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Estate and Gift Tax Planning Opportunities in 2010

As we approach 2011, there is still great uncertainty regarding what the estate and gift tax law will be in the future. Despite this uncertainty, many planning opportunities remain available this year.

Under current tax law, the Federal gift tax rate was reduced to 35% for gifts made in 2010 (as compared to the 45% gift tax rate applicable in 2009 for most gifts). The lifetime exemption from the gift tax is unchanged and remains at $1 million for 2010. Second, the tax law repealed the generation-skipping transfer ("GST") tax for 2010. The GST tax is a transfer tax in addition to the estate and gift tax that is imposed on transfers by a donor to an individual who is more than one generation younger than the donor *(i.e.,* a grandchild). The GST tax is designed to prevent families from avoiding the estate tax by "skipping" generations and making gifts directly to grandchildren.

The current estate and gift tax law ends this year and the Federal wealth transfer tax system as it existed in 2001 will be reinstated. As a consequence, in 2011, the highest gift and estate tax rate will return to 55% and the GST tax will return at a 55% rate unless further changes are made by Congress.

Here are several planning techniques you should consider before December 31, 2010:

Make Gifts to Take Advantage of the 2010 Gift Tax Rate of 35%

Under today's law, the gift tax remains with a $1 million lifetime exemption at a rate of 35% in 2010 (as compared to the 2009 maximum gift tax rate of 45%). After December 31, 2010, the gift tax is scheduled to increase to a maximum rate of 55% in 2011, although the lifetime exemption amount will remain at $1 million. The reduction in the gift tax rate to 35% — the lowest rate since 1934 — may be an opportunity to make larger gifts that are subject to gift tax, especially because it seems unlikely given the current political and economic environment that future gift tax rates will be lower. It is also unlikely that the gift tax exemption will be increased above $1 million, even if the estate tax exemption is reinstated at its 2009 level of $3.5 million. This concept, known as "reunification," has been discussed, but does not seem to have much support.

For example, a gift in 2010 by an individual of $1 million in excess of his $1 million lifetime exemption and the $13,000 annual exclusion would result in a Federal gift tax liability of $350,000. The same gift made in 2009 or 2011 would result in a gift tax of $450,000 and $550,000, respectively. It should be noted that if a donor were to die within three years of making a taxable gift, the amount of the gift tax paid will be included in his estate and subject to estate tax. This estate tax inclusion will not, however, completely erode the benefit of the lower gift tax rate applicable to gifts in 2010. In addition, while the tax may be added back to the estate, any appreciation on the gifted asset will escape estate tax.

Of course, if someone makes a gift this year to take advantage of the lower gift tax rate and lack of GST tax and then dies before the end of 2010, that person would have effectively incurred a 35% gift tax where, if they'd just died and allowed the asset transfer to take place this year as a result of their death, the transfers could have taken place with a 0% transfer tax rate. For this reason, it may make sense to wait until the end of December to make taxable gifts. There are also other techniques that may be used to ensure that a gift is not made until it is known that the donor lived through the end of 2010. Please feel free to call us to discuss these options in more detail.

Make Gifts to Take Advantage of the Repeal of the GST Tax in 2010

Under current law, the GST tax was repealed for transfers made in 2010. In 2011, the GST tax will return at a 55% tax rate and an exclusion amount of approximately $1 .3 million (as compared to a 45% tax rate and $3.5 million exclusion amount in 2009). Coupled with the lower gift tax rate, the repeal of the GST tax presents an opportunity to make gifts to grandchildren and more remote descendants. Although gifts to a grandchild in 2010 will still be subject to the 35% gift tax discussed above, they will not be subject to any additional GST tax; in comparison, a gift to a grandchild in 2011 in excess of the donor's gift and GST tax exclusion amounts will be subject to both gift and GST tax, each imposed at a 55% rate.

