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Personal Planning Strategies

A report for clients and friends of the firm

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What if the Federal Estate Tax Is Repealed?

Introduction

Since the 2004 elections, there has been much discussion about the continued vitality of the Federal estate tax (or, as its opponents refer to it, the "death tax"). President Bush is in favor of its permanent repeal. As a result, a number of bills have been introduced in Congress to modify the Federal estate tax system. Some provide for permanent repeal, while others would retain the tax, but substantially increase the amount that is exempt. On April 14, 2005, by a vote of 272-162, the House of Representatives approved the Permanent Estate Tax Repeal Bill of 2005, which, not surprisingly, given the bill's name, provides for permanent repeal of the Federal estate tax system.

At this point, it is uncertain how the Senate will respond, though a compromise effort is underway. We will keep you informed of future developments.

Current Federal Estate Tax Law

As a result of tax law changes enacted in 2001, the credit equivalent amount (i.e., the amount that can be left to anyone free of Federal estate tax) is now \$1,500,000. That amount is scheduled to increase to \$2,000,000 in 2006 and to \$3,500,000 in 2009. In 2010, the estate tax is to be repealed and then will be re-established in 2011 as it was before 2002. That means that, in 2011, the credit equivalent amount will return to the amount it would have been before the enactment of the 2001 tax law, namely \$1,000,000, and the top tax bracket, having been reduced to 46% by 2009, will increase again to 55%.

The 2001 tax law changes also provided that the Federal generation skipping transfer ("GST") tax exemption (i.e., the amount that can be left to grandchildren or more remote descendants without incurring a GST tax) would increase to $1,500,000 this year. As with the credit equivalent amount, the GST tax exemption is scheduled to increase to $2,000,000 in 2006 and to $3,500,000 in 2009.

As with the estate tax, in 2010, the GST tax is to be repealed and will be re-established in 2011 as it was before 2002. That means that in 2011, the GST tax exemption will return to the amount it would have been before the enactment of the 2001 tax law, namely, $1,000,000 with inflationary adjustments and the GST tax rate, having been reduced to 46% by 2009, will increase again to 55%.

Repeal of the Federal Estate Tax

It is virtually impossible to determine the effect that permanent repeal of the Federal estate tax would have on other provisions of the tax law. However, since current law provides that the Federal estate tax will be repealed for persons dying in 2010, it does provide us with a glimpse of some of the issues that may arise in the wake of ongoing tax reform efforts.

New Basis Rules

Under the current Federal estate tax system, for income tax purposes, all property received by inheritance generally is entitled to a "step-up" in basis equal to its fair market value as of the decedent's death. Thus, although a decedent's property may be subject to estate tax, when the beneficiary ultimately sells it, there only will be capital gain to the extent that the sale price exceeds the property's fair market value at the time of the decedent's death.

If someone should die in 2010, when there will be no Federal estate tax, Section 1022 of the Internal Revenue Code provides for a modified step-up in basis rule. Specifically, Section 1022 provides that the Executor or Personal Representative of a decedent's estate may elect to step-up the basis of the decedent's property by up to $1.3 million, regardless of who receives it.

In addition, Section 1022 provides that the basis of property transferred to a surviving spouse can be increased by an <u>additional</u> $3 million, permitting a total basis step-up for property transferred to a surviving spouse of $4.3 million.

The Executors or Personal Representatives of a decedent's estate would have the responsibility to determine which assets should receive the step-up in basis. Thus, it is important that your current estate planning documents give your Executors or Personal Representatives sufficient flexibility to utilize the modified step-up in basis rules in a tax efficient manner.

With regard to any property received by a beneficiary that is not entitled to the step-up in basis (i.e., property in excess of $1.3 million in value, or $4.3 million in value, if left entirely to a surviving spouse), the income tax basis would be the decedent's original basis, which normally is the decedent's original purchase price.

