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REPORT FROM COUNSEL

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AN UPDATE ON ESTATE PLANNING

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Over two years have passed since the enactment on June 7, 2001 of the federal Economic Growth and Tax Reconciliation Act of 2001 (hereinafter referred to as the "Act") which provided for sweeping changes to the federal estate, gift, and generation-skipping transfer taxes. Although the full effects of the Act on estate planning are not yet known, it is clear that at least some estate plans should be reviewed at this time and possibly revised in the light of the application of certain provisions of the Act.

The provisions of the Act which are most familiar are those pertaining to the scheduled increase in the federal estate tax exemption over the next several years. The present federal estate tax exemption is \$1,000,000, and it will be increased to \$1,500,000 for 2004 and 2005. The exemption will be further increased to \$2,000,000 for 2006 through 2008, and in 2009 the exemption will reach \$3,500,000. The federal estate tax is scheduled to be repealed in its entirety in 2010; however, unless Congress acts to extend the repeal, the federal estate tax will come back into existence in 2011 with an exemption of \$1,000,000.

Less familiar provisions of the Act are those which pertain to the federal gift tax law. In 2002, the lifetime gift tax exemption was raised to \$1,000,000. However, unlike the federal estate tax exemption, which will be increased in the coming years, the gift tax

exemption is fixed at \$1,000,000. Importantly, the federal gift tax will remain in existence even after the repeal of the federal estate tax in 2010. This means that an individual may make gifts during his or her lifetime (not including annual exclusion gifts) totaling no more than \$1,000,000 before federal gift tax is imposed. In addition, the annual gift tax exclusion was raised in 2002 from \$10,000 to \$11,000 due to the application of a cost of living index.

It is widely anticipated that Congress will revise the Act within the next few years; however, no one can predict at this point what those revisions will be. A bill has been introduced in Congress which would make the repeal of the federal estate tax permanent. Although the bill has been approved by the House of Representatives, its future in the Senate is uncertain. What is clear, however, is that there does not appear to be much support in Congress for reversing or limiting the scheduled increase in the federal estate tax exemption. In fact, a compromise was proposed by the Congressional opponents of those seeking to make the repeal of the estate tax permanent that the federal estate tax exemption be set at \$5,000,000.

As noted above, on January 1, 2004, a 50% increase in the federal estate tax exemption, that is, from \$1,000,000 to \$1,500,000, will go into effect. This change in the law may necessitate the revision of some estate plans. For example, the Wills of many married couples provide for a trust funding formula by which a bypass trust and a marital deduction trust would be established following the death of the first of the couple to die. Such provisions are designed to maximize the federal estate tax savings for the couple, and many such Wills were signed at the time when the federal estate tax exemption was set at \$600,000. Under the formula, property having a value equal to the maximum amount of the deceased spouse's remaining federal estate tax exemption would be set aside first to fund the bypass trust, and the balance of the decedent's estate, if any, would then be used to fund the non-taxable marital deduction trust of which only the decedent's surviving spouse can be the beneficiary.

Because the federal estate tax exemption is now \$1,000,000 and will be \$1,500,000 in 2004, this increase in the exemption could present a problem in connection with certain estate plans, particularly those involving a second marriage. In such cases, the individual's Will may provide that the children by his or her first marriage are to be the beneficiaries of the bypass trust and that the surviving spouse is to be the beneficiary of only the marital deduction trust. Given the increase in the federal estate tax exemption, the effect of this estate plan could be that the bypass trust would be "over-funded" and the surviving spouse would be inadvertently disinherited.

For example, if the decedent's estate has a value of \$1,500,000 in 2004 and if the decedent's Will provided for the maximum bypass trust/marital deduction trust formula described above, the decedent's entire estate of \$1,500,000 would be used to fund the bypass trust, and no amount would be available to allocate to the marital deduction trust for the surviving spouse. Although this plan may be most advantageous for federal estate tax purposes, it may not be what the decedent had intended.

Some possible solutions to this problem would be to revise the Will to provide for a cap on the amount to be used to fund the bypass trust or to provide the surviving spouse with a mandatory right to the income of the bypass trust or a right of withdrawal over the principal of the bypass trust. Of course, in cases in which the decedent's surviving spouse is included among the beneficiaries of the income and principal of the bypass trust, the application of the maximum bypass trust/marital deduction trust formula would not likely present the same problem.

