ESTATE PLANNING IN LIGHT OF THE 2001 TAX ACT AND POTENTIAL ESTATE TAX REPEAL

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I. Introduction.

Although the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") made significant changes to estate planning, the general framework and most of the specific elements remain unchanged. For some individuals, estate planning has become more simple as a result of the Act; for many others, it has become much more complicated. Perhaps more than anything, the new law has created great uncertainty about which rules will apply in the future. The purpose of this outline is to focus on a number of common estate planning situations and to analyze some of the important issues that should be considered by estate planners and their clients as a result of the Act.

As seen in the following table, much of the Act's complexity is caused by the increasing exemption amounts for the estate tax and the generation-skipping transfer tax (the "GST tax") over the next seven years. This increase is followed by a one-year repeal, and then culminates with the reinstatement of the law as it existed immediately before the passage of the Act. Meanwhile, the gift tax maintains a constant exemption amount throughout the entire period. Interestingly, beginning in 2004, the unified credit with respect to the gift tax and the estate tax is no longer "unified," while from that point on the estate tax exemption and the GST tax exemption are the same.

Calendar Year	*Gift Tax Exemption*	*Estate Tax Exemption*	*GST Tax Exemption*[1]	*Maximum Estate, Gift and GST Tax Rates*
2002	$1,000,000	$1,000,000	$1,100,000	50%
2003	$1,000,000	$1,000,000	$1,100,000	49%
2004	$1,000,000	$1,500,000	$1,500,000	48%
2005	$1,000,000	$1,500,000	$1,500,000	47%
2006	$1,000,000	$2,000,000	$2,000,000	46%
2007	$1,000,000	$2,000,000	$2,000,000	45%
2008	$1,000,000	$2,000,000	$2,000,000	45%
2009	$1,000,000	$3,500,000	$3,500,000	45%
2010	$1,000,000	N/A (tax repealed)	N/A (tax repealed)	35% (gift tax only)

[1] The $1,100,000 amount in 2003, 2011 and later will be adjusted for inflation.

Calendar Year	*Gift Tax Exemption*	*Estate Tax Exemption*	*GST Tax Exemption*[1]	*Maximum Estate, Gift and GST Tax Rates*
2011 (and after)	$1,000,000	$1,000,000	$1,100,000	55%[2]

[2] The 5% surtax is also reinstated.

The Act creates many issues for estate planners that did not exist under prior law. For example, a drafter must decide how to plan for the potential application of the carry-over basis rules that are scheduled to become effective for one year in 2010. Not only is it often more challenging for the estate planner to prepare and explain the estate plan, it has become harder for many clients to understand and to make decisions. This outline addresses some of the issues that will frequently arise and discusses strategies for resolving them. Many of these issues are especially relevant to estate planning for married couples, and their situation will therefore be given greater attention in this outline.

II. General Overview of Estate Planning Under the Act.

In general, the effect of the Act on an individual's estate plan will depend upon the size of that person's estate. Because of the increased estate tax exemption, the greatest impact is on estates over $1,000,000. However, regardless of the size of the estate, the following simple rule of thumb is helpful in planning under the new law:

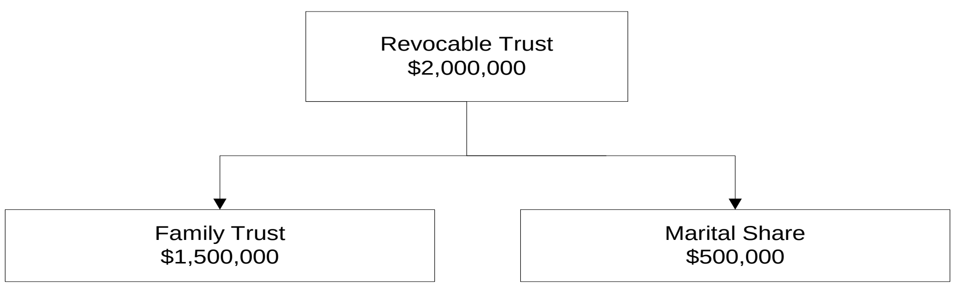
> **Prepare each estate plan based on circumstances as they presently exist, taking into account reasonable expectations for future changes.**

A. Estate Planning for Estates under $1,000,000. For many clients with estates between $675,000 (the former exemption amount) and $1,000,000, estate planning has become easier as a result of the new law. Even with the potential sunset of the Act, these clients may not need to worry about estate taxes because the prior law exemption of $1,000,000 in 2006 would become effective again in 2011. As a result, single taxpayers who fall into this category should not need to engage in annual exclusion gifting or any of the other strategies for reducing an estate. However, it will still be important to monitor the size of the estate over time as the exemption amount increases.

