



Featured Articles:

State Tax Savings Window for Education Savings Plan Contributions

Increased Estate Tax Exemption and Related Estate Planning Considerations

The Privacy of Medical Information in the Context of your Estate Plan

The Private Clients, Trusts & Estates Practice of Sidley Austin Brown & Wood LLP

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STATE TAX SAVINGS WINDOW FOR EDUCATION SAVINGS PLAN CONTRIBUTIONS

Under current Illinois law, an Illinois taxpayer may deduct for Illinois income tax purposes all contributions to BrightStart, Illinois' 529 college savings plan, without any limitation on the amount of the deduction. Thus a client who contributes this year \$11,000 to a BrightStart 529 account for each of his ten grandchildren may deduct \$110,000 from his Illinois income taxes.

In many states that offer a state income tax deduction for contributions to their 529 programs, the deduction is limited to a certain amount each year. Illinois is about to become one of the states that caps the amount that can be deducted each year.

Illinois House Bill 4914, which was signed into law by the governor on July 26 limits the deduction to a maximum of \$10,000 contributed in the taxable year. The new deduction cap would apply to contributions made on or after January 1, 2005. The annual limit appears to be \$10,000 in the aggregate, even if the taxpayer is contributing to BrightStart accounts for a number of different beneficiaries. Further, the new law does not appear to double the limit for married taxpayers filing jointly.

Because the new law will not take effect until January 1, 2005, there is a window of opportunity to make contributions to Illinois' BrightStart 529 savings program prior to the end of the year that will be fully deductible for Illinois state income tax purposes. The gift tax annual exclusion allows you to give up to \$11,000 per beneficiary each year free from gift taxes (\$22,000 in the aggregate for a married couple making a split-gift election on their gift tax returns). Further, Section 529 of the Internal Revenue Code contains a special provision that permits you to make a gift of up to \$55,000 per beneficiary (\$110,000 in the aggregate for a married couple making a split-gift election) to a 529 savings account and elect to treat the gift as if it were made pro rata over five years. Thus, assuming no other gifts were made by you to the beneficiary over the five-year period, and assuming the appropriate election was made on a gift tax return, a \$55,000 gift made this year to a BrightStart

account could be completely protected from gift tax by the gift tax annual exclusion and entirely deductible for Illinois state income tax purposes.

In addition, HB 4914 now permits an Illinois state income tax deduction for contributions to the Illinois Prepaid Tuition Trust Fund, subject to the \$10,000 annual cap.

HB 4914 also deletes from the Illinois statutes a provision that prohibited the consideration of BrightStart contributions for purposes of determining eligibility for or the amount of any scholarship, grant, or monetary assistance awarded by the Illinois Student Assistance Commission, the State of Illinois or any agency thereof. Thus 529 savings accounts may be taken into consideration for Illinois financial aid purposes.

INCREASED ESTATE TAX EXEMPTION AND RELATED ESTATE PLANNING CONSIDERATIONS

You are likely aware that, as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRA"), the estate and gift tax exemption increased to \$1,000,000 on January 1, 2002. Beginning on such date, an individual's first \$1,000,000 of taxable transfers, whether during lifetime or at death, would not incur any federal gift or estate tax.

What you may not realize is that, also as a result of EGTRA, on January 1, 2004, the federal estate tax exemption increased to \$1,500,000. (The estate tax exemption is currently scheduled to increase further to \$2,000,000 in 2006 and \$3,500,000 in 2009, before the estate tax is repealed in 2010 and reinstated (with a \$1,000,000 estate tax exemption) in 2011.) This means that an individual who has not made any taxable gifts during his or her lifetime can transfer up to

\$1,500,000 of property at death without incurring any federal estate tax. With proper estate planning, a husband and wife can transfer up to \$3,000,000 of property free of federal estate tax.

In light of the increased estate tax exemption, you may be wondering whether you should take any steps now to ensure that your estate plan makes maximum use of the estate tax exemption available to you.

Do I need to amend my estate planning documents to take advantage of the increased federal estate tax exemption? Not necessarily. In general, existing estate planning documents for married persons allocate property according to a formula designed to make optimum use of the federal estate tax exemption. From a tax standpoint, these documents will realize the full benefit of the increased federal estate tax exemption, and they will continue to realize the full benefit of the federal estate tax exemption as it increases over the next several years.

