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Personal Planning Strategies

A report for clients and friends of the firm

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Federal Estate, Gift and GST Tax Changes

As we reported in our June 2001 and December 2003 issues, the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") made significant changes to the Federal estate, gift and generation-skipping transfer ("GST") tax laws.

Beginning in 2006:

- The top federal estate and gift tax rates will decrease from 47% to 46%.
- The federal estate and GST tax exemptions will increase from $1.5 million to $2 million.
- The federal gift tax exemption will remain at $1 million.
- The annual gift tax exclusion will increase from $11,000 to $12,000 ($24,000 in the case of a married couple).
- The annual gift tax exclusion increases from $117,000 to $120,000 for gifts made to a non-citizen spouse.

Although the reduced federal estate tax rate and higher exclusion amounts are good news, many states (such as Connecticut, Massachusetts, New Jersey and New York) do not follow the federal changes, resulting in higher combined estate taxes, as discussed later in this issue.

The table that follows summarizes changes in the federal estate, gift and GST taxes from 2006 through 2010, when the estate tax is scheduled for repeal (before being reinstated in 2011) as well as the rates and exemptions that would apply in 2011:

Calendar Year	Top Federal Estate and Gift Tax Rate	Federal Estate Tax Exemption	Federal GST Tax Exemption	Federal Gift Tax Exemption
2006	46%	$2 million	$2 million	$1 million
2007	45%	$2 million	$2 million	$1 million
2008	45%	$2 million	$2 million	$1 million
2009	45%	$3.5 million	$3.5 million	$1 million
2010	Gift Tax Rate Equals Top Individual Income Tax Rate	Estate Tax Repealed	GST Tax Repealed	$1 million
2011	55%	Estate Tax Returns With $1 million Exemption	GST Tax Returns With $1,060,000 Exemption Plus Inflation Adjustment	$1 million

State Estate Tax Changes

Despite the reduction in the maximum federal estate tax rate, some estates (including those in Connecticut, Massachusetts, New Jersey and New York) will have to pay a state estate tax in addition to any federal estate tax. Because of such tax, many individuals have decided to become residents in states which do not impose estate taxes, such as Florida.

Prior to the Act, a credit against federal estate taxes (up to a statutory maximum amount) was allowed for death taxes paid to a state. Most states capped their own estate tax at the maximum federal credit amount. Therefore, paying state estate taxes did not cause an increase in estate taxes, because the federal government gave each estate a credit for taxes paid to the state.

Under the Act, however, the state death tax credit was repealed entirely in 2005 and was replaced by a deduction for state death taxes actually paid.

What this means is that states (such as California and Florida) that follow the federal changes made by the Act will have no estate tax, and, thus, will lose revenue, due to the repeal of the state death tax credit.

Several states concerned with this loss of revenue have "decoupled" from the federal system in order to preserve the tax dollars they would otherwise have lost by the repeal of the state death tax credit. For instance, as shown in the chart below, Massachusetts, New Jersey and New York have "decoupled" from the federal system and impose an estate

State	Top State Estate Tax Rate	Maximum State Exemption for 2006	Maximum Federal Exemption for 2006
California	N/A	N/A	$2,000,000
Florida	N/A	N/A	$2,000,000
Massachusetts	16%	$1,000,000	$2,000,000
New Jersey	16%	$675,000	$2,000,000
New York	16%	$1,000,000	$2,000,000
Connecticut	16%	$2,000,000	$2,000,000

tax calculated with reference to a maximum federal exemption that is lower than the actual maximum federal exemption available that year for federal purposes:

By decoupling from the federal estate tax, New York retained a state estate tax with a top rate of 16%, which New Yorkers must pay in addition to the federal estate tax. As a result, the combined top federal and New York estate tax rate is 54.64% for 2006. This represents a decline from the top combined rate of 55.48% in 2005, but is significantly higher than the top federal rate of 46% as illustrated below:

Year of Death	New York State Estate Tax Rate (allowed as a deduction from Federal estate tax due)	Top Federal Estate Tax Rate	Combined Top Federal and New York State Estate Tax Rate
2006	16%	46%	54.64%

For a New York decedent dying in 2006 with a taxable estate under $2 million, a Federal estate tax return is not required to be filed.

