

# Estate Tax Planning And Marketing Opportunities Of The Economic Growth And Tax Relief Reconciliation Act Of 2001

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## Abstract

*The best advice tax practitioners can give clients after the 2001 Tax Relief Act, is that the optimal time to die in the next decade will be 2010! What has been touted as a repeal of the Federal estate tax, has actually resulted in increasing the importance of estate tax planning. This is due to several factors. First, the rate reduction is phased in so slowly that in 2009, the top estate rate will still be 45% and the exemption amount only \$3.5 million. In 2010, repeal is actually achieved, but for one year only. The "repeal" sunsets in 2011 when the estate tax comes back in full, using a maximum 55% rate and a \$1 million exemption. Basis of inherited property may prove to be a nightmare. Some property will get a stepped up basis, other property will not. Further complicating the picture is that the gift tax has not been repealed.*

*The estate tax planner will be faced with a host of issues to consider. Which estate planning strategies are still valid? What new planning tools will be developed? Many wills will include obsolete provisions and will need to be redrafted. Health of the client will become more important in the planning process. Marketing issues of planning under such uncertainty abound. This paper examines the new estate and gift tax provisions; offers strategies for navigating the sea of complexity and uncertainty; and explores the marketing opportunities for financial planners created by the new law.*

*It is dangerous to make predictions.....especially about the future.*

*Samuel Goldwyn*

## Introduction

The Federal Estate and Gift Tax has never been a large source of revenue for the United States Treasury. In the year 2000, it accounted for only 1.4% of total collections of the Internal Revenue Service and affected less than 2% of all Americans (IRS). Yet, its scheduled repeal in the Economic Growth and Tax Relief Reconciliation Act of 2001 was the topic of hot debate and more-than-usual political rhetoric.

In February 2001, Nightline (ABC News) devoted an entire segment to examining the social desirability of estate tax repeal as seen from both the wealthy taxpayer and the small business owner. During that same month, a petition drive against the repeal was signed by Williams Gates, Sr., Warren Buffett, George Soros, Ben Cohen (of Ben and Jerry's), and 116 other wealthy taxpayers. The petition initially appeared in the New York Times and later appeared in other newspapers across the country. By the time the fray had died down, legislation was passed that did repeal the estate tax....but not for almost nine years. The end result is a quagmire of

*Readers with comments or questions are encouraged to contact the authors via email.* complexity and uncertainty. While this situation will require hours of diligent study to comprehend the ramifications for clients, it will also create a significant opportunity for the marketing-savvy financial planner.

## **History of the Estate and Gift Tax**

As with most taxes, the purpose of the initial U.S. tax on wealth was to raise revenue. As early as 1797, Congress imposed a stamp duty on inherited property to help defray the expenses of the naval fleet expansion, deemed necessary because of French attacks on American shipping. Congress temporarily imposed a federal inheritance tax (imposed upon individuals receiving property from a decedent) during the Civil War (1862-1870) and again at the start of the Spanish-American War (1898-1902). In 1916, the estate tax was passed by Congress to “break up the swollen fortunes of the rich.” More to the point, America also needed the revenue to gear up for entry into World War I (Citizens for Tax Justice).

When first enacted, estate tax rates ranged from 1 to 10 percent with an exemption of \$50,000. By 1942, the highest marginal rate had increased to 77% while the exemption had only increased to \$60,000. The gift tax was permanently enacted in 1932 as a separate tax from the estate tax, with rates ranging from .75% to 45%, coinciding with an increase in the highest marginal estate tax rate to 45% (Peckman, page 311).

The Tax Reform Act of 1976 unified the gift and estate tax, using one tax rate structure and one lifetime credit/exemption equivalent. Although imperfect, the tax structure attempted to equalize the taxation of transfers during life, and transfer at death. Rates ranged from 18-70% and the exemption amount was increased to \$175,625. Legislation in 1981 increased the exemption to \$600,000 and lowered the highest marginal rate to 55%. Under the Clinton Administration, the Taxpayer Relief Act of 1997 scheduled annual increases in the exemption amount, reaching \$1,000,000 in 2006.

## **Statistical Overview of Estate and Gift Tax**

In the year 2000, estate and gift taxes accounted for only 1.4% of total Internal Revenue Service collections, just under \$30 billion. California (9,729), Florida (9,729), and New York (7,915) topped the list of states with the most estate tax returns filed. The three states with the fewest estate tax returns filed included Vermont (257), Wyoming (152) and Alaska (93). In summary, the estate tax doesn't affect a significant portion of the population, nor does it generate a significant percentage of total revenue (IRS).

## **Estate Tax Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001**

The Washington Times (6/11/01) proclaimed, “2010 becomes a good year to die.” The Wall Street Journal (6/1/01) admonished that the administrative burden on families will be daunting. The 7/1/01 issue of Financial Planning called it the financial planner's new best friend...enough complexities and complications to keep planners obscenely successful for the next ten years. How could repeal of a tax cause such a stir?

