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**ESTATE PLANNING IN AN UNCERTAIN TAX ENVIRONMENT:  
PLANNING GUIDANCE FOR 2006 AND BEYOND**

By David Holstein (May, 2006)

**OVERVIEW OF THE SIGNIFICANT CHANGES MADE BY THE ECONOMIC GROWTH  
AND TAX RELIEF RECONCILIATION ACT OF 2001 (THE "2001 TAX ACT")**

**Changes in the Estate, Gift and GST Exemption Amounts and Highest Tax Rates**

The most significant changes made by the 2001 Tax Act were (i) the phased-in increase in the applicable exclusion amount (also referred to as the "unified credit" or "exemption equivalent") for estate taxes and the eventual repeal of the estate tax (ii) the increase in the applicable exclusion amount for gift taxes to \$1 million, and (iii) the increase in the generation skipping transfer ("GST") tax exemption and the eventual repeal of the GST tax. The following table summarizes these changes:

<b>Calendar Year</b>	<b>Estate and GST Tax Exemption</b>	<b>Gift Tax Exemption</b>	<b>Highest Estate, Gift and GST Tax Rate</b>
<b>2002</b>	<b>\$1,000,000*</b>	\$1,000,000	50%**
2003	\$1,000,000*	\$1,000,000	49%
2004	\$1,500,000	\$1,000,000	48%
2005	\$1,500,000	\$1,000,000	47%
2006	\$2,000,000	\$1,000,000	46%
2007	\$2,000,000	\$1,000,000	45%
2008	\$2,000,000	\$1,000,000	45%
2009	\$3,500,000	\$1,000,000	45%
2010	Taxes Repealed	\$1,000,000	Estate tax repealed for one year. Gift tax rate is top individual income tax rate.
2011 & later	\$1,000,000	\$1,000,000	55%

\* The GST exemption was actually greater than \$1,000,000 for 2002 and 2003 because it was \$1,060,000 for 2001 and was indexed for inflation.

\*\* The 5% surtax on estates over \$10,000,000 was repealed in 2002.



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- The gift tax and estate tax are no longer unified. The gift tax applicable exclusion amount was increased to \$1 million and remains frozen at that amount. The gift tax was not repealed.
- The estate tax exemption and the GST exemption are now coordinated and increase to \$3.5 million by 2009.
- The estate tax and GST are repealed for one year only, in 2010.
- The provisions of the new law sunset in 2011. At that time, the provisions of law in effect prior to the 2001 Act are reinstated.

### **State Death Tax Credit**

The state death tax credit was repealed for decedents dying after 2004, and was replaced by a deduction. The maximum credit was reduced by 25% in 2002, by 50% in 2003, and by 75% in 2004.

- In some states, including New York, the combined Federal estate tax and independent state death tax for certain size estates is now greater than prior to the 2001 Tax Act - in New York, this occurs when the taxable estate exceeds \$1 million.
- In states, such as Florida, where the state death tax is a "soak up" tax, there was no increase in overall estate taxes after enactment of the 2001 Tax Act.

### **Generation Skipping Transfer Tax Technical Changes**

Technical changes to the GST tax now automatically allocate a portion of a taxpayer's GST exemption to trusts that are defined as "GST trusts" under the statute.

- Unfortunately, there are certain automatic allocations that for planning purposes are an inappropriate use of, or a waste of, a taxpayer's GST exemption. In order to avoid automatic allocation, a taxpayer must opt out of the allocation on a timely filed GST tax return.



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### **Other Changes**

- The deduction for Qualified Family Owned Business Interests ("QFOBI") was repealed effective January 1, 2004, when the then applicable exclusion amount of \$1.5 million first exceeded the QFOBI deduction of \$1.3 million. The recapture provisions continue in effect with respect to property for which a QFOBI deduction was taken prior to 2004, even if the triggering event occurs after estate tax repeal.
- The conservation easement exclusion rules were modified to eliminate the requirement that the property be located within a certain distance of a national park, wilderness area, metropolitan area or urban national forest. The only requirement for location is that the real estate be located within the United States or one of its possessions.
- Distributions from a Qualified Domestic Trust ("QDOT") established for a non-U.S. citizen spouse continue to trigger estate tax until 2021, even after repeal. There is no estate tax due upon the death of the non-citizen surviving spouse after repeal.
- The deferral of payment of Federal estate tax under Section 6166 was expanded to include qualified lending and finance companies and certain holding company stock. However, the deferral period was reduced from 14 to 4 years. The maximum number of partners or shareholders in a qualifying business was increased from 15 to 45.

