



SINSHEIMER JUHNKE LEBENS & McIVOR, LLP
ATTORNEYS AT LAW

THE ESTATE AND GIFT TAX A LOOK IN THE CRYSTAL BALL FALL 2008

June 2001 saw enactment of major tax legislation that has resulted in a significant increase in the exemption from estate tax for all US Citizens and permanent residents of the United States. Because of the peculiar parliamentary rules of the Congress, it was not possible in June of 2001 to achieve immediate and complete repeal of the Estate and Gift Tax. Similarly, it was not possible to achieve immediate serious reduction of the burden of the tax. So, there was a compromise. The exemption has increased steadily since 2001, and the rate of tax has decreased.

For people who die in 2008, the estate tax exemption is two million dollars (\$2,000,000) per person. Simply put, if a person who dies in 2008 has total net worth (including some things we count for estate tax that might surprise you) of \$2,000,000 or less and that person has not made gifts during lifetime that required filing a gift tax return, that person's estate will not have to file an estate tax return; and that person's estate will owe no estate tax.

On January 1, 2009, the estate tax exemption will increase to three million five hundred thousand dollars (\$3,500,000). With these numbers in mind, most married couples can pass along to family and friends as much as seven million dollars (\$7,000,000) beginning in 2009, with no estate tax.

Once an estate exceeds the exemption, the rate of tax is now 45%.

Gift Tax, the tax on lifetime transfers, is no longer completely tied to the estate tax. Since 2001, the lifetime exemption for *Taxable Gifts* is one million dollars (\$1,000,000). This is one of the most confusing things people encounter. Most people are familiar with the annual exclusion from gift tax. Those are gifts below a certain amount, currently \$12,000, which a person can give each year to every person, whether or not related. Thus, if you play on a nine-member softball team, and you would like to make gifts to your teammates, you can give each of the other eight players \$12,000 each year and not have to file a gift tax return and not have to pay any tax. It does not matter whether any of them is related to you or not. However, if you make gifts to any

one person in any one year that exceed the annual exclusion amount, you are required to file a gift tax return and report the gift to the IRS. The amount of that gift in excess of \$12,000 is a taxable gift. Over the course of your lifetime, you can give up to \$1,000,000 of those taxable gifts, in the aggregate, before you have to pay any tax. There is still a connection between the gift tax and the estate tax in this way: lifetime taxable gifts use up, dollar for dollar, the estate tax exemption. So, for example, if a person makes lifetime taxable gifts of \$500,000, the exemption from estate tax will be reduced by \$500,000 on her death.

The annual exclusion amount has been \$12,000 since 2006. This exclusion is adjusted automatically based on a cost of living formula. The exclusion only changes, however, when the cumulative adjustment is \$1,000 or more. In 2009, the annual exclusion will be \$13,000. Next year, you can give your teammates \$13,000 each. That may still not assure you a place on the team.

One oddity of the 2001 tax legislation is that it contemplates complete repeal of the estate tax, though not the gift tax, in 2010. Because of those parliamentary rules mentioned earlier, however, that repeal is for only one year. In 2011, the entire 2001 tax act disappears, and the law returns to what it would have been if that act had never existed, with an exemption of only \$1,000,000 per person.

There is also an important income tax component of these changes. For some time, the income tax cost basis of assets that are inherited has been adjusted to each asset's fair market value on the date of death. So, for example, if a person dies this year owning a home that was purchased in 1970 for \$25,000 which is now worth \$500,000, the home will have a new income tax basis of \$500,000. When the person who inherits the home sells it, the gain or loss will be calculated as if he had purchased the home for \$500,000. This is sometimes referred to as "stepped-up basis". However, this works two ways. If that same person who died in 2008 owned a home which he bought in 2006 for \$750,000 but which is now worth \$500,000, the person who inherits that house also has a new income tax basis of \$500,000. Ouch.

The 2001 tax act provided for partial repeal of basis adjustment.

In case you had not noticed, we are in the midst of a national election campaign. No one person determines tax policy alone, but elections do make a difference. Over the past few months, we have heard every variety of sure insight into what will happen depending on who is elected. We do not predict elections, but it is worth looking at what the candidates are saying to get some idea how to plan. Keep in mind that these predictions are ours alone. We may be misreading the tea leaves, and events may control what elected officials are able to do. With that in mind, let's look:

Estate Tax. At this time, neither Senator McCain nor Senator Obama is on record favoring complete repeal of the estate tax in 2011. Both candidates favor eliminating the uncertainty that results from the possible reversion to pre-2001 exemptions and rates in 2011. Senator Obama has said in several places, including on his campaign website, that he favors staying with the 2009 tax levels, i.e., a \$3,500,000 per person exemption with a 45% tax rate above that. *The Wall Street Journal* recently reported that Senator McCain favors an exemption in the range of \$3.5-5 million and a rate reduction to 15%. The economic and war demands on the budget make it unlikely that

lawmakers will be any more generous than the candidates. Nevertheless, an exemption of \$3,500,000 means that only a small percentage of Americans will have any concern about Estate Tax.

Gift Tax. There have been suggestions of rejoining the amount of the gift tax exemption (currently \$1 million) with the estate tax exemption. Neither candidate seems to have been vocal on this issue. We do know that the annual exclusion for smaller gifts will rise to \$13,000 for gifts in 2009.

Income Tax Basis. There seems to be scant enthusiasm for repealing the adjustment to basis. It is likely to remain with us. Keep in mind that as estate tax exemptions increase, the income tax basis adjustments will assume ever more significance for planning purposes.

This article is not intended as advice for anybody to do anything or not to do something. Of course, this is not a complete coverage of the extraordinarily complex world of estate and gift tax and its relationship with income tax. This is our effort to share what we see in the ebb and flow of tax trends that cross our desks every day. You may want to discuss how these changes might affect you. Or you may otherwise wonder if your existing estate plan is still a good fit for you and your circumstances. We would be happy to meet with you to discuss these matters or any aspect of your estate planning.