If the combined estates of a husband and wife in a first marriage are less than $1,000,000, there may no longer be a need for two trusts (assuming no unified credit has been used). The estate planning done for these clients will be similar to what was previously done for couples with less than $675,000. For example, the spouses may choose to execute wills leaving everything to the surviving spouse, or if none, then to a trust for children. Alternatively, they may choose to create a joint trust which is revocable by both spouses during their joint lifetimes, and then by the survivor, and which is funded either during lifetime or at death. However, in many second marriages and other situations where the spouses have different ultimate beneficiaries, there may still be a need for two trusts, even if the combined estates are less than $1,000,000. Of course, there are always borderline cases in which it may be best to plan at the present for a larger estate based on reasonable expectations for growth in asset values.

B. **<u>Estate Planning for Estates Over $1,000,000</u>**. Under the new law, planning for estates over $1,000,000 presents new issues for estate planners to resolve. The resolution of these issues will often depend on making reasonable assumptions about the future. For example, although the estate tax exemption is scheduled for significant increases in the next seven years, we are still faced with a $1,000,000 exemption in 2011 and beyond unless Congress changes the law. Based on the rule of thumb mentioned above, and regardless of life expectancy, the safest approach for a married couple with combined estates over $1,000,000 would be to create separate trusts and to plan for the sheltering of assets. This approach would protect against two distinct possibilities: (1) that both spouses die before the estate tax exemption increases to the point that the combined estates are covered; and (2) that one spouse lives beyond 2010 and Congress allows the exemption to return to $1,000,000.

The following simple illustration shows a typical estate plan for an individual who dies in 2005 with a $2,000,000 estate, an exemption of $1,500,000, and a spouse who survives him.

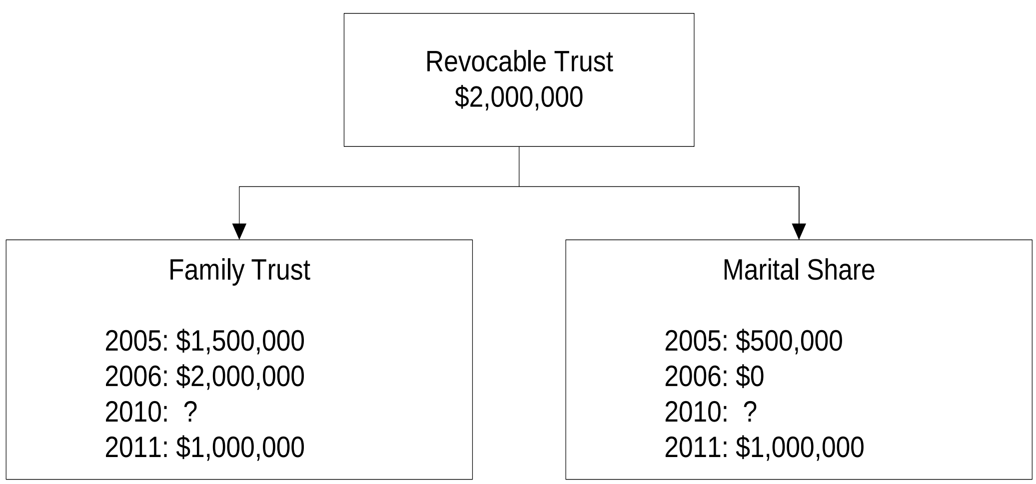


Again, there may be borderline cases in which clients with more than $1,000,000 choose not to shelter assets. Some clients may decide to take their chances, assuming that the growth in the estate tax exemption will at least keep pace with the growth in their estates, and that Congress will never allow the estate tax exemption to return to $1,000,000 in 2011. Two factors that may influence this decision are simplicity and control. Not all people are created equal when it comes to dealing with legal structure in their lives. Also, if in an estate-tax free world, both spouses would choose to leave all assets to the survivor free of trust, they may be uncomfortable restricting that freedom simply to avoid the possible application of an estate tax that only affects their children. In this case, making the surviving spouse the trustee of the shelter trust and providing a $5,000 or 5% annual power of withdrawal, along with the other powers typically given (i.e., all income, power of invasion, power to make gifts, and special power of appointment), may be enough to satisfy their concerns about control.

