How Estate Tax Repeal May Change Your Estate Plan

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The House has passed a bill providing for the permanent repeal of the estate tax. This would eliminate a December 31, 2010, sunset of the estate tax repeal called for under the 2001 tax law. Although the White House is backing the bill, the supporters of this legislation face obstacles in the Senate, where there are probably not enough votes needed for passage of this legislation. In light of this change, the following is a brief overview of the 2001 tax law changes, with some thoughts on how estate tax repeal may affect your current estate planning documents.

Overview of the 2001 Tax Law Changes

The 2001 tax law made estate planning more complicated. Under current law, the estate tax and generation skipping transfer tax (GST) will be repealed, but *only* for the year 2010, unless repeal is permanent. Otherwise, beginning in year 2011, the estate tax rules will revert back to the rules in effect in 2001 (the "sunset" provision). Because political uncertainty makes it impossible to determine if this pending bill, or any form of tax repeal will ever become permanent, the best approach is to structure your estate planning to maximize flexibility. Under current law, until 2010 estate tax relief comes gradually. The highest estate tax rate has dropped from the previous 55 percent rate to a current 49 percent; thereafter the maximum rate drops one percent each year until it levels off at 45 percent in 2007. The estate tax exemption amount is currently $1 million in 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 will equal the estate tax exemption beginning in 2004.

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

You should have a dispositive document (a Revocable Trust or Will) that is as flexible as possible. If you are not married, then your document should not be affected by the 2001 tax law (or the potential repeal) unless you are planning to make 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 $1,000,000), 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, if you are in a second marriage with children from a prior marriage, or similar situation, then the standard formula clause may not work for you, especially as the exemption amount rises.

If repeal becomes permanent, then you will definitely want to revisit how your document is written. The standard formula clause will no longer be needed to save estate taxes.

If you are married and you and your spouse have an estate greater than $1 million, as the year 2010 approaches, you could give some consideration to 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, and (ii) an alternative provision to apply if the estate tax is repealed when you die.

Whether you are married or single, if you currently have a significant estate tax exposure, you should 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).

Please call or e-mail me today to discuss any estate or income tax planning questions you may have.

Greensfelder, Hemker & Gale, P.C.
Telephone: (314) 241-9090