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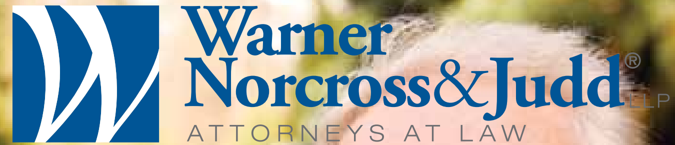


Fall 2010

Gifting Options 2

Low Interest Rates Ideal for Estate Planning 3

Planning During a GST Tax Holiday 4

Contingency Planning 5

Trusts & Estates Newsletter

Estate Planning Focus

ESTATE TAXES ON THE RISE?

by Frank Henke: **fhenke@wnj.com**

2010 has been a very interesting year in the federal estate tax arena, as it marks the first year in nearly a century that a federal estate tax has not been in effect. This is quite significant considering that in 2009, the top marginal estate tax rate was 45% and the estate tax exclusion amount was $3.5 million (which enabled a decedent to protect only $3.5 million in assets from the estate tax).

Many billionaires have died in 2010, most notably George Steinbrenner, owner of the New York Yankees ($1.2 billion estate); Dan Duncan, Texas pipeline tycoon ($8 billion estate); John Kluge, philanthropist ($7 billion estate); and Glen Bell, founder of Taco Bell (value of estate unknown). Unless Congress seeks to reinstate the federal estate tax retroactive to January 1, 2010, the 2010 repeal will result in billions of dollars of estate tax savings for the heirs of these deceased billionaires.

The heirs of individuals who die after 2010 may not be so lucky. Unless Congress acts quickly and implements changes to the federal estate tax system, the federal estate tax is scheduled to return on January 1, 2011, with a top marginal rate of 55% and an estate tax exclusion amount of only $1 million. Based on these changes, the tax will affect a substantially higher number of estates.

For example, assume that John Smith dies in 2011 with a $300,000 home, $1 million dollar life insurance policy and $500,000 401(k) account (i.e.: a total estate of $1.8 million). Considering the changes that are

continued on page 6

Consider Gifting Options Now

by Karen L. Kayes: **kkayes@wnj.com**

As discussed elsewhere in this newsletter, the federal estate and generation-skipping transfer (GST) taxes are scheduled to reappear in 2011, absent Congressional action. The estate and GST taxes will be at higher rates (increasing from the 45% rate in 2009 to 55% in 2011), with a significantly lower tax exemption (decreasing from $3.5 million in 2009 to $1 million in 2011).

Although the estate and generation skipping taxes were repealed for 2010, the gift tax was not. Taxable gifts, in excess of those allowed as tax-free and after use of the $1 million exclusion, are taxed in 2010 at a flat 35%. In 2011, the gift tax will increase to a maximum of 55%.

TAX-FREE GIFTS

These significant increases in the taxation of wealth transfer means individuals who may be subject to estate taxation will want to consider some of the simpler gifting strategies available. They include:

- Gifts of $13,000 to an unlimited number of donees. Especially in 2010, gifts to grandchildren and other younger generation individuals may be desirable.
- Direct payment of tuition expenses to qualified educational organizations on behalf of an individual.
- Direct payment of medical expenses, including health insurance premiums, on behalf of an individual.

Since there is no limit to the number of annual exclusion gifts that a donor may make to different donees, this method of gifting is an extremely useful technique to transfer wealth without reducing a donor's gift and estate tax exemption. The payment of qualified tuition and medical expenses is in addition to the annual exclusion gifts and could thereby significantly reduce a taxable estate.

TAXABLE GIFTS

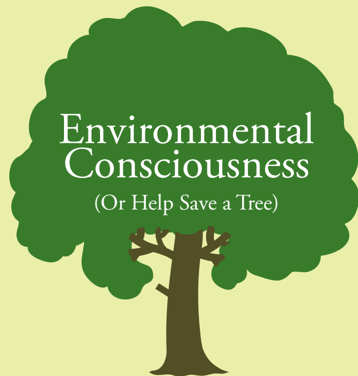
Taxable gifts should also be considered in 2010. If the $1 million exclusion is fully utilized, a donor will pay gift tax. However, in 2010, the gift tax rate is 35%. If the gift is made in 2011, the rate will increase to a maximum of 55%. Similarly, if the asset is left in the donor's estate, at death the value will be taxed at up to 55%.

Since there is no limit to the number of annual exclusion gifts that a donor may make to different donees, simpler gifting strategies are extremely useful techniques to transfer wealth without reducing a donor's gift and estate tax exemption.

