

Estate Planning Bulletin

Opportunity Knocks: As 2011 Approaches, Time Is Running Out for One-Time Estate Planning Opportunities

As the end of the year approaches, it appears increasingly unlikely that Congress will pass legislation on gift and estate taxes before 2011. Many one-time opportunities for gifting and tax planning will expire at the end of 2010. Because it can take time to properly plan and implement tax and estate planning strategies, **we recommend prompt action by all persons who would like to take advantage of these opportunities**, starting with a call to a member of the Estate Planning Group of Vedder Price P.C.

Executive Summary

The following is an executive summary of these key opportunities; a more detailed discussion of each can be found inside this Bulletin:

- ***Gift Tax Will Increase in 2011.*** For 2010 only, the tax rate on gifts that exceed the \$13,000 gift tax annual exclusion and the \$1 million lifetime gift tax exemption is only 35%, compared to a 45% rate in 2009 and rates of up to 55% in 2011 and beyond. Persons who are otherwise facing substantial estate taxes should **consider making gifts this year** to take advantage of the 35% rate.
- ***Bonus Gift Tax Exemption Available for Some Gifts Made in 2010–2011.*** Due to quirks in the way the \$1 million lifetime gift tax exemption is determined, some donors may not have a full \$1 million exemption this year, but if they use the full exemption by the end of 2010, they can obtain a **bonus exemption in 2011**.
- ***Opportunity for Gifts or Trust Distributions to Grandchildren.*** Some gifts or trust distributions to grandchildren (or similar younger-generation beneficiaries) can be made in 2010 *without any generation-skipping transfer tax* (GST tax). Such gifts and distributions must be carefully structured to avoid GST tax in the future, however.
- ***Low Interest Rates May Not Last Much Longer.*** Interest rates have remained low this year, but they will eventually increase. **This year could be the best opportunity** for the foreseeable future to use a **leveraged technique** such as a grantor retained annuity trust (GRAT), an installment sale to a grantor trust, an intra-family loan (including refinancing an existing family loan), or a charitable lead annuity trust.
- ***Converting to Roth IRA with Charitable Deduction to Offset the Tax.*** Conversion of a regular IRA to a Roth IRA in 2010 may provide substantial benefits for certain individuals, in particular those with sufficient liquid assets outside of the IRA to pay the tax. The tax burden can be further reduced, or offset entirely, with substantial charitable gifts made this year. The temporary sunset (for 2010 only) of the phase-out of itemized deductions (including charitable deductions) for high-income earners will allow those taxpayers to obtain a greater after-tax benefit from their 2010 charitable deductions.

Gift Tax Rates Will Increase in 2011

Due to political considerations, the 2001 estate tax act eliminated the estate tax for only one year—2010. The gift tax was retained, even for 2010, primarily to avoid the loss of income tax revenue. For 2010 only, the tax rate on gifts that exceed the \$13,000 gift tax annual exclusion and the \$1 million lifetime gift tax exemption is **only 35%**. This is a substantial discount from the 45% rate for 2009 and rates of up to 55% that will apply after 2010.

Persons facing substantial estate taxes who can afford to transfer assets and pay gift taxes now should give serious consideration to making gifts this year. Gifts in 2010 should substantially reduce the total tax cost of transferring wealth to descendants and other beneficiaries as a result of **four factors**:

- the lower gift tax rate for 2010;
- the shift of future income and appreciation out of the taxable estate;
- the potential for valuation discounts that often apply to gifts but not bequests of the same property; and
- the potential to reduce the taxable estate by the amount of gift taxes paid if the donor survives the gift by three years.

This is illustrated by the three examples in the table on the following page, each involving a donor who has previously used his or her available gift tax annual exclusions and \$1 million lifetime gift tax exemption. The donor owns \$10 million of other assets in addition to a controlling interest in a company, which would be included in the donor's estate without valuation discounts (Example 1). Examples 2 and 3 assume a gift of the interest in the company structured in a way that achieves valuation discounts for lack of marketability and lack of control.

It appears increasingly likely that Congress will not act in 2010 to retroactively impose a higher gift tax rate on gifts made previously in 2010. However, to avoid that risk entirely, a gift could be set up in advance of the year-end and then executed in late December 2010 after the possibility of a retroactive rate increase disappears. Other, more complicated alternatives can be structured to allow final decisions to be postponed into 2011.

