The Guttenberg Press

Preserving Your Assets ... Planning Your Future

LAW OFFICES OF ARYEH GUTTENBERG • 1777 REISTERSTOWN ROAD • BALTIMORE MARYLAND 21208 • 410-484-7711

Winter 2003

Dear Friend:

We hope you have had a most enjoyable summer.

There has been much legislative activity recently affecting your taxes. The new 2003 Tax Act, discussed in this issue, provides income tax reductions with important ancillary effects on your estate planning. But the important news is that the 2003 Tax Act did not directly address the proposals for estate tax repeal. The reason is that with budget deficits projected to be more than $400 billion this year and almost $500 billion next year, large tax reduction measures were "off the table." For that reason, estate tax repeal is dead at this point as Republican proponents have not been able to garner the votes needed for Senate passage. So, it's important to focus on proactive planning possibilities for estate tax reduction. One such strategy discussed in this issue is the Life Insurance Trust, which is, in our minds, a panacea indeed for estate tax savings.

Let's stay in touch!

The Life Insurance Trust - A Panacea for Estate Tax Savings

Life insurance is a valuable tool in the estate planning process. It can provide liquidity, thereby avoiding forced sales of assets at depressed prices to pay estate taxes. In addition, insurance can replace the lost income of a decedent and meet the immediate and future needs of surviving family members. It can also be used to preserve assets within a family without diminution by estate taxes.

Estate Tax Benefits of the ILIT

There is a highly strategic estate planning tool that is specific to life insurance. This is the Irrevocable Life Insurance Trust ("ILIT"). Properly structured, the ILIT can result in large amounts of insurance proceeds passing to children and even grandchildren without estate or income tax in either the insured's or the insured spouse's estate. The ILIT essentially enlarges the estate tax exemption. That exemption is $1,000,000 per person in 2003 and is scheduled to increase to $1,500,000 in 2004 (for a married couple -- $2,000,000 in 2003 or $3,000,000 in 2004, if Wills are properly structured). With an ILIT, all insurance proceeds could be exempt from estate tax without utilizing the estate tax exemption. For instance, a married couple with $3,000,000 in life insurance and $2,000,000 in other assets could pass all $5,000,000 to their children without federal estate tax.

Three key tax rules underlie the tax benefits of ILITs.

- *Income Tax.* The death benefit of life insurance is generally not subject to income tax.
- *Estate Tax.* If the beneficiary of life insurance is not the insured's estate and the insured does not own the policy, the death benefit is not included in the decedent's estate.
- *Gift Tax.* Contributions to the Trust can be excluded from gift tax by virtue of the annual gift tax exclusion.

A ILIT that is properly structured and administered utilizes all three such tax exclusions.

Procedures are Tricky But Well Worth It

Meticulous procedures are required for establishing and preserving the tax benefits of an ILIT. Briefly, the insured sets up an irrevocable trust which is both the

Article Continues on Page 2, Column 2

IN THIS ISSUE:

- Life Insurance Trust - A Panacea for Estate Tax Savings
- ILIT Case Study and Checklist
- Proactive Planning and Strategies Under the 2003 Tax Act
- Things We've Been Up to Lately

Example:Benefits of ILIT

Lee is married with two children and owns a $1million life insurance policy on his life, which he acquired to provide financial protection for his wife and children upon his death. Lee wishes to ensure that any proceeds remaining at his wife's death be preserved for his children without estate tax.

With an ILIT

On September 1, 2003, Lee assigns the policy to an ILIT. Under the terms of the ILIT, the income is to be paid to Lee's spouse, Helena, for her lifetime and the trustee has the power to invade the trust's principal as necessary to provide for the health, education, support and maintenance of Helena or their two children. Upon Helena's death, the assets would be distributed in equal shares to their two children (in trust if a child is under the age of 30).

If Lee survives for more than 3 years after the assignment of the policy to the ILIT (i.e., after September 1, 2006), insurance proceeds would be excluded from his estate. In addition, any proceeds not used by Helena during her lifetime would be excluded from her estate

Without an ILIT

In contrast, if Lee failed to assign ownership of the $1 million policy, at his death the proceeds would be included in his gross estate but would still avoid estate tax if Helena was the primary beneficiary of the policy (because of the marital deduction). However, upon Helena's later death, the remaining proceeds potentially would be subject to the estate taxes at rates as high as 49% (depending upon the size of the Helena's taxable estate). If, for example, the remaining proceeds totaled $1million at Helena's death, that could generate an additional estate tax of up to $490,000– which Lee easily could have avoided by setting up the ILIT.

Checklist for Establishing and Maintaining an ILIT

- Preparation of Irrevocable Trust Agreement (by Attorney)
- Preparation and filing of Form SS-4, Application for Tax ID# (by Attorney)
- Completion of new application for insurance (new policy) or assign existing policy to ILIT and designate ILIT as beneficiary
- Opening of separate bank account (checking) for new trust
- Preparation of check from insured's personal account to trust account - Ongoing
- Mailing or delivery (by trustees) of "Crummey notice letters" to beneficiaries whenever funds are received by Trust (prepared by Attorney) - Ongoing
- After withdrawal period expires, payment (by trustees) of premium to insurance company from newly-opened trust account - Ongoing
- Before April 15th of year following the contribution to ILIT, filing of gift and generation-skipping tax return (Form 709), if necessary, for beneficial gift and GST tax treatment.

