HOFFMAN SABBAN & WATENMAKER

LAWYERS

2001 Update: The 2001 Tax Act

Hoffman, Sabban & Watenmaker strives to keep our clients and friends informed of important developments affecting their estate and tax planning. This memo covers **three important developments**: The **new tax bill** may revolutionize estate planning. Recent changes in the rules regarding **distributions from IRAs and qualified retirement plans** will affect how much you must withdraw from such plans during your life and after your death, and how you write your beneficiary designations. Finally, people with **split dollar insurance arrangements** will want to review those arrangements because of a recent IRS announcement.

I. Changes in the Gift, Estate & Generation-Skipping Transfer Taxes.

A. Summary.

1. Phased in Repeal. The new tax bill provides for the phase out of the estate and generation-skipping transfer ("GST") tax by 2010, but will retain the gift tax and partially eliminate the "step-up in basis" at death. However, many people believe that the promised elimination of the estate and GST will never occur because the enormous revenue loss that will take place beginning in 2010 will prompt Congress to stop the phaseout before then.

The bill promises to reduce the rates of, and raise the amount exempted from, the gift, estate and GST taxes, as shown on the following table:

Gift, Estate and GST Tax Table For Years 2002 - 2010

Year	Estate & GST Tax Exemption	Maximum Estate & GST tax rate	Gift Tax Exemption	Maximum Gift Tax Rate
2002	$1,000,000*	50%	$1,000,000	50%
2003	$1,000,000*	49%	$1,000,000	49%
2004	$1,500,000	48%	$1,000,000	48%
2005	$1,500,000	47%	$1,000,000	47%
2006	$2,000,000	46%	$1,000,000	46%
2007	$2,000,000	45%	$1,000,000	45%
2008	$2,000,000	45%	$1,000,000	45%
2009	$3,500,000	45%	$1,000,000	45%
2010	Unlimited	None	$1,000,000	Highest individual income tax rate (35%)

*Note that the exemption from the generation-skipping transfer tax will remain at $1,060,000 for 2001, and will increase with changes in the cost of living for 2002 and 2003. In 2004 and thereafter, the generation-skipping transfer tax exemption will be the same as the estate tax exemption.

Even though the estate and generation-skipping transfer taxes are scheduled to be repealed in 2010, all tax reductions under the 2001 Tax Act are scheduled to be eliminated in 2011. Thus, the current provisions of the gift, estate and generation- skipping transfer taxes would again become effective in 2011 unless Congress acts to extend the provisions of the 2001 Tax Act prior to 2011.

Even after the estate tax has been repealed, gifts will continue to be subject to gift tax once your cumulative lifetime gifts exceed the $1,000,000 lifetime exemption. (As under current law, there will be no tax, and no reduction of the lifetime exemption, for gifts of up to $10,000 per person per year, or for amounts paid directly for school tuition or medical expenses). The gift tax was retained in order to prevent people from reducing their income taxes by transferring income producing assets to children or friends, thus shifting the resulting income tax liability to people in lower tax brackets.

There is one limited situation where the estate tax will remain in effect after 2010: If a Qualified Domestic Trust ("QDT") is set up on the death of a person who dies before 2010 (in order to obtain an estate tax marital deduction for assets benefitting a spouse who is not a U.S. citizen), then any principal distributions from the QDT before the earlier of 2022 or the death of the surviving spouse will be subject to estate tax. However, if the surviving spouse dies after 2009, no estate tax will be imposed on the QDT.

2. <u>Carryover Basis</u>. After repeal, there will no longer be an automatic step-up in basis at death. Generally, the basis will be the **lesser** of the asset's fair market value or the decedent's basis. However, at death, the Executor can increase the basis of the decedent's assets by $1.3 million, plus any unused net operating loss carryovers, plus any unused capital loss carryovers, plus "built-in losses" (i.e., where the basis is greater than the value). An additional $3 million basis increase will be allowed for assets passing to a surviving spouse, or to certain types of trusts for the benefit of a spouse (such as the typical Marital Trust contained in many current estate plans).

You can't increase an asset's basis above fair market value. Also, you can't increase the basis of certain foreign corporation stock or items of "income in respect of a decedent" (such as installment sale notes or retirement plan benefits). Both halves of community property assets can receive a basis increase at the first spouse's death. If an asset is held by spouses in joint tenancy, then only the decedent's half of the basis can receive a basis increase at the first spouse's death.

The basis of assets of a non-resident alien decedent will only be allowed to be increased by $60,000, and the rules regarding increases in basis for capital loss carryovers, net operating loss carryovers and built-in losses won't apply.

3. <u>Gain Exclusion for Principal Residence</u>. A principal residence of a decedent can be sold by an heir and the $250,000 gain exclusion will apply if the decedent, the heir, or both lived in the home satisfying the 2 out of 5 year ownership and residency rules.

