

Congress Passes Broad Estate, Gift and Generation-Skipping Tax Changes

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On May 26, 2001, Congress passed sweeping tax legislation that modifies the estate, gift and generation-skipping tax regimes. The measures first reduce and then ultimately repeal the estate and generation-skipping taxes, while leaving the gift tax system in force. The provisions gradually phase in over the next nine years, with estate tax repeal occurring in 2010. These new provisions “sunset” at the end of 2010. As a result, estate tax repeal will be effective only for one year, unless reenacted in the future by Congress. During the (one-year) repeal period, assets generally will have a carryover basis at death.

Sweeping Changes

The significant changes include:

- Repeal of estate and generation-skipping transfer (“GST”) taxes in 2010, but continuation of the gift tax indefinitely.
- Reduction in the top estate, gift and GST tax rate from 55% to 50% beginning in 2002, with gradual reductions to 45% during the period 2003 through 2009. Thereafter, the highest marginal gift tax rate will be 35%.
- Increase in the estate tax exemption from \$675,000 to \$1 million beginning in 2002, with gradual increases to \$3.5 million during the period from 2004 through 2009.
- Increase in the lifetime gift tax exemption from \$675,000 to \$1 million beginning in 2002, with the exemption remaining fixed at \$1 million.
- Carryover basis (generally) for property received from decedents dying after 2009.
- Reduction of credit for state death taxes followed by replacement with a deduction.

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A. Expanded Exemptions/Reduced Rates Table of Exemption Amounts and Highest Estate, Gift and GST Tax Rates

Calendar Year	Estate and GST Tax Transfer Exemption	Highest Estate, Gift and GST Tax Rates	Lifetime Gift Tax Exemption
2001	\$675,000 (estate) \$1 million* (GST)	55%	\$675,000
2002	\$1 million*	50%	\$1 million
2003	\$1 million*	49%	\$1 million
2004	\$1.5 million	48%	\$1 million
2005	\$1.5 million	47%	\$1 million
2006	\$2 million	46%	\$1 million
2007	\$2 million	45%	\$1 million
2008	\$2 million	45%	\$1 million
2009	\$3.5 million	45%	\$1 million
2010	N/A (taxes repealed)	35% (gift tax only)	\$1 million

* The GST exemption is slightly higher than \$1 million, because of inflation adjustments that will continue to apply until December 31, 2003.

B. Estate and GST Tax Estate and GST taxes are repealed, effective for decedents dying (or generation-skipping transfers occurring) on or after January 1, 2010. In the interim, the top marginal tax rate will decrease from the current 55% rate to 50% on January 1, 2002, and gradually decrease thereafter to 45% in 2009. In addition to the rate reduction, the applicable exclusion amount for transfers at death will increase gradually more than five fold from its current amount of \$675,000 to \$3.5 million in 2009. The GST tax exemption amount will more than triple from its current \$1 million amount.

C. Gift Tax While the estate and GST taxes are repealed effective in 2010, the same is not true for the gift tax. The maximum amount that an individual may transfer tax free during his or her life will be \$1 million, commencing January 1, 2002. Unlike the estate and GST tax exemptions, the gift tax exemption will be capped at that level indefinitely. Therefore, starting in 2004, when the estate tax and GST tax exemptions increase to \$1.5 million, an individual no longer will be able to use his or her entire estate tax exemption during his or her lifetime. To the extent an individual has used his or her gift tax

exemption, his or her estate tax exemption will be reduced correspondingly. The gift tax rates will continue to match the estate tax rates until 2009. In 2010, the top gift tax rate will be set at 35% (which is the highest individual income tax rate under the legislation), while the estate and GST taxes will phase out.

D. Basis of Assets Transferred At Death Under current law, subject to certain limited exceptions, assets inherited from a decedent generally receive a “stepped-up basis.” Consequently, the basis of inherited assets generally is the fair market value on the date of the decedent’s death (or six-month anniversary of death, if a special alternate valuation date is elected). This step-up in basis wipes out the taxable gain on any appreciation that occurred prior to the decedent’s death.

