Client Advisory | *October 2010*

A Once In a Lifetime Opportunity?

The last quarter of 2010 may be the **best** opportunity clients will see in their lifetimes to transfer wealth to their children, grandchildren and other individual beneficiaries. This window has opened because of the unusual fallout from tax legislation enacted in 2001, combined with Congress's failure to this point to pass corrective or reform legislation.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (a/k/a "EGTRRA") reduced gift taxes, generation-skipping transfer taxes and estate taxes for the limited period of 2001 through 2010. Pre-EGTRRA estate and gift tax rates of up to 55% (plus an additional 5% surtax on certain estates and gifts) dropped to 45% by 2009. In addition, the estate tax exemption increased from $675,000 to $3.5 million. For 2010, the estate tax has been repealed completely in favor of a carryover tax basis for income tax purposes at death, the generation-skipping transfer tax (a separate tax on transfers to persons two or more generations below the transferor) also has been repealed, and the gift tax rate has dropped to 35%.

The result of the 2010 changes is that the gift tax rate is now at its lowest level since 1935, while the estate tax and generation-skipping transfer tax have temporarily disappeared.

On January 1, 2011, however, under the current law the pre-EGTRRA estate tax, generation-skipping transfer tax and gift tax will reappear in full force with a roll back of the estate tax exemption to $1 million and top marginal estate and gift tax rates of 55% (plus the additional 5% surtax on certain estates and gifts).

Why Act Now?

Although the current tax environment has been in place since the beginning of 2010, it has existed under the shadow of potential retroactive changes to the tax law. Until late in 2009, most practitioners and legislative observers believed that Congress would enact permanent or, at least temporary, changes to the transfer tax regime before 2010 arrived. Since the beginning of the year, there has been a risk that 2010 gifts designed to take advantage of the low rates would be frustrated by retroactive legislation. In addition, there has been a reluctance to structure 2010 transfers and incur gift taxes at even the low gift tax rate of 35% when there was a risk that a transferor might die during 2010 and, in such case, pass to heirs assets entirely free of transfer taxes.

As the end of 2010 nears, it appears increasingly less likely that Congress will address the transfer tax system for 2010 or enact legislation which would apply retroactively. Finally, as the end of 2010 nears, individuals are in a better position to assess their chances of surviving to 2011 when their assets will again be subject to the estate tax.

There is an additional reason to act now. Several popular estate planning strategies involving use of leveraged gifts or valuation discounts, such as grantor retained annuity trusts ("GRATs") and family limited partnerships and limited liability companies, have been the target of proposed legislation which may severely limit their effectiveness.

Finally, in the current economy many asset values are depressed and federal statutory interest rates used for valuing gifts of term or remainder interests are at historic lows.

We encourage our clients, especially those who have significant wealth and are in the position to make substantial gifts, to evaluate their circumstances in light of the unique set of factors and opportunities currently in place.

2010 Gift Planning

Gift Tax versus Estate Tax

Under tax laws now in effect, an individual may make a taxable gift of property during 2010 and pay gift tax at a 35% rate or may retain the property and pay estate tax at death if the individual survives until at least 2011. The following table illustrates the benefit of the lifetime giving versus transferring property at death. The table assumes that (1) the client has $1,350,000 of available funds out of which to make the transfer and pay the tax, (2) the client already has used all available credits, exemptions and any available annual exclusion, and (3) an estate tax rate of 55% applies at the client's death in 2011 or later. The advantages of the gift scenario are that (1) the property is subject to a lower rate of tax and (2) the amount of the gift tax paid is not included in the calculation of the estate tax (provided

Gift Scenario		Estate Scenario	
Total Funds:	$1,350,000	Total Funds (Estate Value):	$1,350,000
Tax on Gift at 35%:	$350,000	Estate Tax at 55%:	$742,500
Gift to Heirs:	**$1,000,000***	Residue to Heirs:	**$607,500***

*Note that these values do not reflect the cost of later capital gains which may be incurred on property. Gifted property has a carry over basis whereas property passing to heirs through an estate receives a step up in basis (with the exception of deaths occurring in 2010).

that the donor survives the date of the gift by 3 years). The result of a successful gift is that the heirs receive 29% more of the total funds available.

