December 15, 2010

Estate Planning Update - December 2010

The following is a brief summary of some estate planning developments and opportunities that may be of interest to you.

We hope you find this helpful and look forward to hearing from you with any questions.

YEAR-END PLANNING OPPORTUNITIES

The one-year repeal of the federal estate tax in 2010 and the failure of Congress to address it have been well publicized. As we approach the end of 2010 and the likelihood of reinstatement of the pre-2010 tax laws becomes increasingly more remote, it is appropriate to consider ways to take advantage of the 2010 estate and gift tax laws.

In fact, there are several ways to take advantage of the current tax environment that should be considered as part of year-end planning. These include making large taxable gifts, making certain "generation-skipping" transfers, and distributing property from certain multi-generation trusts that will again be subject to generation-skipping transfer ("GST") tax after this year.

What is the current law?

For 2010, the federal estate and GST taxes are repealed under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). The federal gift tax remains in place, but with a reduced top rate of 35 percent, down from 45 percent in 2009.

Congress may still attempt to reinstate the estate and GST taxes retroactively to January 1, 2010 (the House in fact passed legislation extending the 2009 tax rates, but the Senate never took up the bill). Whether Congress will pass legislation retroactively or prospectively and what form the legislation will take are still uncertain. However, following the midterm elections and at this late stage, it appears unlikely that Congress will act to "fix" the estate tax before the end of 2010. Unless Congress provides otherwise, on January 1, 2011, the federal estate, GST and gift tax laws return to what they were in 2001. Thus, there will be a federal estate and gift tax with an exemption of $1,000,000 and a top tax rate of 55 percent (plus a 5 percent surtax on estates from $10 million to $17 million). There will also be a GST tax with an exemption of about $1,360,000 and a tax rate of 55 percent.

What does this mean?

Our sense continues to be that even if repeal were to remain in effect for all of 2010, it will not be extended beyond that time and that future estate tax rates and exemptions will be closer to the 2009 levels ($3,500,000 exemption with a 45% top tax rate) than the scheduled 2011 levels ($1,000,000 exemption with a 55% top tax rate). It remains unclear, however, whether Congress will accomplish these changes before the end of 2010 or whether we will begin next year with continued uncertainty. In addition, whether Congress will attempt to raise exemptions and lower tax rates even further than the 2009 levels, especially under the constraints of current budgetary restrictions, remains to be seen.

In light of the expected return of the federal estate and GST taxes along these lines, we recommend that you consider the

following opportunities to make transfers in 2010 designed to reduce or eliminate estate and/or GST taxes in the future.

Consider taxable gifts

The federal gift tax rate is scheduled to increase from a top rate of 35 percent this year to a top rate of 55 percent next year. If you are considering making sizable gifts to your children or grandchildren, 2010 is an especially good time to do so. In most years, there is a tax benefit of making taxable gifts and paying gift tax because the gift tax paid is removed from the donor's estate (if the donor lives at least three years after making the gift) along with all future appreciation on the gifted asset. In 2010, this benefit is enhanced as a result of the especially low gift tax rate.

For example, making a $1,000,000 taxable gift in 2010 instead of making the same gift in 2011 will result in a short-term savings of $200,000 in gift tax due next April and a combined gift and estate tax savings at the donor's death of about $90,000 (the combined savings would be reduced to $55,000 if the 2011 top tax rate is reduced to 45 percent). More significantly, potential aggregate tax savings at the donor's death by making a $1,000,000 gift in 2010 as compared to not making the gift at all could be as much as $300,000!

While the numbers can be compelling, there are downsides to making large gifts. The donor needs to part with the gift itself now and the gift tax liability in April 2011. In addition, there is a risk that Congress will retroactively impose a higher gift tax rate for 2010 as part of the estate tax legislation, although it is unlikely a donor would end up in a worse position by making the taxable gift.

Consider outright gifts to grandchildren

The benefits of 2010 taxable gifts are increased for transfers to grandchildren and others treated as "skip" persons for GST tax purposes, although there are some technical issues that may essentially limit this opportunity to outright transfers for the reasons discussed below. Like the federal estate tax, the GST tax is completely repealed for generation-skipping transfers occurring in 2010. However, the GST tax comes back in full force in 2011 at a 55 percent rate unless Congress acts to provide relief.

Outright transfers to adult grandchildren in 2010 should entirely escape GST tax as long as there is no retroactive reinstatement of the GST tax. The tax cost of retroactive reinstatement is very high because of the mechanics of the GST tax. However, if the donor has not previously used all of the $3,500,000 exemption, this risk is mitigated if the 2010 transfers do not exceed the remaining exemption.

There is much less clarity on how a gift in trust to a grandchild might be treated because the GST tax often applies to a distribution from a trust, not the transfer to the trust. How, or whether, taxpayers can use trusts to benefit from the GST repeal in 2010 currently remains exceedingly uncertain, and it seems unlikely that this uncertainty will be resolved before the end of the year.

Similar concerns apply to various forms of indirect gifts to grandchildren. Transfers to custodianship arrangements under the Uniform Transfer to Minors Act are treated as "trust equivalents" under the GST tax rules, and there is concern that Section 529 educational accounts, limited liability companies and partnerships could be treated the same for GST purposes.

Consider distributions from existing trusts

Trusts that were established prior to 2010 that include grandchildren as permissible beneficiaries but are not "exempt" for GST tax purposes may provide an opportunity to take advantage of the current GST tax repeal. Transfers to grandchildren from those trusts in 2010 will escape GST tax, absent its retroactive reinstatement. As long as making transfers to grandchildren is otherwise consistent with the terms of the trust (including the interests of any other beneficiaries), and especially if the trust is likely to terminate over the next few years, this is an excellent opportunity to avoid GST taxation of trust property down the road at perhaps 45 or 55 percent by making distributions to grandchildren this year.

Thus, the repeal of the estate and GST taxes for 2010, combined with the increasingly unlikely prospect of action by Congress by year end, creates an opportunity to make transfers to children or grandchildren that may escape transfer taxes for future generations. Gifts of this kind must be carefully considered, however, in light of the possibility of retroactive reinstatement of the prior tax laws.