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US Federal Estate Tax Update and Overview

Ian Watson
3 Stone Buildings

I. A history lesson: The US Federal Estate and Gift Tax in 2001

As of March 20101, the US federal estate, gift and generation-skipping transfer taxes (collectively, "transfer taxes") remain in a state of flux. The estate and generation-skipping transfer taxes (though not the gift tax) has in fact been repealed for 2010, though it is still possible Congress might try to reinstate it with retroactive effect, which may invite a constitutional challenge. If no further action is taken, the federal transfer tax system is slated to reappear on 1 January 2011 just as it was in 2001, and there may well be legislation in the meantime to extend the old system albeit with a different level of exemption. It is necessary, therefore, to understand the system as it was in 2001 in order to understand how the present situation came to be and what it is likely to look like in the near future.

Until 2001, the US federal estate and gift taxes were imposed on aggregate lifetime gifts after 1976 and transfers at death taxed at the following graduated rates:

Table 1. US Federal Estate and Gift Tax Graduated Rates – (2001)

A	B	C	D	E
Between ...	**... and**	**Tax ...**		**Rate on excess over column A**
0	$10,000		–	18%
$10,000	$20,000	$1,800	plus	20%
$20,000	$40,000	$3,800	plus	22%
$40,000	$60,000	$8,200	plus	24%
$60,000	$80,000	$13,000	plus	26%
$80,000	$100,000	$18,200	plus	28%
$100,000	$150,000	$23,800	plus	30%
$150,000	$250,000	$38,800	plus	32%
$250,000	$500,000	$70,800	plus	34%
$500,000	$750,000	$155,800	plus	37%
$750,000	$1,000,000	$248,300	plus	39%
$1,000,000	$1,250,000	$345,800	plus	41%
$1,250,000	$1,500,000	$448,300	plus	43%
$1,500,000	$2,000,000	$555,800	plus	45%
$2,000,000	$2,500,000	$780,800	plus	49%
$2,500,000	$3,000,000	$1,025,800	plus	53%
$3,000,000	–	$1,290,800	plus	55%

In addition, there was a surcharge of 5% on amounts between $10 million and $17,184,000. The effect of this was to taper off the benefit of the "unified credit" (see below) and lower graduated rates so that estates above the top limit paid a flat rate of 55%.

There was also a generation-skipping transfer tax at top estate tax rate on assets passing to or for the benefit of "skip-persons" – i.e., relatives more than one generation below or unrelated persons more than 37½ years younger than) the donor or testator. Each donor or testator had a $1 million GST exemption that could be allocated among any relevant dispositions, whether outright or in trust, permanently exempting those assets from the tax.

Basic US estate planning for married persons generally included the use of a non-marital trust to preserve the effective exemption of the first spouse to die, similar to a UK nil rate band discretionary trust, and securing marital (or charitable relief) for the balance of the estate of the first to die. If the client was also subject to UK IHT on the same assets, some care needed to be taken to ensure that marital and charitable dispositions qualified for relief in both countries.

In addition to the federal tax, most states imposed their own death taxes (based on domicile or situs within the state), though in many cases these were fully credited against federal tax.

Assets owned at death received a step up in basis to fair market value at date of death (or the alternate valuation date, generally 6 months later).

The "Unified Credit"

For US citizens or domiciliaries in 2001, the first $675,000 escaped tax by virtue of what was historically called the "unified credit". Taking this credit into account, the tax on the estate (including lifetime gifts) of a US citizen or domiciliary in 2001 was as follows:

Table 2. US Federal Estate and Gift Taxes, Reflecting Unified Credit Equivalent of $675,000 for US Citizens or Domiciliaries – (2001)

A	B	C	D	E	F	G
Between...	**... and**	**Tax ...**		**Rate on excess over column A**	**Total on full amount of column B**	**Overall rate**
0	$10,000		–	18%		
$10,000	$20,000	$1,800	Plus	20%		
$20,000	$40,000	$3,800	Plus	22%		
$40,000	$60,000	$8,200	Plus	24%		
$60,000	$80,000	$13,000	Plus	26%		
$80,000	$100,000	$18,200	Plus	28%		
$100,000	$150,000	$23,800	Plus	30%		
$150,000	$250,000	$38,800	Plus	32%		
$250,000	$500,000	$70,800	Plus	34%		
$500,000	$750,000	$155,800	Plus	37%	$27,750	3.7%
$750,000	$1,000,000	$248,300	Plus	39%	$125,250	12.5%
$1,000,000	$1,250,000	$345,800	Plus	41%	$227,750	18.2%
$1,250,000	$1,500,000	$448,300	Plus	43%	$335,250	22.4%
$1,500,000	$2,000,000	$555,800	Plus	45%	$560,250	28.0%
$2,000,000	$2,500,000	$780,800	Plus	49%	$805,250	32.2%
$2,500,000	$3,000,000	$1,025,800	Plus	53%	$1,070,250	35.7%
$3,000,000	*$3,865,000*[*]	$1,290,800	Plus	55%	$1,546,000	40.0%

For US persons who were also domiciled or deemed domiciled in the United Kingdom, it was relevant that the US federal estate tax reached an overall effective rate of 40% at about $3,865,000.[*] Since US federal and UK death taxes may generally be offset, only clients in this category with total estates (including aggregate lifetime gifts) above this amount would be faced with US federal taxes in excess of what they would pay in the UK anyway – though as different rules apply on each side of the Atlantic to PETs, business assets, valuation issues, etc., the point where US and UK taxes were the same could vary.

