TRUSTS & ESTATES
ALERT
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Before the Stroke of Midnight – 2010 Year-End Opportunities

On January 1, 2010, the federal estate and generation-skipping transfer (GST) taxes were repealed, and the top gift tax rate was reduced to 35%. Under the sunset provisions of the 2001 Tax Act known as EGTRRA, on the stroke of midnight New Year's Eve, these changes will be eliminated. Beginning on January 1, 2011, the estate and GST taxes will be reinstated with a $1 million exemption and a maximum rate of 60%.[1] The lifetime $1 million gift tax exemption will continue but the maximum gift tax rate will increase to 60%. This Alert highlights some estate planning opportunities for individuals to consider before the end of 2010.

Congress' Inaction and the Recent Election Results Create an Uncertain 2011

Few predicted that the 2010 estate tax repeal would actually occur, and while there has been much speculation as to the future of the estate and GST taxes, there is no clear picture. The chart on the next page illustrates the 2009 and 2010 rates and highlights the most often discussed possibilities for 2011. Unless and until Congress acts, the rates listed in the 2011—EGTRRA Sunsets column will govern.

In addition to providing an overview of what the future may hold, the chart also raises questions about the traditional strategy of deferring income. When tax rates are known and foreseeably constant, it generally makes economic sense to defer income. Considering the uncertainty surrounding future tax rates, deferral continues to be a strong strategy if the deferral is for an extended period of time. Conversely, if the deferral is only for a year or two, acceleration may be preferable as 2010 rates are projected to be lower than the rates in 2011 and 2012.

Gifting

Annual Gifting Opportunities. This year, a maximum of $13,000 per individual ($26,000 per couple) may be gifted to any individual without incurring a gift tax. A donor may also make payments directly to an educational institution for tuition costs or to a medical care provider for medical costs (including medical insurance) without incurring a gift tax.

Large Gifting Opportunities. In 2010, gifts over the $1 million lifetime exemption will benefit from the lowest gift tax rate (35%) since the 1930s and gifts to grandchildren or more remote generations will benefit from the absence of the GST tax. This window for gifting is fairly short — unless Congress acts, the maximum gift tax rate will increase to 60% in 2011 and the GST tax will be restored. In particular, families should consider whether the low gift tax makes 2010 a good year to forgive intra-family debt. In addition, low asset values, particularly in real estate and family businesses, may further enhance the benefits of gifting these assets. Under current law, these transfers are often eligible for a valuation discount for lack of control and/or lack of marketability. However, proposals exist that would eliminate valuation discounts in the future in the family context, increasing the tax on these transfers.

Grantor Retained Annuity Trusts (GRATs). Individuals may benefit from creating Grantor Retained Annuity Trusts ("GRATs"). A GRAT is a trust that is created for a term of years during which the grantor receives an annuity payment at least annually. If the assets of the GRAT outperform the Section 7520 Rate (which is at a historic low of 1.8% for gifts made in December 2010), the balance remaining at the end of the GRAT term will pass to the designated beneficiaries, often the grantor's family members or trusts for their benefit. So long as the grantor survives the GRAT term, the assets in the GRAT are not included in the grantor's estate and no estate tax will be assessed on the balance passing to the beneficiaries. For this reason, GRATs are commonly created with a short term (two or three years). However, legislation has been proposed that would require a minimum ten-year term and prohibit zeroed out GRATs (GRATs designed to incur no gift tax exposure). Creating a GRAT this year would allow a taxpayer to take advantage of the current law.

For all of these gifting options, careful consideration is necessary prior to the end of the year to (1) balance the benefits of potential tax breaks and an individual's or family's overall goals; (2) consider the impact of Congressional action or inaction; and (3) weigh the risk that if a taxpayer dies in 2010 after having made a taxable gift, the transfer will not benefit

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1. When this Alert uses 60% as the maximum rate, the 60% refers to the maximum bracket of 55% plus the 5% surcharge for estates or gifts between $10 million and approximately $17 million.

