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ESTATE PLANNING ADVISORY

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A periodic publication of our Trusts & Estates Department, the Wiggin & Dana Estate Planning Advisory is intended to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners. This issue focuses on estate planning under the Economic Growth and Tax Relief Reconciliation Act of 2001.

The New Tax Act – Estate Planning Implications

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the “Act”) provides for a gradual phase out of the federal estate and generation-skipping transfer (“GST”) taxes and a modification of the federal gift tax over the next ten years. Although the Act offers the prospect of having one’s estate pass to heirs free of federal estate and GST taxes, the Act also creates a great deal of uncertainty because of a “sunset provision” and a long phase-out period.

Set forth on pages two and three of this Client Advisory are the primary estate, GST and gift tax provisions of the Act. Before delving into the details, however, it may be helpful to first highlight some of the potential implications of the new law. *Many, if not all, of our clients should revisit their estate plans in light of the new Act. Among the issues that should be considered are the following:*

Flexibility. The Act phases in changes between now and 2009, then repeals certain taxes for one year, and then reinstates current tax provisions. Given the substantial uncertainty this creates for planning purposes, it is important to build flexibility into your estate plan and to give your executors and trustees appropriate discretionary powers, so that however the circumstances turn out, your estate plan can be adapted to best meet the needs of your family and other beneficiaries.

Formula Bequests. Under the Act, the applicable exclusion amount is scheduled to increase dramatically in the coming years (i.e., from \$675,000 in 2001 to \$3.5 million in 2009). This change makes it important to review the provisions of

your estate planning documents that establish formula bequests based upon the applicable exclusion amount. For example, your will might call for a trust to be funded with an amount equivalent to the entire applicable exclusion amount for the benefit of your children, with the remainder of your assets going to your spouse. If you died in 2001 with an estate valued at \$2 million, the children’s trust would be funded with \$675,000 and your spouse would get \$1,325,000. If, however, you died in 2006, the entire \$2 million would pass to the children’s trust and your spouse would get nothing. Even if the exempt trust includes your spouse as a beneficiary, it may be important to consider what share of your estate should be set aside for the exclusive benefit of your spouse. A change in your documents may be necessary in order to achieve the results you intend.

Liquidity. The Act increases the applicable exclusion amount and decreases the marginal estate and GST tax rates over the next several years. As a result, individuals may not need to provide for the same level of liquidity to pay estate taxes at death. This may change your need for life insurance or may alter your long-term investment strategy. However, potential income and capital gains tax liabilities will continue to be of concern.

Titling Property. Attention should be paid to how property is titled in order to benefit from the increased exemption amounts. Married individuals should review their assets to ensure that each spouse has ownership of a sufficient amount of assets in order to take advantage of

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the increased exemption. If that is not the case, the couple should consider re-titling assets accordingly.

Basis and Capital Gains. Repeal of the estate tax will bring with it a change in the basis rules. Instead of getting a "step up" in basis to fair market value, inherited assets will retain the basis of the decedent (i.e., "carryover" basis), subject to certain exceptions. As a result, it will be important to consider your basis in assets in deciding how they will be distributed. Furthermore, because of certain elective provisions available only to a surviving spouse, it may become advisable to provide express instructions in your estate planning documents setting forth how you want the new basis rules to be applied.

Gift Tax Programs. Although the lifetime gift tax exemption amount is scheduled to increase to \$1 million as of 2002, the gift tax is not slated for repeal. In the short term, the increase in the exemption amount makes it advantageous to increase the amount of assets transferred by lifetime gifts. Such gifts remove assets (and their future appreciation) from the donor's estate. This may become particularly important if the estate tax returns in its present form in 2011. However, if, as many believe will happen, Congress amends the Act and "freezes" the exemption at some intermediate level (say, \$2 million) and abandons the proposed changes to the basis and capital gains rules, donors may want to hold on to specific assets so that heirs can take advantage of the step up in basis at death. In other words, gifting programs need to be carefully considered to maximize tax benefits.

Summary of the Act

ESTATE TAX PROVISIONS

Increase in the Applicable Exclusion Amount.

