Tax Relief Act—2001, and Jobs and Growth Tax Act—2003: An Overview

The law signed on June 7, 2001, by President George W. Bush—the Economic Growth and Tax Relief Reconciliation Act of 2001 (Tax Relief Act–2001)—remains the largest tax cut in over twenty years and delivered tax savings to nearly every American taxpayer.

The Tax Relief Act–2001 was wide sweeping and provided tax relief in four main areas:

- *Retirement plans.* Tax Relief Act–2001 increased the allowed contributions to most types of retirement plans. These increases are phased in over several years and are then indexed for future years. There is even a catch-up provision for those over the age of 50.
- *Marginal tax rates reduced.* A new 10 percent marginal tax bracket replaced a portion of the 15 percent bracket. All brackets are reduced on a phase-in basis between now and 2006.
- *Education funding incentives.* Withdrawals from qualified tuition plans are now tax-free and the rules for transferring between plans were relaxed.
- *Estate, gift, and generation-skipping transfers.* The limits on tax-free transfers to heirs are increased over a period of years leading up to estate tax repeal on January 1, 2010. During this phase-in period, tax rates are also reduced.

Unfortunately, the Tax Relief Act–2001 has a sunset provision, which means that unless Congress extends this tax law, or makes it permanent, it will revert back to the old law on January 1, 2011.

Subsequent to the Tax Relief Act–2001, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Jobs and Growth Act–2003). The Jobs and Growth Act–2003 did not change many of the provisions of the Tax Relief Act–2001; however, the 2003 Act accelerated many of the income tax provisions. The Jobs and Growth Act–2003 did not affect the Estate, Gift, and Generation-Skipping Tax provisions of the Tax Relief Act–2001.

Let's examine each of these areas in more detail.

Retirement Savings and Pension Reform

Tax Relief Act–2001 provided for significant increases in contribution limits to various types of retirement plans.

Traditional Individual Retirement Accounts and Roth Individual Retirement Accounts

Under the prior law, annual contributions to Traditional IRAs (individual retirement accounts) and Roth IRAs were limited to $2,000. Now, qualifying taxpayers will eventually be able to deduct $5,000 or more annually for Traditional IRAs. If you are age 50 or older, the law provides for a catch-up provision, allowing additional contributions of up to $1,000 per year. The purpose of the catch-up provision is to allow individuals to make up for missed retirement savings opportunities earlier in life. Table 1.1 illustrates how the contribution limits are phased in.

Unfortunately, the old rules concerning income-based eligibility still apply to both the Traditional IRA and the Roth IRA. For a refresher on these rules, review Table 1.2. Also, don't forget that alimony is considered earned income for the purpose of eligibility for contributions to both the Traditional IRA and the Roth IRA.

TABLE 1.1 Increasing Traditional IRA and Roth IRA Contribution Limits

Year	Maximum Contribution under Age 50	Year	Additional Contribution under Catch-up Provision[1]
2005–2007	$4,000	2006 and after	$1,000
2008	$5,000		
2009	Indexed (possibly $5,150)		

[1]For eligible individuals age 50 and older.

TABLE 1.2 Adjusted Gross Income (AGI) Limitations for Deductible Contributions for 2005

	Traditional IRA	Roth IRA
Single[1]	$50,000–$60,000	$95,000–$110,000
Head of Household[1]	$50,000–$60,000	$95,000–$110,000
Married-Filing Separately	$0–$10,000	$0–$10,000
Married-Filing Jointly[1]	$70,000–$80,000	$150,000–$160,000
Non-working Spouse[2]	$150,000–$160,000	$150,000–$160,000

[1]The AGI limits will gradually increase until 2007, when the phase-out is $80,000–$100,000.
[2]This AGI phase-out of deductibility limitations apply to nonworking spouses whose working spouse is an active participant in an employer-sponsored retirement plan.

Employer-Provided Retirement Plans

The Tax Relief Act–2001 also provides significant expansion of allowable contributions and rules to employer provided retirement plans. The types of plans covered include: 401(k), 403(b), SIMPLE (Savings Incentive Match Plan for Employees), and 457 plans. As with the IRAs, Congress has seen fit to substantially increase the allowable contributions to these qualified plans. These increases are phased in over a number of years. Table 1.3 provides a summary of the contribution limitations.

If you are age 50 or older you have an opportunity to contribute even more to these plans based on catch-up provisions. Table 1.4 illustrates your maximum contribution limits.

