



JANUARY 2011 CLIENT UPDATE

Dear Clients and Friends:

As you are aware, on December 17, 2010, the Federal Government enacted the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “2010 Tax Act”) changing, among other things, the estate, gift and generation-skipping transfer (“GST”) tax regime once again. Unfortunately, the 2010 Tax Act does not provide us with the certainty we had hoped for as the Act is only in effect for two years. Beginning January 1, 2013, the Internal Revenue Code will revert to its pre-2002 version unless there is further legislative action to make the 2010 Tax Act changes permanent or otherwise alter the transfer tax system yet again. This letter will outline some of the ways the new law can be used to a taxpayer’s advantage. However, because the law may revert to its pre-2002 version in 2013, the opportunities created by the 2010 Tax Act may not be what they appear to be, and you should consult with your Cummings & Lockwood attorney to determine which strategies are appropriate to best meet your goals before implementing any of the suggestions in this letter.

Estate, Gift and GST Tax Rates and Exemptions in 2011 and 2012

Under the 2010 Tax Act, the estate, gift and GST tax rates all are set at a maximum rate of 35%. This is a significant decrease from the 2009 rates of 45% and the 2001 rate of 55%. Furthermore, the 2010 Tax Act increased the amounts exempt from these taxes to \$5,000,000 and unified the gift tax and estate tax so that the entire \$5,000,000 exemption can be used during lifetime or at death or some combination in between. In recent years, only \$1,000,000 of the total exemption was available for lifetime use.

For those clients who have already used their entire \$1,000,000 gift tax exemption, these increased exemptions offer an opportunity to make additional gifts tax free and to shelter gifts from the GST tax as well. Even for those clients who have not yet used their lifetime gift exemptions, the increased exemption amounts and reduced tax rates make 2011 and 2012 good years to consider making lifetime transfers.

When making gifting decisions, remember that if you live in a state that has a separate gift tax system, such as Connecticut, it is important to take state taxes into account as well. For

example, Connecticut's gift tax exemption remains at \$3,500,000, meaning that if a Connecticut resident makes a \$5,000,000 gift to take full advantage of the federal exemption available this year, a tax of \$122,000 will be due on the \$1,500,000 difference between the federal and Connecticut exemptions.

Exemption Portability

As many married clients are aware, until this year the federal tax system gave each person an estate tax exemption, thus allowing a married couple with a proper estate plan to pass on a total of twice the exemption amount to their beneficiaries. However, under prior law, if the first spouse to die lacked sufficient assets in his or her individual name or left his or her assets entirely to the surviving spouse outright, the benefit of the estate tax exemption of the first spouse to die was wasted. The 2010 Tax Act provides that if the first spouse to die dies after December 31, 2010, any unused exemption of the first spouse to die can be transferred to the surviving spouse by the Executor and saved for later use to reduce estate taxes in the surviving spouse's estate. The unused exemption of the first spouse to die will also be available to the surviving spouse to shelter lifetime gifts by the surviving spouse.

While this new "portability" feature of the estate tax exemption will certainly be useful in correcting flawed estate plans after a client's death, we do not recommend relying on portability in lieu of a traditional plan that proactively uses the exemptions of both spouses, typically by leaving at the first spouse's death the exemption amount to a trust for the surviving spouse, customarily referred to as an "Estate Tax Sheltered Trust" or "Trust Exempt from Estate Tax." This is true for a number of reasons:

- 1) there are currently no states that allow portability of state estate tax exemptions, meaning that such state exemptions may be wasted and state estate taxes increased by relying on portability;
- 2) under the traditional system of using the exemption of each spouse the exempt amount *plus all of the appreciation on that amount between the death of the first spouse and the death of the surviving spouse* escapes estate tax, whereas portability only protects the unused exempt amount from estate tax;
- 3) the exemption transferred to the surviving spouse under the portability regime is no longer available in the surviving spouse's estate if the surviving spouse remarries and the new spouse also predeceases the surviving spouse;
- 4) the surviving spouse may use the exemption to benefit different individuals than the first spouse intended;

