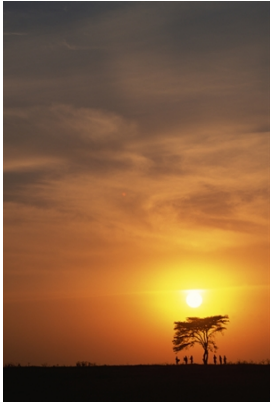


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The New Estate Tax Rules and Your Estate Plan



Looking ahead

Without further legislation in the interim, the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 are scheduled to sunset, or expire, on January 1, 2013, at which time tax rates and exemption amounts return to their 2001 levels (subject to increases for inflation in some cases).

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act) includes new gift, estate, and generation-skipping transfer (GST) tax provisions. The 2010 Tax Act provides that in 2011 and 2012, the gift and estate tax exemption is \$5 million (indexed for inflation in 2012), the GST tax exemption is also \$5 million (indexed for inflation in 2012), and the maximum rate for both taxes is 35%. New to estate tax law is gift and estate tax exemption portability: generally, any gift and estate tax exemption left unused by a deceased spouse can be transferred to the surviving spouse. The GST tax exemption, however, is not portable. These major changes are temporary: absent further legislation, in 2013, the exemptions are generally scheduled to drop to \$1 million, the maximum rate will jump to 55%, and portability will be repealed. You should understand how these new and temporary rules may affect your estate plan.

Exemption portability

Under prior law, the gift and estate tax exemption was effectively "use it or lose it." In order to fully utilize their respective exemptions, married couples often implemented a bypass plan: they divided assets between a marital trust and a credit shelter, or bypass, trust (this is often referred to as an A/B trust plan). Under the 2010 Tax Act, the estate of a deceased spouse can transfer to the surviving spouse any portion of the exemption it does not use (this portion is referred to as the deceased spousal unused exclusion amount, or DSUEA). The surviving spouse's exemption, then, is increased by the DSUEA, which the surviving spouse can use for lifetime gifts or transfers at death.

Example: *At the time of Henry's death in 2011, he had made \$1 million in taxable gifts and had an estate of \$2 million. The DSUEA available to his surviving spouse, Linda, is \$2 million (\$5 million - (\$1 million + \$2 million)). This \$2 million can be added to Linda's own exemption for a total of \$7 million (\$5 million + \$2 million).*

The portability of the exemption coupled with an increase in the exemption amount to \$5 million per taxpayer allows a married couple to pass on up to \$10 million gift and estate tax free in 2011 and 2012. Though this seems to negate the usefulness of A/B trust planning, there are still many reasons to consider using A/B trusts.

- The assets of the surviving spouse, including those inherited from the deceased spouse, may appreciate in value at a rate greater than the rate at which the exemption amount increases. This may cause assets in the surviving spouse's estate to exceed that spouse's available exemption. On the other hand, appreciation of assets placed in a credit shelter trust will avoid estate tax at the death of the surviving spouse.
- The distribution of assets placed in the credit shelter trust can be controlled. Since the trust is irrevocable, your plan of distribution to particular beneficiaries cannot be altered by your surviving spouse. Leaving your entire estate directly to your surviving spouse would leave the ultimate distribution of those assets to his or her discretion.
- A credit shelter trust may also protect trust assets from the claims of any creditors of your surviving spouse and the trust beneficiaries. You can also include a spendthrift provision to limit your surviving spouse's access to trust assets, thus preserving their value for the trust beneficiaries.
- The portability feature is in effect for two years only, and is scheduled to expire in 2013, unless Congress enacts further legislation.