4. <u>Incomplete Gifts</u>. After repeal, a lifetime transfer to a trust which, for income tax purposes, is not a grantor trust of the settlor or the settlor's spouse, will be treated as a taxable gift. This rule was inserted to stop people from shifting income (for income tax purposes) to lower income tax bracket friends or relatives, while avoiding gift taxes.

5. <u>Deemed Sale on Death</u>. After repeal, a transfer at death to a non-resident alien will be treated as a taxable sale. Also, if an asset has a basis less than the debt on the property, a transfer to the government, charity or a foreign person will cause gain to be recognized equal to the difference between the debt and the basis.

6. Section 529 Plans. Qualified State Tuition Plans (also called Section 529 Plans) have been useful because they have no income thresholds, and because you can contribute up to $50,000 in one year free of gift tax (using up your current year's $10,000 annual gift tax exemption plus the next four years of exemption). Under the new law, starting in 2002, amounts withdrawn from Section 529 Plans and used for qualified higher education expenses will be completely free from federal income tax. This makes such plans even better devices for gifts on behalf of young people than under current law. The law makes other technical changes to such plans making them more attractive.

B. Implications.

1. Will We Ever See Repeal? Estate planning under the new law is difficult, since many people believe that the provision for repeal may never become effective; or if it does go into effect, then Congress may not vote to continue the repeal and reduction provisions after the 2001 Tax Act "sunsets" in 2011. It has been projected that revenue loss from 2010 to 2020 due to the gift, estate and generation-skipping transfer tax provisions will be about $1 trillion; but that amount has been excluded from the current budget debate because it occurs more than 10 years in the future. Coincidently, in 2011, the first of the "baby boomers" (those born after 1945) will reach age 65 and start to draw social security and Medicare. The revenue loss from repeal of the estate tax, plus the increase in government costs, may persuade the Congress to stop the phaseout.

2. State Budgets. Many states (including California) have received substantial tax revenues from a share of the federal estate tax (due to the "state death tax credit"). The new tax bill cuts that credit by 25% in 2002, and phases it out by 2005. This will put pressure on the states to raise income or other taxes, or suffer a reduction in their credit rating. California is prohibited (by a constitutional amendment adopted by the voters) from instituting a new inheritance tax.

3. Life Insurance. Be sure that your life insurance company has adequate reserves. Some companies have derived a substantial part of their profits from selling "cash value" policies in order to fund expected estate taxes. If people no longer feel the need to keep insurance for that purpose, then there may be an "adverse selection" phenomenon, with healthy people cashing in their policies and ill people keeping their policies in effect.

As the estate tax exemption increases and the maximum estate tax rate declines, you may want to review the amount of insurance you maintain to provide for estate taxes. Some people may want to cancel their cash value insurance, and instead buy term insurance (such as a 10-year level premium policy), but in general we believe that this is not a wise move. It is not clear that we will ever see full repeal. There may be taxable income realized on cancellation of a policy. Cash value insurance may be an important tax planning tool in the future, since cash value isn't taxed as it builds up, in some cases cash can be withdrawn from the policy tax free, and the proceeds can be received income and (with proper planning) estate tax free, without carryover basis concerns. Insurance will also be important to deal with such matters as buy-sell agreements, paying the capital gains tax on sales of assets after death, and equalizing gifts among children where there is a family business passing to some but not all children. If you plan to cancel a policy, and you are over age 65, you may want to investigate the sale of the policy to a viatical settlement company, which may pay you more than the cash value of the policy.

4. <u>Should You Liquidate Your FLP</u>? If and when the increased exemptions go into effect, you may want to consider undoing some estate planning now in effect. For example, if you have assets worth less than the estate tax exemption, you may want to dissolve any family limited partnerships so that the value on death is increased, and you can "step up" the basis to a higher value.

5. <u>Should You Revise Your Estate Plan Now</u>? Many estate plans will **<u>not</u>** have to be revised because of the change in the law, unless and until estate tax repeal actually takes effect in 2010. Almost all estate plans prepared by Hoffman, Sabban & Watenmaker will automatically adjust for the increase in the estate tax exemption. Since August 1997, we have been anticipating an increase in the gift and estate tax exemption to $1,000,000, and the new law simply will get to that level sooner than we had anticipated.

However, some plans may be affected by an increase in the exemption above $1,000,000, which will occur in 2003. **If you want us to review your plan in light of the new law or because of any other change in your circumstances, we will be happy to do so at our regular hourly rates. A review will probably cost between $500 and $1,000 if no meeting is necessary. If you want us to review your plan, please contact us and provide us with a current financial statement and let us know if there have been any significant changes in your personal situation (such as a marriage or the birth of a child) since your plan was prepared.**

There are a few cases where you might want to make changes before 2010:

(a) <u>Increased Exemption Distorts Plan</u>. If you are married and your estate plan leaves an amount equal to the estate tax exemption to your children, grandchildren or friends, with the balance to your spouse, you may want to consider limiting the gift to children, grandchildren and friends to an amount less than the exemption. Otherwise, your spouse may receive too little and your children, grandchildren and friends too much. Similarly, if your plan leaves the amount of your GST exemption to grandchildren, you may want to consider limiting this gift, since it may leave your children too little and your grandchildren too much.

