The

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Key Issues For 2005

It is a brand new year and in a dynamic context of taxation and economics, it is essential for professional planners to once again take stock of where we stand for 2005 and what looms ahead in the immediate future. Numerous limits are in flux due to phased-in changes or cost-of-living adjustments.

There are a number of planning issues that remain on the table and 2005 may be the final chapter of *Strangi* regarding family limited partnerships. Yet the fate of the estate tax repeal, the prospect of a carry-over basis down the road, and the impact of state inheritance and estate taxes are inescapable issues.

The Repeal Unraveled?

One could made the case for the estate tax being made permanent or at least remaining on track over the next four years. The current administration has invested political capital in the repeal. President Bush has taken a no-new-taxes vow, and knows all too well what resulted when his father reneged on a similar

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pledge. So one plausible scenario is simply a continuation of the present track record. The repeal would phase in on schedule and, if there is to be a change in course, it will have to happen on the next President's watch in 2009.

Yet all the elements of a deal to alter the estate tax sooner rather than later are present. Submitted for your consideration are the following factors:

(1) As a result of the 22nd Amendment to the United States Constitution, President Bush is barred from serving a third term. He doesn't have to be concerned about breaking a tax pledge affecting his chances of reelection.

(2) The Administration has expressed a strong interest in stabilizing Social Security. This would not only be a legacy-securing achievement, but would also neutralize an important political issue in future elections. But to accomplish this, concessions involving the estate tax may be involved.

(3) Based on the records of past presidents, the most likely time to obtain consensus on major legislation is early during a President's second term. Right now may be the ideal time to get anything done, i.e., coming off the election, with the President's party in control of both the Senate and Congress, and long before the next Presidential election.

(4) A bipartisan compromise that preserves most of the repeal by establishing a high exemption of $3.5 million or $5 million, or more, could have a longer lasting impact on the tax code. A bit of perspective is in order.

War, Peace, & The Estate Tax

For some of us who have devoted so much of our professional careers in pursuit of ways to avoid or reduce the federal estate tax, the total repeal does feel like a revolution, a total change of fundamental approaches. It feels unprecedented and unique.

But it is not. Our nation has enacted and repealed the estate tax on several occasions.

One explanation that crops up in articles is that there is a pendulum of social opinion. During hard economic times, people want to tax the rich, but during times of prosperity, it becomes intellectually fashionable to tolerate the wealthy. When the middle class feels affluent enough to identify with the wealthy, it too wants to transfer wealth without taxation.

But it has always been financial reality that has summoned the estate tax back into existence. Wars cost money. And if there is one constant verity that haunts mankind, it is war.

In 1797 the estate tax was instituted to finance naval operations against France. The end of the conflict meant the end of the tax in 1802.

In 1862 the estate tax returned to finance the Civil War. The war ended in 1865 and by 1870, the tax was repealed.

In 1898 the estate tax was called back into active duty to pay for the Spanish-American War. In 1902, the tax received an honorable discharge once more.

Lost tariff revenues from World War I prompted the re-imposition of the tax in 1916. And it was the cost of World War II that drove the top estate tax rate up to 77%.

It is only in times of peace that estate taxes have been repealed in the past. And maybe those occasions coincide with times of prosperity and confidence when the wealthy are tolerated. While there is always hope for peace and prosperity, there will always remain the potential for war and a new estate tax in the future.

Hug Your Estate Tax Today

Plenty of arguments are out there for keeping the estate tax in some form. Let's take a tour of them.

Total repeal of the estate tax affects many estates that have already been planned in anticipation of a tax. There is a small but important part of our economy that involves professionals (attorneys, accountants, financial planners) as well as publishing companies, software developers, etc., which all revolve around estate-tax-related planning.

Many philanthropic organizations have long-term concerns about fund-raising; charities need an estate tax angle to encourage donors. There are concerns that private foundations will be impacted as well. (There are, of course, arguments countering these fears as well; it would be cynical to assume that all philanthropy is motivated solely by tax consequences.)

Some of the wealthiest and most influential Americans are opposed to the repeal. A group called United for a Fair Economy issued a press release from Bill Gates, Sr., and former Federal Reserve Chairman Paul Volcker in opposition to the repeal of the estate tax.

And there is the economic context, which has shifted dramatically from when the estate tax repeal was first conceived. Back then, we had a budget surplus and a booming stock market. Five years later,

there is a different picture. The stock market has not been kind, the nation's budget deficit is critical, war expenses are mounting, and there are concerns about the adequacy of the Social Security trust fund.

Five years ago, we were looking at the prospect of rapidly growing estates and a unified credit that would have first reached $950,000 in 2005. Today, many estates have had setbacks and the exemption amount is at $1.5 million and one year from $2 million.

None of this bodes well for estate tax repeal. But that's all old news and there is no indication their cumulative weight could persuade the administration to compromise on the estate tax repeal in any way. However, there is one issue still out there that could turn the historic tides.

The Sleeping Giant

In 2010, the stepped-up basis is supposed to be replaced by a carry-over basis. For many estates, the change may be a non-issue. There is a $1.3-million step-up in basis available for each individual as well as a $3-million step up in basis for transfers from a decedent's estate to a spouse. Those amounts apply to the appreciation in value.

Example: Sam buys a company worth $7 million. At his death the company is worth $10 million. Under current law, assets transferred from Sam's estate are stepped-up in value to $10 million. Sam's heirs can then sell the company for $10 million without incurring a capital gain.

