HOFFMAN SABBAN & WATENMAKER

LAWYERS

Year 2000 Issue: Estate Tax Repeal or Reduction

For many years, Hoffman, Sabban & Watenmaker has provided to its clients and friends an update regarding important changes in the law which occurred in the past year. This year, we have decided that there is only one subject which we will discuss, because of its overriding importance to many of our clients: The prospect for repeal of the estate, gift and generation-skipping transfer tax laws (the "transfer taxes").

During 2000, Congress passed a bill to repeal these taxes at the end of a 10-year phaseout period. The bill was vetoed by President Clinton, but there were insufficient votes in the Senate to override the veto. The Democrats offered a substitute bill, which would have substantially increased the exemption from estate and gift taxes, but the Republicans rejected any bill which would not eventually lead to repeal.

It seems clear to us that something will happen in the near future to lessen the impact of the transfer taxes, but we cannot be certain what shape that bill will take. Even if a bill is adopted to repeal the transfer taxes over 10 years, it is possible that a subsequent Democratic administration would stop the phaseout and reinstate the transfer taxes.

The purpose of this letter is threefold:

1. We will explain the 2000 Republican and Democratic bills, since the final result in 2001 will likely bear some resemblance to these bills.

2. We will discuss the strategies that should be adopted during this period of uncertainty, and over any phaseout period if the transfer taxes are repealed with a delayed effective date.

3. We will discuss the non-tax reasons why people may still want to use many of the strategies which we now employ in estate planning.

I. <u>The Reduction Plans</u>.

A. <u>Current Law</u>.

Currently, all estate and gift tax rates range from 18% to 55%, with the maximum rate applicable above $3,000,000; but the "unified credit" against those taxes effectively eliminates the taxes on the portion of the tax from 18% to 34%. This credit is comparable to an exemption of $675,000, based on the lowest rates. The exemption is scheduled to increase to $1,000,000 by 2006. The exemption is increased to $1,300,000 if an estate includes active business assets amounting to over 50% of the estate. There is a 5% additional tax (increasing the maximum tax to 60%) on the portion of the estate between $10,000,000 and $17,184,000.

There is a flat 55% generation-skipping transfer tax ("GST") (which is imposed ***in addition to*** the estate and gift tax) on transfers to a grandchild (or a person deemed to be in that generation, such as a grandniece or grandnephew) or to any unrelated person more than 37½ years younger than the transferor; but there is currently a $1,030,000 exemption from the tax.

When a person dies, the income tax basis of all of the decedent's assets (other than income items, such as IRA and pension benefits, called "IRD" items) is changed to the value of the assets, thus effectively wiping out all accrued but unrealized capital gains and losses. If an asset is held as community property, the gains and losses on both spouses' interests are eliminated when either spouse dies. This is referred to as the "stepped-up basis." B. The Republican Plan.

The Republican plan would immediately reduce the maximum tax rate on estates and gifts to 50%, and eliminate the 5% additional tax on estates over $10,000,000. It would reduce the remaining rates (which would range from 18% to 50%) by from 1% to 2% each year, but with the lowest rate not being reduced below the lowest income tax rate (currently 15%). Thus, the maximum rate would drop to 49% in 2003 and thereafter gradually drop to 40½% by 2009. The transfer taxes would be eliminated in 2010.

There would be no increase in the exemptions during the phaseout period. However, the exemption amount would be converted from a credit (equal to the tax on $675,000) to a deduction (of $675,000). In this context, a deduction is more valuable because taxes are reduced at the highest, instead of the lowest, brackets.

In 2010, the stepped-up basis is eliminated, with two exceptions. First, assets (other than IRD items) with a net equity of $3,000,000 passing to a surviving spouse will get a stepped-up basis. Second, assets (other than IRD items) with a net equity of $1,300,000 passing to anyone will get a stepped-up basis. However, the special advantage for community property assets will be lost.

Certain relief provisions will be adopted with respect to the generation-skipping transfer tax to cover the next 10 years. Other provisions offer relief if the GST exemption was not properly claimed in past years. C. The Democratic Plan.

Under the Democratic plan, estate tax rates would be reduced immediately by a factor of 20%. Therefore, the maximum rate would fall to 44% (55% - 11%). Different versions of the bills called for an increase in the exemption to $1,000,000 or $1,100,000 immediately, with an eventual increase in 2006 to $1,200,000 or $2,000,000. The exemption for closely-held businesses would be immediately increased to $2,000,000 per spouse ($4,000,000 per couple). Thus, compared to the Republican plan, this plan would provide greater immediate benefits for all taxable estates, but eventually it would provide lesser benefits for larger estates.

The Democratic plan would eliminate the use of discounts for estate and gift tax valuations in some cases. No discounts would be allowed if a family controlled a business, and no discounts would be allowed for non-business assets (such as securities). A few other tax increases would be included, such as changing the credit for state death taxes to a deduction. II. Strategies for the Near Future.

Since transfer taxes likely will be reduced soon, you may want to avoid transfers that give rise to gift tax until changes are made. But, if your assets exceed $675,000, and you can afford to part with assets, the following non-taxable gifts may still make sense: Gifts of annual exclusion amounts ($10,000 per recipient per year), and $675,000 over a lifetime. That is because if estate taxes are not repealed (or if a bill to repeal the taxes is adopted, but a later administration revokes the repeal), then income and growth on the assets previously given away will avoid transfer tax.

