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Alert Memo

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OVERVIEW OF ESTATE, GIFT AND GST TAX PLANNING IN LIGHT OF 2010 TAX LEGISLATION

This memorandum reviews lifetime and testamentary estate planning in the current tax environment, including considerations relating to the enactment of the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 (the "Act").

Under the Act, in 2011 and 2012, the amounts that may pass free of estate, gift and generation-skipping transfer ("GST") tax (the "Estate Tax Exemption", "Gift Tax Exemption" and "GST Exemption", respectively) are set at $5 million,[1] and the estate, gift and GST tax rates for transfers in excess of the exemptions are set at 35%.[2] In addition, the Act includes provisions that generally make the Estate Tax Exemption (but not the GST Exemption) "portable" between spouses, meaning that, under most circumstances, the unused Estate Tax Exemption of a deceased spouse may be used by the surviving spouse.

The Act sunsets at the end of 2012. Therefore, unless there is further legislation, the time period in which to take advantage of these beneficial exemptions and tax rates is limited. Some clients may thus wish to make taxable gifts to children or more remote issue during this two-year period.

Clients should also review their testamentary estate plans to ensure that they are appropriate in light of the significant increase to the Estate Tax Exemption and GST Exemption and the new portability rules.

The following discussion provides a broad overview of lifetime gift techniques and testamentary estate planning under current law, including the opportunities and challenges related to the changes contained in the Act. Part I of the memorandum reviews various lifetime gift techniques, and Part II of the memorandum discusses testamentary estate planning.

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[1] The exemptions are indexed for inflation in 2012.

[2] Unless otherwise noted, references to tax exemptions and rates refer to Federal (and not state) tax laws.

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I. LIFETIME GIFTS

This part of the memorandum discusses various lifetime giving techniques, all of which are still viable under the Act.

A. Gift Tax Exemption

Each individual may make taxable gifts during life, that is, gifts that do not qualify for the annual exclusion or the exemption for educational or medical expenses (discussed in Section C below) in an amount up to the Gift Tax Exemption, without the imposition of a gift tax.[3] The Gift Tax Exemption is $5 million (or $10 million for a married couple who elects to split gifts) in 2011 and 2012, with the 2012 exemption indexed for inflation. Individuals who have already used the $1 million Gift Tax Exemption that was in effect prior to the Act, including those who have made gifts in excess of $1 million and, therefore, have paid gift taxes, will have a remaining Gift Tax Exemption of $4 million (or $8 million for a married couple who elects to split gifts) in 2011 and 2012. Taxable gifts in excess of the Gift Tax Exemption will be subject to a 35% gift tax.

Under the new law, if a deceased spouse did not fully use his or her Estate Tax Exemption, under most circumstances, the surviving spouse may use that unused exemption at his or her death. The unused Estate Tax Exemption of the first spouse to die may also be used during the lifetime of the surviving spouse.[4]

Absent further congressional action, in 2013, the Gift Tax Exemption will decrease to $1 million and the maximum gift tax rate will increase to 55%. Further, portability of the Estate Tax Exemption will no longer be available.

1. Early use of Gift Tax Exemption. In light of the substantial increase in the Gift Tax Exemption to $5 million, a unique opportunity is presented to transfer wealth to children or more remote issue in 2011 and 2012. Because the Gift Tax Exemption is scheduled to revert to $1 million in 2013, individuals interested in "locking in" this increased Gift Tax Exemption should consider making taxable gifts during this two-year period.[5]

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[3] In some states, such as Connecticut, a state gift tax may be imposed on a gift of the full Gift Tax Exemption.

[4] It should be noted, however, that the amount of the unused Estate Tax Exemption of the first spouse to die is not "locked in" until the death of the surviving spouse, and, as discussed in Part II, Paragraph 3, the first spouse's unused Estate Tax Exemption may be reduced or forfeited, even after the surviving spouse makes a lifetime gift of such unused Estate Tax Exemption. As a result, a surviving spouse's lifetime use of a deceased spouse's unused Estate Tax Exemption could result in an additional estate tax on the death of the surviving spouse.

