

MARJORIE S. SCHULTZ & ASSOCIATES

Attorneys At Law

MARJORIE S. SCHULTZ
KRISTINE D. MACLAY

Courtlandt Square
3220 Louisiana Street, Suite 201
Houston, Texas 77006
(713) 521-3434 - Telephone
(713) 521-1633 - Fax

HOW REAL IS REPEAL?

Now that the dust has settled, we thought it would be useful to take a look at recent changes to gift and estate tax laws. The Economic Growth and Tax Relief Reconciliation Act of 2001 was signed into law by President Bush on June 7, 2001. The Act made dramatic changes to our current gift and estate tax laws, including, as has been widely reported, the repeal of the estate tax. Under the Act, however, the "repeal" is to be accomplished in various phases over the next ten years. Therefore, in order to understand the changes made by the Act, it is necessary to briefly review the law in place today.

Current Law

The current law is a unified system of gift and estate taxation with one progressive rate schedule, which is based on the cumulative property transfers made by a taxpayer during life and at death. Gift taxes are imposed in each year to the extent that transfers from one individual to another exceed the "annual exclusion" amount of \$10,000. Estate taxes are determined by applying the appropriate unified tax rate to the value of the cumulative lifetime and death time transfers and then subtracting the tax payable on the lifetime transfers.

There is a unified credit against gift and estate taxes that currently is equivalent to an exemption from gift and estate tax of \$675,000. The tax rate applicable after subtracting the exemption equivalent is 37%, and under our progressive rate system, the tax rates climb to 55% for transfers that exceed \$3,000,000. When paying federal estate tax, there is a credit for payment of the Texas inheritance tax, and Texas ties that tax to the amount of the federal credit.

In addition to the unified credit amount, you are allowed an unlimited deduction from the value of your gross estate for property passing to your surviving spouse so long as the property passes in an appropriate form (either outright or to a trust that has certain provisions). This deduction is known as the "marital deduction".

In addition to the gift and estate tax, federal law provides for a generation-skipping transfer tax. The tax applies to transfers of property to "skip persons". In general, a "skip person" is someone who is more than one generation below the person making the transfer (in other words, a grandchild). The generation-skipping transfer tax is a flat tax tied to the highest estate tax rate, which rate currently is 55%. Under current law, each taxpayer can designate approximately \$1,000,000 worth of properties to be exempt from the generation-

skipping transfer tax. For example, either during life or by Will, a taxpayer may transfer to grandchildren properties worth \$1 million and exempt that transfer from the generation-skipping transfer tax; however, the gift and estate tax system still applies to the transfer. If the transfer is not exempt, the gift or estate tax can combine with the generation-skipping transfer tax to result in an aggregate tax of almost 80%.

Under current law, the income tax basis of all assets included in a decedent's estate for estate tax purposes is "stepped-up" to the fair market value of those assets as of the date of death, as reported for estate tax purposes.

Changes to the Current Law Under the Act

Under the Act, the gift and estate tax system will no longer be "unified". The gift tax exemption will increase to \$1,000,000 in 2002 and then remain fixed at that amount. Gift taxes will still be imposed on lifetime gifts in excess of a cumulative \$1,000,000. The \$10,000 annual exclusion (inflation indexed) will still be available.

The estate tax exemption will be increased in various increments over the next ten years as follows:

| <u>Years</u> | <u>Estate Tax Exemption</u> |
|--------------|-----------------------------|
| 2002-2003 | \$1,000,000 |
| 2004-2005 | \$1,500,000 |
| 2006-2008 | \$2,000,000 |
| 2009 | \$3,500,000 |

As the estate tax exemption increases, the maximum estate tax rate decreases in various increments over the same period (from 50% in 2002 to 45% in 2009).

The generation-skipping tax exemption amount will also significantly increase beginning in 2004. At that time, the increases in the GST exemption amount will coordinate with those of the estate tax exemption.

Under the Act, the state death tax credit will be phased out, and repealed in 2005. It is unclear whether Texas will implement a new inheritance tax law when the federal credit that the State now receives is reduced and then eliminated.

The Act also makes significant changes to the way that the income tax basis of property passing from a decedent to his or her heirs is calculated. Beginning in 2010, the current step-up in basis that the assets of a decedent's estate receive upon death will be substantially limited. An executor will be able to "step-up" the basis of up to \$1,300,000 of appreciated property (with an additional \$3,000,000 of "step-up" to property passing to a surviving spouse).

Because of this change, it will be particularly important to keep accurate records reflecting the income tax basis of all assets.

Sunset Provision

Although under the Act, the estate tax is scheduled to be repealed in its entirety in 2010, *the repeal will only be effective for one year*. The Act contains a “sunset” provision under which the current law (with a \$1,000,000 exemption and 55% maximum tax rate) will come back into effect on January 1, 2011 if no additional legislative action is taken to extend the repeal. It is also important to remember that the Presidential and Congressional elections over the next ten years may have a profound effect on whether repeal ever becomes a reality.

How These Changes May Impact Your Estate Plan

The above discussion is a general overview of some of the changes to the gift and estate tax laws made by the Act. While these changes are significant, at this point, we do not believe that it is necessary to revise most estate planning instruments drafted under the current tax laws immediately. However, as the estate tax exemption increases over the next few years, the distribution of estates under many Wills that include gifts tied to certain statutory exemptions will be dramatically altered. Because the Act makes such significant changes, we recommend that everyone review their current Wills and re-evaluate their estate plan with a tax planning professional within the next few years. We also recommend immediate review for (i) anyone who may be concerned that his or her capacity to make a new Will may be impaired within the next few years, and (ii) those persons whose current Will gives either the estate tax exemption (currently \$675,000) or the generation-skipping tax exemption (currently approximately \$1,000,000) to someone other than a trust for their spouse. With both such exemptions scheduled to increase greatly over the next few years, it will be important to review such Wills as soon as possible. It will also be important to review beneficiary designations for life insurance and employee benefits where such items make up a significant part of the taxable estate.

As the law develops over the next few years, estate plans may require review and modification. If you would like additional information, or if you would like to discuss how these new laws may effect you, please contact us.