However, a New York estate tax return must be filed and a New York estate tax will be due if the decedent's taxable estate exceeds $1 million.

Likewise, a New Jersey estate tax return must be filed and a New Jersey estate tax will be due for a New Jersey decedent, if his or her taxable estate exceeds $675,000. A Massachusetts estate tax return must be filed and a Massachusetts estate tax will be due for a Massachusetts decedent, if his or her taxable estate exceeds $1 million.

After briefly decoupling from the federal system in 2004, Connecticut eliminated its succession tax and enacted a wholly new estate and gift tax system in 2005. The new law provides for a $2 million combined gift and estate tax exemption amount. At death, the decedent's Connecticut taxable estate consists of the sum of Connecticut taxable gifts made by the decedent during all years beginning on or after January 1, 2005 and the decedent's taxable estate (as determined for federal estate tax purposes). If the decedent's Connecticut taxable estate equals $2 million or less, no tax is due; if, however, the taxable estate exceeds $2 million, tax on the entire amount (including the first $2 million) must be paid. Thus, a decedent with a Connecticut taxable estate of $2,000,000 pays no estate taxes, but a decedent with a Connecticut taxable estate of $2,000,001 must pay tax on all $2,000,001, a state tax bill of $101,740.

As illustrated in the following chart, the estate of a decedent dying in 2006 with a $2 million estate would pay no state estate tax, if he or she were a resident of California, Florida or Connecticut. Nor would the decedent pay any federal estate tax, since the federal estate tax exemption is $2 million.

Year of Death	Value of Gross Estate	Federal Estate Tax	California Estate Tax	Connecticut Estate Tax	Florida Estate Tax
2006	$2,000,000	$0	$0	$0	$0

However, if the decedent were a resident of Massachusetts, New York or New Jersey, his or her estate would have to pay a $99,600 state estate tax (and a Connecticut estate of $2,000,001 would have to pay a $101,740 state estate tax) since those states do not conform to the Federal changes. Therefore, whether or not a state follows the Federal estate tax changes introduced by the Act can affect the total amount of estate taxes due.

Year of Death	Value of Gross Estate	Federal Estate Tax	Massachusetts Estate Tax	New York Estate Tax	New Jersey Estate Tax
2006	$2,000,000	$0	$99,600	$99,600	$99,600

The amount of state estate taxes due becomes substantial in large estates. In 2006, the estate of a decedent with a taxable estate of $15 million will pay federal and state estate taxes totaling $6,998,072 if the decedent were domiciled in Massachusetts, New Jersey or New York and $7,125,468 if the decedent were domiciled in Connecticut, but only $5,980,000 if the decedent were domiciled in California or Florida. Accordingly, individuals with a residence in Connecticut, Massachusetts, New Jersey or New York and a second residence in California or Florida might consider establishing their primary residence in California or Florida.

Federal Gift Tax Returns for 2005

If you or, in certain instances your spouse, made any gifts during 2005, you *may* be required to file a Federal gift tax return for 2005. The requirement that you file a gift tax return does not necessarily mean that must pay gift tax.

Available Gift Tax Exclusions and Exemption

Each year, an individual has a gift tax annual exclusion of up to $11,000 (in 2005) or $12,000 per donee (in 2006 and indexed for inflation thereafter). Spouses may elect to "split" gifts, thereby increasing the gift tax annual exclusion

to $22,000 (in 2005) or $24,000 per donee (in 2006 and indexed for inflation thereafter). In addition to the gift tax annual exclusion, an unlimited gift tax exclusion is available to pay someone's medical or educational expenses. The payment must be made directly to the medical or educational institution providing the service. Each individual also has a lifetime gift tax exemption, which permits tax-free gifts of up to $1,000,000, in the aggregate over and above annual exclusion gifts.

