

# The Increasing Estate and Gift Tax Exemption and the Increased Annual Exclusion: Opportunities and Pitfalls

In June 2001, after extensive debate and partisan rancor, Congress passed and the President signed a tax bill which made extensive changes to the Estate and Gift Tax laws. As of January 1, 2002, the exemption from Estate and/or Gift taxes rose to \$1 million. The exemption from Estate taxes only will increase to \$1.5 million as of January 1, 2004, to \$2 million as of January 1, 2006 and to \$3.5 million as of January 1, 2009. As of January 1, 2010, the estate tax is repealed altogether, but the tax is reinstated as of January 1, 2011 with an exemption of only \$1 million. In addition, changes to the gift tax laws have become effective in 2002 as well.

The changes to the law provide a number of opportunities as well as pitfalls that all taxpayers should be aware of.

## Opportunities:

1. **Increased Annual Exclusion:** The annual exclusion from gift taxes has increased from \$10,000 per donee to \$11,000 per donee. Thus, any individual can reduce the taxable size of his or her estate by making \$11,000 gifts each year to as many individuals as he or she wishes. There are no negative tax consequences to these gifts. They do not generate the payment of any gift tax and they do not create the need to file a gift tax return. (Gifts larger than \$11,000 per year per donee will create the need to file a gift tax return. Whether or not gift tax will be payable will depend upon the amount of the prior taxable gifts above and beyond the annual exclusion amount). The increased annual exclusion allows individuals more flexibility in reducing the size of their taxable estates.
2. **Increased gift tax exemption:** The increase of the gift tax exemption from \$675,000 to \$1 million means that larger gifts can be made without having to pay any gift tax. This advantage can be particularly useful if discounted values can be obtained on the property transferred. (Such discounts could be obtained by transferring a home to a Qualified Personal Residence Trust or transferring various assets to a Family Limited Partnership which, if properly structured, could qualify for discounts.) Individuals who had previously fully

utilized their exemption now have an additional \$325,000 available. Thus, individuals now have increased flexibility in reducing the size of their taxable estates.

### 3. Increased Estate Tax Exemption:

Because of the increase in the Estate Tax Exemption, many estates will now be freed of the necessity to engage in gifting or other tax related strategies because they will no longer fall within the estate tax threshold. This may allow individuals to refrain from engaging in planning that they would not otherwise have done if not for tax considerations. Obviously, the increased exemption will also reduce the estate tax burden on estates that are taxable.

## Pitfalls:

1. **Formula Clauses in Old Wills:** Many individuals have executed wills or trusts that define bequests to children or to trusts based upon the amount of the exemption from estate taxes. This has been a very common feature which is contained in a very high percentage of wills of those individuals with taxable estates over the past 20 years. All those wills or trusts must now be revisited because of the increased exemption. Formerly, if an individual had a \$2 million estate, he or she may have felt completely comfortable leaving \$600,000 - \$700,000 to his or her children and the balance to his or her spouse. However, as the exemption increases, this type of formula clause in a Will will have the effect of leaving much more to the children and ultimately potentially disinheriting the spouse. It is unlikely that this effect was intended or is desired. Therefore, clients need to have their planning reviewed and may need to make changes depending upon the level of their assets, the current state of the law and the current state of their health. Possible solutions to this problem include capping the bequest to the children, using disclaimer wills which leave the option up to the survivor whether or not to engage in tax planning, or rearranging assets between spouses.
2. **Do Not Assume Repeal:** The estate tax has not necessarily been repealed. In fact, even under the law as it presently exists,

although the estate tax will cease to exist in 2010, it will come back again for all individuals dying in 2011 and thereafter. Few tax experts expect that repeal will ever become effective, and even fewer believe that the law will be changed to make repeal permanent. Thus, clients are strongly urged not to complete their planning or ignore their planning based upon the assumption that there will be no estate tax. In fact, many believe that a likely compromise will be to allow some, but not necessarily all, of the increased exemption jumps to take effect in return for eliminating repeal and also eliminating the current provisions in the law wherein the exemption goes back down to the \$1 million plateau that it currently occupies. It is also worth noting that, under any circumstances, the estate tax is in effect through at least 2010 and many individuals will pass away before that time.

3. **Deunification of the former unified credit.** Under the prior law, the estate and gift tax exemption had for many years been identical. Under the new law the gift tax exemption is frozen at \$1 million, even though the estate tax exemption will increase. Thus, clients who may have wanted to shift assets to their children in order to reduce the income tax burden may be prevented from doing so, because of the potential of a gift tax burden. In any case, transfers should not be made without taking this issue into consideration.