ESTATE AND TAX PLANNING IN UNCERTAIN TIMES WHAT WILL THE TAX LAW BE IN 2011

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ESTATE TAX LAWS

	2009	2010	2011
Estate Tax Exemption	$3,500,000	Unlimited	$1,000,000
GST Exemption	$3,500,000	Unlimited	$1,100,000
Gift Tax Exemption	$1,000,000	$1,000,000	$1,000,00
Maximum Rate	45%	35%	55 – 60%
New Basis	Yes	$1,300,000 + $3,000,000	Yes

I. Interim Estate Planning Concepts

A. For married clients generally the most commonly recommended approach, absent family circumstances, is to balance the estates fairly equally between the spouses. On the first death the estate planning documents will provide that all assets pass to the surviving spouse BUT the surviving spouse is expressly authorized to disclaim. The disclaimed property may pass to the children directly or the disclaimed property may pass to a trust of which the spouse is a beneficiary. The latter approach can be established to give the surviving spouse maximum protection but still reduce his or her prospective estates.

B. For single clients, the planning concepts are remaining fairly much the same. Recommendations for single clients facing estate taxes remain substantially the same – making gifts, reducing valuations and obtaining discounts, charitable transfers, etc.

C. For clients making Generation Skipping Transfers, the prospective decrease in the GST tax exemption means such transfers should be reviewed and possibly reduced.

II. Income Tax Update

A. General Tax Legislation

1. The Hiring Incentives to Restore Employment (HIRE) Act - New incentives allow for deductions up to $6,621 per newly hired employee.

2. S-Corporation Legislation - This year, the U.S. House of Representatives passed legislation which provided that non-salary income received from an S-corporation would be subject to FICA, precluding one of the main tax advantages for S-corporations. This provision would only apply to small service-based businesses. Currently, the U.S. Senate has not passed this legislation.

3. Health Insurance Tax Credit and COBRA Payment Deductions.

4. Codification of the Economic Substance Doctrine.

5. Uncertain Tax Positions Disclosure.

B. Individual Income Tax

1. Capital gains and dividend tax rates will change. See below for details. Ordinary dividends and, in some situations, corporate liquidations may be advisable.

2. No income limits on Roth IRA conversions. This is a major benefit in 2010 - anyone can convert a traditional IRA to a Roth IRA and they have the option of paying the taxes resulting from the conversion over two tax years - 2011 and 2012.

3. It is no longer possible to opt to deduct state and local sales taxes on your federal return (for the moment). Prior to 2010, a taxpayer could choose to deduct state sales tax payments instead of state and local income taxes. Congress let this option expire at the start of this year. However, there have been efforts to enact a provision to extend the state and local sales tax deduction.

C. Deductions

1. Health Insurance Tax Credit and COBRA Payment Deductions.

2. Internal Revenue Code § 179 deduction amount of $250,000 extended - This section of the tax code allows small and medium-sized businesses to deduct the full cost of new business property up to an annual ceiling limitation. In 2008 and 2009, the annual limitation was $250,000. The $250,000 deduction amount was extended for the 2010 tax year under the Hiring Incentives to Restore Employment (HIRE) Act. It is scheduled to go down to $25,000 in 2011.

3. Bonus Depreciation not extended at this time. Internal Revenue Code § 168(k) allows additional depreciation for property placed in service in the current year in addition to the sec. 179 deduction. This is another reason why investing in new equipment this year may be a good decision since bonus depreciation has not been extended at this time.

4. Reminder - Charitable deductions of business property. Temporary tax laws provided enhanced charitable deductions to businesses that donated food, inventory, or computer equipment during 2008 and 2009. It was not extended into 2010.

5. Reminder - Business mileage deduction rates have been decreased. If you use a personal vehicle for business purpose, be aware that the business mileage deduction is now 50¢ a mile in 2010 (9 percent lower than the 55¢ per mile figure from 2009).

