STIMMEL, STIMMEL & SMITH, P.C.

***<u>SPECIAL NEWSLETTER ON THE "NEW" TAX LAW</u>*....or...**

Congress Does it Again:
THE PHASE OUT, REPEAL...AND AUTOMATIC REINSTATEMENT OF THE FEDERAL ESTATE TAX

September, 2001

<u>Introductions and Summary:</u>

As described in detail below, after much huffing and puffing, the Federal Government has enacted a law which, over time, phases out the current Federal Estate Tax...and one year after it is entirely repealed, reinstates itself entirely as if no such phase out had occurred.

This particular act of nonsense is apparently predicated on the unstated belief that such a stupid enactment will force a future Congress to act mature enough to actually pass a law that will remain effective...such as full repeal...and take the political heat. Of course, if the next Congress is as courageous as this one, then you may find yourself paying no tax if you are smart enough to die on December 31, 2010...and 55% estate tax if you die a day later in the following year.

And, of course, there are some kickers meanwhile which effect gift tax and stepped up basis and which you must keep in mind as you attempt to adjust to this law-non law that was passed.

Probably you should do nothing concerning estate planning until you see what the next Congress does...or does not do...but you must take into account in your economic planning the alterations in both Estate Tax and Income Tax as described below as the years progress and a call to your CPA makes good sense. And if you do not have a good CPA, get one for you need a professional to handle the foibles of our leaders.

THE REPEAL OVER TIME OF THE FEDERAL ESTATE AND GENERATION SKIPPING TRANSFER TAX....AND ITS REENACTMENT IN 2011.

Last June 7, 2001, President George Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 ("**EGTRRA**" or "Act").

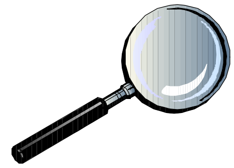
The Act reduces the **federal income tax** brackets over a phase-in period (the top tax bracket is reduced from 39.6% to 35% by 2006), EGTRRA phases out <u>and</u> repeals by 2010 the **federal estate tax**; repeals the **federal generation-skipping transfer tax** ("GSTT'); retains the **federal gift tax** in modified form with new reporting requirements; and **substantially eliminates the step-up in basis at death for income tax purposes in favor of a modified carryover basis**.

The current tax laws are reinstated in full, however, on **January 1, 2011.** *In other words, the new law that repeals the estate tax and the GSTT' is itself repealed in 2011 by a "sunset" provision and, unless there is further legislation, in 2011 we will be right back where we are today and your current plan, if correctly worked out, should be appropriate.*

Which is more than a little annoying. It means that if you die during this phase out period, you get some, if not all the benefits. If you die in 2010, you get all the benefits. If you die in 2011, and have altered your estate plan to conform to the requirements of 2010, your plan could very well be disastrous. Put in other words, unless you plan the date of your death correctly, you can not know if your tax planning is valid.

Most of the experts are recommending you do nothing...mostly because it is unclear what you should do unless you know the precise date of your death. One thing you should do...is know the new law, at least in outline. That follows below:

Repeal of Estate and GST TAX



1. In 2010, the Federal Estate and GST taxes are repealed.

2. Federal gift taxes are not repealed, and beginning in 2010, the top gift tax rate will be the top individual income tax rate as provided under the Act.

3. Further, the gift tax exemption is frozen at *$1.0 million from 2002 forward*. Generally, a transfer to a trust will be considered a taxable gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the federal grantor trust provisions of the Internal Revenue Code.

4. No change is made to the annual gift tax exclusion of $10,000, plus future inflation adjustments.

5. The following Phase Out Schedule Applies:

In 2002, the 5% surtax (which phases out the benefit of the graduated gift and estate tax rams) and the gift and estate tax rates in excess of 50% are repealed.
In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) is increased to $1 million.

In 2003 the estate and gift tax rates in excess of 49% are repealed.

In 2004 the estate and gift tax rates in excess of 48% are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $1.5 million. The unified credit effective exemption amount for gift tax purposes remains at $1 million as increased in 2002; it remains at $1.0 million and does not t increase parallel with the estate tax exemption amount.

In addition, in 2004, the family owned business deduction is repealed.

In 2005, the estate and gift tax rates in excess of 47% are repealed.

In 2006, the estate and gift tax rates in excess of 46% are repealed and the unified credit effective exemption amount for estate tax purposes is increased to $2 million.

In 2007, the estate and gift tax rates in excess of 45% are repealed.

In 2009, the unified credit effective exemption amount is increased to $3.5 million.

In 2010, the estate and GST taxes are repealed.

This is summarized in a chart, attached.