- 5) the GST exemption is not portable and in most cases the best way to use GST exemption is to combine it with the estate tax exemption when the first spouse dies (i.e., by allocating it to an Estate Tax Sheltered Trust);
- 6) an Estate Tax Sheltered Trust can provide additional benefits such as enhanced protection against creditors (including a new spouse) and certainty that the trust property will pass to the intended beneficiaries upon the surviving spouse's death; and
- 7) most importantly, the 2010 Tax Act and the portability of exemptions it provides is only in effect for two years, and there is no certainty that a deceased spouse's exemption will still be available under the law when the surviving spouse dies.

The Benefits and Myths of Using your \$5,000,000 Gift Tax Exemption(s) in 2011 and 2012 (Is this two-year opportunity too good to be true?)

The first reaction of many of our clients to the news of the increase in the gift tax exemption to \$5,000,000 in 2011 and 2012 was a sense of urgency to take advantage of it out of fear that it would disappear in 2013. While this reaction may be good news for their children because they may receive substantial assets sooner, it is important to understand that such gifts may not necessarily save taxes or increase the total assets passing to such children during their parents' lifetimes and at their deaths. The reason is that given the temporary nature of the increased exemptions and the way the estate tax appears to be coordinated with the gift tax under the current unified structure, what is tax-free now may be taxed later.

To illustrate one possible way this could result in a future tax, let's assume (i) an unmarried client uses his or her \$5,000,000 gift tax exemption to make \$5,000,000 of gifts to children in 2012, (ii) the federal estate and gift tax exemptions each revert to \$1,000,000 in 2013 and (iii) the maximum estate tax rate is fixed at 50%. The client dies in 2022 with \$5,000,000 of other assets. Calculating the federal estate tax under the current requirements, the client's taxable estate consists of the \$5,000,000 of assets owned at death **plus** the \$5,000,000 of gifts made in 2012. The estate tax exemption in effect at death avoids the imposition of tax on only \$1,000,000 and the resulting estate tax is \$4,500,000. Assuming the property gifted in 2012 does not increase in value between 2012 and 2022, the estate tax is exactly what it would have been if the client had not made the gifts. On the other hand, if the future growth and income ("total return") on the property between 2012 and 2022 had annualized at 7%, the total return of \$5,000,000 would not be taxed in the client's estate and a tax savings of \$2,500,000 would be achieved. Note that the benefit of the exemption gift is solely attributable to appreciation of the gift outside the client's estate.

There is a much different, and potentially devastating, result, however, if the same client is married and wants to leave his or her estate to a surviving spouse at death. The \$5,000,000 in gifts will be subject to tax at the death of the donor spouse even though the client's remaining estate was intended for the surviving spouse and would

have qualified for the marital deduction. This will result in federal taxes being due at the death of the first spouse in excess of \$4,000,000, leaving less than \$1,000,000 for the spouse. In the absence of the gift, this tax could have been postponed until the death of the surviving spouse. Unless there is corrective legislation to prevent this outcome, the use of the \$5,000,000 exemption could jeopardize the amount left to take care of the surviving spouse in our example. Married clients will want to be sure the surviving spouse has sufficient funds in all situations and possibly consider the use of gifting techniques described later in this letter that would allow the surviving spouse access to the gifted assets.

Exemption gifts are not as powerful as gifts that qualify for the \$13,000 annual exclusion from gift tax. Annual exclusion gifts are not included in the taxable estate at death. Consequently, exemption gifts should be carefully considered if they will jeopardize the client's financial wherewithal to continue making the maximum annual exclusion gifts of \$13,000 per beneficiary.

Since the tax benefit of exemption gifts is limited to avoiding estate tax on the future income and appreciation on the gifted property, it may be better to transfer the property using a "freeze" technique designed to use the exemption, such as a QPRT, a GRAT or a sale or loan to a trust. A freeze technique may also reduce the potentially negative consequence of the gifted property declining in value after the gift is made and may permit a client to transfer assets without risking his or her financial security by limiting the transfer to the future total return on the transferred property in excess of a fixed return retained by the client, rather than the full current value of the property.