Continued from Page 1: The Life Insurance Trust - A Panacea for Estate Tax Savings

owner and beneficiary of one or more life insurance policies. The insured selects and determines those beneficiaries whom the insured wishes to receive the proceeds after his or her death -- typically spouse and children.

With respect to a new policy, the trust purchases a life insurance policy on the insured's life. If the insured already owns the policy, the benefits of the ILIT can be achieved by assigning the policy to the trust. If certain basic rules are complied with, the designation of the trust as owner and beneficiary shifts the policy outside the insured's estate, so that there are no estate taxes when the policy matures and the proceeds are paid to the trust. And, no estate or income taxes are payable in the surviving spouse's estate either.

Advantage of Setting up Trust Before Acquiring Policy: The estate tax benefit is lost if the insured dies within 3-years after transferring the policy to the ILIT. Therefore, if possible, the ILIT should purchase the policy at the outset. If the policy is already owned by the insured, the transfer to the trust should be effected as soon as possible to start the 3-year clock.

"Crummey Rights": Careful drafting of the trust and the inclusion of a legal fiction known as "Crummey rights" (named after a victorious taxpayer named "Crummey") can qualify the transfers to the trust for the annual gift tax exclusion. This entails sending annual notice letters to the beneficiaries. This technique has been approved by the IRS and the Courts. These notices require careful planning, particularly with high premium policies.

Other Sophisticated Uses

In addition to estate liquidity and family protection, ILIT's can have other sophisticated uses.

- As a "wealth replacement vehicle" for the benefit of family members - to substitute for the value passing to charity at the termination of a charitable remainder trust. (Insurance could be purchased through an estate tax-exempt ILIT to make up the value of the assets "lost" to charity.)
- As a "dynasty trust" to preserve trust assets and reduce estate tax over many succeeding generations.

We hope to discuss the uses of "charitable trusts " and "dynasty trusts" in future issues.

In sum, while ILIT's entail some complexity, in practice they are rather simple to set up and administer with proper legal advice. We will assist you in ensuing compliance with the structure and annual formalities. (See our simple checklist in adjacent column.) The significant estate tax savings and the multiple uses certainly make the ILIT worth considering as a strategic part of one's estate plan.

PROACTIVE PLANNING AND STRATEGIES UNDER THE 2003 TAX ACT

On May 28,2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (called "JGTRRA" or the "2003 Tax Act"). Individuals are the principal beneficiaries of the tax relief afforded by the 2003 Tax Act which includes income tax rate reductions, capital gains and dividend rate reductions, marriage penalty relief, child tax credit increases, and some alternative minimum tax relief. Here's a brief summary of provisions of particular interest for our clients with strategies for proactive income and estate tax planning:

Tax Rate Relief. The top rate on ordinary income, including salary and interest is trimmed from 38.6% to 35%, effective from January 1, 2003. This accelerates the cuts from the 2001 Tax Act. The rates in the 27, 30, 35 and 38.6% brackets are trimmed to 25, 28, 33 and 35%.

Observation: Because of the tax rate's decline, tax exempt bonds may be slightly disadvantaged relative to taxable bonds in the short term.

Tip: If you are salaried, your may have noticed a bigger paycheck because your employer has reduced the amount of taxes withheld to account for the rate reduction. Instead of taking the extra savings, you may consider doubling up on savings by electing to put more into your 401(k) or other deferred retirement account.

Alternative Minimum Tax ("AMT"). This is the "big elephant in the room" under the 2003 Tax Act. Although there is limited relief for those hit with the AMT in the form of increases in the AMT exemption (to prevent the AMT from consuming the tax savings under the new law), more and more taxpayers will be ensnared by the AMT.

Capital Gains Relief. Long-term capital gains from sales on or after May 6, 2003 (and from installment sale payments received after that date) are now taxed at a maximum rate of only 15% (down from 20%) – the lowest rate since 1933!

Dividend Relief. The top rate on most dividends is slashed from 38.6% to 15%-- the lowest rate since 1916! But there are some key caveats:

- *Holding Period.* In order to be eligible for the favored 15% rate, the stock must have been held for at least 60 days of the 120 days surrounding the ex-dividend date.
- *Bond Funds.* While payouts from a bond fund may be called "dividends," they are really interest and do not qualify.
- *REIT Dividends* --do not generally get the favored rate.

Observation and Tip: The new preferred rates don't apply to dividends received in tax-deferred retirement accounts such as traditional IRAs, 401(k)s, and SEP accounts. Dividends accumulated in these accounts will still be taxed at regular rates when withdrawn as cash distributions. Now, more than ever, it makes sense to hold more of your assets generating ordinary income (taxable interest and short-term capital gains) in a tax-deferred account, and longer-term equity and dividend-paying investments in a taxable account.

