Private Clients, Trusts and Estates *update*

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New Name, Same Top Professional Service

As you can see, our group has changed its name to "Private Clients, Trusts and Estates." This change reflects the broader range of tax and wealth transfer planning that we regularly provide in addition to traditional estate planning and estate administration work. What ties these services all together are the clients who benefit from them-private individuals, their families and their family business and charitable organizations.

Estate Tax Reform Update

Congress has been debating Federal estate tax reform legislation since the summer of 2005. They came very close once again to passing a new estate tax bill this past August, but the bill failed to gain the necessary 60 votes in the Senate (the vote was 56-42).

Underlying the push for new estate tax legislation is a general recognition in Congress that the current rules, enacted in 2001, are unworkable. The current law provides for an increasing estate tax exclusion amount through 2009, full repeal of the estate tax in 2010, and then return of the estate tax in 2011 with the higher rates and lower exclusions that applied under pre-2001 law.[1] Thus, under the current system, the estate of an individual who dies in 2009 would have a $3,500,000 exemption and a top estate tax rate of 45%. The estate of an individual who dies in 2010 would have no estate tax. The estate of an individual who dies in 2011, would have only a $1,000,000 exemption and a top tax rate of 55%. After enactment of the 2001 Tax Act, many had hoped that Congress would be able to leverage the temporary repeal in 2010 into a permanent repeal of the estate tax. It now appears, though, that permanent repeal is not achievable. Therefore, efforts have turned to reforming the current system.

[1] Please note that this discussion addresses only the Federal estate tax; state estate taxes may result in additional estate tax liability.

H.R. 5970, the bill that failed to pass the Senate in August, provided what many believe is a sensible replacement for the current system. It likely will be the starting point for reconsidering estate tax reform legislation now that the fall 2006 elections are over. H.R. 5970 contained the following provisions:

1. A $5 million applicable exclusion amount.

2. Reunification of the estate tax and gift tax, so the $5 million amount would apply for estate tax and gift tax purposes too (currently the gift tax exclusion is capped at $1 million).

3. A 15% estate tax rate for the first $25 million (pegged to the long-term capital gains tax rate — 15% currently, scheduled to rise to 20% in 2011).

4. A 30% estate tax rate for estates over $25 million.

5. Portability of the applicable exclusion amount between spouses. This would allow a surviving spouse to use the unused exclusion of the first spouse to die. (It would not allow the first spouse to die to accelerate use of the other spouse's exclusion).

6. Elimination of the deduction for state death taxes.

7. Exclusion amounts and tax brackets would be inflation adjusted beginning in 2015.

8. Provisions would be phased-in beginning January 1, 2010, and would take place over 5 years. The current system, with a $2 million estate tax exclusion, increasing to $3.5 million in 2009, would stay in place through 2009.

If enacted, these changes would eliminate the estate tax for many individuals and families, and significantly reduce the estate tax for almost everyone else. An increase in the gift tax exclusion to $5 million would be an important change for more wealthy families. It would provide an opportunity to transfer significant additional property without gift tax during life. The current gift tax exclusion amount is $1 million, and most individuals have limited their taxable gifts to this amount. The ability to transfer an additional $4 million of property ($8 million for a married couple) would be a significant new opportunity.

Some people have suggested that estate tax reform will not occur given that Democrats now have a majority of both the House and the Senate. However, H.R. 5970 and prior estate tax reform bills all passed the House easily. The Senate leadership recognizes that something needs to be done to replace the existing estate tax rules. In fact, Sen. Baucas, who will chair the Senate Finance Committee when the new Congress reconvenes, called for Congress to consider a reform package again in the lame-duck session. While that did not happen,

Sen. Baucas' statement suggests that estate tax reform will not be cast aside in 2007.

Schiff Hardin's Private Clients, Trusts and Estates Group continues to follow the legislative process closely, and to analyze the impact of both the existing rules and the proposed legislation on estate planning. Regardless of the outcome, all estate plans must be carefully monitored as the law evolves to be certain that the estate plan continues to fulfill the client expectations.

Planning Opportunities with Retirement Assets

Lifetime Charitable Gifts from IRAs Now Allowed (for a limited time only)

For years, our clients have asked why they are not allowed to make direct gifts from IRAs to charity. Congress finally has given individuals this ability, but with lots of limitations.

The 2006 Pension Protection Act permits individuals to make distributions, up to $100,000 each year directly from their IRAs to charity. These distributions are not included in income so long as they are made on or after the date the IRA owner attains the age of 70½, and only for the years 2006 and 2007.