What Types of Gifts Require a Gift Tax Return To Be Filed?

Outright Gifts of Cash or Property (Not in Trust)

If an individual makes gifts of cash or property in an amount that does not exceed the gift tax annual exclusion, he or she is not required to file a gift tax return. If he or she and his or her spouse, together, elect to "split" gifts, both may be required to file gift tax returns under certain circumstances. You should contact your Proskauer Rose personal planning attorney, if you and your spouse plan to "split" gifts.

If an individual makes gifts of cash or property in excess of the gift tax annual exclusion (other than to pay for medical or educational expenses as discussed above) to someone other than his or her spouse, he or she is required to file a gift tax return. The donor's $1,000,000 lifetime gift tax exemption is reduced by the value of the gift, less the $11,000 (or, next year, $12,000) annual gift tax exclusion. If the donor already has used all of his or her $1,000,000 lifetime gift tax exemption, the gift will be subject to tax. Otherwise, no gift tax will be due with the return.

Gifts of Cash or Property in Trust

In general, when an individual makes gifts of cash or property to a trust, he or she is making a gift and a gift tax return must be filed. For example, this rule would apply to Qualified Personal Residence Trusts ("QPRTs"), Grantor Retained Annuity Trusts ("GRATs") and many other types of trusts.

A gift of an insurance policy to a trust constitutes a gift of property based on the approximate value of the policy, not the face amount. Thus, the rules discussed above also apply to gifts of insurance policies.

However, if the gift to the trust's beneficiaries does not exceed $11,000 (or, next year, $12,000) per beneficiary and notices of withdrawal rights (commonly referred to as "Crummey" notices) are properly used, a gift tax return need not be filed.

Charitable Trusts

Gifts made to a charitable remainder trust or a charitable lead trust while the donor is living, require filing a gift tax return.

Generation-Skipping Transfer Tax Issues

If a trust is structured as a generation-skipping transfer ("GST") tax trust, a gift tax return should be filed because a separate GST tax exemption may automatically be allocated to the gift. With respect to transfers to which you don't want your GST tax exemption automatically allocated, you must "opt out" of that allocation on a timely-filed gift tax return. Accordingly, you should contact your Proskauer Rose personal planning attorney to let you know whether you should allocate GST tax exemption on a gift tax return or "opt out" of the automatic allocation rules.

Gifts Between Spouses

If a gift is made from one spouse to the other, a gift tax return is not required, unless the gift is made to a trust (sometimes referred to as an inter-vivos QTIP trust) for the spouse's benefit. In addition, there are special rules that apply when a gift is made to a spouse who is not a United States citizen. You should contact your Proskauer Rose personal planning attorney, if you plan to make such a gift.

When Must a Gift Tax Return be Filed?

Your 2005 gift tax return is due on April 15, 2006, the same date as your 2005 individual income tax return is due. An automatic four-month extension to August 15, 2006 will be available. The extension request can be made either when you apply for the automatic extension for your individual income tax return or it can be made separately on Form 8892. It also is possible to obtain an additional two-month extension from August 15 to October 16, 2006. However, if a gift tax is due for 2005, *the tax must be paid* on April 15, 2006, with the initial extension request.

In most cases, the GST tax exemption (and election to "opt out" of an automatic allocation of GST tax exemption) must be allocated on a timely-filed gift tax return, including extensions actually granted.

Who Should Prepare Your Gift Tax Return?

Most accountants are able to prepare gift tax returns. However, because of the complex rules that apply to the allocation of the GST tax exemption on gift tax returns and the adequate disclosure rules (as discussed below), you should send a copy to your Proskauer Rose personal planning attorney for review before it is filed.

