

Six Landmark Square
Stamford, CT 06901
203.327.1700 Phone
203.351.4535 Fax

3001 Tamiami Trail North
Naples, FL 34103
239.262.8311 Phone
239.262.6092 Fax

Two Greenwich Plaza
Greenwich, CT 06830
203.869.1200 Phone
203.869.3120 Fax

8000 Health Center Blvd., Suite 300
Bonita Springs, FL 34135
239.947.8811 Phone
239.947.8025 Fax

75 Isham Road, Suite 400
West Hartford, CT 06107
860.313.4900 Phone
860.313.4993 Fax

11760 U.S. Highway 1, Suite 505W
Palm Beach Gardens, FL 33408
561.214.8500 Phone
561.214.8514 Fax

DECEMBER 2011 CLIENT UPDATE

Dear Clients and Friends:

On December 17, 2010, the Federal Government enacted what we know as the 2010 Tax Act (the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010) changing the estate, gift and generation-skipping transfer (“GST”) tax regime once again. The 2010 Tax Act changed the rules, but only for 2011 and 2012. 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 permanent or otherwise alter the transfer tax system again. Absent such legislation, the gift and estate tax exemptions are scheduled to return to \$1,000,000 on January 1, 2013, and the maximum gift and estate tax rates will increase to 55%. Likewise, absent additional legislation, on January 1, 2013 the GST rate will revert to 55% and the exemption will return to \$1,000,000, indexed for inflation.

In our January 2011 Client Update, we described various planning techniques for taking advantage of the 2010 Tax Act before its expiration on December 31, 2012. However, clients may not have that long. On November 17, 2011 the “Sensible Estate Tax Act of 2011” was introduced by Congressman Jim McDermott, a senior member of the House Ways and Means Committee, essentially accelerating the end of the 2010 Tax Act to December 31, 2011. This bill follows weeks of unconfirmed rumors from Capitol Hill that the 2010 Tax Act rules were to be rolled back. While the Sensible Estate Tax Act may not be enacted, at least in its current version, it appears that clients would be best advised to take advantage of the 2010 Tax Act while they still can and not wait until the end of 2012.

ESTATE, GIFT AND GST RATES AND EXEMPTIONS UNDER THE 2010 TAX ACT

Under the 2010 Tax Act, the estate, gift and GST tax rates all were set at a maximum rate of 35%. This is a significant decrease from the 2009 rates of 45% and the 2001 rates of 55%. Furthermore, the 2010 Tax Act increased the amounts exempt from these taxes to \$5,000,000, indexed for inflation, 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 of both. The gift tax and estate tax exemptions are scheduled to increase to \$5,120,000 on January 1, 2012 based on the inflation index.

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 free¹ and to exempt gifts from 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 this a good time 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 was reduced retroactively as of January 1, 2011 to \$2,000,000 meaning that if a Connecticut resident makes a \$5,000,000 gift to take full advantage of the federal exemption available this year, a Connecticut tax of \$230,000 will be due on the \$3,000,000 difference between the federal and Connecticut exemptions.

There are a number of ways to take advantage of the increased gift and GST tax exemptions to take advantage of the window to make larger gifts. 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 tax exemptions,

¹ It is important to understand that using the federal gift tax exemptions provided in the 2010 Tax Act may not necessarily save taxes or increase the total assets passing to 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 2011, (ii) the federal estate and gift tax exemptions each revert to \$1,000,000 in 2013 (or sooner) 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 2011. The estate tax exemption in effect at death avoids the imposition of tax on only \$1,000,000. Thus, the resulting estate tax is \$4,500,000. Assuming the property gifted in 2011 does not increase in value between 2011 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 2011 and 2022 had annualized at 7%, the total return of approximately \$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 and providing the children with access to the gifted assets sooner.

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.

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.

USING THE \$5,000,000 GST EXEMPTION UNDER THE 2010 TAX ACT

While gifts to your grandchildren can be structured to qualify for both the gift tax annual exclusion and the GST 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.