To illustrate the savings, let's assume John has an estate of $2 million. He has 3 children and 6 grandchildren. In 2011, without having made any gifts, the estate tax owing will be $560,250. If, during 2010, John makes annual exclusion gifts to each of his children and grandchildren, he will have reduced his taxable estate to $1,883,000, and reduced the federal estate tax to $507,600, a savings of $52,650. If, instead, John gifts $1 million among his children and grandchildren, he will pay $268,100 in gift tax. If he lives 3 years beyond the payment of the gift tax, the amount of the tax paid will also be excluded from his estate, resulting in zero estate tax liability.

REVIEW YOUR OPTIONS

It is impossible to know for certain what the estate and gift tax system will ultimately look like for 2011, let alone for future years. In fact, Congress may attempt to alter the 2010 system retroactively. Regardless, for those likely to be subject to estate tax, consultation with a Warner Norcross & Judd estate planning attorney is recommended to determine if any of these strategies will work for you.



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Low interest rates ideal for estate planning

by Carl W. Dufendach: **cdufendach@wnj.com**

We are constantly reminded that interest rates are low. This may make you think about refinancing your mortgage. Another good idea is to take a look at estate planning. When interest rates are low, certain estate planning tools become especially attractive.

Coupled with the fact that the estate tax is currently scheduled to come back with a vengeance in 2011 (with top transfer tax rates of 55%), now is a good time to look for planning tools to reduce the estate tax burden on your family or business. Here are some options that you might want to consider.

LOANS OR INSTALLMENT SALES

Loans or installment sales of assets may be made to children or grandchildren at very low interest rates. Multiple negative tax consequences (both income and gift tax) apply when related parties make interest-free loans. To avoid those consequences, related-party loans must be made at minimum (safe harbor) interest rates.

These safe harbors (known as applicable federal rates or AFR) vary based upon the duration of the loan and the timing of the required loan payments. The short-term rate and the mid-term rate hit historic lows in November, 2010. For example, short-term loans of three years or less requiring annual payments (which could be interest-only with a balloon payment at maturity) can now be made at 0.35% interest. These rates are low enough that your children or other intended beneficiaries can purchase low-risk, income-based investments such as insured CDs, T-Bills, top-rated bonds, etc., or other investments, through loans from you.

The spread between the income they receive and the interest they pay you passes without any gift taxes or the use of any gift tax exemption. Making these loans to children in lower income tax brackets (who are not subject to the kiddie tax) can also reduce overall family income taxes. Mid-term loans of 3 to 9 years may be made at an AFR rate of 1.59%, and long-term loans may use a still low safe harbor rate of 3.35%.

GRANTOR RETAINED ANNUITY TRUST (GRAT)

A GRAT is structured with required fixed payments being made to you, the grantor, over a fixed period (the annuity payments). The payments are designed actuarially to be nearly equal to the amount that you put into the GRAT. The balance remaining after the annuity payments, if any, passes to the named beneficiaries. The annuity payments and their value are based upon a current calculated interest rate. That rate was at an all-time low in October and November at 2 percent, matching the February 2009 rate (the 7520 rate). This generally means that the combination of all income generated from and appreciation of the assets placed in a GRAT, which together exceed the 7520 rate, passes to children without gift taxation.

CHARITABLE LEAD ANNUITY TRUST (CLAT)

A CLAT is a gift to a trust that works a lot like a GRAT, but pays the annuity to charity. With one type of CLAT, you can receive a current charitable deduction for the value of the charitable annuity. The remainder then goes to or in trust for descendants. With a 2% 7520 rate, the value of the annuity is high, and if the performance is better than the assumed 2%, the remainder interest to the descendants could be significant. The CLAT is generally used by someone with current charitable desires, but with a desire to leverage potential excess future growth to family.

INTENTIONAL GRANTOR IRREVOCABLE TRUST (IGIT)

In some situations, you might be willing to sell to the children, but not desire to pay a capital gain tax on the sale. In that circumstance, a sale to an IGIT can be useful. You may again use the low interest rates mentioned in the "Loans" discussion above: 0.35% for up to 3 years, 1.59% for more than 3 and up to 9 years, and 3.35% for longer than 9 years.

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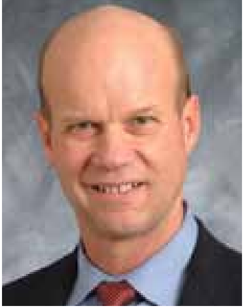

mvanharen@wnj.com

The generation-skipping transfer (GST) tax does not apply this year, but it returns next year. This one-year GST tax holiday opens many opportunities, but also has significant traps that should be avoided.

