“ESTATE PLANNING AFTER DEATH TAX REPEAL”

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I. BASIC PROVISIONS OF THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001[1]

A. Increased Exclusion Amounts, Reduced Tax Rates and Possible Estate Tax Repeal.

Calendar Year	Estate Tax Exclusion Amount	Highest Estate, Gift & GST* Tax Rates
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2010	Tax Repealed	35%**
2011	$1 million	55%
	*Beginning in 2004, the GST Exemption will be equal to Estate Tax Exclusion Amount **Gift-Tax rate equal to highest individual income-tax rate	

B. Will Tax Repeal be a Reality OR should the Act be retitled “Throw Mama from the Train in 2010 Tax Reform Act?

Sunset Provisions - Will the Sunset Really Set? - News of Death Tax repeal in 2010 may be greatly exaggerated since in order to meet arcane Congressional budget rules, the Senate and House conferees added “sunset provisions” officially causing the entire legislation enacted by the 2001 Tax Relief Act to expire in 2011 (with the pre-

[1] Substantial thanks from the following resources: (1) “Sophisticated Estate Planning for Uncertain Times: What you Need to Know and Do About Estate Tax ‘Repeal’“, IICLE 10/11/2001 seminar outline by Charles F. (Monty) Newlin, McGuire Woods LLP; and (2) “Estate Planning Strategies After Estate Tax Reform”, by the Estate Planning Department of Schiff, Hardin & Waite (CCH Incorporated, 2001).

enactment law to be reinstated in such year).

C. How do you Spell Illinois Inheritance Tax Re-enactment?

1. State Death Credit Repealed. In an unfair sleight of hand to save Federal tax dollars, under the new law such credit is reduced in yearly 25% increments beginning in 2002 and completely repealed in 2005.

2. Reinstatement Illinois Inheritance Tax. Will Illinois reinstate its prior law inheritance tax (not based on the Federal calculation of estate taxes) to make up this lost revenue? Like the repeal of the Federal Death Tax, it's probably too early to tell.

3. Still Scrutinize Apportionment Clauses. Attorneys should continue to give close attention to tax apportionment clauses in wills and trusts relating to state inheritance taxes

D. Gift Tax Remains with $1 Million Exemption to Discourage Income Tax Avoidance Schemes.

1. Gift Tax Retained. Gift tax retained to negate abusive gifting transactions designed to avoid income taxes

2. Static $1 Million Exemption. Code Section 2505(a) gift tax exclusions is set at $1 million in 2002 and thereafter for lifetime transfers (no inflation adjustment)

Example. If taxable gifts are $1.4 million in 2006, the amount in excess of the $1 million gift tax exclusion amount ($400,000) is subject to gift tax even though the estate tax exclusion amount is then $2 million. The remaining $1 million estate tax exclusion amount ($2 million reduced by $1 million exempt taxable gift) would be applied to the donor's estate upon his or her death.

3. Current Annual Exclusion Rules Retained. Current rules retained as to annual exclusion of $10,000 (indexed for inflation, although there has been no inflation increase yet) for transfers of present interests in property to any donee during the taxable year. Further, unlimited transfers between citizen spouses are still permitted without imposition of a gift tax as are unlimited gifts for certain educational and medical expenses under Code Section 2503(e).

4. Disadvantage of Lifetime Gifts under Death Tax Repeal.

   a. No Advantage. If there is no estate tax, lifetime gifts generally have no advantage over testamentary gifts (under former law, lifetime gifts had the advantage of being computed on a tax-exclusive, rather than at tax inclusive basis, thus significantly reducing the effect rate of tax). Further, there is no advantage of removing the post-gift appreciation from the donor's estate.

   b. Loss of Basis Step-up. Gifted assets may lose the benefit of a step-up in basis at death (subject to the $3 million/$1.3 million basis adjustment rules of the modified carryover basis regime discussed below).

5. Planning Under the $1 Million Gift Tax Limit.

   a. Gifts should still probably be made if desirable for personal or family reasons.

   b. High-basis (not low-basis) assets are desirable objects for lifetime giving.

   c. Loans Among Family Members Increasingly Popular.

      (1) Code Section 7872 minimum interest rate OR make annual exclusion gifts of the imputed interest.

      (2) Loan forgiven at death (no cancellation of indebtedness income to borrower).

   d. For wealthy clients, outright transfers to donees may handcuff donee's ability to make *future transfers* to his or her children because of $1 million gift tax limits.