Beginning with calendar year 2003, eligible retirement plans began to offer employees the ability to make voluntary contributions into a separate account for their Traditional IRA and Roth IRA. We expect this to remain a popular feature, but a word of caution is in order. The primary advantage of this feature is that your contributions are made through payroll deduction. The disadvantage is that you will likely be limited to the investment choices currently available through your plan. Contrast

TABLE 1.3 Contribution Limitations for Certain Contributory Retirement Plans

Year	401(k); 403(b) Plans	SIMPLE Plans	457 Plans
2005	$14,000	$10,000	$14,000
2006	$15,000	Indexed	$15,000
2007	Indexed ($15,450 est.)		Indexed

TABLE 1.4 **The "Catch-up" Provisions: Retirement Plan Contribution Limits for Plan Participants Age 50 and Older**

Year	401(k); 403(b); 457(b) Plans	SIMPLE Plans
2005	$18,000	$12,000
2006	$20,000	$12,500
2007	Indexed[1]	Indexed[1]

[1]Indexing is based on allowable contributions excluding any catch-up contributions. See Table 1.3.

this with your ability to open your IRA, for example, through a discount broker such as Charles Schwab and Company where you would have access to over 5,000 mutual funds as well as individual stocks, bonds, and so forth. Generally, the better choice will be to maintain control of your IRA outside of your company's retirement plan.

The Tax Relief Act–2001 provides additional incentives for low-income taxpayers to contribute to their retirement plan [401(k), 403(b), 457(b), Traditional IRA, or Roth IRA] by providing tax credits for contributions. This is a temporary program that will be available only for calendar years 2005–2006. For those who are eligible, this is an excellent opportunity to get Uncle Sam to pay a portion of your retirement plan contribution. This credit would be claimed on the individual's tax return. Table 1.5 outlines how the tax credit works.

An interesting option provided under the Tax Relief Act–2001 permits employers to add a feature that allows employees to elect Roth status for all or part of their contributions to their employer's 401(k) or 403(b) plan. This means that your contribution would be includable as income, but future distributions would be tax-free. This option will not become available until 2006.

Under prior law, employer deduction limits for qualified profit sharing plans and stock option plans were restricted to 15 percent of the compensation of the employees covered by the plan. Furthermore, for 401(k) plans, employee elective deferrals were counted towards this 15 percent limitation. Under the Tax Relief Act–2001, the 15 percent limitation was increased to 25 percent beginning in 2002, and elective deferrals under 401(k) plans are no longer subject to the limitation. This is important because many employers have employed a

TABLE 1.5 Tax Credit for Low-Income Taxpayers Contributing to a 401(k), 403(b), 457(b), Traditional IRA, or Roth IRA

	Adjusted Gross Income (AGI)		
Credit %[1]	Single and Married–Filing Separate	Head of Household	Joint
50	up to $15,000	up to $22,500	up to $30,000
20	$15,000–$16,250	$22,500–$24,375	$30,000–$32,500
10	$16,250–$25,000	$24,375–$37,500	$32,500–$50,000

Example: Jim's employment income is $25,000 per year and his wife, Janice, is a stay-at-home mom. They decide to contribute $2,000 to an IRA. Because their adjusted gross income is less than $30,000, they will receive a $1,000 tax credit. This tax credit will offset dollar-for-dollar $1,000 of earned income.

[1]Credit applies to the first $2,000 of contribution.

dual-plan strategy in order to achieve the maximum deferral (25 percent) under prior law. Under this strategy, an employer would adopt a profit sharing plan that allowed the employer, at his or her discretion, to contribute from $0 and up to 15 percent of covered employee compensation. Then the employer would add a money purchase pension plan that *required* the employer to contribute 10 percent of all eligible employee compensation. This provided the employer the option of making maximum contributions (25 percent) when company profitability made this possible or to contribute as little as 10 percent in years when the company needed to reduce expenses. Under the Tax Relief Act–2001, it may be advisable to use a single plan design with a profit sharing plan.

Tip

Employers who are currently using a combination profit sharing plan and/or money purchase pension plan should consider terminating the money purchase pension plan because the Tax Relief Act–2001 allows contributions to profit sharing plans of up to 25 percent of eligible employee compensation. As a result, you will reap two benefits:

1. **You will no longer have the requirement of the *mandatory* money purchase pension plan contributions. You'll have the flexibility of making contributions up to the legal limit (25 percent).**
2. **You will likely reduce your plan administration expenses, particularly if you go from a dual plan to one plan (the profit sharing plan).**

The Tax Relief Act–2001 also raised the ceiling on the total dollar contributions for profit sharing plans, money purchase pension plans, and contributory plans such as the 401(k). Prior law restricted contributions to the lesser of 25 percent of compensation or $35,000 (based on maximum compensation of $170,000 per year). For plan years beginning January 1, 2004, you can contribute the lesser of 100 percent of your compensation or $41,000 (based on maximum compensation of $205,000). For future plan years the $41,000 limit is inflation indexed in $1,000 increments. For 2005, the limit is $42,000.