Perhaps the most well publicized effect of the Act is the increase in the applicable exclusion amount, i.e., the amount each person may pass to heirs estate tax free. Currently, the exclusion amount is \$675,000. The Act increases the exclusion amount to \$1,000,000 for individuals dying in 2002 and 2003. Thereafter, the exclusion amount will increase to \$3,500,000 by 2009 (see chart on next page?). In 2010, because of repeal, all assets will pass estate tax free regardless of their value. However, if a future Congress fails to extend the repeal beyond 2010, the estate tax as

it existed just prior to the passage of the Act will be back in full force in 2011.

Decrease in Estate Tax Rates. In addition to increasing the applicable exclusion amount, the Act benefits taxpayers by decreasing the marginal estate tax rates over time, until the eventual repeal of the estate tax in 2010. The current law, which applies to estates of individuals who die in 2001, imposes a tax of between 37% and 55%, depending on the estate's value. Beginning in 2002, the Act reduces the maximum estate tax rate to 50%. Thereafter, the maximum estate tax rate drops 1% per year until 2007. If you die in 2007 through 2009, the maximum rate will be 45%. Finally, in 2010 the estate tax is repealed. However, unless Congress acts, the maximum 55% rate will return with the estate tax in 2011.

GENERATION SKIPPING TRANSFER ("GST") TAX PROVISIONS

Like the estate tax, similar changes in tax rates and exemption amounts will occur with the GST tax, i.e., the tax imposed on transfers that skip a generation, such as transfers to grandchildren or more remote descendants. The maximum GST tax rates will track the maximum federal estate tax rate. The current GST exemption amount is \$1,060,000 and will be indexed for inflation over the next two years. In 2004, the GST tax exemption amount will increase in tandem with that of the estate tax, until repeal in 2010. Absent further Congressional action, the \$1,060,000 exemption amount will then return in 2011.

GIFT TAX PROVISIONS

Unlike the estate and GST taxes, the gift tax has been modified, but not repealed, under the Act. The maximum gift tax rates will track the estate and generation-skipping rates through 2009, but in 2010, the gift tax rate is 35%. Under the sunset provision, the rate increases to 55% (the 2001 rate) in 2011, unless Congress acts. Importantly, the gift tax exemption amount does not increase in tandem with the estate and GST taxes; it increases to \$1,000,000 in 2002 and remains there through 2011.

CAPITAL GAINS: CHANGES TO THE BASIS RULES

Modified Carryover Basis. Estate tax repeal does not come without a price. Under the current estate tax system, beneficiaries of a decedent's

The Economic Growth and Tax Relief Reconciliation Act of 2001 changes the estate planning landscape in many ways. Attorneys in Wiggin & Dana's Trusts and Estates Department would welcome the opportunity to review your estate plan with you and discuss steps that you may need to take in order to ensure that your intentions will be realized. Our names and telephone numbers are listed on the back page of this Advisory.

estate are deemed to have a basis in inherited property equal to the property's fair market value. (This is usually called the "step-up" basis, although in some situations use of fair market value is actually a "step-down.")

The Act replaces step-up basis with a modified "carryover" basis. In 2010, your heirs will no longer have their inheritance reduced by federal estate taxes. However, the assets they inherit will have a basis equal to the lesser of your cost basis or the fair market value at your death. For example, assume you purchased 1,000 shares of stock at \$10 per share. Your cost basis would be \$10,000. Further assume that you die in 2010, at which time the stock is valued at \$50 per share. The original 1,000 shares, now worth \$50,000, are bequeathed to your children. Under the Act, the stock will pass free of estate tax. However, if your children sell the stock immediately, they will incur capital gains liability for the \$40 per share difference between your cost basis (\$10 per share) and the date of death value (\$50 per share). Note that under the same facts, if the date of death value was \$5 per share, because the fair market value at the time of your death (\$5 per share) is less than your cost basis (\$10 per share), the children would have to take the lesser value as their cost basis.

The Act modifies the carryover basis rules to permit the executor of an estate to assign a step-up in basis for up to \$1,300,000 in certain assets. In addition, the executor is authorized to apply a step-up in basis for up to an additional \$3,000,000 in qualified assets transferred to the surviving spouse. Assets acquired by the decedent by gift from an individual other than his or her spouse do not qualify for the elective step-up in basis, nor does income in respect of a decedent (e.g., retirement plan distributions).

