

OVERVIEW OF CURRENT ESTATE TAX LAW

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Federal tax law imposes an estate tax on property held at death, including property over which the decedent held certain powers. There are various deductions, exemptions and credits applied against the estate tax, so that estate tax is not due at every person's death. In some states, state estate tax may be imposed in addition to federal estate tax, or may be due even when no federal estate tax is due (this is not currently the case in Colorado).

The federal estate tax was significantly changed in 2001 by The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). EGTRRA repeals the estate and generation-skipping transfer ("GST") tax in 2010. The gift tax will not be repealed and the gift tax exemption has been frozen at \$1 million. The current stepped-up basis rules will be repealed in 2010, replaced with limited step-up and carryover basis. Perhaps its most unusual aspect is that the entire Act will sunset on December 31, 2010 and the federal estate, gift and GST taxes as they existed just prior to EGTRRA will return. EGTRRA has also prompted many states to changes their estate tax systems.

The following is a very brief summary of the most significant aspects of EGTRRA relating to carryover basis rules, and the estate, gift and GST tax.

I. CHANGES TO THE ESTATE, GIFT AND GST TAXES.

No federal estate tax is due if the decedent's estate does not exceed the estate tax exemption amount reduced by the amount of gift tax exemption used during life. This was the law before EGTRRA. EGTRRA increased the estate, GST and gift tax exemptions and lowered the top estate tax rate.

Year	Top Estate Tax Rate	Estate Tax Exemption	GST Exemption	Gift Tax Exemption
2001	55%	\$675,000	\$1,060,000	\$675,000
2002	50%	\$1 million	\$1,110,000	\$1 million
2003	49%	\$1 million	\$1,120,000	\$1 million
2004	48%	\$1.5 million	\$1.5 million	\$1 million
2005	47%	\$1.5 million	\$1.5 million	\$1 million
2006	46%	\$2 million	\$2 million	\$1 million
2007	45%	\$2 million	\$2 million	\$1 million
2008	45%	\$2 million	\$2 million	\$1 million
2009	45%	\$3.5 million	\$3.5 million	\$1 million
2010	repealed	N/A	N/A	\$1 million
2011	55%	\$1 million	\$1,200,000+	\$1 million

II. CARRYOVER BASIS.

A. CURRENT RULE (UNLIMITED STEP-UP). The current rule is that all qualifying property of a decedent receives a new (stepped-up) basis equal to the fair market value of the property on the date of decedent's death. Basis is used in determining capital gain when an asset is sold.

B. NEW RULE (CARRYOVER BASIS). For decedents dying in 2010, unlimited step-up will not be available. A decedent's property will be permitted a \$1.3 million step-up in basis, with an additional \$3 million step-up in the case of property passing to a surviving spouse or a qualifying trust for the spouse.

III. CHANGE TO STATE ESTATE AND INHERITANCE TAXES.

A. STATE DEATH TAX CREDIT. As of 2005, the state death tax credit previously granted by the federal system has been completely repealed and replaced with a deduction. As of 2001, most states, including Colorado, had a "pick-up tax" tied to the federal state death tax credit. The state death tax credit, in effect, gave a portion of the federal estate tax payable by a decedent's estate to the state. The total estate tax paid by the estate was not greater than would have been due if the state had no estate tax.

B. STATES THAT HAVE RETAINED A PICK-UP TAX. Some states, such as Colorado, have retained a pick-up tax tied to the federal state death tax credit and have not changed their estate tax laws to "decouple" from the federal estate tax. Therefore, Colorado and other states that have not decoupled effectively have no state estate tax (and no state estate tax return must be filed in Colorado and similar states). Other states that have not decoupled include Alabama, Alaska, Arizona, Arkansas, California, Delaware, Florida, Georgia, Hawaii, Idaho, Louisiana, Michigan, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Dakota, South Carolina, South Dakota, Texas, Utah, West Virginia and Wyoming.

C. STATES THAT HAVE DECOUPLED. States may impose a state estate or inheritance tax on the estates of decedents who either 1) reside in the state at death, or 2) own property in the state at death. Some states that had a pick-up tax before EGTRRA have decoupled from the federal estate tax system. In decoupled states, state estate tax may be due in addition to federal estate tax. Also, state tax may be due even if no federal estate tax is due. The estate tax systems of these decoupled states take three different forms:

1. INHERITANCE TAX. An inheritance tax uses varying tax rates depending upon the relationship of the beneficiary to the decedent. There is a zero tax rate on transfers to a spouse. Transfers to a trust for a spouse may or may not qualify for the zero tax rate. In some states, the zero tax rate also applies to certain relatives. States with an inheritance tax are Indiana, Iowa, Kansas, Kentucky, Maryland, Nebraska, New Jersey and Pennsylvania.

