BY BROOKS J. HOLCOMB

death TAX eulogy may be premature

Some in Washington claim to have repealed the estate tax. But the reports of its death may be greatly exaggerated.

On June 8, 2001, President George Bush signed the $1.35 trillion Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act). But the Act contains a sunset provision, which provides that its estate and income tax changes will not apply to years beginning after December 31, 2010,[1] unless Congress reenacts them. This could mean only a one-year repeal period, because the estate tax repeal does not begin until Jan. 1, 2010.

Thus, heirs face the following situation: If their ailing mother passes away on December 31, 2010, the heirs will inherit her estate free of any transfer tax. However, if she makes it to January 1, 2011, half of her estate will be taxed away. This creates some interesting incentives. Maybe the Act should have been called the "Throw Momma From the Train Act of 2001."[2]

The Act is the largest tax reduction measure in more than 20 years and will take effect over 11 years. The bulk of the tax legislation is phased in during 2006 to 2010 through a complicated array of back-loaded benefits (see charts).

What does the Act do?

- It provides significant income tax rate cuts to individuals.
- It increases the estate and generation-skipping transfer (GST) tax exemptions of the Internal Revenue Code and provides for the eventual repeal of the estate and GST taxes in 2010.
- It substitutes carryover basis rules for stepped-up basis rules on the transfer of assets at death for income tax purposes.

Estate & Gift Tax Rate Reduction

Beginning in 2002 and continuing through 2010, the estate and gift tax rates will be reduced. In 2002, the maximum estate tax rate is reduced to 50 percent, and the 5 percent surtax on large estates is repealed. The maximum estate and gift tax rate will be reduced by an additional 1 percent per year through 2007. The Act, § 511(c).

For years after 2007, the maximum estate and gift tax rate of 45 percent will remain unchanged until the estate tax is repealed in 2010, at which time the maximum gift tax rate will be set to equal the top individual income tax rate as provided under the Act (i.e., 35 percent). *Id.* § 511(d).

The apparent rationale for retaining the gift tax is to prevent income tax avoidance by transfers of income-producing assets between high-income and low-income taxpayers without any transfer tax cost. The maximum tax rate for GST transfers, either during life or at death, will equal the highest estate tax rate in effect for that year. *Id.* § 511(c).

Estate & GST Tax Exemption Amounts Increase

In 2002, the exemption amount for the estate tax will increase to $1 million. The GST tax exemption amounts in 2002 and 2003 will be determined under the current rules that provide for a $1 million exemption adjusted annually for inflation. *Id.* § 521(c). Beginning in 2004, the GST tax exemption amount for a given year will equal the estate tax exemption amount for such year. *Id.* For deaths occurring in 2004 and 2005, the estate tax exemption amount will increase to $1.5 million and for 2006, 2007 and 2008 will increase to $2 million. A final increase to $3.5 million will occur in 2009. *Id.* § 521(a). In 2010, the estate tax and GST tax will be completely repealed. *Id.* § 501(a). However, the gift tax will not be repealed. The gift tax exclusion amount will increase to $1 million in 2002 and will remain at that amount through 2010. *Id.* § 521(b).

New Basis Rules After 2009

During the one-year repeal period, a modified carryover basis system will be implemented. Under present law, property acquired from a decedent receives a new basis equal to fair market value (a "stepped-up" basis), which could be a step-up or a step-down depending on whether the property has appreciated or depreciated since being acquired by the decedent.[3]

After the estate and GST taxes are repealed in 2010, the step-up in basis rules will be replaced by a modified carryover basis system. Recipients of property transferred at the decedent's death will receive a basis in the transferred property equal to the lesser of the decedent's basis or the fair market value of the property on the date of the decedent's death. The Act, § 542(a). The Act provides for a step-down in basis, but never a step-up, which means that beneficiaries can only acquire the decedent's taxable gains but never any deductible losses.

There are two major exceptions to the new carryover basis rules: a $1.3 million general step-up and a $3 million step-up for property transferred to a surviving spouse. The decedent's estate generally will be permitted to increase the basis of assets by up to $1.3 million. In addition, assets transferred to a surviving spouse may receive a step-up of up to $3 million. Thus, the basis of property transferred to a surviving spouse could be increased by a total of $4.3 million.

Nonresidents who are not U.S. citizens will be allowed to increase the basis of property received from a decedent by up to $60,000. Basis increases will be allocable on an asset-by-asset basis by the personal representative of the decedent's estate or by the trustee of a revocable trust. The $60,000, $1.3 million and $3 million basis increase amounts will be adjusted annually for inflation occurring after 2010.

For marital and community property purposes, the decedent will be treated as having owned a one-half share of the marital or community property held by a surviving spouse. All of such property will be eligible for a basis increase if at least one-half of such marital or community property was owned by, and was acquired from, the decedent.

