

**THE PRESENT AND FUTURE OF THE FEDERAL ESTATE TAX**  
**By THOMAS C. MORRISON**  
**J.D. & LL.M. (in taxation)**  
**web page [www/tcmorrison.net](http://www.tcmorrison.net)**

Most Americans do not have to be concerned about the federal estate tax. In 2004, less than 1% of all estates will pay federal estate taxes. In 2004, estates under \$1,500,000 will not even have to file an estate tax return. And with reasonably simple estate planning, married persons can now avoid paying estate taxes on estates up to \$3,000,000! This article will help you understand the current and future status of the federal estate tax.

1. THE FREE SPACE: EXEMPTIONS & DEDUCTIONS & EXCLUSIONS ..... 1  
2. ESTATE TAX RATES..... 2  
3. WHAT IS TAXED ..... 2  
4. 2010 - WHAT HAPPENS IN THE YEAR OF ELIMINATION..... 2  
5. TAX PLANNING STRATEGIES..... 3  
6. THE FUTURE OF THE ESTATE TAX..... 3

**1. THE FREE SPACE: EXEMPTIONS & DEDUCTIONS & EXCLUSIONS**

Estate taxes are not imposed on most estates, because estates are allowed avoid any tax on gifts to surviving spouses and charities. In addition, estates do not have to pay taxes unless in excess of an exemption.

**Exempt gifts**

Every person’s estate is entitled to an exemption from the estate tax. For worried taxpayers, the news is good. Exemption levels are scheduled to increase as follows:

year of death	exemption per person	maximum tax-free estate for a properly planned estate for married couples
2004-2005	\$1,500,000	\$3,000,000
2006-2008	\$2,000,000	\$4,000,000
2009	\$3,500,000	\$7,000,000
2010	The estate tax is eliminated this year only!	
2011 and later	\$1,000,000	\$2,000,000

**Unlimited marital deductions**

In addition to exempt gifts, qualified marital gifts are deductible. For example, Microsoft founder Bill Gates can directly give his entire \$40 billion+ estate to his wife without having his estate incur any estate or gift taxes! He is even allowed to restrict his \$40 billion+ gift to his wife by leaving it to her (usually in a trust) for life and then to his children on her death.

**Unlimited charitable deductions**

In addition to exempt gifts and marital gifts, qualified charitable gifts are deductible. Again, Microsoft founder Bill Gates can directly give all of his \$40 billion+ estate to his own qualified private foundation without incurring gift or estate taxes. Often the very wealthy set-up their own

charitable (private) foundations, favoring their own charitable interests, which foundations are sometimes managed by a decedent's own children or parents.

## 2. ESTATE TAX RATES

After using up the free space (exemptions, deductions and exclusions), estate tax rates begin at a very high percentage and minimally progressive to slightly higher rates. Smaller estates fail to enjoy any significantly lower rates than larger ones. Estate tax rates are scheduled to change as follows:

year of death	Rate (%) Lowest/highest
2004	45-48
2005	45-47
2006	46
2007	45
2008	45
2009	45
2010	0
2011	37-50

## 3. WHAT IS TAXED

For taxable estates, the estate tax is imposed on the fair market value of property at the time of death or six months after the date of death, at the choice of the taxpayer. The alternate valuation helps in situations where the value of stocks and/or other property dramatically drop shortly after a person dies. On death, property does include assets passing through probate, typically bank accounts, stocks, bonds, cars, furnishings, etc and property passing outside of probate, typically IRA accounts, pensions and annuities, life insurance, property passing thru a revocable trust, and a jointly held assets such as: a residence, bank account and brokerage account. Many persons fail to consider pensions, IRAs, life insurance and jointly owned assets as part of their estate. Because of the marital deduction, pensions and IRAs passing to a surviving spouse will not generate any estate tax.

## 4. 2010 - WHAT HAPPENS IN THE YEAR OF ELIMINATION

In 2010, but only 2010, the estate tax is eliminated. Elimination could not be made permanent, because the U.S. Senate was one vote shy of mustering a necessary a 60% vote of approval. In 2011 the estate tax, if not changed, will revert back to where these changes began in 2002. Under our present system, capital gains income taxes do not usually occur when inherited assets are sold. This is because most inherited assets get a fresh start tax basis, equal to the fair market value on a decedent's death. In 2010, Congress exposes inherited wealth to capital gains taxes, when those inherited assets are sold. But in 2010, when the estate tax is eliminated, Congress also took away the fresh start tax basis in inherited assets. This will be a surprise when some heirs will sell their inherited ranch and find out that they are stuck with a tax basis equal to what grandpa paid for it 80 years ago.

## 5. TAX PLANNING STRATEGIES

Taxwise, the scheduled changes in the estate/gift tax law makes estate planning more challenging than before, especially because it is difficult to predict which set of rules will apply when a person dies.

