ROBERT A. UNDERHILL P.C.

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# RAUPC News

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## The new newsletter

We welcome you to the inaugural publication of our quarterly newsletter here at Robert A. Underhill P.C. Through this newsletter we will provide updates of current tax law developments which may affect your tax matters. We will present articles on topics such as taxation, estate and wealth transfer planning, business planning and sucession, investment advisory and financial planning.

Understanding that the tax law is often inexorably complex and difficult to explain, we will strive to present material in an easy-to-digest format which will provide pragmatic information to you, the reader.

As we print this newsletter we are in the midst of great change here at the office. We have moved into our new office space at Suite 3300, Two Union Square, 601 Union Street. The office design and layout looks spectacular, and we are excited to have our very own home here in Two Union Square at last. Additionally, we have brought on three additional people to swell our ranks to eight.

Your patience is appreciated as we gradually get organized and settled in our new space. We apologize in advance if we inadvertently hang up on you while we try to unravel the mysteries of our phone system, or if you have to stand in our bare waiting area due to our current lack of seating.

## Estate tax reform: thoughts and commentary

*By Robert A. Underhill*

Many of our clients have heard us talk with a bit of disdain at the mess Congress has made of the estate and gift tax system. And there has been a fair amount of local contribution to the national debate over repeal versus retention of the estate tax. In our view, it is likely to remain, but having said that, we admit it is a bit of a political prediction. We're coming into the time of year when many families consider completing annual gifts to children or grandchildren, or give earnest thought to more comprehensive family wealth planning. So in this commentary, we'll offer a quick review of where the law stands and some thoughts about its place in our overall tax system.

The estate and gift tax laws are an excise tax imposed on the value of property—any property, real, tangible, and intangible—transferred to someone other than one's spouse. What constitutes a taxable gift or a taxable transfer at death is dealt with in an ample body of tax law, and can include property you once owned but no longer do and property you never owned but which is held for your benefit or over which you have some control. Gifts to charities are effectively excluded due to an offsetting deduction. Congress intends for the tax to fall roughly once every generation, and attempts to skip generations in one's gifting or estate plan are thwarted by a generation-skipping transfer tax. The current exemption amount, tax rate and therefore taxes paid are not so much a function of your wealth and dispositive scheme as they are the year you so happen to die. The legislation enacted in 2001 lowers rates and raises exemption amounts over a nine-year period, largely back ended for fiscal reasons. The whole estate and gift tax system is then repealed for a year and, assuming no intervening legislation, is thereafter reinstated to the same rates and exemptions that prevailed before 2001. Thus,

the whole mess is rigged to force Congress to revisit the matter before the end of 2010. (The rate and exemption phase-ins are attached below.)

Historically, the estate and gift tax is founded more in social policy than revenue collection. One of its central premises has been to deter the perpetuation of wealth concentrations. Consequently, the more widely one's wealth is dispersed across both people and time, the less it is taxed. While people might debate the social policy implications of such a system, it is undeniably a legitimate government objective in its origins.

Planning one's estate and family giving are among the most personal and significant of all family decisions. Ideally, it is done in an environment of stable government and equally stable laws, free of interference of anything or anyone except one's personal beliefs and desires and those of his or her loved ones.

With the rate of government taking at 55% as recently as last year (currently 50%), the government ends up being the principal player in many estate plans. No passive social premise here; instead, a rather intrusive influencer of one's overall wealth plan. And as I suggest to clients, the government usually ends up being the largest single heir in most estates.

For the next eight years we have anything but stable laws. In fact, due to the way the vast majority of wills are drafted, the prolonged phase-in of the 2001 legislation will be a key determinant of who gets what (and that may end up being very different than what the testator intended). Many wills contain formula language that says, in effect: "put so much of my estate in a trust for my children as may pass tax-free to a non-spouse under the tax code." The balance generally passes to the spouse, either outright or in trust. For someone dying with a $5 million estate in 2001, that would have been $650,000 to the children's trust and $4,350,000 to the spouse. Absent a change in the testator's plan, in 2009 the tax law will automatically shift the distribution to put $3,500,000 in the children's trust and leave only $1,500,000 to the spouse. And if death occurs in 2010, the kids get nothing - the whole of the estate will pass to the spouse. Wait another year to die and we're back to where we started - kids get $650,000.

The response to all this must be a rather nimble will or estate plan. Wills can be changed at any time, but they rarely are. And changing a will every year to reflect a new 12-month set of exemptions and tax rates is nonsense. But once death occurs, nothing can change in the document. Change and adaptation can occur only with a grant of discretion to the executor/trustee contained in the instrument.