D. Federal Income Tax Brackets For 2010 – Based On Taxable Income Ranges

Tax Rate	Married Couples Filing Jointly	Most Single Filers
10%	Not over $16,750	Not over $8,375
15%	$16,750 - $68,000	$8,375 - $34,000
25%	$68,000 - $137,300	$34,000 - $82,400
28%	$137,300 - $209,250	$82,400 - $171,850
33%	$209,250 - $373,650	$171,850 - $373,650
35%	Over $373,650	Over $373,650

Federal Income Tax Brackets For 2011–Based On Taxable Income Ranges

Tax Rate	Married Couples Filing Jointly	Most Single Filers
10%	Not over $17,050	Not over $8,525
15%	$17,050 – $69,300	$8,525 – $34,650
25%	$69,300 – $139,850	$34,650 – $83,900
28%	$139,850 – $235,550	$83,900 – $194,150
36%	$235,550 – $380,500	$194,150 – $380,500
39.6%	Over $380,500	Over $380,500

This chart assumes that the highest two federal tax brackets move back to their pre-Bush tax cut levels of 33% and 35%, respectively and that brackets increase at 2.5%.

Federal Capital Gain Tax Brackets For 2010

Tax Bracket	Short Term	Long Term
10%	10%	0%
15%	15%	0%
25%	25%	15%
28%	28%	15%
33%	33%	15%
35%	35%	15%

Most Dividends are taxed at 15%.

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Federal Capital Gain Tax Brackets For 2011

Tax Rate	Short Term	Long Term
10%	10%	10%
15%	15%	20%
25%	25%	20%
28%	28%	20%
36%	36%	20%
39.6%	39.6%	20%

Dividends will be taxed at ordinary income tax rates, similarly to Short Term Capital Gain, instead of at a flat rate of 15%.

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ESTATE PLANNING FOR
EXECUTIVES & BUSINESS OWNERS

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I. General Planning Principles

A. Last Will & Testament (or revocable trust)

B. Advanced Directives

C. Coordinate beneficiary designations

II. Issues for Executives

A. Income in __________________ of Decedent

1. Retirement plans
2. Non-qualified deferred compensation plans
3. Stock options

B. __________________ estates of spouses

1. Retirement plans
2. Non-qualified deferred compensation plans
3. Stock options

C. __________________ beneficiary designations.

III. Issues for Business Owners

A. __________________ succession issues

1. Shareholder makeup
2. Qualifying shareholders (trusts)
3. Transfer opportunities (GRATs, Sales to IDITs, SCINs)

B. __________________ succession issues

1. Officers

2. Board of Directors

C. __________________ issues

1. Income taxes
2. Estate taxes
3. Nine (9) month deadline
4. 6166 election

D. __________________ strategies

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ESTATE PLANNING IN A LOW INTEREST RATE ENVIRONMENT

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I. Overview.

It is very difficult for our clients to implement the various techniques to reduce or eliminate the federal estate tax when we do not know the status of the law. In the absence of a change in the law for 2011, individuals will be faced with an estate tax exemption amount of $1 million per person or $2 million per couple. Even if Congress does act, it is unlikely that the federal estate tax will be completely eliminated, with an exemption of between $3 million and $5 million per person most likely. In other words, there will still be a need for persons with substantial estates to look at the potential techniques for saving estate taxes for their families.

We are currently living in an environment where low interest rates are prevalent. This state of affairs is not advantageous if you are looking to invest in a certificate of deposit, but is very advantageous for mortgage rates, and certain estate planning techniques.

The IRS publishes monthly the minimum required interest rates on loans between related parties and the required interest rate assumption for calculating the value of gifts of future interests.

For the month of September, 2010, the assumed interest rate for calculating the value of gifts of future interests is 2.4%. The August required interest rates for loans between related parties are as follows: Short term notes - .53%; mid-term notes – 2.18%; and long term notes – 3.79%.