Assets which are Gift Candidates

The advantage of making a taxable gift shown above can be magnified further by selecting the best property to give away. For example, excellent candidates for gifts include (i) rapidly appreciating assets, (ii) assets with depressed valuations, (iii) assets with a high tax basis and (iv) assets that are valued at a discount for transfer purposes. Other candidates include large intra-family loans, marital trust assets (after distribution from the trust to the surviving spouse) and interests in split-dollar insurance.

Gift Transactions

Certain wealth transfer transactions, such as installment sales and GRATs, are greatly affected by applicable federal interest rates which are a factor in valuation. These rates, which are changed monthly, are now very low (2%, 1.71% or even 0.41% in October, depending upon the terms of the transaction employed) making use of these transactions extremely attractive at this time.

As mentioned above, recent legislative attempts and proposals targeting GRATs and valuation discounts for family limited partnerships or limited liability companies indicate that their effectiveness may be curtailed dramatically in the near future. Therefore, there may be a limited opportunity for clients who wish to use these strategies.

Gifts to Grandchildren and Other Skip Persons

The current year repeal of the generation-skipping transfer tax offers an opportunity for significant tax savings for gifts this year to a grandchild (or members of younger generations). If a grandchild is a minor or otherwise not mature enough to receive a gift directly, the gift may be structured to protect against dissipation of the gift by the beneficiary.

A gift to a grandchild (not covered by a limited exemption from the generation-skipping transfer tax) generally is subject to a tax equal to the highest estate tax rate (45% in 2009 and potentially 55% in 2011). In addition, both the amount received by the grandchild and the amount of generation-skipping transfer tax paid are subject to a gift tax (45% in 2009, 35% in 2010 and potentially 55% in 2011). Below is a table comparing the cost of transferring $1 million directly to a grandchild under several different scenarios based on the current state of the law. The table assumes that all credits, exemptions and exclusions against the various taxes already have been used, and that the top marginal rate of the relevant tax applies.

The additional tax cost of making a gift to a grandchild in the future makes it worth considering making that same gift in the last quarter of 2010.

Terminally Ill Clients and Planning for Deaths in 2010

The unusual tax landscape in 2010 also creates unique issues and planning considerations for persons whose life expectancies are short and for persons responsible for administering estates of individuals who have died in 2010.

Individuals with limited life expectancies should confirm that dispositive provisions in their wills and trusts linked to estate tax laws (which are typically found in plans for married couples) will not lead to unintended consequences because of the drastic flux the transfer tax system has undergone. They also should ensure they are in a position, should they not survive until 2011, to take full advantage of enormous potential tax savings through flexibility in their estate plans and optimal allocation of asset ownership with their spouses. Likewise, there are post-mortem elections and actions that should be considered by executors and heirs of decedents dying in 2010 to take advantage of potential tax savings.

	Gift in 2010	Gift in 2011	From Estate in 2011
Total Amount Needed:	**$1,350,000**	**$2,402,500**	**$3,444,444**
Gift Tax	($350,000)	($550,000)	N/A
Estate Tax	N/A	N/A	($1,894,444)
GST Tax	($0)	($550,000)	($550,000)
Gift Tax on GST Tax	($0)	($302,550)	N/A
To Grandchild	**$1,000,000**	**$1,000,000**	**$1,000,000**
Total Taxes Paid	$350,000	$1,402,500	$2,444,444
Extra Cost Post 2010:	**N/A**	**$1,052,500**	**$2,094,444**

(Once again, this analysis does not consider the variation in capital gains which may occur as a result of the carry over basis for a gifted asset versus the step up in basis for an asset passing through an estate.)

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Should you wish to discuss planning opportunities described in this alert or how the 2010 landscape may affect your specific circumstances, please contact your Private Client attorney as soon as possible and well in advance of the end of this year.

This advisory is for guidance only and is not intended to be a substitute for specific legal advice. If you would like further information, please contact the Edwards Angell Palmer & Dodge LLP attorney responsible for your matters or one of the attorneys listed below:

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