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Estate Planning Bulletin

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If you have questions regarding material in this issue of *Estate Planning Bulletin* or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor, Igor Potym *(group leader)* at (312/609-7542) or any other Vedder Price attorney with whom you have worked.

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Special Report

Estate Tax Repeal: Setting the Record Straight

Introduction

On June 7, 2001, President George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"). Perhaps the most controversial aspect of the legislative debate was repeal of the federal estate tax. Proponents of repeal argued that the estate tax was unfair, amounted to a double tax on income and threatened the existence of family businesses and farms. Opponents countered that repeal was too costly and provided a tax break only for the wealthy. The result was a compromise that is fraught with confusion and uncertainty. Nonetheless, the Act must be taken seriously because it will have a more pervasive effect on estate planning than any other tax legislation in recent memory. This Special Report addresses important questions raised by the Act. As the answers to these questions make clear, the Act makes proper estate planning more important than ever.

Estate, Gift and GST Taxes

Q. Has the federal estate tax been repealed?

A. Probably not.

Contrary to the claims of many politicians and some media reports, the estate tax is alive and well, unless you happen to die in 2010. From 2001 to 2009 the highest estate tax rate declines gradually from 55% to 45% and the estate tax exemption increases from $675,000 to $3,500,000. The estate tax is repealed for persons dying in 2010. Under a "sunset provision," the estate tax is reinstated in 2011 with a maximum rate of 55% and a $1,000,000 exemption, unless Congress takes further action. Similar changes are made to the federal generation-skipping transfer (GST) tax. The estate and GST tax rates and exemptions are summarized in the following table:

ESTATE AND GST TAX RATES AND EXEMPTIONS

Year	Highest Estate Tax Rate	Estate Tax Exemptions	GST Tax Rate	GST Exemptions
2001	55%	$675,000	55%	$1,060,000
2002	50%	$1,000,000	50%	$1,060,000*
2003	49%	$1,000,000	49%	$1,060,000*
2004	48%	$1,500,000	48%	$1,500,000
2005	47%	$1,500,000	47%	$1,500,000
2006	46%	$2,000,000	46%	$2,000,000
2007	45%	$2,000,000	45%	$2,000,000
2008	45%	$2,000,000	45%	$2,000,000
2009	45%	$3,500,000	45%	$3,500,000
2010	0%	N/A	0%	N/A
2011	55%	$1,000,000	55%	$1,060,000*

*To be adjusted for inflation.

Q. Has the federal gift tax been repealed?

A. No.

Instead of repealing the gift tax, Congress merely increased the gift tax exemption beginning in 2002 – but only to $1,000,000 – and gradually reduced the maximum gift tax rate to 35% in 2010. Like the estate and GST taxes, the highest gift tax rate returns to 55% in 2011, absent further action by Congress. As is the case under current law, the gift tax exemption is reduced by cumulative gifts in excess of the $10,000 gift tax annual exclusion and the estate tax exemption also is reduced by such gifts. The following table summarizes the changes in the highest gift tax rate and the gift tax exemption:

HIGHEST GIFT TAX RATE AND GIFT TAX EXEMPTION

Year	Highest Gift Tax Rate	Gift Tax Exemption
2001	55%	$675,000
2002	50%	$1,000,000
2003	49%	$1,000,000
2004	48%	$1,000,000
2005	47%	$1,000,000
2006	46%	$1,000,000
2007	45%	$1,000,000
2008	45%	$1,000,000
2009	45%	$1,000,000
2010	35%	$1,000,000
2011	55%	$1,000,000

Retention of the gift tax surprised many. Ostensibly, this was done to prevent income tax avoidance by means of lifetime gifts, but skeptics might claim that it was done to facilitate retention of the estate tax or even a possible return of the estate tax if it ever is repealed permanently. Because the gift tax discourages lifetime transfers of wealth, people will own more assets at death that will be subject to estate tax if the estate tax is not repealed permanently after 2009.

Q. Have state death taxes been repealed?

A. Yes.

Although the Act does not directly repeal state death taxes, including the Illinois estate tax, it effectively does so for most states. The federal estate tax provides a credit for death taxes paid to a state. Illinois and many other states impose an estate tax equal to this credit. The Act gradually reduces the credit and the credit is repealed completely after 2004. As a result, after 2004 many states' death taxes will be eliminated. To replace the lost revenue, some states may enact new death taxes not tied to the federal estate tax. In the few states that already have such a death tax (such as New York, New Jersey and Connecticut), the total federal and state death taxes actually may increase over the next few years.

