

Thomas W. Abendroth
312.258.5501
tabendroth@schiffhardin.com

Barry S. Albers
312.258.5611
balbers@schiffhardin.com
Trust and Estate Litigation

Svetlana V. Bekman
312.258.5523
sbekman@schiffhardin.com

Scott Bieber
312.258.5636
sbieber@schiffhardin.com

David C. Blickenstaff
312.258.5637
dblickenstaff@schiffhardin.com
Trust and Estate Litigation

Harmon A. Brown
312.258.5690
hbrown@schiffhardin.com

Louise M. Fitzsimons
212.745.0822
lfitzsimons@schiffhardin.com

Charles D. Fox IV
312.258.5506
cfox@schiffhardin.com

Theresa M. Hellmann
312.258.5562
thellmann@schiffhardin.com

P. Gregory Hess
212.745.0812
ghess@schiffhardin.com

David R. Hodgman
312.258.5714
dhodgman@schiffhardin.com

Carter Howard
847.853.2525
choward@interaccess.com

Michael J. Huft
312.258.5627
mhuft@schiffhardin.com

Kim A. Kamin
312.258.5621
kkamin@schiffhardin.com

Theodora P. Karnegis
312.258.5731
tkarnegis@schiffhardin.com

Robert E. Kolek
312.258.5755
rkolek@schiffhardin.com

Katherine J. Levy
847.295.4305
klevy@schiffhardin.com

David A. Milberg
312.258.4579
dmilberg@schiffhardin.com

Margaret A. Nagela
312.258.5518
mnagela@schiffhardin.com

Paul B. O'Flaherty
312.258.5605
poflaherty@schiffhardin.com

Robert R. Pluth, Jr.
312.258.5535
rpluth@schiffhardin.com

Debra L. Stetter
312.258.5741
dstetter@schiffhardin.com

Thomas R. Wechter
312.258.5756
twechter@schiffhardin.com

Elizabeth H. Weissman
312.258.5645
eweissman@schiffhardin.com



Estate Planning & Administration Group

UPDATE

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Welcome to the Debut Edition of the Schiff Hardin LLP Estate Planning & Administration Group Update

News you can use and planning ideas worth considering from our Schiff Hardin LLP Estate Planning & Administration Group.

In this and in future editions, our topics will be timely and our text will be brief.

We hope these Updates will be of service to our clients and colleagues in the financial services industry. We would like to hear your thoughts and comments.

*Schiff Hardin LLP
Estate Planning & Administration Group*

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2004 Increase in Estate Tax Exemptions

Watch Out For Lower Gift Tax Exemption

As of January 1, 2004, the federal estate tax exemption goes up to \$1.5 million per person - \$3 million per married couple. But the gift tax exemption doesn't change — it is still only \$1 million. This means that if your cumulative taxable gifts exceed \$1 million (\$2 million for a married couple), a tax will be incurred. Remember too that taxable gifts are charged against your estate tax exemption. If you used up your \$1 million gift tax exemption during your life, your remaining estate tax exemption is only \$500,000 (for deaths in 2004).

Keep Your Balance — Between Marital and Family Trusts — And Still Maximize Your After-Tax Balance

The increase in the estate tax exemption provides planning opportunities but may also present a trap for the unwary. Most modern estate plans take advantage of the estate tax exemption by a formula which in essence says: "Take my exemption (now \$1.5 million) and put that amount into a family trust for my spouse and children. Put the rest of my estate into a marital trust exclusively for my spouse." With the increased exemption, if the estate of the first spouse to die is \$1.5 million or less, the entire estate will end up in the family trust and nothing will go into the marital trust. Family trusts typically are for the benefit of the surviving spouse **and** the children.

Although the surviving spouse is often the preferred beneficiary under the family trust, it may be appropriate to modify the family trust provisions in your estate plan to put more teeth into that preference. One way to do that is to allow distributions to children only in circumstances where it is clear that the distribution would not jeopardize the surviving spouse's future support. For larger estates, this is probably less of a concern. However, it should be noted that the estate tax exemption is scheduled to continue to increase in steps, over the next several years. Accordingly, even in larger estates, these concerns may arise in the future.

