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Estate Planning in Uncertain Times

By: Ken Bloom and Darren Bodner

More than ever, the fate of the Federal Estate Tax is the topic under discussion in attorney's and accountant's offices, as well as at the local diner. The Economic Growth and Tax Relief Reconciliation Act ("the Act"), passed by Congress in 2001 and in effect through 2010, provided immediate relief from federal estate taxes by increasing the tax-free amount of asset transfers on death, currently \$1.5 million in 2005, and eventually reaching \$3.5 million in 2009. Overall, the estate tax is only expected to effect the wealthiest one to two percent of the nation. For one year only, the estate tax will be completely repealed in 2010, unless Congress votes to extend the repeal. Many tax professionals believe that Congress will raise the exemption in lieu of complete repeal.

For individuals dying in 2005 with a taxable estate, the excess (less any other deductions) over the exemption amount will be taxed at rates starting at 41% and reaching a maximum of 47%. For example, in 2005, an estate valued at \$2.0 million would receive an exemption for the first \$1.5 million and will owe \$225,000 in taxes on the remaining \$500,000. It is also important to determine whether your state imposes any estate taxes, since many states, including Illinois and Wisconsin, are imposing their own taxes since the Federal Credit for State Death Taxes (so-called "decoupling" of estate taxes) no longer exists.

However, the benefits of estate planning expand far beyond estate tax considerations. When planning for the transfer of assets to your heirs, it is crucial to consider the value of an up to date will, the advantages of using a trust, income tax considerations, and other necessary planning.

The Importance of a Will

Even if the assets of your estate are below the federal exemption amount, and thus will not be taxed, it is important to draft and maintain an up-to-date will. A will provides a plan to distribute your assets to your heirs. A well drafted will can reduce conflicts after your death and allow the assets to be distributed more quickly. If you die without a will, you will lose the ability to direct the distribution of your estate, because the state in which you reside will determine who receives your assets according to its particular probate laws.

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An advantage of a will is that it is an extremely flexible document whose terms can be changed or updated as needed. Thus, you should revise it periodically for any changes in your life or in the tax laws.

Along these lines, if you already have a will drafted, you may want to consider how it has been effected by the Act. For instance, many wills contained provisions designed to reduce the amount of the federal estate tax by donating amounts to charities. If the federal estate tax is repealed or you fall below the exemption amount, you will need to decide whether you want to make provisions for charity regardless of the lack of estate tax, or your charitable bequests may be lost inadvertently. Similarly, pre-Act wills that provided benefits in trust to a surviving spouse in a second marriage situation, may, as a result of the act, disinherit the surviving spouse, leaving all the assets to the children to the first marriage.

Advantages of a Trust

A frequently beneficial component of an estate plan includes the establishment of a revocable living trust. A trust is an arrangement where property is transferred with the intention that it be administered by a trustee for one or more beneficiaries. During the Settlor's lifetime, the Settlor will usually be the Trustee and the trust will typically be for the benefit of the Settlor, the Settlor's spouse, and any dependent children. If the Settlor becomes unable to act, the named successor Trustee, such as the spouse, adult children, other relatives, close friends or a bank or trust company will take over the management of the trust, obviating the need for a court monitored guardianship.

Depending on your particular circumstances, a trust may be more advantageous than a will. One advantage of a trust is that it can avoid the probate system altogether. Probate can take anywhere from six months to several years, while a trust may be able to permit the transfer of assets to your heirs almost immediately. Further, while probate is a public proceeding and can allow anyone to learn what property is in the estate, a trust provides much more privacy. A trust can also include a mechanism to manage the assets for your heirs, which is particularly important for gifts to minor children. Finally, a trust can include provisions designed to capture the estate tax exemption of the first spouse to die, reducing or even eliminating the estate tax on the survivor's death.