      (1) Premium on annual exclusion gifts and gift discounting techniques (i.e., family limited partnerships, GRATS, etc.) to leverage the $1 million gift tax.

      (2) Generation skipping type trusts drafted to provide broad flexible provisions for distribution to family members or charities without gift tax consequences. (SEE APPENDIX A FOR FORM).

         (a) separate trusts created for each child, with child as his or her own trustee.

(b) child can make distributions subject to ascertainable standard, but an independent trustee can distribute trust property to child's descendants without gift tax consequences.

(c) child has broad testamentary powers of appointment to continue or terminate trust.

E. Modified Carryover Basis Regimen for Large Estates.

1. New Code Section 1014. After repeal of the Death Tax, the prior-law rules under Code Section 1014 providing for a fair market value (i.e., "stepped-up") basis for property acquired from a decedent are repealed. Under the "modified carryover basis" regime of Code Section 1022, property transferred at the decedent's death will generally receive a basis equal to the lesser of:

a. the decedent's adjusted basis in the assets; or

b. the date-of-death fair market value of such assets.

2. Exceptions - Generally full Step-up in Basis for Most Clients - but Step-up limited to $3 million and $1.3 million ADDITIONAL BASIS adjustments. However, there are three potential adjustments to basis:

a. $1.3 million basis adjustment (adjusted for inflation) to be added to the carryover basis of assets held at death;

b. $3 million basis adjustment (adjusted for inflation) to be allocated among the assets passing to a surviving spouse (either outright or as QTIP property); and

c. Basis adjustment for certain unused built-in losses and loss carry-overs. The executor elects which assets will receive the basis increase.

3. Miscellaneous Rules.

a. Property over which the decedent held a power of appointment does not qualify to receive any basis step-up.

b. Maximum $60,000 step-up for nonresident aliens.

c. Code Section 6018 carryover information reporting requirements are substantial (including value, basis, holding period and characterization), along with a $10,000 noncompliance penalty under Code Section 6716.

d. "Anti-abuse" three-year rule generally prevents basis step-up for property acquired within three years of death by gift or by intervivos transfer for less than adequate consideration. However, this rule does not apply to property acquired by the decedent from his or her spouse (unless the spouse acquired the property during such three-year period).

4. Examples.

a. EXAMPLE #1. Decedent dies in 2011 owning stock worth $7 million and having an adjusted basis of $3.7 million. Such stock passes to Decedent's son. The maximum additional basis adjustment is $1.3 million and the basis of such stock can be increased to $5 million. If such stock passes to Decedent's spouse, the maximum additional basis adjustment is $3 million and the stock basis can be increased to $6.7 million.

b. EXAMPLE #2. Decedent dies in 2011 owning stock worth $9.3 million and having an adjusted basis of $3.7 million. Such stock conceivably could have a cumulative $5.6 million basis adjustment: (i) the $1.3 million adjustment of the first spouse to die; (ii) the $3 million adjustment for assets transferred to a surviving spouse; and (iii) the $1.3 million adjustment of the surviving spouse.

5. Liability Concerns of the Executor in Allocating Additional Basis to Assets.

a. Consider exculpatory clauses in will or trust to absolve the executor from liability for making selective basis adjustments not giving all non-cash assets a full basis "step up".

b. Basis increases should be added to those assets that are identified as likely to be sold (or subject to depreciation recapture) to avoid the payment of future income taxes.

c. However, how can such allocation be rationally made if the assets are fragmented among multiple beneficiaries with competing interests?

d. The underlying estate planning documents should either direct specific basis adjustments or contain broad exculpatory language to protect the executor from the criticism of unhappy beneficiaries not blessed with full basis step-up.

6. Drafting Clauses. (SEE APPENDIX B FOR FORM)

7. Even if Death Tax Repeal becomes Permanent, will Carryover Basis be Retained?

F. Traps for the Unwary.

1. For Clients Who Previously "Used" the Unified Credit and Paid a Gift Tax.

a. For example, in 2001, if gift tax was previously paid, the $75,000 increase in the unified credit (from $600,000 to $675,000 will not necessarily cover $75,000 of additional gifts (due to progressive rate brackets and declining maximum estate tax rates).

b. Example. Grandpa Moses funded $1 million GST trust in 1997 (using then unified credit of $600,000) and paid gift tax of $153,000. In 2001, Grandpa Moses can make only an additional $67,683 of gifts without paying estate taxes (not $75,000 which most of us would have thought since the unified credit had increased $75,000 since 1997).