Marginal Tax Rates

The Tax Relief Act–2001 increased the number of tax brackets from five to six by introducing a 10 percent tax bracket to replace a portion of the current 15 percent bracket. The law then reduced the 28, 31, 36, and 39.6 percent brackets over six years to 25, 28, 33, and 35 percent, respectively. This change began on July 1, 2001. The Jobs and Growth Act–2003 accelerated the declining tax rates. The rates scheduled for 2006 were made effective January 1, 2003. See Table 1.6 for a complete review of the schedule for joint and single tax filers.

Although the Jobs and Growth Act–2003 accelerated the income tax marginal rate reductions, all of the rate reductions are subject to the Tax Relief Act–2001 sunset provision, which will return the rates to 15, 28, 31, 36, and 39.6 percent after 2010.

TABLE 1.6 Schedule of Reduction of Individual Income Tax Rates

Year	$0–$12,000	$12,001–$45,200[1]	$45,201–$109,250	$109,251–$166,500	$166,501–$297,350	$297,351+
Joint Filers						
2004 through 2006	10%	15%	25%	28%	33%	35%
Year	**$0–$6,000**	**$6,001–$27,050**	**$27,051–$65,550**	**$65,551–$136,750**	**$136,751–$297,350**	**$297,351+**
Single Filers						
2004 through 2006	10%	15%	25%	28%	33%	35%

[1]This table does not reflect Marriage Relief provisions of the act that affect the 15% bracket beginning in 2005.

Tip

Use these lower rates as an opportunity to increase your contributions to your company's retirement plan. When it's time to retire, you'll be glad to have the additional money in your account.

Additional provisions will reduce, then repeal the limitation on itemized deductions; provide temporary relief from AMT (alternative minimum tax) taxes; reduce the marriage penalty; and increase the child care credit.

Education Funding Incentives

Saving and paying for educational costs became a lot easier under the Tax Relief Act–2001. The act made significant modifications to both Education IRAs and Section 529 plans. What follows is an overview of both plans. All changes became effective as of January 1, 2002, unless otherwise stated.

Education IRA

Under prior law, you could make a nondeductible contribution of up to $500 per year to an Education IRA. Your earnings grew tax-free and the distributions, when used for qualified educational expenses, were taxed at the student beneficiary's tax bracket. While this Education IRA was beneficial, it was only a partial solution to the problem of funding today's education costs.

With the passage of the Tax Relief Act–2001, Congress took a giant step toward providing real assistance in reducing the costs of education. The most significant provisions included the following:

- Increased the contribution limits from $500 per year to $2,000 per year.
- Provided that distributions, when used to pay for qualified education expenses, would be tax-free.
- Allowed tax-free withdrawals for elementary (including kindergarten) and secondary public, private, and religious school tuition and expenses.
- Included tuition, room and board, tutoring, uniforms, extended day program costs, computer technology hardware and software, Internet access, and special needs services for special needs beneficiary as qualifying expenses.

- Allowed HOPE Scholarship Credit and Lifetime Learning Credit for other expenses.
- Extended the time in which the contribution can be made to April 15 of the following tax year.
- Your ability to contribute to an Education IRA is phased out above certain income levels. The Tax Relief Act–2001 increased the phase-out range for joint filers with adjusted gross income (AGI) of $190,000–$220,000. The phase-out range for single tax filers is AGI of $95,000–$110,000, the same as the prior law.
- Repealed the excise tax when a contribution to an Education IRA is made in the same year as a contribution to a qualified tuition plan for the same beneficiary.

This enhanced Education IRA provided—and still provides—significant incentives to prefund education expenses.

Tip

If you would like to make a contribution to an Education IRA for your child but don't qualify because your AGI is too high, consider having your child contribute to his or her own account. Unlike other IRAs, a person does not have to have earned income to contribute to an Education IRA nor is there a minimum age requirement.