III. <u>Specific Estate Planning Issues Under the Act</u>.

A. <u>Different Beneficiaries and the Danger of Fixing Shares by Formula</u>. As noted, a common estate plan for a taxable estate is to divide assets between a Family Trust (i.e., a “shelter trust”) and a Marital Share, with ultimate distribution to the children of the Grantor. As the estate tax exemption grows, many estate plans with formula funding provisions will automatically increase the amount funded to the Family Trust and correspondingly reduce the Marital Trust. In the event of estate tax repeal, a formula that provides for the smallest marital deduction necessary to reduce estate taxes to zero will leave everything to the Family Trust. In contrast, a reverse formula that provides for funding the exemption amount to the Family Trust might be interpreted as leaving everything to the Marital Share, since there would be no more exemption.

The following illustration shows the typical allocations, based on various years of death, for a deceased individual who leaves a $2,000,000 estate and a surviving spouse.



If the benefits provided to the spouse under the Marital Share and the Family Trust are identical, these funding differences may be of no consequence. However, if the two Trusts have different beneficiaries, or other substantive provisions that differ, the consequences may be significant. For example, it is not uncommon in a second marriage situation for a decedent to leave the estate tax exemption amount outright to children and to retain the balance in a QTIP Marital Trust for the decedent's spouse. Under the new law, this type of planning could have the result of disinheriting the surviving spouse, depending upon the year of death.

Example 1

> John dies in 2006 with an estate of $2,000,000. At the time of his death, he was married to Sarah and had two children from a prior marriage. In 1997, he created a revocable trust that at his death would distribute an amount equal to his maximum estate tax exemption to his children. The balance of his estate is to be held in a QTIP Marital Trust for his wife. At the time John created his revocable trust, the maximum estate tax exemption was $600,000. However, because he dies with an exemption of $2,000,000, his entire estate is distributed to his children and nothing is held in trust for his wife.

The same problem could also arise in connection with a formula based on the GST tax exemption.

Example 2

> Margaret dies in 2009 with an estate of $3,000,000. Ten years earlier, she created a revocable trust that at her death would hold her maximum generation-skipping tax exemption in trust for her grandchildren. The balance of her estate was to be distributed to her three children, free of trust. At the time Margaret created her trust, the maximum generation-skipping tax exemption was $1,000,000. However, because she dies with an exemption of $3,500,000, her entire estate is held in trust for her grandchildren and her children receive nothing.

These examples illustrate the importance of carefully reviewing estate planning documents in light of the changes made by the new law, and placing caps on formula dispositions when appropriate. In Example 1, above, an appropriate provision might limit the children's distribution to $600,000, and provide for the balance of the non-marital share to be held in trust for the spouse's benefit. In Example 2, above, an appropriate funding formula might limit the grandchildren's share to be the lesser of $1,000,000 or the maximum generation-skipping exemption available (and in the event of repeal, simply $1,000,000). On the other hand, if the only reason to leave assets to grandchildren is to avoid additional estate tax on the estates of wealthy children, then the grantor might also include an alternative distribution providing for distribution to children in the event of estate tax repeal.

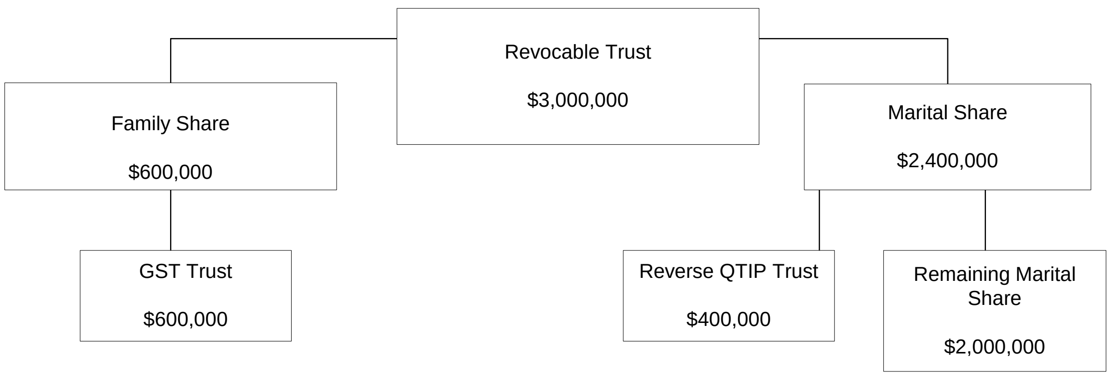
B. Carry-Over Basis Issues. Under current law, the income tax basis of most property owned by an individual at death is "stepped-up" to the property's full fair market value at that time, resulting in the elimination of potential capital gain as of that date. Under the new law, for a decedent who dies in 2010, basis may still be stepped-up to fair market value, but the amount of the basis increase cannot exceed $1,300,000, plus another $3,000,000 for assets transferred to a surviving spouse. If the decedent's estate planning provides for a formula disposition of all assets to a non-marital shelter trust, a step-up of $1,300,000 will still be available, but not the additional $3,000,000 step-up.

