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Income Tax Changes, Estate Tax Changes And Implications for Charitable Giving Of the Economic Growth and Tax Relief Reconciliation Act of 2001

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The new tax law that was enacted June 7, 2001 changes several aspects of individual income taxation, including lowering the rates and largely eliminating the marriage penalty. The new law also phases in substantial changes to the federal estate, gift and generation-skipping transfer taxes, that ultimately result in repeal of the estate and generation-skipping transfer taxes in 2010. Individuals with potentially taxable estates and charities that depend on tax incentives to help drive fundraising have taken a keen interest in what these changes may mean for them. Descriptions in the press and the huge price tag of the package suggest that the changes are sweeping and profound. However, for two key reasons, the changes made by this law will have a very limited effect on individuals doing estate planning and charities seeking contributions. Here are those two reasons.

- ***Everything Sunsets*** As enacted, all of the changes made by this law sunset after December 31, 2010. As of January 1, 2011, the tax law will revert to where it was before this new legislation was enacted. Individual income tax rates will increase from the 10%-35% spread that the new law will put in place to the 15%-39.6% spread that existed before enactment. The estate tax and the generation-skipping transfer tax will go back into effect, and the unified credit will provide an exclusion from tax for estates of up to $1 million, as pre-enactment law would have provided. The temporary nature of these changes and the length of the time line for their implementation makes all of the changes highly unstable. Therefore, most individuals will not want to make any substantial changes in their tax and estate planning in reliance on these changes actually occurring as currently scheduled. It is reasonable to expect Congress to revisit these changes and their effective dates within the next several years.

- ***Charitable Deductions Remain Unchanged*** With the exception of two small favorable changes affecting the rules for conservation easements, no changes were made to the rules for the charitable contribution deduction under the income tax, the estate tax or the gift tax. The tax incentives for making a charitable contribution during life or at death remain largely unchanged except in 2010 when the estate tax is repealed. Until more definitive action is taken on the future of the estate tax and

> the income tax rate cuts, there is little reason for charities to be concerned about a diminished tax incentive for charitable giving.

Below, we present a summary of the income tax rate changes and the estate and gift tax changes, and we describe their implications for estate planning and charitable giving.

Income Tax Rate Changes

Rate changes are relevant to charitable giving because they affect the "price" of a charitable gift and the amount of after-tax income available for charitable giving. Under the new law, the rates are lowered over a five-year span. The following table summarizes the rate changes.

	Federal Income Tax Rate Brackets					
Prior to July 1, 2001	N/A	15%	28%	31%	36%	39.6%
July 1, 2001 – 2003	10%	15%	27%	30%	35%	38.6%
2004-2005	10%	15%	26%	29%	34%	37.6%
2006-2010	10%	15%	25%	28%	33%	35%

In addition, beginning in 2005, the end point of the 15% bracket is increased for married taxpayers filing jointly to provide relief from the marriage penalty. From 2008 through 2010, the 15% bracket for joint filers will be twice as large as the 15% bracket for singles.

Repeal of Limitation on Itemized Deductions and Personal Exemptions

The new law phases out the limitation on itemized deductions. The limitation requires all taxpayers with adjusted gross income over a certain point ($132,950 for 2001) to reduce the deductions they may claim, including their charitable contribution deductions, by a specified amount. The reduction is the lesser of 3% of adjusted gross income in excess of the threshold point or 80% of itemized deductions. Similarly the new law phases out the limitation on the use of personal exemptions by high income taxpayers. This limitation requires all taxpayers with adjusted gross income over a certain point ($132,950 for single taxpayers and $199,450 for married taxpayers filing jointly for 2001) to reduce the personal exemptions they may claim for themselves and their dependents by a specified amount. As a result of this limitation, very high income taxpayers lose their personal exemptions altogether, giving them higher effective tax rates. The new law phases out both of these limitations between 2006 and 2009 by letting taxpayers keep a larger proportion of their itemized deductions and personal exemptions each year. The limitations are repealed for 2010.

Estate and Gift Tax

The new law makes a number of incremental changes to the taxes that apply to gratuitous transfers: the estate tax, the gift tax and the generation-skipping transfer tax. The changes lower the overall liability for transfer taxes by lowering the rates and increasing the unified credit until 2010 when the estate tax and the generation-skipping transfer tax are repealed for individuals who die (or make generation-skipping transfers) in that year. The taxes are reinstated for 2011 and years thereafter at the rates and with the unified credit amount that were in place before the new law was enacted. The gift tax is retained for all years. Here is more detail on some of the specific changes.

