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**Estate, Gift and Generation-Skipping Taxes: The Implications of the Economic Growth and Tax Relief Reconciliation Act of 2001**


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The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act") was signed into law on June 7, 2001. This memorandum discusses the gift, estate and generation-skipping transfer tax provisions of the 2001 Act, their rationale, their future and their planning implications.

## Executive Summary


The 2001 Act reduces estate and gift tax rates and increases the unified credit. These gradual changes occur in 2002 through 2009. The increases in the unified credit may require changes to some existing estate plans. While no single course of action is appropriate for all taxpayers, every individual with a net worth in excess of one million dollars would be well advised to review his or her current estate plan in light of the 2001 Act changes.

In 2010, the estate and generation-skipping transfer taxes – but not the gift tax – are repealed, but only for one year. At the strike of midnight on December 31, 2010, all of the changes made by the 2001 Act sunset and the law reverts to what it would have been had the 2001 Act not been passed. The sunset provision creates an environment of uncertainty and essentially requires Congress to pass additional legislation to modify the 2001 Act provisions. Whether the additional legislation will make repeal permanent, or whether it will eliminate repeal altogether, of course, is not known at this time, but the outcome will turn on economic, budgetary and political considerations. The key to planning in this time of uncertainty is flexibility. In some cases, this will mean frequent reviews and revisions of the estate plan. In other cases, estate plans will be designed to anticipate potential changes in law and provide flexibility to accommodate an unknown future.


## Description of and Rationale for the 2001 Act Provisions

In order to facilitate planning, this memorandum reviews the 2001 Act changes as they are scheduled to be implemented each year. We favor this chronological approach because it highlights changes and opportunities as they occur, year-by-year, and puts the significance of repeal in its proper place. Moreover, with repeal of the estate tax far from certain, the year-by-year analysis gives an instant view of what the state of the law would be if Congress were to freeze the changes in any year between now and 2010.

For **2001**, retroactive to the beginning of the year, the 2001 Act makes changes to the generation-skipping transfer tax, and the estate tax treatment of conservation easements and special use valuation property.

- Generation-Skipping Transfer Tax (GST): The 2001 Act makes a number of changes in the GST area. These changes were primarily designed to provide relief when errors have been made in allocating the GST exemption. In that vein, the 2001 Act permits the IRS to grant relief under section 9100 where GST exemption was not allocated to a trust despite evidence that the attorney or accountant intended that an allocation be made. The 2001 Act also adds a rule that an exemption allocation that is in substantial compliance with the rules will be allowed. These changes apply to ruling requests pending on or filed after December 31, 2000. The GST provisions also expand the circumstances in which an automatic allocation of GST exemption will be made to a trust. Relief is also made available, under section 9100 and substantial compliance, in the event that a taxpayer intended to elect out of these automatic allocation provisions. Other GST provisions in the 2001 Act make it easier to sever a trust with an inclusion ratio greater than zero into two trusts, one with an inclusion ratio of one and the other with an inclusion ratio of zero. Finally, the GST provisions allow retroactive allocations of GST exemption in the event of an out-of-order death (*i.e.*, a beneficiary who is member of a younger generation dies before the transferor, who is a member of an older generation).

- Conservation Easements: The 2001 Act expands the estate tax exemption for conservation easements in two respects. First, it eliminates the geographic restrictions so that any property in the United States or its possessions is eligible for the estate tax conservation easement exclusion. Second, the 2001 Act provides that the 30% test – the requirement that the easement must reduce the value of the property by at least 30% in order to obtain the maximum exclusion – applies at the time the easement is granted, not at the time of the property-owner's death. These two changes make a very beneficial tax planning technique available to more property owners. Conservation easements give more advantageous tax benefits than any other kind of charitable gift. If given during life, the property owner may obtain an income tax deduction for the amount the property value is reduced by the easement. In addition, the value of the easement is not included in the decedent's estate (since the decedent did not own the easement at the time of death). Finally, a further estate tax exclusion is allowed for qualifying easements. This exclusion in effect shelters other assets of the estate from taxation. In some circumstances, the combined income and estate tax benefits can exceed the reduction in value of the property due to the easement. The 2001 Act changes expand the availability of these benefits.