For example, let's assume a seventy-year-old client has a net worth of \$20,000,000. If the client gifts \$5,000,000 to his children in 2012, the client will avoid estate tax on the future growth and income on the \$5,000,000 of transferred property, but will also reduce his net worth by 25%. Alternatively, the additional exemption amount can be employed to provide principal in a trust that could be used as security for a loan. The client could then sell the bulk of his assets to the trust, taking back from the trust some combination of cash and a promissory note. The client would avoid estate tax on the future income and growth on the assets in the trust in excess of the interest rate paid on the note, which over the client's life expectancy should be far greater than the future growth and income on the \$5,000,000 gifted in the first example. The client would also have the security of having gifted only a fraction of his net worth, while entering a secured transaction on the balance. There are many different ways to utilize the new gift tax exemption (some others are discussed below) and you should consult your Cummings & Lockwood attorney to consider strategies that may benefit you and your family.

Using the \$5,000,000 GST Exemption before 2013

Unless the \$5,000,000 GST Exemption is extended to 2013 and beyond, we would recommend that clients consider taking advantage of it before 2013. Unlike the gift tax exemption recapture discussed above, there is no “recapture” of the GST Exemption at death if the exemptions decline in 2013.

While gifts to your grandchildren can be structured to qualify for both the gift tax annual exclusion and the generation-skipping tax annual exclusion, such gifts must either be made outright to grandchildren or to a specially designed trust for the grandchild's sole benefit and includible in the grandchild's estate. Gifts to trusts for a spouse and/or children that pass to grandchildren upon the deaths of the spouse and children require the allocation of GST exemption to avoid the GST tax when distributions are eventually made to grandchildren. If you are interested in using the increased GST Exemption before 2013, a number of the estate planning techniques discussed below may be ideal for this objective.

Tax Formula Clauses under Wills and Trusts

If your current Will or Trust divides your estate so that the share exempt from estate tax passes to a beneficiary other than a trust for the benefit of your spouse or the share of your estate exempt from GST Tax does not pass to a trust or trusts for the benefit of your children, you should contact your Cummings & Lockwood attorney as soon as possible to consider whether the increase of the exemptions to \$5,000,000 reduces the property passing to or in trust for your spouse or children to less than you would want.

Lifetime Gifting Options under the Temporary Law

There are a number of ways (some of which have already been mentioned above) to take advantage of the increased gift and GST tax exemptions both to initiate or continue lifetime gifts at greater speed and to take advantage of the window to make larger gifts without an immediate tax before the gift tax exemption possibly returns in 2013 to \$1,000,000 or some amount less than \$5,000,000. None of the techniques described below are new or unique to the temporary tax regime, and you may have considered or implemented some of them already. The temporary increase in gift and GST tax exemptions, however, may make these techniques more attractive and effective. Depending on your financial circumstances, the nature of your assets and your intended beneficiaries, one or more of the techniques listed below may be an appropriate way to utilize this new gifting opportunity.

Gifts to Estate Reduction Trusts for Spouse and/or Other Family Members

An Estate Reduction Trust is an irrevocable trust created by you for the benefit of your spouse and/or other family members. Gifting assets to such a trust removes the assets and their appreciation from your taxable estate. If you are married, a gift to such a trust can be

particularly attractive because your spouse can be the primary beneficiary of the trust. This allows the assets to be segregated from your estate while still being available to your spouse, and through your spouse to you, while your spouse is alive. With careful planning and some restrictions, each spouse can create and fund his or her own Estate Reduction Trust so that each can use their respective \$5,000,000 gift exemption. In addition, if you choose to allocate GST exemption to the gifts to an Estate Reduction Trust, the trust assets, and their appreciation can also be removed from the GST tax system for as long as the trust exists, meaning that eventual transfers from the trust to grandchildren and more remote descendants can be made without any tax.

