

## TAX & TRANSACTIONS BULLETIN

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Federal Estate Tax Credit Rises to \$1.5 Million

- On January 1, 2004, the Credit against Federal estate tax increased to \$1.5 million
- Every individual may transfer \$1.5 million at death tax-free
- With Proper Planning, a married couple may transfer \$3 million at death tax-free
- The Generation Skipping (GST) Credit also increased to \$1.5 million

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### ESTATE TAX CREDIT RISES TO \$1.5 MILLION

Effective January 1, 2004, the Federal Estate Tax Credit<sup>1</sup> increased to \$1.5 Million. The increased Estate Credit is great news for the Family. With proper planning, a married couple may now transfer \$3 million to their children tax-free. This tax savings creates greater Family wealth.

People often desire to keep their wealth within the Family. Typically, a married couple distributes assets for each other during their joint lifetimes, and then distributes assets to younger generations. These distributions are subject to 3 transfer taxes: Gift tax, Estate tax, and Generation Skipping (GST) tax. These 3 taxes are interrelated, and apply to all transfers of wealth from one individual to another.



Each tax has its own Credit. The Credit reduces tax on a dollar-for-dollar basis. A Credit thus permits tax-free transfers of Family wealth. The Credits assist a married couple in providing for each other during their joint lifetimes, and then distributing property to their children and grandchildren. Careful planning with Credits can maximize Family tax savings.

The Federal Credits, respectively, are as follows:

<u>Year:</u>	<u>Estate Credit:</u>	<u>Gift Credit:</u>	<u>GST Credit:</u>
2002 and 2003	\$1,000,000	\$1,000,000	\$1,120,000 <sup>2</sup>
2004 and 2005	\$1,500,000	\$1,000,000	\$1,500,000
2006, 2007, and 2008	\$2,000,000	\$1,000,000	\$2,000,000
2009	\$3,500,000	\$1,000,000	\$3,500,000

The increased Estate Credit (and GST Credit) is highly beneficial for the Family. With proper planning, a married couple may, at death,<sup>3</sup> transfer \$3 million to their children and grandchildren tax-free. This tax-free transfer permits greater accumulations of Family wealth. (Note that both the Estate tax and GST tax are

<sup>1</sup>Every U.S. taxpayer receives an Applicable Exclusion Amount which permits tax-free gifts during life or tax-free bequests upon death. This Applicable Exclusion Amount thus functions as a credit to reduce tax, and is conveniently referred to as the "Tax Credit".

<sup>2</sup>The GST credit was \$1,100,000 in 2002, and \$1,120,000 in 2003.

<sup>3</sup>Note that although both the Estate and GST Credits increased, the Gift Credit did not increase. Thus, although a person may transfer \$1.5 Million at death tax-free, a person may transfer only \$1.0 Million during life tax-free. This discrepancy reflects the fact that Congress might lower the Estate Credit in the future. Congress does not want an individual to make tax-free lifetime gifts now, which exceed the amount the individual could transmit tax-free at death in the future.

## ESTATE TAX CREDIT RISES TO \$1.5 MILLION (cont'd)

scheduled to be repealed for individuals dying in 2010. Each tax is then reinstated in 2011. Many practitioners expect Congress to pass legislation prior to 2009, to clarify this situation).

Additional Federal tax laws which became effective January 1, 2004, are:

- The annual exclusion for gifts remains at \$11,000.
- The annual exclusion for gifts to a non-citizen spouse increases to \$114,000.
- The maximum Gift/Estate tax rate (and flat GST rate) is 48%.
- The state death-tax credit is reduced to 25% of its original amount under Code Section 2011.
- The deduction for a qualified family-owned business interest ("QFOBI") is repealed for estates of decedents dying after December 31, 2003.

