

## **When Momma Won't Jump...**

*Beginning-of-the-year tax planning opportunities under new law*

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The 2001 Tax Legislation has been cynically referred to as the "Throw Momma From The Train Act" due to its peculiar one-year repeal of the estate tax system in 2010. Due to the phase-in of the many varied provisions of the Act, estate planning and estate administration in particular will be constantly evolving. An understanding of the upcoming changes is important to maximizing a positive result for our clients.

### **Increase in the Transfer Tax Exemption Amount**

As of January 1, 2002 a \$1.0 million estate tax exemption took effect. The estate tax exemption will increase to \$1.5 million in 2004, and to \$2.0 million in 2006 under the 2001 tax act. Consequently, the marital and bypass trust funding on Form 706 will vary depending on the year of death.

As the exemption increases to \$3.5 million in 2009, the marital trust may not be funded at all. Bypass or residuary trusts may need to be redrafted to provide flexibility to the trustee in supporting the surviving spouse, including mandatory income or broadening the standard for principal distributions.

For larger estates, gifts up to the amount of the estate tax exemption should be reviewed. As of January 1, 2002, another \$325,000 of value can be gifted without incurring a current transfer tax, provided that no prior taxable gifts have been made.

A common estate planning strategy has been to gift property expected to appreciate significantly to a family limited partnership or irrevocable trust. This technique may become less popular as 2010 approaches because of the anticipated loss of the basis adjustment rules of the present Internal Revenue Code §1014.

### **Decrease in Tax Rates**

As of January 1, 2002, the maximum transfer tax rate decreased to 50%. In addition, the 5 percent surcharge on estates over \$10 million is abolished. This change in rate affects marital deduction planning for estates of more than \$2.0 million when the first spouse has already died.

Incurring a tax on the first estate and taking advantage of graduated rates up to the maximum transfer tax rate results in a lower combined estate tax than if assets were exempt from tax by QTIP election and added to the survivor's estate – until 2006, when the flat tax of 46 percent will apply. Estate tax advisors should lay out this strategy for clients well before the QTIP election or disclaimer due date.

In larger estates, the surviving spouse should also be advised that claiming the maximum marital deduction under a Qualified Terminable Interest Property (QTIP) trust may eliminate tax on the first estate, but increase the overall tax on the deceased spouse's estate and the survivor's estate together, if death occurs before or after 2010.

### **Generation Skipping Taxes**

After 2003 the generation skipping tax exemption amount will track the increase in the estate tax exemption. Gifts up to the estate tax exemption can be made for larger estates, and the availability of a corresponding generation skipping tax exemption will follow.

Two changes in the generation skipping provisions were effective in year 2001. Federal estate tax law now recognizes the severance of trusts into separate exempt and non-exempt generation skipping shares by any means available under the governing instrument or local law.

The statute authorizing severance does not specify who can accomplish the severance, but it can occur at any time. A power drafted in a trust allowing a trustee to make the severance, for example, may provide for additional planning flexibility, rather than establishing the shares currently.

The second change now in effect allows retroactive allocation of the generation skipping exemption on any timely filed gift tax return. Some settlors have been reluctant to allocate the exemption to a trust where their children will receive the trust property unless there is an unusual order of death. The trust property is distributed to the child upon the settlor's death and the exemption is therefore wasted.

Under the 2001 changes in the Federal estate tax law, the settlor can make a retroactive allocation to a previous gift in trust if a child dies. The lure of late allocations must be weighed against the risk that the settlor may die without having made an allocation, and the child dies thereafter but before the trust terminates. The generation skipping exemption now will be automatically allocated to certain generation skipping trusts. When preparing gift tax returns for any gifts after year 2000, preparers may now need to think in terms of avoiding the automatic allocation. A major exception to the new deemed allocation rules are trusts providing that more than 20 percent of the trust principal may be withdrawn by nonskip persons prior to age 46.

The typical revocable trust for children with stepped distributions and a contingent remainder to grandchildren would fall within this exception. Such a trust, of course, could qualify for the late allocation of the generation skipping exemption described earlier.

## **State Death Taxes**

The state death tax credit is scheduled for a quick death itself. The credit will be reduced by 25 percent each year beginning in 2002, leading to repeal in 2005. More than 30 states now have a state death tax equal to the federal credit, and state legislatures will be considering legislation to make up for revenue loss from this provision – perhaps enacting an independent state estate tax. In addition to keeping current on local legislation, estate tax return preparers need to be aware that state estate taxes are a deduction and no longer a credit after 2004.

Marital deduction formula clauses that refer to the state death tax credit should be reviewed to insure that only the reduced credit is used to calculate the marital deduction amount.

## **Retirement Planning**

In January 2001, significant revisions in Treasury regulations regarding IRAs were published. The new regulations now default to the recalculation method on the death of the first spouse that formerly had to be elected before the required beginning date (usually age 70 ½). Most importantly for planning purposes, the IRA beneficiary is not finally determined until December 31 of the calendar year after the participant's death.

The beneficiary designation form should contain the name of both a primary and a contingent beneficiary. Through disclaimer by the primary beneficiary, the beneficiary of the IRA could be “changed” after death. Present IRA beneficiary designations should be reviewed to provide for a contingent beneficiary such as a surviving spouse (assuming the QTIP Trust is the primary beneficiary) or children.

In reviewing disclaimers as part of post-death planning, the effect on IRA distributions must now also be considered.

## **A Brave New World**

Professional seminars are now morphing from explanations of the new tax provisions to discussions of drafting and other specific planning techniques. All professional advisors are encouraged to contribute to this discourse and to learn from suggestions and experience of others.

If the estate tax is repealed as scheduled in 2010, traditional estate tax planning will be stood in its head. Instead of focusing on removing assets from the estate, the goal would become forcing assets back into the estate, both to avoid tax, and to take advantage of the new limited increase in basis provisions.

Deferred income assets, such as retirement plans or installment notes, will become less advantageous because they continue not to qualify for the increase in basis provisions.

In the near future, basis information needs to be added to the estate tax preparation checklist given to clients. As 2010 approaches, there may be hybrid planning if the first estate tax return is calculated under current law with adjustments, but the survivor's estate may mature in the year of repeal of the estate tax.

Aggregate division in community property states or other allocation of assets should be considered to take advantage of changes in basis rules. In a hybrid estate, for instance, consider allocating lowest basis assets to the bypass trust to obtain the step-up under present law, and allocating assets with slightly more basis directly to the surviving spouse or to a survivor's trust to take advantage of the basis increase in the survivor's estate - if death occurs after 2009.

Any QTIP trusts may need to be written with flexibility to allow distributions to a surviving spouse, since the new law provides specifically that assets in a QTIP trust do not qualify for increase in basis in the survivor's estate. If the new basis rules take effect, the client will need to weigh the comfort of an assured disposition of the QTIP assets on the survivor's death against possible negative income tax consequences.

### **Stay Alert**

All proposed changes in the 2001 Tax Act expire after 2010. Even before that date, tax changes may be subject to legislative change or repeal prior to becoming effecting.

The US government has taken on major new commitments in light of the events of September 11, 2001, and it may be necessary to reduce or eliminate scheduled future tax cuts to meet new budget priorities. It is crucial to keep apprised of ongoing tax law changes, to prepare client information letters, and to continually review estate plans if changes to the estate tax law take effect as scheduled.