From a non-tax standpoint, you should consider whether revisions to your estate plan are appropriate. If your estate plan makes a formula gift of the estate tax exempt amount, you should be certain that you are comfortable with having the increased amount of property pass to the recipient of that gift, rather than to the other beneficiaries of your estate. For example, assume your estate plan was prepared in 2001 when the estate tax exemption was \$675,000. At that point you and your spouse may have been comfortable making a formula gift of the estate tax exempt amount to your children upon the first spouse's death, and giving the residue to the survivor of you and your spouse. However, now that the estate tax exemption has increased to \$1,500,000, a formula gift of the estate tax exempt amount to your children at the first spouse's

death may be more than what you intended. If appropriate given the size of your estate, you may want to consider capping the amount of property passing to or for the benefit of beneficiaries other than the surviving spouse, either as a specific dollar amount or as a percentage of the estate, rather than relying solely on a formula gift.

It is important to note that EGTRA also provided for the generation-skipping transfer (GST) exemption to increase and equal the estate tax exemption beginning on January 1, 2004. As a result, the same factors to be considered in determining whether a revision to a formula gift of your estate tax exemption is necessary will apply in determining whether a revision to any formula gift of the GST exemption is necessary.

I hear that more and more states are amending their estate tax laws to impose a state estate tax that is no longer tied to the federal credit for state death taxes. Are changes to my estate plan necessary in light of these state law changes? That depends on where you are domiciled and whether you are willing to pay some tax at the first spouse's death in order to make maximum use of the federal estate tax exemption.

State estate tax revenues have been declining over the past four years as a result of EGTRA. In fact, this year states that charge an estate tax equal to the amount of the federal state death tax credit are now receiving only one-fourth of the amount of tax they would have received prior to EGTRA. As a result, many states have changed their laws to ensure a more steady stream of revenue from the estates of decedents who were domiciled in, or owned real property in, that state. As a

result of the state tax law changes, it is possible that, depending on where you are domiciled, a formula estate plan that makes maximum use of the federal estate tax exemption at the first spouse's death may trigger the payment of state estate tax at the first spouse's death.

To illustrate, assume that a married couple's estate plan provides for property having a value equal to the federal estate tax exemption to pass upon the first spouse's death to a tax bypass trust for the benefit of the surviving spouse and the couple's children, and the residue of the estate to pass outright to the surviving spouse. If the first spouse died in 2004, \$1,500,000 would pass to the tax bypass trust for the spouse and children, and the residue of the estate would pass outright to the surviving spouse. In this example, if the couple were domiciled in New York, New York would impose an estate tax on \$500,000 of property (i.e., the amount by which the portion of the estate not passing to the surviving spouse exceeds \$1,000,000). (Because Illinois recognizes the increased federal estate tax exemption through 2008, a similar problem would not arise for an Illinois resident who owns no out-of-state property until 2009.) In order to avoid payment of a state estate tax upon the first spouse's death, the couple's estate plan could be amended to limit the gift to the tax bypass trust to the amount of property that would result in no estate tax - federal or state - being payable at the first spouse's death. The downside to this approach, however, is that more assets would be subject to federal estate tax at the surviving spouse's death. Typically, the marginal federal estate tax rate is significantly higher than any state's marginal estate tax rate. Thus, although payment of tax at the first spouse's death may

be less than desirable, it still may be preferable to failing to fully use your federal estate tax exemption.

Should my spouse and I be concerned about how we hold title to our combined assets? The plain and simple answer is "yes". Even if your estate plans are drafted to make maximum use of the estate tax exemption, if your assets are not properly allocated between you and your spouse, the planning techniques could fail and unnecessary estate taxes may be imposed at the survivor's death.

For example, assume that a married couple has combined assets of \$3,000,000, with \$2,500,000 of assets titled in husband's name and \$500,000 of assets titled in wife's name. If wife dies first, even if her estate plan provides for property having a value equal to the estate tax exempt amount to pass to a tax bypass trust, the trust will be funded only with wife's \$500,000, not the full amount of the estate tax exemption available to her. At husband's subsequent death, only \$1,500,000 of his \$2,500,000 in assets will be sheltered from tax by the federal estate tax exemption, and a federal estate tax of \$430,000 would be due. By contrast, if the couple's assets were divided equally between husband and wife, the full \$3,000,000 of assets would be sheltered from tax by the couple's federal estate tax exemptions, and no federal estate tax would be due at either death.

