Estate and Gift Taxes – What Now?

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"). The Act includes temporary (two years) higher federal estate, gift and generation skipping transfer tax exemptions, portability and lower tax rates for transfers made at death or during an individual's lifetime. The Act reunifies the three exemptions at $5 million per person ($10 million per couple) and reinstitutes stepped up basis. Further, the Act sets a top estate, gift and generation skipping transfer tax rate of 35%, equaling the lowest rate in recent history, for transfers occurring in 2011 and 2012. In addition, The Act provides that any unused portion of the $5 million available exemption at a spouse's death during 2011 or 2012 would be eligible to be carried over to the surviving spouse.

For the next two years, the gift-tax exemption jumps to $5 million from $1 million for individuals and to $10 million from $2 million for couples - meaning people can give away that much without paying a penny in gift taxes.

What's more, the tax rate on gifts above those amounts fell to 35% from a scheduled 55%, a boon to ultra-wealthy people who want to give away even more money. The current gift-tax break could affect a broad swath of American families. According to the most recent Federal Reserve Survey of Consumer Finances, in 2007, 5.4 million households had net worth of $2 million or more. Even if folks cannot or do not want to make large gifts now that the government has expanded the gift-tax and estate-tax exemptions to $5 million, experts (according to the Wall Street Journal) urge a review of an existing will - especially if it as one or more trusts.

THE TWO YEAR WINDOW

The federal estate tax has been a political chess game between both political parties since the enactment of the 2001 tax provisions. There are those who doubt whether there will ever be "permanent" estate tax reform. This Act does not provide long term estate tax comfort. Remember - it's only the estate tax law in effect when the individual dies that counts!

When evaluating the political risk involved in delaying planning beyond this two-year window, consider also that the cost of the tax relief in this Act is estimated at $858 billion by the Congressional Budget Office. This cost may impede future efforts to make the Act's changes permanent. Unless further legislative action is taken, the estate and gift tax exemptions and rates that went into effect on January 1, 2011 will revert back to their 2001 limits of $1M and generally 55% beginning on January 1, 2013.

If the goal is to protect and pass on wealth to family members and future generations intact, then instead of waiting for Congress to create permanent estate tax legislation, affluent individuals and business-owners should consider taking back control of their estate planning, transcend the politics, and take positive action that protects their family and their overall wealth - for the long term. Bottom line? PLAN NOW!

PLANNING IDEAS

Legacy Enhancement
The current lifetime gift exemption is at an all-time high of $5 million, enabling significant gift tax free transfers during 2011 and 2012. Our clients should consider gifting $5 million to an ILIT and enhancing this legacy through the purchase of life insurance. Add a long-term care rider to super-charge this idea!

Ultimate Product Flexibility
Will there ever be "permanent" estate tax reform? New innovative products address this issue. These products provide an option to purchase additional death benefit if estate tax exemptions *fall* and tax rates *rise* AND alternatively provide high early cash values allowing for almost total refunds if exemptions *rise* and rates *fall*!

Trust Opportunities
During this current planning window, large gifts to Dynasty and Spousal Access trusts may be appropriate. Likewise, gifts and sales to Grantor Trusts, with easier seeding due to the increased gift tax exemption, have the potential to remove significant amounts of wealth. This major increase in the gifting exemption may also allow for more funding of already established Intentionally Defective Grantor Trusts (IDGTs) and Beneficiary Defective Grantor Trusts (BDGTs). One concern over these estate planning arrangements is the unease over thinly capitalizing IDGTs or BDGTs calling into question their financial worthiness. This may be a good time to reexamine these installed techniques and see if they might benefit from increased funding to give greater financial substance to the arrangements.

STRATEGY: Charitable Lead Annuity Trust
DESCRIPTION: These can be set up in life or at death; they make annual income payments to charity for a set term. The remainder goes to heirs. Tax treatment depends on whether the donor claims a charitable deduction; low current interest rates help donors reduce gift taxes.

STRATEGY: Credit-Shelter Trust
DESCRIPTION: A couple sets up one for each spouse, ensuring that heirs benefit from the full estate-tax exemption for both partners. Under pre-2010 law, if a surviving spouse inherited all the partner's assets outright, the heirs could lose the benefit of the first spouse's exemption without a credit shelter trust. They can still make sense under current law.

STRATEGY: Dynasty Trust
DESCRIPTION: Twenty-eight states plus Washington, D.C., permit irrevocable trusts with instate trustees to endure for generations, and perhaps forever. If structured properly, such trusts can avoid estate or generation-skipping taxes.

STRATEGY: Grantor Retained Annuity Trust (GRAT)
DESCRIPTION: Over a preset term, these return principal to the giver. If the asset appreciates, the trust pays the donor a preset interest payment; extra appreciation is tax-free to beneficiaries. GRATs are appropriate for donors who don't want to part with principal or

those who want to transfer more than their individual exemption, as they can be structured with no gift-tax consequences.

STRATEGY: Grantor Trust
DESCRIPTION: Grantor trusts allow donors to pay capital gains and income taxes on investments in the trust on behalf of beneficiaries. Because the IRS doesn't consider these payments a gift, they can be a good way to leverage the transfer of wealth.

STRATEGY: Qualified Personal Residence Trust
DESCRIPTION: Donors may give a home to beneficiaries at a discount to current market value and transfer future appreciation tax free. The donor remains the home's owner for the trust's term. After that he must move or pay rent, which can be another way to give more to heirs.

STRATEGY: Qualified Terminable Interest Property Trust
DESCRIPTION: Often used by those with children from a prior marriage, these trusts provide a surviving spouse with income, and sometimes principal, free of estate tax. The donor retains control over who inherits the remaining assets after the survivor dies; those assets are then subject to estate tax.

STRATEGY: Sale to an Intentionally Defective Grantor Trust (IDGT)
DESCRIPTION: A way to transfer more than $5 million per individual to heirs. The donor starts a trust with a gift and then lends it up to 10 times more to buy an asset. As long as the asset appreciates, the trust can cover the loan, with the remainder going to beneficiaries. However, IDGT are not explicitly allowed by the tax code, and the IRS sometimes challenges them.

STRATEGY: Spousal-Access Trust
DESCRIPTION: These may be appropriate if an individual is worried about making irrevocable gift with the spouse or other heir as beneficiary. Risks include divorce; trustee denial of spousal payouts; and IRS scrutiny if spousal payments are too predictable.

STRATEGY: Self-Settled Trust
DESCRIPTION: These provide trustees discretion to distribute assets to the donor. Properly structured and located in a favorable jurisdiction, the trust can be excluded from the donor's estate. Note the sole authority, an IRS Private Letter Ruling, is nonbinding.