Section 529 Plans

Section 529 plans (also referred to as qualified tuition plans) received a dramatic boost under the Tax Relief Act–2001. Because of the importance of these programs in both funding the costs of higher education and estate planning, they will be covered in detail in this section.

WHAT IS A SECTION 529 PLAN?

A Section 529 plan is a program that allows individuals to: (1) purchase tuition credits or certificates on behalf of a designated beneficiary, entitling the beneficiary to a waiver or payment of the beneficiary's higher education expenses; or (2) make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account.

PLAN CONTRIBUTIONS

A Section 529 plan may only accept contributions in the form of cash and not in property. However, a Section 529 plan may accept payment by check, money order, credit card, or other similar methods.

There are no limits as to the amount of money that can be contributed to a Section 529 plan (unless limited by the plan sponsor); however, there are penalties for distributions not used for qualified education expenses. Most importantly, unlike the Education IRA, there are no income phase-out rules that prevent high-income taxpayers from contributing to a Section 529 plan.

TAX-FREE GROWTH

Earnings in a Section 529 plan grow tax deferred until distributions are made, at which time the distributions are tax-free if used to pay qualified education expenses. For example, suppose you and your spouse contributed $100,000 to a Section 529 plan on behalf of a one-year-old grandchild. This $100,000 would grow tax-free until such time as it is distributed for higher education expenses, presumably beginning at the child's age 18. If your plan sponsor averaged a 9 percent return, the account value would exceed $400,000 by the time you are ready to begin drawing funds for your grandchild's college. When the funds are then used to pay for qualified education expenses, there will be no income taxes due on those distributions. Qualified higher education expenses include tuition, books, supplies, equipment, fees, expenses for special needs services, and room and board (within certain limits). The amount of qualified higher education expenses is reduced by scholarships and amounts paid by the beneficiary or others that qualify for the HOPE Scholarship or Lifetime Learning Credits.

Tip

If you are currently using a Uniform Gift to Minors Account (UGMA) or a Uniform Transfer to Minors Account (UTMA) as a funding vehicle for your child's education, consider the Section 529 plan or an Education IRA instead. By doing so, you'll not only avoid current taxation on earnings (remember the so-called kiddie tax?), but distributions used for education expenses will be tax-free.

PENALTIES ON NONQUALIFIED DISTRIBUTIONS

If distributions from a Section 529 plan are not used for qualified education expenses, a 10 percent penalty is imposed on the recipient of the funds. In addition, the *earnings portion* of the distribution is subject to ordinary income taxes. Usually, the tax will be triggered when distributions exceed the educational expenses of the designated beneficiary. Any funds not distributed prior to the beneficiary attaining the age of 30 will be deemed a nonqualifying distribution (an exception applies for a special needs beneficiary). Exceptions to this penalty apply for payments made due to the beneficiary's death, disability, or receipt of a scholarship.

INVESTMENT OPTIONS

One potential downside of Section 529 plans is that you are unable to direct the investments of the plan. The investment accounts are operated as blind pools where you have no input over specific investment decisions. Most plan sponsors do, however, indicate the general investment approach they use. Often, contributors have the ability to select from a variety of investment strategies, with some Section 529 plans offering as many as 10 options. An important feature added under the Tax Relief Act–2001 is the ability to switch from one state-sponsored program to another every 12 months. This significantly increases your ability to change your broad investment strategy to meet your particular needs.

GIFT TAX CONSEQUENCES

A contribution to a Section 529 plan is considered a completed gift from the account owner to the designated beneficiary at the time of the contribution and is thus eligible for the annual gift tax exclusion (currently $11,000, or $22,000 in the case of a joint gift by spouses). If the contribution exceeds the annual gift tax exclusion, the amount not exceeding five times the current annual exclusion may be applied pro rata to annual exclusions over five years.

For example, you could make an initial contribution of $55,000 for each designated beneficiary without incurring gift tax liability for the contribution. The $55,000 contribution would be treated as if you made a $11,000 contribution in each of the next five years. Note that this presumes that no other gifts are made to the beneficiary during this five-year period. Any additional gifts would be subject to gift taxes. However, because the annual exclusion amount is indexed for inflation, this amount could increase in future years. Married couples can join together in making gifts, thus increasing the potential contribution to $110,000 without incurring gift taxes.