The Executors or Personal Representatives of a decedent's estate also would have the responsibility to determine this carryover basis for the property in excess of the threshold amount. It may be difficult to determine the decedent's original basis. If the Executors or Personal Representatives are unable to establish the decedent's original basis, the Internal Revenue Service may take the position that the beneficiary's basis is zero.

When the beneficiary subsequently sells property without a step-up in basis, there will be a capital gain to the extent that the sale price exceeds the decedent's original basis.

Gift Taxes

Neither the tax law changes enacted in 2001 nor any repeal or reform legislation now on the table repeals the Federal gift tax.

During 2010, the year in which the Federal estate tax is scheduled for repeal, gifts in excess of a taxpayer's lifetime exemption of $1 million (which was not scheduled to increase over what it was in 2001) will be subject to the Federal gift tax at a flat rate of 35% (the top Federal income tax rate). Of course, gifts to a spouse (or to certain trusts for the benefit of a spouse) will not count toward the $1 million lifetime exemption or be subject to the Federal gift tax. But taxpayers may be less inclined to make gifts to non-spouses, since transfers to non-spouses made at death would not be subject to tax in light of repeal of the Federal estate tax.

In addition, beginning in 2010, any gift to a trust would be taxable unless the trust is treated as wholly owned by the donor or the donor's spouse under provisions of the Internal Revenue Code known as the "grantor trust" rules. These rules cause trust income to be taxed as part of the creator's income rather than as part of the trust's income.

Continuation of the Federal gift tax will significantly affect the future of estate planning and also will require a rethinking and possible revision of existing estate plans.

State Estate Taxes

Even if the Federal estate tax is repealed, it is likely that many states will continue to impose their own estate tax.

For taxpayers who were New York residents, the state credit equivalent amount remains at $1 million, meaning that property passing to a non-spouse in excess of $1 million is subject to New York estate tax. In New Jersey, the credit equivalent amount is $675,000, meaning that property passing to a non-spouse in excess of $675,000 is subject to New Jersey estate tax.

State estate taxes can be significant (for example, the top New York estate tax rate is now 16%). Some states, however, such as Florida and California, do not impose a state estate tax.

For our clients who reside in states with an estate tax, regardless of whether there is a Federal estate tax, it will be important to implement an estate plan that minimizes the payment of state estate taxes. Similarly, for our clients who are thinking of moving to another state or who recently have done so, these state estate tax issues must be considered carefully.

The administration of a decedent's estate in states that impose an estate tax may become more complicated in light of Federal estate tax repeal than under current law. Executors or Personal Representatives would be responsible for the determinations described above and for preparing and filing state estate tax returns in the appropriate jurisdictions. Given that states with a state estate tax retain their current basis step-up rule, it is possible that property will have one basis for Federal income tax purposes and a different basis for state income tax purposes.

Revising Your Estate Plan

Under the current Federal estate tax system, many estate plans take full advantage of the marital deduction on the death of the first spouse in order to defer payment of Federal estate taxes until the death of the surviving spouse. These plans typically provide that the surviving spouse receives the bulk of the first spouse's estate (either outright or in trust) and, upon the survivor's death, the balance, after the payment of Federal estate taxes, will pass to children (or grandchildren).

However, if the Federal estate tax is repealed, you may want to make provisions for your children (or grandchildren) on the death of the first spouse, since there no longer will be a need for tax deferral. We have begun to draft contingency provisions in the event that the Federal estate tax is repealed that provide that all or a percentage of the estate will be held in a trust for the benefit both of a surviving spouse <u>and</u> for descendants (a "sprinkle trust"). Since the Federal gift tax remains in effect, if a surviving spouse (as a trustee of that spouse's trust, together with others) were to make lifetime transfers to children or grandchildren, it would provide a way to advance funds to descendants without triggering a gift tax. In this manner, distributions to children or grandchildren would not have to wait until the death of a surviving spouse.

Conclusion

In light of uncertainty surrounding the future of the Federal estate tax, we encourage our clients to review the provisions of their current estate planning documents with their Proskauer Personal Planning attorney and then to discuss with him or her how repeal of the Federal estate tax may affect their plans and to determine what changes, if any, should be made.