Therefore, if the value of a couple's combined assets exceeds the estate tax exempt amount by more than an insignificant amount, they may wish to consider, for tax planning purposes, retitling some of their assets, so that each spouse has assets having a value equal to the estate tax exempt amount in his or her own name (or in the name of, or payable to, his or her

revocable living trust). In that way, regardless of which spouse dies first, there will be sufficient assets in the first spouse's estate to make maximum use of his or her estate tax exemption. (It should be noted that the exemption available to the first spouse's estate will not apply to property owned by husband and wife as joint tenants; such property will automatically pass, by operation of law, to the surviving spouse at the first spouse's death. Disposition of the first spouse's interest in jointly held property will not be governed by the provisions of the first spouse's estate plan.)

I have already made taxable lifetime gifts of \$1,000,000. Should I plan on making an additional lifetime gift of \$500,000 this year because of the increase in the exemption amount? No. While the estate tax exemption increased from \$1,000,000 to \$1,500,000 as of January 1st, the gift tax exemption did not. It is scheduled to stay at \$1,000,000 indefinitely, without regard to the scheduled increases in the estate tax exemption and the projected repeal of the estate tax. This means that any taxable lifetime gifts in excess of \$1,000,000 would be subject to federal gift tax, beginning at a marginal tax rate of 41%, and going as high as 48%.

For clients of substantial means, making lifetime gifts equal to the full amount of the \$1,000,000 gift tax exemption has been and continues to be a good tax planning strategy. Because a gift in excess of the \$1,000,000 gift tax exemption will trigger payment of gift tax and there is still a possibility that estate taxes will be completely repealed, we are reluctant to recommend making any gift requiring the payment of significant gift tax.

Nonetheless, for some individuals of substantial means,

lifetime gifts that require the payment of gift tax may still be appropriate and advisable. This might be true, for example, for persons (i) who have a limited life expectancy, (ii) who are convinced there will be no permanent repeal of the estate tax (in this case, lifetime gifts would be beneficial because they are effectively taxed at lower rates than gifts made at death), (iii) who want to remove future appreciation from their estate, or (iv) who live in a state that does not impose state gift tax but imposes an estate tax in excess of the federal credit.

What's the bottom line? It is good practice to review your estate plan every few years, as well as at any time when significant changes occur in your family relationships, the value of your estate and the relevant laws impacting the disposition of your estate at your death. At a minimum, this year's increased estate tax exemption is change enough to warrant a review of your estate plan. Whether changes to your plan are advisable and, if so, what planning strategies are to be used in light of the increased estate tax exemption will depend in large part on the value of your estate, your age and your health.

THE PRIVACY OF MEDICAL INFORMATION IN THE CONTEXT OF YOUR ESTATE PLAN

You may have noticed that checking in at your physician's office has gotten a little more complex lately. In addition to providing your address and insurance card, you now may be asked to designate in writing what information can be communicated to your family members on your behalf, and whether the physician's office can leave medical information in your voicemail. Welcome to the world of the Health Insurance Portability and Accountability Act, or "HIPAA"!

In enacting rules to protect your personal health information, Congress has created a new system of "Privacy Policies" for medical information, that can change completely how and when your medical information will be disclosed to persons other than yourself.

HIPAA will have an impact on your estate plan as well as on your trips to the doctor. For example, your revocable trust may provide that you are the sole trustee as long as you are "able" to act, or your power of attorney for property may provide that it becomes effective when you become "incapacitated." In both of those cases, the likely evidence of your incapacity or inability to act would come from your physician. However, if you have not given advance written permission for someone to obtain that information, your physician may be legally prohibited from discussing your condition with your property agent or successor trustee. This may undermine the disability planning benefits of using revocable trusts and powers of attorney. If there is no one who can determine whether or not you have the capacity to act, it may be necessary to undertake guardianship proceedings, which you intended to avoid by creating a revocable living trust or signing a power of attorney for property.

Fortunately, there are two relatively simple ways to avoid this outcome. First, if you have executed a health care power of attorney that names an agent, that agent should be able to obtain your medical information. If your health care agent is the same person as your successor trustee or property agent, or is someone who would cooperate with your successor trustee or property agent, you may be able to rely on the

health care agent to obtain the necessary medical information from the providers and share it with your other fiduciaries. Alternatively, by signing a HIPAA Authorization for Use and Release of Medical Information form, expressly directing any physician providing treatment to you to release your "personally identifying health information" concerning your condition to your property agent or successor trustee for the

purpose of determining your capacity, you can assure that the disability planning elements of your estate plan will operate as you choose. The authorization form can be customized to limit the persons who can receive the information or the kind of information they can receive, if you have concerns about your privacy.

If you would like our assistance to consider and advise whether you need to take any action, please contact your Sidley Austin Brown & Wood LLP Private Clients, Trusts & Estates Group attorney.

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