ESTATE TAX CONSEQUENCES

Even though the donor retains the right to change the designated beneficiary (to another member of the donor's family) and to receive distributions from the account if no other person is designated, funds invested in the Section 529 plan are not included in the donor's gross estate unless the funds are in fact returned to the donor. Thus, once you contribute an amount to a Section 529 plan, that amount is out of your estate(s), as is the future appreciation on that amount. However, if a contribution exceeding the annual exclusion is applied pro rata to the annual exclusion over five years but the donor dies before the fifth year, that portion of the contribution that has not yet been applied to the annual exclusion for the years following the donor's death will be included in the donor's estate.

For example, suppose Mr. Leonard contributes $55,000 to a Section 529 plan and elects to have this applied pro rata over the next five years to the annual exclusion. Furthermore, assume Mr. Leonard passes away in the fourth year following the contribution. The amount of the annual exclusion to be applied in the fifth year ($11,000) would be brought back into Mr. Leonard's estate.

COORDINATION WITH THE HOPE SCHOLARSHIP AND LIFETIME LEARNING CREDITS

Taxpayers will be able to use HOPE Scholarship and Lifetime Learning Credits during the same year distributions are taken for a Section 529 plan as long as the monies are used for different qualified education expenses. In other words, you cannot claim the HOPE Scholarship Credit for room and board and then use Section 529 funds to pay for room and board.

Tip

Creditor Protection for Section 529 Plans?
Funds held in a Section 529 plan may be subject to the claims of creditors and divorce proceedings. Typically, state law will prevail. If you are concerned about creditor protection, consider using a Section 529 plan sponsored by a state that has strong creditor protection laws.

For more information on Section 529 plans go to www.welchgroup.com/CoolLinks.

SOME FINAL THOUGHTS ON SECTION 529 PLANS

Note that under the Section 529 plan, you are able to change your beneficiary. This is important because one child may choose not to attend college or may attend a relatively inexpensive college while another child may attend a very expensive college. A Section 529 plan allows you to move your funds around as needed. The Tax Relief Act–2001 included "cousins" in the definition of family member.

Tax Relief Act–2001—Miscellaneous Provisions Relating to Education

Several other provisions of the Tax Relief Act–2001 are worth noting:

- Employers are now allowed to offer education assistance programs providing up to $5,250 per year for an employee. The payment is deductible by the employer and not includable in the income of the employee. Undergraduate and graduate courses qualify, and the courses do not have to be related to the employee's job-related field.
- An above-the-line deduction is allowed for qualified higher education expenses for certain taxpayers. This benefit became available for tax years 2002–2005. Table 1.7 indicates the qualifying income limitations and deduction amounts.
- The new law loosens the requirements for deductibility of student loan interest.

The Jobs and Growth Act–2003 provided significant capital gains tax relief. The law immediately dropped the maximum net capital gains rate by 5 percentage points from 20 percent to 15 percent. The 10 percent capital gains rate for "lower-income" taxpayers fell to 5 percent. The effective date of May 6, 2003, caused some accounting administrative problems. You may remember several amended Form 1099s from investment companies because of the mid-year effective date. The lower rates are expected to continue through December 31, 2007. In 2008, the 5 percent rate for "low-income" taxpayers will drop to 0 percent, but only for one year. The 15 percent rate for non-low-income taxpayers remains the same in 2008. On January 1, 2009, the pre–Jobs and Growth Tax Act rates of 20 percent and 10 percent return.

The Jobs and Growth Act–2003 also provided significant tax relief for certain dividends from domestic or qualified foreign corporations. Such dividends received are taxed at a 15 percent rate. This special rate terminates on December 31, 2008, and the pre–Jobs and Growth Tax Act rates return in January of 2009. A tax advisor should

TABLE 1.7 College Tuition Deduction

	Maximum AGI to Qualify for Deduction		
Year	**Single Tax Filer**	**Joint Tax Filer**	**Applicable Deduction**
2005[1]	AGI under $65,000	AGI under $130,000	$4,000
2004–2005[1]	AGI over $65,000 but under $80,000	AGI over $130,000 but under $160,000	$2,000

[1]Deduction expires after 2005.

be consulted to determine whether a dividend qualifies for the lower tax treatment.

Business and Corporate Tax Relief

The Jobs and Growth Act–2003 provided certain business and corporate tax relief. For business property placed in service in tax years of 2004 and 2005, the business taxpayer can immediately deduct (rather than depreciate) up to $100,000 in qualified property placed in service for the year.

For certain new property (instead of used property that may be new to the business), there may be an available 50 percent bonus depreciation depending on the type of property involved, if it was placed in service before January 1, 2005.