As for the debate surrounding ultimate repeal of the estate and gift tax system, some thoughts and observations:

The estate and gift tax, originating principally in social policy, are not significant revenue raisers (although the migration of generational wealth over the next decade will bring a bubble of tax dollars to the government). The estate tax was brought permanently into the tax code nearly 90 years ago ,in part to bust up wealth concentrations of industrialist-capitalists of the era, who were fearful reminders to Congress of the aristoccracies of Europe (from which most Americans had fled in the century prior).

The tax had one prior stint in the U.S. tax system during the Civil War. Death or inheritance taxes are not uncommon in countries where ownership of private property exists, and in earlier times were favored because they were easy to collect. An event had occurred (someone had died). The event was a matter of public record. There were certain formalities involved, as were lawyers and probate courts. And the value of property was, in most cases, easily ascertained: land and livestock, dwellings and coins. To be contrasted with an income tax, which requires extensive record-keeping, relatively educated taxpayers, largely voluntary compliance, and an economic system where most goods and services are exchanged for dollars, as opposed to other goods and services (barter). At the time of the Civil War, in a predominantly agricultural/rural society, none of these conditions existed, and taxes on income were not possible.

I have seen through many closely held business owners the concern and worry for both family and business of a tax that amounts to half the value of their company. Can the company survive it? Is the burden fair to our children who will continue in the

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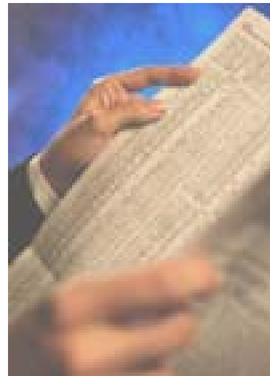
business? While the tax payment can be deferred for up to 14 years at a relatively low rate of interest (a tax relief measure for closely held businesses), founders correctly consider the tax obligation as debt (and documents the estate must sign with the government to gain the relief make that assessment unmistakable). And they also assume that funds for payment of the tax must inevitably come from the business. Apart from the fairness issues of potentially losing to the government half the value of their enterprise, they view the tax as a threat to the very business they created. Many conclude that it is best for all if the business is sold or liquidated.

But the problems a death tax creates for many closely held businesses can probably be mitigated without an outright repeal of the system. A local champion of repeal for the sake of saving family businesses is Frank Blethen of the Seattle Times Co. If Mr. Blethen were to leave his stock in the company to his heirs, it may well be that there should be no tax on that event. There is clear justification under a long-standing theory of tax law that tax should be imposed only when there is "wherewithal to pay." There is also substantial sentiment toward elimination of the tax as a major threat to the preservation of family businesses in America, which are viewed as great sources of enterprise and employment, if not part of our cultural heritage. But that is not quite persuasive as to the question of repeal of the entire system. In fact, if Frank Blethen's heirs were to turn around and sell his Seattle Times Co. soon after his demise, say to the Hearst Company, it seems as if both of the arguments advanced have vanished. His heirs have cash, and therefore unmistakably the wherewithal to pay a tax. And we no longer have a family-owned business, or at least not a business owned by the family that founded it.



The estate and gift tax has played a role in the long-standing domestic tax policy of a progressive tax system. A complete repeal of the tax would clearly reduce that progressivity. Some view the tax as unfair in that virtually everything taxed in one's estate has previously been taxed as income when earned, giving the government essentially a second bite at the same apple. But it is also reasonable to view the two taxes together as part of a social policy objective that the overall tax system should have some level of progressivity.

Eliminating the estate tax might require an increase in income tax rates to maintain that objective, but that could diminish the productivity of capital. We've seen that before. Marginal income tax rates in the 1970s ranged as high as 70% (upwards of 75% in most states). The wealthy behaved very differently with their money then, and deployed their capital in ways designed more to shelter it from such aggressive tax rates than to produce incremental income. It would not be placing too much credit to proclaim that the dramatic income tax rate reductions of the 1986 Tax Act opened the door to historic increases in the productivity of both labor and capital in the decade that followed.

Most tax economists argue that the progressivity of our overall tax system must also consider taxes on sales and labor. Unmistakably, lower income workers pay a higher percentage of their income on both. In Washington State, high sales tax rates take relatively more from workers who spend most of what they make, and less from savers. Payroll taxes amount to 7 ½ % of pay for a worker earning $80,000, but just over 2% from someone earning $500,000.

But in making a case for progressivity, and the role of the estate tax in that system, one needn't assume that a 50% rate of tax on one's accumulated wealth is either fair or necessary.

