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Personal Planning Strategies

A report
for clients
and friends
of the firm

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January 2004 Update - Federal and State Estate and GST Tax Changes

Federal Estate and GST Tax Changes

As we reported in our June 2001 issue, 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") taxes.

Beginning in 2004, the top federal estate and gift tax rates decrease from 49% to 48% and the federal estate and GST tax exemptions increase from $1 million to $1.5 million. The federal gift tax exemption remains at $1 million. Although this is good news, many states (such as Connecticut, New York and New Jersey) are not following the federal changes, as discussed later in this issue.

The table that follows summarizes changes in the federal estate, gift and GST taxes from 2003 through 2010, when the estate tax is scheduled for repeal (before being reinstated in 2011):

Calendar Year	Top Federal Estate and Gift Tax Rate	Federal Estate Tax Exemption	Federal GST Tax Exemption	Federal Gift Tax Exemption
2003	49%	$1 million	$1,120,000	$1 million
2004	48%	$1.5 million	$1.5 million	$1 million
2005	47%	$1.5 million	$1.5 million	$1 million
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2010	Gift Tax Rate Equals Top Individual Income Tax Rate	Estate Tax Repealed	GST Tax Repealed	$1 million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 $1,120,000 Exemption Plus Inflation Adjustment	$1 million

State Estate Tax Changes

Despite the reduction in the maximum federal estate tax rate, some estates will have to pay a state estate tax in addition to any federal estate tax. Prior to the Act, a state death tax credit (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, only 25% of what otherwise would have been the maximum state death tax credit is allowed in 2004. Beginning in 2005, the state death tax credit is repealed entirely and replaced by a deduction in computing the federal estate tax for state death taxes actually paid.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 lose revenue due to the reduction and repeal of the state death tax credit. The good news for taxpayers in these states is that unless they change their laws, in 2004 they will only pay 25% of what they would have paid to these states prior to the Act, and beginning in 2005 they will pay no state estate taxes.

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 phase-out of the state death tax credit. For instance, some states impose an estate tax calculated with reference to the maximum federal credit available as of a specific date prior to the Act. In these states, including New York and New Jersey, a resident decedent's estate may be burdened by a state estate tax in addition to the federal estate tax.

The combined top federal and New York estate tax rates in 2004 actually exceed the combined rates in effect prior to the Act. For instance, a New York decedent dying in 2004 is subject to a New York estate tax at a top rate of 12% in addition to the federal estate tax as reflected below:

Year of Death	Former State Death Tax Credit Rate	Allowable Federal State Death Tax Credit (25% of Former State Death Tax Credit)	New York State Estate Tax in Excess of Allowable Federal State Death Credit	Top Federal Estate Tax Rate	Combined Top Federal and New York State Tax Rate
2004	16%	4%	12%	48%	60%

Additionally, many states that have "decoupled" have not raised their estate tax exemptions beyond $1 million. New York only recognizes an estate tax exemption of $1 million and New Jersey only recognizes an estate tax exemption of $675,000. Therefore, for a decedent dying in 2004 with a taxable estate under $1.5 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 if the decedent's taxable estate exceeds $675,000.

Connecticut recently "decoupled" from the federal system for a six month period starting July 1, 2004. For decedents dying between July 1, 2004 through December 31, 2004, Connecticut recognizes an estate tax exemption of only $1 million and imposes an estate tax calculated by multiplying the allowable federal credit by 1.3. However, the state estate tax imposed during this six-month period will be repealed if Connecticut receives certain federal assistance in the fiscal year beginning July 1, 2004.

As illustrated in the following chart, the estate of a decedent dying in 2004 with a $1.5 million estate would pay no federal estate tax, since the federal estate tax exemption is $1.5 million. If the decedent were a resident of California or Florida, his or her estate would not pay state estate tax either. However, if the decedent were a resident of New York or New Jersey, his or her estate would have to pay a $64,400 state estate tax since New York and New Jersey do not conform to the federal changes. If the decedent were a resident of Connecticut, his or her estate would have to pay a $83,720 state estate tax, if the decedent died between July 1, 2004 and December 31, 2004. 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	Federal Estate Tax	California Estate Tax	Connecticut Estate Tax	Florida Estate Tax	New York Estate Tax	New Jersey Estate Tax
2004	0%	0%	$83,720 (STARTING 7/1/04)	0%	$64,400	$64,400

The amount becomes substantial in large estates. In 2004, the estate of a decedent with a taxable estate of $15 million will pay federal and state estate taxes totaling $7,865,100 if the decedent were domiciled in New York, but only $6,465,000 if the decedent were domiciled in Florida. Accordingly, individuals with a residence in New York, New Jersey or Connecticut and a second residence in Florida, should consider establishing their primary residence in Florida.