- Special Use Valuation: The 2001 Act includes a provision of very limited applicability granting a one year window to file a claim for refund where recapture taxes were paid due to the cash leasing of a farm to certain relatives.

Effective **January 1, 2002**, the following additional provisions, affecting the estate tax surtax, marginal rates, the unified credit, the state death tax credit and the installment payment of estate taxes, go into effect:

- Surtax Repealed: The five percent surtax, which serves to increase the marginal estate tax rate to 60% in the range from $10,000,000 to $17,184,000, will be repealed. The purpose of the surtax was to take away the benefit of the lower rate brackets for larger estates and apply a flat 55% rate.

- Unified Credit: The applicable exclusion amount will increase to $1,000,000 for purposes of the estate and gift taxes.

- Marginal rates: The top marginal rate for estate and gift tax will be reduced to 50%. The rate for GST tax will also fall to 50%. The range of rates applicable to estates of U.S. persons (after taking into account the unified credit) then will be 41% to 50%.

- State Death Tax Credit: The amount allowed as a state death tax credit will be reduced by 25%. Under present law, an estate may claim a credit against the federal estate tax for state-level death taxes of up to a certain amount. Most states impose state taxes that allow them to collect the maximum revenue possible without increasing the estate's net tax bill. By phasing out the state death tax credit, the 2001 Act re-opens competition between the states on death taxes. It also disaggregrates the federal and state estate tax rates, so as to give the illusion of more federal rate reduction than really exists. Whether states will impose a death tax that is not creditable against the federal estate tax, and what the rates of any such taxes will be, remain unknown.

- Installment Payments of Estate Tax: The 2001 Act makes three changes to the installment payment plan eligibility effective for 2002. First, in defining a closely-held business interest (i.e., one eligible for installment payments), the maximum number of shareholders or partners is increased from 15 to 45. Second, the installment payment plan is made available to lending and finance businesses. Third, the 2001 Act clarifies that the stock of the operating company at the end of a string of one or more holding companies need not be non-readily tradable. However, businesses qualifying under the new lending, finance and holding company rules will not be eligible for the four years of interest only payments, and must pay the deferred tax over five, rather than ten, years.

Effective **January 1, 2003**, the following additional provisions, affecting marginal rates and the state death tax credit, go into effect:

- Marginal Rates: The top marginal rate for estate and gift tax will be reduced to 49%. The rate for GST tax will also fall to 49%. Thus the range of rates applicable to estates of U.S. persons (after taking into account the unified credit) will be 41% to 49%.

- State Death Tax Credit: The amount allowed as a state death tax credit will be reduced by 50% from present law amounts.

Effective **January 1, 2004**, the following additional provisions, affecting the unified credit, the GST exemption amount, marginal rates, the state death tax credit and the qualified family owned-business interest deduction, go into effect:

- Unified Credit: The applicable exclusion amount will increase to $1,500,000. However, only $1,000,000 can be used for lifetime gifts; cumulative lifetime gifts in excess of $1,000,000 will be subject to gift tax. Thus the "unified credit" will really become a “disunified credit.”

- GST Exemption: The GST exemption will increase to $1,500,000, and on a going forward basis, will be linked to the applicable exclusion amount. This change will simplify drafting for testamentary GST trusts.

- Marginal Rates: The top marginal rate for estate and gift tax will be reduced to 48%. The rate for GST tax will also fall to 48%. Thus the range of rates applicable to estates of U.S. persons (after taking into account the unified credit) will be 45% to 48%.

- State Death Tax Credit: The amount allowed as a state death tax credit will be reduced by 75% from present law amounts.

- Qualified Family Owned Business Interest Deduction: Due to increases in the unified credit, the amount allowed as a deduction for a qualified family owned business interest will effectively be reduced to zero. Consequently, the provision allowing for the deduction will be repealed.

Effective **January 1, 2005**, the following additional provisions, affecting marginal rates and the state death tax credit, go into effect:

- Marginal Rates: The top marginal rate for estate and gift tax will be reduced to 47%. The rate for GST tax will also fall to 47%. Thus the range of rates applicable to estates of U.S. persons (after taking into account the unified credit) will be 45% to 47%.