Statute of Limitations

Adequate disclosure of gifts is required in order to commence the gift tax statute of limitations and to provide final-

ity for purposes of determining the value of adjusted taxable gifts (those that are "added back" for estate tax purposes) made in prior years. In essence, a significant amount of information must be disclosed to commence running of the gift tax statute of limitations.

Please call your Proskauer Rose personal planning attorney, if you have any questions regarding your 2005 gift tax return.

Transfer-on-Death Accounts: A New Form of Security Registration for New Yorkers

Starting in 2006, a new law, officially known as the "Transfer-on-Death Security Registration Act," will allow a New York resident to register securities so that they can automatically pass to a pre-designated beneficiary at his or her death.

While this new form of security registration, which already is permitted in many other states (including Florida and California), has its advantages, it also has certain pitfalls, which must be considered before you decide to title securities in this manner.

This new form of security registration will allow you to register a security with a beneficiary designation whether you hold it in certificate form or in an account. It can be done by using the words "transfer on death" (or the abbreviation "TOD") or the words "pay on death" (or the abbreviation "POD") after your name and before the name of your beneficiary. For example: "John Smith TOD John Smith, Jr." or "John Smith pay on death John Smith, Jr."

If you register securities in this manner, it will have no effect on your ownership of them. You can continue to hold the securities indefinitely, sell them or close the account in which they are held, in each instance, without having to consult with your designated beneficiary.

Your beneficiary designation is effective only at your death. During your lifetime, you can cancel or change it at any time, and in New York you can revoke or amend it by an express provision in your Will. You do not need the consent of your beneficiary to do so.

Upon your death, the securities registered in beneficiary form will pass to your beneficiary automatically, if he or she survives you. In New York, if you previously had designated your spouse as beneficiary and you later divorce, the divorce will revoke any benefits your former spouse otherwise would have received.

In short, registering securities in this manner has many of the characteristics of a "Totten trust," which is a type of registration available for bank accounts and certificates of deposit. Both provide benefits directly to a named beneficiary at the account owner's death (thereby avoiding probate), allow the owner to maintain control over the account during his or her lifetime and are subject to revocation (or amendment) by an express direction in the owner's Will.

There are several advantages to registering securities in beneficiary form. For one, it allows you to transfer securities at your death without first having to offer your Will for probate. Your designated beneficiary will not be burdened with the time, expense and market risks associated with probate.

This new type of security registration provides a better alternative to using a joint tenancy with right of survivorship arrangement.

A joint account with right of survivorship is created when two (or more) people register an account in such a way that, upon the death of one of them, the property automatically passes to the other (or others). Although a joint account with right of survivorship allows the account assets to pass to the surviving joint tenant immediately after the other's death (like a security registered in beneficiary form), it may result in unexpected and undesirable results for the owners. For example, lifetime entitlement and control are shared between the account owners and, therefore, this joint form of security registration works only when the owners cooperate. Problems could, and often do, arise when there is a disagreement between the owners or when one becomes incapacitated or insolvent. Moreover, if a joint account is funded by only one tenant (who is not a spouse of the other joint tenant), unwanted gift tax costs may be incurred.

While security registration in beneficiary form avoids some of the problems associated with joint accounts, it is not free of shortcomings. Specifically, it may unintentionally alter your estate plan. Securities titled in this manner pass directly to the designated beneficiary at the owner's death, and the terms of a Will or revocable trust do not control the disposition of the assets (unless the Will or revocable trust includes an express direction stating otherwise). Unless you coordinate the provisions of your Will or revocable trust with your beneficiary designation, you could end up passing more wealth to your designated beneficiary than you might otherwise intend.

In addition, the beneficiary designation takes effect only if the beneficiary survives you. You should not assume that securities registered in beneficiary form offers an adequate Will substitute. If there is no beneficiary to take the assets, your estate will become the default payee, and the terms of your Will will control how the securities will be distributed.

