

The Challenge of Estate Planning in 2002 and Beyond

*Featuring a Description and Analysis
of the 2001 Tax Legislation*

By the Trusts and Estates Lawyers
of McGuireWoods LLP



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**FEATURING A DESCRIPTION AND ANALYSIS OF THE
2001 TAX LEGISLATION**

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PREVIEW AND SUMMARY OF ACTION NEEDED

1. Review all existing irrevocable trusts:
 - If transfers have been made to the trust on or after January 1, 2001, ensure that the GST exemption allocation is appropriate. (See section 7.a on page 19.)
 - If the trust was created or added to at any time on or after September 26, 1985, identify any GST exemption allocations that need to be corrected. (See section 7.d on page 21.)
 - If the trust was created before September 26, 1985, consider how it might be prolonged or otherwise used more efficiently.
2. Review all estate plans in general:
 - Especially estate plans for married couples that depend on formula dispositions. (See section 5.b on page 13.)
 - Especially estate plans where multiple marriages or multiple families are involved, to ensure that fairness is preserved. (See section 5.d on page 15.)
 - Especially the ownership and titling of assets by married couples, in view of increasing exclusion amounts. (See section 5.a on page 13.)
3. Investigate opportunities for leveraged gifts to transfer wealth with a minimum of gift tax exposure. (See section 5.e on page 15.)
4. Consider the special opportunities and requirements for certain assets:
 - The tax benefits of a conservation easement for any property that qualifies. (See section 6.a on page 17.)
 - Structuring a closely held business to qualify for the expanded availability of extended payments of estate tax. (See section 6.b on page 18.)
 - A claim for refund by June 6, 2002, if special use valuation for farm or business property has ever been denied, by reason of cash rents, on the occasion of a family member's death. (See section 6.c on page 18.)
5. Watch for changes in either federal or state law. (See section 4 on page 11.)
6. Start keeping better basis records, in case carryover basis ever becomes the law. (See section 3 on page 11.)

* * * * *

THE CHALLENGE OF ESTATE PLANNING IN 2002 AND BEYOND

With the arrival of 2002, a number of the phased estate and gift tax changes enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“the 2001 Act”) began to take effect. Ultimately, if the legislation is to be believed, the estate tax will be “repealed” in the year 2010, and then will revive again in 2011 when the repeal “sunsets.” Meanwhile, other important changes made by the 2001 Act are already in effect and should be taken into account in the preparation of tax returns that are due this April 15. In this memorandum, the trust and estates lawyers of McGuireWoods describe selected provisions of the 2001 Act and offer a number of observations to assist in estate planning, tax planning, estate administration, and tax return preparation under the phased-in changes.

1. CENTERPIECE OF THE LEGISLATION: GENERAL TAX CUTS

a. Background of the Tax System Since 1977: Unified Rates and Unified Credit

In the tax system applicable to both gifts during life and transfers at death, transfers are taxed on a cumulative basis at rates that increase as the amount subject to tax goes up. All lifetime gifts are added together to determine the gift tax “bracket,” or the rate of tax. At death, all taxable gifts since 1977 are added to the value of the estate to determine the estate tax bracket. (This is sometimes called the “unification” of the gift and estate tax rates.)

The tax law allows a *credit* against the gift and estate tax, or a dollar-for-dollar reduction of the tax payable. Like the “unified” gift tax rates, the credit is “unified”—that is, it is calculated on a cumulative basis from year to year. Thus, the unified credit available in any year is the amount prescribed for that year *less* any amount used as a credit in prior years. Table 1 shows the level of that unified credit since 1977, together with the amount of gifts that a credit of that level would shelter from tax (generally referred to by estate planners as the “exemption equivalent” since 1977 and called the “applicable exclusion amount” in the statute since 1997):

TABLE 1 Historical Unified Credit		
Year	Unified Credit	Exemption Equivalent/ Exclusion Amount
1977	\$30,000	\$120,667
1978	\$34,000	\$134,000
1979	\$38,000	\$147,333
1980	\$42,500	\$161,563
1981	\$47,000	\$175,625
1982	\$62,800	\$225,000
1983	\$79,300	\$275,000
1984	\$96,300	\$325,000
1985	\$121,800	\$400,000
1986	\$155,800	\$500,000
1987-97	\$192,800	\$600,000
1998	\$202,050	\$625,000
1999	\$211,300	\$650,000
2000-01	\$220,550	\$675,000

Tax Rates: The “beginning” rate for gift and estate tax purposes is ordinarily thought of as the first rate that applies above the “exemption equivalent” or “exclusion amount.” From 1986 through 2001, that rate was 37%, and it was therefore common to refer to 37% as the “beginning” gift and estate tax rate. Reflecting the “progressive” tax brackets, the tax rate, often referred to technically as the “marginal” rate, increased to 39% for cumulative transfers (by gift or at death) above \$750,000, 41% above \$1,000,000, 43% above \$1,250,000, 45% above 1,500,000, 49% above \$2,000,000, 53% above \$2,500,000, and 55% above \$3,000,000. (These rates had not changed since 1984, and the rates up to \$3,000,000 had not changed since 1977.)

In 1987, Congress added a special 60% rate bracket, in the form of a 5% surtax on the first several million dollars of cumulative transfers over \$10 million, designed to make both the average effective rate and the marginal rate exactly 55% for the largest estates.

The Generation-Skipping Transfer (GST) Tax: In addition to the gift and estate tax, since 1987 there has been a generation-skipping transfer (GST) tax, which applies to transfers to persons two or more generations younger than the transferor. The GST tax is imposed at a flat rate equal to the highest gift or estate tax rate, which congressional committee reports in 1987 clarified would be the top regular rate of 55%, not the special 60% rate resulting from the 5% surtax over \$10 million. Each individual is entitled to an exemption from GST tax in the amount of \$1 million, and beginning in 1999 this amount has been adjusted annually for inflation, in \$10,000 increments, until it was \$1,060,000 in 2001. The purpose of the GST tax is to prevent the avoidance of tax at each generation level by the excessive use of long-term multi-generation trusts—that is, use of such trusts in excess of the GST exemption.

b. Estate Tax Cuts Under the 2001 Act

In the 2001 Act, which President Bush signed into law on June 7, 2001, Congress gave effect to its determination that estate tax relief was needed to reduce the increasing number of estates subject to estate tax, to reduce hardships on families inheriting farms and small businesses, and to address what it viewed as a mounting public opinion that a “death tax” is unfair. While the Act did not satisfy the appetite of some Members of Congress for immediate repeal of all transfer taxes, the Act does repeal the estate tax and GST tax (but not the gift tax) in 2010. Relief is accomplished in the interim by lowering the top rates and increasing the amount that can be transferred tax free (the “exclusion amount”). Of concern to taxpayers and estate planners alike is the notorious “sunset” provision that would reinstate prior law in 2011, if Congress fails to legislate in the intervening years. The sunset provision creates an air of uncertainty, and it ensures that the budgetary and policy debate over estate tax repeal is not over.

Table 2 shows the phased increases in the estate tax exclusion amount, the increases in the unified credit needed to achieve those exclusion amounts, and the decreases in the top estate tax rate mandated by the 2001 Act (with 2001 included for comparison):

Year	Exclusion Amount	Unified Credit	Beginning Rate	Top Rate
2001	\$675,000	\$220,550	37%	55% (60%)
2002	\$1,000,000	\$345,800	41%	50%*
2003	\$1,000,000	\$345,800	41%	49%*
2004	\$1,500,000	\$555,800	45%	48%*
2005	\$1,500,000	\$555,800	45%	47%*
2006	\$2,000,000	\$780,800		46%*
2007	\$2,000,000	\$780,800		45%*
2008	\$2,000,000	\$780,800		45%*
2009	\$3,500,000	\$1,455,800		45%*
2010	No federal tax.* The estate tax is repealed.			
2011	\$1,000,000	\$345,800	41%	55% (60%)

* Note: The combined rate of federal and **state** tax in some states may be higher, as explained beginning on page 8.

The “beginning rate” in Table 2 is the first rate that actually takes effect, after the applicable exclusion—that is, 37% for the 2001 exclusion amount of \$675,000, and 41% for the 2002 exclusion amount of \$1,000,000. After 2005, the beginning rate is the same as the top rate, as a result of the increased exclusion amount. In effect, beginning in 2006, that will result in a flat estate tax rate, once the exclusion amount is exceeded.

Table 2 shows the repeal of the estate tax scheduled for 2010 and the reinstatement under the “sunset” provision in 2011. Although the 2011 sunset restores the law that was in effect before the 2001

Act, that law already included phased increases in the exclusion amount to \$1,000,000 by 2006. That explains the sunset exclusion amount and unified credit of \$1,000,000 and \$345,800 in 2011.