Non-US citizens not domiciled in the US, who were similarly taxed *on US situs assets only,* were only allowed a unified credit sheltering a mere *$60 thousand* of US situs assets from tax (though they were allowed a full $1 million GST exemption). They were taxed as follows:

[*] This figure is shown in Table 2 at the bottom of Column B in italics to illustrate the calculation, even though it is not the limit of any tax bracket.

Table 3. US Federal Estate and Gift Tax Graduated Rates Showing Tax for Non-US Citizens Not US-Domiciled– (2001)

A	B	C	D	E	F	G
Between ...	**... and**	**Tax ...**		**Rate on excess over column A**	**Total on full amount of column B**	**Overall rate**
0	$10,000		–	18%		
$10,000	$20,000	$1,800	Plus	20%		
$20,000	$40,000	$3,800	Plus	22%		
$40,000	$60,000	$8,200	Plus	24%		
$60,000	$80,000	$13,000	Plus	26%	$5,200	6.5%
$80,000	$100,000	$18,200	Plus	28%	$10,800	10.8%
$100,000	$150,000	$23,800	Plus	30%	$25,800	17.2%
$150,000	$250,000	$38,800	Plus	32%	$57,800	23.1%
$250,000	$500,000	$70,800	Plus	34%	$142,800	28.6%
$500,000	$750,000	$155,800	Plus	37%	$235,300	31.4%
$750,000	$1,000,000	$248,300	Plus	39%	$332,800	33.3%
$1,000,000	$1,250,000	$345,800	Plus	41%	$435,300	34.8%
$1,250,000	$1,500,000	$448,300	Plus	43%	$542,800	36.2%
$1,500,000	$2,000,000	$555,800	Plus	45%	$767,800	38.4%
$2,000,000	$2,500,000	$780,800	Plus	49%	$1,012,800	40.5%
$2,500,000	$3,000,000	$1,025,800	Plus	53%	$1,277,800	42.6%
$3,000,000	–	$1,290,800	Plus	55%		

For persons subject to IHT on the same assets, the crossover point where US taxes reach 40% is about $2,355,000 – significantly lower than for US citizens or domiciliaries subject to IHT, though of course the taxes only apply to US situs assets.

Very briefly, assets that are sited in the US for federal transfer tax purposes generally include

- Real property and chattels situated in the US at death,
- Shares of companies incorporated in the US,
- Certain US debt obligations,
- Business-related assets owned by a sole proprietor and used in a US business activity (including land, machinery and equipment, patents, accounts receivable and goodwill).

Note, however, that non-US citizens not domiciled in the US are not subject to gift tax on the transfer of US-sited intangible assets. The general situs rules may also be altered by treaty. In particular, Article 5 of the 1978 US/UK Estate Tax Treaty provides that UK domiciliaries are only subject to US transfer tax on US real property and business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services. Note, however, that US estate

tax treaties do not cover state death taxes.

II. The "Repeal"

Under the terms of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the federal estate tax was "repealed" in stages by gradually increasing the unified credit and lowering the top rate of tax. By 2009, the unified credit had been increased to exempt $3.5 million for US citizens or domiciliaries, and the top rate of tax had been reduced to 45%. The result was a flat rate of tax at 45% on estates (including lifetime gifts) over that amount. For the duration of 2010 only, the estate tax and generation-skipping transfer taxes were fully repealed, but (to prevent taxpayers from taking advantage of the temporary repeal of the estate tax) the gift tax remains, at a flat rate of 35% and with a $1 million lifetime exemption.

Other changes imposed by EGTRRA were a repeal of the 5% surcharge on very large estates and a change to the carry-over basis rules. Instead of stepping up the basis of assets owned by a decedent to the value at the date of death or the alternate valuation date, the basis of anyone owning assets received from a decedent is now the *lower* of the value at the decedent's death or the decedent's basis. This means the recipient will potentially be liable to tax on a future sale of unrealised appreciation in the hands of the decedent. Each estate, however, may now allocate to individual assets a step-up to date of death values for up to $1.3 million of unrealised gain. An additional $3 million of stepped up basis may be allocated to assets passing to a surviving spouse outright or in certain trusts. Both of these allowances are indexed to inflation from 2010.