Estate, Gift, and Generation-Skipping Transfers

The Tax Relief Act–2001 provides some relief from the death tax imposed on estates of individuals who have paid taxes their entire lives. Although the estate and generation-skipping taxes are repealed in 2010, the repeal is not permanent. This uncertainty creates planning problems that we will address in this book. To accentuate the problem the new law presents for planners, see if you can answer the question in the next box.

Under the Tax Relief Act–2001, what amount of federal estate tax will be owed on an estate of $5,000,000?

a. $1,665,000

b. $675,000

c. $0

d. $2,045,000

Give up? The answer is that all four answers are correct! The first answer, *a*, is correct if you die in 2005; *b* is correct if you die in 2009; *c* is correct if you die in 2010 (the estate tax is repealed for *one* year!); and *d* is correct if you die in 2011. We hope you are beginning to see the importance of careful planning in the wake of the Tax Relief Act–2001.

Please don't misunderstand. The Tax Relief Act–2001 does provide potentially significant tax relief, assuming that death occurs prior to January 1, 2011. Also, it is generally assumed that prior to that date Congress will either make the estate tax repeal permanent or provide some other substantial estate tax relief. Table 1.8 shows the dramatic savings under the tax law.

Following is a list of select provisions that could affect your estate planning:

- The tax law lowered the maximum estate, gift, and generation-skipping tax rates, and it raised the amount of assets that are not subject to estate taxes (applicable exclusion amount). Table 1.9 outlines how the increases in the applicable exclusion amount and the estate tax rate reductions are phased in.
- Although the new tax law repealed the estate and generation-skipping taxes in 2010, *the gift tax will remain in effect with a $1,000,000 unified credit effective exemption amount.* The highest gift tax rate will equal the highest income tax rate then in effect. As a result, family gifting plans may need to be adjusted.

TABLE 1.8 Potential Estate (Death) Tax Savings under Tax Relief Act–2001 as Compared to Death in 2001

	$5 Million Estate	$10 Million Estate	$20 Million Estate	$50 Million Estate	$100 Million Estate
2001 tax	$1,997,000	$4,549,000	$10,408,200	$26,453,750	$54,408,200
2002 tax	$1,430,000	$3,930,000	$8,930,000	$23,930,000	$48,930,000
Savings	$567,000	$619,000	$1,478,200	$2,523,750	$5,478,200
2003 tax	$1,415,000	$3,865,000	$8,765,000	$23,465,000	$48,486,000
Savings	$582,000	$684,000	$1,643,200	$2,988,750	$5,922,200
2004 tax	$960,000	$3,360,000	$8,160,000	$22,560,000	$46,560,000
Savings	$1,037,000	$1,189,000	$2,248,200	$3,893,750	$7,848,200
2005 tax	$940,000	$3,290,000	$7,990,000	$22,090,000	$45,590,000
Savings	$1,057,000	$1,259,000	$2,418,200	$4,363,750	$8,818,200
2006 tax	$460,000	$2,760,800	$7,360,000	$21,160,000	$44,160,000
Savings	$1,537,000	$1,788,200	$3,048,200	$5,293,750	$10,248,200
2007–2008 tax	$450,000	$2,700,000	$7,200,000	$20,700,000	$43,200,000
Savings	$1,547,000	$1,849,000	$3,208,200	$5,753,750	$11,208,200
2009 tax	$ 0	$1,350,000	$5,850,000	$19,350,000	$41,850,000
Savings	$1,997,000	$3,199,000	$4,558,200	$7,103,750	$12,558,200
2010 tax	$ 0	$ 0	$ 0	$ 0	$ 0
Savings	$1,997,000	$4,549,000	$10,408,200	$26,453,750	$54,408,200

Please note that estimated tax liability stems from joint estate tax liability of husband and wife, assuming first spouse to die sheltered maximum credit amount available.

TABLE 1.9 Tax Relief Act–2001 Applicable Exclusion Amount Phase-In

Year	Applicable Exclusion Amount	Maximum Estate Tax Rate (%)
2005	$1,500,000	47
2006	$2,000,000	46
2007	$2,000,000	45
2008	$2,000,000	45
2009	$3,500,000	45
2010	Estate tax repealed	0
2011	$1,000,000[1]	55

[1]Tax Relief Act–2001 is automatically repealed unless Congress extends the law.