The 2001 Act repeals the 5% surtax, which had created a special 60% rate bracket for transfers over \$10 million. The surtax and 60% bracket would return in the 2011 sunset.

c. Generation-Skipping Transfer (GST) Tax Cuts Under the 2001 Act

The GST exemption, \$1,060,000 in 2001, has increased by reason of inflation to \$1,100,000 in 2002. It will increase for inflation once more in 2003. Then, under the 2001 Act, the GST exemption will be the same as the estate tax exclusion amount. For all years, the GST tax rate is still a flat rate equal to the top estate tax rate. For 2010, the GST tax, like the estate tax, is repealed, but in 2011 it revives. These changes are summarized in Table 3:

Year	Estate Tax Exclusion	GST Exemption	GST Tax Rate
2001	\$675,000	\$1,060,000	55%
2002	\$1,000,000	\$1,100,000	50%
2003	\$1,000,000	\$1,130,000*	49%
2004	\$1,500,000	\$1,500,000	48%
2005	\$1,500,000	\$1,500,000	47%
2006	\$2,000,000	\$2,000,000	46%
2007	\$2,000,000	\$2,000,000	45%
2008	\$2,000,000	\$2,000,000	45%
2009	\$3,500,000	\$3,500,000	45%
2010	No tax. The GST tax is repealed.		
2011	\$1,000,000	\$1,370,000*	55%

* Estimated, assuming 2.5% annual inflation.

d. Gift Tax Cuts Under the 2001 Act

For 2002 and 2003, the gift tax is reduced just like the estate tax—the exclusion amount is increased to \$1 million, and the top rate is cut to 50%. ***But in 2004 and beyond, when the estate tax exclusion amount is increased above \$1 million, the gift tax exclusion amount stays at \$1 million.*** In fact, when the estate tax is repealed in 2010, the gift tax continues in effect, with an exclusion amount of \$1 million and a flat 35% rate. Table 4 summarizes:

Year	Exclusion Amount	Unified Credit	Beginning Rate	Top Rate
2001	\$675,000	\$220,550	37%	55% (60%)
2002	\$1,000,000	\$345,800	41%	50%
2003	\$1,000,000	\$345,800	41%	49%
2004	\$1,000,000	\$345,800	41%	48%
2005	\$1,000,000	\$345,800	41%	47%
2006	\$1,000,000	\$345,800	41%	46%
2007	\$1,000,000	\$345,800	41%	45%
2008	\$1,000,000	\$345,800	41%	45%
2009	\$1,000,000	\$345,800	41%	45%
2010	\$1,000,000	\$330,800	35%	
2011	\$1,000,000	\$345,800	41%	55% (60%)

The reason most commonly reported for Congress's decision to "deunify" the gift tax and estate tax, by capping the gift tax exclusion amount at \$1 million and retaining the gift tax after the estate tax is repealed, is that a robust gift tax is needed to prevent people from freely transferring appreciated and income-producing assets to family members and others with more favorable income tax profiles, such as lower income tax brackets.¹

2. THE SURPRISING EFFECT ON—AND OF—STATE TAXES

a. The Law Before the 2001 Act

Since the earliest days of the estate tax, there has been a "credit for state death taxes," allowing a dollar-for-dollar reduction of federal estate tax liability for the amount of estate or inheritance taxes paid to a state or the District of Columbia. This credit, however, is limited by a statutory cap set by the federal tax code. With very narrow exceptions, this means that any amount of state inheritance or estate tax paid in excess of the statutory cap cannot be used to reduce the federal estate tax liability, either as a dollar-for-dollar credit or as a deduction.

The existence of the federal credit has gradually changed the way in which state estate and inheritance taxes are imposed and administered. The great majority of states have come to impose an estate tax that is exactly equal to the amount of the federal credit. Since such a tax soaks up the federal credit, it is often called a "soak-up" tax. A state with a soak-up tax can collect the maximum amount of state estate tax that reduces the federal estate tax, but if it collects no more than that, the state tax does not increase the overall estate tax liability (both federal and state) that is payable with respect to the estate and thus does not increase the overall tax burden on the citizens of that state.

A state can also enforce a soak-up tax with very limited administrative burden. The state taxing authority can simply defer to the Internal Revenue Service's determination of the federal estate tax liability, and determine the state estate tax on the basis of the formula for the federal credit in the federal statute. As a result, many states with soak-up taxes have downsized the enforcement and administrative mechanisms for their state estate taxes to a bare minimum. In addition, the more uniform and objective standard for computing the state estate tax amount makes domicile and location of property less of an issue, because a soak-up tax tends to be relatively uniform from state to state. Even in cases where a decedent owned property in more than one state, the states involved typically divide the tax revenue between them in proportion to the relative values of the property located in each state.

Understanding the exact manner in which a soak-up tax is statutorily imposed is critical to understanding how the 2001 Act affects state estate taxes. In some states, the state estate tax is tied strictly to the amount of the federal credit allowable by the federal statute as it exists in any year from time to time (*a "pure" or "floating" soak-up tax*). For example, the laws of Illinois, Maryland, and Florida provide that the state estate tax imposed on the estate of a decedent who dies in any year will be equal to the amount of the federal credit as it exists in that year.² In other states, however, the state estate tax imposed is tied to the amount of the federal credit allowable by federal law as of a certain date before the enactment of the 2001 Act (*a "fixed" or "anchored" soak-up tax*). As an example of this type of tax, Virginia law provides that the Virginia estate tax shall be no less than the amount of the federal credit as it existed in 1978, obviously prior to the enactment of the 2001 Act. The laws of North Carolina and the District of Columbia are similar; they use different dates, but in each case they use a date that is prior to the 2001 Act.

b. The 2001 Act

The 2001 Act reduces, and then eliminates, the federal credit for state death taxes over a period of four years. In 2002, the credit is reduced by 25% of its historical amount; in 2003, by 50% of its historical amount; and in 2004, by 75% of its historical amount. In 2005, the credit is eliminated altogether and is replaced with a general deduction for amounts paid for state estate and inheritance taxes. The deduction continues until the estate tax repeal in 2010. As a deduction, state estate taxes paid would reduce the value of the taxable estate, and thereby, indirectly, the federal estate tax payable. The federal estate tax would not, however, be reduced, dollar for dollar, by the amount of state estate taxes paid. (Of course, as the 2001 Act exists now, the deduction “sunset” and converts back to a credit in 2011.)³

In a Pure Soak-Up State: The effect of this change in the federal credit will depend on what type of soak-up statute the controlling jurisdiction has adopted. In a pure soak-up jurisdiction such as Illinois, Maryland, or Florida, the state estate tax that would otherwise be payable under pre-2001-Act law will be reduced by 25% in the case of decedents dying in 2002, by 50% in 2003, and by 75% in 2004, because the state estate tax is simply the amount of the allowable credit. In such states, the state estate tax will continue to be allowed in full as a credit against the federal tax, and, as a result, will not increase the overall amount of estate taxes that will otherwise be payable. In addition, there will be no state estate tax in a pure soak-up jurisdiction from 2005 to 2010 because there will no longer be a federal credit.

Table 5 illustrates the effect of the 2001 Act on state taxes in a pure soak-up state, such as Illinois, Maryland, or Florida, on a hypothetical taxable estate of \$10 million (approximately the level at which the top state tax “soak-up” rate takes effect):

Year	a State Pure Soak-Up Tax		b [c - a] Net Federal Estate Tax		c Gross Estate Tax	
	Tax	Change from 2001	Tax	Change from 2001	Gross Tax	Change from 2001
2001	\$1,067,600	—	\$3,852,650	—	\$4,920,250	—
2002	\$800,700	-25%	\$3,629,300	-6%	\$4,430,000	-10%
2003	\$533,800	-50%	\$3,821,200	-1%	\$4,355,000	-11%
2004	\$266,900	-75%	\$3,798,100	-1%	\$4,065,000	-17%
2005	0	-100%	\$3,985,000	+3%	\$3,985,000	-19%
2006	0	-100%	\$3,680,000	-4%	\$3,680,000	-25%
2007	0	-100%	\$3,600,000	-7%	\$3,600,000	-27%
2008	0	-100%	\$3,600,000	-7%	\$3,600,000	-27%
2009	0	-100%	\$2,925,000	-24%	\$2,925,000	-41%
2010	0	-100%	0	-100%	0	-100%
2011	\$1,067,600	0	\$3,727,400	-3%	\$4,795,000	-3%

In a Fixed Soak-Up State: In a fixed soak-up jurisdiction, such as Virginia, North Carolina, or the District of Columbia, however, the state estate tax will not disappear, because the state estate tax is fixed at the level of the federal credit as it existed before the 2001 Act. The actual amount of the federal credit will nevertheless be reduced by the 2001 Act, even though the state tax payable is not. Thus, in a fixed soak-up jurisdiction, for 2002, 2003, and 2004, the amount of state estate taxes payable in some states will be more than the amount that is allowed as a credit. The excess of the state estate taxes payable that is not allowed as a credit will also not be allowable as a deduction from the taxable estate before 2005. ***That loss of credit will effectively increase the overall tax liability of an estate and thereby reduce (and in some cases even completely offset) the overall tax benefits of the 2001 Act for estates in fixed soak-up jurisdictions.***

Similarly, the conversion of the credit to a deduction in 2005 will not eliminate the burden of state estate taxes payable in the fixed soak-up states. In 2005 through 2009, the amount of state estate tax payable will be allowed as a deduction, which will reduce the value of the taxable estate on which the federal estate tax is based (but will not reduce the federal estate tax dollar for dollar). Thus, again, the state estate tax in those states will increase the overall tax liability of an estate.