2. Qualified Domestic Trust ("QDOT") Exception. Under Code Section 2210(b)(1), the estate tax will continue to be imposed on distributions from a QDOT for a noncitizen spouse made before January 1, 2021 with respect to the surviving spouse of a decedent dying before January 1, 2010.

II. DRAFTING ISSUES UNDER THE NEW LAW.

A. Philosophical Concerns.

1. Broaden the Estate Planning Process Beyond Estate Tax Savings (estate tax issues will have less importance)

2. More Attention to Dispositive Provisions.

a. Non-tax Benefits of Trusts:

(1) Manner in which assets pass to beneficiaries (outright or in

trust; setting priorities among beneficiaries).

(2) Reduction of probate and estate administration costs.

(3) Creditor protection for beneficiaries.

(4) To What Extent Should a Beneficiary's share be "trapped" in trust? (i) desirability assets having a positive (not negative) impact on beneficiaries; (ii) protecting a beneficiary from the beneficiary's own imprudence or incapacity.

(5) Asset management.

(6) Controlling assets under the law of a particular jurisdiction.

b. More Attention to Income Tax Planning, i.e., ASSET ALLOCATION to take Full Advantage to Maximize Available Basis Step Up

(1) Plan so each spouse has sufficient assets to use the $1.3 million basis adjustment (i.e., not the repealed unified credit).

(a) QTIP "trap". Upon death of surviving spouse, QTIP trust funded by the first spouse to die (and subject to $3 million basis adjustment) is not eligible for $1.3 million basis adjustment.

(2) Plan so surviving spouse has enough assets to use the $3 million basis adjustment (i.e., not the repealed unified credit).

(3) Planning strategies:

(a) Build up estate of spouse likely to die first

(b) Surviving spouse should generally receive all of the estate up to the maximum $3 million additional basis adjustment (children *can* receive property to utilize the $1.3 million basis adjustment).

Example. John dies survived by his spouse and owning only Abbott stock with a basis of 25 cents on the dollar. John would need to own $5,733,333 of Abbott stock to take advantage of the full $4.3 million available basis adjustment. Moreover, $4 million of that amount would have to be transferred in a manner that qualifies for the spousal property basis increase, either outright to the spouse or in QTIP form.

3. Attorney's Attitude Toward New Law.

a. The "Do-Nothing" Approach - Why should one advise clients of the new law if such law is only an illusion which will someday disappear? (i.e., revise estate plans after law becomes more certain).

(1) Unrealistic. Such a view is unrealistic and unbending to the probable realty that if not estate tax repeal, estate tax reform will substantially raise the bar and make planning unnecessary for all but the richest of our clients.

(2) Problem of Incapacity. What if an individual is unable to amend his or her estate plan because of disability? No client is certain to be alive and competent during phase-in of law.

b. The "Middle Course" Approach - Presume that the new rules will be with us for an intermediate horizon such as 5 years (i.e., focus on near-term relief and not the possibility of full repeal in 2010 or full reinstatement in 2011).

(1) This approach would assume the permanence (at least) of the $2 million [2006] estate tax exclusion amount and probably dictate "business as usual" for most clients with greater assets or short life expectancies.

(2) Disclosing and explaining this time frame would enable clients to accept or reject your assumptions and implicitly determine the degree of sophistication, cost and planning to be taken into account.

B. Marital Deduction Planning (revise marital deduction formulas to cover increasing estate tax exclusion amounts?)

1. Classical Issues - Most estate plans are "A/B" plans using a "marital formula" to carve out a "credit shelter share" (to take advantage of the estate tax exclusion amount) and leaving the remaining "marital share" to the surviving spouse to qualify for the marital deduction.

a. Many different types of marital formulas:

b. During administration the value of assets may increase or decrease.

(1) Where does increase go?

(a) To credit shelter trust, or

(b) To marital trust.

(2) Is there capital gains triggered on funding the credit shelter or marital share?

2. Three Primary Marital Formulas.

a. Pecuniary Marital Formula which defines the marital share as a fixed dollar amount with the residue passing to the credit shelter share.

(1) Attributes.

(a) Capital gains upon funding marital share.

(b) Trustee can "pick and choose" assets to fund marital share.