Joint Tenancy Problems

Assets title as a "joint tenancy" will generally pass to the surviving joint tenant upon the death of the first joint tenant. Thus, it is crucial to remember to be very careful when setting up investment accounts or real estate, etc., in joint tenancy or payable on death, since such designations will supercede any distribution provisions under your will or trust. To compound the problem, the surviving joint tenant/payable on death beneficiary will usually also receive the asset without any estate tax, *effectively shifting the estate tax burden to the takers under the will*. Additionally, assets left in joint tenancy to a spouse eliminate the ability to capture the estate tax exemption of the first spouse to die, potentially increasing the estate tax due upon the surviving spouse's death.

Income Tax Considerations

Beyond the federal estate tax, estate planning can also be used to minimize federal income taxes for you and your heirs. Two primary sources of income taxes resulting from assets in your estate arise from income producing assets (for example, stock dividends) and the sale of appreciated property (property which has increased in value while you have held it).

Income Producing Assets

Dividends and interest from income producing assets are taxed at the rate of the individual possessing the underlying asset. Alternatively, you could transfer the asset to an heir who would pay tax on the income at their individual rate. For example, if you are in the 35% tax bracket, and receive interest on a bond of \$5,000, you would pay a tax of \$1,750 on the income. However, if you transferred the bond to a child who is in the 15% tax bracket, he/she would only pay tax of \$750 on the \$5,000 of income, representing a savings of \$1,000, or even greater savings if the child had less than \$800 of unearned income prior to the transfer. Keep in mind however, that you may only make gifts of up to \$11,000 per donee (\$22,000 if a spouse consents) without using up any of the estate tax exemption available at death.

Appreciated Property

A federal income tax is triggered on the sale of appreciated property for any increase in the value of property that occurred during the time which you held the asset. Thus, if you buy stock for \$1,000, and you later sell it for \$11,000, you will be taxed on the \$10,000 of appreciation in the property. Further, if you give away such appreciated property, the recipient will measure any gain on the sale or transfer of the property in the same manner as you would have if you sold the asset yourself. Thus, if you gave away the stock to your son who subsequently sold it for \$11,000, your son would be taxed on \$10,000 of appreciation based on your cost of the property.

However, heirs receive property transferred at death at what is called a "stepped-up basis". A stepped-up basis allows the heir to determine any gain or loss on inherited property based on the value of the property at the time of the decedent's death, not at what the property originally cost the decedent. Thus, if you died still owning the stock, and at the time of death the stock was valued at \$11,000, if your son immediately sold the inherited stock, he would recognize no gain on the transaction, and the \$10,000 of appreciation would escape taxation. Be careful though--if estate taxes are eliminated, this benefit of the "stepped-up basis" may also be eliminated, causing an increase in income taxes.

Therefore, to minimize federal income taxes for you and your heirs, it may be advantageous to transfer income producing assets during your lifetime and include highly appreciated assets in your estate, as long as including such assets in your estate does not trigger estate taxes. This planning idea would not be appropriate for larger estates.

Retirement Account Financing Considerations

Another important consideration is the proper funding of your retirement account. If used properly, certain investment products can help ensure that you will have sufficient income for the remainder of your life. Annuities, for instance, offered by most major insurance companies, can provide a guaranteed monthly payment for as long as the annuity holder lives. For example, an individual nearing retirement who pays \$300,000 toward an annuity could receive about \$1,900 a month for life. The downside is that when the annuity holder dies, the payments will normally cease, although certain products exist to extend coverage to a designated beneficiary.

Other Considerations

Estate planning can encompass other non-financial concerns, such as the creation of a living will and/or Power of Attorney for Health Care to govern the use of life support and consent to medical procedures and the grant of a Power of Attorney for Property/Financial Affairs in case of incompetence of the Principal. If Terri Schiavo had signed Powers of Attorney documents, her situation would not have attracted nationwide attention.

Planning Is and Remains Essential

Federal estate tax laws have frequently changed over the last few decades, and may change again in the near future. Indeed, although the tax is scheduled to be completely repealed in 2010, if Congress takes no further action it will return again in 2011. Further, even if the federal estate tax is fully repealed, most states will impose their own estate tax.

Therefore, estate planning remains essential for both estate tax and other considerations. Be sure to discuss the techniques and considerations described above with your legal, financial and tax advisors before making any changes to your estate planning documents.