A/B trust plans with formula clauses

If you currently have an A/B trust plan, it may no longer carry out your intended wishes because of the increased exemption amount. Many of these plans use a formula clause that transfers to the credit shelter trust an amount equal to the most that can pass free from estate tax, with the remainder passing to the marital trust for the benefit of the spouse. For example, say a spouse died in 2002 with an estate

Beware of the "clawback"

Say you make a gift in the amount of the exemption in 2012 (\$5 million), then you die in 2013 when the exemption reverts to \$1 million, which it is currently scheduled to do. Will your estate be taxed on the difference? This problem is referred to as the "clawback" and while most practitioners believe it ultimately won't apply, there is no legal documentation that definitively refute that possibility.

worth \$5 million and an estate tax exemption of \$1 million. The full exemption amount, or \$1 million, would have been transferred to the credit shelter trust and \$4 million would have passed to the marital trust. Under the same facts in 2011, since the exemption has increased, the entire \$5 million estate will transfer to the credit shelter trust, to which the surviving spouse may have little or no access. Review your estate plan carefully with an estate planning professional to be sure your intentions will be carried out under the new laws.

Wealth transfer strategies through gifting

Because of the larger exemptions and lower tax rates, 2011 and 2012 provide an unprecedented opportunity for gifting.

By making gifts up to the exemption amount, you can significantly reduce the value of your estate without incurring gift tax. In addition, any future appreciation on the gifted assets will escape taxation. Assets with the most potential to increase in value, such as real estate (e.g., a vacation home), expensive art, furniture, jewelry, and closely held business interests, offer the best tax savings opportunity.

Gifting may be done in several different forms. These include direct gifts to individuals, gifts made in trust (e.g., grantor retained annuity trusts and qualified personal residence trusts), and intra-family loans. Currently, you can also employ techniques that leverage the temporarily high exemptions to potentially provide an even greater tax benefit (for example, creating a family limited partnership may also provide valuation discounts for tax purposes).

For high-net-worth married couples, gifting to an irrevocable life insurance trust (ILIT) designed as a dynasty trust can reduce estate size while providing a substantial gift for multiple generations (depending on how long a trust can last under the laws of your particular state). The value of the gift may be increased (leveraged) by the purchase of second-to-die life insurance within the trust. Further, the larger exemptions enable you to increase, gift tax free, the premiums paid for life insurance policies that are owned by the ILIT or other family members. Premium payments on such policies are taxable gifts, so these premium payments are often limited to avoid incurring gift tax. This in turn restricts the amount of life insurance that can be purchased. But the increased gift tax exclusion in 2011 and 2012

provides the opportunity to make significantly greater gifts of premium payments, which can be used to buy a larger life insurance policy.

The increased exemption may also prove beneficial for same-sex couples whose estate planning is limited due to a lack of gift or estate tax marital deduction. At least for 2011 and 2012, assets of significant worth can be transferred between partners without gift tax consequences.

Before implementing a gifting plan, however, there are a few issues you should consider.

- Can you afford to make the gift in the first place (you may need those assets and the related cash flow in the future)?
- Do you anticipate that your estate will be subject to estate taxes at your death?
- Is minimizing estate taxes more important to you than retaining control over the asset?
- Do you have concerns about gifting large amounts to your heirs (i.e., is the recipient competent to manage the asset)?
- Does the transfer tax savings outweigh the potential capital gains tax the recipient may incur if the asset is later sold? The recipient of the gift gets a carryover basis (i.e., your tax basis) for income tax purposes. On the other hand, property left to an individual as a result of death will generally receive a step-up in cost basis to fair market value at date of death, resulting in potentially less income tax to pay when such an asset is ultimately sold.

Caution: *The amount of gift tax exemption you used prior to 2011 will reduce the \$5 million available to you under the 2010 Tax Act. For example, a person who used \$1 million of his or her exemption prior to January 1, 2011, will be able to make additional gifts totaling \$4 million during 2011 and 2012 free from gift tax.*

Tip: *In addition to this limited opportunity to transfer a significant amount of wealth tax free, it's important to remember that you can still take advantage of the \$13,000 per person per year annual gift tax exclusion for 2011 and 2012. Also, gifts of tuition payments and payment of medical expenses (if paid directly to the institutions) are still tax free and can be made at any time.*

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