The tax is complicated. When it applies, it is a flat tax at the highest estate or gift tax rate and may be triggered by a gift to or distribution from a trust to a "skip person." Under the GST tax, a skip person is a grandchild, great-grandchild, grandniece/grandnephew or someone other than a spouse who is more than 37.5 years younger than you.

A GOOD YEAR FOR GIFTS

As noted elsewhere in this issue, the gift tax continues to apply in 2010. Thus, annual exclusion gifts, gifts sheltered by the $1 million lifetime gift tax exclusion, or taxable gifts are free of GST tax in 2010. So, this year is a particularly good year for gifts. The value of many assets are down, and if a gift made in 2010 attracts a gift tax, the rate will be the lowest rate (35%) in decades.

Annual exclusion gifts, gifts sheltered by the $1 million lifetime gift tax exclusion, or taxable gifts are free of GST tax in 2010.

The gift tax was enacted in 1924, and only the 33.5% rate that applied in 1932-1934 is lower. Also, unless the law is changed, the estate tax returns next year with rates as high as 55% and an exemption of only $1 million. There is also a subtle but very valuable advantage that makes a gift tax payment more attractive than an estate tax payment. For those who pay a gift tax and survive three years beyond the gift, the gift tax paid is not an asset in their estate.

These factors, combined with the absence of the GST tax, make 2010 an excellent year for outright gifts to anyone, including skip persons. The gift tax still applies, but the GST tax does not. If, however, a 2010 gift is in a trust or a "trust equivalent," the assets are exposed to GST tax when the GST tax returns next year. This is a trap for the unwary.

WATCH FOR PITFALLS

An outright gift to a grandchild or other skip person is generally appropriate when the recipient is an adult and is able to manage the gift. If, however, the recipient is a minor or someone who might not appropriately manage an outright gift (for example, the recipient is disabled, has exhibited an inability to properly manage money or has creditor problems), a gift to a trust permits the trustee to manage the gifted assets. Unfortunately, however, when those assets are distributed next year or thereafter, the distribution will most likely be exposed to the GST tax. The same rule applies to a gift to custodianship under the Uniform Transfer to Minors Act.

In some situations, the tax savings from a gift that avoids GST tax may be so compelling that strategies will be implemented to permit an outright gift to a minor. This will usually involve a large taxable gift of an interest in a family-held corporation, LLC or partnership this year and a petition to the probate court, perhaps next year, for the appointment of a conservator to manage the assets until the minor attains majority. While not free from doubt, it appears that assets in a conservatorship estate will not be later exposed to the GST tax when it returns next year.

Another trap exists for trusts that have previously been protected from GST tax by the application of GST exemption to all prior gifts to the trust. There is no GST exemption to apply in 2010. Thus, a gift this year may taint a trust that was previously GST exempt. We generally recommend that no gifts be made to these trusts in 2010. If, however, the trust must have additional resources this year – for example, to pay the premium on a life insurance policy, then it is best if the donor loan the money this year and consider options next year when the GST tax returns. Short-term loans this year can have very low interest rates (less than 1%).

Thus, the GST tax holiday encourages outright gifts to adult skip persons. Outright gifts to minors are more complicated and should generally be avoided, but in some cases should still be pursued due to the tax benefits. Finally, careful attention is needed for trusts that have previously been protected with the GST exemption, as there is no exemption to apply in 2010.

A NOTE OF CAUTION

One final word of caution. The current position of the administration seeks the retroactive application of the 2009 estate and GST law to 2010. There remains, therefore, the possibility that the next tax law might eliminate the 2010 GST tax holiday. Despite the traps and challenges, there are significant once-in-a-lifetime planning opportunities that will disappear at the end of this year. These gifting opportunities should be discussed with your Warner Norcross & Judd estate planning attorney.

Contingency Planning

in an Uncertain Tax Environment

by Jay Kennedy and Scott Hancock: **jkennedy@wnj.com, shancock@wnj.com**

The scheduled expiration of the Bush-era tax cuts at the end of this year has caused considerable uncertainty regarding year-end tax planning. These tax cuts, which include significant income tax rate changes, the gradual elimination of the estate tax and other tax relief, were included in legislation that contains sunset provisions. These provisions generally phase out the tax cuts after the end of the year.

IMPACT ON INDIVIDUAL TAXPAYERS

Most of the attention has focused on the replacement of the lower Bush-era marginal income tax rates with the rates in place before the tax-cut legislation. The tax cuts reduced the ordinary income marginal tax rates to 10%, 15%, 25%, 28%, 33% and 35%, and the tax rates on long-term capital gains and qualified dividends to 0% and 15%. The scheduled sunset of the Bush-era tax cuts will mean the expiration of the 10% tax bracket. The 25%, 28%, 33% and 35% tax brackets will revert to the 28%, 31%, 36% and 39.6% tax brackets, respectively.

