Insight on

Estate Planning

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. . . that is the estate planning question

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Estate Planning Pitfall

You made large taxable gifts in 2010

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To give or not to give in 2011 and 2012 …

. . . that is the estate planning question

Gifting has always been an important part of estate planning. And now that the gift tax exemption stands at $5 million ($10 million for married couples filing jointly) and the top gift tax rate is 35%, the tax environment is especially favorable for making large gifts.

But because these levels are scheduled to expire after 2012, the question of whether you should maximize your gifts to your children or other loved ones this year and next is a good one. Let's take a look at a few answers.

A limited-time offer?

Determining whether you should give away assets now depends, in part, on what you believe will happen to gift and estate taxes in 2013. If you expect Congress to allow the estate tax to revert to levels prescribed by pre-2001 tax law — with the exemption shrinking to $1 million and the top tax rate jumping to 55% — you might view the current law as a limited-time offer to transfer substantial amounts of wealth tax-free.

On the other hand, if you think Congress will make the $5 million exemption and 35% tax rate permanent, there's less pressure to act now. Of course, there's another advantage to transferring wealth sooner rather than later, even if the exemption amount and tax rate stay the same: After you make a gift, any future appreciation in the gifted asset's value is shielded from gift and estate taxes (though there may be an income tax disadvantage if the recipient wishes to sell the asset).

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Is there a risk of recapture?

You might be worried that, if you make large gifts now — but by the time you die the exemption has been reduced — some or all of these gifts will be "recaptured" and subject to estate tax. This recapture — or "clawback" — risk is a legitimate concern because of the way estate tax is calculated: Previous taxable gifts are added back into your estate (at their date-of-gift values), estate tax is computed on the total (based on the exemption amount and tax rate in effect on the date of death) and the tax is reduced by any gift taxes previously paid.

Many estate planning advisors believe that Congress didn't intend tax-free gifts made in 2011 and 2012 to be subject to estate tax in later years if the exemption amount is reduced. There's even a provision in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (the law that established the 2011 and 2012 gift tax exemption and rates) that appears to address this issue. Unfortunately, it's not yet clear how this provision will work, and it will take further guidance from the IRS to know for sure. In the meantime, taking advantage of the $5 million exemption remains a good strategy if you can afford to make large gifts now.

Max out nontaxable gifts

Last year's Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act provides a great opportunity for making large, tax-exempt gifts. But before making such gifts, consider first making the most of *non*taxable gifts, such as annual exclusion gifts (currently up to $13,000 per recipient or $26,000 for gifts you split with your spouse) and direct payments of qualified medical expenses or tuition.

These gifts allow you to transfer significant amounts of wealth tax-free, without tapping any of your $5 million exemption and with no risk of recapture in the event Congress reduces the exemption in the future.

And don't underestimate the tax-saving power of nontaxable gifts. Suppose, for example, that you and your spouse have four married children and five grandchildren, and that two grandchildren attend colleges that charge tuition of $40,000 per year. You and your spouse could make nontaxable gifts of $26,000 per year for each child (and each of their spouses) as well as for each grandchild, and pay the $80,000 in tuition, for total nontaxable gifts of $418,000 per year.

Where do FLPs and GRATs fit in?

If you decide to make the most of the $5 million exemption, consider using tools that allow you to leverage your gifts, such as family limited partnerships (FLPs) and grantor retained annuity trusts (GRATs). With careful planning, you can use these vehicles to transfer assets to family members at discounted values for gift-tax purposes, allowing you to transfer greater amounts of wealth tax-free.

Some lawmakers wanted to reduce or eliminate the tax benefits of FLPs and GRATs, but Congress omitted those proposals from the 2010 Tax Relief act. It's possible that similar proposals will be introduced in the future, however, so it may be a good idea to take advantage of these tools soon.

Preparing for an uncertain future

With the gift tax exemption currently at an all-time high, lifetime giving can be a particularly powerful tool for tax-efficient transfer of wealth. But estate planning in uncertain times can be a challenge, so it's a good idea to build flexibility into your plan to deal with whatever surprises Congress throws your way. One gifting strategy that isn't affected by changing tax rates and exemption amounts is making *non*taxable gifts. (See "Max out nontaxable gifts" above.) ∎

CRTs and CLTs offer dual beneficial interests

Charitable giving can provide many intangible benefits to you and your family, which can be as rewarding as the estate tax savings that can result from your donations. To help achieve your philanthropic and estate planning goals, consider a charitable remainder trust (CRT) or a charitable lead trust (CLT).