Can You Amend an Irrevocable Trust?

When a trust is established to receive a gift, the trust must be irrevocable if the gift is to be considered complete. That means that the trust creator not only cannot revoke it, but he or she also cannot revise it later.

Any trust created under his or her will also becomes irrevocable when the trust creator dies.

Unforeseeable events may render faulty what once seemed like a sound dispositive plan. For instance, often trusts end when a beneficiary attains a certain age. However, if the trust beneficiary has creditor, drug, medical or other problems, a distribution of those funds could have disastrous consequences to the beneficiary.

For many years in New York, an otherwise irrevocable trust could only be amended with the consent of the trust creator and all of the beneficiaries of the trust. If the trust creator had died or if there were minor beneficiaries of the trust, there was no way to amend the trust.

A very flexible provision of New York law now makes it possible for the trustee, without the consent of the beneficiaries or trust creator, to change the terms of a trust by transferring the old trust property to a new trust. New York Estates, Powers and Trusts Law Section 10-6.6(b) allows that if (1) the trust is located in New York and governed by New York law, (2) the trustee has broad discretion to invade principal for the trust beneficiary (deemed a power of appointment under the statute), (3) the trustee's exercise of that discretion does not reduce the beneficiary's fixed income rights, if there are any, and (4) the new trust is for the benefit of the current beneficiary and whoever else may be a "proper object" of the trustee's power to make distributions.

One important limitation applies if there are restrictions to the trustee's authority to make principal distributions to the beneficiary. If principal can be invaded only for the health, education, maintenance and support of the beneficiary, for example, the statute is inapplicable.

The statute does not require court approval of the trustee's exercise of discretion to transfer trust assets to a new trust. It merely requires that all of the interested parties receive notice of the transfer and that copies of the related papers be filed in, but not reviewed by, the court. As a result, even the assets in testamentary trusts, which are normally subject to close court scrutiny and intervention, may be transferred to a new trust without court authorization.

We have used the statute with increasing frequency. In one case, a trust was created for an infant who, later, was discovered to be disabled and applied for and was receiving government benefits. The trust was scheduled to terminate when she turned thirty. Had the trust terminated then, all of the assets would have been subject to Medicaid reimbursement. Instead, the assets were transferred to a new trust that is available to supplement government benefits, for which she is still qualified, and anything remaining in it at her death will pass to other family members.

We also have consolidated into a single trust, for the sake of greater efficiency and lower administrative cost, several continuing trusts that were created under different instruments for one beneficiary.

Only Alaska, Delaware and Tennessee now have statutes similar to New York's. Florida has two separate trust reformation statutes – one that requires court approval and one that does not.

In Florida, if the trust creator is deceased an otherwise irrevocable trust could be amended with the consent of the trustees and all of the beneficiaries of the trust without court approval. If the creator of the trust is alive, the creator of the trust, the trustees and all beneficiaries of the trust can consent to amend a trust. In other situations, the court can be asked to approve of an amendment to a trust.

If your trust is not governed by the law of one of those states, it may, nonetheless, include provisions that "mirror" the statute and enable the trustee to reach the same result.

No matter the source of a trustee's authority to, in effect, amend an irrevocable trust, care must be taken to ensure that any proposed trust-to-trust transfer does not trigger adverse generation-skipping transfer tax, estate tax, gift tax or income tax consequences.

If you would like to learn more about how these expansive trustee powers might be used, a member of the Personal Planning Department will be happy to assist you.

Prenuptial Agreements

Prenuptial agreements are becoming more commonplace as more couples enter into second marriages or enter into first marriages with assets that require special protection.

All marriages end — either by divorce or by death of a spouse — and a prenuptial agreement can be a valuable way to protect not only yourself, but also children from a previous marriage or your interest in a family business. Even though it may be difficult to raise the issue of a prenuptial agreement, doing so can minimize the potential problems when a marriage ends and can be a valuable way to settle contentious financial issues.

What?