- <u>State Death Tax Credit</u>: The state death tax credit will be repealed and replaced with a deduction for state death taxes paid. Whether any state death taxes are actually imposed will depend upon state law, and the actions of state legislatures. Note that if a state continues to impose state death taxes at the same level as in 2001, the overall (federal + state) death tax rate on an estate will hardly have changed from pre-2001 Act rates.

Effective **January 1, 2006**, the following additional provisions, affecting the unified credit, the GST exemption and marginal rates, go into effect:

- <u>Unified Credit</u>: The applicable exclusion amount will increase to $2,000,000. However, only $1,000,000 can be used for lifetime gifts.

- <u>GST Exemption</u>: The GST exemption will increase to $2,000,000.

- <u>Marginal Rates</u>: The top marginal rate for estate and gift tax will be reduced to 46%. The rate for GST tax will also fall to 46%. Due to increases in the unified credit, estate tax will apply to estates of U.S. persons (after taking into account the unified credit) at a flat 46% rate.

Effective **January 1, 2007**, the top marginal rate for estate and gift taxes will be reduced to 45%. The rate for GST tax will also fall to 45%. The estate tax will then apply to estates of U.S. persons at a flat 45% rate.

No additional estate and gift tax changes from the 2001 Act are effective **January 1, 2008**.

Effective **January 1, 2009**, the following additional provisions, affecting the unified credit and the GST exemption, go into effect:

- <u>Unified Credit</u>: The applicable exclusion amount will increase to $3,500,000. However, only $1,000,000 can be used for lifetime gifts.

- <u>GST Exemption</u>: The GST exemption will increase to $3,500,000.

Effective **January 1, 2010**, the estate and generation-skipping transfer taxes will be repealed. The gift tax will remain in effect. A modified carryover basis regime will apply to property transferred at death. If these changes ever go into effect on a permanent basis, all estate plans for wealthy individuals should be reviewed and revised.

Although a description of every provision associated with repeal is beyond the scope of this article, the central provisions are as follows:

- <u>Gift Tax</u>: Although the estate and GST taxes will be repealed, the gift tax will continue in effect. The purpose of retaining the gift tax was to prevent income tax avoidance through the shifting of the incidence of income and capital gains taxes to lower bracket taxpayers and non-taxable individuals. The applicable exclusion amount for the gift tax will continue to be $1,000,000. The top marginal gift tax rate will be 35%. The annual exclusion (generally $10,000 per donor per donee, indexed for inflation), as well as the exclusion for payment of medical and educational expenses, will continue to apply, as will the deductions for charitable and marital gifts. With respect to transfers in trust, the definition of a completed gift will be amended so that a transfer in trust will be a taxable gift unless the trust is a wholly owned grantor trust. A gift in trust could still qualify for the annual exclusion through the use of a withdrawal power.

- General Basis Rule: The recipient's basis in property "acquired from a decedent" will be the lesser of (a) the adjusted basis of the decedent, or (b) the fair market value on the date of death.

- Additional Basis Allowed: Every U.S. decedent will be allowed $1.3 million of additional basis to be allocated to property "owned" by the decedent at death. Allocation will be made by the executor on a return filed with the decedent's last income tax return. In addition to the $1.3 million, additional basis will be granted in an amount equal to the decedent's unused built-in losses and loss carryovers. In no event can basis be added to property that would result in its basis being increased beyond its fair market value on the date of the decedent's death.

- Marital Property: An additional $3.0 million of basis will be available for allocation to property passing to a surviving spouse. Qualifying property will include only property that passes outright to the spouse, or property that would have qualified for a QTIP election under current law.

- Property to Which Basis Cannot Be Allocated: The 2001 Act states that basis cannot be allocated to three types of property (even if such property is "acquired from the decedent" and "owned" by the decedent at death): (a) property acquired by the decedent by gift (other than from the decedent's spouse) within three years of death, (b) stock of a foreign personal holding company, domestic international sales company (DISC), former DISC, foreign investment company or passive foreign investment company (PFIC), and (c) items constituting income in respect of a decedent. Note most importantly that traditional IRAs, 401(k) accounts and similar tax-deferred retirement accounts all constitute income in respect of a decedent.