The Need for Good Record-Keeping. The elective step-up in basis modification is certainly a favorable aspect to the carryover basis rules, particularly for the surviving spouse. However, much like the difficulties associated with the standard carryover basis rules, executors will have the added responsibility of tracking the assets to which a step-up in basis has been assigned. In order to do so, the executor must know the decedent's original cost basis so as to be able to account for how much of the step-up was assigned and to which assets. Thus, the new carryover basis rules will require that individuals keep detailed statements and receipts for all assets eventually to be transferred at their death. Where assets have been purchased many years prior to death, locating the statements and receipts may be difficult.

Predicting the Future

The Sunset Provision. No one knows what 2011 will bring. In order for the repeal of the estate and GST taxes and the modification of the gift tax to survive beyond December 31, 2010, Congress must affirmatively reenact these provisions. Politically, it may be difficult for legislators to justify a permanent repeal of the estate and GST taxes – taxes that are paid by only the wealthiest taxpayers. Moreover, the current economic situation may prompt Congress to act sooner, possibly by halting the phase-out at some fixed point (e.g., by capping the applicable exclusion amount at, say, \$2 million and fixing the maximum rate at, say, 45%). Against this backdrop, it becomes especially important that one's estate plan be flexible and adaptable to changing circumstances.

Estate, Gift and GST Tax Provisions Under the New Tax Laws

Year of Death	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Maximum Estate and GST Tax Rate	55%	50%	49%	48%	47%	46%	45%	45%	45%	Repealed	55%
Maximum Gift Tax Rate	55%	50%	49%	48%	47%	46%	45%	45%	45%	35%	55%
Applicable Exclusion Amount	\$675,000	\$1M	\$1M	\$1.5M	\$1.5M	\$2M	\$2M	\$2M	\$3.5M	Repealed	\$1M
GST Exemption Amount	\$1,060,000	\$1,060,000 Indexed	\$1,060,000 Indexed	\$1.5M	\$1.5M	\$2M	\$2M	\$2M	\$3.5M	Repealed	\$1,060,000 Indexed
Gift Tax Exemption	\$675,000	\$1M	\$1M	\$1M	\$1M	\$1M	\$1M	\$1M	\$1M	\$1M	\$1M

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IN FOCUS: Paying for Education: Provisions in the New Tax Act

Recent years have seen the cost of education, particularly at the post-secondary level, rise to staggering levels, outpacing inflation and income growth. The new tax act includes specific provisions addressing the ways in which taxpayers can get an early start on financing a child's education, two of which are addressed below.

Education IRAs. Under the existing law, taxpayers may contribute to an Education IRA up to \$500 per beneficiary per year until the beneficiary attains age eighteen (18). The contribution limit is phased out depending on the contributor's adjusted gross income. The funds in the IRA must be used for qualified higher education expenses. Higher education in this context means post-high school.

The new tax act makes Education IRAs more attractive by increasing the amount of annual contributions one can make to each beneficiary and by expanding the definition of qualified education expenses. Beginning in 2002, individuals may make annual contributions of up to \$2,000 per beneficiary, and qualified education expenses will include elementary and secondary school expenses. In addition, the Act authorizes corporations to make contributions to Education IRAs, and increases the phase-out range for married contributors filing jointly to \$190,000 - \$220,000 (i.e., double that of single taxpayers).

Qualified Tuition Programs (Section 529 Plans). Existing law provides that individuals may establish an account under a State operated program on behalf of a beneficiary to be used for the beneficiary's qualified higher education expenses (e.g., tuition, room and board, books, school fees and supplies). The contribution is considered a completed gift and, therefore, the donor may use his or her annual gift tax exclusion amount (\$10,000 per recipient) to avoid gift tax liability. Furthermore, the account may be "pre-funded" with up to five years of annual exclusion gifts, which may result in a higher total return on the investment. The accounts grow on a tax-deferred basis; earnings are taxed only upon distribution, at the student's income tax rate (a rate usually much lower than that of the contributor). The beneficiary may be changed at any time.

The new tax act removes the requirement that the contribution be made to a program established and maintained by a State. Instead, beginning in 2002, contributions may be made to programs of "eligible educational institutions," which include private schools, colleges and universities. In addition, beginning in 2002, distributions from State programs will no longer be subject to income tax, provided the distributions are used to pay qualified higher education expenses. This income tax rule will apply to privately run programs beginning in 2004.

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