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Estate Planning Update

July 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.

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FEDERAL ESTATE TAX UPDATE

At the time of our last newsletter in December 2009, the House of Representatives had passed legislation extending the 2009 estate tax exemptions and rates for another year, and we were hopeful that this would be addressed by the Senate shortly thereafter. Six months later, we are still waiting for congressional action. There is currently no federal estate or generation-skipping transfer (GST) tax. In the absence of congressional action, both taxes are scheduled to be reinstated in 2011, with a $1,000,000 estate tax exemption and GST tax exemption of about $1,340,000.

Efforts at a congressional resolution continue, including the possibility of retroactively extending the 2009 rate and exemptions through 2011 to allow Congress more time to address the issue without election year pressures. Recent reports suggest that no action will be taken until after mid-term elections in November. 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). Whether Congress will raise exemptions and lower tax rates even further, especially under the constraints of current budgetary restrictions, remains to be seen.

We will continue to monitor the situation in Washington and provide an update when the dust settles.

PROPOSED LEGISLATION TARGETS SHORT-TERM, ZEROED-OUT GRATs

A grantor retained annuity trust ("GRAT") is a potentially highly effective tax planning tool. In light of pending federal legislation that would affect the tax planning benefits of GRATs, you should consider setting up a GRAT now under the current rules.

GRATs under the Current Rules

A GRAT is a trust designed to transfer future appreciation without any gift or estate tax charged on that growth. The trustee of the GRAT annually pays to the person setting it up (the "grantor") a designated percentage of the initial fair market value of the trust for the term of the trust, say two years. That percentage is based on the prevailing federal interest rate for the month that the GRAT is funded. The assets originally transferred to the trust, plus interest, are thus returned to the grantor. Any growth in excess of the applicable annual interest rate is accumulated in the trust and, so long as the grantor is living at the end of the trust term, passes to children (or other beneficiaries). GRATs offer the potential for transfers to the next generation without tax cost because they can be "zeroed-out" for gift tax purposes. More importantly, they offer that potential with no significant tax risk because they have been specifically approved by the IRS.

Thus, a GRAT can be created that generates no gift tax. It moves future appreciation above a current interest rate (2.8% per year for a GRAT funded in July 2010) down to children. For example, a two-year GRAT funded in July 2010 with $1,000,000 would generate "winnings" of about $51,600 passing to children free of estate and gift tax, assuming a 6% annual rate of return on the GRAT assets.

Proposed Changes

Currently, a GRAT can be designed to last for a short period of time, often two or three years. The tax benefits of a GRAT are lost if the grantor is not living at the end of the selected term—a GRAT only "works" if the person setting it up survives the term. The proposed legislation requires a ten-year minimum term, increasing the mortality risk of a GRAT. Additionally, under the proposed legislation the value of the remainder must result in a taxable gift, thus forcing the grantor to use some of his or her $1,000,000 lifetime gift tax exemption. The House has passed these changes, and the Senate is considering them now. The changes would become effective upon enactment.

What to Consider

If you want to implement a short-term GRAT that is "zeroed-out" for gift tax purposes under current law, you must establish a GRAT before the federal legislation is enacted. In addition to avoiding a current taxable gift, creating a GRAT now under the existing rules avoids the mortality risk of a longer-term GRAT. If you have an existing GRAT in place, you may want to consider strategies to either "lock-in" good investment performance or "swap" assets for under-performing assets. In either case, a new GRAT could be beneficial.

Please let us know immediately if you would like to discuss the possibility of setting up a short-term, zeroed-out GRAT now under the current rules.

PLANNING CONSIDERATIONS IN LIGHT OF SCHEDULED FEDERAL INCOME TAX CHANGES

With the looming expiration of many of the income tax benefits passed over the last decade, federal income tax rates in 2010 may be at their lowest levels for some time to come. The following discussion summarizes some of the expiring tax benefits and suggests some ways to help you plan to minimize your tax expense in light of pending increases in federal income tax rates.

Background

Over the past several years, a variety of income tax reductions were enacted by Congress, all of which no longer apply after 2010, including: reductions to taxes on long-term capital gains and certain dividends, reducing the so-called marriage penalty, reducing marginal income tax rates, increasing the child credit, reducing the phase-out of certain itemized deductions, and reducing the phase-out of personal exemptions. Although there has been some discussion of extending these tax reductions for families with annual incomes under $200,000, there is no pending legislation to do so, and families with income above $200,000 should expect these income tax reductions to disappear next year. In addition, the recently enacted healthcare reform legislation includes additional tax increases, especially for couples earning more than $250,000 per year.