In addition, the Act repeals the credit for state GST taxes after 2004, effectively repealing the state GST tax in states, including Illinois, that have a GST tax equal to the federal credit.

Q. Will Congress make further changes?

A. Almost certainly.
It is unlikely that Congress will retain a system that repeals the estate tax only for persons who die in 2010. Among the many options, the two most likely are fixing the rate and exemption amounts at some point between now and 2010 and repeal of the sunset provision so that repeal of the estate tax becomes permanent. In addition, even if the estate tax is repealed permanently, there is no assurance that a future Congress will not reinstate the tax. Predicting the course Congress will choose is impossible. In the meantime, estate planning documents must be flexible enough to adjust to any scenario.

Income Tax

Q. Is there an income tax downside to estate tax repeal?

A. Yes.
Accompanying the repeal of the estate tax in 2010 is the reintroduction of "carryover basis." Under current law, the income tax basis of inherited property generally is the fair market value of the property at the decedent's

death, frequently referred to as "stepped-up basis." This rule allows assets to be sold immediately after death without capital gain tax. Under a carryover basis regime, the income tax basis of inherited property will be the decedent's adjusted basis immediately before death (or the fair market value of the property at death, if lower) with certain adjustments. Therefore, sales of inherited property after 2009 likely will result in capital gain tax. An especially troubling aspect of carryover basis is the burden of maintaining cost basis records for all assets. This could be particularly difficult for assets that have changed hands via gift, assets that were purchased many years ago and assets with a frequently adjusted basis, such as stock of an S corporation and stock acquired under a dividend reinvestment plan.

Q. Will all inherited assets have a carryover basis?

A. No.

Three significant upward adjustments can be made to the basis of inherited property, but the increased basis cannot exceed the fair market value of the decedent's property at the decedent's death. First, $1,300,000 of basis can be added to the basis of a decedent's property. For example, if a decedent's property has a fair market value of $6,000,000 and a basis of $1,000,000, the basis of such property would increase to $2,300,000 ($1,000,000 original basis plus $1,300,000 basis increase). Second, the $1,300,000 amount is increased by certain capital and net operating losses. Finally, the basis of property passing to a surviving spouse either outright or in a qualified terminable interest property (QTIP) trust can be increased by an additional $3,000,000. A QTIP trust is a trust that pays all income to the surviving spouse and has no beneficiary other than the spouse during his or her lifetime. However, property held in a QTIP trust will not be eligible for the $1,300,000 basis increase at the spouse's death; instead, the spouse must have other assets to use the basis increase. Also, certain trusts that qualify for the estate tax marital deduction under current law may not be eligible for the $3,000,000 basis increase and may need to be revised. The $1,300,000 and $3,000,000 basis adjustments must be allocated to specific assets by the executor.

A basis increase generally is not allowed for assets acquired by gift within three years of death. As is the case under current law, certain assets, such as IRAs, retirement plans and nonqualified stock options, are not eligible for a basis increase.

Q. Does a principal residence receive special treatment under the Act?

A. Yes.
Under current law, a single taxpayer may exclude up to $250,000 of gain on the sale of his or her principal residence provided he or she owned and lived in the home at least two out of the five years preceding the sale. Under the Act, a deceased taxpayer's use and ownership can be used in determining eligibility for the exclusion of gain for a sale after death. In effect, this amounts to an additional basis increase of up to $250,000 for a principal residence. However, eligibility for the exclusion based on the decedent's use and ownership will expire with the passage of time.

Q. Does the Act make education savings programs more attractive?

A. Yes.
Qualified state tuition programs (sometimes known as section 529 plans) are an attractive way of saving for a child's college education. The Act makes these plans even more attractive by providing that, beginning in 2002, distributions from such plans will be tax-free to the extent they are used for qualified higher education expenses. The Act also allows colleges and universities to form networks that will allow an individual to save for any institution in the network rather than for a specific college or university. Also, the Act increases the amount that may be contributed to an Educational IRA (EIRA) from $500 to $1,000 annually. The income threshold for making contributions to EIRAs has not been changed. Generally, EIRAs are not available to

high-income taxpayers.

Estate Planning

Q. Should estate plans be reviewed?

A. Yes.
The Act has a more pervasive effect on estate planning than any change in the estate tax laws since the Economic Recovery Tax Act of 1981. Every estate plan should be reviewed as soon as possible and further reviews should be conducted every few years thereafter to insure that changes in the law do not adversely affect the estate plan or result in unintended consequences. Many estate plans will need to be revised. Simply waiting until the law changes to revise an estate plan is not advisable because a person could become incompetent before the law changes or die before changing his or her estate plan.

