost too much. So in 2010, the step-up rules are changed. You still get a step up of \$1.3 million when you die, plus an additional \$3 million on property left to your spouse. In other words, if you have property valued at \$6 million at your death, with a basis of \$1 million, your beneficiaries have a basis of \$2.3 million (the old basis plus \$1.3 million). If your beneficiary is your husband or wife, then the basis will be \$5.3 million (the old basis plus \$1.3 million plus \$3 million). Under the old rules, your beneficiaries would have a basis of \$6 million. Until 2009 and then again in 2011, the full step-up applies.

Notice that this bill has not been called tax simplification?

## **IV. Cost of the Repeal**

### ***A. To the Federal Government***

The annual budget cost of the estate tax repeal stays in the range of \$5 billion to \$15 billion until 2010. In 2010, it jumps to about \$24 billion. In 2011, it increases to about \$54 billion. Note that the cost seems to lag behind the changes. This is because your estate has 9 months to pay most estate taxes. So, most estates of people dying in 2010 (during the repeal) don't cause any revenue loss until 2011.

EGTRRA's income tax provisions will cost about \$100 billion in 2011.

### ***B. To the State Governments***

The loss of the State Death Tax credit will reduce revenues to states that use a "pickup" estate tax. A majority of states, including Virginia, use a pickup estate tax. Virginia's Department of Finance estimated that revenue from Inheritance, Gift and Estate Taxes would be about \$125,000,000 in Fiscal Year 2001. I assume that without amending the state tax codes, all of that revenue will be lost. If states do reinstate an estate tax in the same size as the current credit, then moderate estates will be harder hit than large estates. Under the old State death tax credit system, moderate estates often paid more to the state than to the federal government. Large estates paid more to the feds than to the states.

### ***C. To Charities***

One motivation for charitable giving is to avoid estate taxes. A number of tools are available to take advantage of charitable giving to reduce income taxes, capital gains taxes, and estate taxes. Some of these tools actually leave the family more money than not making the charitable gift. Some charities are concerned that EGTRRA will reduce the tax motivation for making charitable gifts and thus will make it more difficult to raise money. We don't have figures for this, any figures anyone claims to have are likely little more than guesses. Time will tell.

## **V. Will there be further changes?**

Most observers have concluded that EGTRRA will have to be changed before 2011. Some experts believe that the revenue loss from the tax bill is larger than advertised. In any case, the revenue losses to the states and to charities are not factored in. On the other hand, tax reductions might stimulate the economy to make up some or all of the revenue losses. Again, time will tell.

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States will need to make up the revenue lost by the repeal of the State death tax credit. In 2002, every state that sets its own estate tax as equal to the maximum State death tax credit is going to lose 25% of its estate tax revenue. In 2005, the State's estate tax revenue will be gone. The majority of states with such a death tax will have to respond through spending cuts; imposition of a new estate tax; or increases in other taxes. A few lucky states may have the financial resources to not need to respond.

The phase-in to repeal, the repeal, and then the cancellation of the repeal leave estate planners with 3 different systems to plan for. Every person could die before 2010, in 2010, or after 2010. We have to plan for all 3! It is quite a challenge. Will Congress and the President respond? It depends on who is in power and the economic situation.

Think like a Congressman for a moment. We're coming up on 2010. If revenues and spending are still balanced, that's great and we can go through with the repeal and even make it permanent. But, if revenues are down and we're looking at deficits again, where are we going to get the money? Most of your constituents pay income tax. Only 0.1% of estates will owe taxes in 2009. Going back to the old estate tax rules will save \$54 billion and affect only a small number of voters (but a lot of your contributors). Where are you going to try to get the revenue? It's hard to say at this point.

If you are opposed to estate tax repeal, you might do nothing and let the 2011 reversion to the old rules stand. If you support repeal and you can't get the votes for full repeal, maybe you'll make a deal to give up repeal and keep the higher exemption and reduction in estate tax rates. In short, we don't think that anybody knows what will happen to the estate tax over the next 10 years. Perhaps we'll see true repeal; perhaps the temporary repeal will never happen; perhaps we'll get exactly what just passed. Who knows? The problem is, that means we have to plan for all possibilities.

## VI. Conclusion

Some of you, and perhaps some of your clients, might be thinking that we don't have to worry about estate planning now that the estate tax has been repealed. This cannot be further from the truth. First, remember that most estate planning is not about reducing estate taxes, it's about family and personal goals. Remember the estate planning pyramid and the jigsaw puzzle story: saving taxes is only the last piece of the puzzle. In our counseling oriented estate planning process, we focus on letting you keep control as long as you can. We work on providing for you and your spouse should you become disabled. We work on providing for your spouse and your dependents after your death. We work on identifying to whom you want to leave your property; when they can get it; and how they can get it. We work on providing for pets; for parents; for charitable causes that are important to you. None of this is changed by the demise of the estate tax.

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Even if our major concern is estate taxes, we still need to plan for them. Can you promise me you'll die in 2010? Or that the real repeal will occur before you die? Even if real repeal happens, will States step in with new estate taxes? Our crystal ball is foggy.

In the meantime, we need to continue planning just like we do now. It is now especially important to have a formal updating system, such as Graft Law Offices' TrustWorks Maintenance System or Frank McClure's Across the Years, the McClure Project, to keep abreast of the rapid changes in this area. Estate tax practitioners will need to use a lot of effort to keep up with the changes in the law and the new techniques to take advantage of the changes.

Be proactive. Make sure that you and your clients adjust your plans to take advantage of the changes in the law. Make sure that your clients aren't fooled into believing that estate taxes are gone or that they don't need to worry about estate planning anymore. Feel free to send them to one of our estate planning workshops, but make sure that they see somebody who is qualified to do proper planning. Please call me with your questions about the estate and gift tax changes that are part of EGTRRA. I will be happy to discuss them with you, or to give a presentation to your office. Good luck.

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