

## THE STATE OF THE ESTATE TAX: WHAT WE KNOW AND WHAT WE DON'T KNOW

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TOPIC: Taxation, Federal Law and the Impact on Personal Tax & Estate Planning

### Where Do Matters Stand?

Let's begin with some perspective. We are about to witness the greatest intergenerational shift of wealth in history. At the same time, we are witnessing the biggest federal debt in our nation's history – and it continues to grow. The service on our national debt is the third most costly item in the federal budget, behind defense and Social Security.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), enacted on June 7, 2001, included extensive reductions in the federal estate tax, with a complete repeal in 2010. In other words, while the federal debt mushrooms and the national debt service continues to spiral upwards, Congress enacted legislation to *reduce* federal tax collections.

What's wrong with this picture?

### Looking Ahead & Planning For The Future

The wealth transfer planning process contemplates steps to reduce or eliminate taxes payable at death and gift taxes payable during life in connection with transfers of assets. In 2001, Congress enacted a schedule for increasing the estate tax applicable exclusion amount (the amount of an estate exempt from taxes), and modestly diminishing the maximum estate tax bracket, with a repeal of the federal estate tax in its entirety in the year 2010. However, the planning process for many is complicated because the tax schedule contains a sunset provision: the exemption reverts to \$1,000,000 in 2011, as though the increased exemptions and repeal had never occurred. Moreover, the lifetime exemption from the federal gift tax remains fixed at \$1,000,000. It has been clear to the estate planning community that the only certainty inherent in the legislation was that Congress would need to revisit the entire estate tax question sometime before 2011.

If you are among those for whom planning (to avoid transfer tax losses) is important, take heed. The biggest adversary you may face is complacency, if you abandon planning in the belief repeal is a *fait accompli*.

### States Are The First To Pay In 2005: What Does That Do To Tax Collections?

To pay for the anticipated decrease in federal estate tax revenues, the tradeoff was to phase out the credit for state death taxes at the end of 2004, and to limit the step-up in income tax basis enjoyed by all estates, regardless of whether the estate is subject to estate tax. In the last several years, many states that formerly had an estate tax equal to the amount of the federal credit for state death taxes realized that, beginning in 2005, there would be no state estate tax revenue as a result of the elimination of the state death tax credit. Confronted by this threat, about one-third of the states have taken various actions to shore up their own estate-tax systems, including separating (or "decoupling") from the federal estate-tax system, according to Bruno Graziano of CCH Inc. Those decoupled states are: Connecticut, Illinois, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Vermont, Virginia, Washington, Wisconsin and the District of Columbia. As more revenue-hungry states discover the impact starting in 2005, expect more to follow suit.

*In light of the recent changes, tax advisers say it is increasingly important for clients to review their estate plans and update their wills -- and possibly even consider moving to another state. "Florida is particularly attractive" because it doesn't have either a state income tax or estate tax, says Don Weigandt, a managing director of J.P. Morgan Private Bank in Los Angeles, a unit of J.P. Morgan Chase & Co.*

*Figuring out how big your state estate tax might be is surprisingly complex, especially for people who own homes in different states, says Martin Nissenbaum of Ernst & Young in New York. "Where you actually are when you die isn't relevant," he says. "It's where you're domiciled and where your property is located. Even if you're legally domiciled in one state, your estate may be subject to tax in another state depending on where your assets physically are located."*

In the meantime, there has been an ongoing public discussion about the wisdom and value of having a federal estate tax, against a backdrop of increased federal budget deficits and an economy that has not been as vigorous as it was when the estate tax was last revised. President Bush formed a committee to study the estate tax and make recommendations. Congress has now focused on the matter in earnest. The House of Representatives has passed one bill repealing the estate tax in its entirety, beginning in 2010. There are proposals for compromise which include increased exemptions of \$3,500,000 to \$5,000,000, and perhaps lower marginal tax rates than the current 46 percent. As in the past, there will likely be a number of bills introduced and voted upon before a final decision on the federal estate tax is reached. One encouraging sign is the statement by Rep. William Thomas (R-Calif.), the chairman of the House Ways and Means Committee, who said that certainty in the area of the estate tax was needed, if repeal was not possible.

Those favoring estate tax repeal believe that it is an unfair and unnecessary tax that impacts family businesses and farms disproportionately, and subjects assets to "double tax" since the assets were likely subject to income tax during the taxpayer's life.

Those who favor retention of an estate tax (including some of the nation's wealthiest individuals) believe that the estate tax affects only two percent of the population, and is therefore not unfair; that elimination of the tax will have a cost conservatively estimated at \$290 billion dollars over the next 10 years, and that compromises will be made that may affect many more taxpayers than does the estate tax. For example, if carryover basis were eliminated, the beneficiaries of an estate would pay capital gains tax when inherited real estate or stock is sold based on the deceased's basis, rather than the value at the deceased's death (stepped-up basis). And, so far there has been no discussion about whether the current \$1,000,000 lifetime exemption from the gift tax would be affected by any legislation. While it is premature to speculate what will ultimately be decided, it is clear that many taxpayers are likely to be affected.

With that said, we are planning as usual for clients. Many estate planning professionals assume that there will be some sort of tax, if not now, at some point in the future. As a result, flexible planning is often recommended to accommodate changes not only in the tax structure but in families and their financial situations as well.

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