Gifts to Lifetime Marital or "QTIP" Trusts

If you want to be more certain of your access to the assets in your Estate Reduction Trust, even if your spouse predeceases you or you are later divorced, certain types of trusts can be established by you during your lifetime for the benefit of your spouse to which you can transfer assets without gift tax because the trust qualifies for the marital deduction. These trusts are commonly referred to as Qualified Terminable Interest Property ("QTIP") trusts. While Lifetime QTIP trusts do not use gift tax exemption and therefore are not an effective vehicle for locking in the temporarily increased exemption, these trusts allow you to take advantage of your GST exemption in a manner that allows your spouse, and through your spouse, you, to enjoy the assets while you are alive. Unlike the Estate Reduction Trust, however, the QTIP can continue for your benefit if your spouse predeceases you.

The Lifetime QTIP would initially be a trust for your spouse which would pay the income of the trust to your spouse at least annually. The Trustee of the trust would be able to make principal distributions to your spouse in any amount as well. This trust would last for your spouse's lifetime. At your spouse's death, the trust could continue on the same terms for your benefit, and at your later death (or at the death of your spouse if you predecease your spouse), the remaining trust property would be transferred to grandchildren and more remote descendants or to trusts for the benefit of multiple generations (which could include your children). With the temporary increase in the GST exemption, a transfer to a Lifetime QTIP can be an especially effective GST tool because by creating the QTIP you are locking in the increased GST exemption and allowing the trust assets to grow during your and your spouse's remaining lifetimes so that the appreciated value of the trust upon the death of the surviving spouse is exempt from generation-skipping tax.

Lifetime QTIPs are very versatile. They are often used for a different purpose. Lifetime QTIP trusts can be used to build up the estate of a spouse who does not have sufficient property to use available gift, estate or GST tax exemptions should he or she predecease you. With those exemptions increasing to \$5,000,000, the Lifetime QTIP will have appeal in situations where the transferor spouse wants to determine the ultimate disposition of property using the exemptions of the other spouse.

Gifts to Self-Settled Trusts

Under certain circumstances and in certain states it may be possible to create and fund a trust and to include yourself as a beneficiary of that trust. Such a structure may be desirable if you want to maximize your gifting potential while the exemptions are \$5,000,000 but you are reluctant to part with assets you may need in the future. While self-settled trusts can offer the “best of both worlds” in terms of giving away assets while retaining them, the law governing both the ability to create such trusts and their effectiveness for tax purposes is still evolving, and creating such a trust will require a determination as to not only the terms but also the location of the trust.

Qualified Personal Residence Trusts (“QPRTs”)

A Qualified Personal Residence Trust is designed to be a tax-efficient means of transferring a personal residence to your intended beneficiaries. The concept of a QPRT is relatively simple: the owner of the personal residence transfers it to a trust but retains the right to live rent-free in the residence for a specified number of years. At the end of that period, ownership of the residence is transferred to the beneficiaries (or a trust for their benefit) and is removed from the estate of the original owner. At that time, the original owner can rent the property from the beneficiaries if he or she wishes to remain in the house.

The tax advantage of the QPRT comes primarily from the way in which the value of the residence is calculated for gift tax purposes. The value of the gift is not the full value of the residence on the date of the gift, but rather the gift is valued based on the beneficiaries’ right to receive the residence only after the specified number of years. The value is calculated based on a number of factors including the age of the donor, the number of years the donor can remain in the house rent-free, the value of the residence at the time of the gift and the IRS prescribed interest rate required for the calculation.

However, no matter how a QPRT is structured to reduce the gift, the gift will still be substantial. With the increased gift exemptions, QPRTs may be an appropriate gifting opportunity for people who otherwise would not consider such a gift because they did not have enough gift exemption remaining or did not want to use the more limited exemption on such a gift but now find themselves with “extra” exemption to spare.