Many of the estate planning techniques we use involve the gift of partial interests. For example, assume John transfers assets worth $100,000 to a Charitable Remainder Unitrust that provides a $5,000 distribution to his daughter every year for 10 years. At the end of the 10 years, the remaining trust assets are distributed to charity. John receives an income tax deduction for the contribution to the trust and a gift tax charitable deduction for the right of the charity to receive $5,000 for 10 years. Under current interest rates that gift is worth approximately $60,000 of the total $100,000 gift. John has made a taxable gift of $40,000 to his daughter. If the trust only maintains its value (after annual distributions) for the ten year period, charity will receive $100,000 of value for a reported gift and his daughter would have received $50,000. In addition, John has satisfied some of his charitable intent.

Many of the estate planning techniques recommended by estate planners involve this type of split interest, the most common of which are briefly explained below.

II. Estate Planning Techniques.

A. Attractive techniques in a low interest rate environment. When interest rates are low, the following techniques result in a smaller reported gift to the individual's beneficiaries. If the fund out-performs the interest rate assumptions, a larger amount passes to those beneficiaries than the IRS assumes.

1. ***Charitable Lead Trust***. A charitable lead trust is a technique in which a charity receives a percentage of the trust assets for a period of years, with the family members receiving the trust assets after the term.

> **Example**: Mary contributes $1,000,000 to a charitable lead trust for a term of 10 years, and she provides in the document that the charity receive $50,000 per year for 10 years. Any amounts left in the trust at the end of the 10 years will be distributed to her children, although she could have named a trust for her family or retained the right to receive back the money left in the trust. Mary made a $1,000,000 gift at the time she put the money in the trust, but of that amount, approximately $435,000 (using the August 2010 required IRS interest rate) would be treated as a charitable contribution, and only $565,000 would be treated as a gift. If the fund earned 8% per year, the fund would be worth over $1,400,000 at the end of the 10 year term, after payments of $500,000 to charity. Mary transferred $1,400,000 for a reportable gift of $565,000, which saves transfer taxes on $800,000 of appreciation. That would save $360,000 of taxes at a 45% tax rate.

This technique has several different ways of being set up, all of which have slightly different income and estate/gift tax consequences. An annuity trust established as a "grantor trust" (which causes all trust income to be taxed to the grantor) would give an immediate income tax deduction to the grantor, but the deduction is recouped over the term of the trust when the income is earned in the trust. An annuity trust established as a non-grantor trust does not provide any income tax deduction to the grantor but there is an income tax deduction to the trust of any amounts payable to the charity each year.

2. ***Grantor Retained Annuity Trust (GRAT)***. This is a trust for a term of years in which an individual retains an income interest payable annually. The trust assets remaining at the end of the term would be distributed to a beneficiary, either an outright beneficiary or a trust. The idea is to retain an interest that actuarially approximates the value of the trust, and then have the trust assets outperform the retained income interest.

> **Example**: John transfers $500,000 to the trust for a 5 year term and retains the right to receive back $90,000 per year for the 5 year period (it is usually a graduated payment, beginning at a low figure and increasing by, for example, 10% per year so that he receives back a total of $450,000). If the fund earns 8% per year, John will have made a taxable gift at the beginning of the term of $45,000 and the remaining fund will, at the end of the term, be worth $99,000, or a gift of approximately $45,000 worth of appreciation at no gift tax cost. If the fund earns 10% per year, it will be worth $146,000 at the end of the term, or a gift of over $100,000 at no gift tax cost.

The downside of this technique is the possibility that the fund will not earn enough to pay the annuity to the donor, or that that the GRAT "failed." The donor must survive the term, although both spouses may be beneficiaries, which reduces the risk. There is no tax consequence of failure. The cost to the donor is the cost of establishing and administering it. Many people do a series of GRATs with less money and for shorter terms to hedge against the possibility of having a failure of a large amount.

Another possibility is to combine a GRAT with an asset that is discounted, such as a minority interest in a real estate entity, investment entity or operating entity. In the above example, if an individual transfers a minority interest in a corporation to the GRAT, the value of the gift would not be $500,000 but would be approximately $350,000.