- Under prior law and under the Tax Relief Act–2001 for calendar years 2005–2009, a decedent's heirs receive a new tax basis (called a *step-up basis*) in property received from the decedent equal to the property's fair market value as of the date of death (or six months after the date of death if elected by the executor). As a result, if the property has appreciated, the heirs can sell the property shortly after the decedent's death without recognizing taxable gain. Under the Tax Relief Act–2001, *for calendar year 2010, heirs will not receive a new tax basis, regardless of when assets were purchased.* Instead, with limited exceptions, heirs will take the property subject to the decedent's old tax basis, which could result in the heirs recognizing taxable gain when and if the property is sold. However, due to two exceptions to this new rule, some taxable gain will be avoidable. First, $1,300,000 worth of certain assets can receive a new, fair market value basis, and second, the estate can increase the basis of an additional $3,000,000 worth of certain assets transferred to a surviving spouse. *As a result, it is critically important that taxpayers begin compiling accurate records to document the income tax basis of their property. These records will determine future generations' income tax liability.*
- Additionally, accurate tax basis records must be kept beginning in 2010 because a decedent's personal representative and/or trustee will be required to report detailed information to the Internal Revenue Service (IRS) of transfers at death in excess of $1.3 million and for certain transfers of appreciated property. Noncompliance will result in financial penalties.
- Although the tax law repeals the estate and generation-skipping taxes in 2010, the law also allows the Tax Relief Act–2001 to

automatically "sunset" after December 31, 2010. In effect, the tax law repeals the estate tax and the generation-skipping tax for one year—2010. Due to budgetary restrictions, the law allows the estate tax rules, rates, and exemptions in effect prior to passage of the Tax Relief Act–2001 to come back in force in 2011. The prospect of an automatic reinstatement of the current estate, gift, and generation-skipping tax rules in 2011 ensures that Congress will have to face this entire issue again.

Table 1.10 provides a summary of the changes under Tax Relief Act–2001.

Estate Planning Issues under the Tax Relief Act–2001

Because of the breadth and scope of the Tax Relief Act–2001, it becomes necessary for everyone with a net worth of more than $1,000,000 to review their estate plan. An approach we favor is for the client to contact one of their professional advisors on the estate planning team, whether the estate planning lawyer, financial planner, life insurance agent, accountant, or trust officer. Authorize that team member to assemble the team in a preliminary meeting to review the listing of the assets and liabilities (financial x-ray), review the current documents, and then meet with the client and the client's spouse to make team recommendations. This approach maximizes the creative input and communication and often aids in identifying important new alternatives to consider. The financial x-ray would show what assets are titled in the name of each spouse; what, if any, assets are titled in joint names; and, ideally, what assets are in the children's names.

As has been said previously, what will be the estate or death tax is really elective. By making annual gifts during your lifetime, then transferring the maximum tax free amount (applicable exclusion amount) to your children and grandchildren at death, and finally bequesting your remaining estate to a family charitable foundation, your estate tax would be zero.

New provisions in the law should prompt clients to focus on the following:

1. Does each spouse have the new tax-free amount in his or her separate name? The first and simplest step of estate planning is to obtain two tax-free amounts for the family instead of one. This requires, however, not only the proper words in the documents, but that the first spouse to die have titled in his or her name (not jointly) assets with a fair market value (other than qualified retirement plans or IRAs) equal to the tax-free amount ($1,500,000 to

TABLE 1.10 Future Applicable Exclusion Amount Increases

Year	New Law Exclusion Amount (Death)	New Law Exclusion Amount (Gifts)	Old Law Exclusion Amount	Increase from Previous Amount (Death)	Increase from Previous Amount (Gift)	Tax Rate Reductions (%)
2005	$1,500,000	$1,000,000	$950,000	$550,000	$50,000	47
2006	$2,000,000	$1,000,000	$1,000,000	$1,000,000	0	46
2007	$2,000,000	$1,000,000	$1,000,000	$1,000,000	0	45
2008	$2,000,000	$1,000,000	$1,000,000	$1,000,000	0	45
2009	$3,500,000	$1,000,000	$1,000,000	$2,500,000	0	45
2010	100%	$1,000,000	$1,000,000	100% of estate	0	35 gifts only
2011[1]	$1,000,000	$1,000,000	$1,000,000	0	0	55

[1]Effective January 1, 2011, the TRA-2001 "sunsets" and the prior law is reinstated.

$3,500,000, depending on the year). This step will basically save the family between $555,000 and $1,400,000 in taxes.