With the carryover basis scheduled for 2010, appreciated assets could be transferred and could

KEY TAX THRESHOLDS FOR 2005

TOP ESTATE TAX RATE: Drops to 47% (down from a top rate of 48% last year).

ESTATE TAX EXEMPTIONS: Remains at $1.5 million for 2005 for estate and GST tax purposes and goes to $2 million in 2006.

GIFT TAX: Top rate is also 47%, following the estate tax and the generation-skipping transfer tax. Last year the lifetime exemption for gift taxation remained at $1 million, parting company with the estate tax exemption. The gift tax lifetime exemption remains at $1 million in 2005. The gift tax annual exemption remains at $11,000 in 2005.

STATE DEATH TAX: The state death tax credit had been phased out by 75% in 2004. It is completely phased out in 2005 but is now treated as a deduction.

SPECIAL-USE VALUATION: The aggregate decrease in value of an estate using §2032A for estate tax purposes is limited to $870,000 in 2005 (up from $850,000 in 2004).

NONCITIZEN SPOUSES: The exemption under sections 2053 and 2523(I)(2) for gifts to noncitizen spouses increases from $114,000 to $117,000.

RETIREMENT PLANS: The limitation for defined contribution plans under section 415(c)(1)(A) is increased from $41,000 to $42,000. For defined benefit plans, the contribution limit increases from $165,000 to $170,000.

CAPITAL GAINS: Top rates of 15% and 5% continue to apply to capital gains and certain dividends in 2005. Rates rise in 2009 but a low bracket of 0% will exist in 2008.

401(k) LIMITS: The limit on elective deferrals for 401(k) plans rises from $13,000 to $14,000 in 2005.

SOCIAL SECURITY: Social Security and SSI benefits will increase by 2.7% in 2005. The maximum taxable earnings for Social Security withholding rises to $90,000.

KIDDIE TAX: The threshold level of a child's income that triggers income tax at a parent's top rate remains at $800 for 2005.

ATTORNEY FEES: The rate for 2005 is to be $150 per hour.

EXPATRIATES: Those with an average income tax of $127,000 in the five years prior to losing citizenship are subject to tax.

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expose heirs to large capital gains liabilities. However, the available $1.3-million and $3-million step-ups in value could be fully exploited using stepped-up-basis shelter trusts.

Many people like to believe that their businesses and investments will take off and provide their heirs with an immense capital gains issue as a final legacy of their success. There are a large number of estates that can envision the capital gains tax as the largest remaining tax affecting the value of what they transfer to their heirs.

Adding insult to injury, estates affected by a tax resulting from a carry-over basis will also be faced with the burden of proving the value of assets acquired decades earlier. If history is any guide, the regulations required to administer this system will fill a fair-sized volume. By the way, the last time this was attempted was a disaster. Is it worth creating a new system that will police a miniscule fraction of estates?

Could a provision to simply retain the stepped-up basis be the critical piece that seals the deal on a compromise that preserves the estate tax?

Decoupled States and Thresholds for State Death Taxation

State	Threshold
Connecticut	$1,000,000
Illinois	$1,500,000
Kansas	$ 850,000
Maine	$ 850,000
Maryland	$1,500,000
Massachusetts	$ 850,000
Minnesota	$ 850,000
Nebraska	$1,000,000
New Jersey	$ 675,000
New York	$1,000,000
North Carolina	$1,500,000
Ohio	$3,100,000
Oregon	$ 850,000
Rhode Island	$ 675,000
Vermont	$1,500,000
Virginia	$1,500,000
Washington	$ 850,000
Washington, D.C.	$1,000,000
Wisconsin	$ 675,000

Persons in the following states should review state tax impact if their estates exceed the threshold amounts listed above. CAVEAT: Chart reflects data from mid-2004. *Source: CBPP.*

Decoupled and Fancy Free

Alas, the state death tax credit, fondly referred to as the "sponge tax" has been phased out. It's mooching days are over. States cannot siphon off funds on their way to Washington. Now states seeking revenues from death taxes will have to impose a seperate and highly conspicuous tax of their own.

What had been a relatively uniform approach to state taxation of estates has devolved into a tower of babble, or balls spreading across a pool table upon impact, or all the stars of the milky way.

There was no shortage of available metaphors but whoever first described the situation as "decoupling" probably wishes they had trademarked the phrase somehow. "Decoupling" is now synonymous with states having unique death tax approaches.

Will 2005 become a 50-state train wreck? In a series of articles on the website of the Center on Budget and Policy Priorities, Elizabeth C. McNichol analyzes the economics of decoupling. Revenues projected for 2003 through 2007 reveal how much is at stake. For California, decoupling would mean an extra $5.23 billion. Florida and Texas had $2.6 billion and $1.12 billion at stake, respectively.

As of June 30, 2004, 19 states had a state death tax that kicks in once estates exceed an exemption amount ranging from $675,000 in New Jersey to $1.5 million in Illinois, and 25 states had no state death taxes.

An individual residing in a state that decouples and who would end up paying a significant state death tax as a result may consider lifetime gifts. Many states that have decoupled do not impose a gift tax. This raises the potential for death-bed gifts and the issues such a technique gives rise to. See, Stetter, *Deathbed gifts: A savings opportunity for residents of decoupled states*, 31 Estate Planning 6 (June, 2004).

Other approaches include changing legal domicile or holding out-of-state property in a family limited partnership or limited liability corporation.

Finally, last minute changes in state laws may make it useful to arrange for post-mortem planning by a surviving spouse or fiduciary.