

# ESTATE PLANNING UNDER TAX ACT OF 2001<sup>©</sup>

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On May 25, 2001, Congress passed the *Economic Growth and Tax Relief Reconciliation Act of 2001*. This act represents a very complicated change in Federal tax law for income taxes as well as gift, estate and generations skipping (GST) taxes. The focus of this article is the effect the law has on estate planning.

A common misunderstanding that Americans and even many of their advisors have is that taxation on estates was or will be eliminated by this Tax Act. That simply is not the case. Planning for taxation of estates is just as important as ever, and will continue to be far into the future. Further, tax and other planning strategies for estates are now a good deal more complicated in many cases and the results more unpredictable. Another misunderstanding that many Americans may have is that they no longer need to even plan for things such as probate avoidance, eventual transfer of their estate to the rightful heirs, asset protection, etc. But the Tax Act has no bearing at all on these non-tax issues of estate planning. Those concerns still need to be planned for the same as before.

In this article we will generically refer to "death taxes". By that we mean any tax which may be imposed as a result of someone dying and leaving assets, especially if some of the assets will be sold by the heirs. We are not limiting the term "death taxes" to just estate taxes or to any other single tax.

There are twelve major features of the Tax Act for estate planning purposes, and numerous more minor ones. We will provide a simplified overview of the major features below. After the overview we will provide comments on how these features impact the planning for taxation of estates.

## Twelve Major Estate Planning Features of 2001 Tax Act

1. The estate tax unified credit exemptions and GST tax exemptions will increase in a series

of steps to \$3.5 million in 2009. See Table 1 below for the specifics. The "Exempt Amount" shown in the Table is the value of an estate which is free of any estate taxes for the year indicated. This amount increments up to the \$3.5 million level before the tax is completely eliminated.

2. The top rate for estate and GST taxes will decrease in a series of annual steps through 2007. See Table 1 below for specifics. The percentage "Rate" shown in the Table represents the maximum estate or GST tax rate for the year indicated. The minimum rate is 37% for each year shown. So some amount of an estate which exceeds the exempt amount will be taxed at 37%, and, if large enough, the rest of the estate would hit higher brackets, topping out at the rate shown in the Table for that year.

Note. The GST or generation skipping tax is a double tax imposed in addition to and on top of the estate tax on any portion of a decedent's estate which is left to a "skip" generation person. An example of a skip generation person would be the decedent's grandchild when the grandchild's parent is still alive. If the grandchild's parent is not alive, the grandchild is not treated as a skip generation person.

### Scheduled Changes in Estate and GST Tax Exemptions & Rates (Gift Taxes Not Included!)

| Year | Rate | Exempt 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 | 0%   | Unlimited     |

\* Unchanged from prior law

Table 1

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3. Estate and GST taxes are repealed, eliminated, from 1/1/2010 forward.

4. The gift tax unified credit exemption amount for life time gifts will go to \$1 million in 2002 and remain at that level unless the law changes it later (gift taxes will *not* be repealed in 2010). See Table 2 below for specifics.

5. The top rate for gift taxes will decrease in a series of steps through 2010. These rate changes are the same as the above estate and GST rate changes, except that the gift tax is not repealed in 2010 as estate and GST taxes are, and a final rate of 35% is set in 2010. See Table 2 below for specifics.

| Scheduled Changes in Gift Tax Exemptions and Rates |      |               |
|--|------|---------------|
| Year   | Rate | Exempt Amount |
| 2001   | 55%  | 675,000*      |
| 2002   | 50%  | 1,000,000     |
| 2003   | 49%  | 1,000,000     |
| 2004   | 48%  | 1,000,000     |
| 2005   | 47%  | 1,000,000     |
| 2006   | 46%  | 1,000,000     |
| 2007   | 45%  | 1,000,000     |
| 2008   | 45%  | 1,000,000     |
| 2009   | 45%  | 1,000,000     |
| 2010+  | 35%  | 1,000,000**   |

\* Unchanged from prior law  
 \*\* Permanent?

Table 2

6. Starting in 2010 the step-up in basis in estates will be limited to a maximum of \$1.3 million step-up on top of the estate's original basis when passing to a non-spouse, and \$3 million when passing to a surviving spouse. Prior to 2010 an estate has an unlimited basis step-up. See Tables 3 and 4 below for illustrative examples of basis step-up starting in 2010. There are an number of complications and other rules regarding basis step-up in the Tax Act, but they are beyond the scope of this article.