The maximum tax rates on long-term capital gains and qualified dividends will increase from 15% to 20%. "Qualified dividends," which were taxable at long-term capital gain rates under the tax-cut provisions, are scheduled to be taxed at ordinary income tax rates, as under prior law. This would mean a 164% increase in the tax on these dividends (from 15% to 39.6%) for some taxpayers.

In addition to increases in marginal income tax rates, the scheduled expiration of other Bush-era tax reduction provisions would increase taxes for many families. These include the reintroduction of the limitation on itemized deductions and the personal exemption phaseout for higher income taxpayers. The marriage penalty relief provisions would also be eliminated under the sunset provisions as well as the alternative minimum tax relief provisions.

The Obama administration has proposed retaining certain tax cuts. The proposals would allow the top two individual income tax brackets to return to 36% and 39.6% from their current levels of 33% and 35%, respectively, for single filers making more than $200,000 and joint filers making more than $250,000. In addition, the administration has proposed allowing the maximum tax rates on both long-term capital gains and qualified dividends to increase from 15% to 20% for these higher-income taxpayers. The administration also proposed allowing the return of the personal exemption phaseout and the limitation on itemized deductions, but only for single filers making more than $200,000 and joint filers making more than $250,000.

To date, Congress has not taken any action to prevent the expiration of any of the Bush-era tax cuts, including the ones the Obama administration proposed extending. However, it is possible that Congress will take some action before the end of the year. Any changes this year will probably be enacted after the November elections.

It is difficult to predict the future of the Bush-era tax cuts. Even if the Republican Party gains control of Congress, it is extremely unlikely that they will have a veto-proof majority. On the other hand, some Democrats have supported the extension of the tax cuts for all taxpayers, at least in the short term, to stimulate job growth. While we cannot predict the final resolution of these issues, we can offer some general tax planning guidance that should be considered later when the tax rules applicable to next year may be more clear. To help you prepare for possible action by Congress, the following guidance considers three possible scenarios of Congressional action.

continued on page 7

scheduled to take effect, John Smith will be able to protect only $1 million of assets from the estate tax; therefore, $800,000 of his assets would be subject to the estate tax at a rate of 55%, resulting in an estate tax liability of more than $400,000.

WHAT DOES 2011 HOLD?

Many believe that Congress will step in and implement (perhaps retroactive to January 1, 2010) a federal estate tax exclusion amount of around $3.5 million and a top marginal estate tax rate of around 45% (again, these are the figures that existed in 2009). However, the longer Congress waits, the more unlikely this becomes.

Additionally, 2010 is an election year, and Congress is gearing up to make other decisions that will not involve raising taxes. Further, if Congress simply decides not to address the estate tax issues, the exclusion amount will automatically fall to $1 million on January 1, 2011, with a top marginal estate tax rate of 55%. This may prove to be a backdoor way for Congress to generate revenue. What will happen is anyone's guess.

In any event, now is a good time for people to update their estate plans in order to implement strategies that are geared to reduce or eliminate potential estate tax liabilities, particularly if the federal estate tax exclusion amount indeed falls to $1 million, as scheduled. For instance, John Smith in the above example could establish an irrevocable life insurance trust (ILIT) during his lifetime and transfer his $1 million life insurance policy to it. Provided he survives for at least 3 years after making the transfer, the strategy would remove his $1 million life insurance policy from his estate for estate tax purposes. This strategy would reduce John Smith's estate to $800,000 (which is below the $1 million federal estate tax exclusion scheduled to take effect in 2011), and would result in estate tax savings of $400,000.

GIFT TAX EXCLUSIONS

A gifting plan involving direct gifts to individuals and/or to various types of trusts is another strategy. In making gifts, the gifted assets are removed from the donor's estate and are not subject to estate taxes upon the donor's death. Individuals are entitled by law to an annual gift tax exclusion and a lifetime gift tax exclusion.

The annual gift tax exclusion gives a donor the ability to gift a specific amount each calendar year. The lifetime gift tax exclusion gives a donor the ability to gift an additional amount in total during lifetime (above and beyond the annual gift tax exclusions that are utilized by the donor). In 2011, the annual gift tax exclusion is scheduled to be $13,000 (as may be adjusted by inflation), and the lifetime gift tax exclusion is scheduled to be $1 million. It is worthwhile to note that real estate,

securities and other assets have substantially decreased in value during the past few years, and the interest rate that the Internal Revenue Service requires donors to use in calculating the value of certain gifts to trusts is extremely low at this time. These factors give donors the opportunity to make best use of their annual gift tax exclusions and lifetime gift tax exclusion.