Caution: There may be temptation under the new law to switch from bonds to preferred stocks paying high dividends. For example, to match the after tax return from a stock paying a 5% dividend, a taxable bond would need to yield 6.5%. There are reasons to be careful about making a major shift into dividend paying stocks. First, this law is "temporary" due to the sunset provisions - see below. Second, bonds and preferred stocks do not carry the same amount of risk, both from a credit standpoint and interest-rate volatility.

Sunrise... Sunset

The 2003 Tax Act takes "sunsets" to a new level. The theme of "Sunrise... Sunset," originally made famous in "Fiddler on the Roof," was introduced into the major estate tax changes of 2001 where Congress decided that the estate tax would be repealed in the year 2010, but would "sunset" in 2011- bringing back the 2001 estate tax system. Business Week ("The New Taxes: Keep a Sharp Eye on the Calendar", 6/18/01, p. 156) compared that 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... a breathtaking budgetary sleight of hand." The rate cuts for dividend and capital gains under the 2003 Act are effective only through 2008. The accelerated cuts in the ordinary income brackets terminate at the end of 2010. Further, all income tax cuts introduced by the 2001 Tax Act and accelerated by the 2003 Tax Act (no estate tax relief accelerated) are scheduled to sunset at the end of 2010 to return to their pre-2001 levels in 2011.

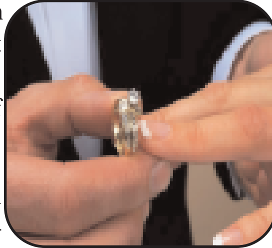
Observation on Estate Planning: Because the 2003 Tax Act did nothing to add sanity to the roller coaster estate tax provisions of the 2001 Tax Act, estate planning will need to stay flexible to maintain your objectives. All estate plans should accommodate change.

Immediate Family Wealth Transfer Opportunities

The benefits for lower bracket taxpayers under the 2003 Tax Act provide additional incentives to take advantage of the family wealth transfer opportunity that current conditions provide, particularly if we anticipate solid improvement in the pace of economic activity in the latter part of 2003 and in 2004. Transfer of assets with a low tax basis to younger-generation family members formerly had the disadvantage of carrying the low basis to the donees. Capital gains relief under the new tax law mitigates much of that. For children age 14 and older who have taxable income up to $28,400, capital gains are taxed at the historically low rate of 5%. This makes lifetime transfers of appreciated assets much more attractive than anticipating the step-up in the basis of assets that pass through an estate at a maximum estate tax rate of 49%. Depressed stock values on the verge of recovery, low interest rates that enhance the value of discounting strategies and the added income tax benefits provided by the new tax law make this an ideal time to implement family wealth transfer plans that will yield enormous benefits for generations to come.

Things We've Been Up to Lately

Congratulations to our paralegal/law clerk, Amanda M. Hunt, on her recent marriage to Adam Franklin. Amanda and Adam were married at The Links at Gettysburg on June 14, 2003. Adam is the proprietor of Franklin Landscaping, LLC.



Mazel Tov to Sandy and Aryeh Guttenberg on the forthcoming marriage of their son, Shaye, to Dina Morrow of Palm Springs, California. The wedding will take place on November 25, 2003 at the Ritz Carlton in Marina del Rey, California.

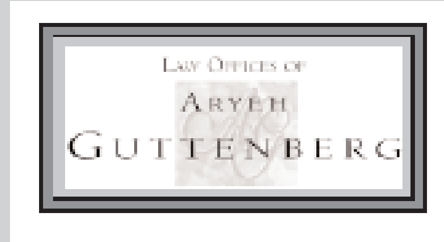
A special thank you to all of our clients and friends for their support and participation in the gala for Shaare Zedek Medical Center of Jerusalem held at the Meyerhoff Symphony Hall on February 2, 2003 featuring The Jerusalem Symphony and honoring our friend, Dr. Morton Rapoport, CEO of the University of Maryland Medical System. The concert, chaired by Aryeh Guttenberg, raised over $500,000 in seed money for a shock trauma unit at the Hospital.

Aryeh has been appointed to the Professional Advisory Board of the University of Maryland Medical Center to assist and advise in its philanthropic and planned giving programs.

Aryeh is working on a special committee of the Maryland Bar Association to evaluate whether Maryland should adopt the Uniform Trust Code. We will keep you posted.

Wishing all our friends a

HAPPY THANKSGIVING!



TELEPHONE: 410-484-7711
FAX: 410-484-3533
EMAIL: aryeh@guttenberglaw.com

ESTATES AND TRUSTS
- Estate and Trust Planning
- Will and Trust Preparation
- Estate and Trust Administration
- Charitable Gift Planning

BUSINESS
- Formation – Corporations, Partnerships, Limited Liability Companies
- Planning and Structuring
- Business Succession Planning
- Business Agreements
- Mergers and Acquisitions

TAX
- Planning and Structuring
- Representation Before IRS and Federal Courts
- Private Foundations

The Guttenberg Press is an informational publication and should not be considered as legal or financial advice as to any specific matter or transaction. Please contact us for further information or specific advice.

Copyright © 2003 by Aryeh Guttenberg

PRSRT STD
U.S. POSTAGE
PAID
BALTIMORE MD
PERMIT NO. 6648