Unified Credit The new law increases the unified credit that taxpayers may use to offset estate and gift tax. Each individual gets a credit that is applied against the tax on his or her cumulative transfers made during life and at death. Before the new law was enacted, the unified credit exemption equivalent was already set to increase in a series of steps from $675,000 in 2001 to $1 million in 2006. The new law accelerates those increases. The unified credit for gift tax purposes increases in 2002 to a level that offsets tax on cumulative gifts of up to $1 million. It remains at that level through 2010. The unified credit for estate tax purposes increases as well. The exemption equivalent at death for each year, from which any amount used during life must be subtracted, is as follows:

Year in which Decedent Dies	**Unified Credit Exemption Equivalents for Estate Tax Purposes**
2002-2003	$1 million
2004-2005	$1.5 million
2006-2008	$2 million
2009	$3.5 million

Rate Changes At present, the estate, gift, and generation-skipping transfer taxes are calculated using a system of graduated rates that run from 18% to 55%. (The unified credit generally eliminates tax imposed at rates lower than 37%.) The new law reduces the top rate each year from 2002 through 2007. The graduated rates below each year's top rate remain in effect, and the rate brackets remain unchanged. However, because the unified credit is increasing as the top rate is falling, the applicable estate and gift tax rates gradually become flat. The generation-skipping transfer tax continues to be imposed at a flat rate equal to the highest estate tax rate, as under present law. The top rate and effective range (after application of the unified credit) for each year is as follows:

Year	**Top Estate, Gift, and GSTT Rate**	**Range of Effective Estate & Gift Tax Rates**
2002	50%	41%-50%
2003	49%	41%-49%
2004	48%	45%-48%
2005	47%	45%-47%
2006	46%	Flat 46%
2007	45%	Flat 45%
2008	45%	Flat 45%
2009	45%	Flat 45%

Phase-out of the State Death Tax Credit At present, an estate may claim a credit against the federal estate tax for state-level death taxes of up to a certain amount. Most states impose soak-up taxes that allow them to collect the maximum revenue possible without increasing the estate's net tax bill. The new law phases out the state death tax credit by reducing the amount of state death taxes that can be credited against the federal estate tax in 2002, 2003, and 2004. In 2005 and thereafter, the state death tax credit is repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia.

Generation-Skipping Transfer Tax The new law includes a package of amendments to the generation-skipping transfer tax effective retroactively to the beginning of this year (2001). In general, these changes are intended to increase the circumstances under which an automatic allocation of GST exemption will be made in order to decrease the errors made in failing to allocate exemption. The package also includes authority for the IRS to give relief for errors in allocation of exemption where there is evidence that the tax return was not filled out as intended. The IRS may also grant relief were there was substantial compliance with the rules regarding the allocation of exemption.

Basis Rules For 2001-2009, the new law preserves the rule that steps up (or down) basis in an asset transferred at death to its fair market value at the owner's date of death. For 2010, the one year in which the estate tax is repealed, the step-up in basis is eliminated, and assets transferred at death generally take a carryover basis (but not in excess of fair market value on the date of death). Executors are given the authority to allocate $1.3 million worth of increased basis (plus additional basis to compensate for lost loss carryforwards and built-in losses) to certain assets passing from the decedent, and an additional $3 million worth of increased basis to assets transferred to a surviving spouse, subject to certain rules. Additional basis can only be added to certain assets passing from the decedent which were owned by the decedent at the time of death. In no event can the additional basis be allocated such that an asset has basis in excess of its fair market value. Like the other estate and gift provisions, these changes sunset in 2011; thus the current step-up in basis for all assets transferred at death is reinstated in 2011.

Gift Tax During 2010, when the estate and generation-skipping taxes are repealed, the gift tax continues in existence. The unified credit will continue to exempt lifetime transfers of up to $1,000,000. The top gift tax rate will be 35%. The annual exclusion (generally $10,000 per donee), as well as the exclusion for payment of medical and educational expenses, continues to apply, as do the deductions for charitable and marital gifts.

Treatment of Nonresident Aliens The new law contains a number of special provisions affecting non-resident alien decedents. First, after repeal of the estate tax in 2010, a non-resident decedent gets only $60,000 of additional basis to allocate to U.S. property, as opposed to the $1.3 million of basis available to estates of U.S. citizens or residents. A non-resident alien's estate does get the benefit of the full $3 million of additional basis for spousal property, regardless of the citizenship or residency of the surviving spouse. Second, if a qualified domestic trust (QDOT) is established upon the death of one spouse before 2010, withdrawals by the non-citizen spouse from the QDOT during life will continue to be subject to the deferred estate tax. Third, under the new law, in 2010, a transfer of assets from a U.S. person's estate to a nonresident who is not a U.S. citizen is treated as a sale or exchange of the assets for their fair market value. The estate must recognize gain to the extent the fair market value exceeds the decedent's basis in the assets that are transferred. Until 2010, and in 2011 and years thereafter, gain will be recognized if a U.S. person transfers assets to a foreign trust or estate, but not if the U.S. person transfers assets to a nonresident who is not a U.S. citizen. Finally, the new law doesn't fit well with the estate and gift tax treaties in effect today. Thus, it may be necessary to renegotiate some or all of the estate tax treaties when and if repeal occurs.