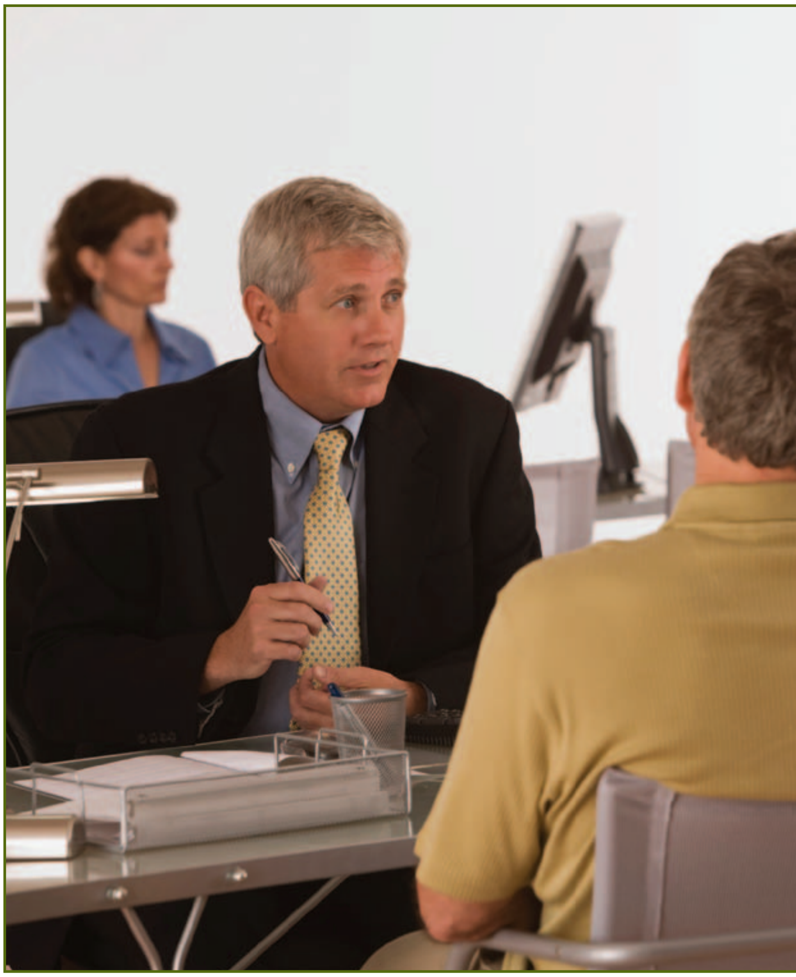
These "split-interest" trusts — so-called because of their dual beneficial interests — provide for both qualified charities and noncharitable beneficiaries, such as you or your loved ones.

CRT strategies

A CRT provides noncharitable beneficiaries with exclusive rights to all distributions until their interests have terminated. At that time, charitable beneficiaries receive the *remainder* — the assets left over in the trust.

> *A CRT can be a useful tool if you'd like to divest yourself of a highly appreciated asset to diversify your portfolio but are concerned about the capital gains tax.*

A CRT can be a particularly useful tool if you'd like to divest yourself of a highly appreciated asset to diversify your portfolio but are concerned about the capital gains tax. You create a CRT,



name yourself the noncharitable beneficiary and transfer the appreciated asset to the trust. Then, the CRT can sell the asset (tax-free because the CRT is tax-exempt) and use the proceeds to purchase diverse, income-producing, assets.

You receive annual payments from the trust for your lifetime, increasing your cash flow. A portion of each payment may be taxable to you, depending on the trust's activity. You might, for instance, have capital gains income attributable to the sale of the highly appreciated shares you transferred to the trust. The gain that you report — and the related tax consequences of the gain — will be spread out as you receive payments.

In addition, you'll enjoy an immediate income tax deduction on creation of the trust, calculated as the present value of the charity's remainder interest. You also can gain recognition within the charitable organization(s) and community as a result of the contribution, unless you prefer to donate anonymously.

And don't forget to consider the estate tax implications: At your death, the trust terminates, and the remaining assets belong to the charity. These assets won't be included in your estate for estate tax purposes.

If you're concerned that, should you die early in the CRT's existence (before you've received many payments from it), there won't be enough assets in your estate for your heirs to receive the inheritances you intended, there are two potential solutions.

1. You can set the CRT term for a specific number of years (rather than your lifetime) and name your heirs as contingent beneficiaries. Then, regardless of whether you live for one day or the entire term, you'll know that your loved ones will be provided for. That is, either you or your heirs will receive the annual distributions for the whole term.

2. You can hedge your bets by purchasing a life insurance policy to make up for the shortfall your heirs might experience. You'll want to do an analysis of how much insurance you'll need, as well as how long you'll need it. Typically, this insurance policy should be held in an irrevocable trust, so the insurance proceeds won't be included in your estate for estate tax purposes.

CLT strategies

A CLT reverses the timing of when the charitable and noncharitable beneficiaries receive distributions: The charitable beneficiaries receive the initial distributions and the noncharitable beneficiaries receive the remainder.

A CLT can be useful when an asset generates substantial income every year, you don't need the income and you wish to eventually pass the asset to your heirs. The CLT generates an income stream for the charity during the trust term, and at your death (or the end of the CLT term, if you've set it for a specific number of years) the asset passes to your family.

A CLT works similarly to a CRT in that you're able to get an immediate income tax deduction on the transfer of assets into the trust. In subsequent years, however, the income generated by the CLT is taxable to you. Unlike a CRT, though, a CLT has a gift tax component, which is calculated as the present value of the noncharitable beneficiary's remainder interest.

