

KING & SPALDING

CLIENT ALERT

Trusts and Estates: New Tax Act and Other Developments Call for Review of Estate Plans

On June 7, 2001, the President signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. Since we have assisted you with your estate planning in the past, we are writing to discuss some of the implications of this new law, as well as other developments in the law which might affect your estate plan.

While many provisions of the new law do not apply immediately, several significant changes do apply as early as next year. For example, the effective exemption from estate and gift tax increases from \$675,000 to \$1 million in 2002. The estate (but not gift) tax exemption rises again, to \$1.5 million in 2004, \$2 million in 2006 and \$3.5 million in 2009; the gift tax exemption remains at \$1 million going forward. Also in 2002, the highest estate tax and gift tax rate is reduced from 55% to 50%, with modest decreases thereafter to a 45% top rate by 2007. In 2010, a full repeal of the estate tax and generation-skipping transfer ("GST") tax is scheduled, although the gift tax is to remain in place at a rate equal to the highest income tax rate. There are also important changes, which occur in 2010 when the estate tax and GST tax are repealed, in the rules governing the adjusted income tax basis of inherited assets.

The 2001 legislation is scheduled to expire on December 31, 2010, at which time the tax law would return to its state before passage of the act. Therefore, the full tax repeal may only last for one year. The law may be modified in the meantime to make this repeal permanent. More likely, we suspect, the repeal of the estate tax and GST tax may be postponed as the years go by and may never actually take effect. Remember, repeal does not extend to the gift tax in any event, as the law is now written.

Planning in this environment is obviously challenging. We discuss below some of the main issues that need to be considered by many clients.

Formula Wills with Bypass and Marital Shares. A majority of our married clients' Wills leave to a bypass trust the maximum amount that can be sheltered by the estate tax exemption, with the balance of the estate passing to the spouse, either outright or in trust, to qualify for the estate tax marital deduction and eliminate all tax otherwise due at death. The marital deduction only postpones the tax until the surviving spouse's death, however. The bypass trust, in contrast, is designed to avoid estate tax for *both* the person making the Will and his or her spouse. For this reason, a two-share Will format is common, utilizing both (i) a bypass trust intended ultimately for descendants, though it may include the spouse as a beneficiary, and (ii) a share left either outright to the surviving spouse, or to a trust for his or her sole benefit so long as he or she lives.

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Given the increases in the estate tax exemption under the new law, individuals whose Wills take this approach should consider whether the estate division resulting from this formula still strikes the proper balance. For example, a formula that currently has the effect of leaving \$675,000 to the bypass trust, and the balance of the assets to or for the spouse, will -- if no changes are made to the formula -- leave the bypass trust \$1.5 million if death occurs in 2004, and \$3.5 million in 2009. In 2010, some provisions of this kind could leave the **entire** estate to the bypass trust. The increased amount passing to the bypass trust reduces, of course, the share of the estate left to or for the sole benefit of the spouse. This result may be acceptable if the spouse is included among the beneficiaries of the bypass trust. It could be a matter of concern, on the other hand, for persons who have been married more than once, if their Wills create a bypass trust for the sole benefit of children by a previous marriage. Under the circumstances, there will probably be many cases in which people will prefer to impose a cap on the amount passing to the bypass trust, in order to assure that the surviving spouse receives at least a minimum amount or percentage of the estate.

Generation-Skipping Transfer Tax Exemption. Many Wills contain formula provisions allocating the amount of the GST tax exemption to a trust that continues for children, grandchildren and more remote descendants, while leaving the balance of the estate to the children alone. The GST tax exemption is currently \$1,060,000. Under the new act, however, it will increase to \$1.5 million in 2004, \$2 million in 2006 and \$3.5 million in 2009. When the GST tax is repealed in 2010, a formula provision may become difficult to interpret and may have the effect of allocating all of the assets to the long-term trust for children, grandchildren and more remote descendants, and eliminating the intended trust-free provisions for children. Clients whose Wills contain a formula geared to the available GST tax exemption need to consider whether they want to make changes to assure that a minimum amount or percentage of the estate goes outright to their children.

Additionally, the new law provides that GST exemption will automatically be allocated to gifts to certain trusts, unless the taxpayer files a gift tax return to reverse that result. Accordingly, any existing trusts to which gifts are made (including the payment of any premiums for life insurance held by such a trust) in or after 2001 should be reviewed to determine whether the automatic allocation will apply, so that unintended waste of GST exemption can be avoided.

Possible Repeal of the Estate Tax. While total repeal of the estate and GST taxes still seems a remote possibility, clients should consider whether they would dispose of their property differently in a tax-free environment. Many of the nontax reasons for creating vehicles such as trusts and family limited partnerships -- such as protecting assets from a beneficiary's inexperience or adverse developments such as divorce -- may become all the more important in families' planning for the disposition of their property.

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Often the marital deduction bequest under a Will is left to a trust for the exclusive benefit of the surviving spouse during his or her lifetime, but with Will provisions that direct where the trust property goes after the survivor's death. In these situations, even if the person who made the Will dies before 2010 so that an estate tax is still in effect, his or her spouse may die many years later, in an estate tax free environment. Therefore, some changes should be considered now in the provisions that dispose of the marital trust property at the surviving spouse's death.

Other Tax Issues. There are other issues, and valuable planning opportunities, that individuals need to consider under the new tax act. For instance, even persons who have already exhausted their gift tax exemptions will have the opportunity to make additional gifts, without a gift tax, when the exemption increases to \$1 million next year.

Non-tax Issues. In addition to the issues and opportunities raised by the new tax act, there have been other developments in the law that may warrant a review of your estate plan. For example, a local Probate Court has taken the view that terms such as "children" or "descendants," when used in a Will, may be construed to include persons who were born out of wedlock unless the Will specifically states otherwise. This is a departure from traditional Georgia case law. Therefore, it may now be advisable to be explicit on this point even though that was not necessary in the past. Similarly, changes in your personal circumstances could affect the appropriateness of your Wills and other arrangements. Therefore, good practice always argues for a review of your estate plan at least every few years.

If you would like for us to review your Will or other estate planning arrangements in light of the matters raised in this Client Alert (or otherwise), please do not hesitate to call. If you have not consulted with one of our Trusts & Estates attorneys recently, you may contact legal assistant Patricia H. Varner at 404-572-2472, to schedule an appointment.