### Preserving two exemptions

In a properly planned estate, a husband and wife can each use separate exemptions (now to \$3,000,000). These strategies are traditionally accomplished through A/B trusts or marital/nonmarital or marital/credit shelter trusts, Q-tip trusts and disclaimer trusts.

### Disclaimer trusts provide flexibility

Disclaimer trusts have become particularly popular. Disclaimer trusts allow a surviving spouse to choose whether to take all or less than all of the deceased spouse's estate. That decision can be made within 9 months after the first spouse dies. This post mortem estate planning allows better choices, since the amount of the available exemption will then be known.

### Dissipating assets with tax-free gifts during life

In addition, persons can reduce their potential estates by making tax-free gifts before they die by making annually excludable gifts. Presently any person can make qualified gifts of \$11,000 per year per person tax-free. If properly made, for example, Bill Gates could substantially dissipate his wealth by making annually excludable \$11,000 gifts to every individual listed in the New York City phone book, and not suffer any adverse income or estate tax consequences.

## 6. THE FUTURE OF THE ESTATE TAX

In the year 2001, Congress began phasing out the estate tax and has eliminated it altogether for the year 2010. Since 2001, America has suffered huge losses in the stock market, gone to war, and wracked up unprecedented deficits. In the aftermath of these intervening events, Congress must now decide whether to permanently eliminate the estate tax after 2010. Without doing anything, in 2011, the estate tax will resuscitate with its smaller \$1 million exemption, as it existed in 2002. More likely, Congress will intervene before 2010 and permanently reinstate the estate tax with some improvements. Why and how?

Economists all agree that the disparity of wealth in the America is widening, not narrowing. And regardless of higher income tax rates for higher incomes, the middle class continues to bear the bulk of the tax load. If wealth separation continues, America's middle class and its tax base will be destroyed. The estate tax is one mechanism to share, not confiscate, wealth and help preserve a strong and needed middle class.

The "graduated" income tax has failed to control the widening disparity of wealth in America. In the year 2000, the top 400 individual American taxpayers averaged \$174 million each in reported income but only paid an average of 22.29% in income taxes (from I.R.S. statistics), while last year, approximately one-half of all Montanan's filed federal income tax returns averaging only \$21,000 in reported income. This year, American wage earners will continue paying directly and indirectly 15.3% in Social Security and Medicare taxes on the first \$87,900 of their wages (self-employed persons pay the same tax as "self-employment taxes" on their earned income) in addition to income taxes on the same earnings. In fact, about one-half of all

federal income taxes extracted from individual taxpayers are derived from these regressive flat taxes on “earned income.” If these taxes were doubled, the individual income tax could be eliminated! Even though 5% of individual taxpayers pay about 50% of the individual “income tax,” informed taxpayers should not feel guilty, but mad, because this statistic misleadingly fails to consider the income tax burden of Social Security/Medicare/self-employment taxes on their “earned incomes.” When these taxes are included as “income” taxes, wage earners and self-employed workers proportionately pay far more real income taxes than the 22.9% average rate paid by America’s top 400 super-rich! This fact alone explains why the graduated “income tax” has failed to check the widening disparity of wealth in America and why Congress will have to retain the estate tax to keep wealth disparity under control.

To some, it appears that the estate tax raises little revenue (presently less than 2% of overall federal revenue). Some predict that for this reason, Congress will permanently eliminate it. But the lack of estate tax revenue may be misleading. The super-rich typically choose to make tax-free charitable gifts to their own private foundations than pay estate taxes. To qualify, these charitable gifts have to be for the public good. During Congressional hearings, Bill Gates (through his father) and Warren Buffet unselfishly advocated retention of the estate tax. Similarly Jackie Kennedy recently passed most of her \$100 million estate tax-free to her own private foundation, paying only \$6,000 in estate taxes. But perhaps, a tax should not exist solely to favor a person’s own chosen charities, especially when the government needs money. Perhaps, in retaining the estate tax, Congress might consider limiting (as does the income tax) the charitable deduction in estates to 50%. Charities might oppose this simple reform, but would be wiser to support it in order to make retention of the estate tax more palatable. Being a country that has been burdened with the costly responsibilities of maintaining worldwide peace, America could, in choosing to retain the estate tax, make itself a larger beneficiary of its own estate tax.

To some, it is feared that the estate tax takes away incentives for people to be creative and to work hard and to be frugal, core American virtues. These fears could be sufficiently mitigated if Congress were to raise its exemption to \$5 million or even to \$10 million and then start the estate tax at a much lower level than the presently obscene 45% beginning rate. This approach would eliminate any need to keep complicated and somewhat discriminatory schemes for protecting the devolution of small family businesses and farms. But in retaining the estate tax, Congress is not likely to be concerned over whether those 400 taxpayers, who averaged \$174 million in annual income, will lose their incentive to work or to continue earning income.

Congress is in need of money. Supreme Court Justice Oliver Wendell Holmes was perceptive, when he stated: “Taxation is the price of civilized society.” A permanent estate tax will likely remain part of the price of our civilized society.

version 03/15/04 4:31 PM