Table 6 illustrates these effects in a fixed soak-up jurisdiction like Virginia, North Carolina, or the District of Columbia—again for a hypothetical taxable estate of \$10 million.⁴

Year	a State Fixed Soak-Up Tax		b Federal Estate Tax		c [a + b] Total Estate Taxes	
	Tax	Change from 2001	Tax	Change from 2001	Total Taxes	Change from 2001
2001	\$1,067,600	—	\$3,852,650	—	\$4,920,250	—
2002	\$1,067,600	0	\$3,629,300	-6%	\$4,696,900	-5%
2003	\$1,067,600	0	\$3,821,200	-1%	\$4,888,800	-1%
2004	\$1,067,600	0	\$3,798,100	-1%	\$4,865,700	-1% ⁵
2005	\$926,923	-13%	\$3,549,346	-8%	\$4,476,269	-9%
2006	\$926,923	-13%	\$3,253,615	-16%	\$4,180,538	-15%
2007	\$926,923	-13%	\$3,182,885	-17%	\$4,109,808	-16%
2008	\$926,923	-13%	\$3,182,885	-17%	\$4,109,808	-16%
2009	\$926,923	-13%	\$2,507,885	-35%	\$3,434,808	-30%
2010	\$926,923	-13%	0	-100%	\$926,923	-81%
2011	\$1,067,600	0	\$3,727,400	-3%	\$4,795,000	-3%

Marginal Rates: All this interplay with the state death tax credit has a dramatic effect on the overall estate tax “marginal rate”—the rate of estate tax paid on the “top dollar” in the estate, considering both federal and state taxes. In a “pure” soak-up state, the marginal rate is the “advertised” rate set out in the 2001 Act and in Table 2 above. But in a “fixed” soak-up state, the top state rate stays at its 2001 level of 16%, but, beginning in 2005, is deductible in the calculation of the taxable estate.⁶

These effects on marginal rates are summarized in Table 7:

Year	In a Pure Soak-Up State (IL, MD, FL, etc.)	In a Fixed Soak-Up Jurisdiction (VA, NC, DC, etc.)
2001	55% (60%)	55% (60%)
2002	50%	54%
2003	49%	57%
2004	48%	60%
2005	47%	54.31%
2006	46%	53.45%
2007	45%	52.59%
2008	45%	52.59%
2009	45%	52.59%
2010	—	13.79%
2011	55% (60%)	55% (60%)

Thus, at the very high end of estates, the overall tax rate does not drop much over this decade in a fixed soak-up jurisdiction, and it even goes up for some estates in the short term. This is apparently one of the ways Congress kept down the cost of the 2001 tax “reductions.”

3. CARRYOVER BASIS FOR A POST-ESTATE-TAX WORLD

Currently, in general, the property owned by a decedent at death, and other property that is subject to estate tax upon the decedent’s death, receives a new basis for income tax purposes equal to the value that is used for estate tax purposes. When property has increased in value, the new basis is generally higher than the decedent’s basis had been and for that reason is often referred to as a “*stepped-up basis*.” But in the case of any property that has declined in value, the new basis by reason of death is in fact a *stepped-down* basis. In either case, basis is important because it is a deduction from the sale proceeds in determining the capital gain on a subsequent sale, and in the case of depreciable property the depreciation deduction each year is generally a percentage of the basis.

In addition to the simplification that a new basis at death provides, since records of basis generally are not kept, it is widely thought that a “stepped-up basis” is in some sense “paid for” by the estate tax that is imposed on the *entire* value of property, including the built-in unrealized appreciation. Thus, it is not totally a surprise that in the 2001 Act Congress accompanies the repeal of the estate tax in 2010 with a repeal of the general stepped-up basis system. Instead, in 2010, the basis of property received from a decedent will generally be the decedent’s basis in the property immediately before death, called a “*carryover basis*”—or the date-of-death value of the property, whichever is less.

The 2001 Act allows every decedent’s estate \$1.3 million of “free basis” (\$60,000 in the case of a nonresident alien decedent) that can be allocated by the executor as a step-up to the basis of appreciated property. In the case of a married decedent, the executor can allocate an additional \$3 million of basis to property passing to the surviving spouse—either outright or in a trust from which the spouse is entitled to all the income for life.⁷ Of course, because of the “sunset” provision, this portion of the 2001 Act does not apply after 2010 either, and carryover basis will be in effect for just one year (2010), unless Congress acts further. Nevertheless, even people who are skeptical of ever actually seeing the repeal of the estate tax and the other changes scheduled for 2010 would be well advised to retain better basis records, at least for the future.

4. PROSPECTS FOR FURTHER CHANGES IN THE LAW

a. Changes in Federal Law

It is widely assumed that Congress is not likely to allow such an unstable and irrational tax regime—including a one-year repeal of the estate and GST taxes followed by total revival of pre-2001-Act law—to stand. *Many observers believe that Congress can never allow repeal to take effect, because it will simply be too expensive, particularly if repeal was in effect for more than one year and was closer than nine years away.* This may be especially true in 2011 and beyond, which is exactly when “baby boomers” will be reaching age 65 and presumably beginning in serious numbers to consider retirement and participation in a strained Social Security system. *On the other hand, many observers, including many lawmakers who voted for the 2001 Act, point out that repeal is now the law of the land, one of the most significant domestic accomplishments of President Bush’s first year, and would be politically impossible to undo.* Meanwhile, if Congress remains as closely divided as it is today, it is entirely possible that the same political and procedural climate that produced the 2001 Act in the first place will prevent any meaningful change from the repeal-for-one-year approach after all.⁸

While inaction and suspense for the entire decade is possible, the most likely scenario appears to be that Congress, working with the President, will begin to move toward some rationalization of the estate tax system in about 2005, after two more congressional elections and when the President will be either a second-term George W. Bush or a Democratic challenger. It is tempting to predict that this rationalization of the estate tax system will include freezing the increases in the exclusion amount and the decreases in the top marginal rate at some combination of the exclusions and rates already “on the books” for the various years between now and 2010. But history teaches that Congress is not that predictable. Just two years ago, for example, hardly anyone would have predicted the “deunification” of the estate and gift taxes, the four-year phase-out of the 75-year-old state death tax credit regime, or the repeal of the estate and GST taxes for a solitary year. Even if a future Congress picks some combination of exclusions and rates from the ten-year menu the current Congress has already written, it is likely to do so in some *manner* that no one now anticipates.

b. Changes in State Law

It is likely that some states will change their estate tax statutes in light of the changes in the 2001 Act—both “pure soak-up” states that stand to lose a significant amount of revenue as a result of the reduction and then effective repeal of their taxes by this federal statute and “fixed soak-up” states that now see their citizens faced with an incremental burden of state tax that lawmakers never contemplated. This is especially true if there is no significant clarifying federal legislation until at least 2005, because by then the federal credit for state death taxes will be completely phased out, and it is often more difficult to restore such a provision after it has fallen completely out of use. In an ironic twist of self-fulfilling reinforcement, if a number of states have changed their tax structures by 2005 to adjust to the phase-out of the federal credit, that state action itself may provide a reason, or an excuse, for Congress not to turn the clock back and reinstate the credit.

With many state legislative sessions, like Virginia’s, just beginning, it is impossible to predict how states may respond, but a coordinated and uniform response from the several states is probably far too much to hope for. It is obviously relevant that many states are facing significant budget deficits. Other relevant factors include the general attitude of the population and lawmakers toward “death taxes,” the ability and willingness of a state to rebuild an enforcement mechanism if needed, and (in Florida, for example) state constitutional constraints.

In Virginia, a proposal to convert to a “pure soak-up” tax is pending in the new session of the General Assembly, but a projected budget deficit of over \$2 billion, continued uneasiness with the way the personal property tax (“car tax”) cut over the past four years was handled, and a new Democratic governor who has said he will view tax cuts skeptically are significant obstacles for such a proposal to overcome.

For the most part, we are going to have to take a “wait and see” approach with respect to targeted planning for changes in state estate tax laws. McGuireWoods lawyers will monitor the status of state legislation and will be available to consult with our clients as more information is available. Persons with assets located in two or more states will need to remember that the estate tax treatment of those assets will depend on the specific law of those states.

5. ACTION NEEDED BY THOSE MOST AFFECTED

Most estate plans should be reviewed in light of the 2001 Act. Because of the significant estate tax reductions scheduled to take effect under the Act, some will find that taxes will become less of a constraint, and they can enjoy more freedom to accomplish their personal non-tax objectives. For others, the changes in the estate tax exclusions over the next decade will present the challenge of “keeping up,” especially in estate plans that use formulas written with much different exclusions in mind. Some will find that a reduction from a 55% estate tax rate to a 45% rate (or especially a 52.59% rate in some states—see Table 7) is not meaningful at all, and their challenge will be to continue to find useful tax-saving techniques.