[5] As a result of the manner in which the estate tax is currently calculated, if an individual makes taxable gifts of $5 million before 2013 and the Estate Tax Exemption is subsequently reduced below $5 million, there is a risk that an additional estate tax could be imposed at death on the difference between the Gift Tax Exemption at the time of the gift and the reduced Estate Tax Exemption.

There are a number of benefits to making use of the Gift Tax Exemption. First, early use of the Gift Tax Exemption removes the investment return on the transferred property from the donor's estate tax base. In addition, a number of states, including New York and New Jersey, do not have a gift tax but do impose an estate tax. Thus, depending upon the donor's domicile at his or her death, a gift of the Gift Tax Exemption may avoid a state transfer tax on the transferred property.

2. High-basis assets. In order to maximize the benefits of making lifetime gifts, as a general matter, it is advantageous to make the gifts with cash or other assets in which the donor has a high income tax basis. While an asset passing at death generally benefits from a "step-up" in the asset's income tax basis to the fair market value at the time of death, an asset transferred by gift retains the donor's basis (a so-called "carry-over basis"), which may result in capital gains tax being payable by the donee on the subsequent sale of the transferred asset.

3. Family limited partnerships. A gift of an interest in a family limited partnership ("FLP") may allow a donor to transfer significant wealth with the benefit of a valuation discount for gift (and estate) tax purposes to reflect restrictions on transferability and liquidation. To sustain such a discount, it is important to have a business purpose for the FLP. It is also important to have a contemporaneous appraisal of the FLP, documenting the basis for the valuation discount.

4. Grantor trusts. A gift of the Gift Tax Exemption can be enhanced by making the gift to a so-called "grantor trust". A grantor trust is invisible for income tax purposes, and all income and capital gains of the trust are reported on the donor's income tax return. Because the donor pays the income taxes on trust income, the donor is able to provide a gift-tax-free benefit to the trust beneficiaries.

In addition, because a grantor trust is ignored for income tax purposes, transactions between the donor and the trust, such as sales and loans, are disregarded for income tax purposes, providing additional estate planning opportunities, as discussed in Section B below.

5. Use of GST Exemption. If a donor creates a trust for the benefit of a child and the child's issue, a GST tax will be imposed, with certain exceptions, during the life of the child when distributions are made to grandchildren or more remote issue, and upon the child's death. The tax is imposed at the top estate tax rate, currently 35%. The imposition of the GST tax can be avoided by allocating to the trust the donor's GST Exemption. Such a GST-exempt trust may pass to multiple generations without an estate, gift or GST tax.

Under the Act, each individual has a GST Exemption of $5 million (or $10 million for a married couple who elects to split gifts) in 2011 and 2012, with the 2012 exemption indexed for inflation. Absent further congressional action, the GST

Exemption will revert to $1 million, indexed for inflation, in 2013. An individual who is interested in making early use of his or her Gift Tax Exemption should consider establishing a trust for multiple generations and allocating GST Exemption to that trust. In addition, a donor may allocate GST Exemption to currently existing trusts that are not already exempt from the GST tax.[6]

B. Leveraging Techniques for Lifetime Gifts

The following specialized techniques are designed to leverage the use of the Gift Tax Exemption and thereby pass additional assets to children or more remote issue at minimal or no gift tax cost.

1. Intra-family loans. A low-interest loan may be made by a donor to family members or to a trust for family members. The Internal Revenue Service issues on a monthly basis the "applicable federal rate" ("AFR"), which is the lowest rate that may be used for loans of varying duration without gift tax consequences. The rates for January 2011 are as follows:

Short-term AFR *(3 years or less)*	**0.43%**
Mid-term AFR *(more than 3 years but not more than 9 years)*	**1.95%**
Long-term AFR *(more than 9 years)*	**3.88%**

If a loan is made to a trust, the trust should hold sufficient assets to provide equity coverage for the note in order for the transaction to be respected as a loan and not recharacterized as a gift. If the trust is structured as a grantor trust, the loan by the donor to the trust will have no income tax consequences. Therefore, the donor will not report the interest as income and the trust will not deduct the interest. Further, the donor, and not the trust, will pay the income taxes on any income earned on the loan proceeds, thereby allowing the trust to grow income tax free.

To the extent that the total return on the investments made with the loan proceeds exceeds the interest payable on the note, wealth will have been shifted to the borrower without a gift or estate tax.