Certain property will not be eligible for a basis increase under the new rules. This provision includes property acquired by the decedent by gift (other than from his or her spouse) within three years of the decedent's death. This rule was enacted to prevent a wealthy individual from gaining an increase in basis by giving it to a terminally ill family member.

For example, an individual's mother is terminally ill and has only $300,000 in assets. The individual gifts $1 million in appreciated property to his mother, who dies and bequeaths such property back to the individual. Without the three-year rule, this technique would allow the individual to get a basis increase up to $1 million (the property's fair market value). Also, property constituting income in respect of a decedent (IRD) and stock or securities of a foreign investment company or foreign personal holding company cannot receive a basis adjustment. Under this allocation system, heirs of taxpayers with most of their wealth in IRD items, such as qualified plans and individual retirement accounts (IRAs), will be worse off than others with appreciated assets who are eligible for the step-up in basis.

New Basis Reporting Requirements At Death After 2009

To comply with the new carryover basis rules, the personal representative (or the trustee of a revocable trust) will be required to report to the IRS whenever there is a transfer at death of noncash assets in excess of $1.3 million or when there is a transfer of appreciated property in excess of $25,000 which was received by the decedent within three years of death.[4] The Act imposes penalties of up to $10,000 for failing to comply with the new basis reporting requirements.

Technical Modifications of Generation-Skipping Transfer Tax Rules

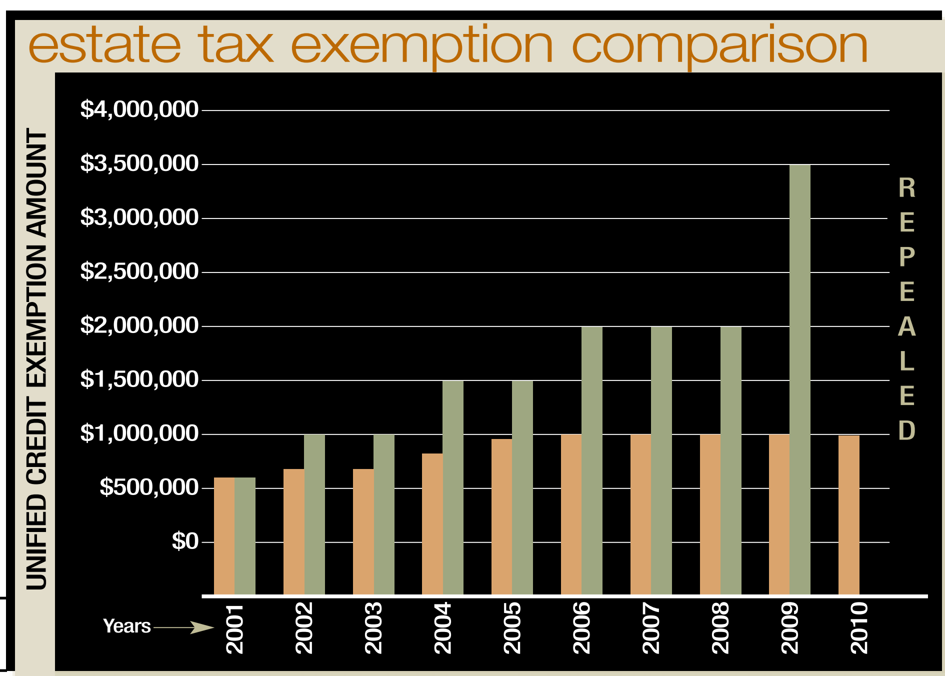
The Act makes a number of technical modifications to the GST tax, which is assessed on gifts in excess of $1 million to grandchildren and others at least two generations below the individual making the gift. These modifications provide for the automatic allocation of the GST exemption to certain trusts and the retroactive allocation of the GST exemption when there is an unusual order of death. *Id.* § 561(a). The Act also provides that a trustee shall have the power (without court approval) to sever and divide a single trust into two separate trusts in order to create a GST exempt trust and a GST non-exempt trust even in cases where there is no direction

year	top estate tax rate	estate tax 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	0%	——

in the governing instrument to make such a division. *Id.* § 562(a). These new technical modifications to the GST tax rules are effective for deaths and/or transfers occurring after December 31, 2000.