Q. Do traditional "A and B Trusts" still work?

A. Possibly not as intended.
Many estate plans create two trusts (sometimes known as A and B Trusts or marital and family trusts) upon the death of the first spouse to die. Property is divided between the two trusts under a formula that generally allocates assets having a value equal to the estate tax exemption to Trust B and the balance of the deceased spouse's assets to Trust A. Trust A is for the sole benefit of the surviving spouse during his or her lifetime, while Trust B often is created for the benefit of children or other descendants. The surviving spouse may or may not be a beneficiary of Trust B. As the estate tax exemption increases under the Act, a larger portion of the estate will be allocated by the formula to

Trust B, thereby reducing the amount allocated to Trust A. Such an allocation may result in the surviving spouse receiving far less for his or her exclusive benefit than was initially intended.

Example: Bill dies with $5,000,000 of assets and has an A and B Trust plan using a typical formula. His wife, Betty, has nominal assets. The following chart shows how the trusts will be funded for a particular year of death:

Year of Death	Trust A	Trust B
2001	$4,325,000	$675,000
2002	$4,000,000	$1,000,000
2003	$4,000,000	$1,000,000
2004	$3,500,000	$1,500,000
2005	$3,500,000	$1,500,000
2006	$3,000,000	$2,000,000
2007	$3,000,000	$2,000,000
2008	$3,000,000	$2,000,000
2009	$1,500,000	$3,500,000
2010	$0	$5,000,000

As the chart shows, the amount passing to Trust A for Betty will decline significantly and she could be disinherited completely if she is not a beneficiary of Trust B.

Even if the surviving spouse is a beneficiary of Trust B, assets passing to that trust may not qualify for the $3,000,000 basis increase available after 2009. For these reasons, all estate plans creating A and B Trusts should be reviewed as soon as possible and revised if necessary to avoid unintended asset allocations and loss of the $3,000,000 basis increase.

Q. Do estate plans using other types of formulas still work?

A. Possibly not as intended.

Any will or trust with a formula tied to either the estate tax exemption or the GST exemption may result in unintended consequences or even an invalid document.

Example: Mary, a widow, dies with $4,000,000 of assets and has an estate plan that allocates her GST exemption to a GST Trust for her descendants that will avoid estate tax for multiple generations and gives the balance of her assets to her children outright. If Mary dies in 2002, the GST Trust will receive $1,060,000 and the children will receive $2,940,000 less estate tax of $1,430,000, netting $1,510,000. If Mary dies in 2009, the GST Trust will receive $3,500,000 and the children will receive only $500,000 less estate tax of $225,000, netting $275,000. If Mary dies in 2010, the result is uncertain. The GST Trust may receive $4,000,000 and the children nothing or the document may be invalid.

In addition, estate plans using terms defined under current law, such as "taxable estate," "gross estate," "taxable gifts," "marital deduction" or "charitable deduction," may not work after 2009 because such terms may have no or a different meaning after 2009.

All estate plans using any type of formula should be reviewed as soon as possible and revised if necessary to avoid unintended consequences or an invalid document.

Q. Are there alternatives to using A and B Trust formulas or other types of formulas?

A. Yes.
A number of alternatives are available to provide flexibility during the transition period and after estate tax repeal. For example, before 2010 using an A and B Trust plan still is an appropriate way to take full advantage of each spouse's estate tax exemption. However, it may be desirable for nontax reasons to limit the amount of assets passing to Trust B. Trust B could be capped at the lesser of the estate tax exemption or a specified dollar amount or percentage of the estate, with the remaining assets passing to Trust A. Another alternative is a provision allowing the surviving spouse to decide how much should be allocated to each trust. Similarly, a formula tied to the GST exemption could be capped at a dollar amount or a percentage of the

estate. Estate planning documents need to be drafted to achieve the desired result regardless of the status of estate tax repeal.

Q. Will estate plans be drafted differently if permanent repeal of the estate tax occurs?

A. Yes.

Permanent estate tax repeal will afford greater flexibility in structuring estate plans. Taxpayers will be free of the constraints of traditional planning designed to minimize taxes. However, many people will want to use trusts for their spouse and descendants that are designed to avoid future estate tax should the estate tax be reinstated. Furthermore, all estate plans will need to take into account the carryover basis rules and include provisions for the allocation of the $1,300,000 and $3,000,000 basis increases. For the reasons discussed above, it is not too early to revise existing estate plans to incorporate provisions that will be appropriate if the estate tax is repealed permanently.