(c) In a rising market, the appreciation is allocated to the credit shelter trust (thus avoiding estate taxes on such appreciation); in a falling market, the credit shelter trust falls below the estate tax exclusion amount ($675,000 under current law).

(2) Still Use After Tax Reform but Fluctuating degree of Capital Gains Exposure for Larger Estates.

(a) Example. $5 million estate

i) 2001 - marital share is $4,325,000.

ii) 2002 to 2003 - marital share is $4,000,000.

iii) 2004 to 2005 - marital share is $3,500,000.

iv) 2006 to 2008 - marital share is $3,000,000.

v) 2009 - marital share is $1,500,000.

vi) 2010 - marital share is $0.

b. Pecuniary Credit Shelter Formula which defines the credit shelter share as a fixed dollar amount with the residue passing to the marital share.

(1) Attributes similar to Pecuniary Marital Formula, except that capital gains is realized on funding credit shelter trust (not marital share) and appreciation and depreciation is allocated to the marital share.

(2) Use Less After Tax Reform because of Increasing Degree of Capital Gains Exposure as Estate Tax Exclusion Amounts Increase.

(a) Example. $5 million estate

i) 2001 - credit shelter trust is $675,000.

ii) 2002 to 2003 - credit shelter trust is $1,000,000.

iii) 2004 to 2005 - credit shelter trust is $1,500,000.

iv) 2006 to 2008 - credit shelter trust is $2,000,000.

v) 2009 - credit shelter trust is $3,500,000.

vi) 2010 - credit shelter trust is entire trust estate.

(b) "Solution" is to fund the marital share quickly after death (this rarely occurs).

c. Fractional Formula in which both the marital share and credit shelter shares are expressed in terms of a fraction of the assets.

(1) Attributes.

(a) No capital gains upon funding marital share.

(b) Trustee can still probably "pick and choose" assets to fund marital share if "non-pro rata" distribution language is used.

(c) Both marital and credit shelter portions share proportionately in the appreciation and depreciation of assets.

(d) Difficult to administer, mainly because fraction needs to be recalculated upon each distribution.

(2) Preferred Marital Formula under new law as it adjusts better to the increasing estate tax exclusion amount?

(3) Example. $3.5 million estate:

(a) Pecuniary credit shelter bequest better in 2001 (only $675,000 funding subject to capital gains).

(b) Pecuniary marital bequest better in 2006 (only $1.5 million funding subject to capital gains).

(c) Pecuniary credit shelter bequest again better in 2011 if 2001 law reinstated.

(d) A Fractional Formula would suffice for all the above situations.

3. Review Plans to Avoid the "Wrong Tape Measure Trap" - the gradually increasing estate tax exclusion amounts (from $675,000 to $3.5 million) may change the distribution of assets in ways not intended by clients.

a. Example #1. Problem of Increasing Estate Tax Exclusion Amount Lessening Marital Share. Husband dies holding a $2 million estate with a trust adopting the typical "A/B" marital bequest formula designed to eliminate or minimize estate tax. If husband dies in 2001, the marital bequest to wife would be $1,325,000 ($2 million less the 2001 exclusion amount of $675,000). If husband dies in 2005, the marital bequest would be $500,000 ($2 million less the 2005 exclusion amount of $1.5 million). If husband dies in 2007, the marital bequest would be zero ($2 million less the 2007 exclusion amount of $2 million).

(1) Thus the possible "swing" in marital assets to the surviving wife is from $1,325,000 to zero, depending on when the husband dies. The swing is exacerbated if the wife is not a beneficiary of the residuary trust.

(2) Beware when spouse is not a beneficiary of the Credit Shelter Trust.

b. Example #2. Problem of Increasing GST Share.
Susan's estate plan directs that the GST trust for her grandchildren receive the maximum amount of property that can be exempted from the GST tax, with the remainder passing to her children. If Susan's estate is $4 million and she dies in 2001, $1,060,000 would be allocated to the GST trust. However, if Susan dies in 2009, the GST trust would receive $3.5 million (effectively disinheriting the children). Query: What is result if the estate tax is fully repealed?

c. Drafting "Solutions"

(1) Make spouse primary beneficiary of Credit Shelter Trust.

(a) Insert in nonmarital trust a "priority" clause that makes clear that the surviving spouse's needs are primary.