With the repeal of the estate tax in 2010, the present-law rule allowing a stepped-up basis at death will be repealed. At that time, the basis of assets received from a decedent generally will be the lesser of the decedent’s basis (i.e., a “carryover basis”) or the fair market value of the property at the decedent’s death. Hence, under the new legislation, any capital gain that occurred during the decedent’s lifetime is not wiped out. However, subject to certain limitations and modifications, the Executor of a decedent’s estate will be permitted to increase the basis of assets transferred up to a total of \$1.3 million, with an additional \$3 million step-up for property transferred to a surviving spouse. The permitted basis increase would be allocated on an asset-by-asset basis. The \$1.3 million and \$3 million figures will be adjusted for inflation, beginning in 2011.

E. State Death Taxes Under current law, a credit is allowed against federal estate tax for estate or inheritance taxes paid by a decedent’s estate or heirs to any state or the District of Columbia with respect to property includ-

ed in the decedent’s gross estate. Many states (such as New York, California and Florida) currently impose an estate tax equal to the maximum federal credit allowed. As a result, the state tax generally does not result in any additional estate tax. It merely allocates the same tax dollars between the federal government and the states.

Under the new legislation, the state death tax credit first is reduced, then repealed and replaced with a deduction. Because many states base their estate taxes on the federal credit, the changes in the state death tax credit will have the ancillary effect of significantly reducing state revenue. Some states may respond by enacting a separate estate tax to make up for lost revenue.

F. Sunset Provisions The provisions enacted by the legislation will terminate on December 31, 2010. Consequently, unless Congress passes further legislation, the provisions of the current tax law will spring back into place (including the estate tax).

Observations/Planning Considerations

- Although, taken as a whole, the changes are substantial, the increase in the estate and GST exemptions and drop in the marginal tax rates are phased in gradually. Since no change occurs until January 1, 2002, there is ample time for individuals to review their estate plans. Individuals should assure themselves that their planning documents take maximum advantage of these important tax changes and continue to carry out their objectives. Because the most significant benefits come in at the end of the phase-in period and repeal does not occur until 2010, taxpayers should consider using available means (such as the marital deduction) to defer estate taxes until the death of the second spouse, when an increased exemption amount and reduced estate tax rates (perhaps even full repeal of the tax) may be in effect.

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- Individuals whose Wills contain a “credit shelter trust” or other provisions based on a formula keyed to the federal estate tax exemption will need to consider whether the amount that will be set aside for spouses, children and/or other beneficiaries is appropriate in light of the increase in the exemption from \$675,000 (currently) to \$3.5 million in 2009, as well as repeal in 2010.
- Married individuals whose Wills currently do not take advantage of the estate tax exemption by making some form of credit shelter bequest will need to reflect upon their plans. A couple together will be able to leave \$2 million to their children free of estate tax as of January 1, 2002, with the amount increasing to \$3 million in 2004, \$4 million in 2006 and \$7 million in 2009, before the estate tax is repealed.
- Individuals should continue to take advantage of the benefits of making lifetime gifts, especially gifts that do not result in the payment of gift tax, to reduce the size of their potential taxable estates. In particular, individuals who can afford to do so should continue to make annual exclusion gifts of \$10,000 per donee (as indexed for inflation), as well as direct payment of qualified medical and educational expenses. These exclusions, which are unchanged by the legislation, may be used to transfer a significant amount of assets and will not count toward the \$1 million cap on lifetime gifts. Furthermore, those individuals who already have exhausted their current gift tax exemptions should consider transferring an additional \$325,000 after January 1 to take advantage of the accelerated \$1 million gift tax exemption.
- All existing trusts—whether set up by individuals during their lifetime or under the Wills of family ancestors—will remain in place and governed by the provisions of the instrument creating such trusts. These trusts will continue to be important in saving potential transfer taxes until such time as repeal of the estate and GST taxes may occur (and perhaps thereafter, to protect against future tax changes).
- All estate planning techniques should be evaluated in light of the tax changes. Many techniques, including irrevocable life insurance trusts, grantor retained annuity trusts and personal residence trusts, will continue to be viable and important into the future. Even after estate tax repeal, traditional estate planning vehicles such as trusts, family limited partnerships and certain life insurance products will continue to be instrumental in transferring wealth and protecting family assets.

Conclusion

It will be critical for each individual to review his or her existing estate plan. Because of uncertainty as to the estate tax law provisions that will be applicable at the time of an individual's death, the plan should be flexible. The plan also should take advantage of the important tax changes implemented by the new legislation and reflect the individual's wishes regarding dispositions for family members, friends and charities.

Please be in touch with any of the members of our Private Client Group listed on the following page. We would be pleased to review your current estate planning documents and offer creative recommendations to deal with the new tax law.

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