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Estate Planning After The Economic Recovery Tax Act of 1981

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The following will examine some of the major provisions of the Economic Recovery Tax Act that affect estate planning. Perhaps one of the greatest impacts of ERTA will be to encourage new planning techniques to meet the needs of estate owners under the new tax legislation. Below are some of its major provisions.

Increase in Unified Credit

Increases in the unified credit against gift and estate taxes will be phased in over a 6-year period culminating in a $192,800 credit in 1987 and thereafter. (See Figure No. 1.) Thus, in 1987 a decedent with a tentative tax base of $600,000 can pass the entire amount free of transfer tax.

Figure 1
Increases in Unified Credit

(1) Year	(2) Amount of Credit	(3) Maximum Tentative Tax Base Sheltered by Credit
1982	$62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 & later	192,800	600,000

Decrease in Maximum Transfer Tax Rates

In addition to increases in the unified credit, the maximum rate bracket for estate and gift taxes will be reduced over a 4-year period from a maximum of 70 percent to a maximum of 50 percent. See Figure No. 2 for the phase down of the top rate bracket. Note that the reduction in rates is applicable only to tentative tax bases of $2.5 million and above. There is no change in the tax rates for tentative tax bases below $2.5 million. Unlike the income tax brackets, the estate and gift tax brackets will **not** be indexed for inflation. Indexing for inflation of income tax brackets will begin in 1985.

Figure 2
Decrease in Maximum Transfer Tax Rate

(1) Year	(2) Top Tax Rate	(3) Applicable to Tentative Tax Base Over
1982	65%	4,000,000
1983	60%	3,500,000
1984	55%	3,000,000
1985	50%	2,500,000

Inflation will Blunt Effect of Increased Unified Credit

The increased unified credit will reduce, and in some cases eliminate, estate taxes. However, inflation during and after the phasing in period of the credit will blunt its effect, especially for a healthy estate that can be expected to grow steadily.

Figure No. 3 illustrates what will happen in the case of a tentative tax base of $550,000 in 1982 that grows at the rate of 10 percent per year. For 1982 the amount exposed to tax will be over $325,000. Taking inflation into account, the phasing in of the unified credit will have the

greatest effect by 1987, but even in that year more than $285,000 will still be exposed to tax. Thereafter, with no further increases in the unified credit, exposure to estate tax increases rapidly to almost $700,000 in 1991. In twenty years, at a 10 percent, annual growth rate, the amount exposed to estate taxes will be in excess of $2.7 million, nearly five times the 1982 tentative tax base.

Figure 3
Exposure to Estate Tax Assuming
10 Percent Growth Rate

	1982	1984	1986	1991 (10 Yrs.)
Value of Tentative Tax Base	$550,000	665,500	805,255	1,296,871
Credit Equivalent	225,000	325,000	500,000	600,000
Exposed to tax	325,000	340,500	305,255	696,871

Unlimited Marital Deduction

Perhaps the most significant change in estate planning brought about by ERTA is an unlimited marital deduction for both estate and gift tax purposes for deaths or gifts after December 31, 1981. The unlimited marital deduction also applies to transfers of a donor's or decedent's interest in community property.

Prior to January 1, 1982, the maximum estate tax marital deduction was the greater of $250,000 or one-half the adjusted gross estate; and the maximum gift tax marital deduction was 100 percent of the first $100,000 and 50 percent of all gifts over $200,000. To prevent a marital bequest that is larger than might have been intended, if a will or trust containing a "maximum marital deduction" formula clause was executed before September 13, 1981, the unlimited marital deduction will not apply. To make it apply the will or trust should be amended to refer specifically to the unlimited marital deduction; or, a state law must be passed in the applicable jurisdiction construing the instrument as referring to the unlimited marital deduction. Don't rely on state law. Wills and trusts should be amended as soon as possible to realize the larger marital deduction. All estate owners should review their situations to determine what steps to take in this regard. Further, in a reversal of pre-1981 tax law, property in which the spouse had only a life estate (a terminal interest) may qualify for the unlimited marital deduction. This new class of property is called Qualified Terminable Interest Property, Q-TIP for short.

Gifts within 3 Years of Death

Effective for decedents dying after 1981, gifts made within 3 years of death will not be included in the decedent's gross estate. However, there is a major exception to this new rule. Any transfer of property made within 3 years of death will be included in the decedent's gross estate if they are transfers with a retained life estate, transfers that take effect at death, revocable transfers, transfers of powers of appointment, transfers of an interest in life insurance.

Under What Circumstances Should Lifetime Gifts be Made?

Under the unified transfer tax system, there is no appreciable savings in transfer taxes for lifetime gifts as opposed to gifts at death, after utilization of the $10,000 annual exclusion. Once the unified credit is used up ($192,800 in 1987 and thereafter), further lifetime gifts result in lifetime payment of transfer taxes and loss of the future uses of those dollars.

Nevertheless, when property that is likely to increase substantially in value in the future will be passed to someone other than the estate owner's spouse, a lifetime gift should be considered. For

example, if the estate owner survives 18 years from the date of a gift to a child and the value of the gift property increases at the rate of 8 percent per year, applying the "rule of 72," the value will double every 9 years. An original gift of $250,000 of property will be worth $1,000,000 at the estate owner's death with $750,000 passing transfer tax free. In addition, income from the property would be taxed to the child during this 18 year period and the child may be in a lower income tax bracket than the estate owner.