It is difficult to generalize. In most cases, it will be possible to craft an effective strategy only in a dialogue between the estate planner and the client, taking the tax changes, the client’s assets, and the client’s priorities all into account at once. This memorandum will mention some specific ideas and recommendations for the sake of illustration, but confirming the suitability of a particular technique for a particular situation will often require careful consideration of a client’s unique characteristics, which a memorandum like this cannot anticipate.

a. Individuals and Couples with Small Estates

Theoretically, married couples with combined estates under \$2 million (and single persons with estates under \$1 million) are now potentially exempt from the estate tax, and their estate plans might be significantly simplified. In the case of married couples, however, it may still be necessary to pay attention to the *ownership* and *titling* of assets between them, so that, for example, they do not end up with too many assets piled up in the survivor’s estate.⁹

It will usually be a good idea to make some inquiries to confirm that the estimate of the size of the estate is reliable. Factors to be considered include easily overlooked assets such as life insurance and retirement benefits, the potential for future appreciation in value, and the possibility of future inheritances or other similar receipts. In addition, it may be appropriate to explore techniques for augmenting an otherwise modest estate, such as with life insurance.

b. Individuals and Couples with Mid-Sized Estates

Many married couples (or single individuals) have estates that may be taxable in 2002 but might not be taxable as the estate tax exclusion amount increases—generally estates between \$2 million and \$7 million or so for married couples (or between \$1 million and \$3.5 million for a single individual). These people—especially married couples—have probably been placed in the most awkward predicament by the 2001 Act.

For example, it is very common for a husband and wife to have estate plans that provide for the first to die to create a “family trust” of sufficient size to use the entire unified credit (or exclusion amount) of the first to die without paying any estate tax at the first death. The balance of the first estate is left outright to the surviving spouse or in a trust for the surviving spouse that qualifies for the estate tax marital deduction. Put another way, the first to die leaves to the survivor enough to eliminate any tax in the first estate, *but no more* (so as not to needlessly add to the survivor’s estate subject to tax at the survivor’s death).

Table 8 sets forth the effect of the scheduled increases in the estate tax unified credit on the size of the marital bequest in such a “reduce-to-zero” estate plan. For estates (of the first spouse to die) of \$2, 4, 8, 12, and 16 million, Table 8 shows the amount of the estate, and the percentage of the estate, that passes to the spouse (or to a marital trust):

TABLE 8 Size of a “Reduce-to-Zero” Marital Bequest Including the dollar amount and the percentage of the estate. (assuming no gifts, full use of the unified credit, and no net state tax) (in millions of dollars)										
Year:	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Exempt:	0.675	1.0	1.0	1.5	1.5	2.0	2.0	2.0	3.5	—
Estate										
2.0	1.325 66%	1.0 50%	1.0 50%	0.5 25%	0.5 25%	0.0 0%	0.0 0%	0.0 0%	0.0 0%	0.0 0%
4.0	3.325 83%	3.0 75%	3.0 75%	2.5 63%	2.5 63%	2.0 50%	2.0 50%	2.0 50%	0.5 13%	0.0 0%
8.0	7.325 92%	7.0 88%	7.0 88%	6.5 81%	6.5 81%	6.0 75%	6.0 75%	6.0 75%	4.5 56%	0.0 0%
12.0	11.325 94%	11.0 92%	11.0 92%	10.5 88%	10.5 88%	10.0 83%	10.0 83%	10.0 83%	8.5 71%	0.0 0%
16.0	15.325 96%	15.0 94%	15.0 94%	14.5 91%	14.5 91%	14.0 88%	14.0 88%	14.0 88%	12.5 78%	0.0 0%

As stated, the portion of the estate that is not part of the marital bequest typically goes to a “family trust.” The surviving spouse often receives all the income from the family trust and can have access to trust corpus either in the discretion of an independent trustee, or subject to an ascertainable standard, or limited to up to 5% of the value of the trust each year, or in some combination of these approaches. Thus, when Table 8 indicates, for example, that the “marital bequest” is “0.0,” that does not necessarily mean that the surviving spouse receives nothing. In fact, the spouse might have a substantial interest in the family trust, but still an interest sufficiently limited that the family trust is not subject to estate tax when the spouse dies.

Nevertheless, Table 8 illustrates the potential distortion in the conventional division of an estate based on the amount that is “exempt” from estate tax by reason of the unified credit (or exclusion amount). For example, for an estate of \$2 million, in 2001 roughly one-third of the estate was exempt from estate tax and two-thirds would go to the surviving spouse under such a formula. In 2002, \$1 million is exempt, and the division is 50-50. Since 1997, we have been planning for an exclusion amount that was scheduled to reach \$1 million by 2006, so a 50-50 split is probably not a surprise. But when the exclusion goes to \$1.5 million in 2004, the spouse’s share is one-fourth, and when the exclusion goes to \$2 million in 2006, the spouse’s marital share is eliminated.

The elimination of the spouse’s marital share of the estate in a case like this might be perfectly appropriate and acceptable, because the spouse might have sufficient other resources, or, as stated, the spouse might have an income interest and broad access to corpus of the family trust, or for other reasons. But these circumstances cannot be taken for granted, and in some cases this distortion of the expected estate plan would be quite a surprise. ***Waiting to address this issue to see how the law really does change runs the risk of becoming incapacitated, which might render it impossible to make further changes to the estate plan.***

c. Individuals and Couples with Large Estates

In larger estates, there may be less concern about potential distortion of that sort. For example, for an estate of \$16 million, as Table 8 shows, a conventional formula bequest to the surviving spouse would be nearly all of the estate (96% down to 88%) through 2008. Even in 2009, that bequest is still 78% of the estate.

The repeal of the estate tax in 2010—if it occurs—is a different matter. In that case, while Table 8 assumes that there would be no formula bequest to the surviving spouse, it is actually possible that a *formula* bequest would leave **everything** to the spouse. Often the result under a formula in a particular set of facts will depend on very technical language of the will or trust—language that has been perfectly appropriate for many years but was not designed for a post-repeal world. The point, though, is not only what result a formula might produce, but **what result people might actually want in a world without a federal estate tax**. Often an estate planning professional tries to help clients identify their objectives apart from tax considerations, but before enactment of the 2001 Act such exercises were typically quite hypothetical. Now they might be more real.

Whether or not Congress really allows the federal estate tax to disappear, larger exclusions and lower rates can make tax a less dominant concern in many estate plans. In these cases, people might be free to provide for their families and others in a more straightforward manner, if taxes are less of a constraint.

d. Multiple Marriage Families

It will be tricky enough to rethink the division of estates and the use of formulas in a simple case where all the children are children of both the husband and wife. When there are children of previous marriages, the challenges can be compounded. Tax laws, which favor bequests to or for the current spouse, are not always helpful.

In many cases, these families will receive significant relief under the 2001 Act. In other cases, though, the potential distortions illustrated in Table 8 can be much more serious when formulas are used to divide decedents' estates, in effect, between different family groups, family groups who may not even be related except through the person who is now deceased. Thus, those families may be the families for whom reexamination of estate plans in light of the 2001 Act is most urgent.

e. Ten Estate Planning Techniques to Consider

In the highly likely event that the estate tax is not permanently repealed after all—individuals, married couples, and families with significant wealth will usually still need to consider techniques for transferring that wealth from generation to generation at the least tax cost. Nevertheless, as described on page 7, the applicable exclusion for gift tax purposes is not scheduled to increase beyond its 2002 level of \$1 million, which means that there will be limited opportunities to shelter lifetime transfers from gift tax. **Unified credit used for lifetime gifts will not be replenished.** In light of those constraints, an August 2001 article on the McGuireWoods website entitled “Ten Estate Planning Techniques to Consider,” by McGuireWoods trusts and estates lawyers W. Birch Douglass, III and Jennifer Schooley Stringer, offered the following advice:

- **Gift Program.** Full utilization of all tax-free gift amounts, including annual exclusion gifts, can significantly reduce the size of your estate. Shifting the growth in the assets from your estate saves transfer taxes on all future appreciation.
- **Generation-Skipping Transfer (GST) Planning.** Making sure you and your spouse each use your full \$1,060,000 GST exemption [now \$1,100,000] can save enormous

amounts in taxes for your family. Taking advantage of generation-skipping through the use of trusts simply means skipping the payment of taxes, not the skipping of benefits for the next generation. Because the beneficiaries can be their own trustees and be given powers of appointment, they can control the investments and the ultimate disposition of the assets. Enhanced savings are available by having the trust continue indefinitely or for the maximum period permitted by the rule against perpetuities or by funding the trust with split-dollar insurance, discounted partnership interests, or having a partially charitable trust.