Q. Will a surviving spouse be better off if the estate tax is repealed permanently?

A. No.

Under current law, there is no estate tax on a bequest to a surviving spouse made either outright or in certain trusts. Thus, from an estate tax perspective, bequests to a surviving spouse are not affected by repeal of the estate tax. However, under current law assets passing to a surviving spouse in this manner would receive a stepped-up basis, allowing the spouse to sell those assets free of capital gain tax. Under the Act, after 2009 the surviving spouse will receive assets with a carryover basis subject to the $1,300,000 and $3,000,000 basis increases. Therefore, after 2009 there may be a greater capital gain tax cost to a surviving spouse who sells assets for liquidity or diversification purposes than under current law.

Family Giving

Q. Do lifetime gifts still make sense?

A. Yes.

Except as discussed below, the $10,000 gift tax annual exclusion has not changed. Accordingly, before 2010, annual exclusion gifts will remain an effective way to reduce a taxable estate that exceeds the estate tax exemption. Even after 2009, such gifts generally will make sense because permanent repeal of the estate tax may not occur or the estate tax could be reinstated in the future. However, after 2009, donors may want to keep enough appreciated assets until death to use fully the $1,300,000 and $3,000,000 basis increases.

In addition, the increase in the gift tax exemption to $1,000,000 in 2002 will provide a further opportunity to reduce a person's taxable estate without paying gift tax. A more difficult question is whether it makes sense to make gifts that would result in gift tax liability. From a tax perspective, such gifts would appear to be ill-advised except in rare circumstances.

Though perhaps unintended by Congress, after 2009 it appears that gifts to a trust no longer will qualify for the $10,000 annual exclusion. Thus, gifts to a trust under which a beneficiary has a withdrawal power and a trust for the benefit of minors may cease to qualify for the annual exclusion after 2009. However, the Act appears to provide that after 2009 a transfer to a grantor trust (that is, a trust all of the income of which is taxed to the grantor or the grantor's spouse) will not be a gift for gift tax purposes. As a result, transfers after 2009 to certain commonly used trusts, such as an irrevocable life insurance trust, will not be gifts.

Q. Do sophisticated lifetime gift and wealth transfer techniques still make sense?

About Vedder Price

Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with 190 attorneys in Chicago, New York City and Livingston, New Jersey.

The Estate and Financial Planning Group

Vedder, Price, Kaufman & Kammholz long has recognized the importance of estate and financial planning and has been in the forefront of this changing area of the law. The firm's practice has both a national and an international scope. Vedder Price's attorneys combine technical experience in all aspects of estate and financial planning with a strong appreciation of personal objectives and concerns in servicing clients in this uniquely personal area.

The firm represents clients with diverse personal objectives and financial interests, including individuals with large estates, individuals with personal situations requiring special planning, owners of closely held businesses, corporate executives and professionals. Vedder Price's Estate and Financial Planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses and not-for-profit organizations, as well as other professionals who consult Vedder Price with respect to their own clients.

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A. Yes.

Many sophisticated gift and wealth transfer techniques will continue to make sense at least through 2009 and probably thereafter. Techniques such as grantor retained annuity trusts, family limited partnerships and installment sales to grantor trusts will continue to be attractive. Such techniques can save estate tax by transferring significant amounts of wealth during lifetime at little or no gift tax cost.

Q. Does the Act affect the allocation of my GST exemption on my gift tax return?

A. Yes.

The Act provides for an automatic allocation of the GST exemption to a transfer in trust that potentially could benefit grandchildren or more remote descendants. Under current law, an allocation of the GST exemption to such a trust must be made by filing a gift tax return. Under the new rules, an automatic allocation may occur unless a gift tax return is filed to opt out of the automatic allocation. Therefore, if any gift to such a trust is made in 2001 or thereafter, it must be determined whether a gift tax return should be filed to opt out of the automatic allocation of GST exemption where such allocation is not desirable. For example, the automatic allocation rule should be considered in the case of a gift to an irrevocable life insurance trust.

Retirement Plans

Q. Are retirement plans affected by the Act?

A. Yes.

The Act makes two significant changes for retirement plans. First, the amount that may be contributed to either a 401(k) or 403(b) plan increases gradually from

$10,500 in 2001 to $15,000 in 2006 for persons who are not yet 50 or to $20,000 for persons who are 50 or older, subject to certain limitations applicable to highly compensated employees. Second, traditional and Roth IRA contribution limits increase gradually from $2,000 in 2001 to $5,000 in 2006 for persons who are not yet 50 or to $6,000 for persons who are 50 or older. However, high-income taxpayers generally may not make contributions to traditional and Roth IRAs.

