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REPORT FROM COUNSEL

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2001: A WHOLE NEW BALLGAME

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What a difference a year can make.

At the beginning of 2001, tax planning was based upon a tax code which had been in place for many years. Although each year brought subtle changes in the form of new IRS rulings and court interpretations, the fundamentals of the code were well understood and regularly integrated into estate, gift and income tax planning. The impending inauguration of George W. Bush, following a close and contested election, did not herald significant changes to the tax code, despite the campaign promises to the contrary. It was presumed that the new President did not have sufficient political clout to persuade Congress to enact them. (After all, the estate tax repeal was passed by Congress in 1999 but was vetoed by President Clinton without much political protest.) Further, the complex rules on managing and withdrawing funds from IRAs had been proposed by the IRS in 1987 and, although never declared to be "final," had been adopted by professionals as the governing rules. Great consideration was given to the designation of beneficiaries and the election of the method to calculate minimum distribution amounts as one approached the key age of 70 ½.

The new Bush Administration proposed changes to the tax code, primarily to reduce income tax rates, but also to eliminate the estate tax, referred to in the debates as the

"death tax." Few expected that the actual elimination of the estate tax would survive Congressional review in a bill that might actually be signed by the President. Most voters do not face the prospect of an estate tax, so the common belief was that the repeal would be dropped from the bill as the more popular desire to reduce income taxes was promoted.

Nevertheless, the final conference bill contained the total repeal of the estate tax in the year 2010, after significant increases in the credit over the intervening years. Due to the rules of the Senate, the final bill is to "sunset" in 2011, thus eliminating the elimination of the estate tax one year after it had occurred!

With regard to IRAs, the IRS radically changed the 1987 rules by providing generous discretion for owners and beneficiaries. Further, the new rules simplified the management of IRAs, much to the relief of all involved. No longer were complex rules in effect regarding the identification of one's "designated beneficiary" at the time required for distributions, beginning at age 70 ½. No longer was an IRA owner confronted with irrevocable choices for computing the minimum amount to be taken each year. Under the new rules, everyone is to be treated the same way, except a person fortunate enough to have a spouse more than 10 years younger. Beneficiaries were granted new freedom to withdraw inherited funds over lifetimes, rather than be forced to withdraw large amounts within a very few years.

New IRA Rules

Prior to 2001, the fundamental rules governing IRAs seemed to be well-established. Surviving spouses could enjoy and control IRAs similar to the owner, but all other beneficiaries would have to withdraw the balance and pay the deferred income tax in a relatively short period of time. The income tax, coupled with the estate tax, made the value of the gift of an IRA considerably less than most other assets available to a decedent. On January 11, 2001, without any advance notice, the IRS issued new rules on retirement funds. These rules replaced the 1987 "proposed" rules. The new rules simplified how retirement funds were to be withdrawn and provided taxpayers with more choices. These changes included:

- * eliminating the need to name a beneficiary at age 70 ½ in order to provide for a lower minimum payout during retirement
- * eliminating the option to "recalculate" life expectancy each year by a retiree
- * authorizing post-death changes in beneficiaries
- * permitting the use of a trust as a beneficiary without losing the right to measure payments during retirement on joint life expectancies
- * reducing, in most cases, the amount which would need to be withdrawn each year, thus reducing the income tax due

In many cases, a retiree can reduce the annual amount which is required to be withdrawn by 20% or more, depending upon his or her age and whether a single life expectancy had been used under the prior rules.

For those with a spouse who is more than 10 years younger, a lower payout is still permitted.

Economic Growth and Tax Relief Reconciliation Act of 2001

The federal estate tax system, under prior law, provided for an expanding credit, which protected a minimum amount of assets from taxation. Practitioners worked to take advantage of this credit for the benefit of a client's children or even grandchildren. Credit-shelter ("by-pass") trusts, family limited partnerships, Qualified Terminable Interest Property ("QTIP") trusts, charitable trusts, gift programs, all combined to leverage the benefit provided by the tax code provisions.

On June 7, 2001, the **Economic Growth and Tax Relief Reconciliation Act** created a new environment for estate, gift and generation-skipping transfer ("GST") taxes. As noted above, the estate and GST taxes are actually scheduled for termination by year 2010. However, the current system will return in 2011, barring intervening action by Congress and the President.

Changes in the tax code have been made throughout its history and often these require adjustments to one's estate plan and/or its documents. The Act, however, makes the adjustments more difficult. On the one hand, total repeal means that all references to present tax code sections and terms become ambiguous, if one assumes the document may be read and interpreted after those sections no longer exist. On the other hand, those same sections could "return" only a year later, so the simple removal of them may not be wise. Also, estate plans that make sense today may not serve any purpose later.

Issues to Consider

Q. For a standard "by-pass" trust, is the amount designated for payment to it correct or will it be "over-funded"?

A. The correct amount should be considered in light of the amount available and the terms of the trust. To the extent that the credit amount exceeds the amount desired for the trust, documents need to provide for a maximum amount, regardless of the credit amount provided by law.

Q. If the amount determined for the trust is correct, have sufficient assets been retitled or designated for payment to the trust to fund it?

A. Again, the amount desired by the client should determine the assets set apart for use in funding the trust. Insurance beneficiary forms and all asset titles need to be reviewed.

Q. Should the by-pass trust be funded if estate tax is repealed but only for the year 2010?

A. A by-pass trust should be funded whenever it is possible that the survivor of a married couple might have a taxable estate, based on the combined value of the assets in the trust and the survivor's other assets. Discretion could be given to the trustee or another disinterested person to make this judgment.

