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Estate Planning & Administration Group

UPDATE

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The Estate Tax: Big Changes On The Way (But Not As Big As Hoped For)

Beginning January 1, 2006, the exemption amount for the estate tax (called the "applicable exclusion amount") increases to \$2,000,000 per person. This means that an individual with an estate of less than \$2,000,000 will not have to worry about estate tax, and that married couples, with proper planning, can shelter up to \$4,000,000 of their property from estate tax. This increase in the exemption is another step in a series of scheduled estate tax reductions under the 2001 Tax Act, the now infamous legislation that provides for a temporary "repeal" of the estate tax. That legislation provides for the exemption to reach \$3,500,000 in 2009, and then for the estate tax to go away entirely in 2010. The estate tax then returns in 2011, at the old rates (55%) and with only a \$1,000,000 exemption.

This summer, certain key Senators, led by Senator Jon Kyl (R-AZ), engaged in serious discussions about a new permanent estate tax that would have a lower tax rate and a higher exemption. Reports from the negotiations indicated that the parties were discussing a new tax rate as low as 15% and an exemption as high as \$10,000,000 per person. That combination was thought to be highly unlikely, however. The

— *The Estate Tax continued on next page*

Year-End Planning

- ✓ Have you made your 2005 annual exclusion gifts?
- ✓ Have you considered accelerating your charitable giving to take advantage of the current suspension of the deduction limits for cash gifts?

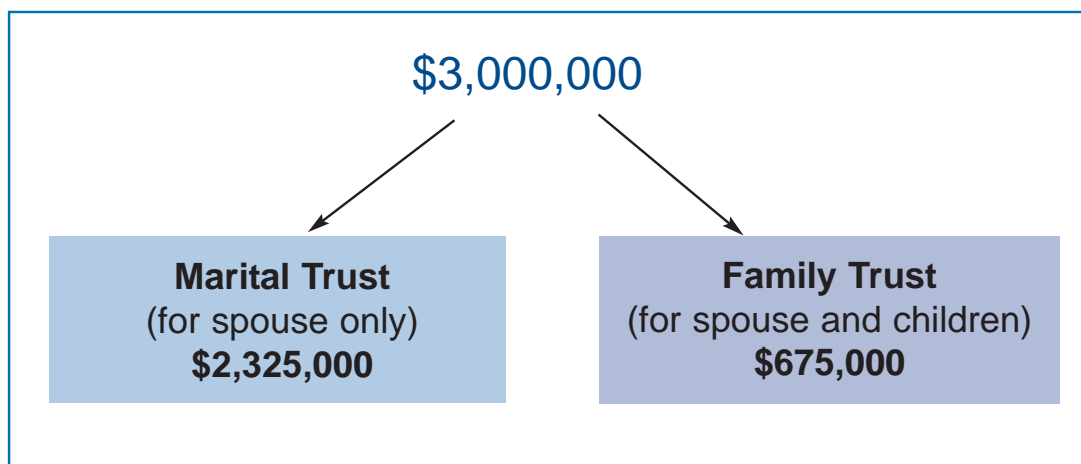
— **The Estate Tax** *continued from cover page*

more likely ranges of a compromise package would be a rate in the 20% to 45% range and an exemption of \$3,500,000 to \$5,000,000 per person.

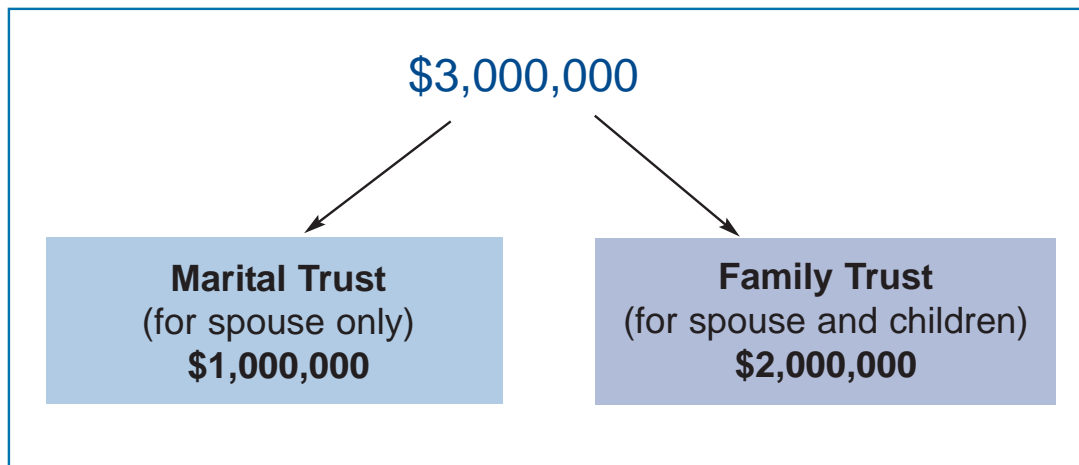
Estate tax reform was scheduled as one of the first items on the Senate's agenda when it returned from its August recess. We had high hopes for a new legislative package before year-end. Unfortunately, Hurricane Katrina changed the agenda, and pushed the estate tax off the front burner. There still is a strong bipartisan core group that would like to resolve the estate tax debate, so major changes may not be too far away.

