

Issues & Answers

ESTATE PLANNING ALERT

New Tax Legislation That Could Impact Your Estate Planning

President Bush recently signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001, which is new tax legislation that could impact your estate planning. Among other changes, the Act substantially changes the federal estate tax (also known as, the “death tax”), generation-skipping tax (“GST”), and gift tax. Over the next nine years, the amount that can be passed to beneficiaries tax-free (the “Exemption Amount”) increases significantly and the tax rate on the largest estates is reduced. Further, the political spin is that the estate tax is repealed in 2010, but in fact the repeal sunsets one year later, therefore unless Congress acts in the interim, the estate tax is reinstated in 2011.

Because these tax changes are complex, we believe Congress and the Department of Treasury will continue to enact additional changes. At the present time, however, we want to inform you of some of the highlights of these tax changes.

1) Rate Reductions And Exemption Amount Increases

- From 2002 through 2009, the estate and gift tax rates and the Exemption Amounts are as follows:

Calendar Year	Estate and GST Tax Exemption Amounts	Highest Estate and Gift Tax Rates
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	N/A (taxes repealed)	Top individual income tax rate under the bill (gift tax only)
2011	Estate taxes reinstated unless Congress acts	

- The gift tax exclusion amount will remain at \$1 million after 2002, with no adjustment for inflation.

2) State Death Tax Credit

- When the estate tax is paid, a portion goes to the federal government and a portion to the state. The amount paid to the state is a direct credit against the federal tax.
- The amount of the state death tax credit will be gradually reduced and replaced with an estate tax deduction for state death taxes paid. If states enact laws to replace this loss of revenue, additional estate planning may be necessary.

3) Carryover Basis

- The current rules that provide for adjusting the basis of a decedent’s assets to fair market value at death will be replaced with a modified carryover basis system for individuals dying after 2009.
- An estate, however, will be permitted to adjust the basis of assets transferred by a decedent to anyone up to \$1.3 million, and a further adjustment of the basis of property transferred to a surviving spouse by an additional \$3 million.

4) Generation-Skipping Tax

■ The GST tax rules are modified in several technical ways making them more user friendly; however, the modifications need to be discussed with each client. The GST tax is also repealed beginning in the year 2010, but unless Congress acts, the repeal sunsets beginning in 2011, and the GST tax is reinstated.

Listed below are examples of situations in which estate plans could result in unintended consequences.

1) Spouse Unintentionally Disinherited

Many couples' trusts and Wills provide that at the first spouse's death, the Exemption Amount passes to children with the balance passing for the benefit of the surviving spouse. The maximum Exemption Amount is now \$675,000 per person, but the Act increases the Exemption Amount in 2002 to \$1 million and it gradually increases to \$3.5 million by the year 2009. The Exemption Amount may represent the entire estate of the first spouse who

died. This may result in children receiving substantially more and the surviving spouse receiving substantially less than the deceased spouse intended, because of the possibility that most or all of the deceased spouse's assets would be distributed to children rather than distributed for the benefit of the surviving spouse.

2) Spouse May Lose Control Of Assets

Many couples' trusts and Wills provide that at the first spouse's death, the Trustee is authorized to distribute income and principal from a trust holding the Exemption Amount (commonly known as the "Bypass Trust") to the surviving spouse and issue, in the Trustee's discretion, for their needs. With the changes in the estate tax laws, and the possibility that the Bypass Trust will be funded with up to \$3.5 million, couples may prefer to direct the Trustee to make mandatory distributions of income and discretionary distributions of principal only to the surviving spouse during the spouse's remaining lifetime.

3) Increased GST Exemption May Unintentionally Restrict Children's Assets

Many couples' trusts and Wills provide that at the second spouse's death, the Trustee is to set aside the GST exemption (which is currently approximately \$1 million per donor) in trust for their children's lifetimes, with the balance of the estate passing outright to the children. With the dramatic increase in the GST exemption amount to \$3.5 million per donor in the year 2009, it is possible that all of the couple's assets would be held in trust for the lifetimes of the couples' children and that no funds would be distributed outright to the children at the second spouse's death. This may not be what is intended.

Because the Act may impact your existing estate planning documents, we invite you to contact us with any questions regarding the sweeping tax changes and how they impact your existing estate plan. ■

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