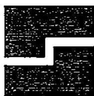
JOEL S. ROTHMAN
& ASSOCIATES, LTD.


Counselors at Law **55 West Monroe Street, Suite 3330, Chicago, IL 60603 (312) 578-0900 (312) 578-0905 FAX**

Joel@RothmanLaw.com

Joel S. Rothman

Thomas D. Sterling
Puneet Cham
Marcie J. Pickard

Of Counsel
Mark T. Neil
Lorri E.K. Otis
Mitchell D. Pawlan
Anita S. Ridge
Robert E. Stigger

August, 2001

Re: Estate Planning Aspects of the New Tax Act

Dear Clients and Friends:

The recently enacted Economic Growth And Tax Relief Reconciliation Act Of 2001 (the "Tax Act") provides the potential for significant tax relief but adds a significant amount of additional complexity and uncertainty as well. We are writing to summarize the key provisions of the Tax Act with respect to estate and gift taxes and to discuss what to expect next and how we feel these changes impact current planning.

I. Changes in the Estate and Gift Tax Exemption Amounts

A. Estate Tax Exemption Increases

The estate tax exemption amount (now called the 'applicable exclusion amount') which each person may give during life or at death, free from estate taxes, was initially established in1981 at $600,000. Despite the passage of twenty years, this estate tax exemption amount has only increased to a current level of $675,000. The most important estate planning change under the Tax Act is the increase in the estate tax exemption amount to $1,000,000 on January 1, 2002, with the exemption scheduled to increase at intervals until 2010 at which time the estate tax is to be repealed for a one-year period at the end of which the estate tax will be restored to the level it was at on January 1, 2002.

The repeal of the estate tax in 2010 can be made permanent by Congress, but is likely to require the affirmative vote of at least 60 Senators. The Tax Act had the affirmative vote of 58 Senators.

B. Gift Tax Exemption Changes

The gift tax system has less changes. The lifetime exclusion for gifts which exceed the annual $10,000 per donee exemption amount increases to $1,000,000 on January 1, 2002. It stays at that level, however, <u>indefinitely</u> - even during the year 2010 when the estate tax at death is completely repealed.

C. Estate and Gift Tax Rate Caps

When an estate becomes subject to a tax liability, the maximum rate of estate tax for the largest estates will be gradually reduced over the next ten years from the current maximum of 55%. The same reductions will apply to the maximum gift tax on lifetime gifts which exceed the lifetime limit of $1,000,000, until 2010. In the year 2010, the top gift tax rate will be set at the highest income tax rate, which is currently scheduled to be 35%. Thereafter, the decrease in the tax rate is scheduled to return to its current level of 55%.

These changes are summarized on the following chart:

Calendar Year	Estate Transfer Exemption	Gift Tax Lifetime Exemption	Highest Estate, Gift and GST Tax Rate
2001	675,000	675,000	55%
2002	1,000,000	1,000,000	50%
2003	1,000,000	1,000,000	49%
2004	1,500,000	1,000,000	48%
2005	1,500,000	1,000,000	47%
2006	2,000,000	1,000,000	46%
2007	2,000,000	1,000,000	45%
2008	2,000,000	1,000,000	45%
2009	3,500,000	1,000,000	45%
2010	Unlimited	1,000,000	35%
2011 and thereafter	1,000,000	1,000,000	55%

II. Other Provisions of the Tax Act

A. Generation Skipping Tax

The Generation-Skipping Tax ("GST") applies to transfers from a person in one generation to a beneficiary who is two or more generations below the original donor, such as transfers to a grandchild or great-grandchild. Under the Tax Act, the GST is repealed, along with the estate tax, effective January 1, 2010 for a one year period. There is an exemption amout before the GST become applicable, which is presently $1,060,000. This GST exemption does not change until January 1, 2004. At that time, the exemption increases to $1,500,000 and then rises in step with the increases in the exemption for estate tax purposes indicated in the chart above.

The GST exemption can be quite valuable. It defines the amount which can be placed in trust for the lifetime benefit of a child or other beneficiary, with creditor protection and other lifetime benefits and which may then be passed, with appreciation in value, upon the death of the lifetime beneficiary to his or her children, other beneficiaries, without being subject to estate tax again as a part of his or her estate or subject to creditors of his or her estate.

B. 5% Surcharge for Large Estates

Current law adds a 5% surcharge to the top estate and gift tax rates for estates between $10,000,000 and $17,184,000 in value. The purpose of this surcharge was to make the estate and gift tax a flat tax for the largest estates. This surcharge is repealed as of January 1, 2002.

C. Repeal of the Step Up in Basis

A long standing feature of our estate tax system has been the existence of a 'step-up' in the basis of assets transferred at a decedent's death. Generally, if a decedent purchased or inherited an asset that has appreciated substantially during his or her lifetime and holds it until death, then the decedent's beneficiary will inherit that asset at the fair market value at the time of the decedent's death, without any capital gains taxes being imposed.