If you make gifts, then gifts of assets with tax bases which are substantially lower than current value are less desirable, since under both the Republican and Democratic plans, there will still be some step-up in basis for those low-basis assets.

There is no reason to believe that it will be necessary to immediately revise your estate plan, no matter what type of <u>reduction</u> plan may be adopted. The estate plans drafted by our firm almost always include provisions designed to maximize the transfer tax benefits, regardless of changes in the law. If an estate tax <u>repeal</u> bill is adopted, then changes may have to be considered before the repeal is fully effective (most likely in 10 years). III. <u>What Impact Would Repeal Have on Your Plan</u>?

If transfer taxes are eventually repealed under a bill like the Republican plan, then there are several considerations that will have to be addressed.

The repeal of transfer taxes will <u>not</u> do the following things, and trusts are still valuable tools to accomplish the following objectives:

- ***Eliminate the public nature and delays of probate administration and the need to plan for incapacity.*** People will still want to consider using a living trust to avoid probate or conservatorship proceedings, and they will still need to have Durable Powers of Attorney.
- ***Eliminate the need to plan for business succession.*** For example, if you have a business where some children are involved in the business while others are not, you must still plan to achieve a smooth transition of control, and devise a plan to accommodate the interests of all the children.
- ***Ensure that your spouse can benefit from your assets but that on your spouse's death the assets will go to your descendants.*** If this is a concern, you will want to leave your assets in trust for your spouse instead of leaving the assets outright to your spouse.
- ***Protect your children or grandchildren from financial inexperience.*** If your children or grandchildren are young, or financially irresponsible, then you will still want to set up a trust and name a Trustee to manage assets for them.
- ***Protect your beneficiaries from creditors.*** A "spendthrift trust" can provide your spouse or descendants with financial benefits from a fund that can't be reached by their creditors.
- ***Help ensure that inherited assets remain the separate property of beneficiaries.*** A trust is a good vehicle for segregating these assets from assets of a beneficiary's marriage, so that inherited assets do not become community property owned one-half by the beneficiary's spouse.
- ***Protect against a loss of governmental benefits to which a beneficiary is entitled.*** If a beneficiary is developmentally disabled or receives government assistance (such as SSI and MediCal), you may want to set up a Special Needs Trust to avoid a loss of benefits.

The repeal of transfer taxes will do the following things:

- ***Allow greater flexibility in estate plans.*** Currently, in order to obtain an estate tax marital deduction, you must either leave assets outright to your spouse, or to a trust giving your spouse all of the trust's income for life. If the estate tax is repealed, you could, for example, provide that assets will be held for the benefit of both your spouse and your descendants in a single trust. You could also provide that your spouse's right to benefit would terminate on the happening of certain events, such as your spouse's remarriage.

  Some married clients have provided in their estate plans for the establishment of trusts solely for the purpose of avoiding estate taxes on the surviving spouse's death. Other people have provided in their estate plans for the establishment of generation-skipping trusts for their children solely to avoid transfer taxes when their children die.

  If, in the absence of transfer taxes, you would leave your assets outright to your spouse or children, and your plan now provides for a trust for them, then you might want to consider adding a provision to your estate plan that would direct that the trusts terminate at the request of the current beneficiary at any time following the repeal of transfer taxes.

- ***Make it a good idea to review your current life insurance plan.*** You will still want to maintain life insurance for a variety of reasons, for example, to pay the income taxes that may be imposed due to a partial loss of a stepped-up basis under the Republican plan. You may still need insurance to provide income to your family following your death, or to fund the purchase of a partner's or fellow shareholder's interest in a business. Insurance proceeds may allow you to equalize gifts between children (for example, if you leave a family business to one child and don't have enough other assets to leave an equal amount to another child). Also, if you have purchased cash value insurance, it may be economically advantageous to retain the insurance, since the cash values will continue to build up on a tax-deferred (and, if the policy is retained until death, an income tax-free) basis.

- ***Perhaps prompt you to rethink plans which leave assets to charity.*** With estate taxes as high as 60%, and combined income and estate taxes on retirement plan benefits as high as 80%, many people have planned to leave substantial portions of their estates to charity (figuring that it was better to leave 100% to a family charitable foundation than as little as 20% to family members). If transfer taxes are substantially reduced or eliminated, these people may want to consider leaving more to members of their family and less to charity. On the other hand, some people may figure that if their family will receive more as a result of the repeal of transfer taxes, they can leave even more to charity without reducing the amount their family will receive.

- ***Place greater importance on income tax planning.*** In particular, if only a portion of a person's assets will qualify for a stepped-up basis at death, plans will have to be carefully examined to determine how to best take advantage of the step-up. Lifetime gifts (which could then be made without transfer tax) may allow income to be taxed to a child at lower income tax brackets than the parent's income tax brackets.

IV. Conclusion.

It will be necessary for you to review your estate plan and update it to take changes in the law into account. As always, we will endeavor to keep you apprised of changes as they occur.