It is clear under current law that an outright gift to a grandchild in 2010 will not be subject to a GST tax. A gift in trust in 2010, however, may be more problematic since under current law, future distributions from that trust to the grandchild may be subject to a GST tax. Therefore, to avoid potential GST tax liabilities in later years, donors should make outright gifts to grandchildren this year rather than gifts to trusts. However, the potential tax savings must be balanced against non-tax issues. For instance, if the grandchild has creditor issues or other problems, an outright distribution may not be prudent.

Making gifts to minor grandchildren in 2010 may not avoid the one year lapse in the GST tax regime; under current law, a gift to a vehicle that can hold property for the benefit of a minor grandchild, such as a uniform transfers to minor's account, is deemed to be a gift to a trust and, therefore, the transfer may be subject to the GST tax in a subsequent year. Consequently, the one year lapse in the GST tax will be advantageous in 2010 for gifts to grandchildren that are made outright and that are also limited to adult beneficiaries.

Use of Gift Tax Exemptions to Reduce Estate and Gift Tax

As we stated above, although the federal estate tax is repealed in 2010, it is scheduled to come back in 2011. The amount of the federal estate tax exemption in 2011 is uncertain; if Congress does nothing, it will be $1.0 million, but Congressional leaders have indicated that they intend to increase it to $3.5 million, the amount that was in effect in 2009. Although the exemption amount and tax rates in future years are uncertain, there is no doubt that the estate tax is returning. Therefore, you should consider making sufficient gifts during your lifetime so that your estate will not exceed the exemption amount in effect at your death.

Any gift-giving programs must take into consideration that your lifetime gifts are subject to a gift tax that is imposed at the same rate as the estate tax. This “unified” system is intended to eliminate any tax advantage to making gifts. But certain types of lifetime transfers are not subject to gift tax, and the end of the year could be a good time to make these tax-free gifts.

Consider Establishing a Grantor Retained Annuity Trust (GRAT)

The GRAT is one of the most powerful and tax efficient wealth transfer tools available today. A GRAT allows a person to share the future appreciation of an asset with the next generation with little or no gift tax cost.

A GRAT is a trust with a specific tern that can be as short as 2 years. The grantor transfers assets to the GRAT and retains an income interest in the trust. This income interest will be stated an annuity percentage of the original assets transferred to the GRAT. The amount of the gift is calculated using the subtraction method. The present value of the annuity payments to the grantor will be subtracted from the original value of the assets placed into the GRAT.

For example, if you put $2,000,000 of assets (stocks) into a 2 year GRAT and the assets grow at 10% per year, your children will receive $256,836 in value at the end of 2 years free of gift tax. If the assets in the GRAT grow at 15% per year, your children receive $430,332 free of gift tax.

Congress has threatened to curtail the use of this gift tax planning technique so there may not be much more time to implement this strategy.

Annual Gift Tax Exclusion

The most commonly-used method for tax-free giving is the annual gift tax exclusion, which allows you to make a gift of up to $13,000 in 2010 to each donee without using your lifetime$1.0 million gift tax exclusion. There is no limit on the number of donees to whom you can make such gifts — if you make $13,000 gifts to 10 donees, you can exclude $130,000 from tax. In addition, if you are married you can double the amount of the exclusion to $26,000 per donee, because you and your spouse can combine your exemptions in a single gift from either of you. The exclusion applies to gifts of any kind of property, although certain types of property may require an appraisal. Gifts of appreciated property can also result in income tax savings, because the recipient will pay the capital gains tax upon any sale. The threat of higher income tax rates in 2011 make this an important consideration.

Your annual gift tax exclusion expires at the end of each year, so the year end is the appropriate time to use it. If you want to make a gift that exceeds the amount of the exclusion, you can effectively double the exclusion by making one gift in December and the second in January. For example, if you are married, you can make a tax-free gift of $52,000 to any individual by making a gift of $26,000 in December 2010 and another $26,000 gift in January 2011.

Because the annual exclusion is applied on a per-donee basis, you can leverage the exclusion by making gifts to multiple members of the same family. For example, you could make $13,000

gifts to each of your son, his wife and their daughter, for a total of $39,000 in tax-free gifts. This tax-free amount can be doubled to $78,000 if your spouse joins in the gifts.