### **Modified Carryover Basis After 2009**

In 2010, after repeal of the estate and GST taxes, a new set of modified carryover basis rules will replace the current rule that provides for a step-up in the basis of most inherited assets at death. Under the new rules, the basis of property will be the lower of its fair market value at the decedent's death and the decedent's adjusted basis in the property at that time. The carried over basis is subject to three adjustments:

- A \$1.3 million increase in basis to be allocated to specific assets by the executor of the estate.
- A \$3 million increase in basis for "qualified spousal property" that passes outright to a spouse or to a "QTIP" type trust.
- Capital loss carryovers and Section 165 losses that would otherwise have been allowable if the decedent were alive or if the property were sold prior to the decedent's death.



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In addition, there are complex rules regarding the categories of assets that would qualify for the three adjustments.

**Sunset on December 31, 2010**

All of the income, estate, gift and GST provisions of the new law expire on December 31, 2010. At that time, the provisions of pre-2001 law come back into effect. For this reason, planning must take into account the possibility of estate and GST tax repeal and, as well, the probability that there will still be estate and GST tax for the foreseeable future.

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**Planning for Alternate Tax Scenarios**

An estate plan must now take into consideration three potential transfer tax regimes, any one of which may be in existence at the time of a decedent's death. Wills and trusts will need to accommodate the possibility that a decedent will die under any one of the following scenarios:

- Death before 2010 during the phase-in of the increased estate and GST tax exemptions and the establishment of a fixed \$1 million gift tax exemption.
- Death in 2010 (and possibly thereafter) when estate and GST taxes will be repealed and when modified carryover basis will be implemented.
- Death in 2011 (and possibly thereafter) when the provisions of current law will be reinstated.

Wills and trusts with tax driven formulas should be reviewed to be certain that the formulas are appropriate based on the size of each spouse's estate and the nature of a person's assets, and to take into account all three of the possible tax scenarios. Consideration should be given to the following:

- The will and any trusts must be drafted so as to properly dispose of assets regardless of when death occurs. Most existing wills with formula clauses do not adequately address how property will pass in the event the Federal estate tax is repealed.
- If the credit shelter share and the marital share will ultimately pass to different beneficiaries - such as in a second marriage situation, a plan with a substantial charitable bequest at the death of the second spouse, or a plan with specified business assets passing



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to only some of the heirs - formula driven clauses should be reviewed to determine whether there should be a "cap" on the dollar value of assets passing into either of the two shares.

- As the exemptions increase under the new law, typical formula provisions will cause more assets to pass into the credit shelter trust and less into the marital share. This may cause more assets than are necessary for elimination of tax at the surviving spouse's death to pass into the credit shelter trust.
- Consideration should be given to establishing a "cap" on what passes into the credit shelter trust.
- The entire estate could be made to pass into a trust that is qualified terminable interest property ("QTIP"). Such a trust must be for the sole benefit of the surviving spouse, and must provide the spouse with all of its income annually. The executor would determine whether to make a partial or complete post-mortem QTIP election. The portion of the trust for which the election is made will qualify for the marital deduction. The portion of the trust for which no election is made will by-pass the surviving spouse's estate. The election will determine the size of the two shares and the corresponding tax effect in the surviving spouse's estate. The portion for which no election is made can be severed and placed into a separate trust of which the children and further descendants are also beneficiaries ("Clayton QTIP").
- The entire estate could be made to pass outright to the surviving spouse, who would utilize post-mortem disclaimers to establish the funding of a credit shelter trust. Note that disclaimers depend upon the good intentions and legal capacity of the surviving spouse, and there is a risk that they will not be made. Disclaimed assets are not free from the creditors of the disclaiming spouse, as are assets in a credit shelter trust and QTIP trust.
- If less than one-third of the estate (including testamentary substitutes) passes to the surviving spouse, the survivor will have the right under New York law to elect to receive a survivor's share under EPTL Section 5-1.1-A in lieu of what is given under the will or trust. As the exemption amount increases between now and 2010, the credit shelter share will encompass a greater portion of a decedent's estate, and the marital share will be smaller. If the marital share (when added to non-probate assets received by the spouse) would be less than one-third of the augmented estate, it will give rise to a right of election. If this is a concern, the estate planning documents should be drafted to ensure that the surviving spouse receives outright at least one-third of the augmented estate.