REVIEW YOUR ESTATE PLANS

The federal deficit is at an all-time high, and most believe that taxes and increased tax rates will be implemented in an attempt to reduce the deficit. This is a critical time for people to review their estate plans in order to ensure that, among other things, they are set up in a way that will provide them with the maximum estate tax savings. Considering the state of the market and economy, it is also an opportune time to take advantage of estate planning strategies like the ones described above.

Low Interest Rates Ideal for Estate Planning continued

Because the sale is to a grantor trust specially designed as such, the sale is not a current capital gain or loss transaction for you. The trust takes the property at your basis, but the asset in the trust is removed from your estate. If the income and appreciation on the asset purchased exceeds the applicable rate, then the excess growth again passes to future generations. The balance on the note you receive back from the trust or the payments on the note would be an asset of your estate.

OTHER OPTIONS

Other estate planning tools such as charitable gift annuities, charitable remainder annuity trusts and qualified personal residence trusts do not generally work quite as well when interest rates are low. The nature of the rate determinations under the AFR rules and Section 7520 generally means that month-to-month changes are not that dramatic. However, a few tenths of a percentage point may make a big difference in the effectiveness of a given tool that enables you to transfer assets to the next generation. See your Warner Norcross & Judd estate planning professional to determine if one of the low interest tools described above may be suitable for your objectives.

Contingency Planning continued

EXTENSION OF TAX CUTS

If Congress extends all of the Bush-era tax cuts, you should consider a traditional strategy of deferring income and accelerating tax deductions. This could include maximizing 401(k) plan contributions, prepaying property taxes and charitable contributions, and other similar strategies.

EXPIRATION OF TAX CUTS

Tax planning becomes more complicated if Congress allows the Bush-era tax cuts to expire. Under these circumstances, you should consider the following possible tax-saving strategies:

- Take dividends from your closely held corporations.
- Sell long-term capital gain assets; defer sale of long-term capital loss assets.
- Accelerate payment of itemized deductions to avoid deduction limitations.
- Convert an S corporation to a C corporation.
- Convert a traditional IRA to a Roth IRA.

The efficacy of these strategies depends upon each taxpayer's individual situation and should therefore be implemented only with the guidance and advice of your tax professional.

ADOPTION OF OBAMA'S PROPOSALS

If Congress ultimately adopts the Obama administration's proposals, single filers making more than $200,000 and joint filers making more than $250,000 would generally be subject to expiration of many of the Bush-era tax cuts, except that qualified dividends of these taxpayers would be taxed at a top rate of 20%, and not at the higher ordinary income tax rates. Taxpayers with income below these limits would generally continue to benefit from the tax cuts.

CONCLUSION

The unprecedented uncertainty surrounding the expiration of the Bush-era tax cuts, which is compounded by this fall's mid-term elections, means that taxpayers are currently unable to confidently implement year-end tax planning. Working closely with tax advisers, taxpayers should begin making contingency plans they can adopt later this year when the fate of the tax cuts should finally be resolved. The efficacy of these strategies depends upon each taxpayer's individual situation and should therefore be implemented only with the guidance and advice of your tax professional.

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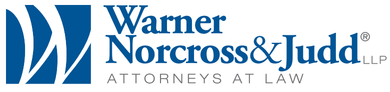
Trusts and Estates Group

Name	Phone
Daniel Borst	(616) 752.2735
Carl Dufendach	(616) 752.2136
Paula Hanks	(231) 727.2634
Mark Harder	(616) 396.3225
Frank Henke	(248) 784.5008
Karen Kayes	(231) 727.2619
Jay Kennedy	(248) 784.5180
Kellen Lynch	(616) 752.2721
Linda Koehn	(616) 752.2323
John Martin	(231) 727.2631
Susan Gell Meyers	(616) 752.2184
Leslie Miller	(616) 752.2296
Laura Morris	(616) 752.2407
Mark Periard	(616) 752.2483
Jeffrey Power	(616) 752.2156
Jennifer Remondino	(616) 396.3243
Todd Simpson	(616) 752.2543
David Skidmore	(616) 752.2491
Jerome Smith	(616) 752.2105
Pamela Squire	(616) 752.2249
Beverly Turner	(616) 752.2419
Michael Van Haren	(616) 752.2125
David Waterstradt	(231) 727.2698

For address corrections, additions or deletions, contact Gena Rinckey at (616) 752.2776 or e-mail grinckey@wnj.com



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