The New Gift Tax Law: Avoiding A Potential Pitfall

Many of the press reports about the new federal tax law have focused on changes in the estate tax: the gradual reduction in rates and increase in the exemption amount through 2009, complete repeal in 2010 and the accompanying cost-basis regime, and the notorious "sunset provision" (whereby the estate tax returns in 2011).

However, many people overlook the fact that the new law has a much different effect on the gift tax. Under the Act, there are two important changes to the gift tax law. First, the exemption amount was increased from $675,000 to $1 million for all years beginning in 2002. Second, the maximum gift tax rate was gradually reduced. The rate decreases each year until 2010, when the maximum gift tax rate will equal the maximum individual income tax rate (now 35%).

It must be emphasized that the Act *did not repeal the gift tax.* In addition, although the federal estate tax exemption increases over the next few years (*e.g.*, to $1.5 million in 2004), the gift tax exemption will remain constant at $1 million. (It is also important to note that, as with all other provisions of the Act, the legislation "sunsets" on January 1, 2011. That is, unless a future Congress revisits the law, the changes expire on that date.)

As a result of the gift tax exemption increasing from $675,000 to $1 million, individuals may make larger gifts without being subject to gift tax. Thus, if a person had utilized his or her full $675,000 exemption amount by 2001 and that person makes an additional gift of $325,000 in 2004, he or she will not be subject to any gift tax. However, if the taxpayer made total gifts in prior years in amounts exceeding the exemption amount of $675,000, a gift tax will be due if the taxpayer makes a gift of $325,000. This is because the gift tax is calculated based on a graduated rate structure and your prior gifts are totaled in calculating the amount of any current gift tax due. If you gave away more than $675,000 in prior years, you are subject to gift tax rates at a higher tax bracket than the additional $325,000 exemption will fully offset.

Therefore, if a taxpayer has pre-2002 gifts totaling more than $675,000, he or she must be careful in making additional gifts to ensure that he or she fully utilizes the benefit of the additional exemption amount without unwittingly becoming subject to gift tax.

The chart below shows, for each year, and for varying amounts of pre-2002 taxable gifts: (1) the amount of gift tax that would be due if a gift of $325,000 were made and (2) the maximum amount that one can gift and still achieve a zero gift tax liability.

Year	Pre-2002 Taxable Gifts	Additional Taxes Due for $325,000 of Current Taxable Gifts	Maximum Amount of Gifts to Maintain Zero Gift Tax Liability
2004	$1,000,000.00	$9,500.00	$302,906.98
	$1,250,000.00	$16,000.00	$289,444.44
	$1,500,000.00	$21,000.00	$278,333.33
	$2,000,000.00	$30,750.00	$260,937.50
	$2,500,000.00	$30,750.00	$260,937.50
	$3,000,000.00	$30,750.00	$260,937.50
2005	$1,000,000.00	$9,500.00	$302,906.98
	$1,250,000.00	$16,000.00	$289,444.44
	$1,500,000.00	$21,000.00	$278,333.33
	$2,000,000.00	$27,500.00	$266,489.36
	$2,500,000.00	$27,500.00	$266,489.36
	$3,000,000.00	$27,500.00	$266,489.36
2006	$1,000,000.00	$9,500.00	$302,906.98
	$1,250,000.00	$16,000.00	$289,444.44
	$1,500,000.00	$21,000.00	$278,333.33
	$2,000,000.00	$24,250.00	$272,282.61
	$2,500,000.00	$24,250.00	$272,282.61
	$3,000,000.00	$24,250.00	$272,282.61
2007 2008 2009	$1,000,000.00	$9,500.00	$302,906.98
	$1,250,000.00	$16,000.00	$289,444.44
	$1,500,000.00	$21,000.00	$278,333.33
	$2,000,000.00	$21,000.00	$278,333.33
	$2,500,000.00	$21,000.00	$278,333.33
	$3,000,000.00	$21,000.00	$278,333.33
2010	$1,000,000.00	$0.00	$357,857.14
	$1,250,000.00	$0.00	$338,513.51
	$1,500,000.00	$0.00	$338,513.51
	$2,000,000.00	$0.00	$338,513.51
	$2,500,000.00	$0.00	$338,513.51
	$3,000,000.00	$0.00	$338,513.51

Increase In Gift Tax Annual Exclusion

An individual can make a gift of up to $11,000 each year to an unlimited number of donees without incurring any gift tax. This amount is known as the annual exclusion and in 2003 it increased from $10,000 to $11,000. In addition, if the donor is married, he or she can give away up to $22,000 to each donee by "splitting" the gift with his or her spouse.

Keep in mind that, even at the very end of 2003, it still will be possible to make gifts covered by the 2003 annual exclusion so long as the gifts are made and the checks clear before year-end. This is a very simple way to transfer money out of your estate at no cost.