If and when these changes occur, they likely will have a major impact on the estate plans of many individuals. *In the meantime, however, do not lose sight of the fact that the phase-in changes occurring under the current law may necessitate changes to estate plans right now.* By January 1, 2006, the applicable exclusion will have increased over three-fold in the last five years, from \$675,000 in 2001 to \$2,000,000. This increase may mean that assets will be allocated under your estate plan very differently from what you anticipated when your estate plan was prepared.

For example, the estate plans of many married individuals provide that the maximum amount that can be exempted from estate tax will be set aside in a non-marital or family trust for the surviving spouse and children. The remaining assets pass to or in trust for the surviving spouse alone, and are not taxed at the first spouse's death because of the marital deduction. The allocation of assets under this kind of estate plan has changed dramatically. For someone with \$3,000,000 of assets, this would have been the allocation based on the exemption in 2001:



In 2006, the allocation is quite different:



The current allocation might leave the surviving spouse feeling insecure. If so, an adjustment to the estate plan may be warranted. The same issue can arise in larger estates, if not next year then within a few years. If the exemption increases to \$3,500,000 in 2009, then the allocation for a \$6,000,000 estate in 2009 would be \$3,500,000 to the Family Trust and \$2,500,000 to the Marital Trust. The surviving spouse would have less than one-half of the property reserved exclusively for him or her. We are addressing these changes in a variety of ways, and tailoring our solutions to the client's specific situation. In some cases, it is sufficient to make a simple change in the terms of the Family Trust to increase the emphasis on putting the spouse's financial security first. In other cases, we might change the formula for allocating property between the two trusts.

A similar issue may exist with the allocation of property between children on the one hand and grandchildren or long term trusts on the other. Again, the increased exemptions (which also apply for the generation-skipping transfer tax) may have shifted the allocation of property in ways the family did not intend. For example, some estate plans provide that the maximum amount of property that can be sheltered from estate and generation-skipping transfer tax will be retained in long-term trusts, with the remaining property distributed outright to children. Given the increased exemption in coming years, this could result in all the property being allocated to the trusts, so the children receive no property outright.

We can illustrate the impact of the increasing exemptions on your estate plan using a simple one page chart. If you have not had your estate plan reviewed in the last five years, the tax changes phasing-in for 2006 are an extra impetus to have a review.

The Power of Annual Giving — Slow and Steady Wins the Race

Annual exclusion gifts are a powerful and easy way to transfer wealth to your descendants or other loved ones. Annual exclusion gifts are freebies from a gift tax standpoint. They do not generate gift tax or use up any of your lifetime exemptions. They can be made to an unlimited number of recipients each year. This year, the limit is \$11,000 per recipient. As of January 1, 2006, this amount is scheduled to increase to \$12,000. In addition, if you are married, your spouse can make his or her own gifts to the same recipients, or if you and your spouse prefer, you can make those gifts for your spouse by making a gift from your assets of up to double the annual exclusion amount (which will be \$24,000 in 2006). This “borrowing” of your spouse’s annual exclusion requires that you file a gift tax return in which your spouse affirmatively consents to split those gifts with you.