The Tax Act repeals the step-up in basis during the period of the estate tax repeal in 2010. The step-up would be replaced by a carryover of the decedent's cost basis (or the date of death value if lower), subject to the following exceptions:

1. A decedent's executor can increase the basis of some of decedent's property up to $1,300,000 (a limited step-up in basis). The executor chooses the property to which this limited step-up will apply.
2. The basis of property passing to a surviving spouse could be increased by an additional $3,000,000, indexed for inflation.
3. Property given to the decedent within 3 years of death by someone other than decedent's spouse cannot be increased in basis.

D. Repeal of the Qualified Family Owned Business Exclusion

The Taxpayer Relief Act of 1997 provided that certain Family Owned Businesses could be exempt from estate taxes, up to $1,300,000 in value, after factoring in the available applicable exclusion amount. This Qualified Family Owned Business Exclusion is repealed as of 2004.

E. State Death Tax Credit

As part of the Federal estate tax system, decedent's estates are given a credit for state death taxes on their Federal estate tax returns. This is a very fundamental form of Federal revenue sharing with the states which does not increase the amount of total estate taxes which are due from an estate and is often referred to as the 'pick up tax'. The amount of this credit is reduced under the Tax Act by 25% in 2002; by 50% in 2003; by 75% in 2004; and is repealed in 2005. Thereafter, estate or inheritance taxes actually paid to a state will be allowed a deduction from the value of the estate but not a tax credit.

III. Initial Observations About the Tax Act

A unique feature of the Tax Act is that to meet previously established bipartisan budgetary restrictions, the Tax Act is automatically repealed after a ten year period, if affirmative action is not taken by Congress and the President.

While it may be foolish to speculate on future political actions, a likely scenario based on historical precedent is that the exemption amounts and tax rates will be effectively 'frozen' in one of the next few years at their then current levels (with future automatic increases for inflation). There will be a number of forces bringing pressure in the next few years for this result, including the following:

A. Economic Reversals

A premise of this tax legislation is that the economy will run strong, generating surpluses, and the government will not miss the significant revenues generated annually from estate and gift taxes and the GST. If that premise fails, then the likelihood of the law lasting until 2011 is slim.

B. Impracticality of Carryover Basis

The repeal of the step-up in basis in favor of a carryover of the decedent's prior cost basis will prove to be particularly challenging. To make carryover basis work, executors and beneficiaries will have to determine the original basis for each asset of a decedent. A repeal of the step-up in basis was previously enacted in 1976. It was repealed shortly thereafter as unworkable. Suppose a decedent acquired an asset in the 1970s or 1980s and held it until death in the year 2010 (after numerous stock splits, mergers and spin-offs). Rare will be the situation where there is information setting forth the decedent's initial basis. How will executors, beneficiaries, estate planning and tax professionals solve these issues? Ouji boards will need to become a standard estate administration tool.

C. Charitable Pressures

Current estate and gift tax laws provide an unlimited deduction for gifts to charities or charitable foundations. This has been a significant source of funds for charities and religious organizations. The potential for lost funds is significant and is likely to result in considerable political pressures being brought to bear as these potential losses become more real.

D. Revenue Losses By The States

Finally, the individual states have in many cases derived 3-5% of their revenue from the pick up tax system under the current estate tax law. Because the credit for state death taxes is reduced in the earliest years, a significant part of the tax reductions during those early years are being financed by revenues being shifted from the states to the Federal government. It seems only a matter of time until pressure is brought by the states to restore the credit for state death taxes as part of future 'tax reform' legislation.

IV. Planning Strategies

We continue to urge our clients to follow the fundamental tax planning principles which have always guided us:

Plan based upon current laws, assuming the worst (while certainly hoping for the best);

Allow for the greatest possible flexibility to address future changes in not only the tax laws but also in financial and family circumstances; and

Review planning regularly to assure that documents as well as the title to assets and the beneficiary designations for insurance policies and retirement plan assets are correct and current.

A. Review Existing Plans in Light of the New Law

Most estate plans for married clients provide that the estate tax exemption amount is set aside in a 'Residuary Trust' (sometimes also known as a 'Family Trust'. 'Credit Shelter Trust' or 'B Trust'), with the balance going either outright to the surviving spouse, or to a Marital Trust for his or her benefit. The increase which begins next year in the estate tax exemption amount suggests that consideration be given to both the dramatic increase which may occur in the amount which will be allocated to the Residuary Trust portion to assure that it is consistent with current wishes, as well as to assure that if sufficient wealth is available, both spouses have adequate funds in their names or in their Revocable Trusts to assure full utilization of the estate tax exemption amount, regardless of the order of deaths.