It is possible, and often preferable, to use a GRAT that is established for a short period of time (2-3 years) and in which the ultimate gift is actuarially calculated to be zero. Assume an individual transfers $1,000,000 of assets to a 2 year GRAT (in August, 2010) that pays the grantor $472,903 at the end of the first year and $567,483 at the end of the second year. If the trust earns (or increases in value) 8% annually, the trust beneficiaries will receive $88,000 at the end of the term, all without using either the annual exclusion or the donor's lifetime exemption. If the trust earns 10% annually, the beneficiaries will receive about $122,000 at the end of the term and if it earns 6% the beneficiaries will receive about $55,000 at the end of the term. Donors have used this by setting up a new GRAT (or series of GRATs with staggered terms) in year one, with the same assets being put back in a new GRAT as were in the expiring GRAT. There is pending legislation to limit the use of short term, zeroed-out GRAT's, so this opportunity should be used as soon as possible.

3. ***Sale of Assets to Defective Grantor Trust***. This is a technique in which an individual sells assets (hopefully appreciating assets) to a trust or trusts for the benefit of children or grandchildren (or other beneficiaries) in exchange for a promissory note (an installment contract sale). Over the term of the note, which bears interest at a relatively low rate, the trust pays the seller back, but any appreciation of the assets over the interest rate inures to the children. If an asset whose value can be discounted can be used, the savings, like in a GRAT, are substantial.

   a. The real benefit of this technique is that the trust is structured so that the senior generation pays the income taxes on the trust (there is no tax on the sale of assets even if there is appreciation); the parents are in effect paying their children's income taxes. This is not treated as a gift, so it is a way to transfer substantial value to the next generation without a tax cost.

   b. This is a technique very similar to a GRAT, but uses a lower interest rate and can probably transfer more value to the next generation with less tax cost because of that and because of the parents paying the taxes for their children. This technique has more of a risk and is more costly to implement, than is a GRAT.

4. ***Lending and Borrowing Money.*** In certain circumstances, it is often to everyone's best interest for an individual to lend money to a family member at the low interest rates currently authorized. If the borrower makes the interest payments, the interest rate can be higher than the interest rates the lender can get on certificates of deposit or other fixed income investments and is less than what the family member would have to pay to a third party. The complicating factors include the issues of whether the lender will actually pay the interest and whether the note is secure. In addition, if the transaction is entered into with only one family member, there are practical and personal issues involved.

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B. **Attractive techniques in a higher interest rate environment**. The following techniques create a smaller gift to the reported gift to the individual's beneficiaries.

1. ***Charitable Remainder Trust***. A charitable remainder trust is the opposite of a charitable lead trust; a non-charitable beneficiary (such as the donor, the donor's children or their parents) receives the annual income interest (5% or more) of the value of the trust for a term of years or for the lifetime of a beneficiary or another person. At the end of the term, the remaining trust assets are distributed to a charitable organization, including a family foundation or donor advised fund. If $1,000,000 was contributed to a charitable remainder trust for a 10 year period with a $50,000 annual payment to the income beneficiary, the charitable deduction would be $565,000 amount (this is exactly opposite of the charitable lead trust illustration above). The charitable remainder trust is also a good way to dispose of highly appreciated stock (or other assets) by contribution to this charitable trust without paying tax on the gain at the time of sale.

2. ***Charitable Gift Annuities***. This is a simple technique in which an individual enters into an agreement with a charitable organization. The individual contributes money to the organization and retains an annual annuity payment, usually for the life of the individual. The amount payable to the individual each year is calculated through use of a published chart based on current interest rates and the age of the individual. At the individual's death, any amount remaining passes to charity.

3. ***Qualified Personal Residence Trust***. This is a technique where an individual transfers a primary or vacation residence into a trust and reserves the right to live in the house for a period of years. At the end of the term, the house is distributed to the ultimate beneficiaries, and any appreciation in the value of the home between now and the end of the term is allocated to the remainder beneficiaries.

   The benefit of this technique is that an individual can give away a substantial amount of appreciation without a gift tax cost. At a low interest rate, however, the value of the remainder interest (and thus the taxable gift) is higher than at a higher interest rate.

