

Trusts and Estates Bulletin

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Estate Tax Repeal?

By Bryan Howard

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"), a \$1.35 trillion tax cut over ten years. It has been widely reported that the Act repeals federal estate taxes. Unfortunately, repeal does not occur until 2010. Repeal will last for only one year. The Act reinstates the current estate tax laws on January 1, 2011. Nevertheless, the Act contains several provisions that will provide very significant estate tax relief for individuals who die before 2011.

Prior to 2010, the exemption amount that everyone can give away tax-free at death will increase from the current \$675,000 to \$1 million in 2002, \$1.5 million in 2004, \$2 million in 2006 and \$3.5 million in 2009. The exemption will revert to \$1 million in 2011. In addition to the increased exemption, the maximum rate of estate tax will be reduced from 60% to 50% in 2002, and then gradually to 45% in 2007. The maximum estate tax rate will revert to 60% in 2011. The credit for state death taxes will be gradually eliminated by 2005, and then replaced by a deduction.

The net impact of these changes is illustrated below for an unmarried resident of Tennessee who dies owning assets valued at \$2.5 million:

Year of <u>Death</u>	Federal and Tennessee Death Taxes			Percentage <u>Decrease</u>
	<u>Current Law</u>	<u>Under Act</u>	<u>Decrease</u>	
2002	\$ 816,600	\$ 735,300	\$ 81,300	10%
2004	\$ 744,850	\$ 580,450	\$ 164,400	22%
2006	\$ 680,000	\$ 300,686	\$ 379,314	56%
2009	\$ 680,000	\$ 130,900*	\$ 549,100	81%
2010	\$ 680,000	\$ 130,900*	\$ 549,100	81%
2011	\$ 680,000	\$ 680,000	\$ 0	0%

* All tax is for Tennessee.

The lifetime gift tax exemption will increase to \$1 million in 2002 and remain there permanently. Congress decided not to increase the gift tax exemption above \$1 million or repeal gift taxes in 2010 because this would have provided an opportunity for wealthy individuals to make large gifts prior to 2011 and thereby avoid estate taxes when the estate tax laws are reinstated. The maximum gift tax rate will decrease from 55% to 50% in 2002, then gradually to 45% in 2007, and finally to 35% in 2010. In 2011, the maximum gift tax rate will revert to 55%.

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In order to replace some of the revenue loss from estate tax repeal in 2010, the rules that provide a stepped-up income tax basis for assets owned at death will be repealed. For the year 2010 only, inherited assets will retain the income tax basis of the decedent. When heirs sell the inherited assets, they will pay a capital gains tax on all appreciation in excess of certain amounts that occurred during the decedent's lifetime. This is referred to as a carryover basis system. Each individual will be entitled to increase basis on \$1.3 million of property given to anyone, and on an additional \$3 million of certain property given to a surviving spouse.

The federal unified credit exemption amount will be different than the Tennessee exemption amount until 2011. The disparity between the federal and Tennessee exemption amounts makes it necessary for all married individuals who want to benefit from the federal changes to revise their Will. In order to take advantage of the maximum federal exemption, yet avoid the payment of Tennessee tax, it will be necessary to establish a Tennessee QTIP Trust™ which qualifies for the Tennessee inheritance tax marital deduction, but not the federal estate marital deduction. Unmarried individuals may also want to change their Wills in light of the lower death taxes that will be imposed if they die before 2011.

The changes made by the act to the estate tax laws have been characterized as bizarre. The exemption amount will increase to \$3.5 million in 2009, and be followed by total repeal of estate tax for one year in 2010. In 2011, the current estate tax system will be reinstated with an exemption amount of \$1 million. These changes are coupled with a very complicated carryover basis system that will be in place for exactly one year. How should you plan your estate in light of these changes? A law which encourages individuals to die before a certain date begs for further legislative action. One of two courses seem likely. Either repeal will be made permanent or the estate tax will remain, yet with a higher exemption, perhaps in the \$2 million to \$3.5 million range. At this time, our advice is to plan as if there will be an estate tax system in place when you die. You should continue to make gifts and to utilize other techniques for avoiding or reducing death taxes. Even if federal estate taxes are actually repealed in the year that you die, these tax minimization measures should prove beneficial for reducing Tennessee inheritance taxes.

The Act contains numerous other provisions that can reduce your income taxes, including expanded opportunities to add money to IRAs and retirement plans and to save money for education expenses in a tax-efficient manner. Please contact Bryan Howard or any other member of our Trusts and Estates Group at 615.244.6380 if you would like to learn more about these additional provisions or the effect of the Act on your estate planning.

The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance.

Certification as a specialist in trusts and estates law is currently not available in Tennessee.

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