A repeal of the estate tax doesn't quite repeal taxes after death. The repeal measures contain companion legislation that eliminates the "step up in basis" rules that allow heirs to take a tax basis in inherited assets equal to the value as determined for estate tax purposes (fair market value as of date of death, or an alternate valuation date). Under current law, inherited assets can be sold by heirs for very little capital gains tax. But if the death tax goes away, a system of "carryover basis" that was in the law very briefly in the early

'80s comes in to take its place. Every inherited asset, from residences and jewelry to shares of stock, would also inherit Mom and Dad's tax basis. Consequently, if the family home had been acquired 30 years ago, with proceeds rolled over from a first home acquired 40 years ago, its tax basis to Mom and Dad is likely a small fraction of its current value. That means when the kids sell it, most of the proceeds would be taxed as gain. Under the current system, Mom and Dad's tax basis steps up to the value of the home on date of death, and unless the home has appreciated further, there will be no tax to the kids on its sale. And what about stock in General Motors that Mom acquired by gift from your Grandfather? Carryover basis takes you all the way back to what your Grandfather paid for the shares. So there is a substitution of taxes here—the 50% estate tax would be replaced with a 15% capital gains tax.

However, there are several problems, one obvious, the others not so. The obvious problem has probably already occurred to you: how many bloody accountants will it take to figure out what Mom and Dad's (or Grandfather's) tax basis was in all the inherited assets? The answer: many (good for us, bad for you).

A less obvious problem is that most heirs currently get stepped up basis (no capital gains tax on the sale of inherited assets), yet no tax was paid by the estate (due to exemptions). Under estate tax repeal, most heirs end up losers—they end up with a capital gains tax. Another problem: repeal of the federal estate tax is one thing, but don't count on repeal of Washington's inheritance tax (currently as high as 16% of the inherited value), certainly not in the current budgetary crisis.

Combining the capital gains tax with Washington's inheritance tax leaves us at close to 30% for large estates, in lieu of the current 50% federal estate tax.

It could be that when Congress inevitably rekindles the debate (as it appears it must before 2010), political compromise will give most people the best of both worlds. The system will remain (meaning step-up in basis will remain), but with larger exemptions, meaning most heirs will get assets both estate tax-free and income tax-free. Exemption amounts of $3 to $5 million (for each spouse) will eliminate estate tax for the vast majority of estates. Remember, the exemptions were $600,000 as recently as several years ago.

There also seems to be significant bipartisan agreement that perhaps rates should end up lower. Rates more in line with maximum income tax rates (35%) seem more consistent with one's notion of property rights and the right to pass property among children and heirs than a clearly confiscatory rate of 55%.

However, one thing to watch out for: the last time we had significant rate reductions were on the income tax side during the Reagan presidency. The top income tax rate went from 50% to 28%. But along with the rate relief, Congress eliminated many of the deductions and tax strategies that higher income taxpayers had employed to reduce their effective tax rate. The result for many was that, despite dramatically lower rates, the increase in their tax base translated to an overall higher tax bill.

The same could happen on the estate tax side. Most well-advised wealthy families effectively leverage down their rate by implementing strategies to reduce their tax base (*i.e.,* the assets that will actually be included in their taxable estate in the event of death). As quid pro quo for lowering rates and raising exemptions, Congress could move similarly to outlaw GRATS, QPRTS, intentionally "defective" trusts, entity discounts and other strategies currently employed to move wealth outside the estate and gift tax system. Any such change would likely allow for grandfathering of prior gifts and existing trusts, but future planning could be presented with far fewer options. If that were to happen, the benefit of a lower tax rate could again be overwhelmed by the much larger base to which it is applied.

**Estate Tax Rates: 2003-2011**

| Year | Rate | Exemption |
|---|---|---|
| 2003 | 49% | $1,000,000 |
| 2004 | 48% | $1,500,000 |
| 2005 | 47% | $1,500,000 |
| 2006 | 46% | $2,000,000 |
| 2007 | 45% | $2,000,000 |
| 2008 | 45% | $2,000,000 |
| 2009 | 45% | $3,500,000 |

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## The new 15 percent rates have us thinking