[6] By way of example, a trust that was funded on the termination of a GRAT, QPRT or CLAT, discussed in Section B, Paragraphs 3, 4 and 5 below, would not typically be GST-exempt, unless a prior allocation of GST Exemption was made at the end of the GRAT, QPRT or CLAT term.

2. Sales to grantor trusts for a note. A variation of the loan to a grantor trust is the sale of an interest in an FLP or other asset in exchange for a note bearing interest at the AFR. The sale of an FLP interest can be particularly effective if the interest purchased is valued at a discount because of its lack of marketability and the purchaser's lack of control. Because the sale is made to a grantor trust, no gain or loss occurs as a result of the sale,[7] and there are no income tax consequences associated with the payment of interest. To the extent that the total return on the asset sold to the trust exceeds the interest rate on the note, a shifting of wealth will have been achieved without a gift or estate tax. As with any loan to a trust, the trust should have sufficient assets to provide equity coverage for the note.

3. Grantor retained annuity trusts. As discussed in prior memoranda, several proposals were advanced in 2010 to limit the opportunity to use grantor retained annuity trusts ("GRATs") by requiring that GRATs have a 10-year minimum term. The Act does not contain such a 10-year requirement, so it is still possible to establish short-term GRATs.

A GRAT may be used to transfer to children, on a gift-tax-free basis, the total return on assets placed in the GRAT in excess of a benchmark interest rate. The benchmark rate for a GRAT is approximately 120% of the mid-term AFR in the month the GRAT is established (2.4% for the month of January 2011).

A GRAT is a trust in which the donor retains the right to receive a fixed annuity for a term of years that is designed to return to the donor the entire amount of the initial gift, plus interest at the benchmark rate. At the end of the term of years, if the total return on the trust property exceeds the benchmark rate, any remaining property in the trust passes to children or to trusts for their benefit without the imposition of a gift tax. Because the GRAT is a grantor trust, the donor pays the income taxes on trust income and the trust can grow income tax free.

If the total return on the trust property equals or is less than the benchmark rate, all of the trust property will return to the donor, but at no tax cost to the donor. If the donor dies before the end of the GRAT term, the trust property is includible in the donor's taxable estate, and there is generally no tax benefit (or tax cost) associated with the gift.

The present value of the children's remainder interest in the GRAT is a taxable gift. The value of the gift equals the value of the assets transferred to the trust less the present value of the donor's retained annuity. The annuity is set so that its present value absorbs almost the entire value of the property given to the GRAT. As a result, the present value of the children's remainder interest, and the taxable gift, is

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[7] However, it is possible that on the death of the donor, a realization event will occur, resulting in the imposition of a capital gains tax, if the note is still outstanding at that time.

close to zero. Further, because the annuity is stated as a percentage of the value of the assets transferred to the trust, if the value of those assets is increased on an audit of the gift tax return, the donor's retained annuity will also increase and the taxable gift to children will still be minimal.

4. Qualified personal residence trusts. Individuals may establish a qualified personal residence trust ("QPRT") to transfer a primary or secondary personal residence to children at a discounted value for gift tax purposes. A QPRT is a trust to which the donor transfers a whole or fractional interest in a residence, retaining the right to occupy the residence and the obligation to pay expenses on the residence for a term of years. After the termination of the QPRT term, the residence would typically be held in further trust for a spouse or children. If the donor wishes to continue to use the residence after the end of the QPRT term, the donor will be required to pay fair market rent, as determined by regular appraisals.

The present value of the remainder interest in the QPRT is a taxable gift. The present value of the remainder interest is calculated by reducing the value of the residence (i) by the present value of the donor's retained interest and (ii) to account for the possibility that the donor will die during the term, in which case the residence will revert to the donor's estate. The value of the residence may also be discounted if a fractional interest in the residence is given to the QPRT. Further, the value of the residence may appreciate over time, and this appreciation is also removed from the donor's transfer tax base without gift taxes.

Because a QPRT is a grantor trust, if the residence is sold during the QPRT term, the donor will pay the capital gains taxes imposed as a result of the sale. On the sale of the residence during the QPRT term, the QPRT typically either invests in a new residence or converts to an annuity trust for the donor.