Conservation Easements

Under prior law, a portion of the value of land that is subject to a conservation easement is excluded from the landowner's estate if the easement is worth more than 10% of the value of the land at the time of the property owner's death, and the easement meets certain requirements. The new law, which is effective for decedents dying this year, changes the relevant date for evaluating the reduction in value caused by the easement from the date of death to the date the easement was granted. The new law also eases the requirement that the land has to be within a specified number of miles of a metropolitan area, a wilderness area, a national park, or an urban forest, by lifting these geographic restrictions and making the estate tax benefits of a qualified conservation easement available for any real property in the United States or its possessions. The changes do not affect the requirements for claiming a charitable contribution deduction for a conservation easement for income tax purposes.

What are the implications for estate planning?

- Planning is difficult when the law is changing and its future is uncertain. Not only is the law scheduled to change nearly every year between now and 2011, but there is additional uncertainty over whether and when Congress will make additional changes to the law. See What is likely to happen to this law?, below.

- Every individual with a net worth in excess of one million dollars would be well advised to review his or her current estate plan in light of the 2001 Act changes. Specifically, do the asset allocations dictated by formula clauses continue to make sense in light of increases in the unified credit, rate reductions and the possibility of repeal? Does the will or revocable trust rely on provisions that are set to be eliminated (such as the state death tax credit or the qualified family owned business interest deduction)? With respect to married clients, are the assets allocated between the spouses in a manner that will allow maximum utilization of the available credits? Does the plan continue to meet the client's non-tax objectives?

- Flexibility in drafting is essential. While it might be nice to prepare a will that deals with every conceivable contingency, this most likely is not possible. Estate planning must take into account possible changes in law, as well as the potential for any client to become incompetent to react to future unforeseen changes. No single approach is appropriate for every client. Rather, the plan must take into account the client's age, health, marital status and level of wealth, among other considerations.

- Continue lifetime giving programs, but be wary of paying any gift tax unless the client is very unlikely to live until 2010.

- Review the living will with the client. Make sure that the client has adequately articulated his or her wishes so that an heir, who may be conflicted between personal and financial interests, is not faced with making an unguided decision whether to continue or terminate life support.

- Detailed planning for carryover basis is going to be premature in most cases, but begin recordkeeping that would aid in the proof of basis.

- Planning will likely be different for clients who do not expect to survive long enough to see the law revised and changes made permanent.

What are the implications for charitable giving?

Charitable giving should not be substantially affected by this new law because donors will still have all of the following motivations propelling them to give.

- Income tax rates remain high, which keeps the price of giving comparatively low. To the extent the rate changes do offer significant tax savings to higher income taxpayers in terms of absolute dollars, they also give those taxpayers more after-tax income that is available for charitable gifts.

- The estate tax remains in place for all but one year. The long time horizon leading up to repeal followed by the almost immediate sunset makes the new law highly unstable and likely to change. Although some donors may wait to make estate plans until they see how the law develops, others who feel they cannot wait due to age or health status will proceed on the assumption that a charitable bequest is still likely to provide an important estate tax benefit. Those who have already written wills that include charitable bequests are unlikely to change their plans until the future of the estate tax becomes more certain.

- Irrespective of whether the estate tax is repealed, charitable remainder trusts continue to allow donors a desirable way to diversify their highly appreciated assets while deferring tax.

- Repeal of the limitation on itemized deductions will enhance the tax benefits of charitable giving for high income taxpayers. The Joint Committee on Taxation recommended repeal of the limitation in their recent simplification study, and inclusion of this item in the new law shows that Congress would like to get this done. However, it can have a real effect on charitable giving only if the timeline for implementation is accelerated, and the repeal is made permanent.

- Many donors want to support the charity, irrespective of the tax benefits. The roughly 70% of taxpayers who are nonitemizers still give, in the aggregate, substantial sums to charity. Many itemizers can be expected to feel the same way.

What is likely to happen to this law?

The long implementation period combined with the single year of repeal for the estate tax makes the current law highly unstable. Exactly how the instability will be resolved will depend on multiple factors, including the outcome of the 2002 and 2004 elections and the availability of budget surpluses to cover the cost of changes. At this point, it seems reasonable to predict that Congress will have two primary options to consider.

- Freeze the Reforms. After a few years of lowering the top marginal rate and increasing the unified credit, Congress could stop any further changes and make that year's law permanent. This approach would preserve the step-up in basis at death and eliminate the administrative complexity associated with the transition to carryover basis. It would also preserve revenue while exempting all but the very richest taxpayers from having to pay transfer taxes or engage in tax driven estate planning.

- Make Repeal Permanent. Congress could enact another bill making the 2001 Act provisions permanent. Repeal could be accelerated, or left to be effective in 2010. As the baby boom generation ages, permanent repeal becomes more expensive with each passing year. Because Congress takes into account revenue effects of legislation only within a 10-year period, the sooner Congress acts to make these provisions permanent the less revenue loss it would need to offset. However, no matter when such legislation is considered, it will be costly. Furthermore, all of the other provisions of the 2001 Act are also scheduled to sunset at the end of 2010. There is no reason to believe that Congress would find the need to make estate tax repeal permanent more urgent than the desire to extend other provisions of the Act, such as marriage penalty relief, lower income tax rates and alternative minimum tax relief. In addition, passage of a bill making the 2001 Act provisions permanent would require the support (or at least the cooperation) of 60 members in order to pass in the Senate.