Current Gift, Estate, and GST Tax Issues

November 17, 2006

TAX-FREE DISTRIBUTIONS FROM IRAS TO QUALIFYING CHARITABLE ORGANIZATIONS

The Pension Protection Act of 2006 provides an exclusion from gross income for up to $100,000 for IRA distributions that otherwise would be taxable, if the distributions are made directly from the IRA to a qualifying charitable organization. The following conditions apply: (1) distributions must be to certain public charities (and, notably, cannot be to donor-advised funds); (2) the IRA owner must have attained age 70 ½ when a distribution is made; and (3) distributions must be made in 2006 or 2007. This exclusion is not available after 2007. A determination of whether it is beneficial to use this exclusion can be made only after taking various factors into account, including income level, assets available for charitable giving, and the level of charitable giving.

FEDERAL GIFT TAX ANNUAL EXCLUSION UNCHANGED

The Federal gift tax Annual Exclusion will remain $12,000 per donee. If you are married and you and your spouse elect to “split” all gifts on your gift tax returns for a particular year, you can “use” your spouse’s Annual Exclusion and give $24,000 of your assets per donee.

In addition to the Annual Exclusion, there continues to be an exclusion from Federal gift tax for payments of another person’s tuition or medical expenses (including medical insurance premiums), so long as the payments are made directly to the institution providing education or to the health care provider. This exclusion is unlimited both with respect to the amount of the payments and the number of allowable recipients.

RISK OF INCREASED STATE ESTATE TAX ON YOUR ESTATE

Married taxpayers can design their estate plans so that on the death of the first spouse to die there is no Federal estate tax, while ensuring that the maximum amount of the assets of the first to die is sheltered from Federal estate tax in both spouses’ estates. This maximum amount, called the Federal Applicable Exclusion amount, is $2 million in 2006, 2007, and 2008, jumps to $3.5 million in 2009, is unlimited in 2010, and then falls back to $1 million in 2011.

Segregating the Federal Applicable Exclusion amount on the death of the first spouse to die so that it is not added to the assets that pass in some form just to the surviving spouse will prevent that amount from being included in the surviving spouse’s taxable estate. Therefore, many estate plans provide that the maximum Federal Applicable Exclusion amount will be held in a trust for the spouse and descendants. However, this approach may create a state estate tax at the death of the first spouse to die, because in some states the state Applicable Exclusion amount is now less than the Federal Applicable Exclusion amount. To avoid the state estate tax, you may want to change your Will if your Will currently provides that the maximum Federal Applicable Exclusion amount passes other than exclusively to the spouse.

For example, in New York, the Applicable Exclusion amount is $1 million and therefore, if you are a New York resident, New York estate tax will be imposed on any amount over $1 million that does not pass to a U.S. citizen spouse (or charity) in a qualifying way. So, if you are a New York resident and die in 2006, 2007, or 2008, and a trust for your spouse and descendants is funded with the full Federal Applicable Exclusion amount, $2 million, no Federal estate tax will be due at your death, but New York estate tax in the amount of $99,600 will be payable. Similarly, if you are a New York resident and die in 2009, and a trust for your spouse and descendants is funded with the full Federal Applicable Exclusion amount, or $3.5 million, no Federal estate tax will be due at your death, but New York estate tax in the amount of $229,200 will be payable. Thus, the New York estate tax cost rises as the Federal Applicable Exclusion amount rises but the New York Applicable Exclusion amount remains fixed. You can avoid the New York tax by capping the amount passing to the trust for spouse and descendants at the lesser of the Federal and New York Applicable Exclusion amounts. This may result in a loss of some of the Federal Applicable Exclusion amount, meaning potentially higher taxes at the death of the second spouse to die.[1]

EFFECTIVE COMBINED TAX RATE FOR NEW YORK RESIDENTS

For your information, the following chart shows the combined effective Federal and New York estate tax top marginal rates for the years 2006-2010:

CALENDAR YEAR	FEDERAL RATE	NEW YORK RATE	EFFECTIVE COMBINED RATE AFTER DEDUCTION OF NY ESTATE TAX
2006	46%	16%	54.64%
2007-2009	45%	16%	53.80%
2010	0	16%	16%

We note that, while the New York estate tax is onerous, New York no longer has a gift tax.

AUTOMATIC ALLOCATION OF GST TAX EXEMPTION

In 2006, 2007, and 2008, each individual has a generation-skipping transfer (“GST”) tax exemption of $2,000,000. This amount increases to $3,500,000 in 2009. The GST tax exemption is valuable because if GST tax exemption is allocated to a transfer to a trust, the transferred property and all post-transfer income and appreciation thereon should be exempt from any further gift, estate or GST tax for the entire life of the trust. Prior to 2001, GST tax exemption was not allocated to a transfer to a trust unless the donor affirmatively allocated GST tax exemption on his or her gift tax return. Since January 1, 2001, however, GST tax exemption is automatically allocated to all transfers to certain types of trusts, unless the donor affirmatively opts out of automatic allocation on his or her gift tax return.

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1 Planning to reduce estate tax at the survivor’s death is particularly important given the uncertain content of future Federal estate tax legislation.

Each year, you should alert your accountant to transfers you make to trusts (including life insurance premiums paid on behalf of insurance trusts) to determine whether you should opt out of, or into, automatic allocation (and whether to opt out or in on a permanent basis) so that your gift tax return, which is due on April 15th of the year following the year of the transfer, can be prepared appropriately.

DISPOSAL OF DECEDENT'S REMAINS

Under a New York law effective as of August 2, 2006, an individual may execute a document providing instructions concerning the disposition of his or her remains and naming someone to control the disposition. In the absence of such an instrument, the following individuals, in descending priority, have the right to control the disposition of remains: the deceased's surviving spouse or domestic partner, any of the deceased's surviving children age 18 or older, either of the deceased's surviving parents, and any of the deceased's surviving siblings age 18 or older.

CHARITABLE GIFTS OF FRACTIONAL INTERESTS

The Pension Protection Act of 2006 imposes new income, gift and estate tax rules with respect to gifts to charity of fractional interests in tangible personal property, such as art. The new rules apply to gifts made on or after August 17, 2006, and often will render charitable gifts of fractional interests in property unattractive to most donors.

The two most serious problems for the donor are recapture of income tax and gift tax charitable deductions and new valuation rules. If a gift of a partial interest is made to charity, the income tax and gift tax deductions will be recaptured (and a surtax will be added) if either: (1) the donor does not contribute all remaining interests in the property to charity within ten years of the initial transfer or, if earlier, the date of the donor's death; or (2) within the time period described above, charity has not taken "substantial physical possession" of the property and used it in a way related to its exempt purpose. For valuation purposes, an additional contribution of a partial interest (after the first contribution of a partial interest has been made) is valued at the lesser of value at the time of the first contribution and value at the time of the second contribution.

If you have any questions about the estate planning issues described in this update, please contact Mildred Kalik (mkalik@stblaw.com; 212-455-2778), Pamela L. Rollins (prollins@stblaw.com; 212-455-3468), or any other member of our Personal Planning Department.

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