7. The federal credit given to estates for payment of the estate's death taxes at the state level will be reduced in a series of four steps, to zero. See Table 5 below for specifics. In some states this will make no difference in the total

amount of estate taxes paid, and in others it will increase the amount of federal estate taxes paid. Check your state's current death tax laws for local results. Also, be aware that some, maybe many, states will likely change their death tax laws now, either to increase taxation or to better integrate with the new federal law.

| Basis Step-Up Example on Estate Left to Non-Spouse |
|--|
| \$ 500,000 Decedent's original basis               |
| 3,500,000 FMV at date of death                     |
| <br>   |
| 3,000,000 Appreciation in estate                   |
| - 1,300,000 Additional basis allowed               |
| = 1,700,000 Capital gain*                          |
| <br>   |
| * Subject To Capital Gains Tax If Sold             |

Table 3

| Basis Step-Up Example on Estate Left to Surviving Spouse |
|--|
| \$ 500,000 Decedent's original basis                     |
| 3,500,000 FMV at date of death                           |
| <br>   |
| 3,000,000 Appreciation in estate                         |
| - 3,000,000 Additional basis allowed                     |
| = -0- Capital gain*                                      |
| <br>   |
| * Subject To Capital Gains Tax If Sold                   |

Table 4

| Scheduled Changes in Size of Deduction Allowed For State Death Taxes |                   |
|--|-------------------|
| Year   | Loss of Deduction |
| 2002   | 25%               |
| 2003   | 50%               |
| 2004   | 75%               |
| 2005 and beyond  | 100%              |

Table 5

8. The special estate tax deduction for family owned businesses will be repealed for individuals dying after 2003. Under the prior law this deduction would have given the estate a total deduction of \$1,300,000 where a family business existed. Since the total exempt amount under the 2001 Tax Act rises to \$1,500,000 in 2004, there is nothing lost here.

9. The annual gift tax exclusion law remains unchanged. This means that any individual can make a gift to any other individual, free of gift taxes or gift tax reporting, of \$10,000 in 2001. Spouses can each give \$10,000 to the same person, making a total of \$20,000 to one person which is a tax free gift. This tax exclusion is indexed to inflation, so the exclusion amount will increase in \$500 increments as sufficient inflation amounts dictate.

10. The \$250,000 per spouse, capital gains exemption on personal residences will flow thru to the estate for the benefit of the heirs. If an estate, heir or qualified trust sells a decedent's principal residence within three years of the decedent's death, the seller will be able to use the 2-out-of-5-years rule for the decedent's use of the residence while alive. Where applicable, the seller can then claim a capital gain exclusion of \$250,000. This exclusion is on top of any basis step-up (under the 2001 Tax Act) which may have been added to the residence's original basis.

11. After 2009, donors of gifts will be required to provide information (fair market value and basis) about the gift property. Failure to make the reports are subject to penalties.

12. The Tax Act is scheduled to sunset, to die, after 12/31/2010, leaving us with (what?).

## Effect of the Act on Estate Planning

**Estate Taxes at the State Level.** While the federal government is phasing estate taxes out by 1/1/2010, the states are not phasing out their death taxes. In fact, many cash strapped states are likely to see the elimination of federal estate taxes as a golden opportunity. It is quite likely that many states will step in to fill the void by increasing their own rates, reducing their exemptions, etc. It is easy to envision that some states will move to hit estates with death tax rates as high as 20% to 25%. The politicians might view that as a "bargain" since the federal rate ranged from 37% to 55%. Some of the states already impose significant death taxation without any increases. So estate owners, with their advisors, need to be seriously in tune with their local death tax situation.

**The Effect of the Loss of Basis Step-Up.** While federal estate taxes will be fully phased

out by 1/1/2010, the step-up in basis will be partially lost. See Tables 3 and 4 above for examples. By limiting the step-up in basis, the 2001 Tax Act shifts the type of taxation from estate taxes to capital gains taxes for the larger, wealthier estates. The partial loss of basis step-up will result in capital gains taxes being paid by the heirs of many estates. This will happen because the heirs will want to sell the real estate, stocks, business interests, etc. (capital assets) which the decedent owned. The estate will get the decedent's basis in these assets plus: Up to \$1.3 million for non-spouses, and up to \$3 million for spouses. So an estate worth as little as \$1.5 million could be subject to a significant amount of capital gains taxes when the heirs sell the assets.