New Rules for Current Use Valuation of Real Property Used in a Family Farm or Business

Prior to ERTA the "current use valuation" method could be used to reduce the gross estate by up to a maximum of $500,000. The $500,000 limitation on reduction from fair market value is increased by ERTA as follows:

For Decedents Dying In	Limit on Reduction in Value
1981	$600,000
1982	700,000
1983 and thereafter	750,000

Prior to ERTA the property had to be used for a qualified purpose by the decedent. Now, the qualified use requirement can be met by either the decedent or a member of the decedent's family using the property for a qualified purpose for the required period. For example, it would now be acceptable if the deceased leased real property to his son who used it for farming.

Installment Payments of Estate Tax Attributable to Closely Held Business

ERTA significantly liberalizes and simplifies the requirements for an estate to qualify for installment payments of estate tax attributable to a closely held business interest. Under the new law an estate can qualify for a 14 year payout of estate taxes attributable to the inclusion of a closely held business interest in the estate if the value of the business interest exceeds 35 percent of the value of the adjusted gross estate. Under the old law for a 14 year payout the value of the business interest had to exceed 65 percent of the adjusted gross estate. Interest only need be paid for the first four years from the original due date. The first installment of tax is due by the end of the fifth year with equal annual installments thereafter until the end of the fourteenth year. Furthermore, two or more businesses can now be combined to meet the 35 percent of the adjusted gross estate test if the decedent owned 20 percent or more of each business. Under the old law the decedent was required to own more than 20 percent of each business to combine their value.

Effects of Income Tax Changes on Estate Planning

The cumulative 23 percent decrease in individual income tax rates by 1984 means that if a person's tax bill was $30,000 for 1980 the same income and deductions will produce a tax of only $23,100 by 1984 and each year thereafter. This translates into an annual savings of $6,900. If this annual savings is vested at 10 percent net after taxes, it will grow to $122,000 in just 10 years. Thus, in addition to the effects of inflation, less income tax paid will mean larger estates in the future. A new source of dollars for investment will have been created.

Reduction in Social Security Benefits Increase Need for Capital at Death

Although many of the provisions of the Economic Recovery Tax Act of 1981 (ERTA) decrease the need for capital at death, some of the provisions of the Omnibus Budget Reconciliation Act of 1981 (OBRA) have the opposite effect. OBRA accomplishes this by reducing social security benefits in the following instances:

2. OBRA eliminates social security benefits for college students ages 18 to 21.
3. OBRA terminates benefits for a parent caring for a child who receives child's benefits when the child reaches age 16 (was age 18 under old law).

A numerical example will help to highlight the effect of these changes. If a 38 year old father dies with an average indexed monthly earnings of $1,725, the loss of social security benefits if that farther is survived by a wife and either one child under age 16 or two children under age 16 will be as follows:

Benefits Lost	One Child	Two Children
Mother's loss for child ages 16 to 18.	$11,952	$ 4,008
College child's loss for ages 18 through 21.	$23,952	$47,856
Total loss of income to the family unit.	$35,904	$51,864

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For a detailed discussion of ERTA'S impact on charitable giving, we invite you to request your complimentary report: "Maximizing The Use of Your Charitable Dollar." Included in this report are tips on:

- *Limitations on the extent of deduction.*
- *Rules of thumb for the giver.*
- *Which giving method is best for you.*
- *Giving only part of the pie.*
- *Present giving or Deferred giving?*
- *Whither charitable giving?*

To receive your copy of this timely report, please return the enclosed reply card.

Tax Reform And Stewardship

Beginning in 1982, if an individual creates a qualified charitable remainder annuity trust or a charitable remainder unitrust with only himself and spouse as beneficiaries, the terminable interest rule (previously discussed) no longer disqualifies it as a tax free transfer. Consequently, the donor will receive a charitable deduction for the interest going to charity and a marital deduction for that interest retained for his spouse.

For the first time those who do not itemize deductions on their income tax return will be able to take a deduction for charitable gifts "above the line." This method is to be phased in over a period of years as follows:

Year	Deduction Limits
1982 and 1983	25% of contributions up to $25
1984	25% of contributions up to $75
1985	50% of all contributions
1986	100% of all contributions

ERTA also includes a liberalized income tax charitable deduction package for corporations. Under previous tax regulations, gifts of inventory was generally limited to their basis (costs) in the property. New tax regulation now permits a contribution deduction of the lesser of the basis plus 50% of the appreciation or twice the property's basis.

A far more important change relating to charitable gifts by corporations has been the increase from 5% to 10% of the taxable income a corporation can deduct. Theoretically corporations are allowed to contribute twice as much as previously permited.

For a more detailed discussion of the new tax economics of stewardship planning, we encourage you to consult with your personal advisor or we invite you to request a copy of your report, "Maximizing The Use of Your Charitable Dollar." To receive your copy, return the enclosed reply card. Of course you may do so without obligation.

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