Expanded Availability of Estate Tax Exclusion For Conservation Easements

Under current law, a personal representative may elect to exclude from the decedent's taxable estate up to 40% of the value of any land subject to a qualified conservation easement.[5] The maximum exclusion is $400,000 for



deaths in 2001, and $500,000 for deaths in 2002 and thereafter. In order to qualify for this special exclusion under the former estate tax rules, the land subject to the easement had to be located within 25 miles of a metropolitan area, national park or wilderness area, or within 10 miles of an Urban National Forest. The Act expands the availability of the conservation easement estate tax exclusion by allowing any property within the United States, that otherwise meets the requirements of a conservation easement, to qualify for the exclusion. The Act § 551(a).

relief act highlights

- Estate & gift tax exemption amounts will increase to $1 million in 2002.
- Estate & gift tax rates will decrease beginning in 2002.
- Estate and generation-skipping transfer tax will be repealed in 2010, but gift tax will remain.
- Stepped-up basis rules for property acquired from a decedent are repealed for deaths after 2009.
- Carryover basis rules will apply beginning in 2010.

Future of a Permanent Estate Tax Repeal

The carryover basis regime was considered to be an administrative nightmare when it was enacted as part of the Tax Reform Act of 1976. Not only was this basis system repealed in 1980, it was repealed retroactively.

Under the Act, the carryover basis provisions are more complicated and administratively complex than the 1976 version because of the potential allocation of the $1.3 million and $3 million of new basis. Also, accurate property records will take on increased importance. For example, real estate that has been held in the family for generations will require decades of accurate records for basis determinations. Without these records, the IRS will prevail on the burden of proof issue and the basis will be kept artificially low, resulting in a higher taxable gain upon sale. Even where records are maintained, heirs will need to distinguish between improvements that add to basis and repairs and expenditures that do not. Records must be kept for assets acquired as gifts or through inheritance.

Under this allocation method, there is the potential for great inequity among beneficiaries. Some beneficiaries may receive high-basis assets, whereas others receive low-basis assets (with substantial amounts of built-in capital gain), although both have the same fair market value. This may lead to family conflicts and potential litigation for the fiduciary who is responsible for making the basis allocations among the various beneficiaries.

Finally, policy and fairness issues arise because the basis of the remaining assets can only step-down and not up. Joel Friedman of the Center on Budget and Policy Priorities has commented that the Act's carryover basis regime is one that has been tried before but was never implemented because the IRS found it to be overly complicated. "Our assumption is that this carryover basis will never really happen," Friedman said.[6] For these and other reasons, repeal will be a highly controversial item in upcoming administrations.

Reenactment of the repeal might be politically difficult because of the demographics of the country in 2010. Baby boomers will reach age 65 and become eligible for Social Security and Medicare the year after the repeal. This will put enormous financial pressure on the Treasury, and the related costs of these programs will increase exponentially in following years. The political will to shift an already growing Social Security burden onto wage earners through higher withholdings and income taxes could make a permanent repeal of the estate tax unlikely.

In a related matter, charities are expected to feel a significant financial pinch from what is in the Act and what was left out. Nearly $90 billion in tax break provisions to aid charities that were in President Bush's initial tax cut proposal were dropped during the legislative process.

Nonprofit groups say that the impact from the Act is twofold. The repeal of the estate tax is estimated to deprive them of up to $6 billion a year in bequests (people give money to charity partly out of genuine altruism and partly to reduce taxes), and the proposed charitable deduction for non-itemizing taxpayers was predicted to have increased charitable giving by $15 billion a year.[7] Also missing from the Act are provisions that would have increased the tax-free amounts that corporations can give to charity and provisions for tax-free donations to charity from IRAs. These issues will need to be addressed if the estate tax is permanently repealed after 2010.

The state death tax credit will be reduced by 25 percent in 2002, 50 percent in 2003, 75 percent in 2004 and will be completely repealed in 2005. The Act, § 531(a). Instead of a credit, a deduction will be given for state death taxes paid. *Id.* §532(b). The result of this is to eliminate the estate tax revenue generated by states that have a "pick-up" tax equal to the state death tax credit, thus shifting a portion of the loss of revenue to the state governments. This will cost the states billions of dollars and cause them to unite as a powerful lobby to retain the estate tax.

Aside from the pragmatic motivations, history has shown that politicians cannot keep their hands off the tax code. The last tax cut of this size was in 1981, Ronald Reagan's first year as president. In each of the three following years, Congress approved tax increases that partially offset the Reagan tax cuts. Then-President George Bush promised no new taxes and subsequently approved them in 1990. President Clinton campaigned for lower taxes in 1992 and then abruptly raised them in 1993.[8] Given this recent history, it is highly unlikely that the transfer tax provisions passed this summer will be the same provisions governing taxpayers and their heirs a decade from now.

Brooks J. Holcomb, J.D., LL.M., *is an attorney at Quarles & Brady Streich Lang LLP in Phoenix practicing with the taxation and trust and estates groups.* *Thanks go out to John K. Bartosz, J.D., LL.M., for his significant contribution to this article.*

endnotes for this article located on page 24.