Under the tax law, the annual exclusion amount increases with inflation. However, it only increases in $1,000 increments and only when the inflation adjustment would raise the amount to the next $1,000. Accordingly, it is expected that the exclusion will remain at $11,000 in 2004.

Qualified State Tuition Programs (529 Plans) Offer Tax-Advantaged Savings For College

Qualified State Tuition Programs (known as 529 Plans because Section 529 of the Internal Revenue Code authorizes the establishment of these accounts) offer a tax-advantaged way to save for a college education. Although 529 Plans are created under the Internal Revenue Code, implementation is at the state level and the states were given some latitude with respect to the implementation of their particular 529 Plans. Accordingly, 529 Plans may vary significantly from state to state, but in all programs the funds transferred to a 529 Plan grow free of federal income tax. Additionally, the Act made some significant changes to 529 Plans, the most significant of which is that as of January 1, 2002, when funds are withdrawn to pay for college the pre-withdrawal earnings in the funds will not be subject to tax. In prior years these earnings were taxed to the beneficiary (who, as a student, may have been in a lower tax bracket) when the funds were withdrawn. Although it is significant that the earnings in 529 Plans are not subject to income tax when withdrawn, the provisions of the Act are scheduled to expire on December 31, 2010, and if the law is not changed before then, earnings in Section 529 Plans will revert to their former status of being tax deferred and not tax free.

How 529 Plans Work

The majority of states have adopted 529 Plans. Each state selects one financial organization to manage its plan. Federal tax rules prohibit contributors and beneficiaries from directing the investments of 529 Plan funds. Funds are invested by the plan manager in one of several mutual funds that the account owner chooses. However, another significant change made by the Act is that, starting in 2002, the account owner has the ability to rollover the 529 Plan into a different 529 Plan once every twelve months. Thus, account owners can now change the way the funds are invested even though they can't pick individual investments for any account.

How New York State's 529 Plan Works

New York State's 529 Plan is run jointly by the state Comptroller and the Higher Education Services Corporation, which designates a fund manager to invest the accounts. Contributions can only be made in cash. Funds are in one of several mutual funds that the account owner chooses. There is no residency requirement — non-residents of New York may open a 529 Plan under New York's program.

On November 14, 2003, Upromise Investments, Inc., which includes the Vanguard Group and Fleet Bank's Columbia Management Group, became New York's new fund manager. If you opened an account through the original fund manager,

Teachers Insurance and Annuity Association of America (TIAA), your investments have been transitioned to comparable Vanguard investments.

Some states such as New York offer additional state income tax benefits. Under New York State's 529 Plan, the first $5,000 of funds contributed each year may be deducted on an individual's income tax return ($10,000 in the case of a married couple filing jointly). Thus, if you and your spouse contribute a total of $10,000 to a 529 Plan, and you are in the top income tax bracket, you will save nearly $700.00 in New York State income tax — more if you are New York City residents. Additionally, even before the Act, the earnings were wholly exempt from New York State income tax when withdrawn for college or other related educational expenses.

As of September 22, 2003, the limit on the maximum amount of funds that can be contributed to New York's 529 Plan was replaced by a maximum account balance that will be adjusted periodically by the state to reflect higher education costs. The maximum account balance currently is $235,000.

When an individual enrolls in an accredited college located anywhere in the United States the funds can be withdrawn to pay for higher education expenses. These expenses include not only tuition, but also fees, supplies, room and board, books, and equipment. Funds may be withdrawn for undergraduate education, graduate schools or approved trade, technical or other occupational schools. To make a qualified withdrawal, the account owner submits a withdrawal form to the Program Manager setting forth the educational expenses of the designated beneficiary and those funds are then transferred directly to the institution of higher learning.

Designated Beneficiary

Whenever you open an account, you must designate a beneficiary (including yourself) of your 529 Plan. If the beneficiary decides not to attend college or does not fully use the funds in his or her account, another member of the beneficiary's family may be designated as the beneficiary instead. In fact, the beneficiary of a 529 Plan can be changed at any time by the account owner.

Limitations and Penalties

There are no income limitations imposed on individuals wishing to establish 529 Plans. If funds are withdrawn from a 529 Plan and not used for educational expenses, the earnings will be subject to federal and state taxation, and, in addition, there is a federally-mandated ten percent penalty imposed on the investment income. The federal penalty does not apply if the withdrawal was made due to the death or disability of the designated beneficiary. Additionally, if the designated beneficiary receives a scholarship, withdrawals may be made without penalty up to the amount of the scholarship. New York no longer imposes a penalty if funds are withdrawn and not used for educational expenses.

As of January 1, 2003, rollovers from New York's 529 Plan to another state's plan are considered to be non-qualified withdrawals for New York income tax purposes and the earnings and contributions for which previous deductions were taken will be subject to state income tax.

