



OktoberVe\$t 2007 Lecture Series
Presented 10/10/07

The Current Estate Tax Law: A Mixture of Confusion and Uncertainty

Mark W. Sprenger, JD
Manager Wealth Management Services
Holt-Smith Advisors

The Federal Transfer Tax System

- The federal government taxes transfers of wealth in three ways:
 1. the Estate Tax (transfers upon death).
 2. the Gift Tax (transfers during lifetime).
 3. the Generation Skipping Transfer Tax (transfers during lifetime & upon death) to prevent property from being transferred to successive generations without intervening estate or gift tax consequences.

The Federal Estate Tax

- As Benjamin Franklin observed over 200 years ago: *“In this world nothing can be said to be certain, except death and taxes.”*
- As a tax on the transfer of wealth upon death, the federal Estate Tax represents the simultaneous convergence of these two inevitabilities.
- The Estate Tax is one of the most contentious components of the federal tax code. During the past 7 years, numerous attempts have been made, without success, to repeal the Estate Tax.
- Arguments for Retention of the Estate Tax:
 1. Prevents wealth inequality.
 2. Enhances charitable giving.
 3. Provides needed tax revenue (\$28 billion in 2006).
- Arguments for Repeal of the Estate Tax:
 1. Hinders the continuation of family-run small businesses.

2. Promotes consumption over saving and investment.
 3. Unfair in Principle – assets have already been subjected to tax during lifetime.
 4. Fosters economic inefficiency – significant monies expended on compliance (due to complexity of law) and tax avoidance (due to available options).
 5. Harms the Environment – land required to be sold or developed to pay tax.
- Of the top 50 industrialized nations, the US currently has the 4th highest Estate Tax rate and will have the 2nd highest in 2011.
 - Key components:
 1. Exempt from Tax: Any amount transferred upon death to the surviving spouse (excluding non US citizen spouse).
 2. Exempt from Tax: Any amount transferred to a “qualified” charity.
 3. Exempt from Tax: Amounts transferred to any beneficiary(s) not exceeding the applicable exemption amount.
 4. An often overlooked but important feature of the Estate Tax is the step-up (to the fair market value at the time of death) in cost basis (for income tax purposes) for transferred assets. The effect of this step-up is to exempt from capital gain taxation on sale the amount of unrealized appreciation at the time of death. There is no step-up in basis for assets transferred during lifetime by gift.

Current Status of the Federal Estate Tax

- In his first year in office, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This law brought major change to the federal transfer tax system. To best understand the impact, the law can essentially be divided into three logical time frames:
 1. 2001 through 2009 – *The Years of Change*
 2. 2010 – *The Year of Repeal*
 3. 2011 – *The Year of Surprise*

2001 through 2009 – <i>The Years of Change</i>

- This period could be best described as: ***“the longer you live, the less your estate tax burden will be”***.
- During this time frame, the amount exempt from Estate Tax gradually increased while the effective tax rate decreased. See Chart on next page.
- To prevent too much of a good thing, the amount exempt from gift tax was frozen at \$1,000,000.

- While no longer completely unified, use of the lifetime gift tax exemption amount will still reduce the estate tax exemption amount available at time of death.
- Unlike the next two periods, you can't be hurt, but you can be helped.

<u>Year</u>	<u>Estate Tax Exemption</u>	<u>Lifetime Gift Tax Exemption</u>	<u>Annual Gift Tax Exclusion*</u>	<u>Maximum Estate Tax Rate</u>	<u>Maximum Gift Tax Rate</u>
2001	\$ 675,000	\$ 675,000	\$10,000	55%	55%
2002	\$1,000,000	\$1,000,000	\$11,000	50%	50%
2003	\$1,000,000	\$1,000,000	\$11,000	49%	49%
2004	\$1,500,000	\$1,000,000	\$11,000	48%	48%
2005	\$1,500,000	\$1,000,000	\$11,000	47%	47%
2006	\$2,000,000	\$1,000,000	\$12,000	46%	46%
2007	\$2,000,000	\$1,000,000	\$12,000	45%	45%
2008	\$2,000,000	\$1,000,000	\$12,000	45%	45%
2009	\$3,500,000	\$1,000,000	\$12,000?	45%	45%

* Indexed for Inflation

2010 – The Year of Repeal

- According to noted columnist and author, Jane Bryant Quinn *“In 2010, ailing parents will keep their bedroom doors locked when their children are in the house. It’s going to be a great year to die.”*
- The first thing to remember is that this is a one-year event.
- No estate, no matter what the size, will be subject to Estate Tax or Generation Skipping Transfer Tax.
- Because of what’s in store the following year, the Gift Tax remains in place, with the same \$1,000,000 lifetime exemption, but a new reduced rate of 35%, the lowest rate since 1933.