Grantor Retained Annuity Trusts (“GRATs”)

The objective of a Grantor Retained Annuity Trust or “GRAT” is to transfer appreciation in value to your beneficiaries free of any gift or estate tax. A GRAT is a trust to which you transfer an asset and from which you receive a fixed amount annually (an “annuity”) for a specified number of years. At the end of the period of years, if you are alive, the trust beneficiaries will receive the assets remaining in the GRAT free of gift and estate tax. The tax advantage of this technique is derived principally from the way in which the value of the

gift to the GRAT is calculated. The value of the gift for gift tax purposes is not the value of the assets transferred, but rather is the value of the right of the remainder beneficiaries to receive the assets after the period of years has expired and the annuity payments have been made to you. The GRAT is typically structured so that the combination of the duration of the GRAT and the annuity amount retained reduces the value of the gift on creation to essentially zero.

While GRATs require the use of minimal gift tax exemption and are not effective vehicles for GST transfers, there has been much discussion in Congress about eliminating some of the most attractive and effective provisions of the GRAT laws in future years. While the 2010 Tax Act did not alter the favorable GRAT provisions, if Congress again takes up tax legislation before January 2013, these trusts may no longer be available or you may not be able to structure them to achieve the maximum chance of success available now.

Grantor Trusts

To further enhance the potential for appreciation of gifted property outside of the donor's taxable estate, many of the trusts described in this letter can be designed as "grantor trusts" which would cause the trust to be treated as the grantor/client for federal income tax purposes. Grantor trust status will cause the grantor/client to be personally taxable on all income earned by the trust and relieves the trust from any liability for income taxes to the government during the grantor/client's lifetime. This substantially increases the growth potential of the trust.

Asset Selection

While the increase in the gift and GST tax exemptions offers new opportunities, it is always important to consider not only the proper amount to give, but also what assets should be used to fund gifts. Assets that are likely to appreciate make better gifts because they are valued for gift tax purposes at the value on the date of the gift. Future appreciation occurs outside of your estate. Likewise, gifts whose value is discounted, such as a minority interest in a business enterprise or otherwise restricted assets, are also good choices.

2011 Actions Regarding GST Transfers in 2010

As discussed in our December 2010 letter to our clients, the 2010 Tax Act increased the amount of GST exemption for transfers made in 2010 to \$5,000,000 and imposed GST tax on gifts in excess of the \$5,000,000 amount at a 0% rate, thereby eliminating the payment of GST tax for 2010 transfers. However, a gift to a grandchild or more remote descendant or to trusts for those individuals, while not generating a currently due GST tax, may be needlessly or inefficiently using GST exemption which could better be applied in future years. This inadvertent use of GST exemption will occur, in most cases, automatically, unless the donor opts out of the automatic allocation rules on a timely filed gift tax return. If you made gifts

to grandchildren, or to trusts for their benefit, it is important that you review with your accountant or attorney whether you should file a 2010 gift tax return (due April 18, 2011, unless put on extension) even if you are certain no tax will be due.

Conclusion

The 2010 Tax Act changed the estate, gift and generation-skipping transfer tax regime once again. Since the Act is effective for only two years, we still lack the certainty for which we had hoped. Once again, the Internal Revenue Code will revert to its pre-2002 version without further legislative action. But the 2010 Tax Act does create opportunities for clients who plan ahead despite its pitfalls.

Palm Beach Office Coming Soon!

The opening of our Florida east coast office is moving forward. We will be located in the Golden Bear Plaza, West Tower, Suite 505 W, 11760 U.S. Highway 1, Palm Beach Gardens, Florida 33408. We believe that this location will allow us to provide effective assistance to our clients who live in Palm Beach and the surrounding area. We anticipate that the office will officially open in March.

Copyright 2011, Cummings & Lockwood LLC. All rights reserved.

In this Update, we have deliberately simplified technical aspects of the law in the interest of clear communication. Under no circumstances should you or your advisors rely solely on the contents of this Update for legal advice, nor should you reach any decisions with respect to your personal tax or estate planning without further discussion and consultation with your advisors.

In accordance with IRS Circular 230, we are required to disclose that: (i) this Update is not intended or written by us to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer; (ii) this Update was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by such materials; and (iii) each taxpayer should seek advice on his or her particular circumstances from an independent tax advisor.