5. Charitable lead annuity trusts. A charitable lead annuity trust ("CLAT") is also an effective means of removing assets from a donor's estate. A CLAT operates in a similar manner to a GRAT, except that the annuity is paid to charity instead of to the donor. The annuity may take the place of part or all of the donor's regular charitable gifts.

As with a GRAT, the CLAT annuity is stated as a percentage of the initial value of the property transferred to the CLAT and is fixed as of the date that the CLAT is created. Like the annuity payable to the donor in a GRAT, the charitable annuity in a CLAT is set by a formula designed so that its present value absorbs almost the entire value of the property given to the CLAT. Charity will receive over the CLAT term the entire amount of the initial gift to the CLAT, plus interest at a benchmark rate of approximately 120% of the mid-term AFR in effect in the month of the gift to the CLAT or in either of the two months preceding the gift to the CLAT (*e.g.*, a

CLAT formed in January or February 2011 may use the December 2010 benchmark rate of 1.8%).

A CLAT can transfer significant assets to children without a gift tax cost. If the total return on trust investments during the charitable term exceeds the benchmark rate, the excess return passes to children at the end of the term, free of transfer taxes.

A CLAT may be structured as a grantor trust. In that event, the donor of the CLAT will receive an income tax deduction in the year the CLAT is created equal to the present value of the annuity payable to charity over the CLAT term. During the term of the CLAT, however, the donor will pay income taxes on trust income with no offsetting charitable deduction. As with other grantor trusts, a CLAT structured as a grantor trust will grow income tax free because the donor pays the income taxes on the trust income. A CLAT that is not a grantor trust may also pay minimal income taxes because the trust will receive a charitable deduction each year for the charitable annuity.

C. Annual Exclusion and Other Tax-free Gifts

Annual exclusion gifts, and the payment of education and medical expenses, are the most basic yet effective ways to transfer assets and the total return on those assets to children and other beneficiaries without a gift tax and without use of the donor's available Gift Tax Exemption.

1. Annual exclusion gifts. Each individual may make annual exclusion gifts in the amount of $13,000[8] per donee annually to children, grandchildren or other individuals (or $26,000 annually for a married couple who elects to split gifts) without gift or GST tax consequences. We recommend that annual exclusion gifts be made early in each calendar year.

Annual exclusion gifts may be made directly to the individual donee (or, in the case of a minor, to a custodian under the Uniform Transfers to Minors Act) or to a specially designed annual exclusion trust.

2. 529 Plans. Annual exclusion gifts may also be made to a College Savings Account, or a "529 Plan", which is an income-tax-advantaged college savings account. Depending on applicable state law, contributions to a 529 Plan may be at least partially deductible by the donor for state income tax purposes. Both the income in the 529 Plan and distributions from the 529 Plan for tuition, fees, books and supplies and room and board are free of Federal (and, in most states, state) income taxes. Moreover, a donor may pre-pay up to five years of annual exclusion gifts for a beneficiary if an election is made on the donor's gift tax return.

8 The annual exclusion is indexed for inflation.

A gift to a 529 Plan may not be the most efficient use of a donor's annual exclusion since such a gift uses up a donor's available annual exclusion with respect to the beneficiary of the 529 Plan, even though a separate exclusion will be available if the donor pays the tuition directly when the beneficiary goes to college. In addition, accumulated earnings that are distributed and are not used for educational purposes will be subject to income taxes and a ten percent Federal withdrawal penalty.

3. Payment of education and medical expenses. In addition to annual exclusion gifts, payments of medical expenses, health insurance premiums and tuition to qualified educational institutions may be made transfer tax free. In order to qualify for this exemption, payments must be made directly to the qualifying educational institution or medical provider.

II. TESTAMENTARY ESTATE PLANNING

Each individual may make bequests at death that do not qualify for the marital or charitable deduction in an amount equal to the individual's Estate Tax Exemption without generating a Federal estate tax. As noted above, the Estate Tax Exemption is $5 million in 2011 and 2012, with the 2012 exemption indexed for inflation, and the estate tax rate is 35%. The Estate Tax Exemption is reduced by lifetime taxable gifts. In addition, under the new law, with certain exceptions, the Estate Tax Exemption is "portable", that is, an individual may use the Estate Tax Exemption of his or her deceased spouse if the deceased spouse did not fully use his or her Estate Tax Exemption.