The owner will not receive a separate charitable deduction for the charitable gift since the distribution is not included in income. Almost all eligible taxpayers will be better off using this technique (rather than withdrawing the funds from the IRA and then writing a check to charity) — especially those who otherwise would exceed their deductible limit for charitable contributions or for other reasons are unable to take full advantage of their itemized deductions.

The new rules apply only if the distribution is made to an operating foundation or a public charity (other than a supporting organization or a donor advised fund). The distribution must be made from the IRA directly to the charity; a distribution to the owner, followed by a transfer to charity, will not qualify. The IRA owner will need to obtain a receipt for the gift the same as is required to support deductions for direct cash gifts to charity.

These rules apply to traditional and Roth IRAs, but not employer sponsored retirement plans, including SIMPLE IRAs and SEPs.

Using Qualified Plans and IRAs to Fund Charitable Gifts at Death

Retirement benefits are subject to both estate and income tax upon the death of the participant, but all those taxes are avoided if the benefit passes to charity at the owner's death. Accordingly, many people view them as good assets to fund charitable bequests. Indeed, given the tax bite that otherwise may apply, even individuals not otherwise particularly charitably inclined, sometimes will name charity as the beneficiary of part or all of their retirement accounts.

One refinement of this planning is to use retirement assets to fund a charitable remainder trust ("CRT") at the death of the owner. Under a CRT one or more family members or other individuals receive payments for a defined period (life or a fixed term of years). The remaining assets pass to charity at the end of that period. The use of a CRT sometimes produces a win/win result generating more after tax cash to the family while also providing substantial benefits to charity. The only loser is the IRS, primarily because the retirement benefits are not subject to income tax when they are paid to the CRT.

In planning for bequests of an IRA or other retirement account directly to charity or into a CRT, the owner should remember that he or she must take required minimum distributions beginning at 70½. This may reduce the amount that was expected to be in the account. To address that, the owner's estate plan could include a contingent make-up bequest (for example, "I give to Alma Mater College the sum of one hundred thousand dollars, reduced, but not below zero, by any amounts received from any IRA of mine at my death").

New Law on IRA "Rollovers" Leads to Confusion

A surviving spouse who inherits a 401(k) plan has the right to roll over the assets of that plan to his or her own IRA. The benefit of a spousal rollover is that the spouse can defer commencing distributions until reaching the age of 70½; and the spouse then also can designate his or her own beneficiaries. When those beneficiaries inherit the IRA after the spouse's death, each can stretch out the IRA distributions over his or her life expectancy. Until recently, a nonspouse beneficiary of a 401(k) plan in most cases did not have a similar right to take payments over his or her life expectancy. Under the Pension Protection Act, nonspouse beneficiaries are given some relief. However, the relief has been widely misunderstood because of the manner in which the Act, and then the press, identified it.

The new provision bears the following title: "Allow Rollovers By Nonspouse Beneficiaries of Certain Retirement Plan Distributions". Commentators have been using the "rollover" terminology to describe this provision, creating the misleading impression that a nonspouse beneficiary of a 401(k) plan now has the same rollover rights as a spouse.

In fact, for distributions occurring after December 31, 2006, the Act only permits a nonspouse beneficiary to transfer his or her share of an inherited 401(k) plan to an inherited IRA account in his or her name. This is a valuable option for a beneficiary of a 401(k) plan because it will allow the beneficiary to defer income tax by stretching distributions from the 401(k) plan over his or her life expectancy. In addition, the beneficiary often will enjoy more investment control over the inherited IRA account than is allowed if the assets remain in the 401(k) plan. For multiple beneficiaries of a 401(k) plan, the new provision also affords each beneficiary an opportunity to pursue his or her own investment strategy, instead of having to accommodate the preferences of all beneficiaries.

But, the new law does not give a nonspouse beneficiary the more generous rollover right of a spouse. The nonspouse beneficiary must begin taking distributions from an inherited IRA by December 31 of the year following the year of the participant decedent's death (unlike a spouse who can defer till the spouse reaches age 70½). And, if the nonspouse beneficiary dies before withdrawing all the funds, the next beneficiaries of the IRA must continue to receive distributions over the nonspouse beneficiary's life expectancy, not over life expectancies of the next beneficiaries. A nonspouse beneficiary must be careful to effect the "rollover" via a trustee-to-trustee transfer. This differs from the spousal "rollover", whereby a surviving spouse may receive a distribution from a decedent's 401(k) in a form of a check and then deposit that check in his or her own IRA.

