The Guttenberg Press

Preserving Your Assets ... Planning Your Future

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Dear Friend:

It's here. The President's idea was simple. Repeal the estate tax. But a repeal was much too risky for budgetary reasons and the country's economic well-being over the next decade. So the long-awaited changes are here, but through a legislative sleight-of-hand, its impact and effect are ephemeral, yet significant. Ephemeral – in that the repeal lasts for one year only- 2010, after which year the new tax bill expires or "sunsets" unless Congress acts again. Significant – in that the changes in place during the period 2001 through 2009 can have major effects on your estate planning.

I have chosen to devote much of this expanded newsletter to these changes with practical analysis and recommendations as to actions and strategies that are necessary and indeed, may be advantageous, for you under the new law. I have already developed various approaches to the new law for clients (and which I am incorporating in a new supplement to my Maryland Estate Planning book). Of course, any strategies and recommendations need to be tailored to your personal and financial circumstances and objectives. As always, I will keep you informed.

Let's stay in touch!

New Estate and Gift Tax Changes Create Opportunities and Require Second Look at Estate Plans

On May 26, 2001, Congress passed, and on June 7, 2001, President Bush signed into law, the Economic Growth and Tax Relief Reconciliation Act of 2001. (I will refer to the new law simply as the "Act.") The Act includes many changes in the income, estate and gift and generation-skipping tax. It may well take months to sift through the provisions of the Act to figure out its effect. But estate planning is something that should never be put off. Indeed, many of you have done estate planning which may be affected by the new law. So, here's my "executive summary" of the key changes in the Act affecting your estate planning, my analysis as to what the changes may mean for your estate planning, and some opportunities created by the changes and recommended action strategies.

Summary of Changes

Phase-In/Phase-Out; Repeal/Sunset-- Now You See It, Now You Don't

There are 2 time periods/concepts that are the core of the changes affecting the estate, gift and generation-skipping taxes: "Phase-In/Phase-Out" and "Repeal/Sunset."

•Phase-In/Phase-Out (2001-2009): For the years 2001 through 2009, the basic estate tax structure remains intact. But two very important things happen during this period. The estate and gift tax rates will be reduced gradually from 55% to 45%, and the lifetime exemption amount for estate taxes will increase from $1 million in 2001 to $3.5 million in 2009. (As will be noted later, the exemption for "gift" taxes remain at $1 million.) These rates and exemption increases are set out in the chart on the next page.

•Repeal/Sunset (2010-2011): On January 1, 2010, the Act repeals the estate and generation-skipping tax – but for one year only – 2010. Due to budgetary restrictions, the new provisions of this new law will "sunset" on December 31, 2010 – bringing us back in the year 2011 to the estate and generation-skipping tax system and rates of the year 2002! (The gift tax, however, is not repealed.) Confused? I will explain below, but before you get lost, here's a chart which details current law, the changes during the phase-in/phase-out period and repeal/sunset.

Other Changes- "Sleepers" Which Can Awaken At Sunrise or Sunset

The Act make several other important changes, which I will briefly review and provide some perspective.

• The Corollary to Repeal of Estate Tax: Elimination of "Step-Up" in Basis. In my article in the Spring 2001 edition of The Guttenberg Press, "The Step-Up in Basis Rule for Inherited Property," I discussed the ever important concept of step-up in basis at death, and pointed out that any "repeal" would be accompanied

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YEAR	LIFETIME EXEMPTION	TOP RATE
2001 (current law)	$675,000	55%
2002	$ 1 million	50%
2003	$ 1 million	49%
2004	$ 1.5 million	48%
2005	$ 1.5 million	47%
2006	$ 2 million	46%
2007	$ 2 million	45%
2008	$ 2 million	45%
2009	$ 3.5 million	45%
2010	REPEALED	0%
2011	$ 1 million	55%

by a concurrent repeal of the very beneficial "step-up" in basis rule. (The "stepped-up" basis generally equals the fair market value on the date of the decedent's death. This step up means that the taxpayer will not owe income tax on the property's appreciation in the hands of the decedent – that appreciation permanently escapes income tax.) With the repeal in 2010, the basis of assets inherited from a decedent will no longer be fully "stepped-up" to reflect date of death values (which would avoid a capital gains tax on a later sale). Rather, beginning in 2010 the basis of assets received from a decedent will "carry over" from the decedent . Thus, death could engender a major income tax. There are, however, two exemptions which could save many estates: $1.3 million of basis will be allowed to be added to certain assets and $3 million of basis will be permitted to be added to assets transferred to a surviving spouse.