A prenuptial agreement is a binding legal contract signed by two people who are planning to marry that details how property will be distributed in the event of divorce and/or death. It allows the couple to vary spousal rights set by law. In this regard, it is important to remember that laws concerning divorce or inheritance are state-specific. Though there are many similarities, no two are exactly the same.

Why?

A prenuptial agreement is one method of minimizing the financial and emotional impact of a divorce. New York law, for example, provides for the "equitable distribution" of marital property on divorce. That means that all property acquired by either or both parties during the marriage, regardless of how title is held, other than by gift or inheritance from third parties, is divisible. Equitable distribution does not mean that all marital property is evenly split. Rather, a court partitioning material property will take into consideration many factors, such as the duration of the marriage, the income of each party and whether the parent having custody of any children of the marriage should continue to occupy the marital residence.

A prenuptial agreement can preserve the separate character of assets you acquired before marriage and can protect your rights in assets acquired while you are married by including terms that address specifically how they are to be divided. In a second marriage, a prenuptial agreement can protect property intended for children from the first marriage.

The agreement also can include terms relating to spousal support, maintenance or alimony in the event of a divorce.

If you've started your own business, a prenuptial agreement can help you preserve what you've worked hard to build. Or if you have substantial interests in and are involved in a family business, a prenuptial agreement can ensure that your interests in the family business stay within the family. Even if a person currently does not have significant assets, if he or she is expecting an inheritance, a prenuptial agreement can help keep family heirlooms and other assets within the family.

A prenuptial agreement also is a valuable tool for protecting your assets when you die. Most states give a surviving spouse a "right of election" against the deceased spouse's estate. The purpose is to protect the surviving spouse from being disinherited. Therefore, regardless of what one spouse provides in his or her will, if he or she is the first to die, the surviving spouse may take a certain percentage of his or her estate.

In many states, a spouse is entitled to a fraction of the other spouse's estate regardless of the terms of his or her will. Very often this requirement can be satisfied by giving the surviving spouse an income interest in a trust that is funded with the required fraction of the first spouse's estate.

However, in some states, like New York, a surviving spouse is entitled to his or her share outright. Accordingly, the surviving spouse then would be free to dispose of it however he or she wishes (including leaving the property to children from the surviving spouse's prior marriage or to a new spouse). In Florida, the statutory elective share percentage is 30% but, unlike New York, certain property held in trust may be applied toward the elective share.

A prenuptial agreement can include a waiver of one's right of election against the other's estate in order to prevent this result. However, the waiver need not prevent either spouse from voluntarily making provisions in his or her will for the other. Additionally, if you are married and die without a will, all or a large percentage of your estate may be left to your surviving spouse under state law. A prenuptial agreement can include a waiver of one's right to part or all of the other's intestate estate. With both of these waivers in an agreement, you can protect assets that, for example, you intend for your children from a previous marriage.

Requirements for a Valid Prenuptial Agreement

Although requirements for prenuptial agreements may vary from state to state, there are a few general rules in this area:

1. There must be complete financial disclosure by both parties. Lack of full disclosure of assets, liabilities and income of either party may support a challenge by the other to the validity of a prenuptial agreement. A claim could be made that one would not have agreed to the terms settled upon, if certain financial information had been revealed earlier.

2. The agreement must be entered into freely by both sides. Even though the failure of one party to be separately represented does not make a prenuptial agreement invalid, it would avoid the appearance of impropriety, if each party had an attorney of his or her own choosing.

3. The agreement must be properly signed and acknowledged. In order for an agreement to be valid, for example, New York law requires that it be signed by each party before a Notary Public. That requirement is strictly enforced. An agreement that fails to meet it generally will be invalid. In Florida, if the prenuptial agreement contains provisions effective in the event of death, the agreement must be executed in conformity with the requirements for a will, i.e., it must be signed in the presence of two attesting witnesses.