- Definition of Ownership: The definition of ownership will be critical. The 2001 Act makes it clear that possession of a general power of appointment does not constitute ownership. Property in a qualified revocable trust is “owned” by the decedent. Property owned jointly by spouses with right of survivorship will be considered to be owned 50% by the deceased spouse. Community property, however, will be eligible for allocation of additional basis to both the decedent's half and the surviving spouse's half.

- Principal Residence: An heir who inherits the decedent’s principal residence may qualify for the decedent’s $250,000 gain exclusion on the sale of the residence provided that the decedent would have satisfied the “2 out of 5 years” rule at the time of the sale. Thus, even if the heir doesn’t live in the house, if the decedent owned and lived in the house until death and the house is sold within three years of death, the exclusion would be available.

- Treatment of Non-Resident Aliens: The provisions relating to repeal of the estate and GST taxes contain several special provisions applicable to estates of non-resident aliens. First, unlike estates of U.S. persons, non-resident aliens' estates will get only $60,000 of additional basis to allocate to U.S. property of the decedent. A non-resident alien's estate does get the benefit of the additional $3.0 million of basis for spousal property, regardless of the citizenship or residency of the surviving spouse. Second, if a qualified domestic trust (QDOT) is established upon the death of one spouse before 2010, withdrawals by the non-citizen spouse from the QDOT during life will continue to be subject to the deferred estate tax. Third, a transfer of assets from a U.S. person's estate to a nonresident who is not a U.S. citizen is treated as a sale or exchange of the assets for their fair market value. The estate must recognize gain to the extent the fair market value exceeds the decedent's basis in the assets that are transferred. Finally, the repeal provisions will not fit well with the estate and gift tax treaties in effect today. Thus, it may be necessary to renegotiate some or all of the estate tax treaties when and if repeal actually occurs.

Effective **January 1, 2011**, all of the estate, gift and generation-skipping transfer tax provisions of the 2001 Act sunset. All rates in effect in 2001, including the five percent surtax, come back into effect. The applicable exclusion amount will be $1,000,000 (as scheduled to go into effect in 2006 under pre-2001 Act law) for both the estate and gift taxes. The GST exemption will be $1,000,000 indexed for inflation since 1997. Step-up in basis at death will resume.

The purpose of the sunset provision was to protect the 2001 Act from challenge under the so-called Byrd Rule (named for its author, Senator Byrd of West Virginia). The Byrd Rule applies to budget bills under consideration in the Senate. The purpose of the Byrd Rule is to keep budget act provisions budget related. Thus, any provision that has revenue effects outside of the 10-year period of the budget is subject to removal from the bill upon challenge by any Senator. The challenge can be overcome only by a 60-vote majority. Because Senate leaders felt the 2001 Act's provisions would not be supported by 60 members, the sunset provision was inserted to avoid violation of the Byrd Rule.

Expected Congressional Action

The long implementation period combined with the single year of repeal for the estate and GST taxes makes the current law highly unstable. Exactly how the instability will be resolved will depend upon multiple factors, including the outcome of the 2002 and 2004 elections and the availability of budget surpluses to cover the cost of changes. At this point, it seems reasonable to predict that Congress will have two primary options to consider:

- Freeze the Reforms. After a few years of lowering the top marginal rate and increasing the unified credit, Congress could stop any further changes and make that year's law permanent. This approach would preserve the step-up in basis at death and eliminate the administrative complexity associated with the transition to carryover basis. It would also preserve revenue while exempting all but the very richest taxpayers from having to pay transfer taxes or engage in tax driven estate planning. The year-by-year analysis above describes what the results of a freeze would be in any given year.