- In a nasty surprise for some people, the full step-up in basis is replaced by carry-over basis. For what this means, see the carry-over basis example in Appendix A.
- A partial reprieve from carry-over basis is granted with a full step-up in basis for up to \$1,300,000 in transfers to beneficiaries and an additional step-up in basis of \$3,000,000 for transfers to the surviving spouse. Don't ask where those make-no-sense-at-all limits came from.
- It's not a perfect world. If you have a \$10 million estate, your kids will want you to die in 2010; however, if you have an estate between \$1.3 million and \$3.5 million with significant unrealized appreciation, your kids will wish that you had died in 2009.

<u>Year</u>	<u>Estate Tax Exemption</u>	<u>Lifetime Gift Tax Exemption</u>	<u>Annual Gift Tax Exclusion</u>	<u>Maximum Estate Tax Rate</u>	<u>Maximum Gift Tax Rate</u>
2010	None	\$1,000,000	\$12,000	0%	35%

2011 – The Year of Surprise

- If you live to see the sunrise on January 1, 2011, your dream of Estate Tax repeal will be over.
- The Conventional Wisdom column in the June 11, 2001 issue of Newsweek summed it up best this way: *“What a weird tax law. If your rich dad dies in 2010, you get it all. If he lasts another year, you get fully taxed.”*
- The amount exempt from Estate Tax goes back down to \$1,000,000.
- The lifetime gift tax exemption remains at \$1,000,000, but the annual exclusion goes back down to \$11,000.
- The top effective estate and gift tax rate goes back up to 55%.
- One positive benefit: carry-over basis is out and full step-up in basis returns.

<u>Year</u>	<u>Estate Tax Exemption</u>	<u>Lifetime Gift Tax Exemption</u>	<u>Annual Gift Tax Exclusion</u>	<u>Maximum Estate Tax Rate</u>	<u>Maximum Gift Tax Rate</u>
2011	\$1,000,000	\$1,000,000	\$11,000	55%	55%

Uncertainty under the Present Law

- In *Gone with the Wind*, Margaret Mitchell observed that “death, taxes and childbirth never come at a convenient time. Nothing could be truer over the next 5 years, when the year you die may make a big difference in your estate tax liability.
- An individual leaving \$5 million dollars to his or her children faces the prospect of paying the following estate taxes:
 1. Year of death 2007 – Estate Tax due: \$1,350,000
 2. Year of death 2008 – Estate Tax due: \$1,350,000
 3. Year of death 2009 – Estate Tax due: \$ 675,000
 4. Year of death 2010 – Estate Tax due: \$ 0
 5. Year of death 2011 – Estate Tax due: \$2,000,000

Likelihood of Permanent Reform Before 2011

- With the Presidential election looming and the expected Congressional gridlock, the chances of anything happening before the election are remote. With any change most likely to occur before 2010, the window of opportunity (i.e. 2009) appears short.
- If the Democrats retain control of Congress or regain the White House, permanent repeal, with an estimated cost of over \$1 trillion over 10 years, is off the table. In reality, it is probably already be off the table since the Republicans couldn't get it done when they controlled both the White House and Congress.
- Is a compromise possible and what would it be? While the Democrats had previously offered up an exemption amount of \$4 million and the latest Republican proposal advocates a \$5 million exemption and a 15% tax rate, in today's political climate, the most likely compromise would be an exemption amount of \$2.5 million to \$3.5 million with a possible rate reduction to 40% to 45%.
- A reform making permanent the 2009 exemption amount (\$3.5 million) and tax rate (45%) would exempt all but 3/10ths of 1% of decedent's estates from tax and still preserve about 60% of the revenue that would be lost from permanent repeal.
- The Government's need for revenue due to proposed governmental spending increases and the cost of the war in Iraq, together with slowing government tax revenues due to economic conditions, will certainly mitigate against the chance of permanent reform. Nevertheless, with less than 2% of decedent's estates subject to tax, while the political constituency favoring reform is not large, it certainly is where the money is; and after all, politics today runs on money.
- A problem. The Tax cuts/benefits sunset. With no action required, debate is limited and political cover is great.

- My best guess is that there will be permanent reform before 2010 and that it will be the estate tax exemption amount and tax rate in effect for 2009 (i.e. \$3.5 million and 45%).