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### **Planning After the Decoupling of the New York and Federal Exemption Amounts**

New Yorkers must now pay a New York estate tax that is not creditable against the Federal estate tax if the New York taxable estate exceeds \$1 million. A decedent with a large estate will want his or her credit shelter trust to be funded with the maximum exemption amount allowable for the year of death - which was \$1 million in 2002 and 2003 and \$1.5 million in 2004 and 2005, and which is \$2 million from 2006 through 2008, and \$3.5 million in 2009. If funded with these amounts, there will be New York estate tax in 2006 through 2009 on the excess over \$1 million. One way to avoid this tax is as follows:

- Fund the credit shelter trust with \$1 million.
- Fund a QTIP trust with the difference between \$1 million and the fully available exemption amount. Elect QTIP trust treatment for New York estate tax purposes, but do not elect QTIP trust treatment for Federal estate tax purposes. There will be no New York estate tax in the decedent's estate on the excess over \$1 million, but that excess will be sheltered from Federal estate tax in the survivor's estate.
- The remainder of the estate assets should pass to or for the benefit of the surviving spouse in a manner that qualifies for both the Federal and New York marital deductions.
- The trust that was QTIPed solely for New York estate tax purposes will be in the New York estate of the surviving spouse. Depending on the value of the spouse's other assets, and the then New York estate tax law (\$1 million current exemption), there may be no or little taxes in the survivor's estate. If the survivor moves out of New York before dying, the QTIP property will not be taxed in New York (unless it consists of real property located in New York).

### **Gift Planning**

It is always advisable to make gifts if it will ultimately save estate and GST taxes and if the donor is willing to part with the gifted assets. The growth in value of the gifted assets is permanently out of the estate of the donor. Gifting of fractional interests in property, or of specially valued gifts such as QPRTS, GRATs, and the like, leverages the otherwise available exclusions or exemptions.

The gift tax is tax exclusive, meaning that if a gift tax is paid, there is no estate tax on the monies used to pay the gift tax. Conversely, the estate tax is tax inclusive, meaning that there is estate tax paid on monies used to pay the estate tax. The advantage of paying gift taxes over paying estate taxes is a savings of approximately one-third. However, one should not consider paying gift taxes



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if one's estate without gifting would be free of estate taxes (which could occur as larger exemption amounts phase-in).

When making gifts, consideration should be given to the following:

- Annual exclusion gifts of \$12,000 per donee, adjusted for inflation.
- Gifts that qualify for the unlimited exclusion for medical and tuition expenses.
- Gifts of the full \$1 million gift tax applicable exclusion amount.
- Gifts that qualify as accelerated annual exclusion gifts to Section 529 tuition programs (up to 5 times the annual exclusion).
- Qualified Personal Residence Trusts ("QPRTs"), Grantor Retained Annuity or Unitrusts ("GRATs" and "GRUTs"), family limited partnerships and limited liability companies, and sales to defective trusts.
- Gifts to a QTIP trust for the spouse (qualifying for the gift tax marital deduction) of sufficient assets so as to preserve the grantor's up to \$3.5 million GST exemption in the event that the exemption is reduced or eliminated in the future and the GST tax is not repealed or is repealed but reinstated. The grantor must make a reverse QTIP election, and the spouse must direct in the spouse's will that taxes on the trust be borne by other assets. If the spouse dies, the grantor may be a beneficiary of the trust without triggering the estate inclusion provisions of Section 2036.

### **Other Planning Considerations**

The new tax law invites review of the following:

- Insurance needs should be reviewed. If insurance is in place primarily to help pay estate taxes, review of the size of the estate and the amount of currently available exemption and future available exemption is necessary. If there is estate tax repeal, then there will be carry over basis, which will create the need for liquidity at the time low basis assets are sold and income taxes are due on the sale. The law provides that repeal will occur only in 2010. The estate tax will return in 2011 with the available exemption being limited to \$1 million. These are all reasons to be cautious about modifying existing insurance protection. In addition, if insurance is being used to equalize bequests, fund buy-outs or to create wealth, then it should remain in place.



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- Beneficiary designations to insurance policies, retirement plans and IRAs should be reviewed. As the exemption from estate tax increases, more of these assets can be sheltered from estate tax. The beneficiary designations should be drafted to permit multiple disclaimers to persons and trusts as a way to maximize estate and GST tax savings.

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