In short, the lawmakers enacted a helpful new provision with an unfortunate name. It is up to the taxpayers, with the help of their advisors, to look behind the label.

Changes in Rules Pertaining to Donor Advised Funds

In recent years, donor advised funds have become a popular technique for making charitable gifts. Donor advised funds combine the flexibility and control of a private foundation with the tax advantages and hassle-free process of contributing to a public charity. A donor advised fund is a separate fund held by a public charity (the "sponsoring organization") to which a donor makes one or more contributions. The donor retains the continuing right to make recommendations of charitable beneficiaries of the fund. The recommendations must be non-binding, but in practice they virtually always are honored. Typically, donor advised funds are sponsored by community foundations, but a number of financial institutions have also created charitable corporations that offer donor advised funds. Until recently, there were no provisions specifically directed to donor advised funds; however, the Pension Protection Act includes new rules that regulate donor advised funds in several respects.

Among the new provisions that now apply to donor advised funds are the following:

- In addition to existing deduction requirements that require receipts for charitable gifts, a donor must obtain from the sponsoring organization a contemporaneous written acknowledgment stating that the sponsoring organization has exclusive legal control over the assets contributed to the donor advised fund.

- The types of assets that can be held by a donor advised fund have been limited. Donor advised funds are now subject to the same excess business holdings rules that apply to private foundations. This precludes donor advised funds from holding more than de minimis positions in closely held entities for any length of time.

- Any payments that benefit the donor or a related person will generate severe excise tax penalties payable by the donor or related person.

- Certain distributions that a public charity can make (e.g., an educational grant to an individual) are either prohibited or subject to significant additional reporting requirements.

- Contributions to donor advised funds at certain types of sponsoring organizations will not be eligible for a charitable deduction. This applies only to a narrow category of public charities known as Type III supporting organizations.

In addition, the Act imposes new reporting requirements on the organizations that sponsor donor advised funds. The Act's provisions reflect a heightened interest by the IRS in regulating this increasingly popular technique. However, the rules should not impact most people who use donor advised funds for straight-forward charitable giving.

New Laws Regarding Disposition of Remains

Recent acts in New York and Illinois allow a person to make a written designation of an agent to make decisions regarding the disposition of the person's remains upon death. In the absence of the written designation, the law provides for a succession of family members to make these decisions. In that regard, the written designation is especially important in situations where the existing law otherwise may provide no right or equal right to preferred decision-makers. The new laws may be particularly welcome for families with same-sex couples, single children of divorced parents, second marriages and separated couples. The acts also allow a person to express his or her special directions regarding disposition of the person's remains. You may wish to discuss the new acts with your Schiff Hardin attorney to determine if a written designation should be part of your estate plan.

Don't Take it to the Grave

While it is prudent to secure the passwords to your email and other on-line accounts during life, it makes sense to preserve access to the passwords for your executor, your attorney-in-fact or other confidant in the event of your death or incapacity. Your on-line contacts (e-mail address book) will enable your executor to alert the necessary people about your death, and other on-line accounts may provide details about your assets, which your executor must gather at your death. If you wish we can maintain a confidential list of passwords, to be opened only in the event of your death.

It also makes sense to plan for the disposition of your on-line property, including music downloads and photo storage sites. To prevent any difficulties for your beneficiaries, you may wish to dispose of these accounts in a Will or Trust.

IRS Provides Good News for Real Estate Investors

This past June, the IRS released guidance regarding the ability to defer estate taxes on real estate interests. If your assets are heavily concentrated in real estate, you may wish to speak with your Schiff Hardin attorney to review the structure and operation of those investments in order to determine if they will qualify for this treatment. Schiff Hardin has worked with several ownership structures designed to help position estates with real estate interests for qualification for installment payment treatment.

Planning Tidbits

The annual gift tax exclusion for 2007 is $12,000 (same as 2006)

The federal estate tax and generation-skipping transfer tax exclusion for 2007 are $2 million (same as 2006) — but the gift tax exclusion is still limited to $1 million.

The Florida Intangible Tax was repealed effective January 1, 2007

Have you reviewed your estate plan? Recent changes in the tax laws, and changes in family or financial circumstances, may necessitate changes. Have you coordinated your retirement and insurance designations with your estate plan?

Tax Matters: To the extent this newsletter concerns tax matters, it is not intended or written to be used, and cannot be used by a taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under law.

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