Gift, Estate and Generation-Skipping Tax Consequences

Under the federal gift tax law, every individual is entitled to give away as much as $11,000 per year, indexed for inflation, to a particular person without any gift tax consequences. To take advantage of this annual exclusion, the recipient must be given complete control of the gift (this is known as having a "present interest" in the gift and is what prevents many transfers in trust from qualifying for the annual exclusion).

Contributions to 529 Plans of up to $11,000 ($22,000 in the case of a married couple) on behalf of an individual are specifically exempt from the present interest requirement and therefore will not be subject to gift tax. Additionally, transfers to a 529 Plan within this limitation are exempt from generation-skipping transfer taxes. If you change the designated beneficiary such a change will not be subject to additional gift tax, but it may be subject to generation-skipping transfer tax if the new beneficiary is in a generation younger than the original beneficiary.

Extra Incentives Under the Gift Tax Law

As a further incentive to establish an account under a 529 Plan, the law allows an individual to utilize five years of annual exclusion amounts immediately. What this means is that if you and your spouse wish to establish an account under a 529 Plan for your grandchild, you may transfer $110,000 to said account immediately and the transfer will qualify for the annual exclusion ratably over the next five years even though it is made today. Accordingly, the gift will be free of all gift and generation-skipping transfer taxes if your death does not occur over those five years. An election to treat it as qualifying for the annual exclusion is made on a gift tax return.

Death of Account Owners and Beneficiaries

Even though you, as owner of a 529 Plan, retain the right to name a new member of the beneficiary's family as the beneficiary of a 529 Plan and control the timing of distributions from the account, the 529 Plan will not be included in your estate upon your death. Upon the death or incompetence of the 529 Plan owner, decisions with respect to the account are made by whomever you designate to succeed you as a contingent owner. If the designated beneficiary dies and funds are

withdrawn due to his or her death, those funds will then be included in the beneficiary's estate and earnings will be subject to income tax.

Caveat

In addition to the annual exclusion from gift tax (which applies to transfers made to a 529 Plan), an unlimited gift tax exclusion is available to pay someone's educational expenses. To be exempt from gift tax, the payment must be made directly to the educational institution providing the service. However, in this regard only tuition payments qualify for this exception - fees, supplies, room and board, books, and equipment will not qualify (although those payments can be made directly to the student and qualify for the annual exclusion). If the annual exclusion is applied to contributions made to a 529 Plan, an individual may be foregoing other estate planning techniques (for example, trusts) which, if structured correctly, may be used for purposes other than education, give the individual control over when the beneficiary has access to the assets and allow the Trustee to direct the investment of the assets. Accordingly, it may be advantageous for some individuals' estate plans to include making "annual exclusion" gifts to individuals outside of a 529 account and then simply paying fees for tuition to educational institutions when those bills are due.

Conclusion

You should consider establishing a 529 Plan for your family members. They provide a tax advantaged means of providing the necessary funds to pay for your loved ones' educational expenses while allowing you to maintain some control over the account during your lifetime.

IRS Issues Final Retirement Plan Minimum Distribution Regulations

In our April 2001 issue, we reported that the Internal Revenue Service published proposed regulations that simplified the retirement plan minimum distribution rules. Now, those regulations are final. They became effective as of January 2003.

Generally, a retirement plan participant must begin to take minimum distributions from the plan by April 1 of the year following his or her attaining age 70½, the "required beginning date." Before the new regulations were enacted, the calculation of the minimum distribution amount was complicated. Now, in most cases, a participant need only consult one Uniform Lifetime Table that we have reproduced. To determine how much a participant must withdraw from his or her plan, he or she simply will divide the prior year's December 31 plan balance by the applicable divisor that appears next to the participant's age in the distribution year.

The Uniform Lifetime Table adopted in the final regulations works in the same manner as the proposed regulation table, but reflects updated life expectancy tables which increased the applicable divisor in each year (decreasing the minimum amount required to be withdrawn). As a result, retirement plan participants can further defer their plan withdrawals.

Although the final regulations are substantially similar to the proposed regulations, some differences do exist, and the simplification of some of the retirement plan rules did not render them all straightforward. Therefore, you should always discuss your retirement plans with your estate planning advisor to ensure that you take maximum advantage of all the applicable rules.

Uniform Lifetime Table for Determining Minimum Distributions - General Rule.

The following table is used for determining the distribution period for lifetime distributions. To determine your minimum distribution in a given year, simply divide your account balance as of the end of the prior year by your applicable divisor. Your age is determined as of your birthday in the relevant distribution year.

Age	Applicable Divisor*	Age	Applicable Divisor
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 +	1.9

Note: the above chart applies to IRA owners, not beneficiaries of inherited IRAs.

*Revised pursuant to final regulations.

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Personal Planning Newsletter

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