The Wisconsin Estate Tax

- The best advice is: *Don't die before year-end!*
- In 2007, an individual with a taxable estate of \$2,000,000 would pay no federal Estate Tax, but could owe \$99,600 in Wisconsin Estate Tax.
- In its current form, assuming no change in state or federal law before year-end, Wisconsin's Estate Tax will disappear at the end of 2007. There is currently no movement on the part of the Governor or the State legislature to extend the Wisconsin Estate Tax even though it does bring in over \$120 million annually.
- If the current federal Estate Tax law remains unchanged and reverts back to the old law in 2011, Wisconsin's Estate Tax will return in 2011 as a "pick-up" tax equal to the federal state death tax credit. This is the way the Wisconsin Estate Tax law was before the Bush tax reforms of 2001 eliminated the state death tax credit. The elimination of this credit effectively eliminated the Wisconsin Estate tax that was equal to the credit. As a result, Wisconsin suspended its "pick-up" Estate Tax and enacted a new Estate Tax, which then disappeared at the end of 2007.
- Interestingly, a return of the Wisconsin Estate Tax as a "pick-up" tax does not result in any additional tax burden (you save in federal Estate Tax what you pay in Wisconsin Estate Tax).
- Because of the disappearance of the Wisconsin Estate Tax at the end of 2007, for decedent's dying after 2007 and before 2011, there may be no step-up in basis, thereby subjecting unrealized appreciation to Wisconsin Income Tax on sale. While the more logical reading of the Wisconsin statutes would favor a step-up in basis, the issue is presently under consideration and review by the Wisconsin Department of Revenue.
- Wisconsin currently has no gift tax having eliminated it in 1991. Wisconsin has never had a generation skipping transfer tax.

Estate Planning Considerations:

- For those individuals likely to have an estate under \$1,000,000 at the time of their death or who plan on leaving all or a significant portion (so that their non-charitable bequests are less than \$1,000,000) of their estate to charity, you don't need to do anything.

- For married couples with larger estates, the plan offering the greatest flexibility in this period of uncertainty is to leave everything to the surviving spouse, with suitable provisions for any amount(s) that the surviving spouse disclaims. The surviving spouse is then expected to disclaim the amount necessary to minimize overall estate tax on both deaths. Because the surviving spouse does not have to disclaim, this option does not work for every couple.
- Married couples with larger estates that don't want to go the disclaimer route should make certain that they take full advantage of the exemption amount in the estate of the first to die.
- Married couples with larger estate should consider using a marital property agreement, where appropriate, to equalize estates and to get, when available, a full step-up in basis in all their assets. While only ½ the value of marital property is included in the decedent's estate, the full value (including the surviving spouse's ½ interest) receives a step-up in basis.
- Single Individuals, with substantial estates and multiple heirs, should consider taking advantage of the \$12,000 annual federal gift tax exclusion and the unlimited exclusion for gifts made by paying an individual's tuition or medical expenses; and possibly, if circumstances so warrant, the \$1,000,000 lifetime exclusion. Be aware when gifting appreciated property that the donee (recipient of the gift) takes the donor's (person making the gift) tax cost basis for determination of gain on sale.
- If death is possible when the carryover basis rules are in effect (2010), remember that the surviving spouse has an additional \$3 million step-up in basis for any assets he or she receives and that charitable beneficiaries can receive low basis assets since they do not incur a taxable gain on sale.

Conclusion:

- In the end, it is safe to assume that the Estate Tax won't entirely disappear.
- So resign yourself to paying your lawyer more and spending more time in consultation because the law is likely to remain complex and likely to change.
- Moreover, stay focused on the primary reasons for estate planning in the first place: to provide for your heirs and to make sure that your assets will be distributed as you wish subject to the terms and conditions you desire.

Cautionary Note: The information presented above is for educational purposes only and is provided with the understanding that Holt-Smith Advisors, Inc. does **NOT** render legal or tax/accounting services. Due to the rapidly changing nature and complexity of the law, the information presented may be outdated or incomplete.

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Appendix A

Carry-over basis example:

Facts: Decedent has a \$3.5 million taxable estate. The taxable estate includes a highly appreciated asset (i.e. a closely-held business interest with a date of death value of \$3.0 million and an income tax cost basis of \$0.00)

The estate is bequeathed to decedent's daughter who has a buyer willing to pay her \$3.0 million for the business.

If decedent dies in 2009:

- There is no federal Estate Tax due because the taxable estate is \$3.5 million and the estate tax exemption amount is \$3.5 million
- There is no taxable capital gain on the sale of the closely-held business interest by the daughter because the estate receives a full step-up in cost basis to the date of death value of \$3.0 million which is also the sale price. Taxable gain equals the sale price less the cost basis (\$3.0 million sale price less \$3.0 million cost basis = \$0 taxable gain)
- **Net to daughter is \$3,000,000.**

If the decedent dies in 2010:

- There is no federal Estate Tax because the Estate Tax is repealed.
- As a result of carry-over basis, there is no step-up in basis for the closely-held business interest and the cost basis is the same as the decedent's, which is \$0.00. Because of the special rules allowing a step-up in basis of \$1.3 million, however, if the entire \$1.3 million is allocated to the closely-held business interest, then the new cost basis is \$1.3 million. The taxable gain on sale is then \$1.7 million (\$3.0 million sale price less \$1.3 million cost basis = \$1.7 million taxable gain). If the tax rate for long-term capital gain remains at 15%, the tax due is \$255,000 and if the tax rate has been raised back up to 28%, the tax due is \$476,000.
- **Net to daughter is either \$2,745,000 or \$2,524,000.**