WHEN?

The estate and gift rate reductions, increases in the estate unified credit exemption equivalent amounts and the GSTT exemption amount, and reductions in and repeal of the state death credit are phased in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers after December 31, 2001.

CARRY OVER BASIS

After repeal of the estate and GSTT, the present law providing for a step-up to fair market value at date of death for income tax basis purposes for property acquired from a decedent are repealed. A modified carryover basis regime then takes effect in 2010, providing that recipients of property transferred from a decedent 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.

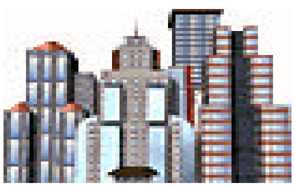
Each decedent is afforded a **$1.3 million step up in basis** allocable to assets as determined by the decedent's personal representative (executor). In addition, those married with a surviving spouse may allocate **three million** in step up in basis to assets received from a deceased spouse.

If the estate tax is repealed and carryover basis is implemented, life insurance may then continue to be useful in estate planning but now, instead of paying estate tax, it will be for the capital gains tax.

Those with long memories may recall that In 1976 Congress adopted carryover basis, only to repeal it retroactively in 1978 because it was unworkable. The same difficulties will pertain here in that clients will need to track basis if the estate tax is truly repealed and the carryover basis regime is implemented; therefore, you may wish to review your record-keeping procedures to adequately track basis. Good luck on that.

Conservation Easements

The Act also expands the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area or Urban National Forest. Thus, under the Act, a qualified conservation easement may be claimed by an estate with respect to **any land** that is located in the United States or its possessions. Thus, if you wish to give away land in the inner city, now you can do so and still qualify. The provisions are effective for estates of decedents dying after December 31, 2000.



Miscellaneous Provisions

Further modifications to the *GSTT* rules and the availability of installment payment relief extended to qualified lending and finance business interests and certain holding company stock also are included in the Act. Lastly, the state death tax credit is being phased out by 25% in 2002, 50% in 2003, 75% in 2004, and is repealed entirely in 2005, after which a deduction will apply for any state inheritance or estate taxes paid to any state.

Repeal of the **state death tax credit** represents a substantial loss of revenue to those states such as California which originally repealed their inheritance tax laws in favor of a system that merely "picks up" the federal state death tax credit. Many states may reinstate inheritance taxes and that includes California..

SO, WHAT'S IT ALL MEAN?

We now have a law which fazes in then disappears with the implicit hope of this Congress that some other Congress will come in and save the day with appropriate replacement of this law with a better one...or at least some planning of what income source will replace the loss of these substantial revenues. It is, in this writer's opinion, the perfect example of the lack of our current legislators to take the risk to do what is unpopular...but to seek popularity by implementing those aspects of the law that garner praise.

So, we get the tax break now...at least slowly...but pay a price in increased capital gains (basis step up loss) and a bigger price later since somehow, somewhere, the loss in revenue will have to be made up. But by then this Congress will be history and will care little, one presumes.

For our clients, it seems of little value to base an estate plan on the assumption that one will die in the magic year...or to plan for what may occur beyond it. Our advice: keep watchful of what happens, adjust your thinking about stepped up basis and its value in estate planning, and do not expect Congress to do more than dodge and weave as the years go by.

Perhaps George Bernard Shaw had the most appropriate comment:

Power does not corrupt men; fools, however, if they get into a position of power, corrupt power.

New Law

Calendar Year	Estate and GST Tax DeathtimeTransfer Exemption	Highest Estate and GiftTax Rates
2002	$1 million *	50%
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	N/A (taxes replealed)	top individual income tax rate under the bill (gift tax only)

*** Technically, GST exemption is $1,060,000, subject to adjustment in 2003**

Old Law

Calendar Year	Estate and Gift Tax Unified Esemption	Highest Estate and GiftTax Rates *	Generation Skipping Exemption Amount **	Generation Skippinng Transfer Tax Flat Rate
2001	$675,000	55%	$1,060,000	55%
2002	$700,000	55%	$1,060,000	55%
2003	$700,000	55%	$1,060,000	55%
2004	$850,000	55%	$1,060,000	55%
2005	$950,000	55%	$1,060,000	55%
2006	$1,000,000	55%	$1,060,000	55%
2007	$1,000,000	55%	$1,060,000	55%
2008	$1,000,000	55%	$1,060,000	55%
2009	$1,000,000	55%	$1,060,000	55%
2010	$1,000,000	55%	$1,060,000	55%

*** Plus a 5% surtax for estates between $10 million and $17,184,000 to phase out graduated rates**

**** Plus cost of living adjustment**