

# ESTATE PLANNING ALERT!

A Special Publication of

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## The Estate Tax "Repeal" Illusion

*On June 7th, President Bush signed into law the most comprehensive tax reform bill in 20 years. You have probably been hearing a lot about the various components of tax reform, including a gradual reduction in the top income tax rates, elimination of the so-called marriage penalty, and liberalization of rules permitting contributions to IRAs and 401(k)s. The media has also mentioned the eventual repeal of the estate tax. A little-publicized provision of the tax bill, however, means that the repeal may never become a reality for most taxpayers.*

On May 26, 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"). This Act is the most extensive tax reform bill in the last generation. Running to 186 pages, the new law contains 85 major provisions, and changes 441 sections of the Internal Revenue Code. The Act makes several changes in the estate and gift tax area, culminating in an elimination of the death tax in 2010, *but only for taxpayers who happen to die in that year!* The President is scheduled to sign the Act into law on June 7. This Alert outlines the major estate and gift tax changes brought about by the Act.

**Estate Tax.** Under the new law, the estate tax remains in effect through 2009. Over the next nine years, the Act reduces the top estate tax rate paid by taxpayers with estates over \$2,500,000, and provides an increased exemption for everyone. Like most tax breaks provided by the Act, estate tax reform is somewhat "back-end loaded." In other words, many of the benefits (including actual repeal) are delayed for several years before they become available. Unless Congress makes further changes, the phase out of the estate tax will follow this timetable:

Year	Top Rate	Exemption Amount
2001	55%	\$675,000
2002	50%	\$1,000,000
2003	49%	\$1,000,000
2004	48%	\$1,500,000
2005	47%	\$1,500,000
2006	46%	\$2,000,000
2007	45%	\$2,000,000
2008	45%	\$2,000,000
2009	45%	\$3,500,000
2010	REPEALED	N/A
2011	55%	\$1,000,000

**Gift Tax.** Despite the scheduled repeal of the estate tax, the gift tax will be retained. Starting in 2010, gifts in excess of a lifetime \$1,000,000 exemption will be subject to gift tax (payable by the giver, not the recipient) computed at the highest individual income tax rate in effect at that time. The retention of the gift tax is designed to keep taxpayers from making gifts of income-laden property from higher to lower bracket taxpayers to reduce income tax costs. Taxable gifts will be subject to new reporting rules to help the IRS verify that the gift recipient pays proper income taxes if the property received is later sold.

**Basis "Step-up."** Once the estate tax is repealed, the Act also repeals the so-called basis "step-up" rule, which allows taxpayers to receive a new cost basis in inherited assets equal to the assets' date-of-death value. Carry-over basis is complex. It was last proposed in 1976, but was quickly repealed as administratively unworkable. The Act provides that, with proper planning, two exceptions will be available to provide a step-up in basis for some assets.

- \$1,300,000 worth of step-up will be allowed for certain assets.
- An additional \$3,000,000 worth of step-up will be allowed for certain assets passing to a surviving spouse (or to a qualified trust for the spouse's benefit).

These rules will require elaborate record keeping for many assets. For example, if you inherit stock from a grandparent, or a farm that has been in the family for generations, you will be required to report gain on the sale of that property based upon your grandparent's basis in the property prior to death, unless some part of his or her \$1,300,000 step-up amount was added to it.

**The Good News.** Despite its shortcomings, the Act is beneficial for most of our clients. The income tax provisions are helpful (although many are deferred for five years or more). The increase of the estate tax exemption to

\$1,000,000 in 2002 is certainly welcome, though less than half of what most practitioners urged. Also, the Act increases the generation skipping transfer tax exemption (currently \$1,060,000, adjusted for inflation) to equal the estate tax exemption beginning in 2004, and makes allocation of GST exemption automatic for many gifts to trusts. This means that many (but not all) of our clients will no longer need to file gift tax returns only to allocate GST exemption, beginning for gifts made in 2001.

*What about the Repeal "Illusion"?* Some in Congress will claim to have truly repealed the estate tax. Actually, however, the Act repeals the estate tax for only one year—2010. As you may have already heard in press reports, *all* of the changes made by the Act (both income and estate tax changes) are repealed after 2010. The current estate tax rules, rates, and exemptions apply to decedents dying after December 31, 2010. This surprising provision was mandated by Congress's budget constraining rules. While solving congressional budget problems, it has the obvious effect of introducing a lot of uncertainty for taxpayers and their advisors, who must try to guess how the law will read with two presidential and four congressional elections intervening before repeal.

*How Do the New Rules Impact Your Estate Plan?* The postponed repeal and later re-enactment of the estate tax make the analysis of the Act's impact on estate plans complex. In

the short run, we make the following initial observations:

- Most of our clients won't need to make any immediate changes to their Wills as a result of the Act. Existing tax planned Wills typically contain clauses that will automatically adjust to take maximum advantage of the exemption increases.
- *Between now and 2008 or so, all of our clients must review their estate plans to analyze the tax implications of their Wills in light of the laws expected to be in effect in 2010 and thereafter. Future law changes may require further review.*
- Clients in second marriages who use tax thresholds to split assets between a second spouse and children from a prior marriage, and other clients who tie distributions to the tax rules, should *review their Wills this year* to ensure that changes to the tax laws don't make unintended changes to the way assets are allocated.
- For all clients, passage of the Act may be a good reason to schedule an appointment for an overall "check-up" to ensure that your estate plan fits your present family and tax situation.

Naturally, we will continue to keep our readers posted on the new law and its implications for your estate planning.

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