Absent further congressional action, in 2013, the Estate Tax Exemption will automatically decrease to $1 million and the maximum estate tax rate will automatically increase to 55%. Further, portability of the Estate Tax Exemption will no longer be available.

1. Formula testamentary Estate Tax Exemption gifts. The estate plans of many married couples are designed to maximize the assets available for the use of the surviving spouse without estate tax and to minimize the estate tax payable on the survivor's death. This is achieved by dividing the deceased spouse's estate into two shares: (i) the deceased spouse's Estate Tax Exemption is given to a trust for the surviving spouse and issue that will be insulated from estate tax at the surviving spouse's subsequent death (a "by-pass trust") and (ii) the balance of the deceased spouse's estate is given to the surviving spouse outright or to a trust qualifying for the marital deduction.

In such plans, the amount of the Estate Tax Exemption that will pass to the by-pass trust on the first death is based on a self-adjusting formula that takes into account fluctuations in the Estate Tax Exemption and the reduction in the available Estate Tax Exemption if the decedent made any taxable gifts during life.

Many clients should review their financial position to determine whether a gift of the full $5 million Estate Tax Exemption would have the effect of diverting too large a share of the deceased spouse's estate from the surviving spouse. In many estate plans, because the gift of the Estate Tax Exemption passes to a trust of which the surviving spouse is a beneficiary, the funds will still be available to the surviving spouse, regardless of the size of the Estate Tax Exemption. However, in plans where the Estate Tax Exemption passes directly to children (or other non-spousal beneficiaries), the client may wish to limit the amount passing to such individuals.

2. Retitling assets. Notwithstanding the portability provisions of the Act, discussed in Paragraph 3 below, in order to fully utilize both spouses' increased Estate Tax Exemptions in 2011 and 2012, we recommend that, in appropriate circumstances, married couples review their balance sheets to ensure that each spouse has sufficient assets in his or her name alone to enable each spouse to fund a gift of his or her Estate Tax Exemption.

3. Portability. An important aspect of the Act is that it permits a surviving spouse to use his or her deceased spouse's unused Estate Tax Exemption, thereby allowing married couples to fully utilize their combined Estate Tax Exemptions even if no by-pass trust is created on the death of the first spouse to die.[9] However, like the other provisions of the Act, this "portability" feature sunsets at the end of 2012. Moreover, each individual may use the unused Estate Tax Exemption of only the last spouse to predecease such individual.

Despite the new portability rules, we still recommend in many instances the continued use of a by-pass trust on the first death. A gift of the Estate Tax Exemption to a by-pass trust offers several advantages over relying on portability, including the following:

- The investment return on the assets held in the by-pass trust after the first death will be shielded from estate tax on the death of the surviving spouse; and
- Unlike the Estate Tax Exemption, the GST Exemption is not portable and, therefore, without further planning, the GST Exemption of the first spouse to die would be lost if not allocated to a by-pass trust.[10]

[9] Portability is available only if the deceased spouse died after December 31, 2010 and the executor of the deceased spouse's estate files a Federal estate tax return making an election for portability to apply.

[10] A deceased spouse's GST Exemption may also be allocated to a trust qualifying for the marital deduction.

Further, if a married couple relies on portability, the Estate Tax Exemption of the first spouse to die could be forfeited entirely or reduced in part under the following circumstances:[11]

- The Estate Tax Exemption of the first spouse to die will be unavailable to the surviving spouse if the surviving spouse remarries and his or her new spouse predeceases the surviving spouse;
- If Federal law is changed to reduce the Estate Tax Exemption after the death of the first spouse to die, the amount of the first spouse's Estate Tax Exemption that is portable will also be reduced;[12] and
- It is uncertain whether portability will be extended beyond 2012.

On the other hand, as discussed in Paragraph 4 below, use of the full Estate Tax Exemption on the first death may result in the imposition of a state estate tax. Thus, reliance on portability (assuming that it is extended beyond 2012) may be appropriate for married couples who do not wish to generate a state estate tax on the death of the first spouse to die.