Over the next ten years, the new legislation mandates the following:

- Reduction of estate, gift and generation skipping transfer tax rates.
- Increases the exclusion amount through 2009.
- Uncouples the gift and estate tax in 2004.
- Repeals the estate and generation skipping transfer taxes in 2010 (gift tax remains in force).
- With repeal, institutes a modified carryover basis for inherited assets.
- In 2011, returns to 55% maximum rate, \$1,000,000 exclusion.

Financial planners not only have to work with a law that changes every year in the near term, but also a repeal that many experts are predicting will never happen due to budget constraints (Gardner, page 588).

## **Rate Reduction Schedule**

The estate tax rates are gradually reduced in the years 2002-2007 from a top marginal rate 55% to 45% in 2007 (Code §§2001, 2010). The rate stays at that level until the 2010 repeal. Gift tax rates follow the estate tax rate until 2009, but the exemption is frozen at \$1 million. Beginning in 2010, the gift tax rate is equal to the highest in-

dividual tax rate (scheduled at 35%).

<b>Year</b>	<b>Top Estate Tax Rate</b>	<b>Estate Tax Exemption</b>	<b>Top Gift Tax Rate</b>	<b>Gift Tax Exemption</b>
2002	50%	\$1 million	50%	\$1 million
2003	49%	\$1 million	49%	\$1 million
2004	48%	\$1.5 million	48%	\$1 million
2005	47%	\$2 million	47%	\$1 million
2006	46%	\$2 million	46%	\$1 million
2007	45%	\$2 million	45%	\$1 million
2008	45%	\$2 million	45%	\$1 million
2009	45%	\$3.5 million	45%	\$1 million
2010	Repealed	Repealed	Highest individual rate (35%)	\$1 million
2011	55% unless Congress acts	\$1 million	35%	\$1 million

Note: Beginning in 2004, the Generation Skipping Transfer Tax exemption will equal the estate tax exemption.

**Carryover Basis Rules for Inherited Property**

Effective with repeal of the estate tax in 2010, property passing from a decedent will not automatically receive a step-up in basis. In general, heirs will use the decedent’s basis in the property. Two exceptions will apply. First, up to \$1.3 million of basis increase will be allowed at the election of the executor, regardless to whom the property passes. An additional increase of \$3 million of basis will be allowed for property passing to the decedent’s spouse (but limited to \$60,000 for property passing to a non-U.S. citizen spouse). The spousal property may be passed outright or as a qualified terminable interest. In addition, the property’s basis cannot be increased above the property’s fair market value (§1022).

The following property is not eligible for basis increase:

- Property acquired by the decedent by gift within three years of death (except for property from a spouse).
- Stock in a foreign personal holding company, a domestic international sales corporation, foreign investment company, or a passive foreign investment company.
- Property that is income in respect of decedent.
- Property included in the gross estate solely because of a decedent’s power of appointment.

**State Death Tax Credit Repeal**

The current state death tax credit will be reduced over the next four years and in 2005, replaced with a deduction. The reduction is scheduled as follows (§2011(b)):

<b>Year</b>	<b>State Death Tax Credit Reduction</b>
2002	25%
2003	50%
2004	75%
2005	Credit is replaced with a deduction from the gross estate

Most states base their death tax on the federal state death tax credit (Fox and Abendroth, page 4). The economic impact of state death tax credit repeal has been estimated at \$100 billion revenue loss by the states over the next ten years (Blattmachr, page 49). Planners should be aware that states will be searching for ways to replace the lost revenue through either a change in the structure of the state death tax, or an increase in other types of state taxes.

**Other Provisions**

The 2001 Act makes several changes to existing law dealing with special provisions for closely held companies. Section 6166 which allows installment payments, is amended to increase the number of allowable shareholders/partners of a closely held company from 15 to 45. In addition, effective 2002, Section 6166 treatment will be available to qualifying lending and finance businesses and to holding companies.

Under current law, Section 2057 allows up to a \$1.3 million exemption for qualifying small business owners. Section 2057 is repealed effective 2004 when the statutory exemption of \$1.5 million exceeds the Section 2057 amount.

New reporting requirements are imposed for executors under the 2001 Act. Effective with repeal in 2010, executors will be required to report testamentary transfers in excess of \$1.3 million and transfers of appreciated property which was acquired by the decedent by gift, within three years of death (§ 6018(a)).

### **Planning Issues Under the New Law**

Estate tax planners will now have to incorporate flexibility in their client strategy. Documents should anticipate several scenarios--permanent repeal, reversion to the 2001 law, and something between the two (lower rate, higher exemption than 2001 law). Disclaimers may prove to be a popular device to improve the ability to adapt to an uncertain future.