Observation: In the unlikely event that a "carryover" basis system comes into place, we need to be prepared. It would be therefore be prudent beginning now to keep detailed records on the prices paid for assets (stocks, real property), especially for hard-to-value assets such as partnership interests.

Generation-Skipping Tax. Currently, there is a $1,060,000 exemption for transfers to grandchildren or to generation-skipping trusts. See Fall, 1999 edition of *The Guttenberg Press*, "Attention Grandparents! Large Tax Savings With Generation-Skipping Trusts." This exemption will apply for the years 2002 and 2003. Beginning in 2004 through the "repeal" in 2010, the GST exemption will be equal to federal estate tax exemption (see chart above).

Observation: This correlation of the estate and GST exemption actually may simplify GST planning since under current law, many clients' estate plans require 3 or even 4 trusts under a Will to maximize the GST exemption (see "Attention Grandparents! Large Tax Savings With Generation-Skipping Trusts."). More importantly, generation-skipping trusts as well as "Dynasty Trusts" are still important planning strategies because we would be hard-pressed to say that there would be a repeal for generations. (In this regard, see Fall, 2000 edition of The Guttenberg Press, "Preserving Wealth with a New Maryland Dynasty Trust"). We can't even safely say it will happen due to the "sunset" provisions of the Act which also applies to the generation-skipping tax. But, as noted later, the increase in the GST exemption may result in increased amounts passing to grandchildren rather than to children under current generation-skipping or dynasty trusts

Gift Tax. Unlike the estate tax and generation-skipping taxes which are subject to "repeal-sunset", the gift tax is not repealed. The rules for gifts are vastly different than those for estates. First, the maximum rates on gifts during the "phase-in" period are reduced in accordance with the table above (for estate taxes). After December 31, 2009, the maximum gift tax rate will be reduced to the highest individual income tax rate for that tax year (i.e., 35 percent under the Act). Second, and of great importance, the exemption equivalent for lifetime gifts made after December 31, 2001 is increased to $1million and remains at that amount for all future years. Therefore, taxable gifts (in excess of the $10,000 annual exclusion) will reduce the $1million exemption. Gifts in excess of annual exclusions available plus the $1million exemption will create immediate gift tax.

Observation: The continuation of the gift tax is an attempt to preclude transfers to lower bracket income family members to circumvent the new carryover basis rules discussed above. If the gift tax were also repealed, taxpayers with appreciated property would be able to transfer such property to a lower bracket family member, who would then sell the property, pay a reduced tax on the gain and then transfer the proceeds to the donor, all without any further tax consequence. Pretty nifty thinking, no?

Reduction/Repeal of Credit for State Death Taxes. Here's one change that is a sure "sleeper" and which I predict will loom to have far reaching effects. The state death tax credit presently allowed for estate taxes actually paid to a state is determined under a graduated rate table with a maximum rate of 16 percent. Under the Act, the maximum credit will be reduced to 12 percent in 2002, 8 percent in 2003, and 4 percent in 2004. In 2005, the state death tax credit will be repealed and replaced with a deduction for death taxes actually paid to any state (or to the District of Columbia).

Observation: The repeal of the death tax credit will affect the majority of states such as Maryland that have a "sponge-tax," i.e., a tax imposed equal to the allowable federal credit, and may lead to the adoption of state inheritance taxes again. ("Inheritance" taxes are different than "death" taxes.) So, watch your statehouse since I fear that states such as Maryland are likely to respond with a new tax on estates. In this regard, I note that Maryland has largely eliminated its inheritance tax for assets passing to most family members. Watch for a new tax if additional revenue is needed as a result of this rather significant change in the federal tax!

Sunset and the Pea in the Huckster's Shell: What Does It All Mean? How Do You Plan?