4. The agreement should not be signed immediately before the wedding ceremony. Both parties should have sufficient time to review and consider the terms of a prenuptial agreement. If it is presented for signature immediately before the wedding ceremony, one party could claim that he or she signed it under duress (because the invitations already had been mailed, the caterers booked, and so on). An agreement might be invalid if one party had insufficient time for review and to obtain independent counsel.

5. The agreement should be fair (when entered into and later, if relied upon). It should not appear that one party is taking advantage of the other, and the terms of the agreement should not be unreasonable based on the facts and circumstances of each couple's particular situation. In Florida, there is no requirement that the prenuptial agreement be "fair." So long as there has been full financial disclosure and the agreement is not the product of fraud, deceit, duress, coercion, misrepresentation or overreaching, the agreement is valid even if the provisions are not fair to the poorer spouse. The agreement must not be "at the 11th hour" – there must be a reasonable time between the signing and the wedding. A Florida District Court upheld a prenuptial agreement in 2004 that it termed "patently unfair and

unreasonable" to the poorer spouse because it was signed with full financial disclosure a full two weeks prior to the wedding.

Discuss Prenuptial Agreements With Your Single Adult Children

If your children are in their twenties, now is a good time to discuss with them the benefits of having a prenuptial agreement, even if they are not presently involved in a serious relationship. It has been our experience that if this topic is discussed with a child before he or she is in a serious relationship, it decreases the risk of your child thinking that you do not "approve" of a particular person and makes your child aware that this is something he or she will want to raise with Mr. or Ms. "Right" when that person comes along.

Conclusion

Although asking your prospective spouse to sign a prenuptial agreement may be difficult, it is a document that can act as a safeguard for both parties. The terms of that agreement also should be coordinated with the rest of your estate plan, not only with the terms of your will, but also, for example, with the terms of any pertinent trusts, insurance policies and retirement plan beneficiary designations.

Connecticut Restores Estate Tax and Revises Gift Tax

As we go to press, the Connecticut legislature has approved a bill to enact an estate tax which is retroactive to January 1, 2005. The Connecticut estate tax will apply to estates in excess of $2,000,000. The rates start at 5.085% and have a top rate of 16% for estates in excess of $10,100,000. An estate tax return is required to be filed nine months after the decedent's date of death. A return is required to be filed by all decedents regardless of whether the estate is taxable. Nonresident estates are subject to Connecticut estate tax if they own real or tangible personal property located in Connecticut and the size of the gross estate is in excess of $2,000,000.

Connecticut has also repealed their gift tax as of January 1, 2005 but replaced it with a new gift tax regime. Under the new gift tax, each individual is given a $2,000,000 lifetime exemption for Connecticut Taxable Gifts. At death, these gifts are brought back into a decedent's estate and a credit is allowed for gift taxes paid.

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Personal Planning Newsletter

Proskauer's Personal Planning Department includes attorneys with significant and diverse personal planning experiences. The following individuals serve as contact persons and would welcome any questions you might have.

Boca Raton

Albert W. Gortz
561.995.4700 — agortz@proskauer.com

Robert Jacobowitz
561.995.4742 — rjacobowitz@proskauer.com

George D. Karibjanian
561.995.4780 — gkaribjanian@proskauer.com

New York

Ilise S. Alba
212.969.3528 — ialba@proskauer.com

Jordana T. Berman
212.969.3749 — jberman@proskauer.com

Henry J. Leibowitz
212.969.3602 — hleibowitz@proskauer.com

John F. Pokorny
212.969.3614 — jpokorny@proskauer.com

Lawrence J. Rothenberg
212.969.3615 — lrothenberg@proskauer.com

Lisa M. Stern
212.969.3968 — lstern@proskauer.com

Philip M. Susswein
212.969.3625 — psusswein@proskauer.com

Ivan Taback
212.969.3662 — itaback@proskauer.com

Jane C. Wang
212.969.3673 — jwang@proskauer.com

Jay D. Waxenberg
212.969.3606 — jwaxenberg@proskauer.com

Los Angeles

Mitchell M. Gaswirth
310.284.5693 — mgaswirth@proskauer.com

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