Large gifts require some planning and implementation, especially if special entities are to be created and appraisals obtained to determine valuation discounts. Consequently, it is important for donors interested in taking advantage of this opportunity to **contact their advisors as soon as possible** so that there is sufficient time to plan and implement the transfers. Donors who wait until December may not have enough time to implement full and optimal strategies.

Gift Tax Exemption Available for Some Gifts Made in 2010–2011

The common understanding that there is a \$1 million lifetime exemption from gift taxes in 2010 and 2011 is not exactly correct. There are some modest but real variations in the way the gift tax exemption is determined in those years. As a result, donors who used \$500,000 or more of their exemption before 2010 do not have a full \$1 million lifetime gift tax exemption in 2010. However, those who use their full amount by the end of 2010 can obtain a small amount (up to \$36,585) of bonus exemption in 2011.

For example, a donor who has made \$1,000,000 of taxable gifts before 2010 will have no additional lifetime gift tax exemption in 2010, but will have another \$36,585 of exemption in 2011. On the other hand, a donor who had made \$600,000 of taxable gifts before 2010 will have only an additional \$394,386 (not \$400,000) of lifetime gift tax exemption remaining in 2010, but if he or she makes a taxable gift of at least \$394,286 in 2010, that taxpayer would have an additional \$41,742 of exemption available in 2011. In each case, careful calculations must be made to determine a donor's remaining gift tax exemption for 2010 and

the amount of taxable gifts that should be made in 2010 to obtain the maximum possible additional exemption in 2011.

Table: Illustration of Benefits of Taxable Gifts in 2010			
Description	Example 1: Bequest in 2015	Example 2: Gift in 2011	Example 3: Gift in 2010
Value of property in 2010, before transfer (transfer = by bequest or gift, as indicated)	\$10,000,000	\$10,000,000	\$10,000,000
Period of appreciation before transfer	5 years	1 year	0 years
Appreciation before transfer, at 5% per year	\$2,762,816	\$500,000	(None)
Value at time of transfer	\$12,762,816	\$10,500,000	\$10,000,000
Valuation discounts (33%*)	\$0	(\$3,465,000)	(\$3,300,000)
Value subject to transfer	\$12,762,816	\$7,035,000	\$6,700,000
Transfer tax type	Estate	Gift	Gift
Marginal transfer tax rate	55%	55%	35%
Transfer taxes (estate or gift; federal and state combined)	\$7,052,689	\$3,699,250	\$2,345,000
Value of other estate in 2015**	\$10,000,000	\$6,300,750	\$7,655,000
Estate taxes on other estate	\$5,671,059	\$3,682,200	\$4,478,000
Net to beneficiaries ***	\$7,276,251	\$8,919,300	\$10,832,000
Cost of postponement compared to 2010 gift	(\$3,555,749)	(\$1,912,700)	(None)
Effective tax rate ****	63.62%	45.28%	38.65%
* Valuation adjustments for factors such as lack of marketability and minority interest are commonly in this range, but sometimes higher or lower. A qualified appraisal should be arranged as part of the planning on the transaction. This table's Example 1 assumes that the interest is retained until death in a manner that does not qualify for valuation discounts.			
** Value of other estate = \$10 million less gift taxes paid (Examples 2 and 3), plus value of other estate in 2015, less estate taxes on other estate			
*** Net to beneficiaries = pre-discount 2010 value less transfer (estate or gift) tax, plus value of other estate in 2015, less estate taxes on other estate			
**** Effective tax rate = tax ÷ (tax + net to beneficiaries)			

Opportunity for Gifts or Trust Distributions to Grandchildren

In years before and after 2010, gifts or trust distributions to grandchildren (or similar younger-generation beneficiaries) were subject to a generation-skipping transfer tax in addition to any gift tax that might be due. The GST tax is a flat tax at the top estate tax rate, and only applies after a lifetime exemption is fully used. Because the GST tax is suspended for 2010, gifts or trust distributions **this year** can **avoid** that additional tax. Such gifts and distributions must be carefully structured to avoid future GST tax, however. Transfers to trusts or trust equivalents (including UTMA accounts) for the benefit of a grandchild will still be subject to GST tax when later distributed to the grandchild. A direct transfer to a grandchild (including, we believe, a

guardianship estate for a minor grandchild) will avoid the tax, both now and later. Persons planning gifts or bequests to grandchildren should consider whether a gift this year might be more advantageous. Trustees expecting future distributions to grandchildren of the trust's donor should consider whether accelerating the distribution into 2010 would provide more of a tax advantage. In both cases, Vedder Price can help analyze whether and to what extent taking action this year would help.