As with CRTs, CLTs can also be funded at your death, but the tax consequences will be different.

Which trust is better for you?

Giving to your favorite charitable organizations is important to you, but you also want to provide for your family. Including a CRT or CLT in your estate plan can help you achieve your goals. ∎

Putting the "state" in your estate plan

For 2011 and 2012, the federal estate tax exemption is set at $5 million and is portable between spouses. In other words, if one spouse dies without using up the exemption (and a timely election is filed), the surviving spouse can add the unused portion to his or her own exemption.

So, at least temporarily, married couples with combined estates worth less than $10 million need not concern themselves with federal estate taxes. But don't get too relaxed: As federal taxes become less significant, state estate taxes — including inheritance and estate taxes — take on a more prominent role. And overlooking their potential impact can be costly.

The state of state estate taxes

Up until 10 years ago, federal law provided estates with a dollar-for-dollar credit, up to 16% of federal estate tax liability, for any inheritance or estate taxes paid to a state. To keep things simple, most states used what was known as a "pick-up" tax tied to the credit amount. This tax didn't increase an estate's overall tax liability; it simply redirected an amount equal to the federal credit from the U.S. Treasury to a state treasury.

The Economic Growth and Tax Relief Reconciliation Act of 2001 eliminated the credit and replaced it with a deduction. This change effectively "disinherited" states that relied on a pick-up tax. States reacted in different ways to this sudden loss of revenue. Some states simply allowed their estate taxes to disappear, but many "decoupled" from the federal estate tax, either by calculating their estate tax based on an earlier version of federal law or by establishing a stand-alone state estate tax system.

In those states that continue to impose an estate tax, exemption amounts vary dramatically. But in most cases they're significantly lower than the federal exemption.

Plan for state taxes

Unless you have the good fortune to live in a state without an estate tax, such as California, it's important to consider state taxes as part of your estate planning. And keep in mind that, if you own property in another state, you may be subject to estate taxes there as well (at least with respect to the property's value).

Let's look at how state estate tax could affect a married couple. Suppose that Derek's estate is worth $4 million, so it's exempt from federal estate tax, but his state imposes an estate tax at a top rate of 45% with a $2 million exemption. Even though no estate planning is required to avoid federal tax (assuming the exemption remains at $5 million), without a plan Derek's estate will owe $900,000 in state tax. He can defer the tax, of course, by transferring his entire estate to his wife, Kathy, but assuming no intervening changes, her estate will owe that same $900,000 in state taxes on her death.

A better strategy is for Derek to give $2 million to Kathy (either outright or in a marital trust) and place $2 million in a credit shelter trust. The credit shelter trust provides Kathy with an income interest for life, after which the assets go to the couple's children.

The trust shields the assets from estate taxes by taking full advantage of Derek's exemption. And by limiting Kathy's rights to the trust principal, the assets bypass her estate. Assuming that Kathy's estate is still worth $2 million when she dies, her exemption will shield it from estate tax.

Review your plan

A plan that meets your objectives today won't necessarily work down the road. Referring back to our fictional couple, Derek and Kathy, suppose that the federal estate tax exemption drops to $1 million in 2013. If Derek dies that year without having adjusted his plan, half of the assets used to fund the credit shelter trust ($1 million) will immediately be subject to federal estate taxes.

To avoid unpleasant tax surprises, it's critical to review your plan periodically in light of changing federal and state laws. ■

Estate Planning Pitfall

You made large taxable gifts in 2010

Without Congressional action, expiring tax law would have resulted in the revival of the 55% gift tax rate (while retaining the $1 million lifetime exemption) for 2011, prompting some taxpayers to accelerate gifts into 2010 to take advantage of the 35% rate. It wasn't until mid-December that Congress passed tax legislation preserving the 35% gift tax rate and increasing the gift tax exemption to $5 million for 2011 and 2012.

Suppose you made a $1 million gift on Dec. 1, 2010. Ignoring the annual gift tax exclusion — and assuming that you'd already used up your $1 million exemption — you'd owe $350,000 in gift tax. If you'd made the same gift one month later (on Jan. 1, 2011) it would have been tax-free.

Can you "undo" the gift? Possibly. One potential option is to attempt to rescind the gift. Whether this strategy is worth the effort depends on your state's rescission laws and how they're interpreted by the IRS and the courts.

Another option is for the recipient to return the gift to you using a qualified disclaimer. This may be difficult to achieve, however, because qualified disclaimers are invalid if the recipient has "accepted" the disclaimed property or any of its benefits. Examples of acts that may indicate acceptance include using the property, accepting income generated by the property (such as dividends, interest or rents) or pledging the property as collateral. Merely taking delivery of title, however, doesn't, by itself, indicate acceptance. Also, keep in mind that a disclaimer must be filed within nine months of receiving the gift.

If you made a large taxable gift last year that you now regret, consult your estate planning advisor to evaluate the possibility of undoing the gift.

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