Use It or Lose It

As previously noted, the estate tax exemption is \$1.5 million per person in 2004 or \$3 million per married couple. Remember, however, that if each spouse does not have a taxable estate equal to at least \$1.5 million, the exemption may not be fully utilized.

Example: Wife has \$5 million of property in her name and husband has only \$100,000 in his name. Husband dies first. The amount of property to which his exemption can be applied is limited to his \$100,000, and the remaining \$1.4 million of husband's exemption is wasted. If wife were to place additional assets in husband's name so that husband's estate was \$1.5 million, no exemption would be lost. This can be accomplished with a marital gift trust if an outright transfer is not appropriate.

And Don't Forget to Remember (Two Other Important Points)

- The generation-skipping tax exemption also increased to \$1.5 million effective January 1, 2004.
- In 2004, tax-free annual exclusion gifts remain at \$11,000 per person per year.

Flex Trusts

Protect Against Creditors While Minimizing Taxes

Giving your heirs their inheritance in trust often will generate significant tax benefits. Less well-understood are the creditor protection benefits of trusts. Both tax and creditor protection benefits can be obtained even though the heir has almost the same level of control over the assets in the trust as if the heir owned them outright. This is accomplished by naming the heir as trustee of the trust and giving the heir the authority to name who receives the assets remaining in the trust at the heir's death. These trusts, which we call "flex trusts," can protect the inherited assets from creditors, including former spouses, while still affording virtually the same control and economic enjoyment as outright ownership. Moreover, many states have eliminated a rule, known as the "rule against perpetuities," so that flex trusts can effectively last for multiple generations. If your current estate plan does not include flex trusts for your children, you would be well advised to consider adding them. Indeed, if your parents' estate plans do not create flex trusts for you, you may be missing an important opportunity to protect your inheritance.

Simpler than You Might Think

Some may be dissuaded from using flex trusts because of their concern that trusts add complexity. However, the additional complexity is modest and can be addressed by hiring an accountant or bank to handle the recordkeeping required — often not much different than the records that an individual would keep anyway. Moreover, those costs, while typically modest, are also tax deductible.

The “Stealth” Estate Tax

What the Federal Government Gives You, Some States Take Back From You

Tax legislation passed in 2001 has been gradually reducing U.S. estate tax rates. Rates have decreased from 55% in 2001 to 48% for individuals dying in 2004. Additional reductions are scheduled for coming years. However, even as rates are reduced, the actual amount of federal estate tax that a decedent's estate may owe is going up in many cases. That is because the 2001 legislation also made changes that result in the federal government sharing less of the estate tax with the states. And of course many states, not willing to see a reduction in their revenues, are changing their laws to make sure they collect the same amount of estate tax as before. As a result, in many states, combined federal and state death taxes are higher today than in 2001. For a decedent dying in 2004, the combined top rate, in many states, will be 57%.

15% Tax Rate on Capital Gains and Dividends

The historically low 15% rates that currently apply to dividends and capital gains are scheduled to phase out in a few years. In the meantime, these rates may afford special opportunities, especially for families with closely-held businesses. One simple, but powerful, planning option for a family business is to declare a large dividend which allows earnings otherwise trapped inside a family corporation to be distributed to family members at the same 15% rate as applies to capital gains. The ability to “purge” income otherwise trapped inside a family corporation may have many other positive tax repercussions. So long as these low tax rates apply, a family corporation also may buy back shares from senior family members which previously would have been subject to taxes of approximately 40%, but now can be done at a maximum federal tax rate of 15%. This may serve many objectives including

Check the Tax Climate Where You Live

This change has two important consequences. First, where you reside may have more of an impact on estate taxes than it did a few years ago. Not all states have acted to preserve their estate tax collections. Arizona, California, Colorado, Florida, Michigan, Nevada and Texas are among the states that are now more hospitable from an estate tax standpoint.