(b) <u>Should You Leave More to Your Spouse</u>? Some clients (especially those with children from a prior marriage, and whose spouse has substantial assets of his or her own) have estate plans which leave their assets to their children, rather than to a trust for their spouse. In view of the possibility of repeal, these clients may want to consider revising their estate plan to leave their assets in excess of the exemption to a trust for their spouse. If the client dies before the estate tax is repealed, and the spouse lives until the estate tax is repealed, their children may eventually receive far more than they would have received if the assets had been left directly to the children at the first spouse's death.

(c) <u>Should You Eliminate Your Bypass Trust</u>? Many married clients have estate plans that establish a "bypass trust" on the death of the first spouse to die. This is done to preserve the estate tax exemption of the first spouse to die, so that amount can eventually pass free of estate tax to children or others.

If you are married, and if the assets of you and your spouse total less than the estate tax exemption, then you might want to consider eliminating the bypass trust created under your estate plan. The benefits of eliminating the bypass trust are that (a) the surviving spouse will be able to "step up" all of the assets at the surviving spouse's death, not just the surviving spouse's assets; and (b) it will eliminate the record keeping and tax return compliance required to maintain a bypass trust. Alternatively, you may want to grant an independent trustee the right to terminate the bypass trust if your spouse's assets plus the bypass trust assets are less than the exemption, or if and when the estate tax has actually been repealed.

On the other hand, a bypass trust provides some benefits which you may not want to eliminate (even if the estate tax is completely repealed). A bypass trust provides creditor protection, and can assure the first spouse to die that when the surviving spouse dies, the assets will pass to the beneficiaries selected by the first spouse to die.

6. Should You Revise Your Plan Upon Repeal? If repeal becomes effective, then much new planning must be done at that time. As discussed above, if you are married, you might want to eliminate your bypass trust, and leave your assets outright to your spouse. On the other hand, if you are married, you will no longer have to leave your assets (in excess of your exemption) to your spouse or charity in order to avoid paying estate taxes, and thus might want to leave more to persons other than your spouse.

If you are married, you may want to plan to maximize the use of your $4.3 million basis step-up. This may affect how much you leave to your spouse, and which assets you leave to your spouse. For example, you may want to leave your most highly appreciated assets to your spouse, but limit the gift so that only $3 million of appreciation is transferred. But, determining how much to leave to your spouse may be difficult. Assets with $3 million of appreciation, for example, may be worth a great deal more than $3 million (e.g., a $10 million asset with a $7 million basis).

Once you have left appreciated assets to your spouse with a total of $3 million of appreciation, you may want to consider what provisions should govern the rest of your assets. For example, you may want to set up a "sprinkling trust" to apportion income among your spouse and children. Your spouse's right to benefit from the trust could terminate if your spouse remarries.

7. Implications for Charity. If repeal becomes effective, provisions for charity should be reviewed. If bequests to your children will no longer be reduced by estate taxes, you may conclude that your children will receive from you more than you would want them to inherit, and thus you might want to consider leaving more to charity. On the other hand, since you will not get a tax benefit from leaving assets to charity, you might want to leave more to your children (who will then get an income tax deduction for amounts they give to charity during their lives).

8. More Information Available. If you would like to read a somewhat more detailed analysis of the implications of the new tax law for estate planning, a memorandum is available on the "Memos of Interests" page of our web site, www.hswlaw.com. If you do not have access to the Internet, please call or write us, and we would be pleased to send you a copy of this memorandum.

II. IRA & Qualified Plan Distributions.

Recently released regulations have changed the amount that must be withdrawn from IRAs and qualified retirement plans after the participant reaches age 70-1/2, or dies. The new rules are effective for 2001 and after. In many cases, the amount you are required to withdraw will be less than under the prior rules, and in no case should the amount you are required to withdraw be greater than under the prior rules. There are numerous changes which affect the distribution of benefits following a death where a trust is named as a beneficiary of plan benefits. You should check with us or a retirement plan advisor to see how these new rules affect your retirement plan designations. A detailed technical outline regarding the new regulations appears on the "Memos of Interest" page of our web site, www.hswlaw.com.

III. **Split Dollar Insurance Plans**.

Split dollar insurance plans generally divide the cost and benefits of an insurance policy between a corporation and an employee. Recently issued rules may adversely affect many of these types of plans. If you participate in a split dollar plan, you should have it reviewed by us or by an insurance professional.