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Trusts & Estates

Law Alert

TAX RELIEF ACT OF 2001

SIGNIFICANT CHANGES IN FEDERAL LEGISLATION MAY AFFECT YOUR ESTATE PLAN

Arthur C. Elgin, Jr., Esquire, and Benjamin D. Fitzgerald, Law Clerk

As you undoubtedly know, President Bush recently signed the "Tax Reform Bill," formally known as The Economic Growth and Tax Relief Reconciliation Act of 2001. In addition to the highly publicized changes to the income tax law, the bill contains several provisions that will make significant changes to the Federal estate and gift tax system over the next decade.

The Act provides a decade-long, phase-in period for the elimination of the estate tax, several changes to the current rules in the interim, and a "carryover basis provision" that is certain to cause confusion and potentially unpleasant income tax consequences to the beneficiaries of many estates. The eventual repeal only applies to the Federal estate and generation-skipping taxes; it does not repeal the Federal gift tax. The repeal of the estate tax will not occur until 2010; and, strangely, absent further legislation, the repeal will be in effect for only one year.

EXEMPTIONS

Under the existing law, there is no Federal estate or gift tax on the first \$675,000 of combined transfers during life or at death for gifts made and individuals dying in 2001; these two taxes are tied together under a unified system having a top rate of 55%. This means, for example, if John Doe died in 2001 and left \$1 million to his brother Ray, John Doe's estate would not be taxed on the first \$675,000 of the \$1 million Ray would be receiving; but it would be taxed on the remaining \$325,000. The 2001 Tax Act substantially increases the \$675,000 estate tax exemption after 2001. It rises to \$1 million for 2002 and 2003, \$1.5 million for 2004 and 2005, \$2 million for 2006 through 2008, and \$3.5 million in 2009. By the two taxes being tied together, it means that if John had given Ray \$255,000

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during his lifetime, then \$500,000 of the \$675,000 would be remaining at his death. However, if he has a \$1 million estate, taxes would be due on \$500,000.

Unfortunately, the gift tax exemption amount does not increase correspondingly. It remains at \$1 million for all years after 2001; and unlike the estate tax, the gift tax is not being repealed after 2010.

ESTATE AND GIFT TAX RATES

The top estate and gift tax rate drops every year. Beginning with 55% in 2001, the tax rate reduces:

- to 50% in 2002
- to 49% in 2003
- to 48% in 2004
- to 47% in 2005
- to 46% in 2006, and
- to 45% in 2007 through 2009.

In 2010, there will be no estate tax and the top gift tax rate will be equal to the top income tax rate at the time. At that time, it will be 35% if no changes are made to the income tax rates.

SWITCH FROM A STEP-UP IN BASIS TO A MODIFIED CARRYOVER BASIS

Under pre-2001 Tax Act law, property acquired from a decedent gets a basis equal to its value at the decedent's death. This is known as receiving a step-up in basis. It means that on a later sale by the heir, he or she will only

have to pay income tax on any appreciation in the property after the decedent's death.

Let's use John Doe for an example. He purchases an asset for \$50,000. When he dies fifteen years later, it is worth \$150,000. If John Doe leaves the asset to his son, and the son sells it and receives \$150,000 for the asset, there would be no tax.

Under the current Federal gift tax law, the donee of a gift assumes the donor's basis (usually its cost) for a gift. As a result, if there is a gift of appreciated stock, the donee will have a taxable gain if he sells at the gift value. This is known as getting a "carryover basis." For an example, assume John Doe had given the previously described asset to his son instead of leaving it to him in his will. If the son then sold it for \$150,000, the son would have realized a \$100,000 gain (the difference between the sale of the asset, \$150,000 and the cost of the asset, \$50,000). As a result, the son would have to pay federal income tax on \$100,000. Whether the recipient gets a step-up in basis or a carryover in basis has significant federal income tax implications for the beneficiary.

After the estate tax is repealed in 2010, a "modified carryover basis provision will replace the stepped-up basis provision." The modified carryover basis provides that recipients of property transferred at the

decedent's death will receive a basis equal to the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent's death. For example, if John Doe paid \$50,000 for the asset (that is, his basis in the asset) and the asset is worth \$150,000 at his death, the recipient of the asset would have to take the \$50,000 basis because it is less than the fair market value at the time of the decedent's death. If later, the recipient sells the asset for \$150,000, the recipient will be taxed on the \$100,000 gain he received as a result of the sale. As a result, the repeal of the estate tax in 2010 benefits the estate, but the change in determining the basis of an asset may adversely affect the beneficiaries of the estate.

Because a straight repeal of the stepped-up basis provision would adversely affect small estates, the 2001 Tax Act replaces step-up in basis with a "modified carryover basis" provision. The "carryover basis" provision only applies to transfers at death of assets in excess of \$1.3 million and spousal transfers in excess of \$4.3 million. To promote compliance with the new basis rules, the bill imposes reporting requirements on large gifts and bequests (i.e., gifts over \$25,000 and estate transfers over \$1.3 million). It also means that it is essential to retain all records of cost or other basis for a purchased item, this means a receipt

or statement showing the amount paid for it.

GENERATION-SKIPPING TRANSFER

The generation-skipping transfer tax is a special tax designed to prevent individuals from avoiding the estate tax by transferring assets to a generation below the next one (e.g., grandfather transferring to grandson rather than to son). The 2001 Act simplifies, reduces, and in 2010, repeals the generation-

skipping transfer act.

SUNSET PROVISION

The "kicker" in the 2001 Tax Act is that it has a "Sunset Provision." Unless there is new legislation extending the law, all of the provisions in the Act expire on December 31, 2010. This means that the current law would be reinstated.

CONCLUSION

The Economic Growth and Tax

Relief Reconciliation Act of 2001 alters the unified system for gift and estate taxes beginning in 2002 and ending in the repeal of the estate tax in 2010. While the 2001 Act may save estate tax to the benefit of heirs, it has added many new planning complications. In lieu of these changes, it will be necessary to reexamine estate plans made prior to the 2001 Act to keep the estate and income taxes to a minimum.

Do you know of others who should receive the Trusts & Estates Law Alert? If so, please complete the form below and fax to: 202-457-1678, attn: Candace Brosowsky, or visit our on-line library at www.jackscamp.com.

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