



Featured Articles:

States Refuse to Fund Federal Estate Tax "Reduction"

New Rules for IRA Beneficiary Designations

Exemptions and Exclusions

The Estate Planning - Private Clients Practice of Sidley Austin Brown & Wood

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States Refuse to Fund Federal Estate Tax "Reduction"

Many married couples design their estate plans to defer payment of any estate tax until the death of the survivor. Due to legislative changes, many existing estate plans may no longer accomplish this result and need to be revised or at least reconsidered. In a nutshell, here is the situation.

The 2001 tax law changes (so-called EGTRRA-The Economic Growth and Tax Reform Reconciliation Act of 2001) mandates the phase-out of the credit for state death taxes allowed in the calculation of U.S. estate taxes. More specifically, the allowable state death tax credit has been reduced to 50% for 2003, will be further reduced to 25% for 2004, and in 2005 will be completely phased out and replaced by a deduction for state death taxes paid.

Because Illinois and most other states for many years have imposed state death taxes in an amount equal to the state death tax credit allowed for U.S. estate tax purposes, the reduction and ultimate phase-out of this credit directly impacts state revenue. To prevent this revenue loss, Illinois has pending legislation, and at least 11 other states plus the District of Columbia have already enacted legislation, to maintain state death taxes equal to the allowable state death tax credit under prior law before the phase-out began. Such legislation is commonly referred to as "decoupling" because it disconnects the state estate tax from the U.S. estate tax laws.

The typical estate plan for a married person provides for dividing the estate in a way that will minimize or eliminate estate taxes and places a portion of the estate in a trust (the Family Trust or Credit Shelter Trust) that will not be subject to estate tax at the surviving spouse's death. If the estate plan provides for minimizing or eliminating federal estate tax, the Family Trust created from the estate of the first spouse to die will be funded with the full amount of the federal estate tax exclusion (\$1,000,000 in 2003; \$1,500,000 in 2004 and 2005; and \$2,000,000 in 2006, 2007 and 2008) in a state with decoupling language, but state death tax will be due at the first spouse's death. Alternatively, if the estate plan provides for minimizing federal and state death taxes, the Family Trust will be funded with less than the

federal estate tax exclusion (\$675,000 under the decoupling laws of many states, but depending upon the state law the amount can vary). Because the first spouse's federal estate tax exclusion would not be fully used, estate taxes at the survivor's death would be increased. For some clients, paying state death taxes at the first death will be the right choice to maximize overall tax savings; others will prefer to defer all tax until the survivor's death.

For example, under the pending Illinois legislation, in 2003 net state death taxes of about \$9,200 would need to be paid in order to fully fund the Family Trust with \$1,000,000; in 2004 and 2005 net state death taxes of about \$47,600 would need to be paid in order to fully fund the Family Trust with \$1,500,000. In 2006 and thereafter, these amounts are scheduled to increase further under current law, although the likelihood of future tax law revision makes it relatively unpredictable what these amounts will be in the longer-term.

These legislative developments require a married couple who live in a state that enacts decoupling legislation to review whether an amendment of their estate plan documents is necessary to accomplish their objectives. Planning options include:

- Amend the estate plan to reduce the Family Trust to produce zero state death taxes at the first spouse's death;
 - Amend the estate plan to fully fund the Family Trust, accepting payment of state death taxes at the first spouse's death;
 - Amend the estate plan to reduce both U.S. and state death taxes to zero, but retain flexibility for the surviving spouse, by disclaimer, to choose to pay some state death tax at the first spouse's death to maximize the Family Trust.
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NEW RULES FOR IRA BENEFICIARY DESIGNATIONS

New, simplified rules on IRA distributions are now in effect.

Payout During IRA Owner's Life.

For required minimum distributions after the IRA owner is age 70-1/2, there is now only one chart that will apply to almost all IRA owners during their lives. Even if a charity is the beneficiary, the new lower required minimum payouts apply during the IRA owner's life. The only exception is that if the beneficiary is the IRA owner's spouse and is more than 10 years younger than the IRA owner, then an even lower payout applies. An IRA owner can always take larger distributions than the legally-mandated minimums, but a slow payout defers income taxes.

Payout After IRA Owner's Death.