Second, the transfer of wealth through lifetime gifts, rather than transfers at death, can be even more meaningful in reducing the estate tax bill. Most states do not have gift taxes. In these states, even deathbed gifts will dramatically reduce taxes. In addition, in many instances leveraged gifting techniques, such as GRATs and QPRTs, discussed in this newsletter, can virtually eliminate the tax that otherwise would apply. In a tax regime with an effective tax rate in excess of 50%, this means that proper planning can more than double the after-tax amounts passing to your heirs.

providing liquidity to senior family members and transferring ownership to younger generations.

The lower income tax rates also have important planning implications for people who do not have family businesses. For example, the low rates may change the desirability of owning equities inside an IRA or other tax-deferred retirement accounts, especially if the owner of those accounts also holds, in his or her own name, significant fixed income investments. While we are not investment advisors, we can help people understand how the tax rules can be used to their investment advantage. When assets are held in a number of different “pockets” such as IRAs, family trusts, and personal accounts, this planning may significantly increase the overall performance of your assets.

Leveraged Gifting Techniques

Turn Estate Taxes into “Voluntary Taxes”

Combined federal and state estate taxes continue to be very high. Yet, for many families, the estate tax fairly could be described as a “voluntary” tax. This is because of the availability of leveraged gifting techniques to transfer assets to your heirs at low or even zero tax rates. Included among those techniques are Grantor Retained Annuity Trusts (GRATs), Charitable Lead Annuity Trusts (CLATs) and Qualified Personal Residence Trusts (QPRTs). Many of these techniques work particularly well in a low-interest rate environment such as prevails today. One size does not fit all, but for most people there is at least one technique that works very well.

GRAT Example: Mr. Jones has a rental building worth \$1 million that generates \$100,000 annual income (10%) which he spends (*i.e.* he does not save it). Given Mr. Jones' other assets, if he continues to hold the building until his death, the death taxes on the \$1 million asset would be about \$500,000 even if it doesn't grow in value. Mr. Jones could, instead, put the building into a GRAT which pays him 10% per year, for the next 15 years. At the end of that 15-year period, the building would pass to a trust for his children or his spouse and children. No gift tax would be due at the time the GRAT is set up or at the time when the building passes to trusts for Mr. Jones' wife or children, even if the building then is worth much more than \$1 million. If Mr. Jones survives the 15-year period, the building would never be taxed in his estate. Thus, use of the GRAT would save over \$500,000 in taxes on a \$1 million asset. If the asset grows (as many do), the tax savings will be even greater.

Other leveraged gifting techniques are also available and may fit your situation.

New IRS Attack on Family Limited Partnerships

The U.S. Tax Court Flips Out Over FLPs

Some of our clients have used Family Limited Partnerships (FLPs) for business and estate planning purposes (Limited Liability Companies "LLCs" are similar). A recent case in the U.S. Tax Court has given the IRS a new avenue to challenge valuation discounts in FLPs and LLCs. The case is *Estate of Strangi*. The gist of the Tax Court's conclusion in *Strangi* was that because the senior family member, Mr. Strangi, could, together with other family members, control partnership decisions on distributions or liquidation, all the property originally contributed to the limited partnership by Mr. Strangi should be included in his estate without valuation discounts. The Court reached this result even though Mr. Strangi had only a minority vote and did not by himself control the partnership.

Case May Be Overturned, But Prudent Planning Required Just in Case

Many practitioners view this aspect of the Court's ruling as unusual and incorrect. Nevertheless, it is causing many estate planning professionals to reexamine how limited partnership arrangements are administered. The Court's ruling, applied literally, would negate the benefit of valuation discounts and bring back into a donor's estate the full, undiscounted, date of death value of prior gifts of FLP or LLC interests.

The Court in *Strangi* also found evidence that Mr. Strangi had an implied agreement with the other partners that he would be able to access property in the partnership whenever he needed it. This also caused the property contributed to the partnership to be included in Mr. Strangi's estate. This part of

the ruling has been supported by other cases, and is not new. It is, nonetheless, a reminder that it is important to dot the "I's" and cross the "T's" when dealing with FLPs and LLCs.

The *Strangi* case is on appeal, and the IRS could lose. Nonetheless, it would be wise to review your FLP/LLC and determine whether it is appropriate to take steps to minimize the potential impact of these developments.

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