Increases In 2011

Absent congressional action, the "qualified dividend" classification will be eliminated in 2011. As a result, all dividends will be taxed as ordinary income, ending the favored treatment of most dividend income. Also, the current favorable rate of 15% on the sale of most assets held for more than one year will no longer apply. Instead, the long-term capital gains rate will be 18% on assets held longer than 5 years and purchased in 2001 or later and 20% for most other long-term capital gains. In addition, the marginal rates for ordinary income will increase, from a current top rate of 35% to a new top rate in 2011 of 39.6%. Finally, in 2011 for a married couple, personal exemptions will phase out beginning at about $250,000 of income and will be eliminated at about $373,000; itemized deductions phase out slowly beginning at about $167,000 of income.

What You Can Do

In the face of rising tax rates, the general rule is to accelerate income and defer deductions. Whether you can control the timing of either and whether the general rule will in fact be helpful to you will depend on many factors, and we recommend that

you consult with your income tax preparer and other advisors before undertaking any income tax planning steps. However, a few general ideas follow that may be helpful depending on your circumstances.

The federal capital gains rate is scheduled to increase by about 33% in 2011. If you are planning to sell appreciated securities with unrealized appreciation within the next year or two, consider selling those securities in 2010, when the gain will be taxed at the lower rates. Similarly, you may wish to defer selling securities at a loss until next year, when those losses can offset 2011 capital gains taxed at the higher rate (or incur 2010 losses that could be carried forward to 2011).

You should also consider accelerating receipt of any ordinary income from 2011 to 2010 to the extent possible. For example, if you have nonqualified stock options that are vested and "in the money," you may wish to exercise some of them in 2010.

If you can "time" deductions such as charitable contributions or state taxes, consider deferring the deductions. However, for married couples earning more than about $167,000 in 2011, an increased portion of your itemized deductions is slated to be disallowed next year and therefore the benefit of timing deductions could be reduced.

Finally, you may wish to establish "529 plans" for your children or grandchildren's education if you have not done so already (or add to existing plans). Assets in a 529 plan are not subject to income tax and remain income-tax free as long the funds are eventually used for qualified education expenses such as tuition, room, board, and books. Thus, 529 plans are tax-efficient options for gifting.

Tax Increases Associated with Healthcare Reform

The tax increases associated with healthcare reform generally do not begin until 2013 but will eventually add to the increased income tax burden. First, the Additional Hospital Insurance Tax imposes an additional 0.9% Medicare tax for married individuals with more than $250,000 of earned income and single individuals with more than $200,000 of earned income. In addition, the Unearned Income Medicare Contribution Tax is a new tax of 3.8% on unearned income, such as interest, dividends, and capital gains taxes, for married couples with total earnings of $250,000 or more and single individuals with total earnings of $200,000 or more. Income from retirement plans such as IRAs and 401(k) plans will be exempt.

The threshold for deducting medical expenses is scheduled to increase to 10% of adjusted gross income (although this increase is deferred until 2016 for individuals age 65 and over and their spouses), and the maximum contributions to flexible savings accounts and health savings accounts will be capped at $2,500 per taxpayer.

The bottom line is that the expiration of many existing income tax benefits and the scheduled increase in federal income tax rates may offer an opportunity to minimize tax expense over the next year or so, depending on your circumstances. We suggest that you raise these issues now with your accountant and other advisors to determine if there are steps you can take this year to plan accordingly.

MANDATORY REPORTING BY U.S. PERSONS OF FOREIGN FINANCIAL ACCOUNTS

Our June 2009 newsletter discussed mandatory reporting by U.S. persons of foreign financial accounts on the "Report of Foreign Bank and Financial Accounts" (FBAR) filings on Form TD F 90-22.1 U.S. persons having a financial interest in or signature or other authority over financial accounts located in foreign countries with an aggregate value greater than $10,000 are required to file an FBAR annually, on or before June 30 of the year following the applicable reporting year (i.e., June 30, 2010, for the 2009 reporting year). The Internal Revenue Service (IRS) and the Financial Crimes Enforcement Network (FinCEN) of the U.S. Department of the Treasury each issued additional guidance on this subject on February 26, 2010.

FinCEN's guidance comes in the form of proposed regulations that clarify the definition of "U.S. persons" who will be required to file the FBAR and which foreign accounts will, in fact, be reportable. The regulations proposed by FinCEN are not yet effective, and there is no indication therein that they may be relied upon pending issuance of final regulations.

The IRS guidance comes in the form of Notice 2010-23 and Announcement 2010-16. The latter temporarily suspends the FBAR filing requirement for persons who are not U.S. citizens, U.S. residents, or domestic entities for 2009 and prior calendar years. The former provides FBAR and Form 1040 filing relief for (i) certain persons having no financial interest but only signature authority over a foreign financial account by granting them a temporary extension to June 30, 2011 to report for 2009 and prior calendar years and (ii) persons having a financial interest in or signature authority over foreign commingled funds other than mutual funds, such as foreign hedge funds or private equity funds, who do not have to file the FBAR with respect to the same for 2009 and prior calendar years.

To understand how the new guidance may apply to you, please contact one of our ICD attorneys listed below.

We hope you found this update helpful. Please contact us with questions about any of these items or anything related to your estate planning needs.

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