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The 2001 Tax Relief Act

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"). The Act makes many changes to the existing tax laws, including the federal "transfer taxes" — the estate, gift and generation skipping transfer (GST) tax laws. The Act includes a $1.35 trillion tax cut — the largest tax cut in twenty years. The tax cuts are phased in over a ten year period, and most of the cuts ($875 billion) are deferred until the years 2005 - 2010. This newsletter will explain the major changes made to the federal transfer taxes by the Act and discuss how these changes impact your estate plan.

The estate tax applies to less than two percent of estates, and almost half of all estate tax payments are made by fewer than 2,500 estates. Nonetheless, Congress was concerned that the tax was beginning to encompass a larger number of taxpayers and exacerbate liquidity problems sometimes caused by the estate tax. The Act reduces the tax from 2002 to 2009 and eliminates it for one year (2010). Effective January 1, 2010, the Act also eliminates the "step-up in basis" rules that allow heirs to receive property from a decedent with a basis equal to the property's fair market value on the date of death. In 2011, the tax (as it exists today) will be reinstated. Congress therefore will need to revisit this issue again over the next decade, under perhaps entirely different political circumstances and economic conditions. The Act also significantly changes the gift tax but does not repeal it.

Year	Top Estate & GST Tax Rate	Exemption Amount
2002	**50%**	**$1 million**
2003	**49%**	**$1 million**
2004	**48%**	**$1.5 million**
2005	**47%**	**$1.5 million**
2006	**46%**	**$2 million**
2007	**45%**	**$2 million**
2008	**45%**	**$2 million**
2009	**45%**	**$3.5 million**
2010	***repealed***	**$0**
2011	**55%**	**$1 million**

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The GST tax does not change in 2002 or 2003. Thus, the GST exemption, currently $1,060,000, will rise in 2002 and 2003 only for inflation. In 2004, the GST exemption will rise to $1.5 million, and from that point forward, the GST exemption and the estate tax exemption will be the same. The GST tax rate in any given year will be the highest estate tax rate during the ten year repeal period.

The Act also makes changes to the GST tax which are effective for transfers made on or after January 1, 2001. These changes are designed to provide taxpayers with relief from common mistakes made when allocating GST exemption on gift tax returns.

Elimination of Step-Up in Basis

Until 2010, the basis of appreciated property inherited from a decedent will equal the property's fair market value on the date of death. Thus, the basis of appreciated property will continue to be "stepped-up" to its date of death value, and heirs will be able to sell the property and pay no capital gain taxes on appreciation that occurred during the decedent's lifetime.

In 2010, when the estate tax is fully repealed, the step-up in basis rules will disappear. In other words, to the extent that a decedent dies with appreciated property, the estate tax will be replaced by an income (capital gains) tax. The basis of appreciated property received from a decedent will equal the decedent's own basis in that property. The basis "carries over" to the heirs, rather than being "stepped-up". There are two exceptions to the carryover basis rules. First, the decedent's executor will be allowed to add $1.3 million of basis to certain appreciated assets owned by the decedent. Second, the executor can add $3 million of basis to property transferred to the decedent's surviving spouse. In the case of property owned by a decedent and the surviving spouse as joint tenants, only one-half of the property is eligible for the basis increase.

Not all property is eligible for the increase in basis under the new rules. Property that is not eligible includes (1) property gifted to the decedent within three years of death from someone other than the decedent's spouse, and (2) property that constitutes the right to receive income that the decedent earned during life but did not actually receive prior to death (for example, assets held in individual retirement accounts and 401(k) plans).

Like the repeal of the estate tax, the carryover basis rules are effective only for the year 2010. The step-up in basis rules go back into effect on January 1, 2011.

Retention of the Gift Tax

The Act does not repeal the gift tax. The gift tax is retained to prevent taxpayers from gifting income-laden property from higher to lower rate taxpayers. In 2002, the lifetime gift tax exclusion amount will rise to $1 million. This amount will remain constant over time and is not indexed for inflation. From 2002 through 2009, the top gift tax rate will equal the top estate tax rate, as shown

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on the table on page 1. In 2010 and later years, the top gift tax rate will equal the highest income tax rate in effect (which, in 2010, is scheduled to be 35%). In 2010, transfers of property to "grantor trusts" (i.e., trusts which are ignored for income tax purposes, and all of the tax attributes of which are reported by the grantor on his or her personal income tax return) will not be considered "gifts" for gift tax purposes (although they may be "gifts" for state law purposes).

What You Should Do

The transfer tax reforms of the Act give families who face estate tax exposure precious little instant gratification. If your will or revocable trust contains the classic "A-B" trust approach designed to ensure full use of your and your spouse's estate and gift exemptions and defer the payment of any estate tax until the second of your deaths, the formulas in your documents will self-adjust to ensure that you both take full advantage of the increases in the exemption amounts provided by the Act. You should review how your assets are titled to ensure that if your assets have a value of less than $2 million, neither you nor your spouse (or your respective revocable trusts) own assets having a value greater than $1 million. If your estate taxable assets exceed $2 million, the rule of thumb is that neither spouse nor his or her revocable trust should have assets valued at less than $1 million. Given the probability that Congress will tinker with the Act over the phase-in period, we are not recommending that our clients make any changes to their documents, such as changes to reflect the carryover basis regime and new exclusions proposed to be effective in 2010, until things come into clearer focus.

For those clients with irrevocable life insurance trusts and other sophisticated estate planning strategies, including family limited partnerships, limited liability companies, qualified personal residence trusts, GRATS and the like, preserve the status quo. The estate and gift tax exemption and exclusion leveraging benefits inherent in these strategies will continue to serve you well throughout the ten year transfer tax phase-out period. And, if Congress does as we expect — change the law again, perhaps to freeze the estate and gift tax exemptions at some point before 2010, retain the transfer taxes, but scrap the carryover basis idea — all of the planning you have in place should continue to serve you and your family well.

This publication is not intended to be legal advice. Counsel should be retained for individual estate planning.
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