If the beneficiaries will be the same either way, one solution to this problem is to leave assets to the surviving spouse, either outright or in a QTIP Marital Trust, which are sufficient to use up the additional $3,000,000 step-up. Exhibit "A" contains a sample clause that reverses the default funding of a shelter trust to the extent necessary to fully utilize the additional $3,000,000 step-up. Under this clause, any assets remaining after using all available basis step-up would be funded to the shelter trust. It should be noted that if a QTIP Trust is used instead of an outright marital share, the trust assets will not qualify at the surviving spouse's death to receive an increased basis with respect to the survivor's $1,300,000 step-up.

The discussion above assumes that, even for estates under the exemption amount, it is better to keep assets out of the surviving spouse's estate because of the risk that an estate tax could be imposed at the survivor's death. This assumption is modified only to the extent necessary to obtain a step-up in basis in the event of repeal. However, even without repeal, if the imposition of an estate tax at the survivor's death is seen as unlikely because of the increased exemption, a client might choose to leave assets to the surviving spouse in order to take advantage of a step-up in basis under IRC § 1014. In that case, the marital disposition could take the form of a QTIP trust. See IRC § 1014(b)(10).

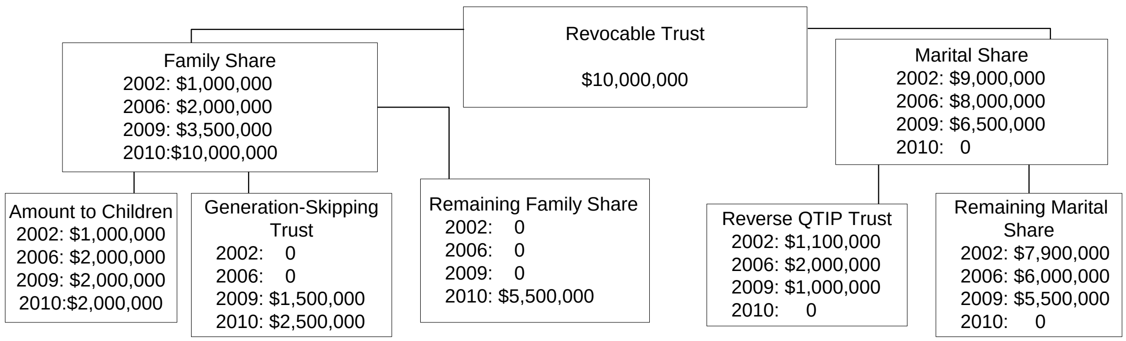
C. Generation-Skipping Planning. In the past, planning for the GST tax was often accomplished through the use of a "triple trust"—i.e., a revocable trust that would split into three specific shares for tax purposes at a decedent's death. First, an amount equal to the estate tax exemption would be funded to the shelter trust and the balance would be allocated to the marital share in the normal way as described above. Second, the marital share would be further divided into two parts. The first part of the marital share would be equal to the difference between the estate tax exemption and the GST tax exemption, and would be funded to a “reverse QTIP Trust.” The purpose of the reverse QTIP Trust is to allow the decedent to be treated as the transferor of the property for GST tax purposes, notwithstanding the fact that the property will be included in the estate of the surviving spouse. The other part of the marital share, or the balance, would take whatever form of marital disposition the decedent preferred (i.e., outright, QTIP, or general power of appointment).