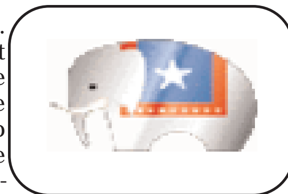
Business Week (The New Taxes: Keep a Sharp Eye on the Calendar, 6/18/01, p. 156) compared the new legislation to a carnival "because many of these tax cuts are like the pea in the huckster's shell game-now you see them, now you don't... and in a breathtaking budgetary sleight of hand, Congress decided that the entire tax law will 'sunset' in 2011-bringing back today's tax rates and estate tax system."

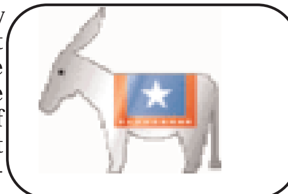
Actually, the "sunset" provisions had me humming from Fiddler on the Roof. When I first read the sunset provisions of the law, I wondered if it was missing something. But I wasn't. The sunset provisions were in this legislation for "budgetary reasons," I am told. Whatever the reason, the sunset is indeed critical for essentially there's no repeal for longer than one year. For the repeal to be somewhat permanent, Congress must at some point start over, revisit these issues and enact new legislation.

Observation: There is only one way to plan under this law and that is to seize the opportunities created by the changes during the phase-in period. And we need to focus on the immediate increase in 2002, keeping in mind the gradual increases. But we can't count on repeal, particularly when Congress also tells us that such repeal is ephemeral by virtue of the "sunset" on 12/31/10. Indeed, in my mind the likelihood of further legislative change even during the "phase-in" period (2001-2009) is significant. The "sunset" provisions simply makes that more obvious.

It is critical to implement planning now to protect yourself regarding future developments. Indeed, planning your estate based upon what may or may not happen requires more than a leap of faith. It's impossible. Here's why.

Sunset/Built-in Reversibility. As stated above, nothing in this law is etched in stone. Indeed, the entire legislation has sunset provisions with built-in reversibility.





Unforseen Political Circumstances. Remember, that even before President Bush signed the law, Democrats were talking about how to revise it. Indeed, the Democrats now control the Senate due to the Jeffords shift. When asked about the possibility of change at his first news conference as majority leader, Senator Tom Daschle of South Dakota said: "I know we're going to revisit it. I just know that at some point that reality is going to come crashing down on all of us and we're going to deal with it." In sum, if Democrats are in power, it's a safe bet that the repeal of the estate tax will never happen.

Economic Factors. Surely, the fate of the new estate tax changes will hinge largely on what happens to the economy. The law was predicated on estimates by the Bush administration and the Congressional Budget Office that the government budget surplus would be $5.6 trillion over the next decade. But such long term forecasts are unreliable. Who can time the stock market? Therefore, if the surplus ends up being smaller, it is unlikely that the tax reductions could be eliminated. Indeed, a decade from now, aging baby boomers will begin straining Social Security and Medicare programs; and the projected surplus may well never appear. No administration - even a republican one - is likely to come close to repealing an estate tax under these circumstances.

Opportunities and Action Strategies

Here is a summary of opportunities and action strategies in light of the new law. Remember, changes create opportunities!

Immediate Check of Will and Trust Documents. The law requires an immediate review of your wills and trust documents. This is particularly critical for those in the following two situations:

All Married Clients with 'Bypass" or "Credit Shelter Trusts. Most estate plans for married clients with modest to high net worths are drafted to make the maximum use of the lifetime exemptions available to both spouses. Typically, an amount equal to the first spouse's exemption (currently $675,000) would pass to a "bypass" or "credit shelter" trust for the benefit of the spouse or children or both. The rest of the estate would pass to the spouse outright or in a marital trust. Of immediate concern is that the new law raises the exemption to $1 million in 2002. (It was initially scheduled to get to $1 million in 2006.) Thus, you may have to rethink the relative distribution of assets between the surviving spouse and children or other family members. Under the new law, you could run the risk of leaving your spouse without sufficient resources. This can apply in all situations but can be especially important in second marriage situations where, for instance, a portion of the estate would pass to children from the first marriage. There are many drafting solutions for this problem. Indeed, certain drafting techniques can be used to maximize the new exemptions as they increase over time.