B. Transfer Assets Out of One's Estate

We continue to believe that with the significant increase in the size of estates over the past 15 years, reducing the estate tax value of one's estate is still important. If, as the current conventional wisdom goes, the estate and gift tax laws will again be altered long before 2011, then transferring assets sooner rather than later remains wise since there is almost no scenario contemplated in which future estate tax legislation will be more favorable than under the Tax Act. It is particularly important to remember that while the estate tax exemption is scheduled to increase beyond the $1,000,000 limit set to go into effect next year, the gift tax exemption amount has no further scheduled increases.

Besides annual exclusion gifting, which continues under the Tax Act, we continue to recommend the following:

1. **Gift Trust.** Gift trusts can provide funds for a spouse, children, grandchildren, and others while removing the assets from the donor's estate. These trusts allow for full use of the annual gift tax exemption amount, remove future appreciation from the donor's estate and allow funds to be invested professionally, if desired, while remaining available for wide variety of uses and can provide significant creditor protection. A husband can, for example, create such a Gift Trust and obtain all of these benefits while still allowing his wife to be both Trustee and trust beneficiary during her lifetime.

2. **Life Insurance Trust.** Irrevocable Life Insurance Trusts or Gift Trusts, if properly written, can also be used to enable all life insurance proceeds to escape estate and gift taxes, while keeping

them available for the needs of a spouse, children or other beneficiaries and providing creditor protection.

3. **Qualified Personal Residence Trust.** This more advanced tax saving technique can allow for the legal transfer of ownership of a personal residence at a significant discount and avoid estate or gift taxes on any future appreciation in value.

4. **Family Limited Partnership.** For many persons the creation of a family limited partnership can provide substantial benefits. Senior family members retain management control while enabling them to make gifts to reduce their estates. It can also provide creditor protection benefits for the family members who are the limited partners and can save significant gift and estate taxes through discounts on the valuation of the limited partnership interests.

5. **Charitable Remainder Trust.** This specialized type of trust arrangement can allow the tax-free sale of investments which have substantial "built in" capital gains tax liabilities. The full amount of the sale proceeds can then be invested to provide income to the donor or other trust beneficiary. The donor also receives an immediate income tax charitable deduction. Typically, upon the death of the donor or the death of the survivor of the donor and his or her spouse, the remaining balance of the trust goes to selected charitable beneficiaries or to a charitable foundation, which may be managed by other family members.

6. **Charitable Foundation.** A charitable foundation can provide an immediate charitable income tax deduction while allowing the donor to defer the actual transfer of a substantial portion of the gift to specific charities over future years. It can also provide a source for charitable giving by children or other later generations of family members on a highly tax advantaged basis.

We hope this letter provides some helpful information and perspective for you. As indicated, the Tax Act is complicated and presents both planning opportunities and pitfalls. Please let us know if you would like to engage us to review your estate plan or if we may be of other assistance.

Kindest personal regards,

Joel S. Rothman & Associates, Ltd.

August, 2001

PRIVACY POLICY OF JOEL S. ROTHMAN & ASSOCIATES, LTD.

Lawyers, as providers of certain personal services, are now required by the Gramm-Leach-Bliley Act to inform their clients of their policies regarding privacy of client information. Our law firm understands your concerns as a client for privacy and the need to ensure the privacy of all your information. Your privacy is important to us and maintaining your trust and confidence is a high priority. Lawyers have been and continue to be bound by professional standards of confidentiality that are even more stringent than those required by this Act. Therefore, we have always protected your right to privacy. The purpose of this notice is to explain our Privacy Policy with regard to personal information about you that we obtain and how we keep that information secure.

NONPUBLIC PERSONAL INFORMATION WE COLLECT

We collect nonpublic personal information about you that is provided to us by you or obtained by us with your authorization or consent.

WE DO NOT DISCLOSE ANY PERSONAL INFORMATION ABOUT OUR CLIENTS OR FORMER CLIENTS TO ANYONE, EXCEPT AS PERMITTED BY LAW AND ANY APPLICABLE STATE ETHICS RULES.

For current and former clients, we do not disclose any nonpublic personal information obtained in the course of our practice except as required or permitted by law. Permitted disclosures include, for instance, providing information to our employees, and in limited situations, to unrelated third parties who need to know that information to assist us in providing services to you. In all such situations, we stress the confidential nature of information being shared.

CONFIDENTIALITY AND SECURITY

We retain records relating to professional services that we provide so that we are better able to assist you with your professional needs and to comply with professional guidelines or requirements of law. In order to guard your nonpublic personal information, we maintain physical, electronic, and procedural safeguards that comply with our professional standards.

****

Please call if you have any questions, because your privacy, our professional ethics, and the ability to provide you with quality legal services are very important to us.