The following diagram illustrates the allocation that would occur in a $3,000,000 estate for a year when the estate tax exemption was $600,000 and the GST tax exemption was $1,000,000:



Since the Act provides that the estate tax exemption and the GST tax exemption will be the same beginning in 2004, generation-skipping planning for some individuals will be greatly simplified because they will no longer require a reverse QTIP Trust. However, especially in a second marriage, it is not uncommon for a decedent to provide an immediate distribution to children at death (perhaps tied to the estate tax exemption amount), with the balance being held for the benefit of the surviving spouse (whether in the marital share or the family share), and with generation-skipping provisions for grandchildren. In this complex scenario, the Act creates great uncertainty, because it is impossible to know which share will provide the funding for the generation-skipping portion, and it may be necessary to create caps on the amounts that are tied to the estate tax and GST tax exemptions. Obviously, drafting this type of estate plan can become extremely challenging, and it is necessary to weigh the costs and benefits involved.

The following diagram illustrates the allocations that would occur in a $10,000,000 estate, based on various years of death, with the lesser of $2,000,000 or the estate tax exemption distributed immediately to children, and the lesser of $2,500,000 or the GST tax exemption held in a generation-skipping trust(s). Please note that these numbers would come out completely different if a provision were included to take advantage of the spousal step-up in basis in 2010. Also, in 2011, the numbers will be the same as 2002 except that the GST tax exemption will have been adjusted for inflation.



D. <u>Miscellaneous</u>. Of course, the Act will affect many other aspects of estate planning. One of the best changes in the new law is the repeal of the family business deduction in 2004, which was found in one of the most complicated tax provisions ever written, and which offered limited benefits to taxpayers because of the number of requirements it contained. Another important change involves the three-year phase-out of the estate tax credit for inheritance taxes paid to a state, and the ultimate replacement of the credit with a deduction in 2005. This change may result in legislation by the states to impose an independent inheritance tax. Finally, in 2010, a new definition of taxable gift will go into effect for transfers to trust, generally providing that such transfers are taxable gifts unless the trust is a grantor trust. Amidst all of the uncertainty created by the new law, one thing is certain—there is going to be more change. This means that communication with clients (e.g., through newsletters, bulletins, etc.) will continue to be a critical part of an estate planning practice.

Exhibit "A"

<u>Alternate Allocation and Distribution in Event of Limitation of Basis Step-Up at Death</u>. Notwithstanding the foregoing, if the GRANTOR is survived by his wife, _______, (with survivorship determined in the manner described in paragraph _____, above) and in the event the step-up in basis available under Section 1014 of the Internal Revenue Code of 1986, as amended, is in any way limited, whether in connection with estate tax repeal under Section 2210 of the Code or otherwise, any property that, at the time of the GRANTOR'S death, would qualify for an additional basis increase for federal income tax purposes solely by virtue of being "Property Acquired from the Decedent" because it is distributed to or for the benefit of the surviving spouse as "Qualified Spousal Property" (as determined in accordance with Sections 1022(c) and (d) of the Internal Revenue Code), shall be paid over and distributed to the [Marital Trust]. In other words, in the event sufficient assets have been allocated to the [Family Trust] to fully utilize the GRANTOR'S "Aggregate Basis Increase" (as defined in Section 1022(b)(2)(B) of the Code), the TRUSTEE shall pay over and distribute assets of the trust estate to the [Marital Trust] as all or part of the Marital Share, but only to the extent necessary to fully utilize the GRANTOR'S "Aggregate Spousal Property Basis Increase" (as defined in Section 1022(c)(2)(B) of the Code). After fully utilizing the GRANTOR'S Aggregate Basis Increase and Aggregate Spousal Property Basis Increase, any remaining assets of the trust estate shall be allocated to the [Family Trust]. In making the allocations between the Family Trust and the Marital Share provided for herein, the TRUSTEE shall distribute assets to the Marital Share which have the lowest relative basis for federal income tax purposes in order to minimize the amount allocated to the Marital Share. Notwithstanding anything contained in this paragraph ____ to the contrary, in the event the GRANTOR'S wife, _______, makes, within nine months of the date of the GRANTOR'S death, a qualified disclaimer (in the manner described in paragraph ___, above), of the Marital Share provided hereunder or any portion thereof, then such disclaimed property or portion thereof shall instead be paid over and administered pursuant to the terms of the Family Trust.