High-Net Worth Clients Who Set Up Generation-Skipping or Dynasty Trusts. This problem would also apply to those clients who have set up generation-skipping or dynasty trusts where more funds than intended would pass to grandchildren rather than children to fully utilize the generation-skipping exemption. This exemption -- which is and still is an important planning technique -- is scheduled to increase over time. These trusts are typically funded with an amount equal to the generation-skipping exemption.

Transfers to Fully Utilize Increasing Exemption. "Congress giveth and Congress taketh away ......" Indeed, look at the "sunset" provisions. There is daylight, but darkness descends quickly with little trace of light. In that light (or dark), one thing you should consider is to make transfers to utilize the $1 million exemption. If you can afford to shift wealth early, lock in the exemption. Who knows what will happen? This Congress is not tomorrow's Congress. I recall Congressional proposals being batted around in the early 1990's of possible decreases in the exemption from $600,000 to $200,000 to raise revenue. So unless you can safely predict that a repeal will happen (impossible), discuss with your estate planning counsel the possibilities of an early gift. As always, it may be advisable to make such gift through a Family Limited Liability Company or Family Limited Partnership to generate a "discount" and maximize the benefit of any gift.

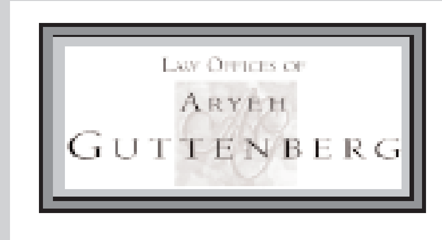
Annual Gifts. Annual exclusion gifts are still very important and should be a cornerstone of a good estate plan for those with taxable estates. With the estate tax here for at least 9 more years (and possibly here to stay), annual gifts make sense. And of course, gifts of assets likely to appreciate (stocks or interests in closely-held business) are the most preferred. Again, gifts should be accomplished if possible, with the use of discounts by setting up a Family Limited Partnership or a Family Limited Liability Company. And, if you believe that repeal is a possibility, then gifts should surely be considered. If there is a repeal in 2010, many assets will not obtain a "step-up" in basis upon death. Therefore it

may be advantageous to make lifetime gifts of low-basis assets instead of holding them at death. Of course, each situation should be reviewed carefully looking at your dispositive goals, your mix of assets and size of estate.

Change Documents for Maximum Flexibility- the Use of Disclaimer Trusts. Fortunately, there are options for those individuals who simply would not create a credit shelter/bypass trust if there were a repeal and no estate tax. Indeed, those individuals' estate and trusts documents would be totally different. There are ways to draft your estate planning documents to provide for maximum flexibility no matter what legislation brings or other changes that occur in personal or financial circumstances. One way is to specifically provide for the contingency of a repeal. The other option, and one which I generally favor, is the "wait and see" or "disclaimer" trust. In this vein, all assets would pass outright to the surviving spouse, but the surviving spouse would be granted a post-mortem election to "disclaim" assets received from the first spouse, and "direct" such assets to a credit shelter/bypass trust. While there are limitations to such a trust, it's a viable option in uncertain times and in the wake of evolving estate tax changes. In addition, as I mentioned earlier, I would encourage you to provide for generation-skipping trusts in your Wills to protect your children from adverse estate taxes. These trusts could also be triggered by a "disclaimer" or by contingency provisions in your Wills and Trust documents.

"Tried and True" Estate Planning Strategies. The phase-out of the estate tax is very gradual and tax rates will remain relatively high until 2010. And, the rates may indeed be raised again in a decade. Therefore, the estate planning techniques that have worked in the past (e.g., Bypass Trusts, QTIP/Marital Trusts, Life Insurance Trusts, Generation-Skipping trusts, Qualified Personal Residence Trusts and Charitable Remainder Trusts -- as examples) will continue to be important for years to come.

Please call our office if you wish any additional information or have any questions or concerns as to how the Act may impact your own personal and financial situation. We have already been exploring strategies that take full advantage of these legislative changes. Certainly, such strategies would be most effective when tailored to the personal and financial circumstances, and specific objectives, of each client.



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