Q. Should retirement plan beneficiary designations be reviewed?

A. Yes.
Beneficiary designations may need to be changed to coordinate the disposition of retirement plans and other assets with the new estate and income tax rules.

Insurance

Q. Does life insurance still make sense?

A. Yes.
Life insurance serves two principal purposes. First, it provides financial security for beneficiaries. Second, life insurance has estate planning advantages. Before 2010, life insurance can be used to replace assets consumed by estate tax. After 2009, if estate tax repeal is made permanent, life insurance will continue to be attractive because the death benefit will not be subject to the carryover basis rules even though the death benefit effectively may represent an appreciated asset. For this reason, life insurance may be a more attractive investment than other assets that will be subject to the carryover basis rules. If a person is considering canceling an existing life insurance policy, it should be kept in mind that permanent repeal of the estate tax may not occur. In making that decision, the possible expense of obtaining a new insurance policy at an older

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age as well as the risk of uninsurability in the future must be considered.

Q. Does an irrevocable life insurance trust still make sense?

A. Yes.
An irrevocable life insurance trust (ILIT) is an attractive way of saving estate tax on the life insurance death benefit. An existing ILIT should be maintained at least until estate tax repeal becomes permanent. Also, if a new life insurance policy will be purchased, creating an ILIT to purchase the policy should be considered. Property transfers to an ILIT after 2009 may not qualify for the gift tax annual exclusion, but this may be a moot point because most ILITs will be grantor trusts and therefore, as discussed above, such transfers will not be treated as gifts.

Charitable Giving

Q. Are there still tax reasons to make lifetime charitable gifts?

A. Yes.
Lifetime gifts to charity continue to qualify for the income tax charitable deduction and may be more attractive in the future. Because itemized deductions are phased out for high-income taxpayers under current law, the income tax deduction for charitable gifts for such taxpayers is reduced. Under the Act, the reduction in itemized deductions is phased out from 2006 through 2009.

While the estate tax remains in effect, lifetime gifts to charity will reduce the value of the taxable estate. If the estate tax is repealed permanently, reducing the estate through lifetime charitable gifts will provide no estate tax benefit. Because of the carryover basis rules, any lifetime charitable gifts made after repeal of the estate tax should be made with low basis assets to preserve high basis assets for bequests to heirs.

Q. Do charitable bequests at death still make sense?

A. Yes.

People make charitable bequests at death for many reasons. For some, charitable bequests are used to limit the amount that will pass to heirs. Others make charitable bequests for purely philanthropic reasons. Saving estate tax remains a benefit of making charitable bequests until the estate tax is repealed. If the estate tax is repealed permanently, larger charitable bequests can be made without reducing the amount passing to other beneficiaries.

IRAs and other retirement plans remain ideal assets to give to charity at death, both before and after repeal of the estate tax. Under current law, retirement plans are subject to both income and estate tax at death. Even if the estate tax is repealed permanently, retirement plans will be taxed as ordinary income when distributed to the beneficiary. By naming a charity as the beneficiary, the full value of the retirement plan will pass to the charity income tax-free, while other assets can be given to heirs.

If the estate tax is repealed permanently and charitable bequests will be made thereafter, low basis assets should be given to charity and cash and high basis assets should be given to family members because of the carryover basis rules.

Q. Does a charitable remainder trust still make sense?

A. Yes.

A charitable remainder trust (CRT) is an attractive means for diversifying low basis assets without an immediate capital gain tax. Generally, the capital gain tax is incurred as annual payments are made from the CRT to the grantor. Using a CRT to convert low basis assets to a stream of cash distributions in a tax-deferred manner will leave the grantor with more cash or higher basis assets to bequeath to heirs. The grantor also could use the stream of distributions from the CRT to purchase life insurance payable to heirs at death. If the estate tax is repealed permanently, heirs who inherit low basis assets also may find a CRT to be an attractive means for liquidating and diversifying those assets with income tax deferral and an immediate income tax deduction. Having the heirs establish the CRT with inherited assets will be more tax efficient than if the decedent had established the CRT at his or her death, because the estate will not receive an income tax deduction.

Q. Should estate plans that make charitable bequests at death be revised?

A. Yes.
As discussed above, the planning strategies for charitable bequests at death will change significantly after repeal of the estate tax. Estate plans should be revised now to ensure that the appropriate strategy will be used whether death occurs before or after repeal.

For questions about the Economic Growth and Tax Relief Reconciliation Act of 2001, please contact any member of the estate planning group.

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