(2) Disclaimer Trust (outright to spouse and spouse disclaims appropriate estate tax exclusion amount to credit shelter trust). Disclaimer would generally be made to the extent that the surviving spouse's own estate tax exclusion amount might not shelter all of the assets of combined assets.

i) "Risk" spouse may not disclaim.

ii) Spouse would also have to decline any powers of appointments over credit shelter trust.

(3) "Single-Fund QTIP" Marital Trust leaving all trust property solely to the benefit of the surviving spouse.

(4) "Clayton QTIP" which gives the executor or trustee the authority to allocate the portion of the trust for which the marital deduction is not elected to the nonmarital trust.

(5) Leave a dollar amount or fixed percentage to surviving spouse and/or GST trust.

(a) i.e. "all (GST Exempt/marital) property, but not to exceed $2,000,000".

(b) i.e., "all (GST Exempt/marital) property, but not to exceed 50% of the gross estate [property available for allocation]".

(6) Over-allocate property to the marital trust and rely on the ability of the surviving spouse to disclaim property to the credit shelter trust.

C. Build Flexibility into Documents to Deal with Possible Changes in Law.

1. Powers of Amendment (SEE APPENDIX C FOR FORMS).

a. In General. Generally, an individual or committee of individuals (i.e., special trustee or "trust protector") can be given the power to rewrite the trust instrument in order to achieve the best result for the family.

(1) Authority to change documents may be limited to changes in tax law; or

(2) Authority to change documents may be limited to any reason in the discretion of the holder.

b. Independent Third Party to Avoid General Power of Appointment Problem. In order to avoid inclusion of the trust property in the taxable estate of the trust protector (by means of being classed as a general power of appointment), he or she should generally be a family member who does not have any interests in the trust.

c. Broad Discretion to React to Changes in Law or Family Circumstances.

(1) Grantor's intentions carefully framed to:

(a) consider future tax law changes (do not make termination mandatory upon estate tax repeal - i.e., have trustee consider what happens if after 2010 the sunset provisions reenacts estate taxes).

(b) specific circumstances of each beneficiary.

(2) Discretion to distribute property upon trust termination:

(a) distribute assets to a different trust for the same beneficiary who has creditor or marital problems.

(b) Can some beneficiaries be treated differently than others?

2. Powers of Appointment - Allows a beneficiary (typically a surviving spouse) to change an estate plan after the death of the first spouse to die. Such power may be motivated by changes in family or tax circumstances.

a. For example, powers of appointment can be used to:

(1) give a trustee broad discretion to distribute appreciated property outright to a beneficiary in order to enable the beneficiary's estate [under the modified carryover basis regime] to allocate basis increases to property following the beneficiary's death (i.e., property distributed to surviving spouse from a QTIP trust).

(2) eliminate trusts serving only an estate tax purpose, such as a GST trust.

b. For "dynasty" type trusts where continuation of the trusts become undesirable, the beneficiaries are given powers of appointment to distribute property out of trust

3. Other Approaches to Deal with Possible Changes in Law.

a. Alternative distribution provisions utilizing traditional estate planning clauses if death occurs before Death Tax Repeal, but leaving all property outright to the surviving spouse if death occurs after Death Tax Repeal.

b. Upon the death of the first spouse to die,

(1) Make substantial gifts to children. or

(2) Transfer all assets to the surviving spouse

D. Planning Techniques Becoming Increasingly Popular?.

1. Disclaimer Trusts.

2. Joint Trusts.

3. "Zeroed-out" Grantor Retained Annuity Trusts (GRATS) - to circumvent $1 million gift limits.

4. Charitable Remainder Trusts (CRTs) may become more popular, especially since the carryover basis rules will increase the need to dispose of low-basis assets at minimal tax cost.

E. Planning Techniques Becoming Less Popular?.

1. Charitable Giving?

a. Charitable lead trusts will probably lose some of their appeal in a regimen with no estate taxes to minimize.

b. Without the constraint of the estate tax limitations, new types of hybrid foundations and charitable trusts may be designed subject to a less rigorous standard of supervision.

2. Advanced Estate Planning Transactions Effectuated Only to Reduce Estate Taxes.

3. Irrevocable Insurance Trusts.

4. Generation-Skipping Transfer Tax (GST) Planning

5. Transactions Involving the Payment of Gift Taxes.

(SEE APPENDIX D FOR HELPFUL OUTLINE AND FORM EXAMPLES FROM THE NORTHERN TRUST LEGAL DEPARTMENT)