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## THE NEW 15% TAX RATE ON DIVIDENDS

Effective January 1, 2003, the federal tax rate on stock dividends received by an individual was reduced to 15%. This tax benefit was part of the *Jobs and Growth Tax Relief Reconciliation Act of 2003*. The new 15% rate on dividend income is a boon for individual taxpayers. The 15% rate applies to dividends received from domestic corporations and from qualified foreign corporations.<sup>1</sup>

There are, however, numerous exceptions to the favorable 15% rate. Interest earned on bonds, certificates of deposit, and savings accounts is still taxed at ordinary rates. Most REIT distributions are still taxed at ordinary rates. Distributions from IRAs, 401(k)s, and annuities are still taxed at ordinary rates (even if the distribution represents dividends paid on stock held in a tax-free account). The 15% rate also fails to apply to dividends paid by tax-exempt corporations, savings & loan companies, and ESOP-related transactions.

Additional exceptions to the 15% rate apply based on the recipient's profile. For instance, an individual must own the stock for at least 61 days during the 121-day period<sup>2</sup> beginning 60 days before the ex-dividend date.<sup>3</sup> The idea is to prevent a person from buying and holding a stock for only a few days, while collecting a dividend taxed at 15%. Also, partnerships, S corporations, estates, and revocable trusts treated as an estate, which are on a fiscal year that began in 2002, may pass through dividends received in 2003 as qualified dividends taxed at the 15% rate. However, individuals on a fiscal year beginning in 2002 and ending in 2003 are not eligible for the 15% rate for dividends received during that fiscal year, even if the dividends are actually received in 2003.



<sup>1</sup>A qualified foreign corporation is any foreign corporation: (a) whose stock is readily tradable on an established securities market in the U.S. (i.e. NASDAQ, any stock exchange registered with the SEC, or an American depository receipt); or (b) that is eligible for benefits of an income tax treaty with the U.S.

<sup>2</sup>As of the date of this Article, IRS had decided to implement in advance certain provisions of the 2003 Technical Corrections Act, actual passage of which is expected soon.

<sup>3</sup>The "ex-dividend date" is the latest date a buyer may purchase stock and remain entitled to collect the upcoming dividend.

## THE NEW 15% TAX RATE ON DIVIDENDS (cont'd)

Another exception to the 15% rate occurs in the context of short-sale transactions. The 15% rate is denied where a taxpayer is under an obligation to make a related payment with respect to a position in substantially similar property. The 15% rate is also denied for "payments in lieu of dividends." The upshot of these rules is illustrated by the following Example:

### **Example – Short Sale Transaction Denies 15% Rate on Dividends Attributable to the Loaned Shares:**

*Anne owns 25 shares of ACME stock. The shares are held in a brokerage account. Under the account contract with Anne, her broker may loan her shares to 3<sup>rd</sup> parties (this arrangement is common for margin accounts). Charlie, a separate client, owns 100 shares of ACME stock. Using the broker as intermediary, Charlie borrows 25 ACME shares from Anne and then short-sells those 25 shares. A week later Charlie receives a \$100 dividend from ACME. Charlie is obligated to remit \$25 of the dividend to Anne because he borrowed shares from her. (Charlie is entitled to keep \$75.) Charlie is not eligible for the 15% rate on the \$25 portion because of his obligation to pay Anne that amount. Anne is also not eligible for the 15% rate on the \$25 portion because her payment was received "in lieu" of a dividend. Thus, \$25 of the original dividend is ineligible for the 15% rate. (The remaining \$75 payment which Charlie keeps is eligible for the 15% rate).*

The 15% federal tax rate on stock dividend income is clearly beneficial. There are, however, numerous exceptions where the 15% fails to apply. Stockholders may want to review their own unique profile to determine eligibility for the favorable rate. Brokers and Dealers may want to confirm that their information reporting systems are accurate and in full compliance.<sup>4</sup>

<sup>4</sup>Notice 2003-67 discusses the information reporting requirements for brokers and dealers who engage in short sales or similar securities lending transactions.

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