2. The client should also focus on what is currently to be done with the tax-free amount at the client's death. Will it simply go in trust for the surviving spouse? Will it go in trust for the benefit of the surviving spouse, children, and grandchildren? Will it go outright to children and grandchildren? In 2001, the client may have been comfortable with $675,000 going to children (tax-free amount) and the balance, in the form of a deductible marital share, to the spouse. Is this level of comfort sustained with a $1,500,000 tax-free amount, or with $2,000,000, $3,500,000, or the client's entire estate, which will be the effect of commonly used formulas in wills in 2010?
3. It would be appropriate to review the living will. Continuing the client on life support in December 2005, December 2006, December 2007, December 2008, and December 2009 could make a significant tax difference in light of the scheduled increases of the death tax–free amount. It could also make a major difference in December of 2010, if the law were to sunset in 2011. These may be rather macabre thoughts, but it is important for the team to get all the issues on the table.

Advisors of taxpayers with net worth exceeding $1,000,000 must become familiar with new carryover basis rules, as follows:

1. In 2010, when the death tax is repealed, property "acquired from a decedent" will take a basis of the lesser of (a) the decedent's adjusted basis or (b) fair market value of the property at the decedent's date of death. However, the Tax Relief Act–2001 provides that up to $1,300,000 may be added to the basis of assets included in the gross estate plus an additional $3,000,000 may be added to the basis of assets transferred to a surviving spouse (total $4,300,000).
2. "Acquired from a decedent" will include:
   a. A bequest, devise, or inheritance of property received by the estate from the decedent.
   b. Qualified revocable trusts property.
   c. Any other property passing without a consideration from the decedent by reason of death.
3. Property that will not qualify for basis increase will be:
   a. Property over which the decedent merely holds a power of appointment. It may be advisable to have the client exercise

the power of appointment to avoid wasting unused basis allocation.

b. A grantor-retained annuity trust or qualified personal residence trust that terminates prior to the term as a result of the decedent's death.

c. Property received by gift within three years of a decedent's death.

d. Certain foreign stocks.

e. Income in respect of decedent property such as retirement accounts, qualified retirement plans, or IRAs.

4. The maximum amount of the increase or step-up in basis will be $1.3 million in 2010, adjusted for inflation in $100,000 increments. In addition, there will be $3,000,000 for surviving spouses, adjusted for inflation in $250,000 increments. By way of example, assume that the decedent owned at death a house with a basis of $500,000 and a fair market value of $1,000,000, and also a condo with a basis of $200,000 and a fair market value at death of $300,000. The house will take a new basis of $1,000,000 at death and the condo, $300,000, but that will be only $600,000 added to the cost. This means there will be $700,000 of remaining step-up in basis still to be allocated. Thus, it is $1.3 million of gain and not $1.3 million of assets.

5. The new Internal Revenue Code Section 6018 will require in 2010 that returns be filed relating to large transfers at death. This form to be filed by the personal representative must report all property (other than cash) acquired from a decedent if the fair market value of such property is greater than the aggregate basis increase allowed under Section 1022(b)(2)(B) (i.e., $1.3 million, and $3,000,000 for surviving spouse). Also to be reported will be any appreciated property acquired from a decedent if such property were not entitled to a basis increase because the decedent received it by gift within three years of death and it was required to be included on a gift tax return. This new return must show the following:

   a. Name and taxpayer identification number of the recipient.

   b. Accurate description of property.

   c. Decedent's adjusted basis and fair market value at date of death.

   d. Decedent's holding period.

   e. Information indicating whether gain is ordinary income.

f. Whether any basis increase was allocated.

g. Any other information that the secretary of the treasury requests.

It would be prudent for taxpayers owning assets that total in value $1,000,000 or more to consider having their financial advisor prepare an annual balance sheet reflecting the cost or tax basis of assets and fair market values. Businesses are typically not troubled by the need to know the adjusted tax basis of various assets because they get an annual balance sheet with this information. Individuals should begin thinking about a similar sheet to avoid difficulty for the personal representative when the estate tax is repealed and the limited carryover basis becomes a reality and the Section 6018 form must be filed.

In summary, you should take the following steps as you undertake estate planning under the Tax Relief Act–2001:

1. Contact your advisor(s) and request a review of your current estate plan in view of the new act.
2. The most prudent assumption for you to make, considering the changes scheduled for 2011, is that the amount of assets that you will be able to pass to nonspousal heirs will be $1,000,000. By providing adequate liquidity under this circumstance, you assure your heirs that you will have adequate resources to pay estate taxes no matter what year you die.

In this chapter we have provided an overview the Tax Relief Act–2001. In our next chapter, we will delve deeper into the importance of developing your estate plan.