- Make Repeal Permanent. Congress could enact another bill making the 2001 Act provisions permanent. Repeal could be accelerated, or left to be effective in 2010. As the baby boom generation ages, permanent repeal becomes more expensive with each passing year. Because Congress takes into account revenue effects of legislation only within a 10-year period, the sooner Congress acts to make these provisions permanent the less revenue loss it would need to offset. However, no matter when such legislation is considered, it will be costly. Furthermore, all of the other provisions of the 2001 Act are also scheduled to sunset by the end of 2010. There is no reason to believe that Congress would find the need to make estate tax repeal permanent more urgent than the desire to extend other provisions of the Act, such as marriage penalty relief, lower income tax rates and alternative minimum tax relief. In addition, passage of a bill making the 2001 Act provisions permanent would require the support (or at least the cooperation) of 60 members in order to pass in the Senate.

Planning Implications

The 2001 Act provides significant estate, gift and GST tax relief for many taxpayers. While no single course of action in response to this legislation is appropriate for all taxpayers, some general principles are relevant:

- Attention to GST Exemption Allocation. The GST changes are in effect now. Thus any transfers to trusts with generation skipping potential should be reviewed to make certain that the new automatic allocation provisions will operate in accordance with the client's plan for allocation of GST exemption. In addition, if you are aware of any existing problems where GST exemption was not allocated to a transfer when it should have been, an application for section 9100 relief should be considered.

- Review Plans. Every individual with a net worth in excess of one million dollars would be well advised to review his or her current estate plan in light of the 2001 Act changes. Specifically, do the asset allocations dictated by formula clauses continue to make sense in light of increases in the unified credit, rate reductions and the possibility of repeal? Does the will or revocable trust rely on provisions that are set to be eliminated (such as the state death tax credit or the qualified family owned business interest deduction)? With respect to married clients, are the assets allocated between the spouses in a manner that will allow maximum utilization of the available credits? Does the plan continue to meet the client's non-tax objectives?

- Use the Gift Tax Exemptions. Continue to take advantage of gift tax exemptions. Make annual exclusion gifts (up to a maximum of $10,000 per donor per donee in 2001). In addition, for appropriate beneficiaries, consider using the annual exclusion amount to fund a 529 Plan account to pay for higher education. Five years' worth of annual exclusions can be used to make a one-time gift of $50,000 to a 529 Plan account without incurring a gift tax (provided the donor lives for 5 years). Funds in the account accumulate tax free, and under the 2001 Act are tax free upon distribution provided they are used for higher education. Separate from the $10,000 annual exclusion, a donor can pay the tuition and medical expenses of any other person directly without incurring a gift tax. Finally, if funds permit, use the unified credit (and GST exemption, if necessary) to transfer additional assets to lower generations.

- Caution on Gift Tax Liability. Be very cautious in incurring any actual gift tax liability. With estate tax repeal on the books, there are only a few scenarios in which actual payment of gift tax would be advantageous unless it is clear that the donor cannot live until the time of potential repeal.

- Charitable Giving. Lifetime gifts to charity remain advantageous under any scenario. As long as the estate tax continues, a lifetime transfer to charity generates an income tax deduction and removes the property from the donor's estate. In the event the estate tax were to be repealed, the income tax deduction would continue to be available, and charity would be a good recipient for highly appreciated assets that will not be stepped up at death. These gifts could be made either by the client before death, or by the heirs after receiving the inheritance. Leaving traditional (but not Roth) IRA assets to charity at death is also advantageous with or without repeal of the estate tax.

- Basis Records. Although eventual imposition of a carryover basis regime is uncertain, now is a good time to start keeping records of basis. This information is necessary in the event the asset is sold, and it will certainly be essential if carryover basis ever comes into effect. This information is much easier to gather while the purchaser of the asset is alive.

- Living Wills. Review the living will with the client. Make sure that the client has adequately articulated his or her wishes so that an heir, who may be conflicted between personal and financial interests, is not faced with making an unguided decision whether to continue or terminate life support.

- Flexibility in Drafting. In this time of uncertainty when the law changes each year, and it is unclear as to where the law will ultimately settle, flexibility in drafting is essential. While it might be nice to prepare a will that deals with every conceivable contingency, this most likely is not possible. Estate planning must take into account possible changes in law, as well as the potential for any client to become incompetent to react to future unforeseen changes. No single approach is appropriate for every client. Rather, the plan must take into account the client’s age, health, marital status and level of wealth, among other considerations.