You can achieve significant benefits for your family if you make annual exclusion gifts each year. These benefits are illustrated by the following example. Consider a husband and wife, each 50 years old, who together have two children and four grandchildren. Based on the 2006 annual exclusion amount, the couple can give a total of \$144,000 to their descendants each year (\$24,000 times 6). If the couple gives \$144,000 to their children and grandchildren each year for the next 30 years and if the after-tax rate of return on the transferred assets is 5%, the couple will succeed in transferring \$10 million tax-free to their children and grandchildren over that time period. If the combined state and federal estate tax rate in effect is 45%, this will save \$4.5 million in estate taxes.

You can use virtually any property that is transferable under state law to make your annual exclusion gifts. Cash, marketable securities and interests in family entities are among the most common assets used for annual exclusion gifts. Fractional interests in real estate, art and other valuable personal property also can be used. Cash has several advantages as gift property — it is easy to transfer and easy to value, and it has a cost basis exactly equal to its fair market value (which means that the recipient receives gift property without any unrealized appreciation or capital gains tax exposure). On the other hand, while fractional interests in real estate and minority interests in closely held companies are more complicated to value and transfer than cash or marketable securities, they offer the advantage of qualifying for valuation discounts and of allowing the donor to retain more control over the management of the assets transferred.

Annual exclusion gifts to children or young adults under age 21 can be made to custodial accounts or to special trusts called “2503(c)” or “minor’s exclusion” trusts. Annual exclusion gifts to adults and minors also can be made to a trust that gives the recipient the right to withdraw the gift property at least for a limited period of time (usually 30 days). These withdrawal rights are often referred to as “Crummey” powers. You can leverage the benefit of your annual gifts if you make them to a trust for multiple gift recipients and then allocate some of your exemption from the generation-skipping transfer tax to that trust. This will allow all of the gift property and all future appreciation on that property to eventually pass to your grandchildren or more remote descendants without being eroded by estate tax at either your death or the deaths of your children.

As described above, the potential benefits from making regular annual gifts is substantial. However, no benefits can be achieved if no gifts are made, and significantly fewer benefits

will be achieved if gifts are not made consistently over time. There is no carryover of any unused annual exclusion gifts from year to year, so if you fail to make a gift to a child or other recipient in 2005, you cannot make up that gift in 2006. So, use the annual exclusion this year, next year and every year thereafter, or lose it!

New Year Resolutions

When is the last time you had an estate plan check-up? Recent changes in the estate tax laws may require changes to your plan in order to preserve your original objectives. Furthermore, changes in your assets or personal circumstances since your current plan was implemented also may require updates to your plan. Should an estate plan check-up be on your list of New Year's resolutions?

When is the last time you checked your retirement account and insurance beneficiary designations to make sure that they are consistent with your estate plan and current law? Inconsistent beneficiary designations can undermine an estate plan and prevent its objectives from being accomplished. Furthermore, the IRS has recently clarified how to qualify trusts as the recipients of retirement plan benefits. We can help you ensure that your designations fit your plan.

Charitable Giving Opportunity — The Sky is the Limit

Congress recently passed the Katrina Emergency Tax Relief Act ("KETRA"), which includes several measures targeted to aid victims of Hurricane Katrina. One of the provisions of KETRA provides an unique opportunity for donors to take deductions for the full value of large charitable gifts without being constrained by the normal deduction limitations. Although clearly motivated by the enormous need of the Katrina victims, this opportunity applies not only to Katrina-related charitable contributions, but to charitable gifts to most public charities for any purpose.

Specifically, KETRA suspends the usual rule that a taxpayer may not take a deduction for charitable gifts in excess of 50% of the taxpayer's adjusted gross income ("AGI"). This suspension applies to any charitable contribution made by an individual between August 28, 2005 and December 31, 2005 as long as (i) the contribution is in cash, and (ii) the contribution is made to a public charity (other than a supporting organization or a donor-advised fund) or a private operating foundation. Any charitable contributions in excess of 100% of the donor's AGI can be carried over to future tax years subject to the usual five-year carryover rules and the normal 50% limitation. The KETRA legislation also provides that charitable contributions that are made between August 28, 2005 and December 31, 2005 (whether or not they are over the 50% limit that would ordinarily apply) are not subject to the 3% of AGI reduction otherwise applied to itemized deductions.

