# Topics: 2001 Estate & Gift Tax Law Changes-
# Less Than Meets the Eye

July 2001

The following is a brief overview of the Tax Relief Act of 2001, with an analysis of how the changes may affect your current estate planning documents. Also included is a discussion of recent IRS changes that simplify planning for distributions from retirement accounts.

*Overview of the Tax Act:* The new tax law makes estate planning more complicated over the next decade. The estate tax and generation skipping tax (GST) will be repealed, but *only* for the year 2010, unless Congress acts before then to make the repeal permanent. Otherwise, beginning in year 2011, the estate tax rules will revert back to the rules in effect in 2001 (known as the "Sunset" provision). Political uncertainty in the upcoming ten years makes it impossible to determine if tax repeal will ever become permanent. The best approach is to structure your estate planning to maximize flexibility. Until 2010 estate tax relief comes gradually. As illustrated in the chart, the relief begins in 2002 with a drop in the highest estate tax rate from the present 55% rate to 50%; thereafter the maximum rate drops one percent each year until it levels off at 45% in 2007. The estate tax exemption amount rises to $1 million in 2002-2003, $1.5 million in 2004-2005, and $2 million in 2006-2008, with a jump to $3.5 million in 2009. The GST exemption, currently at $1,060,000, will continue to be indexed for inflation for 2002-2003; thereafter, it will equal the estate tax exemption.

The gift tax will not be repealed, not even for the year 2010, or thereafter. Beginning in 2002, the highest gift tax rate will gradually reduce over the next nine years; in 2010 the highest gift tax rate will equal the highest individual income tax rate (which is scheduled to be 35%). Beginning in 2002, the gift tax exemption will rise to $1 million and remain constant (this is a change from prior law, where the estate tax and gift tax exemption were the same amount). After the estate tax exemption rises to $1.5 million (in 2004), the gift and estate tax will not be "unified". The present $10,000 per donee annual exclusion will not change.

| Calendar Year | Estate tax exemption | Highest estate and gift tax rates |
|---|---|---|
| 2001 | $675,000 | 55%, plus 5% surtax on certain estates over $10 million |
| 2002 | $1 million | 50% (and surtax repealed) |
| 2003 | $1 million | 49% |
| 2004 | $1.5 million | 48% |
| 2005 | $1.5 million | 47% |
| 2006 | $2 million | 46% |
| 2007 | $2 million | 45% |
| 2008 | $2 million | 45% |
| 2009 | $3.5 million | 45% |
| 2010 | Estate tax repealed | Gift tax remains, equal to top individual income tax rate of 35% |
| 2011 | $1 million | 55% (plus 5% surtax) |

Presently, a decedent's assets receive a "stepped-up" income tax basis to the fair market value of the assets at death. Beginning in 2010, the "step-up" disappears (as a trade off to the repeal of the estate tax), and the property will instead receive a basis equal to the lesser of the fair market value of the property at death or the decedent's basis in the property ("carryover basis"). However, each decedent's estate may "step-up" $1.3 million in assets (and an additional $3 million passing to a surviving spouse).

*How this affects your current estate plan*: Over the next decade, you should have a dispositive document (a

2000 Equitable Building ◆ 10 S. Broadway ◆ St. Louis, Missouri ◆ 63102
12 Wolf Creek Drive ◆ Belleville (Swansea), Illinois ◆ 62226

Estate Planning & Probate Practice Group

Edward F. Reilly, Chairman
314-241-9090

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Revocable Trust or Will) that is as flexible as possible. If you are not married, then your document should not be affected by the new tax law unless your planning makes gifts under a formula using the estate tax exemption amount. If you are married, then (generally speaking) your document will not be affected if it contains a standard "Marital/Family Trust" formula clause (e.g. exemption amount to a family trust, balance to a marital trust). Application of the formula clause will eliminate estate tax on the first spouse's death with the funding of a family trust with the first spouse's estate tax exemption (presently set at $675,000), with the balance passing either to a marital trust, or outright to the surviving spouse. If your document has this kind of formula clause, and you are satisfied with this planning, then no immediate action is warranted. However, this should be reviewed; for example, if you are in a second marriage with children from a prior marriage, or similar situation, then the standard formula clause may no longer work for you, especially as the exemption amount rises. If you feel it is time to review your estate plan in light of the changes, or if you are unsure whether your document has the proper formula clause, then we recommend that you contact us.

If you are married and you and your spouse have an estate greater than $1 million, as the year 2010 approaches, you should consider revising your plan to provide alternative provisions: (i) one provision applying the standard formula clause if you die during a time when the estate tax is still in effect (i.e. before 2010), and (ii) an alternative provision to apply if the estate tax is repealed when you die. However, this action is not one that you immediately need to take because the repeal is not effective until 2010 (if ever!).

Whether you are married or single, if you currently have a significant estate tax exposure, we recommend that you continue with tax saving strategies that utilize lifetime gifts, and valuation discounts, to "leverage" wealth transfers to your family. Current techniques that you may have heard of or already implemented include family limited partnerships, Grantor Retained Annuity Trusts (GRATs), sales to grantor trusts, life insurance trust planning, and Qualified Personal Residence Trusts (QPRTs).

*Rules Simplifying Distributions from Retirement Plans* The IRS recently issued proposed rules simplifying how you calculate your required minimum distribution (RMD) from retirement accounts (e.g., IRAs, 401k plans and other *qualified* plans) without fear of penalty. The primary goal in retirement account planning is to defer the payment of income tax on retirement account assets as long as possible. Income tax is due when funds are distributed from the accounts, so, most often, the best tax planning calls for receiving only the RMD. Account holders typically begin receiving the RMD after reaching age 70 ½. Under the new rules, the RMD is calculated based on just one table, which provides the joint life expectancy of you (the account holder) and your beneficiary, who, regardless of age or identity, is *assumed* to be ten years younger than you. The only exception is one that works in your favor. If your spouse is more than ten years younger than you, then his or her actual life expectancy is used so that the RMD can be lower.

The new rules also make planning easier for mandatory payouts of accounts after the account holder's death. Previously, if you did not have a beneficiary named by April 1 of the year following the year you turned age 70 ½, then the account generally had to be distributed soon after your death. Under the new rules, your beneficiary does not have to be identified until the year following your death. Also for determining the minimum payout of the account, the beneficiary's life expectancy will be determined after your death instead of at the time you reach age 70 ½. Using these new rules effectively will help stretch out the distributions from retirement accounts over a longer period.

Please contact one of our estate planning attorneys if you would like to follow up with any issue concerning your estate plan. We welcome the chance to visit with you.

**Edward F. Reilly**
**Walter L. Wittenberg**
**Garrett C. Reuter**
**MaryAnn G. Nessel**
**Keith A. Herman**
**William G. Jochens**
**Donald E. Weihl**
**Joseph R. Lowery**
**JenniferA. Clump**
**Laura L. Staley**