2. STAND-ALONE ESTATE TAX. A stand-alone estate tax means an estate tax (as opposed to an inheritance tax) that is not based on the state death tax credit. These states grant a state estate tax exemption. If the decedent's estate is less than the exemption amount, no state estate tax is due. In some of these states, the exemption amount is \$1,000,000, while in others it is \$2,000,000. There are other differences in how the estate tax of these states works. States with a stand-alone estate tax include Connecticut, Nebraska, Ohio, Oklahoma, Tennessee and Washington.

3. DECOUPLED PICK-UP TAX. A decoupled pick-up tax is a state estate tax based on the state death tax credit that was in effect just prior to EGTRRA. These states vary in whether they recognize the estate tax exemption amount as it has increased under EGTRRA (\$2,000,000 in 2006), or whether they only grant a lesser amount of estate tax exemption (\$675,000 or \$1,000,000). There are other differences in how the estate tax of these states works. Some of the states with a decoupled pick-up tax are Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, North Carolina, Oregon, Rhode Island, Vermont, Virginia and Wisconsin.

IV. EFFECT OF EGTRRA

A. ESTATES SUBJECT TO FEDERAL ESTATE TAX ARE DECREASING. As the estate tax exemption amount increases, the number of estates subject to federal estate tax are decreasing. Some figures on the number of decedents' estates that will pay federal estate tax as a percentage of all U.S. deaths is as follows:

<u>Year</u>	<u>Exemption Amount</u>	<u>Estates Owing Estate Tax</u>
2000	\$675,000	2.2%
2003	\$1 million	1.3%
2006 (projected)	\$2 million	.5%
2009 (projected)	\$3.5 million	.3%

B. EFFECT OF CHANGES TO THE STATE ESTATE TAXES. Prior to EGTRRA, the federal estate tax and the state estate tax (for most states) were one unified system. If a decedent's estate was not taxable under the federal system, it was not taxable by the state (assuming the state had a pick-up tax). Now there are a range of different state estate tax systems. Since the state exemption amount is not necessarily the same as the federal exemption amount, state estate tax may be due even if federal estate tax is not due.

C. IMPLICATIONS FOR ESTATE PLANNING. Estate planning is more complicated than it was before the passage of EGTRRA. Estate plans that incorporate estate tax planning should anticipate the increasing exemption amount, carryover basis and sunset of EGTRRA (at which time the estate tax exemption amount will drop back to \$1,000,000 and, therefore, estates that are not currently taxable may be taxable). Also, individuals residing in or owning property in a state with state estate tax should have estate plans that take those tax laws into account.

V. FUTURE OF THE ESTATE TAX

The future of the federal estate tax is a topic for discussion during nearly every legislative session. The fate of the federal estate tax could take one of the following forms, or a different form entirely:

A. NO CHANGE TO THE LAW. By choice or by failure to reach a political compromise, Congress could leave the tax laws under EGTRRA in place. As a result, the estate tax would be repealed for one year (2010), during which time carryover basis would take its place. The estate tax laws as they existed before EGTRRA would be revived in 2011.

B. MAKE REPEAL OF THE ESTATE TAX PERMANENT. Congress could make repeal of the estate tax permanent. The estate tax would be repealed in 2010 and replaced with carryover basis, and that tax regime would continue beyond 2010.

C. REPEAL THE REPEAL. Congress could prevent the scheduled repeal of the estate tax. The estate tax laws as they apply in 2006 could remain in place. There are several different variations that have been proposed under the option of repealing the repeal, including the following:

- Increase the exemption amount. An increase may be phased in so that the exemption amount increases incrementally every few years until reaching a certain amount (*e.g.* \$5,000,000), at which time it could be indexed for inflation.
- Make the estate tax exemption portable between spouses, so that the surviving spouse can utilize the unused exemption amount of the deceased spouse.
- Decrease the estate tax rates.
- Reinstate the state death tax credit or, alternatively, make repeal of the credit permanent.

Sources

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