- **Family Limited Partnerships (FLPs).** Giving limited partnership interests instead of outright ownership of particular assets generally results in substantial valuation discounts. Apart from the transfer tax savings, a limited partnership offers a good vehicle to manage assets over an extended period of time and helps protect the assets from the claims of the partners' creditors and from interference by the partners' spouses. If environmental or other potential liabilities are an issue, a limited liability company (LLC) can be used.
- **Charitable Lead Trusts.** This technique allows you to "discount" the value of the gift by the actuarial value of the charitable annuity or unitrust amount payable for a term of years or for your or another's lifetime. The charitable lead trust has an advantage over an outright charitable gift or a charitable remainder trust, as the lead trust allows the capital to be kept in the family. Your own private foundation can be the charitable recipient.
- **Private Foundations.** A private foundation creates flexibility in charitable giving and permits the family to continue as stewards over that part of the family wealth transferred to the entity by outright gifts, bequests, or charitable lead or remainder trusts.
- **Grantor Retained Annuity Trusts (GRATs).** Your retained right to receive an annuity for a fixed term acts as a discount in valuing the gift of the remaining interest in the trust. GRATs, particularly short-term ones with high payout rates, afford great gift tax leverage and flexibility and offer an alternative to charitable lead trusts for those who have little or no charitable motivations.
- **Qualified Personal Residence Trusts (QPRTs).** This is a way to give away your principal or secondary residence, or both, subject to your right to occupy the home for a fixed period. Thereafter, you can rent the house from your children or other beneficiaries. Like a GRAT or charitable lead trust, this type of trust also provides the opportunity for gift tax leverage.
- **Split-Dollar Life Insurance.** For business owners, life insurance owned by a GST trust and paid for by the business offers an attractive way to buy substantial amounts of insurance with only a negligible use of GST exemption. Greater leverage is present with second-to-die policy arrangements.
- **Intrafamily Sales.** Selling an appreciating asset or a remainder interest in such an asset to a family member or to a "grantor" trust for an installment note is a way to "freeze" your estate because the note will not grow in value beyond any interest that is accrued and compounded. Triggering a future capital gain or other income tax cost may be less costly than an estate tax assessed against an appreciating asset. Selling for a private annuity or self-canceling note can produce greater savings.

- **Applicable Federal Rate (AFR) Loans.** By making intrafamily loans accruing at the lowest interest rate required by the IRS, you are likewise “freezing” your estate while allowing your family members to make equity investments in their own names and otherwise to enjoy the economic benefits of your wealth without the payment of gift taxes.

6. OTHER ESTATE TAX CHANGES IN THE 2001 ACT

The 2001 Act contains other miscellaneous estate tax changes, some of very limited application but nevertheless important in those circumstances in which they do apply.

a. Qualified Conservation Easements

One of the most intriguing and potentially helpful of these changes is a liberalization of the rules for claiming a special exclusion from federal estate tax for land subject to a “qualified conservation easement.”

A conservation easement places certain restrictions on the development and use of land. Typically, the easement is donated by a landowner to a charitable conservation organization or government agency that agrees to accept and enforce the restrictions. The landowner donating a conservation easement is eligible for a charitable contribution deduction for federal income tax purposes and for certain estate tax benefits only if the restrictions in the easement last forever. The landowner retains ownership of the land and may sell or otherwise transfer it, subject to the restrictions in the easement.

Prior Law: Since 1998, the executor of an estate including land subject to a qualified conservation easement could elect to exclude up to 40% of the value of the land from the estate for federal estate tax purposes (the “Qualified Conservation Easement”—or “QCE”—Exclusion). The maximum QCE Exclusion amount may be reduced, depending upon the value of the land and the value of the easement.¹⁰

In order to qualify for the QCE Exclusion, prior law required that the land subject to the conservation easement be located (a) within 25 miles of a metropolitan area, (b) within 25 miles of a national park or wilderness area designated as part of the National Wilderness Preservation System, or (c) within 10 miles of a designated Urban National Forest. Prior law was unclear as to whether the QCE Exclusion amount should be determined as of the date of the contribution of the easement or as of the date of the landowner’s death.

Changes Made by the 2001 Act: The 2001 Act expands the availability of the QCE Exclusion by eliminating the location requirements, effective in 2002. Therefore, for estates of decedents dying after December 31, 2000, all land located in the United States or a U.S. possession will be eligible for the QCE Exclusion from estate tax. The 2001 Act also clarifies that the date for determining the QCE Exclusion amount is the date of the contribution of the easement rather than the date of the landowner’s death.

Planning Notes and Comments: Elimination of the location requirements will enable many more landowners to take advantage of the QCE Exclusion for federal estate tax purposes, especially landowners in western states where much of the land does not satisfy the location requirements imposed under prior law. In addition, clarification of the date for determining the QCE Exclusion amount will give landowners assurance that if an easement satisfies the required value thresholds on the date of its donation, the land subject to the easement will qualify for the full 40% QCE Exclusion on the landowner’s death.

As with the rest of the 2001 Act, the changes made to the qualified conservation easement rules will not apply to estates of decedents dying after 2010, if Congress does not change the law before then.

In addition, landowners who previously donated a qualified conservation easement and have retained rights to develop the land subject to the easement should be aware that the “recapture tax” provisions under prior law will continue to apply, even after the “repeal” of the estate tax in 2010. Such landowners can avoid imposition of the recapture tax if they execute an agreement to extinguish their development rights within the earlier of (1) two years after the date of the decedent’s death or (2) the date the land subject to the conservation easement is sold.

Several proposals are currently under consideration by Congress that would further expand the tax benefits available for contributions of conservation easements or expand the types of conservation easements that qualify for tax-favored treatment. While it is impossible to predict how or when Congress may change the law in this respect, it is entirely possible that Congress will continue to expand the tax benefits available with respect to conservation easements, thereby enhancing an already valuable estate planning tool.

b. Extended Payment of Estate Tax

Subject to detailed requirements, the law allows the executors of estates holding interests in certain closely held businesses to pay the estate tax attributable to those business interests in installments over an extended period of time, which can be as long as 14 years. Under the 2001 Act, beginning in 2002, that privilege is expanded to “qualifying lending and finance businesses” and to the nonmarketable stock of holding companies (even if the stock of the underlying companies was marketable). The Act also increases the number of shareholders or partners in a business that automatically qualifies as “closely held” for this purpose from 15 to 45, beginning in 2002.

c. Special Use Valuation

Subject to detailed requirements, the law provides special favorable valuation rules for real estate used in farming or other businesses. In 1997, but effective as of 1977, Congress clarified that this privilege would not be jeopardized by certain cash rents to family members. Beneficiaries of old estates whose refund claims under this relief provision would have been barred by the statute of limitations are now entitled to refunds, *if they file claims for refund no later than June 6, 2002*.

d. Qualified Family Owned Business Interests

In 1997, Congress also enacted a special estate tax deduction available to owners of “qualified family-owned business interests” (called “QFOBIs”). The rules for qualifying for and administering this special rule were extremely complicated and roundly criticized. The QFOBI deduction is coordinated with other estate tax rules to provide a combined benefit equivalent to an exclusion of \$1.3 million. Effective in 2004, under the 2001 Act, the QFOBI deduction would generally be obsolete, because the exclusion amount will increase to \$1.5 million for everybody in that year. Accordingly, effective in 2004, the 2001 Act repeals the QFOBI deduction.

7. MODIFICATION OF GST EXEMPTION ALLOCATION RULES

The generation-skipping transfer tax (“GST tax”) is imposed on certain distributions from trusts and certain terminations of interests in trusts with reference to an “inclusion ratio,” which determines how heavily the trust is taxed. An inclusion ratio of 1 means that distributions and terminations are subject to GST tax at 1 times the applicable rate, currently 50%; an inclusion ratio of 0.6 means that distributions and terminations are subject to a tax of 0.6 times the applicable rate, or 30%; and so forth. Generally, the inclusion ratio is determined by the transferor’s allocation of “GST exemption” to the trust. A full allocation of exemption equal to 100% of the value of the trust at the effective date of the allocation produces an inclusion ratio of zero, an allocation of exemption equal to 40% of the value of the trust produces an inclusion ratio of 0.6, and so forth.

Although the 2001 Act does not repeal the GST tax until 2010, the Act includes revisions to the GST exemption allocation rules that are *generally effective as of January 1, 2001*. These changes will enable transferors to maximize the use of their GST exemption during the phase-out period. Furthermore, these changes could provide existing long-term trusts with opportunities to cure existing problems and ensure that transferors’ GST exemptions are fully used and optimally allocated. The following is a summary of the changes to the GST exemption allocation rules:

a. Deemed Allocation of GST Exemption

The New Rule: Under the 2001 Act, a transferor’s unused GST exemption will now be allocated automatically to lifetime transfers after December 31, 2000, to a “GST trust”—generally, under complicated rules, a trust that Congress viewed as likely to have a generation-skipping transfer in the future with respect to the transferor.¹¹ The effect of the new deemed allocation rule is that those trusts will be protected from the GST tax by an automatic allocation of the transferor’s unused GST exemption.¹²

A transferor can elect not to have the automatic allocation rules apply, on a gift tax return for the year in which the transfer was made. Furthermore, transferors can elect not to have the automatic allocation rules apply to any and all transfers made by such individual to a particular trust and may elect to treat any trust as a GST trust.

Some Very Surprising Applications: Although the 2001 Act cures or relieves a number of GST tax problems, it also creates a pitfall that appears to make it necessary to review all irrevocable trusts—particularly life insurance trusts and other trusts depending on the use of “Crummey” withdrawal powers—to make sure that those trusts are not “GST trusts,” gifts to which automatically (and perhaps unnecessarily) consume a part of the donor’s GST exemption. This is especially undesirable in estate plans designed to use the GST exemption during lifetime or at death in another, more effective, manner.