Tuition Payment Exclusion

In addition to the annual gift tax exclusion, you are allowed to make gift-tax-free tuition payments for any individual. There is no limit on the amount that can be excluded, except that the payment must be to a tax-exempt school at any level and for the purpose of education or training. The exclusion applies only to tuition —payments for room and board, books, computers, or related expenses are not eligible. Because there is no limit on the amount of the gift, its timing is less important than it is with the annual exclusion. Nevertheless, if you have the choice of making either a tuition payment or an annual exclusion gift for a particular beneficiary, it will usually be better to make the tuition payment, because that will give you the option of making an annual exclusion gift later in the year.

The income tax deduction for tuition payments expired at the end of 2009. To obtain the deduction, the tuition payment had to be made to an institution of higher education on behalf of a dependent, and your adjusted gross income was required to be below certain limits. There are proposals to reinstate this deduction for 2010, so it is possible that your gift of a tuition payment would have some income tax advantages.

Section 529 College Savings Plans

Contributions to a § 529 college savings plan do not qualify for the exclusion for tuition payments, but can take advantage of the $13,000 annual gift tax exclusion. The contribution to the plan may also entitle you to a state income tax deduction.

Distributions from a 529 plan can be used for a wide range of educational expenses, including tuition, fees, books, supplies, computers, and room and board. An added advantage of a gift to a 529 plan is that the income earned on the plan contributions is tax-free, as long as it is eventually used for educational purposes. Thus, you can reduce your own income taxes by funding a 529 plan with savings that would have been used for college anyway. And because you can name yourself as the custodian of the account, you ensure that your beneficiary uses the account for educational purposes.

A special rule allows you to use up to five annual gift tax exclusions when funding a 529 college savings plan. You can fund a savings plan with up to $65,000 (5 × $13,000)this year and then file an election with the IRS to spread this gift over five years (2010 - 2014) for gift tax purposes. By using five annual exclusions, the entire gift becomes gift-tax-free, although you will have to wait until 2015 to make another tax-free contribution.

Medical Payment Exclusion

The payment of a beneficiary's medical expenses is also excluded from the gift tax, with no limitation on the amount excluded. To qualify for this exclusion, the payment must be made

directly to the provider, and it must be for medical expenses of the type that would qualify for an income tax deduction. You can also claim an income tax deduction for the payment if it is made for your spouse or dependent.

The exclusion for medical payments includes the payment of medical insurance premiums. If you have a child or grandchild who is paying for his or her own insurance, payment of their insurance premiums is an efficient means of making a tax-free gift that does not consume the $13,000 annual or $1.0 million lifetime exclusion.

Gifts in Trust

Despite the tax savings, you may be uneasy about making outright gifts to your children or grandchildren, due to your loss of control over how they use the gift. This concern can be addressed by making the gifts in trust, which will allow you to determine when they receive the money and how it is to be used.

There are special requirements for ensuring that a gift in trust qualifies for the $13,000 annual exclusion. Usually, the trust is drafted to provide the beneficiary with temporary withdrawal rights over the gift (usually for 30 days), such that it is considered a present interest rather than one that vests in the future. Although this presents a risk of the beneficiary withdrawing the gift from the trust, the probability of your terminating any further gifts to the trust is usually sufficient to prevent this. If you are interested in making a gift in trust, we will be glad to explain how this can be done.

Charitable Gifts

The year end is a good time to review your charitable giving to ensure that it is being done in the most tax-efficient manner. Charitable giving is a form of estate planning, because a gift to charity will never be subject to estate or gift tax and provides you with an immediate income tax deduction. If you are planning to make a large gift before January 1, we should review its impact on your 2010 income tax liability and whether it may make sense to defer all or a portion of the gift to 2011. If the gift is of property and will require an appraisal (usually required for gifts of property with a value in excess of $5,000, other than publicly traded stock), we should start the process as soon as possible so that the appraisal is available before year end.

In conclusion, we hope that the information in this letter is useful in your year-end gift planning. If you wish to take advantage of any of the planning techniques that we have described, please feel free to call.