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The IRS Restructuring and Reform Act of 1998 Includes Significant Changes

By Debra K. Smietanski

The IRS Restructuring and Reform Act of 1998 provides a number of technical corrections to provisions in the Taxpayer Relief Act of 1997 and other legislation, in addition to some significant new provisions. The following is a summary of the corrections and changes under this new Act which affect the gift and estate tax area:

Capital Gains Tax Rates

The 1998 Act reduces the required holding period for long term capital gains tax treatment for individuals from eighteen (18) months to twelve (12) months (i.e., 20% or 10%, depending on the taxpayer's highest marginal tax bracket). This change eliminates the 28% mid-term capital gain's tax rate created by the 1997 Act for property held more than one year, but less than eighteen (18) months, and would be retroactive for sales or exchanges after December 31, 1997.

Phase Out of the Applicable Credit Not Corrected

The 1998 Act does not include a technical correction which was suggested to correct a provision in the1997 Act that was intended to phase out the applicable credit (unified credit) and graduated estate tax rates for very large states (taxable estates between $17,141,000 and $21,040,000). The phase out rule in the 1997 Act only phased out the benefits of the graduated rates, but not the applicable credit. The proposal to make a technical correction that would have provided for the phase out of the applicable credit as well was not adopted in the 1998 Act.

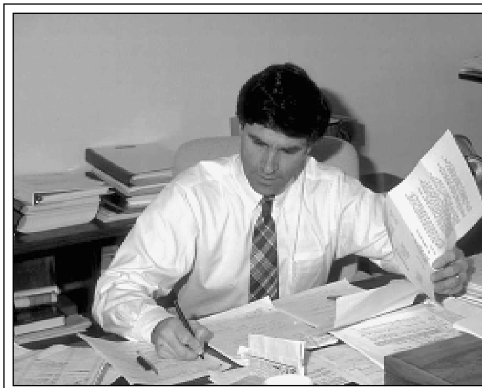
Qualified Family-Owned Business Exclusion Now a Deduction

The Qualified Family-Owned Business exclusion which was enacted in the 1997 Act has now been changed to a deduction in the 1998 Act. The maximum deduction for certain family-owned

The Selection of A Trustee: Filling Your Shoes

By Patricia Lebow and Amy Blum

Trusts are becoming increasingly important in estate planning for people with moderate to significant wealth. The role of trusts has been said to be to protect from creditors and predators and from lack of ability and disability. With proper planning, trusts can be established to serve all of these functions as well as to provide the following benefits: protection of family wealth, reduction of taxes and avoidance of probate.



The Selection of a Trustee Warrants Considerable Thought

These three benefits are often the primary focus of discussion in estate planning while the questions of who should serve as trustee and successor trustee are sometimes overlooked. In our judgment, the decision of who is chosen as trustee, what powers and discretion are granted to that trustee and who is that trustee's successor are central issues that warrant considerable thought. These choices may greatly affect how well the trust operates, to what extent the intentions of the person creating the trust are fulfilled and how the needs of the beneficiaries are met.

In choosing a trustee, the settlor or person establishing a trust should consider the financial capability of the proposed trustee and his or her ability to deal well and fairly with all trust beneficiaries. While professional trustees,

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business interests is $675,000. If this deduction applies to an estate, the applicable credit amount (which is now $625,000, but scheduled to increase to $1,000,000 by the year 2006), generally remains at $625,000 regardless of the year in which the decedent dies. However, if the amount of the deduction is less than $675,000, the applicable credit amount may be increased by the excess of $675,000 over the allowable deduction.

Indexing of Generation-Skipping Transfer Tax Exemption

The 1998 Act clarifies that the indexing of the $1,000,000 generation-skipping tax exemption applies to all generation-skipping transfers (i.e. direct skips, taxable terminations and taxable distributions) made after 1998. Further, any increase in the generation-skipping tax exemption for any calendar year due to the indexing will only apply to generation-skipping transfers made during or after that calendar year.

Value of Prior Gifts for Gift and Estate Tax Purposes

The 1998 Act clarifies that in determining the amount of adjusted taxable gifts made in preceding gift tax periods for purposes of calculating the gift or estate tax, the value of those prior gifts is the value of the gifts as finally determined for gift tax purposes, even if no gift tax was assessed or paid.

Post Death Qualified Conservation Easement Deduction

The 1998 Act clarifies that if a qualified conservation easement contribution is made after the date of a taxpayer's death, an estate tax charitable deduction is allowed, however, no income tax charitable deduction is allowed to the decedent's estate or his/her heirs.