Example 1. Father created Trust 1 some years ago and has been making annual cash gifts to Trust 1, subject to “Crummey” withdrawal powers designed to qualify the gifts for the gift tax annual exclusion. Trust 1 owns a life insurance policy on Father’s life and uses the annual gift monies to pay the premiums to keep the policy in existence. At Father’s death, Trust 1 will continue for the benefit of Mother for her life. At Mother’s death, the assets of Trust 1 will pass to Father’s and Mother’s then living descendants, subject to contingent trusts for any beneficiaries under age 23.

Example 2. Trust 2 owns a second-to-die insurance policy on the lives of Father and Mother funded with annual “Crummey” right-of-withdrawal gifts. Trust 2 provides that, at the death of the surviving spouse, the trustee can use the insurance proceeds to make

loans to the survivor's estate to provide funds to pay estate taxes, and after 15 months the assets of Trust 2 are to be divided into shares for the then living descendants.

It appears that neither of these trusts is designed or expected to provide benefits to any generation below that of the grantor's children, and thus neither trust would ordinarily be subject to GST tax. Nevertheless, under the new rules enacted by the 2001 Act, it appears possible that both these trusts would be viewed as "GST trusts," meaning that *each gift made to either trust by Father during 2001 and subsequent years will automatically consume part of Father's GST exemption, unless he elects out of the automatic allocation, which may have to be done as early as on a 2001 gift tax return (due April 15, 2002).*

In other cases, donors may want the automatic allocation rule to apply—for example, in a true generation-skipping situation in which the trust agreement directs that the child's share of a trust be held for the child's life with remainder to the child's descendants. But even then the 2001 Act adds complicating wrinkles, if the trust is funded with "Crummey" right-of-withdrawal gifts, and the result might depend on the particular level of those gifts from year to year.

Action Needed: It is again very difficult to generalize in a memorandum like this, but *the administration of any irrevocable trust to which any additions have been made after December 31, 2000, or to which any additions might be made in the future should be examined carefully to make sure that the GST tax treatment, intentional or by default, accords with the transferor's intent and makes sense in the overall estate plan.*

b. Retroactive Allocation of GST Exemption

Under prior law, if a transferor did not plan for the untimely death of a second-generation beneficiary (such as the transferor's child) and failed to allocate GST exemption to a trust, at the death of that beneficiary the assets of the trust could be subject to a GST tax if they passed to a younger-generation beneficiary (such as the transferor's grandchild). Under the 2001 Act, when there is an unanticipated order of deaths, it might be possible to make retroactive allocations of GST exemption to any previous transfer or transfers to a trust, to prevent that result.

For example, if a transferor created a trust primarily for the college education of his daughter, providing that the trust property would be distributed to the daughter when she reached the age of 25, he would ordinarily not regard the trust as a likely source of a generation-skipping transfer and would not allocate GST exemption to it. Indeed, allocation of GST exemption to a trust that would probably vest in the daughter would be regarded as a waste of the exemption. If then, the daughter died before she reached 25 and her share of the trust passed to her children (grandchildren of the transferor), the passage of her interest to her children would be subject to GST tax. Under the new law, however, upon the daughter's death, the transferor would be able to allocate GST exemption to the trust if he wished.

The allocation is to be made on the gift tax return filed for gifts made during the calendar year in which the unanticipated death occurs. In such case, the gift tax value of such transfer or transfers will be treated as if the allocation had been made on a timely filed gift tax return for the year or years in which a transfer was made to the trust.

While in general no action is needed with respect to this type of trust unless and until there is the type of event that might cause a GST tax to be imposed, it might, again, be prudent to reexamine every irrevocable trust to make sure that it is being administered in a way that would best accommodate the retroactive allocation of GST exemption (and, if appropriate, a severance as described in the next two paragraphs), if that becomes necessary.

c. Severance of Trusts

Under prior law, a severance of a trust would be effective for GST tax purposes only if the governing instrument of a trust or local law authorized the severance, the trust was subject to estate tax, and the severance occurred prior to the due date of the estate tax return. The 2001 Act relaxes these requirements. Under the Act, a trust may now be severed into two or more trusts at any time if the trust is divided on a fractional basis and the new trusts provide for the same succession of interests of beneficiaries as provided in the original trust.

As a result, it will now be much easier to divide an existing generation-skipping trust with a mixed inclusion ratio (an inclusion ratio greater than zero and less than one) into two trusts, one with an inclusion ratio of zero and another with an inclusion ratio of one. That is always desirable, because it permits each trust to be administered exclusively as either a fully GST-taxable trust or a fully GST-tax-free trust, as the case may be. For example, distributions that would not be subject to GST tax in any event (such as distributions to the original transferor's children) could be made from the taxable trust, while distributions that would otherwise be taxable (such as distributions to the original transferor's grandchildren) could be made from the tax-exempt trust, and the investment philosophies of the respective trusts could be adjusted accordingly.

d. Relief for Late Allocations and Elections

The 2001 Act provides retroactive relief for late GST exemption allocations and elections. The Act directs the Internal Revenue Service to set forth the circumstances and procedures under which extensions of time will now be granted to taxpayers to make an allocation of GST exemption to gifts (or transfers at death) and to make an election not to have the statutory automatic allocation rules apply to transfers.

The Internal Revenue Service has now published guidance confirming that the standards and procedures will be the standards that have been in place since 1997 for the granting of so-called "9100 relief." The appropriate way to request relief is to submit a ruling request to the National Office of the IRS, including affidavits from the transferor and others with relevant knowledge about the allocation or election that was intended. ***The new rules apply to allocations and elections that should have been made before 2001, as well as to those that should have been made in 2001, or should be made in the future.***

The overall standard for granting this relief is that the transferor must have acted "reasonably and in good faith." All relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer, and other relevant factors are to be considered, without regard to whether any period of limitations has expired. Among the excuses that are likely to be recognized are ignorance of the need for the action (taking the transferor's experience and the complexity of the issue into account) and reasonable reliance on a tax return preparer or other tax professional, who fails to make or recommend the action that was missed.

On the other hand, if the transferor was informed about the need for the action and affirmatively chose not to take it, or if the late action is influenced by hindsight in the face of changed circumstances, then it will be hard to persuade the IRS that the transferor acted reasonably and in good faith. For example, if a transferor creates three generation-skipping trusts and many years later seeks permission to allocate GST exemption to the trust that has increased the most in value, the transferor will have to present extremely compelling proof that the request is not based on hindsight and that the actions have been reasonable and in good faith.

Again the indicated action is to review existing irrevocable trusts created (or added to) on or after September 26, 1985 (the effective date of the GST tax), and the gift or estate tax returns that were filed with respect to those trusts, to identify any trust that should be considered for this new relief.

8. SELECTED INCOME TAX CHANGES

a. Reductions and Rebates

Aside from estate and GST tax repeal and gift tax reductions, the 2001 Act includes other important elements that are focused on the individual. Topping the list is the marginal income tax rate reduction, which represents \$875 billion of the total \$1.35 trillion cost of the tax legislation. For years after 2000, tax rate reductions are achieved by the introduction of a new 10% tax bracket for individuals (not estates and trusts) and the reduction of the higher tax rates (other than the 15% bracket) for all taxpayers over six years. The 28%, 31%, and 36% rates are reduced by three percentage points over the six-year phase-in period, but the highest current rate of 39.6% is reduced by 4.6 percentage points, as follows:

2000	39.6%
2001	39.1%
2002 and 2003	38.6%
2004 and 2005	37.6%
2006 and beyond	35.0%

Most individual taxpayers realized the benefit of the 10% bracket retroactively, in the form of a much-acclaimed refund check—\$300 for most single taxpayers, \$600 for most married taxpayers filing jointly, and \$500 for most heads of households.

b. 529 Plans

Background: In 1996, Congress introduced “529 plans” (so called because they are governed by section 529 of the Internal Revenue Code) to encourage families to save for college.

