

InBrief

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Tax Act of 2001 PART 2



Robert O. Blatti

Estate and Gift Taxes, Federal and State

Robert O. Blatti

In a previous newsletter article, we summarized the provisions of the Tax Relief Reconciliation Act of 2001, which made sweeping changes to our federal tax code. This is the second in a series of articles focusing on some of the specific provisions of the Tax Act of 2001 that may affect your estate and estate plan. In this article, we will focus on the changes to the federal estate and gift “exemption equivalent”, which is the maximum amount a taxpayer can gift during their lifetime, or pass to others upon their death, without incurring a federal tax.

Lifetime Gifts

A lifetime gift is any property or asset that one person or legal entity transfers to another person or legal entity for less than the fair market. This includes transfers for which a person receives nothing in exchange, and transfers for which a person receives something, but something less than what the property or asset is worth. Taxable gifts can be made to and from natural persons, or to and from irrevocable trusts, corporations, partnerships, and other legal entities. For example, if a person transfers assets into an irrevocable trust, or gives real property to children, a gift has occurred.

Under prior law, a person could transfer up to \$675,000.00 worth of assets to others, either through lifetime gifts or after death, without any tax consequences to either party. This was referred to as the “unified credit”. Beginning in Year 2002, a person can now transfer up to \$1,000,000.00 worth of assets during their lifetime and upon their death without tax consequences. Beginning in Year 2004, the exemption equivalents will be no longer “unified”, and a person will be allowed to gift up to \$1,000,000.00 worth of assets during their lifetime, and transfer another \$500,000.00 worth of assets upon their death, or, if no lifetime gifts are made, up to \$1,500,000.00 upon death, without tax consequences. After 2002, the gift tax exemption equivalent will remain at \$1,000,000.00 but, as explained below, the estate tax (transfers at death), will continue to increase.

In addition to the lifetime gift tax exemption equivalent, there is also an “annual exclusion.” The annual exclusion is the value of assets that a person can transfer during any tax year, without reducing their lifetime gift tax exemption equivalent. Under prior law, this amount was set at \$10,000.00 per person, per year. Under the Tax Act of 2001, this amount is reviewed each year and adjusted for inflation; the current annual exclusion is \$11,000.00. As an example of how the annual exclusion works, if a parent was to give \$11,000.00 worth of stock to a child, that parent would still have the full \$1,000,000.00 lifetime gift exemption available for future gifts. However, if the parent gifted \$20,000.00 worth

of stock to child, all in the same year, the parent’s lifetime gift exemption would be reduced by \$9,000.00 (\$20,000.00 minus the \$11,000.00 annual exclusion).

The Estate Tax

The federal estate tax is based upon the value of a person’s “taxable estate” at the time of death. For many, the size of their taxable estate is much larger than they may think. The taxable estate not only includes real property, bank accounts, investments, and personal property owned at death, but also the proceeds from life insurance policies, some assets gifted away prior to death, property owned jointly with others, real property in which the person held a life estate at death, and some property over which a person holds a “power of appointment.”

As stated above, the estate tax and the gift exemption equivalents were unified at a total of \$675,000.00 under prior law. Under the Tax Act of 2001, the gift tax exemption equivalent was increased to \$1,000,000.00 beginning January 2002, and stays at this amount. The Tax Act of 2001 gradually increases the estate tax exemption equivalent, currently at \$1,000,000.00, up to \$2,000,000.00 in Year 2006, and repeals the estate tax entirely beginning Year 2010. However, if Congress and the President fail to extend the Tax Act of 2001 by the end of Year 2010, the Act expires, and we are back to the unified credit that existed prior to Year 2001, with maximum tax-free lifetime gifts and transfers at death of \$675,000.00.

The Tax Act of 2001 also gradually reduces the tax rate that taxable estates will pay for transfers exceeding the estate exemption equivalent. Under prior law, these tax rates ranged from 37% to 55%. Beginning this year, the highest tax rate is 50%, and this rate will gradually be reduced to 45% until the estate tax is repealed beginning in Year 2010. The estate and gift tax begin to apply with the first dollar over the exemption equivalent that is transferred by gift or upon death.