If your designated beneficiary is someone other than your spouse, the securities may be subject to an estate (and possibly a generation-skipping transfer) tax at your death (assuming your lifetime exemptions against such taxes are not otherwise available). These taxes will be paid as your Will directs, which may or may not provide that the taxes be paid by the person who receives the securities. Since the value of a security account could be substantial (resulting in a large transfer tax), if the tax provision in your Will does not take into account the securities registered in beneficiary form, the tax burden might fall on someone who does not benefit from the receipt of the securities.

Security registration in beneficiary form has its advantages, but you must consider its consequences before titling assets in this manner. While your Will or revocable trust may state your intentions, the ownership and transfer of assets are dictated by how they are titled.

Katrina Tax Relief Legislation Increases Deduction Limits on Charitable Contributions of Cash

The "Katrina Emergency Tax Relief Act of 2005" ("KETRA"), signed into law by President Bush on September 23, 2005, temporarily lifts certain deductibility limits on charitable contributions of cash made during the period between August 28, 2005 and December 31, 2005. In the case of individual donors, there is no requirement that the contributions be made to organizations engaged in Hurricane Katrina relief efforts.

Suspense of Percentage Limitations

Under current law, the amount deductible by an individual taxpayer is limited to a percentage of the taxpayer's contribution base, which is his or her adjusted gross income ("AGI") without regard to any net operating loss carryback. The applicable percentage limitation depends on the nature of the donee organization, but in any case, the deduction is capped at 50 percent of the taxpayer's contribution base. Any charitable contributions in excess of the percentage limitation may generally be carried forward as a deduction in the following five years.

The provisions in KETRA remove the 50% limitation and allow deductions for "Qualified Contributions" (defined below) up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. Qualified Contributions which exceed this amount may generally be carried forward as a deduction in the following five years.

For example, assume individual A's contribution base is $100,000. On July 30, 2005, A contributed $60,000 to University X. Before the passage of KETRA, A would have been allowed a $50,000 deduction for 2005, reaching his or her 50% cap. The excess, an additional $10,000, may be carried forward as a deduction in the following five years. Now assume that on October 4, 2005, A made a Qualified Contribution of $80,000. Under KETRA, A is allowed a deduction of $100,000 for 2005 ($50,000 computed without regard to the Qualified Contribution plus $50,000 from the Qualified Contribution). $40,000 ($10,000 of excess from the June 30 contribution plus $30,000 of excess from the October 4 contribution) may be carried forward as a deduction in the following five years.

Qualified Contributions

Qualified contributions are defined as cash contributions made during the period beginning on August 28, 2005 and ending on December 31, 2005, to charitable organizations such as churches, hospitals, schools, universities, and other qualified non-profit organizations. Only gifts to public charities will qualify. Gift to private foundations, supporting organizations, charitable trusts or donor advised funds will not qualify. It should be noted that gifts of property, such as stock and land, will not qualify for the unlimited deduction.

Withdrawals from Retirement Plans

The result of this unlimited charitable contribution deduction is to permit individuals over the age of 59-1/2 to make unlimited Individual Retirement Account withdrawals and donate such withdrawals to charity prior to the end of 2005 without being subject to income tax on the withdrawals. This charitable giving technique should also work for withdrawals and gifts made from 401(k) plans, 403(b) plans and other qualified retirement plans. However, it should be noted that retirement plan withdrawals may increase income for state income tax purposes and if these withdrawals are given to charity they may not be deductible under state law to the same extent that they are deductible under federal law.

Overall Limitation on Itemized Deductions

Under current law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by 3 percent of the taxpayer's AGI in excess of a certain threshold. For 2005, that AGI threshold is $145,950 ($72,975 for a married individual filing a separate return).

Under KETRA, the charitable deduction up to the amount of Qualified Contributions made during the year is not treated as an itemized deduction for purposes of the overall limitation on itemized deductions.

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