On a different note, the increase in the federal estate tax exemption may enable many married couples to greatly simplify their estate plans. For example, when the federal estate tax exemption was \$600,000, a couple having a combined estate valued at \$1,200,000 would likely have been advised to split the ownership of their assets into separate shares of \$600,000 each. Following the death of the first of them to die, the decedent's \$600,000 could be set aside and used to fund the bypass trust. This would enable the exemption of the first of them to die to be utilized and thereby enable the couple's combined federal estate tax exemptions of \$1,200,000 to pass to their heirs free of federal estate tax.

However, in 2004, when the federal estate tax exemption will be \$1,500,000, the same couple would no longer need to have the bypass trust/marital deduction trust formula included in their Wills. The surviving spouse's \$1,500,000 exemption would be sufficient to exempt their combined assets of \$1,200,000 from federal estate tax at the surviving spouse's death.

The couple could re-title all of their assets into joint names and they could sign simple Wills leaving their entire estates to each other. The assets owned jointly by the couple would then pass to the survivor automatically. If the deceased spouse owned no assets in his or her name alone at death, there might be no need for the first decedent's Will to be probated. Having a simple Will would also eliminate the expense of establishing a bypass trust and a marital deduction trust. It would also eliminate the expenses associated with maintaining the trusts such as the preparation of the trusts' annual income tax returns. In addition, assets owned jointly by a married couple would enjoy the significant protections provided by the law against the claims of creditors.

What Should You Do Now in Regard to Your Estate Plan?

First, because the Act does not provide for the repeal of the federal gift tax law, but, rather, provides for a gift tax exemption of \$1,000,000, it may make sense, if you have not already begun to do so, to consider making annual exclusion gifts. As noted above, the annual exclusion amount is now \$11,000. A gift in that amount may be made each year to any number of donees without any federal gift tax consequences, and splitting the gift with a spouse would enable annual exclusion gifts of \$22,000 to be made. Such gifts would not reduce your \$1,000,000 gift tax exemption, and the gifts would achieve the benefit of shifting the future appreciation and income generated by the assets which are the subject of the gifts from your estate to the beneficiary.

In addition, you may wish to keep in mind that the gift tax law also provides that payments made by a donor directly to an educational institution for tuition or to a provider of medical care for the donee do not count towards the donor's annual exclusion gifts, nor do they reduce the donor's \$1,000,000 lifetime gift tax exemption. So long as such gifts are made for qualified educational or medical purposes, there is no limitation on the amounts of such gifts.

Second, you should review your estate plan to make sure that it continues to make sense for yourself and for your heirs; and, certainly, if either of the situations described above applies to your estate plan, a revision to your Will may be in order. Indeed, a periodic review of your estate plan is advisable in order to ensure that your intentions with regard to your assets will be fulfilled in an efficient and tax effective manner.

About the Author

Mr. Anfang is a shareholder and director of the firm and practices primarily in the areas of estate planning and trust and estate administration. He received his undergraduate degree from Georgetown University's School of Arts and Sciences in 1972 and his law degree from Georgetown University Law Center in 1976.

FIRM ANNOUNCEMENT

The firm is pleased to announce that it has recently re-located its offices. The firm's new address is: Sherrard, German & Kelly, P.C., 28th Floor, Two PNC Plaza, 620 Liberty Avenue, Pittsburgh, PA 15222. The firm's telephone and fax numbers and its e-mail addresses and website are unchanged.

FEDERAL PRIVACY RULE PROTECTS HEALTH INFORMATION

Recently, the first-ever federal privacy standards to protect individuals' health-care information went into effect. The mandate for these standards, collectively known as the Privacy Rule, was in the Health Insurance Portability and Accountability Act of 1996 (HIPAA).

The Privacy Rule gives individuals access to their medical records and greater control over the use and disclosure of their personal health information. States are still free to keep or adopt their own policies or practices that are at least as protective as the new federal requirements.

Who Is Covered

Entities subject to the Privacy Rule include health-care providers, health plans (including insurance companies and HMOs), and health-care clearinghouses, such as physicians' billing services. The regulations also apply to "business associates," meaning any organization or person (other than a worker for a covered entity) that receives or accesses private medical information on behalf of a covered entity. When a covered entity uses a business associate, the two must enter into a written agreement containing specific protections for the health information used or disclosed by the business associate.

On its face, the Privacy Rule does not directly apply to employers, but that is not to say that employers need not become familiar with its requirements. Employers frequently interact with covered entities and their business associates. In addition, employers administering their own group health plans are effectively brought within the reach of the Privacy Rule.

