Fox Rothschild LLP
ATTORNEYS AT LAW

MARCH 2011

TAX & ESTATES DEPARTMENT

ALERT

Recognizing Estate Planning Opportunities Under the Tax Relief Act of 2010

In December 2010, we issued an alert informing you of the passage of the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010, which had a wide impact on estate planning strategies. Fox Rothschild attorneys are issuing specific alerts on a number of issues relating to the Act. This is the third in the series.

For as long as the government has imposed an estate tax, estate planning professionals have sought effective ways to minimize the impact of tax on a decedent's estate. While many creative techniques, with varying degrees of success, have been developed over the years, the estate planner's tool box was generally limited based on available exemptions. For instance, the gift tax exemption had been previously limited to $1 million per individual and $2 million per married couple.

With the passage of Tax Relief Act of 2010, however, the size of a taxpayer's estate, gift and generation-skipping transfer (GST) tax exemptions have been dramatically increased for 2011 and 2012. Such unexpected (and likely short-lived) generosity by Congress has resulted in exemptions of $5 million for individuals and $10 million per married couple, while the tax rates have been lowered to a flat 35 percent. The Act also introduced a new concept called "portability," which allows the executor of a decedent spouse's estate to elect to make the deceased spouse's unused estate and gift tax (but not GST tax) exemptions available to the surviving spouse.

As a result of the increase in the exemptions, estate planners have been empowered to fully implement many traditional gift and estate planning strategies. Techniques previously used to remove assets, as well as their future appreciation, from taxable estates have been "super-charged" by potentially allowing significantly more assets to pass to children, grandchildren (and perhaps other generations) by leveraging the increased exemptions. The cornerstone principle of using valuation discounts (i.e., lack of marketability and minority interest) to transfer assets to younger generations goes hand-in-hand with various planning opportunities that have been bolstered by the Act. Some of those opportunities are:

- **Simple Gifts**—Gifts, whether outright or in trust, to various individuals do not have to be complicated, depending upon the nature of the assets being transferred, to take advantage of the $5 million/$10 million exemptions. However, the desire for simplicity should not override the importance of maximizing the efficient use of the exemptions through appraisals that may employ valuation discounts. Further, it is more advantageous than ever to gift property for the benefit of grandchildren since potential estate taxes can likely be deferred for decades.
- **Lifetime Credit Shelter Trusts**—An effective way for a donor-spouse to "lock-in" the increased gift tax exemptions is to establish a "lifetime credit shelter trust" for the benefit of a spouse or another beneficiary. The donor-spouse would fund the trust with assets equal to the remaining exemption and

would be advised to favor assets likely to appreciate over time. Since the assets, as well as their future appreciation, would not be includable in either spouse's taxable estate, the possible future reduction by Congress of the exemptions would have no effect on the trust. Further, to take advantage of both spouses' increased exemptions, each spouse can establish a lifetime credit shelter trust for the benefit of the other, albeit not identical so as not to violate the "reciprocal trust doctrine." Careful drafting should alleviate the potential for inclusion of the trusts in the taxable estates of the spouses.

- **Qualified Personal Residence Trusts (QPRTs)—** The use of a QPRT attempts to remove a taxpayer's personal residence from his or her taxable estate, provided the taxpayer survives the term of the trust. While QPRTs have been used effectively for many years, the transfer of the residence to the trust results in a taxable gift by the taxpayer. Thus, the feasibility of using a QPRT depends on both the value of the gift (likely to be greatly discounted) as well as the amount of the taxpayer's remaining gift tax exemption. The advent of the $5 million exemptions has broadened the ability of a taxpayer to transfer a valuable residence to a QPRT while staying within the increased exemption and increasing the likelihood of avoiding the payment of gift tax.

- **Grantor Retained Annuity Trust (GRAT)—** The use of "zeroed-out" GRATs in recent years has been popular partly because there is no gift element to establishing the GRAT. The GRAT technique involves the formation of a trust (usually funded with highly appreciated assets) for a term of years where the grantor retains the right to an annuity payment over the term of the trust. Since the annuity amount is partially dependent on a published governmental interest rate (i.e., "7520 rate"), the current low interest rate environment has significantly expanded the use of GRATs. The goal of the GRAT is to shift the potential additional appreciation on the assets after funding from the taxable estate of the taxpayer to the trust beneficiaries. Further, the lower the annuity paid to the grantor, the more assets that will theoretically pass to trust beneficiaries. While other techniques take direct advantage of the increased exemptions, GRATs do not use any gift tax exemption and thus preserve more of the exemptions for additional gifting strategies or a taxpayer's estate.

- **Sale to a Grantor Trust—**Selling an asset to a grantor trust has become a favorite technique of estate planners in recent years. Because a grantor and his or her grantor trust, in the eyes of the IRS, are considered the same "income tax person," any transaction between a grantor and his or her grantor trust is "neutral" for income tax purposes; resulting in the non-recognition of capital gains upon the grantor's sale. Additionally, since the grantor is required to include the net income of the trust on his or her personal income tax return, the trust can accumulate additional assets for the benefit of the trust beneficiaries.

  Since an important element of the sale is for the grantor to initially gift to the trust (i.e., "seed" the trust) a portion of the anticipated selling price (while taking back a promissory note for the balance), the increased gift tax exemption should enable the grantor to more comfortably fund the transaction and preserve more of his or her exemption for additional estate planning. Seeding the trust with more assets and taking back a reduced promissory note may increase the likelihood the transaction is a bona fide sale while also decreasing cash flow requirements attributable to the promissory note. Finally, since a grantor may allocate his or her GST tax exemption to the grantor trust (unlike a GRAT), the larger exemption can result in substantially increasing the assets passed to future generations.

- **Life Insurance—**Taxpayers may think the increased exemptions reduce their need for life insurance, especially to fund the payment of estate taxes. However, life insurance serves many needs, not the least of which is providing financial security to the family of a decedent. Additionally, since the current exemptions may not be extended past 2012, it may be short-sighted to rely on the increased exemptions to provide long-term protection to the estate. Insurance needs should be reviewed in detail with the possibility of using the increased exemptions to explore ways of maximizing coverage. For instance, paying more premiums up front, previously unfeasible because of the lower exemptions, may now make sense.

While these techniques by no means represent an exhaustive list, they present an array of opportunities that should be reviewed with your estate planner to determine what works best for you and your family. Congress has certainly provided taxpayers with the impetus to redistribute wealth among our loved ones, and that opportunity should not be overlooked.

Please Call Us With Your Questions

We encourage you to contact your relationship lawyer at Fox Rothschild or a member of the firm's Tax and Estates Department in the state in which you maintain your permanent residence to discuss the potential impact of the Tax Relief Act of 2010 on your current estate plan and evaluate whether appropriate changes should be made.