The opportunity offered by KETRA is particularly timely for charitably inclined taxpayers over the age of 59 1/2 who have large tax-deferred retirement accounts that they will not need to access for retirement. Since any amount withdrawn from a retirement account during 2005 will be treated as income in 2005 and thereby increase the taxpayer's AGI, the entire amount

— [Charitable Giving](#) *continued on page 6*

— Charitable Giving *continued from page 5*

withdrawn, even if it is the entire account, can be contributed to a public charity before the end of the year and will be fully deductible this year. For taxpayers under age 59 ½, the benefit of taking advantage of the KETRA provisions to accelerate charitable giving is reduced because, in most cases, the taxpayer will still be subject to the 10% premature withdrawal penalty for withdrawals from retirement accounts. Also, for taxpayers of any age, the increase in AGI that will result from withdrawing pre-tax retirement assets to make large charitable contributions may impact other aspects of their 2005 return, such as reducing an individual's ability to take deductions that are subject to the 2% floor. Still, for many individuals, KETRA offers an unique opportunity to tax-efficiently use retirement assets for charitable gifts during life.

If you have been delaying making a large charitable gift because of the deduction limits, you should consider whether it makes sense to make the gift now while the normal limit on deductions is suspended. Prompt action, however, will be necessary as the opportunity only lasts until the end of this year.

Visit for the Weather, Stay for the Benefits

Florida domicile - its not just for retirement

More and more of our clients are considering Florida residency, This is not just for the year-round warmer temperatures and usually sunny skies, but also for the favorable tax climate, as well as homestead asset protection benefits that may help you weather against certain types of creditor claims.

In order to take advantage of Florida's tax and assets protection benefits, you must be domiciled there. Being domiciled in a state is not the same as owning a residence there. A person may have multiple residences, but only one domicile. Your domicile is your permanent and principal home. It is relatively simple to become a Florida domiciliary. The process usually involves filing a form that declares Florida to be your domicile, changing your mailing address, voter's registration, and driver's license to reflect your Florida home as your permanent home, and otherwise holding Florida out to your family, friends, and business associates as your principal home. If you are a "snowbird" or otherwise own a residence in more than one state, the process will also involve reviewing what ties remain to your former state of domicile. It will be important to be consistent and thorough in documenting that Florida is your current domicile in order to prevent your former state of domicile from continuing to assert that you are subject to its tax laws.

When it comes to your income, Florida is not taxing

Florida does not impose a state income tax on its residents. In contrast, a New York State and City resident in the top income tax bracket will pay local taxes at the rate of 12.15%; for an Illinois resident, the local rate is 3% (although no tax is paid on income from retirement accounts and social security benefits). (Please note that wages earned in New York or Illinois are subject to tax in those states, regardless of domicile.) Thus, a New York resident who receives \$500,000 in dividend income each year can save over \$60,000 in income taxes by moving to Florida, and a New York resident planning to sell a closely held business can save 12.15% of the appreciation realized by the sale (which easily can be in the millions) by changing his domicile from New York to Florida prior to the sale.

In lieu of a state income tax, Florida levies a relatively modest intangible personal property tax of \$1 per \$1,000 of the fair market value of intangible property (e.g., stock, bonds, mutual funds) owned, managed or controlled by a Florida resident on January 1. However, it is relatively easy to legally avoid the Florida intangibles personal property tax rate. The Florida statute exempts various assets including family limited partnerships from the intangibles tax. In addition, under the statute, if you hold your assets in a certain kind of trust, the intangible tax does not apply.

You worked hard for your assets; pass more to your heirs

Most states impose some form of death tax on their residents. Florida not only does not impose such a tax, but by the terms of its constitution, it may not. Currently, this means that Florida estates pay about 8.5% less in estate tax than most other states.

There is no place like home

The Florida homestead exemption protects homes from the claims of creditors (subject to certain limits imposed by the Bankruptcy Abuse Prevention and Consumer Act of 2005) and gives residents a break in their real estate taxes. In addition, residents of Florida can qualify for a cap on increases in their real estate taxes. The Florida homestead, however, is inflexible in nature and thus must be carefully considered in the context of the owner's estate plan in order to insure that planning for it does not prevent effective transfer tax planning. We can help you to obtain the benefits of the homestead exemption without losing the benefits of effective transfer tax planning.

With the addition of **John Dadakis** and **Scott Newman** in our New York office, our group boasts four experienced attorneys licensed to practice law in Florida.



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