The "Sunset" Provision

In a typically American political compromise, all of the tax changed wrought by EGTRRA will disappear on 1 January 2011 unless both houses of Congress and the White House enact legislation in the meantime to make the repeal permanent. Though there have been several attempts to do so, as well as attempts to modify the repeal – by increasing the unified credit to shelter, say, the 2009 figure of $3.5 million, for example – none was successful. Other as yet unsuccessful proposals included a "portable" unified credit similar to the nil rate band under the recent IHT rules in the UK, so that the surviving spouse may make use of any unused credit in the estate of the first spouse to die without the need for a trust. Congress may yet act to extend or alter the tax regime, but it is impossible to predict the outcome. In the current economic and political climate, however, it is unlikely that there will be a permanent repeal.

As things now stand, in 2011 the federal estate and gift taxes will revert to the same graduated rates as

in 2001, although the unified credit for US citizens or domiciliaries will shelter $1 million instead of $675,000, as this increase had already been scheduled prior to EGTRRA. The taxes for US citizens or domiciliaries from 2011 are slated to be as follows:

Table 4. US Federal Estate and Gift Taxes, Reflecting Unified Credit Equivalent of $1 Million for US Citizens or Domiciliaries – (2011 in the absence of further legislation)

A	B	C	D	E	F	G
Between ...	**... and**	**Tax ...**		**Rate on excess over column A**	**Total on full amount of column B**	**Overall rate**
0	$10,000		–	18%		
$10,000	$20,000	$1,800	Plus	20%		
$20,000	$40,000	$3,800	Plus	22%		
$40,000	$60,000	$8,200	Plus	24%		
$60,000	$80,000	$13,000	Plus	26%		
$80,000	$100,000	$18,200	Plus	28%		
$100,000	$150,000	$23,800	Plus	30%		
$150,000	$250,000	$38,800	Plus	32%		
$250,000	$500,000	$70,800	Plus	34%		
$500,000	$750,000	$155,800	Plus	37%		
$750,000	$1,000,000	$248,300	Plus	39%		
$1,000,000	$1,250,000	$345,800	Plus	41%	$102,500	8.2%
$1,250,000	$1,500,000	$448,300	Plus	43%	$210,000	14.0%
$1,500,000	$2,000,000	$555,800	Plus	45%	$435,000	21.8%
$2,000,000	$2,500,000	$780,800	Plus	49%	$680,000	27.2%
$2,500,000	$3,000,000	$1,025,800	Plus	53%	$945,000	31.5%
$3,000,000	*$4,700,000*[†]	$1,290,800	Plus	55%	$1,880,000	40.0%

The crossover point where overall US taxes reach 40% will therefore be about $4.7 million[†].

Throughout the staged repeal up to 2009, the unified credit equivalent for non-US citizens not domiciled in the US remained $60,000. In 2011, absent further legislation, their tax liabilities will revert to that shown in Table 2.

The resulting uncertainty about the tax thresholds makes estate planning for UK domiciliaries with US connections difficult at present. In particular, the unpredictable level of the unified credit drastically affects the crossover point for clients also subject to 40% IHT. Though for non-US citizens not domiciled in the US this point will remain at about $2,355,000 (absent further legislation), the figure may vary widely for US citizens domiciled in the UK for IHT purposes. Possible crossover points include $3,865,000 (with a 2001 unified credit equivalent of $675,000) and $4,700,000 (with the

[†] This figure is shown in Table 4 at the bottom of Column B in italics to illustrate the calculation, even though it is not the limit of any tax bracket.

scheduled $1 million equivalent in 2011). If the 2009 unified credit equivalent of $3.5 million is adopted (with no other changes), a flat 55% rate of tax would apply, and the 40% crossover point would not be reached until about $8,150,000. The unified credit equivalent may well end up somewhere between those figures, and one of the recent unsuccessful legislative proposals would have made it $5 million.

III. Planning for the Future?

No simple course presents itself to deal with these uncertainties. While UK clients with taxable US assets safely below the lowest threshold may get away with relatively simple planning to preserve the unified credit of the first spouse to die with a non-marital trust, leaving the balance to the surviving spouse so as to qualify for marital relief in both the US and UK, for those who may or may not be subject to higher US tax than UK IHT it may be necessary to be more creative.

While clients may be understandably reluctant to undertake expensive planning that may quickly become obsolete, it is important to put something in place for anyone who is otherwise intestate, and existing wills should be reviewed to ensure that any formulas for marital or charitable dispositions will continue to work through these uncertain times. In many cases it may be necessary to include alternate provisions to apply depending on whether there is an estate tax, or whether US taxes exceed UK taxes, at the time of death. To some extent, flexibility may be preserved with powers of appointment or discretions given to executors and trustees, so long as these do not interfere with the US rules for marital and charitable relief.

State taxes, too, take on greater significance in 2010 than hitherto. The several states have a number of different rules (not only with respect to taxes, but also as to such matters as community property and the inheritance rights of spouses), so competent local advice will be necessary.

Above all, anyone planning for clients who may be subject to US federal transfer taxes will need to keep a weather eye on Congress for future changes.

Ian Watson
3 Stone Buildings
Lincoln's Inn
London WC2A 3XL

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