	2009	2010	2011— EGTRRA Sunsets	2011— Executive or Congressional Proposals
Income Tax Brackets	Maximum rate: 35%	Maximum rate: 35%	Maximum rate: 39.6%[2]	*Proposal One:* Extend the Bush Tax Cuts for two years with the maximum rate remaining 35% *Proposal Two:* Retain current tax rates, except the highest two brackets would increase to 36% and 39.6%
Capital Gains Rates	Maximum rate: 15%	Maximum rate: 15%	Maximum rate: 20%	*Proposal One*: Maximum rate: 15% *Proposal Two:* Maximum rate: • 15% for individuals in all but the two highest income tax brackets • 20% for high-income individuals
Estate Tax and GST Tax— Exemptions[3]	$3.5 million per individual	No Estate Tax or GST Tax; therefore, no exemption	$1.34 million per individual (adjusted for inflation) State death tax credit reinstated	*Proposal One:* $3.5 million per individual *Proposal Two:* $5 million per individual *Proposal Three:* Unused exemptions of the first spouse to die may be available at second death
Estate Tax and GST Tax— Rates	Maximum rate: 45%	No Estate Tax or GST Tax	Maximum rate: 60%	*Proposal One:* Maximum rate: 35% *Proposal Two:* Maximum rate: 45% *Proposal Three:* Maximum rate: 55%
Gift Tax— Exemption	$1 million per individual	$1 million per individual	$1 million per individual	*Proposal One:* $1 million per individual *Proposal Two:* Unify the gift and estate tax exemptions enabling complete usage for lifetime gifts
Gift Tax— Rates	Maximum rate: 45%	Maximum rate: 35%	Maximum rate: 60%	*Proposal One:* Maximum rate: 35% *Proposal Two:* Maximum rate: 45% *Proposal Three:* Maximum rate: 55%

2. The Alternative Minimum Tax exemption will remain at $33,750 for individuals and $45,000 for married couples filing jointly. The "stealth tax" associated with numerous personal exemptions and itemized deductions will be reinstated causing high-income individuals to lose some of these exemptions and deductions due to income phase-out limits.

3. Property inherited in 2010 will receive a carryover (decedent's) basis and the ability to allocate an additional $1.3 million (plus $3 million to a spouse). For 2011, inherited property will receive a step-up (fair market value) basis.

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from the temporary repeal of the federal estate tax (which would have been available for transfers occurring under the taxpayer's will).

Non-exempt GST Trust Distributions to Grandchildren

This may be an optimal year to make distributions from or terminate non-exempt GST trusts because distributions in 2010 to a transferor's grandchildren or more remote generations will presumably pass free of GST tax. Beginning in 2011, such transfers may be subject to GST tax at a rate as high as 60%.

IRA Conversions

It may be advantageous to convert a traditional IRA, 401(k) or 403(b) to a Roth IRA account or, if your 401(k) or 403(b) plan permits, to elect an "in-plan" Roth conversion. In a Roth IRA, assets grow tax-free similar to a traditional IRA, but "qualified distributions" are not taxable to the account owner or beneficiary. Furthermore, the account owner has no minimum distribution requirements during his or her lifetime.

Traditionally, high-income individuals were prohibited from converting; however, starting in 2010, any taxpayer, regardless of income, may convert. For 2010, the income taxes on these conversions will not include the 10% premature distribution penalty (distributions made prior to age 59 ½) and the tax will be paid over the next two years (50% in 2011 and 50% in 2012). Alternatively, a taxpayer may elect to pay the entire amount in 2010, which may be advisable in light of the proposed income tax rate increases. Conversion this year is beneficial for taxpayers who (1) are not planning to retire for a number of years; (2) anticipate being taxed in a higher bracket in the future; (3) are able to pay the conversion taxes from non-retirement account assets; (4) are not planning to gift the IRA to charity; and (5) have special favorable tax attributes. Finally, because the conversion may be undone anytime before 2010 taxes are due, a taxpayer has a safeguard if rates do not increase or circumstances arise that would diminish the benefits of the conversion (such as a precipitous fall in the market value of the account).

Charitable Giving

Due to the historical low of both the Section 7520 Rate and gift tax rate, 2010 is a great time for charitable lead trusts (CLTs). A CLT is a trust that makes a payment to a charitable organization for a set period of time. At the end of the trust term, the remaining assets are paid to one or more noncharitable beneficiaries, typically family members. The low Section 7520 Rate causes the present value of the charity's annuity to be higher allowing for a higher charitable deduction while decreasing the taxable gift to the non-charitable interest. Taxpayers who are interested in creating a CLT or in making other charitable gifts should consult their advisors to confirm tax-exempt status and review the applicable deduction limits to structure gifts for optimal tax benefits.

Concluding Reflection

This Alert assumes that Congress will not retroactively impose the estate tax and GST tax on 2010 transfers. Retroactive laws are generally unconstitutional; however, there are a number of cases that have upheld retroactive taxes when there was a legitimate legislative interest. Due to these uncertain times, careful planning is a critical step in meeting your planning goals. ◆

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This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking legal action.

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