Low Interest Rates May Not Last Much Longer

Interest rates remained low this year, but they will eventually increase. We may never see a better opportunity to use **leveraged techniques** such as GRATs, installment sales to grantor trusts, intra-family loans (including refinancing existing family loans) and charitable lead annuity trusts. A weighted average of Treasury rates is used to calculate the rates used in these wealth transfer techniques. Once those rates increase, techniques that perform best with low interest rates will lose some of their advantage. This would affect some of the most attractive wealth transfer techniques, all of which are described in prior newsletters:

- GRAT: a gift of future appreciation while retaining the present value of the transferred property
- Charitable lead annuity trust (CLAT): a gift of future appreciation while transferring the present value of the transferred property to charities of the donor's choice
- Installment sale to grantor trust: a sale of appreciating property without immediate income tax consequences, with low interest rates and principal repayment in the future
- Intra-family loan (including refinancing of a prior loan): giving family members the benefit of lower interest rates than those available from commercial lenders

Because these leveraged techniques will be far more powerful while interest rates remain low, **now is the time to put these techniques to work for you.**

Converting to Roth IRA with Charitable Deduction to Offset the Tax

Starting with 2010, the income ceiling for conversions of regular IRAs to Roth IRAs was eliminated. Conversion of a regular IRA to a Roth IRA in 2010 or 2011 can provide a substantial benefit for certain individuals, in particular those with sufficient liquid assets outside of the IRA to pay the tax. Conversions in 2010 are generally more favorable than those postponed to 2011, both for a lower tax rate (under current law) and for the option to spread the additional taxable income over two years (2011 and 2012).

The tax burden of a Roth IRA conversion can be further reduced, or offset entirely, with substantial charitable gifts made this year. Donors who have substantial charitable plans but do not wish to donate large amounts to independent charities in the current year could make substantial charitable gifts this year to a private foundation or donor-advised fund, from which those funds could be donated in turn to other charities over many years. Private foundations and, to a lesser extent, donor-advised funds take some time to set up in time for gifts to be completed by year-end. If this opportunity is of interest, donors should contact their advisors as soon as possible.

From 1990 through 2009, and again after 2010, high-income taxpayers (with \$166,800 or more of adjusted gross income in 2009) lost up to the lesser of 3% of their AGI or 80% of their itemized deductions (including charitable deductions). The temporary sunset (for 2010 only) of this reduction of itemized deductions will allow those high-income taxpayers to obtain a greater after-tax benefit from their 2010 charitable deductions.

To Reduce Tax Uncertainty, Plan Now, Execute in December

Some tax legislation in the 2010 post-election "lame duck" session cannot be ruled out, and the chances for tax legislation in early 2011 are even greater. Unfortunately, the opportunities described in this Bulletin

will generally have to be implemented by the end of 2010 to take full advantage of them. Fortunately, the types of tax legislation that would most likely be passed in early 2011 will not remove the advantages of transactions completed in 2010.

Time for Action

Many of the opportunities described in this Bulletin have an absolute expiration date: December 31, 2010. Others may not be available much longer than that in this volatile economic and legislative environment. Your advisors in the Estate Planning Group at Vedder Price P.C. can identify the opportunities that are most relevant in your situation and implement them while the opportunities remain available. Contacting us soon will reduce the risk of running out of time to implement the strategies before year-end.

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For questions about estate planning opportunities created by the current economic environment, please contact any member of the estate planning group.

About Vedder Price

Vedder Price P.C. is a national business-oriented law firm composed of 265 attorneys in Chicago, New York City and Washington, D.C.

The Estate Planning Group

Vedder Price P.C. has long recognized the importance of estate planning and has been at the forefront of this ever-changing area of the law. The firm's practice has both a national and an international scope. Vedder Price attorneys combine technical experience in all aspects of estate and financial planning with a strong appreciation of personal objectives and concerns in servicing clients in this uniquely personal area.

The firm represents clients with diverse personal objectives and financial interests, including individuals with large estates, individuals with personal situations requiring special planning, owners of closely held businesses, corporate executives and professionals. Vedder Price estate planning attorneys also represent executors, administrators, trustees and guardians. In addition, the firm provides estate and financial planning counsel to businesses and not-for-profit organizations, as well as other professionals who consult Vedder Price with respect to their own clients.

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If you have any questions regarding material in this issue of the Estate Planning Bulletin or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor, Igor Potym (group leader), at 312-609-7542 or at ipotym@vedderprice.com.

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