State Taxation of Estates

Prior to the Tax Act of 2001, most states, including Minnesota, taxed estates using a “pick-up” tax. The federal estate tax provisions allowed an estate a direct credit for state taxes imposed on an estate. Many states, including Minnesota, simply took the amount of this credit from the federal government and imposed no additional taxes on the estate. In addition, many state tax laws mirrored the federal exemption equivalent, which avoided any state tax on estates that were not taxed under the federal estate tax provisions. However, as of the date of this article, Minnesota has so far failed or declined to change its estate tax provisions to increase the



As of the date of this article, Minnesota has so far failed or declined to change its estate tax provisions to increase the estate tax exemption equivalent to match the increase in the federal exemption; the exemption equivalent in Minnesota remains at \$700,000.00.

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estate tax exemption equivalent to match the increase in the federal exemption; the exemption equivalent in Minnesota remains at \$700,000.00. The effect is that, under current Minnesota law, an estate of \$900,000.00 would not be taxed under the federal tax code, but \$200,000.00 of that estate would be taxed under the Minnesota tax laws. With the loss of funds from the estate tax credit, it is widely believed that many states that employed the pick-up tax for taxation of estates prior to June 2001 will pass legislation in the coming year to create a separate state tax system for estates to offset this loss of revenue.

Conclusion:***The Effect on Your Estate or Estate Plan***

The changes to federal estate and gift tax under the Tax Act of 2001 create new planning strategies and opportunities for those with more substantial estates. However, because the law may be repealed after Year 2010, or before, it also creates a great deal of uncertainty. A common strategy for estate planners has always been to make full use of the tax provisions that allow unlimited tax-free transfers to spouses, in combination with the gift and estate tax

exemption equivalents, to put together estate plans that allow estates to be transferred with little or no tax consequences.

However, some of the estate plans put in place prior to June 2001 fail to account for an ever-changing estate tax exemption equivalent, and/or contain gifting plans that do not take full advantage of the increased gift tax exemption equivalents. These plans may also fail to account for possible estate taxation by the state, which may have not existed prior to June 2001.

If you have an estate plan that was developed before June 2001, that includes a family and credit shelter trust, and a marital trust, it is possible that your plan uses a formula that could leave your spouse with substantially fewer assets upon your death than was anticipated when the estate plan was created. There are tools available to an estate planner to create an estate plan that utilizes all of the advantages of the Tax Act of 2001, but still is flexible enough to weather any expected or unexpected changes in the federal tax code. Whether you have an existing estate plan, or not, now is a good time to see your attorney or other estate planner for a review.

Experience counts in the courtroom

Local lawyers mentor clerks in legal matters

Joel Hagen, Daily Journal



Katrina Wass, Sam Rufer, Nick Heydt and Luke Robinson are all working toward their law degrees and benefiting from experience as law clerks at Pemberton, Sorlie, Rufer and Kershner law firm in Fergus Falls. Journal photo by Joel Hagen.

The Pemberton, Sorlie, Rufer and Kershner law firm in Fergus Falls is helping four young law clerks this summer earn experience in the field. Each clerk benefits with one-on-one experience with an attorney as a mentor.

Luke Robinson, of Mahtomedi, said experience is the most important thing to have when trying to find a job after school, and working as a clerk is the best way to learn.

"You learn things that could never be taught at school," said Sam Rufer, originally from Fergus Falls.

They said it was like night and day with the law firm and school.

"I've enjoyed the interaction I've had with all the attorneys," said Nick Heydt from Alexandria. "It's really different from a school setting."

Katrina Wass of Underwood agreed. "The exposure you get here is amazing," she said.

Heydt describes the experience as "sink or swim with a life jacket." He said the attorneys are always available and open to questions when he needs them.

They said there was a large difference between working in Fergus Falls compared to the cities. The consensus was that the large law firms in the cities can treat clerks with soft gloves, but at the Fergus Falls firm, they learn by working in many areas. They said most firms in Minneapolis wouldn't have given them the many opportunities to client exposure they have already had in Fergus Falls.

"They really do throw you into here in a positive way," Wass said.

Managing partner at the firm, Morrie Kershner, said they almost always have about one to four clerks for several reasons. He said the first reason is they are always looking for good people to hire as attorneys and this is the best way to judge their work. He said about 75 percent of the lawyers at the firm in the last 25 years were clerks before they started here. Kershner said the firm also believes it is an important part of any student's education as well as a help to the firm.

"We give them a much more varied experience," he said. "I think a smaller general practice firm that has some of everything as opposed to a large firm organized by department is able to provide clerks with a broader range of experience."

The four clerks started in mid-May and will continue through mid-August before heading back to their last year of school.

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