Q. For GST-exempt trusts, should someone have the ability to terminate them "early" if estate tax repeal or changes in exemptions permit?

A. Yes, if possible. Many GST-exempt trusts are designed to have a long life. The primary purpose is to segregate funds from the life beneficiary's estate. Thus, if that person is not subject to estate tax, either because the tax is repealed or because the threshold amount is raised sufficiently above his or her net worth, it would best to have a method by which the principal could be distributed free of trust.

Q. Should gifts during lifetime be made? If so, should they be limited to annual exclusion amounts or may the unified credit equivalent be used?

A. Gifts should only be made if the donor is able to live comfortably without such assets. If gifts are made in a way that does not cause any gift tax to be paid, the fact that the estate tax repeal may occur would not cause any loss to the donor; it simply means the tax benefit for making the gift may be removed.

Q. Are "split interest" gifts ever wise during this period?

A. Split interest gifts are those gifts in which the donor retains an interest for a period of time, after which the property is transferred to another. A common example is a Qualified Personal Residence Trust ("QPRT"). The donor transfers a residence to the QPRT and enjoys the use of the property for a period of years, after which title is deeded to the donor's children. The initial transfer causes a gift to be made to the children equal to the value of the future rights to the property. If the estate tax repeal is permanent, the donor will have parted with the property for no tax benefit. Often the donor would not want the property to be in his or her children's names if the donor could have retained ownership without increasing any estate or gift taxes. If estate tax repeal is not permanent, a split interest gift can still make sense. Unfortunately, in some cases, we will not know the correct answer until it is too late to take advantage of this technique, due to the fact that a split interest gift needs to be implemented over a period of several years in order to achieve any substantial benefit.

Q. Should a Charitable Remainder Unitrust ("CRUT") be made the beneficiary of an IRA?

A. Prior to 2001, the designation of the payment of IRA balances to a CRUT may have resulted in more funds being distributed to family members than would have

been possible if the family members had been named as the direct primary beneficiaries of the IRAs. This was largely due to the rules requiring the withdrawals of IRA funds within a relatively short period of time, thereby causing income taxes to be due. With the new IRA rules permitting payments of IRA funds over the lifetime of a beneficiary, the CRUT technique will likely reduce the funds paid to family members, rather than increase them.

The goal of any estate plan is to permit a person to pass property to his or her intended beneficiaries as efficiently as possible and with the lowest tax cost.

It is therefore recommended that all estate plan documents, including insurance and retirement fund beneficiary designations and asset titling, be reviewed in the context of the Act and each person's individual intentions. This is the only way to know if any changes will be needed. Adjustments, however, will have to be designed to reflect not only the current tax environment but also an alternate "repeal" environment, in order to be prepared to handle either circumstance. Each plan should incorporate as much flexibility as possible, and our experience with the new Tax Act should be closely monitored over the next decade to allow for other necessary modifications.

About the Author

Peter Y. Herchenroether is a shareholder of Sherrard, German & Kelly, P.C. Mr. Herchenroether practices in the areas of estate planning and administration, charitable organizations, and real estate. He received his undergraduate degree from Westminster College in 1976 and his law degree from Vanderbilt University in 1979.

NEW RIGHT FOR WORKERS AT DISCIPLINARY MEETINGS

Two employees at a foundation wrote office memoranda stating that their supervisor was not needed on a project and that he had behaved inappropriately and unprofessionally. The foundation's executive director informed one of the employees that she wanted to meet with him and the supervisor. Feeling intimidated at the prospect of the meeting, the employee asked that his fellow complaining employee be present as well. When this request was refused, and the employee declined to attend the meeting alone, he was fired for insubordination.

The fired employee ultimately was found to be entitled to reinstatement to his position, with an award of back pay. The decision by a federal appellate court breaks new ground for non-union employees and employers, because the basis for the ruling is a principle previously associated only with union workers. It is settled law that an employer commits an unfair labor practice under the National Labor Relations Act if it denies a union

employee's request to have a union representative present at an investigatory interview that the employee reasonably believes might result in disciplinary action.

The National Labor Relations Board has changed course several times on the question of whether this right also can be asserted by employees who are not in unions. In the case of the foundation employee, it answered that question in the affirmative, and the appeals court agreed.

The impact of the decision could well mean that in most cases a company should either allow an employee to have a co-worker present at a meeting that could be perceived as leading to disciplinary action or not have the meeting at all.

The right to have a co-worker present must be triggered by a request from the employee. Many employees, especially those not in a union, are unaware of this right and are unlikely to assert it. Managers and supervisors do not benefit from the ruling, as they are not "employees" as defined in the National Labor Relations Act. Non-union employees probably can only insist on being accompanied by a co-worker, rather than having a supervisor, manager, or outside representative present. The purpose of the right is to allow employees to engage in "mutual aid and protection." The rule applies only to a meeting that could lead to discipline, not a meeting whose purpose is simply to announce predetermined disciplinary action.

NEW ATTORNEY JOINS THE FIRM

Robert J. Courie is an associate attorney with the firm and is a member of the firm's Corporate and Financial Services Groups. Prior to returning to law school, Mr. Courie was employed by Mellon Bank, N.A. and PNC Bank, N.A. in various corporate banking positions. Mr. Courie is a 1986 graduate of the Pennsylvania State University and a 2000 graduate of the University of Pittsburgh School of Law. Mr. Courie also earned his Master of Business Administration (MBA) degree from the Pennsylvania State University in 1989. Mr. Courie is a former president, treasurer, and director of Pittsburgh Young Professionals (PYP).