There are two kinds of 529 plans: prepaid tuition arrangements and educational savings accounts. Prepaid tuition arrangements essentially allow a person to purchase “tomorrow’s tuition at today’s prices.” Educational savings accounts allow a person to make contributions to an account for a designated beneficiary, which contributions are then invested (typically in mutual funds) and grow free of income tax until distributions are made to pay the beneficiary’s “qualified higher education expenses.” “Qualified higher education expenses” consist of tuition, room and board, fees, books, and supplies required for attendance at a post-secondary educational institution. In the event a distribution is not used to pay qualified higher education expenses, or if money is refunded to a contributor or a beneficiary for a reason other than the death or disability of the beneficiary or the beneficiary’s receipt of a scholarship, a penalty is imposed on the earnings portion of a distribution. Contributors may transfer or “roll over” credits or other amounts from one account to another without incurring income tax or penalties, so long as the beneficiary of the new account is a member of the family of the original beneficiary. Typically, when a contribution is made, the contributor selects one of several investment strategies. The law required that after that time the contributor may have no control over investment of the account assets.¹³

Prior to the 2001 Act, the primary tax advantages of 529 plans were that (i) earnings on contributions were exempt from income taxes until distributed, at which time they were taxed to the beneficiary, typically in a lower tax rate bracket than the contributor; and (ii) contributions were treated as completed gifts (and with certain exceptions, excluded from estate tax upon the contributor's death) and qualified for the gift tax and GST tax annual exclusions, even though the contributor retained the right to decide when and to whom the funds were distributed and the right to reacquire the funds at any time. In addition, contributions could be "front-end loaded," meaning that an individual could contribute up to \$50,000 (five \$10,000 annual exclusions) in one year and elect to have the contribution taken into account for gift tax purposes ratably over a five-year period, so that the contribution was fully sheltered by the individual's annual exclusions for gift and GST tax purposes for those five years.¹⁴

529 Plans Even More Attractive Under the 2001 Act: Under the 2001 Act, distributions from 529 plans, including prepaid tuition credits and cash distributions, are fully exempt from federal income tax to the extent they are used to pay qualified higher education expenses. (Many states also exempt qualifying distributions from state income tax.)

Prior to the 2001 Act, qualified tuition programs could be established and maintained only by states or state agencies. The 2001 Act enables private institutions to sponsor their own prepaid tuition programs (but not education savings accounts), beginning in 2004.

The 2001 Act expands the rules regarding account rollovers. Whereas prior law prohibited tax-free rollovers for the benefit of the same beneficiary, the 2001 Act authorizes tax-free transfer of credits or other amounts from one 529 plan account to another 529 plan account for the same beneficiary (limited to one rollover per 12-month period). In addition, for purposes of tax-free rollovers, the 2001 Act expands the definition of "members of the beneficiary's family" to include first cousins (so that if a grandmother sets up an account for her son's only child, and that grandchild does not attend college, the grandmother may roll over the account tax-free to an account for the benefit of her daughter's child).

The 2001 Act also eliminates the rule prohibiting an individual from making contributions to a 529 plan and a Coverdell ESA in the same year.

c. Education IRAs (Coverdell Education Savings Accounts)

Background: In 1997, Congress enabled taxpayers to establish education individual retirement accounts or "Education IRAs." On July 26, 2001, President Bush signed legislation formally renaming Education IRAs as "Coverdell Education Savings Accounts" ("Coverdell ESAs"), in memory of the late Senator Paul Coverdell of Georgia, a supporter of Education IRAs.

Despite its origin as an "Education IRA," a Coverdell ESA is not a retirement savings vehicle; rather, it is an account created exclusively to pay qualified education expenses of a named beneficiary. Unlike 529 plans, the contributor of a Coverdell ESA has control over account investment.

Prior to the 2001 Act, contributions to a Coverdell ESA were limited to \$500 per beneficiary per year, and contributions were phased out for higher income contributors (single filers with modified adjusted gross income ("AGI") between \$95,000 and \$110,000, and joint filers with modified AGI between \$150,000 and \$160,000). Contributions are made with after-tax dollars, and earnings on the contributions grow income-tax-free until distribution. Upon distribution, any earnings portion of the distribution used to pay qualified higher education expenses is exempt from income tax; any earnings portion not used to pay qualified higher education expenses is includable in the beneficiary's gross income and generally subject to a 10% penalty.

Expansions and Modifications in the 2001 Act: The 2001 Act expands and modifies the rules governing Coverdell ESAs. The 2001 Act increases the maximum annual contribution from \$500 to \$2,000 beginning this year (2002), and the accounts may now be used for elementary and secondary education (kindergarten through grade 12), and for public, private, or religious schools. Qualified elementary and secondary education expenses include expenses for academic tutoring, the purchase of computer technology or equipment or Internet services, room and board, uniforms, transportation, and supplementary items and services as required by the school. The phase-out range for married taxpayers filing jointly is increased to twice the amounts for single filers, thereby eliminating the “marriage penalty” of prior law. Thus, the permissible \$2,000 annual contribution is phased out for joint filers with modified AGI at or above \$190,000 and less than \$220,000. (The phase-out applies only to individual contributors; contributions made by entities, such as corporations or tax-exempt organizations, are not subject to the phase-out rules.)

The 2001 Act also authorizes the Internal Revenue Service to issue special rules with respect to Coverdell ESAs established for individuals with special needs.

d. Changes Affecting the Alternative Minimum Tax

The income tax system is designed with two parallel income taxes—the regular tax and the alternative minimum tax (“AMT”). Taxpayers are required to calculate their tax liability under both regimes and pay the tax due under the higher of the two computed liabilities. One of the key differences between the regular tax and the AMT is the disallowance of certain itemized deductions under the AMT. In particular, state and local taxes (including income taxes, property taxes, and intangibles taxes) and miscellaneous itemized deductions subject to the 2%-of-AGI floor (such as investment expenses) are added back to the taxpayer’s taxable income as computed under the regular tax to yield the taxpayer’s income for AMT purposes. Currently, an adjustment is also made for the amount of the 3% phase-out on itemized deductions incurred by taxpayers with adjusted gross income over a certain amount (for 2001, \$132,950). The phase-out amount is subtracted from the other adjustments in computing the amount of income subject to the AMT.

Like the regular tax calculation, the AMT also provides an exemption amount that reduces the taxpayer’s alternative minimum taxable income. The 2001 Act increases the AMT exemption amount for married and single taxpayers by \$4,000 and \$2,000, respectively, effective for 2001. The Act provides no further increases to the AMT exemption amount.

Beginning in 2006, the Act provides for a reduction and eventual elimination of the phase-outs with respect to both the personal exemption and itemized deductions. As a result, taxpayers with adjusted gross income higher than the 3% phase-out floor will receive more of the benefit of their deductions and will see a reduction in the amount of income subject to the regular income tax. Conversely, to the extent that a greater benefit is received under the regular tax computation, these deduction items are added to increase the taxpayer’s alternative minimum taxable income. The minimal increase in the AMT exemption is not expected to provide much relief in this area.

The elimination of the 3% phase-out can be a trap for the unwary and may result in a far greater number of taxpayers being subject to the AMT. Beginning in 2005, taxpayers will have to take care that the payment of certain itemized deductions before year-end (traditionally recommended to accelerate the regular tax benefit of the deduction) will not result in increased AMT and loss of the benefit of the deductions.

e. Limited “Marriage Penalty” Relief and Other Phase-Outs

The Marriage Penalty and the Standard Deduction: Under current law, the standard deduction for married taxpayers filing jointly who do not itemize deductions is approximately 167% of the deduction for single taxpayers. It is often said that this effectively “penalizes” taxpayers for being married, on the theory that a “marriage-friendly” deduction system would provide a deduction for a married couple filing a joint return that is fully 200% of that for a single taxpayer.

Under the 2001 Act, this marriage penalty (or at least the portion related to the standard deduction) is phased out over a five-year period beginning in 2005 by annual increases in the standard deduction for married taxpayers filing jointly, based on a percentage of the single taxpayers standard deduction. Table 10 summarizes the relief:

2001-2004	167%
2005	174%
2006	184%
2007	187%
2008	190%
2009 and beyond	200%

The Marriage Penalty and the 15% Bracket: A similar “marriage penalty” is also present in the income tax brackets themselves. Although the 2001 Act does not fully relieve the penalty in all brackets, it does provide relief up to the maximum amount of income subject to the 15% tax bracket. Beginning in 2005, that amount (the “top” of the 15% bracket) for married taxpayers filing jointly is increased annually over a four-year period until the 15% bracket marriage penalty is fully phased out in 2008. That relief is summarized in Table 11:

2001-2004	167%
2005	180%
2006	187%
2007	193%
2008 and beyond	200%

The new 10% income tax rate that the 2001 Act carves out of the existing 15% bracket is already marriage “friendly,” in that the maximum income taxable at 10% for married taxpayers filing jointly is 200% of that for single taxpayers.

The Personal Exemption Phase-Out: Under current law, taxpayers exceeding a certain threshold of AGI face a personal exemption phase-out (commonly called “PEP”). For 2001, the thresholds are \$132,950 for single taxpayers, \$199,450 for married taxpayers filing jointly, \$166,200 for heads of household, and \$99,725 for married taxpayers filing separately. The deductible personal exemption amount is reduced by 2% for each \$2,500 (\$1,250 for married taxpayers filing separately) by which the taxpayers’ AGI exceeds the threshold amount.

In 2006, the 2001 Act begins a five-year phase-out of the PEP. The PEP is reduced by one-third in 2006 and 2007 and by two-thirds in 2008 and 2009. In 2010, the PEP is completely repealed.

The Itemized Deduction Limitation: Under current law, the total amount of most allowable itemized deductions is reduced by 3% of the amount by which a taxpayer's AGI exceeds \$132,950 (\$66,475 for married taxpayers filing separately). After application of all other limitations on deductions (such as the separate floors on deductions), the overall amount of itemized deductions may be reduced by up to 80%.

Beginning in 2006, the 2001 Act begins a five-year phase-out of the total itemized deduction limitation. Like the PEP, the deduction limitation is reduced by one-third in 2006 and 2007, reduced by two-thirds in 2008 and 2009, and repealed in 2010.