Taxpayer Protections

The 1998 Act provides for the creation of an independent oversight board and gives taxpayers a number of additional rights and protections including increased protections for innocent spouses. As an example, the IRS will now have the burden of proof in some court proceedings in the future against individual taxpayers. In addition, the 1998 Act facilitates an innocent spouse's recovery of full or partial relief from joint liability for his or her spouse's erroneously understated tax. Further, taxpayers who are successful in disputes with the IRS may have the opportunity to receive increased judgments for administrative and litigation costs as well as for civil damages for abusive IRS collection practices. There will be some additional restrictions on the IRS' ability to levy and seize property and the Service will now have to refund overpayments of tax sooner and justify its reasons for denying refunds in more cases.

Conclusion

The summary provided above does not contain all of the technical corrections and changes which are a part of the 1998 Act. Some of these additional changes or corrections may be of use to you in your estate planning and it is advisable to consult with a professional who specializes in the area of estate planning to determine whether or not any of these changes or corrections may affect your estate plan. ❖

The Advantages Of Qualified Personal Residence Trusts

By Carl S. Rosen

A Qualified Personal Residence Trust (QPRT) allows an individual to transfer the value of his or her residence into trust for himself or herself, and then pass it to his or her children (or grandchildren) at a greatly discounted gift tax cost. It works as follows: the personal residence is deeded from the grantor's name into the trust, the grantor would then retain the right to use the residence for a set number of years and, at the end of the term, the residence would pass to his or her children.

For gift tax purposes, the IRS determines the value of the gift of the residence to the children as equal to the value of the residence reduced by the value of the grantor's term interest in the residence. The term interest is based on the grantor's age at the time of the gift, the length of the trust term and the IRS interest rate in effect at the time of the gift. For example, if a 65 year old grantor contributed a residence valued at $5,000,000 and retained a 7 year term when the IRS interest rate was 6.8%, the gift of the residence to the trust would be valued at approximately $262,000.

QRPT's Allow the Transfer of a Residence at a Discounted Gift Tax Cost

Note that the grantor would be required to file a gift tax return reflecting the amount of the gift, although no gift tax would be due if the grantor had not previously fully utilized his or her applicable credit (unified credit). Also note that if the grantor should die during the trust term, the entire value of the residence would be included in his or her estate for estate tax purposes, and, essentially, the transaction would be undone.

Should the grantor decide to remain in the residence after the trust term, he or she would be free to rent the residence (or repurchase it) from his or her children. (However, under current law, the grantor may not repurchase the residence prior to the end of the trust term). A lease of the residence following the end of the trust term would provide tax benefits as it would allow the grantor to reduce the amount of his or her estate by the amount of the lease payments without triggering a taxable gift to the grantor's children. Remember that every dollar eliminated from the grantor's estate in lease payments may save approximately $.55 in estate taxes. Although the lease payment would be considered taxable rental income for the children, in all likelihood such income would be taxed at a lower income tax rate. ❖

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such as banks, generally have more expertise in investments and trust administration, individual trustees provide a more personal touch and can significantly lower the cost of trust administration. Individual trustees also offer a personal relationship along with continuity as contrasted to bank officers who may frequently change jobs resulting in a constant flux of individuals handling a particular trust. The combination of an individual and a professional trustee sometimes is the best alternative, but as each situation is different, there are no rules that can be developed to meet all needs. The important point is to consider all options and the consequences of each before making a decision.

Under all circumstances, a trustee is first and foremost a "fiduciary", which means that a trustee is in a position of trust and owes certain duties toward others. The fundamental duties of a trustee are to carry out the terms of the trust, to act with reasonable care and skill, to act in good faith toward all beneficiaries and to always put the beneficiaries' interests above the trustee's personal interests. A trustee must always act in good faith. This means that a trustee must act with the utmost honesty and loyalty toward the trust. A provision granting the trustee absolute discretion would not relieve the trustee from this duty. Associated with this good faith is the obligation to put the interests of the trust first.

A Trustee is first and foremost a "fiduciary"

For example, in the establishment of a trust for the primary benefit of a current beneficiary, such as a surviving spouse, the trustee may choose to invest trust assets to produce maximum income for the spouse at the expense of capital growth, which would otherwise benefit the remainder beneficiaries. This example illustrates both the importance of a trustee being properly advised on how to carry out his or her duties and of customizing trustee provisions to meet the Settlor's particular wishes.

Another example is, where a business interest is placed into a trust following a death in the family, the best trustee to administer such an interest might be involved in the family business. Thought should be given to providing a trustee under these circumstances with business management powers which enable him or her to deal with the business on reasonable commercial terms and avoid the prohibition against self-dealing.

At the end of the day, proper legal advice will not only lead to maximizing tax savings, but will also assist the Settlor in understanding the importance of a trust and the trustees and in making sound choices…as he or she tries to fill the settlor's shoes. ❖

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