A major impact of the legislation is the new importance placed on basis. Under previous law, beneficiaries got a new start on basis—the fair market value at the decedent's death. After repeal, carryover basis will require taxpayers to maintain detailed records to support basis valuations after their death. In addition, which assets get a basis increase and which do not could result in friction between executor and beneficiaries. The beneficiaries who do not get an increase in basis will face higher capital gains tax when they dispose of the asset.

If repeal is a possibility, making taxable gifts between now and 2010 may not be advisable. Of course, the \$10,000 annual exclusion still remains in effect and its use should be maximized. The annual exclusion is particularly useful in transferring limited partnership interests in a family owned business.

Life insurance, usually placed in an irrevocable life insurance trust, has been an often used tool to provide funds to pay estate taxes upon the decedent's death. Even if the estate tax is repealed, life insurance will continue to be a useful estate planning tool. After repeal, life insurance proceeds can be used to fund capital gains tax that arises upon sale of an inherited asset that has not received an increase in basis up to market value.

### **Marketing Opportunities Related to the Act**

To fully understand the marketing considerations of the 2001 tax changes, financial planners should examine the situation from the clients' point of view. If an experienced and highly trained planner requires several hours of study to comprehend the complexities, clients will likely find themselves baffled. One of the planner's primary responsibilities is to ease the anxiety clients feel with this type of uncertainty. We will examine the marketing opportunities from two differing but related aspects of practice management: client retention and new client acquisition. Client retention is critical because it drives current profitability. Client acquisition is important because it determines future sales and profits.

In a recent article on client retention, Bill Carter, president of Carter Financial Management, noted that, "I rarely see people leaving financial planning firms because planners don't do a competent job. Most of the time, people leave because they think they aren't being well taken care of—the service is not there." (Newton, page 64). Certainly, clients want to know how the estate tax changes will affect them. What steps would constitute good customer service in this environment?

An essential first step is the information and education process. A summary of the main provisions of the tax act included with regular mailing of statements is a good beginning, but most clients will find this type of gener-

ic data to be more confusing than helpful. Therefore, planners may want to offer a more personalized impact analysis. If significant levels of client information are maintained in an electronic database, the planner could develop several common scenarios and use semi-customized analyses to illustrate the range of effects clients should expect based on their general characteristics. Of course, some clients will either not fit the common scenarios or will want more individualized analysis.

The revenue generation aspects of these communications will depend on the particular fee arrangements employed by the planner. For example, there may be no immediate benefit for the planner who charges based on a percentage of the client's investment portfolio. In this case, a well-maintained relational database would prove valuable since it would allow quicker and more efficient evaluation and communication. In addition, the long term benefit of higher client retention should be greatly enhanced as useful information lands in clients' hands in a timely manner. On the opposite side, planners who charge an hourly fee will benefit most from encouraging more detailed, custom analyses. For planners that are compensated mainly from the sale of commissioned products, the benefit will depend upon the degree to which the act requires changes in the clients' investment and estate transfer vehicles. Again, a marketing database could assist in rapidly identifying those clients with the greatest need for estate related changes to their plans.


The high level of uncertainty surrounding some of the changes also creates an excellent atmosphere for recruiting new clients. Since referrals and personal recommendations are often one of the top methods for obtaining new clients (Quinn, page 84), the steps outlined above should not only please current clients, but may well result in increased business from their acquaintances. However, more proactive methods can also be employed.

Direct mail, whether traditional or electronic, is an excellent form of marketing for situations requiring the communication of substantial amounts of complicated information. Recall that we have already prepared two levels of analysis of the estate tax act, the generic summary of main provisions and the semi-custom impact analysis based upon common client characteristics. Both of these can be put to further use in the client acquisition process.

One popular method, known as the two-stage process, involves an initial, relatively large mailing based on some type of broad criteria such as Zip Codes. Since a high degree of homogeneity exists within many geographic areas, chances are high that mailing the generic summary piece to the Zip Codes representing current customers would primarily reach potential clients with characteristics similar to your current target market. The purpose of this initial mailing is to generate interest in how the estate tax changes might affect the recipients' personal financial situation.

Those who respond to the first mailing are sent the semi-custom analysis, providing the potential client an idea of the magnitude of the consequences of failing to properly develop contingency plans for their estate transfer under the various possibilities discussed earlier in this paper. When using the direct email approach, the second stage is achieved much more rapidly by allowing the recipient to link to the planner's website to obtain the semi-custom information. Regardless of the delivery method, most recipients that face potential estate planning problems will come to the conclusion at this point that they need to seek professional assistance.

## **Conclusion**

Most observers agree that complete repeal of the estate tax is far from certain. If the economy continues to slow, and projected budget surpluses shrink, that uncertainty increases. The possibility of a change in administration and/or party control of Congress adds to the uncertainty. It is essential that financial planners be able to communicate to their clients the best ways to deal with this dynamic, changing environment. Planners and their clients need to be proactive in taking steps to maximize estate plan flexibility. All of these factors contribute to an unprecedented opportunity to develop innovative estate planning vehicles and strengthen client relationships. 

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