   One of the disadvantages of this technique is that after the end of the term of years, the donor cannot force the remainder beneficiaries to let him or her live in the house or even rent it to him or her. The donor would want to make sure that the term is acceptable and may end at a time when the use of the home may no longer be attractive. Although this technique is used for vacation residences quite a bit, an Iowa personal residence often does not appreciate enough from year to year to accomplish much tax savings. Many people are concerned about whether the housing market will have enough appreciation in future years for this to be a good technique, although a lot of vacation homes are now valued quite low.

C. Other Estate Planning Techniques Not Affected by Interest Rates.

1. ***Use of annual exclusion gifts***. The easiest technique in the estate planning toolkit is the annual gift. An individual or couple with potential estate tax exposure should make use of annual exclusion gifts to the extent their financial situation allows. Any amounts given should be made in an amount the donor is comfortable with.

   a. An individual may currently give $13,000.00 per donee or $26,000.00 for a married couple.

   b. An individual may make annual exclusion gifts not only to children, but to their spouses and children. If an individual is concerned about each family receiving the same amount, because they have different numbers of children, the donor can deal with that situation by "making up" for unequal gifts at death, or by using a portion of the $1 million lifetime exemption to make gifts equal "by family" as opposed to being equal for each beneficiary.

   c. Annual exclusion gifts can often be combined with other techniques.

2. ***Equalize spouses' estates to the extent possible***. It has always been a good idea to equalize the value of both spouses' estates to the extent possible so that both parties may use their full gift and estate tax exemption amount, regardless of the order of death. In many instances, this is difficult, particularly if a couple's net worth consists of employment benefits and retirement plans or a business owned by one family member. This is something that should be reviewed with each couple individually. If a couple wishes to equalize assets between them, but do not want the spouse whose estate is being augmented to have full power of disposition over the assets being transferred to the spouse, an inter vivos QTIP trust can be used.

The spouse with the larger estate transfers assets to a trust for the benefit of the surviving spouse. Upon the surviving spouse's death, those trust assets pass to the ultimate beneficiaries set out in the trust document. This may be particularly important for couples in a second marriage.

3. ***Use of lifetime gift tax exemption amount.*** Every individual can give up to $1,000,000 of assets during his or her lifetime, which will count toward the unified credit exemption. A gift like this would also allow all appreciation on the assets subject to the gift to accrue for the benefit of the family rather than being included in the donor's estate. If, for example, an individual gives away $1,000,000 worth of assets now, and dies when the assets are worth $2,000,000, the children will save estate taxes of approximately $450,000 at 2009 rates. Both the annual exclusion gifts and the lifetime exemption gifts can be used in conjunction with the other techniques discussed below in order to pass more value to the next generation.

4. ***Charitable Foundation or Donor Advised Fund.*** A charitable foundation or donor advised fund is a way to create an endowment with charitable contributions in a way that allows an individual to make large contributions to the foundation or fund in any given year, with future distributions to the donor's preferred charities. This is particularly important if an individual is going to have a year with large income, but does not want to make charitable contributions to the charities in as large an amount as he or she may want to obtain as a charitable deduction for income tax purposes.

5. ***Family Limited Partnership or Limited Liability Company.*** This technique is one in which an individual or couple creates a limited liability company or a limited partnership to hold investment assets or other assets. Over time, the older generation can give interests in the company to their children (and their families, if desirable), and could even use this as a way to make annual exclusion gifts without giving away liquid assets. The benefit of giving an interest in a company instead of giving stock itself is that the value of the gift could be discounted by 30-35% because the company interest is not marketable and is only a minority interest.

    Example: Julie contributes $1,000,000 of securities to a limited liability company and retains 100% of the membership interests in the company. At a later time, she gives each of her children a 2% membership interests, which would have a liquidation value of $20,000 each. Since the membership interest is not marketable and represents a minority interest in the Company, the reportable gift tax value would be closer to $13,000 to $14,000 because of the marketability and minority discounts. This technique has been subject to a lot of IRS scrutiny over the past several years, but most planners still recommend its use if carefully planned and implemented. Appraisals are highly recommended of both of the underlying assets and the newly formed company.

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