The general rule is that after the IRA owner's death, the IRA can be paid out over the life expectancy of the individual beneficiary of the IRA (determined as of the death of the IRA owner, and with such life expectancy then reduced by one year each year thereafter). This works well if each IRA beneficiary is a named individual (other than an aged individual, such as a parent or grandparent), or if the IRA beneficiary is the class of the IRA owner's descendants. But if a beneficiary is a charity or a trust, then the following complexities are encountered:

- Charity as Beneficiary. Under the new rules, if a charitable beneficiary is paid out in full by September 30 of the year after the IRA owner's death, then the rest of the IRA can be distributed to the individual beneficiaries of the IRA based on his or her life expectancy. But if this is not done, then the IRA will have to be fully distributed within five years after the IRA owner's death.

- **Living Trust as IRA Beneficiary.** The IRA owner's living trust can work well as an IRA beneficiary if all the beneficiaries of the living trust are certain to be individuals who are not aged. But if the living trust provides for a power of appointment that permits distributions to individuals other than the IRA owner's descendants or to charities, then a much shorter payout period may apply to the IRA. If property can be appointed to spouses of descendants, for example, this may require your living trust to take distribution of your IRA (after your death) over a period as short as 5 years. In addition, if a charity is a beneficiary of the trust and is not paid out in full by September 30 of the year after the IRA owner's death, or if the trust permits the IRA to be used to pay estate taxes or estate expenses or debts, then a much shorter payout period may apply to the IRA.
- **Marital Trust as Beneficiary.** As under the old rules, if an IRA is payable to a Marital Trust, the Marital Trust must contain special provisions to ensure that the IRA will qualify for the marital deduction.

Tips for IRA Beneficiary Designations

- Do not make your IRA payable to your estate. That shortens the payout period after your death, and makes your IRA unnecessarily available to creditors.
- Making your IRA payable outright to your spouse maximizes flexibility, may permit distribution to be deferred, and permits IRA distributions to be made slowly.
- If you want to designate your living trust as your IRA beneficiary (or as your contingent IRA beneficiary if your spouse predeceases you), then you should consult with your attorney about the new IRA distribution rules.

- Most of the foregoing analysis has assumed that both the IRA owner and the IRA beneficiaries will want to have the flexibility of taking IRA distributions slowly, so as to defer income taxes.

However, sometimes other factors, such as holding the IRA in trust, may dominate the analysis.

EXEMPTIONS AND EXCLUSIONS

Estate Tax Exclusion. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the exclusion from federal estate tax increased on January 1, 2002, from \$675,000 to \$1,000,000, and that level continues for the estates of persons dying in 2003. The exclusion is scheduled to increase again on January 1, 2004, to \$1,500,000, and to \$2,000,000 on January 1, 2006. For the estates of persons dying during 2009, the applicable exclusion will be \$3,500,000. Estates having a gross value of less than the exclusion amount will have no federal tax due and are not required to file a federal estate tax return.

Gift Tax Exclusion. For the first time since 1976, the federal gift tax exclusion is no longer tied to the estate tax exclusion in a single transfer tax regime. The gift tax exclusion increased as of January 1, 2002 to \$1,000,000 but will not increase from that point. For federal gift tax purposes, the annual exclusion for gifts of present interests in property is indexed for inflation and has increased to \$11,000 (\$22,000 for a married couple who make a split gift election) as of January 1, 2002.

GST Exemption. The separate generation-skipping transfer (GST) tax exemption has been indexed for inflation and for lifetime or testamentary gifts or bequests which skip a generation in 2003, the GST exemption is currently \$1,120,000. However, on January 1, 2004, the GST exemption is scheduled to increase under EGTRRA to \$1,500,000, and thereafter, the federal estate tax exclusion and the GST exemption will increase in tandem through 2009.

Repeal and Sunset. On January 1, 2010, the federal estate tax and GST tax are scheduled to be repealed entirely for estates of persons dying, or gifts made, in that one year. However, on January 1, 2011, the repeal disappears and the federal estate tax and GST tax are to be restored to the Internal Revenue Code provisions applicable on December 31, 2001. In other words, the federal estate tax exclusion will revert to \$1,000,000, and the GST tax exemption will

be at the level that would have applied, after indexing for inflation, under the Internal Revenue Code as it prevailed before the passage of EGTRRA. Under the repeal/restoration provision of EGTRRA, the gift tax will revert to its level equal to the federal estate tax exemption.

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

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