Safeguards for Individuals

The Privacy Rule applies to "protected health information" (PHI), defined as all individually identifiable health information held or transmitted in any form or media, whether electronic, paper, or oral. Individuals generally should be able to see and obtain copies of their PHI within 30 days of a request. Covered entities must provide a notice to individuals describing how their PHI may be used and informing them of their rights under the Privacy Rule.

In the interest of promoting quality health care, providers are not restricted in their ability to share information needed to treat patients. Generally, PHI may not be used for purposes unrelated to health care. However, in the rare cases where it is allowed, only a minimum amount of protected information may be used or shared. Covered entities may release medical information to outside businesses such as insurers, banks, or marketing firms only with specific written authorization from the individual.

The Privacy Rule gives individuals the right to request alternative means or locations for receiving PHI communications. For example, a patient could ask a doctor to communicate with the patient through a designated telephone number or address. Another reasonable accommodation might be sending medical information to a patient in a closed envelope rather than on a postcard.

Policies and Procedures

The Privacy Rule requires covered entities to set up policies and procedures to protect the confidentiality of PHI. Written privacy procedures must identify staff with access to PHI and describe how such information will be used and when it may be disclosed. There must be training of employees in privacy procedures and designation of an individual to be responsible for insuring that those procedures are followed.

Covered entities may continue existing disclosures of health information for certain public responsibilities, subject to limits and safeguards that are specific to such circumstances. Examples include emergencies, identification of the body of a deceased person, and public health needs. If there is no other law that mandates disclosure to meet a particular public responsibility, covered entities may use their professional judgment to decide whether to make disclosures.

Enforcement

The Government may impose civil penalties of \$100 for each failure to comply with a Privacy Rule requirement. A penalty may not exceed \$25,000 per year for multiple violations of the same requirement in a calendar year. If a violation is due to reasonable cause, involved no willful neglect, and is corrected within 30 days of when an entity knew or should have known about it, no civil penalty may be imposed. A knowing violation of the Privacy Rule could also bring a fine of \$50,000 and up to a one-year prison term. Maximum criminal penalties are higher if the wrongful conduct involves false pretenses, or use of the health information for commercial advantage, personal gain, or malicious harm.

HIGHLIGHTS OF THE NEW FEDERAL TAX ACT

On May 28, 2003, the Jobs and Growth Tax Relief Reconciliation Act of 2003 became law. Much of this federal tax law applies only to the years 2003 and 2004, after which provisions in the 2001 Tax Act will again become effective. Nonetheless, the Act contains some significant changes for individuals as well as businesses.

Individuals

The child tax credit increases from \$600 to \$1,000, which is an acceleration of a scheduled phase-in that was to have occurred between 2005 and 2010. In 2005, the credit will fall to \$700, but will then gradually rise to \$1,000 again by 2010 by virtue of the 2001 Act.

The standard deduction for married couples will double to twice the amount of the standard deduction for single taxpayers. Married taxpayers filing a separate return will claim the same standard deduction as a single person. Similarly, for 2003 and 2004, the upper limit of the 15% income tax bracket for married couples will increase to a dollar amount that is twice that for a single taxpayer.

For 2003, income levels for the 10% tax bracket will increase to \$7,000 for single taxpayers and \$14,000 for joint filers. In 2004, these levels of income will be indexed for inflation. Retroactive to January 1, 2003, the new tax rates for individuals are 10%, 15%, 25%, 28%, 33%, and 35%. For transactions taking place from May 6, 2003 to December

31, 2007, the maximum capital gain tax rate has dropped from 20% to 15%, and from 10% to 5% for lower-income taxpayers.

To reduce the double taxation of corporate earnings, dividends received by an individual shareholder from a domestic or qualified foreign corporation will be taxed like capital gain income. This means a rate of 15% for most taxpayers and 5% for those at lower-income levels, assuming the stock is held for at least the holding period set by law. Dividends from certain corporations are not eligible for this new treatment, such as those from tax-exempt charities, farmers' cooperatives, and particular foreign companies.

Businesses

The Act increases the amount of investment that may be deducted immediately by small businesses from \$25,000 to \$100,000. The amount of this deduction is reduced by the amount that the cost of the business assets exceeds \$400,000. Under prior law, this phase-out of the deduction began at \$200,000.

The additional first-year bonus depreciation deduction is increased from 30% to 50% for investments acquired and put into service between May 5, 2003 and January 1, 2005. Qualifying property still must be brand new, with a class life of 20 years or less.