Sunset: Of course, unless Congress acts further, these relief provisions, including those that fully take effect in 2010, "sunset" in 2011.

f. Retirement Benefits

On the heels of new proposed regulations regarding minimum required distributions,¹⁵ the 2001 Act made several beneficial changes to the law relating to retirement savings plans.

Under the 2001 Act, the annual IRA contribution limit is increased from \$2,000 in 2001 to \$3,000 in 2002-2004, \$4,000 in 2005-2007, and \$5,000 in 2008. After 2008, the maximum amount is indexed annually for inflation in \$500 increments. Individuals aged 50 and older may make additional "catch up" contributions of \$500 in 2002-2005, and \$1,000 in 2006 and thereafter.

Similarly, the annual 401(k) contribution limit is increased from \$10,500 in 2001 to \$11,000 in 2002, and then an additional \$1,000 per year until it reaches \$15,000 in 2006. After 2006, the maximum amount is indexed for inflation in \$500 increments. Beginning in 2002, individuals aged 50 and older may make additional "catch-up" contributions to 401(k) and other qualified plans (such as 403(b) and 457(b) plans).

The 2001 Act also provides that beginning in 2006, participants may elect to make all or a portion of their contributions to 401(k) and 403(b) plans with after-tax dollars designated as "Roth contributions." Distributions attributed to Roth contributions, as with "Roth IRA" contributions, will generally not be subject to income tax.

* * * * *

ENDNOTES

¹ A cynic would speculate that another reason for retaining the gift tax even when the estate tax is repealed in 2010 is that this will prevent wholesale tax-free transfers during 2010 that would remove property from the reach of the estate, gift, and GST taxes when they were reinstated in 2011.

² In Maryland, in some cases there is also an “inheritance tax” that is calculated independently of the federal credit.

³ An obscure provision of the GST tax provisions enacted in 1986 is a credit in the amount of up to 5% of the federal GST tax for certain GST taxes paid to states at the time of an individual’s death. Unlike the credit for state death taxes, the GST tax credit was widely viewed as a bad idea, or at least unnecessary, at the time, and few states were known to have seriously considered a state GST tax. In any event, the 2001 Act also eliminates this credit, effective in 2005 (but without a phase-out).

⁴ Beginning in 2005, the state estate tax itself will be allowed as a deduction, which will reduce the taxable estate to less than \$10 million (and reduce both the federal tax and the state tax itself). For fairness of comparison, Table 6 ignores the deduction for state tax in determining the \$10 million size of the taxable estate, so that an estate of exactly the same size is analyzed each year, but, beginning in 2005, the deduction of the state tax is taken into account in calculating both the federal tax and the state tax itself. That is why the state tax is reduced, beginning in 2005, in Table 6; even though the credit calculation is the same, the taxable estate is lower.

⁵ In 2004, the exemption equivalent would have risen to \$850,000 under the pre-2001-Act law, and the total tax on a \$10 million taxable estate would have been \$4,795,000. Thus, for such an estate, the new law will actually represent a tax *increase* for 2004.

⁶ The deduction of a 16% top state estate tax has the effect of rendering the effective federal marginal rate 84% of the published top rate. This effect, together with the effect of that reduction of the taxable estate on the amount of the state death tax credit itself, are reflected in the calculation of the overall marginal rates (in fixed soak-up jurisdictions) in Table 7, as well as in the calculation of the federal and state taxes themselves in Table 6.

⁷ The 2001 Act provides that after 2010 the \$1.3 million amount will be indexed for inflation in \$100,000 increments, the \$60,000 amount will be indexed in \$5,000 increments, and the \$3 million amount will be indexed in \$250,000 increments.

⁸ The “sunset” of the 2001 Act after ten years results from a rule in the Senate that in the expedited procedures that apply to “budget reconciliation,” anything that is “extraneous” to implementing congressional budget targets is subject to being stricken from the legislation if any Senator raises a point of order to that effect. (This rule is known as the “*Byrd Rule*,” because it is set forth in an amendment of the Congressional Budget Act sponsored in 1990 by Senator Robert Byrd of West Virginia.) Anything that affects government revenues beyond the ten-year budget projection window is considered “extraneous” to budget reconciliation. If there is a point of order, it may be waived by a vote of 60 Senators. Hence, any tax provision that affects federal revenues beyond ten years may be enacted only with tacit consent—that is, if no point of order is raised—or with the support of 60 Senators. Many provisions of the 2001 Act, including the repeal of the estate tax, were too controversial to expect the support of 60 Senators, and the 2001 Act was brought to the Senate floor only with the ten-year sunset provision in it.

Certainly the attacks of September 11 and the subsequent military actions have had an impact on this aspect of American life as well as all others. Despite huge bipartisan support for our Armed Forces and our national resolve, the underlying differences over domestic economic and tax policy that were evident in the 2000 election results, in the closely divided Congress, and in the enactment of the 2001 Act itself continue nearly the same as they were before. If anything, with both general economic trends and a call from the White House for over \$80 billion of defense and homeland security spending combining to postpone the decade’s anticipated budget surpluses, it is hard to argue that permanent repeal of the estate tax is *more* likely than it was before.

⁹ It will be important to consider the possibility of divorce and concerns of asset protection, which might influence the way property is owned.

¹⁰ The maximum QCE Exclusion amount is 40%, but that amount must be reduced by 2 percentage points for each percentage point by which the value of the easement falls below 30% of the value of the land unencumbered by the easement. For example, if the value of the easement is 29% of the unencumbered value of the land, the maximum QCE Exclusion is 38%; if the value of the easement is 28% of the unencumbered value of the land, the maximum QCE Exclusion is 36%; and so forth, until there is no allowable QCE Exclusion at all if the value of the easement is 10% or less of the unencumbered value of the land.

¹¹ A GST trust is defined as a trust that could have a generation-skipping transfer in the future with respect to the transferor, *unless* one of the following is true:

- (i) The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons before the individual reaches age 46, on or before a date specified in the trust instrument that will occur before the individual reaches age 46, or before an event that may reasonably be expected to occur before the individual reaches age 46.
- (ii) The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the trust instrument who is more than 10 years older than such individuals.
- (iii) The trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in (i) or (ii) above, more than 25% of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals.
- (iv) Any portion of the trust would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.
- (v) The trust is a charitable lead annuity trust or a charitable remainder trust.
- (vi) The trust is a charitable lead unitrust, the noncharitable beneficiary of which is a non-skip person.

¹² The new rules also apply to the termination of “estate tax inclusion periods” after December 31, 2000.

¹³ Following enactment of the 2001 Act, the Internal Revenue Service published guidance qualifying the prohibition against a contributor’s investment direction after the initial contribution. This IRS guidance now permits plan sponsors to allow a change among offered investment strategies once per calendar year and upon a change in the designated beneficiary of the account.

¹⁴ Beginning in 2002, the annual gift tax exclusion is \$11,000, effectively permitting a one-time contribution of \$55,000, taken into account ratably over five years.

¹⁵ In January 2001, the IRS published new proposed regulations designed to simplify the rules governing distributions from qualified plans (such as 401(k) plans) and individual retirement accounts (IRAs). The new rules are generally effective for distributions beginning in 2002.

Under the old rules, the plan participant (including an IRA owner for this purposes) was required to make certain irrevocable elections (generally by April 1 of the year following the year in which the participant reached age 70½) concerning the designation of beneficiaries and the annual recalculation of life expectancy. These elections would bind the participant in future years, during which personal and financial circumstances could change significantly. In response to concerns that these requirements were unreasonably restrictive and the rules too complex (often resulting in inadvertent irrevocable elections by default), the IRS issued new rules to make it easier for individuals and retirement plan administrators to understand and administer the minimum distribution rules.

The new rules provide a uniform table enabling a participant to base the calculation of the required minimum distributions during the participant's life solely on the participant's current age and his or her account balance as of the end of the prior year, thereby eliminating the need for the participant to determine a designated beneficiary by a certain date or to decide whether or not to recalculate life expectancy each year. The uniform table reflects the joint life expectancy of the participant and a beneficiary ten years younger than the participant. (An exception applies to allow the participant to use actual joint life expectancy if the participant's sole beneficiary is the participant's spouse and the spouse is more than 10 years younger than the participant.) For most participants, the new calculation method results in smaller required minimum distributions and a longer distribution period, thereby enabling greater potential income tax deferral.

The new rules also permit the designated beneficiary to be determined as late as the end of the year following the year of the participant's death, which enables the participant to change the designated beneficiary after distributions commence without affecting the amount of future distributions, and allows post-mortem planning to "fix" problematic beneficiary designations or maximize payout periods for multiple beneficiaries.

Although the new rules eliminate the need to have a designated beneficiary in place by the required beginning date for distributions, the designated beneficiary's life expectancy continues to determine minimum required distributions *after* the death of the participant. Accordingly, it is still essential for an individual to designate appropriate primary and contingent beneficiaries to ensure that benefits are distributed to the appropriate individuals or charities and to achieve the greatest tax savings.