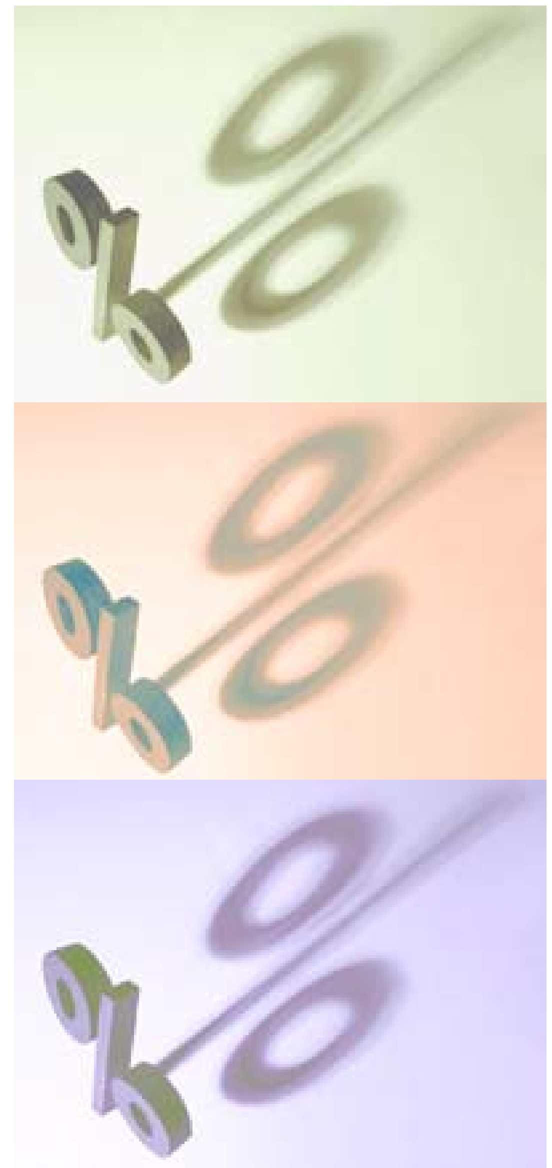
*By Robert A. Underhill*

We never thought we'd see the day when a good many of our clients would be in a 15% tax bracket. For those taxpayers without significant amounts of salary or business income, that's exactly where we are. The 2003 Tax Act provides for a top rate of 15% on net long-term capital gains and most dividends. In a few years we'll undoubtedly look back and view these rates as, literally, the bargain of the century. So, for as long as it lasts, we need to think a bit differently in structuring income and deductions (the new rates are due to sunset after 2007, but already there is some discussion in Congress of repeal or phase-out for higher income taxpayers).

The phenomenon occurs if one's personal exemptions, itemized deductions and business losses exceed the ordinary 35% rate income in one's return (principally salary, business income, taxable interest and short-term capital gains). For many, these deductions will "strip out" the ordinary rate income, leaving only 15% rate income subject to tax.

For those who find themselves in this situation, and who expect the rates to last for a few years or more, here are some things to think about:

- The holding of tax-free bonds seems unjustified. In a 15% bracket, the yield advantage of taxable bonds will generally deliver a premium on an after-tax basis.
- Gifts to children or grandchildren made with a view of shifting income-producing assets to lower income tax brackets may lose some of their impetus.
- Section 529 College Funds become somewhat less compelling in that much of the tax savings from the tax-free growth in such plans comes in the form of income that would otherwise be taxed at only 15%.
- The desirability of deferrals into 401(k) and other tax-qualified retirement plans requires more complicated analysis in that all distributions from such plans will be taxed at the highest ordinary rate in the year of distribution, even distributions of account earnings from dividends and capital gains. The same can be said of any form of deferred compensation.
- Incentive stock options (ISOs) gain a bit more advantage against nonqualified stock options as the capital gain to ordinary income rate differential is expanded.
- Carrying larger mortgages in consideration of the tax savings from the mortgage interest deduction should be reevaluated for those in a 15% bracket.
- Charitable contributions get substantially less "tax subsidy." Large gifts, such as to fulfill pledges, or fund private foundations or charitable trusts, might be deferred a few years to await higher rates.
- Finally, for those clients in California and Oregon, well, you know.



# Tax Calendar

| Date | Taxpayer | Event |
|---|---|---|
| March 15, 2004 | Corporations | Due date for domestic C or S corporations or foreign corporations with U.S. offices to file their prior year income tax return (Form 1120 or Form 1120S). File form 7004, together with payment, to obtain an automatic six-month extension of time to file. |
| April 15, 2004 | Partnerships | Due date for partnerships and LLCs to file thier prior year income tax returns (Form 1065). File Form 8736 to obtain an automatic three-month extension of time to file. |
| April 15, 2004 | Individuals | Due date for individuals to file their prior year income tax returns (Form 1040, Form 1040-A, or Form 1040-EZ). File Form 4868 to obtain an automatic four-month extension of time to file. |
| April 15, 2004 | Individuals | First installment of current year estimated tax is due (Form 1040-ES). |

**ROBERT A. UNDERHILL P.C.**

601 Union Street
Suite 3300
Seattle, WA 98101

Phone 206.357.3033
Fax 206.357.3034
On the Web at www.raupc.com

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