4. State estate taxes. Under the Act, a gift of the full Estate Tax Exemption on the death of the first spouse to die may generate a state estate tax. A number of states, including New York, New Jersey and Connecticut, have not increased their exemptions from the state estate tax to match the increase in the Estate Tax Exemption. In these states, a formula gift of the Estate Tax Exemption will generate a state estate tax on the death of the first spouse to die. In New York and New Jersey, the amount of the state estate tax payable on the death of a spouse who makes a formula gift of the full Estate Tax Exemption will be up to approximately $444,000 in 2011 and 2012. In Connecticut, the amount of the state estate tax payable on the death of a spouse who makes a formula gift of the full Estate Tax Exemption will be approximately $122,000 in 2011 and 2012.

Under prior law, it often made sense to pay the state estate tax on the first death in order to shelter the full Estate Tax Exemption from estate taxes on the death of the second spouse to die. However, portability permits (with the exceptions noted above) the first spouse's Estate Tax Exemption to be used on the second death without generating a state estate tax on the first death. Some married couples may,

[11] There is a possibility of forfeiture of the Estate Tax Exemption of the first spouse to die even if the surviving spouse makes a gift prior to his or her death of the first spouse's Estate Tax Exemption, potentially resulting in an additional estate tax on the surviving spouse's death.

[12] For example, if the unused Estate Tax Exemption of the first spouse to die is $5 million and the full Estate Tax Exemption in effect at the surviving spouse's death is only $3.5 million, $1.5 million of the first spouse's unused Estate Tax Exemption will be unavailable to the surviving spouse.

therefore, wish to limit the by-pass trust to the amount that may pass free of state estate taxes.

In some states, such as Connecticut, it is possible to create a trust for the surviving spouse that qualifies for the marital deduction in the state of domicile but that does not qualify for the Federal estate tax marital deduction. Such a trust, known as a "state-only QTIP" trust, would allow a married couple to avoid a state estate tax on the death of the first spouse to die while still making full use of his or her Estate Tax Exemption.

5. Use of GST Exemption. As noted above, the GST Exemption is $5 million in 2011 and 2012, with the 2012 exemption indexed for inflation. Typically, a married couple interested in taking advantage of the GST Exemption under their testamentary estate plan would create a by-pass trust for the surviving spouse that passes to lifetime trusts for children and more remote issue on the death of the surviving spouse. The GST Exemption would, on the death of the first spouse to die, be allocated to the by-pass trust, so that the trusts to be created for children and more remote issue on the death of the surviving spouse would be GST-exempt and would eventually pass to grandchildren and more remote issue without the imposition of an estate or GST tax. On the death of the surviving spouse, the surviving spouse would also create lifetime trusts for children and more remote issue to which the surviving spouse's GST Exemption would be allocated.

Alternatively, some estate plans make a gift of the GST Exemption on the death of the first spouse to die (as well as on the death of the surviving spouse) directly to trusts for children and more remote issue.[13] Under this alternative, a surviving spouse has no interest in the property used to fund the GST Exemption gift. With the increase in the GST Exemption to $5 million, clients may wish to review these plans to insure that sufficient funds will still be available to the surviving spouse.

The GST Exemption, unlike the Estate Tax Exemption, is not portable. Thus, a married couple interested in taking advantage of the GST Exemption of the first spouse to die needs to create a trust (or make gifts directly to grandchildren or more remote issue) on the first death in order to preserve the first spouse's GST Exemption.

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[13] In this scenario, if the first spouse to die has already used a portion of the Gift Tax Exemption during life with respect to gifts to children or others that do not skip a generation, a gift of the full GST Exemption on the death of the first spouse to die will not have all of the protection of the Estate Tax Exemption and could result in the imposition of an estate tax. Such a tax may be avoided by establishing a marital trust to which the first spouse's GST Exemption is allocated, thereby deferring the estate tax until the death of the surviving spouse.

Although there is still considerable uncertainty regarding the estate, gift and GST tax laws beyond 2012, the Act provides an opportunity to transfer wealth to children and more remote issue through gift- and GST-tax-free transfers in 2011 and 2012. Further, the increase in the Estate Tax Exemption and the introduction of the portability provisions make this an appropriate time to review estate plans. Please contact any of the attorneys in our Private Clients and Charitable Organizations Practice Group if you have any questions regarding this memorandum or would like to discuss any aspect of your estate plan.

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