**The Effect of the Sunset Provision of the New Tax Act.** The Act's expiration provision is a real wild card. The Act will go out of existence at the end of 2010 unless Congress takes specific steps otherwise. It is highly unlikely that Congress will let the law die. That could result in chaos if the IRS, the courts and the states did not agree on what law was in effect. So Congress will undoubtedly revisit this Act, though it is very unlikely they will simply extend it as is. The law is likely to need some fine tuning. It is too complicated to think there won't be some negative side effects. More importantly, though, tax reform is about 99% politically motivated and only 1% motivated by the taxpayers' best interests. Politics and the sunset provision guarantee changes at some point. This means that after 2010 we will most likely have a much different law than the 2001 Tax Act.

Unfortunately for us, the innocent taxpayers, nothing we plan for can be relied on to be valid a few years down the road. Estates worth upwards of \$1 million per person need to have their position seriously re-assessed every two or three years until some stability is back in the system.

**Effect on the Elderly or Those in Failing Health.** For individuals who are unlikely to live past 2009, their death tax planning techniques should be much the same as they have been practiced for the past few decades. There will be some amount of federal estate taxes charged against some estates through 2009, and most states will continue to impose some type of death tax as well. Further, the full step-up in basis under the old tax laws will continue in

effect through 2009, and that helps “stabilize” death tax planning as we have practiced it.

The earlier that an estate owner dies in the transition years of 2001 - 2009, the more likely it is that their estate will be subject to federal estate taxes, and the higher the rate will be. A good estate planner will be required to make the calculations which forecast the tax amount which is likely to be payable. We say “good estate planner” because of the now, highly variable nature of estate taxation. Once forecasts or estimates are done, the estate planner can then recommend various strategies to these individuals with short life expectancies, to mitigate the effects of estate taxes. This will involve the same tools that have been used for some time, including for example:

1. Family trusts, utilizing bypass (credit shelter) and QTIP trusts for married couples
2. Irrevocable life insurance trusts to provide tax free death benefits to pay the estate taxes
3. Gifting programs, utilizing either the \$10,000 annual exclusion or the unified gift tax credit
4. Private annuities, which in selected cases are highly effective at reducing taxable estates
5. Charitable giving, both before and after death

**Effect on Those Who Are Likely to Live Beyond 2009.** This is the area where death tax planning gets really dicey under the 2001 Tax Act. You can never preclude the possibility that even a young and healthy person will die before 2010, and at the same time you have to plan that these individuals will live until 2010 or later. Yet 2010 is set to create a major change in death tax planning requirements. While federal estate taxes will be fully phased out by 1/1/2010, the step-up in basis will be partially lost. The partial loss of basis step-up will result in capital gains taxes being paid by the heirs of many estates (we are shifting wealthier estates from estate taxes to capital gains taxes under the 2001 Tax Act). Further, it is quite likely that many states will step in to fill the void in death taxes by increasing their rates, reducing their exemptions, etc. All these new death tax

considerations will make it necessary to create multi-faceted plans for some individuals, more complicated than prior planning.

Our options for mitigating death taxes (no matter what type) should include a family trust, either a living or life estate type. Both types can and should be designed to be “grantor trusts” under federal tax law, which makes the trust tax neutral. The trust would be designed with the following features:

1. The trust has a bypass or credit shelter trust provision. When the first spouse dies, this provision allows the trustee to create a new, irrevocable trust to hold the decedent’s assets, or an amount of money equal to the value of the decedent’s assets. The decedent’s assets which are placed in the bypass trust will receive an exemption from estate taxes and a step-up in basis, up to the maximum allowed by both the federal and state governments in the year of the first spouse’s death. Before 2010 the decedent’s share could be large enough for some federal estate taxation, but the basis step-up is unlimited. After 2010 there would be no federal estate taxes and a limit of \$1.3 million basis step-up. In either case, state death taxes beyond some exempt amount will apply.
2. The trust has a “C” or QTIP trust provision. When the first spouse dies, this provision allows the trustee to create a new, irrevocable trust to hold some or all the decedent’s assets. Any assets placed in this trust will not be included in the decedent’s taxable estate, but will instead be deemed to be in the surviving spouse’s estate. Whether the first spouse dies before or after 2010, there will be no estate taxes on the assets in this trust as a result of the first spouse’s death (because the assets are in the survivor’s taxable estate, and he/she hasn’t died yet). However, if the first spouse dies in 2010 or later, the amount placed in this trust will get a step-up in basis of up to \$3 million since the assets are effectively transferred to the surviving spouse.
3. The original trust has special language allowing the trustee to have maximum flexibility on the death of the first spouse. This language allows the trustee to fund either or both the QTIP and bypass trusts, in

any manner and amount necessary to achieve minimum taxation of any type tax, at either the state or federal level.

Before the 2001 Tax Act, it is quite possible that only a bypass trust provision would have been included in the original trust, and specific instructions would have been included on how much asset value to put in the bypass trust. But the Act has many variables, and we have no ability to predict what is precisely the best planning. We could have either or both a basis step-up (capital gains tax) and an estate tax problem. In one case we would want to fund only the bypass trust, in another case we would want to fund only the QTIP trust, and in a third case we would want to fund both of them to some extent. We won't know until the first spouse dies what strategy will result in the least taxes. So we are compelled to plan for a variety of contingencies, then leave final planning until the first spouse dies. Unfortunately, this will cost the estate owner somewhat more in the creation of a trust, and the trust will be more complicated to understand and deal with when the first spouse dies. But there is no better alternative given the variables of current death tax planning.

What if the basis is very high, or can be when the personal residence basis step-up is factored in. What difference would there be in the trust, if any? If we are fairly certain that basis step-up (capital gains taxes) is not going to be a problem, we could create a family trust with just the bypass trust provision. No QTIP trust provision would be necessary.

What if the appreciation in an estate is too large to exempt with the \$1.3/3.0 million basis step-ups which are available? Besides using a family trust to its maximum benefit, the estate planner must look to other strategies such as the irrevocable life insurance trust and/or a private annuity/trust. The life insurance death benefit would provide the cash to pay the capital gains tax. The private annuity trust gets a basis step-up to the face value of the private annuity contract, and thereby potentially eliminates capital gains taxes in the trust.

Note: A full discussion on the workings of a private annuity are beyond the limitations of this article. See [www.nafep.com](http://www.nafep.com), then select "Capital Gains Tax Planning" for detailed information on capital gains deferral and private annuities.

**Effect on Existing Planing.** If you as an individual expect to be worth upwards of \$1 million by the time of your death or the year 2010, whichever comes earlier, (and if you are married, that is upwards of \$2 million), your existing trust or other estate planning needs to be revisited and probably amended. When estimating your estate's worth, don't forget to factor in the value of death benefits from life insurance, money you are likely to inherit and residual amounts in pension plans. Even if you have a sophisticated trust, prepared just a few months ago, and even if the trust has both a bypass and a QTIP trust provision, you need to have your plan checked. The trust provisions are probably wrong for the new tax law and too inflexible to allow your successors to take maximum advantage of exemptions, basis step-ups and lowered tax rates. Amending your plan could easily save your estate tens or hundreds of thousands of dollars in one or more taxes.

## Conclusion

In estate planning it is good advice to plan as if you will reach a ripe old age, and then also plan as if you will die tomorrow. That advice has never been more true than now. We must accommodate both the long term and the short term in one comprehensive estate plan, a plan which possesses maximum flexibility. We just don't know what death taxation laws will be in place when we die.

Another piece of good advice is to get a *good* estate planner. That has always been true, but it is far more critical now because of the vastly more complicated situation we are in. Many estate planners weren't doing a good job before in planning for the death taxes of their clients. Even fewer of them will be able to now.

And finally, if you have already done trust and estate planning, your plan probably needs to be amended if you expect your estate to be worth a million dollars or more. Yes, amending your plan will cost more money now, but your estate will probably benefit many times over by taking another look at it.

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For more information on estate planning, capital gains deferral or asset protection, see:

**[www.nafep.com](http://www.nafep.com)**