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 removed from your taxable estate while still being available to your spouse. 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 to enjoy the assets while you are alive. Unlike the Estate Reduction Trust, however, it is possible for the QTIP to 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. It is possible to design the QTIP so that at your spouse's death, the trust could continue for your benefit. 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. 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 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 DYNASTY TRUSTS

A dynasty trust is a trust that is designed to benefit multiple generations by continuing to hold property in trust for each generation with the assets in the trust not being subject to estate tax or GST tax. The increased gift tax exemption and GST exemption under the 2010 Tax Act present an excellent opportunity to fund a dynasty trust using your increased gift tax exemption and allocating GST exemption to such gift for the benefit of your descendants.

Many states, including Connecticut and New York, still have statutes that require a trust to terminate within a specified period. Some states, such as Delaware, have modified or repealed these "rules against perpetuities" to allow a trust to continue either for a period significantly longer than the traditional time (21 years after the death of the last member in a named class of then living individuals) or even continue in perpetuity with no required termination. Florida law allows a trust to continue for 360 years from the date of its creation. Establishing a dynasty trust in these advantageous jurisdictions potentially enables multiple generations to enjoy the trust assets free of estate tax and GST tax. This dynasty trust planning is available even if you are not a resident of these favorable states by selecting a Trustee who is resident there.

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 discount rate required for the calculation. A higher IRS discount rate produces a lower gift tax value. Although the IRS rates have been at historic lows, suppressed property values may still produce favorable outcomes. Additionally, for clients over age 65, a low IRS rate has less of an impact on the gift tax value.

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")

Because of low interest rates, the use of Grantor Retained Annuity Trusts ("GRATs") has become very popular. GRATs allow you to transfer certain assets to your beneficiaries at a discounted gift tax value. This is because you retain the right to receive payments from the GRAT for a certain number of years before the GRAT terminates in favor of your beneficiaries. The amount of the payments you can receive can be calculated so that you will be deemed to have made a "zero gift" upon funding of the GRAT. With the increased gift exemptions, GRATs may allow clients to design a GRAT with a lower annual payment, while using the gift tax exemption to cover the value of the remainder interest for your beneficiaries to avoid gift tax.

GIFTS TO SELF-SETTLED TRUSTS

Under certain circumstances and in certain states it may be possible for you to make a gift to an irrevocable trust and include yourself as a beneficiary of that trust. Such a structure may be desirable if you want to maximize your gifting while the gift tax exemption is \$5,000,000 but you are reluctant to part with assets due to future uncertainty. Making gifts to a self-settled trust can prove to be the tool to overcome these psychological barriers. The law governing both the ability to create such trusts and their effectiveness for tax purposes is still evolving. However, the IRS recently has given guidance on this planning. Generally, the donor cannot have a pre-arranged or underlying agreement as to the distribution of assets

from the self-settled trust. Ultimately, the primary benefit of a self-settled trust is to allow you to make a tax efficient gift while providing distributions to you if circumstances warrant.

FRACTIONAL INTEREST GIFTS

Gifts of fractional interests in property (including gifts of interests in limited partnerships or limited liability companies) to your beneficiaries may be made at a discounted gift tax value. This is because gifts of a fractional interest are often not freely marketable and the underlying asset is not one that can be freely controlled by the donee. Valuation discounts are justified as a result of this lack of marketability and lack of control. Any of the trusts discussed above can be funded with property using a fractional interest. With the increased gift exemption, clients have more “cushion” in using these types of gifts without paying gift tax.

THE SENSIBLE ESTATE TAX ACT OF 2011

The Sensible Estate Tax Act of 2011, introduced on November 17, 2011, would accelerate to December 31, 2011, the return to the pre-2002 gift and estate tax rules. With the pressure building on the Congress to organize its fiscal affairs, the chance that this bill or one like it will be included in a grand compromise sometime before December 31, 2012 cannot be dismissed. The Sensible Estate Tax Act would:

1. Reduce the federal estate tax exemption to \$1 million for persons dying after December 31, 2011 and set the top rate at 55 percent.
2. Coordinate the federal gift tax rates and exemptions with this estate tax structure.
3. Restore the credit against federal estate tax for state transfer taxes allowing all states the so-called “pick-up” tax.
4. Restrict fractional interest discounts for transfers after enactment of non-business assets owned by entities not actively traded.
5. Require GRATs funded after enactment to have a minimum term of 10 years and a remainder greater than zero.
6. Impose a 90 year limit on the protection from GST tax for trusts to which GST exemption is allocated after enactment.
7. Make permanent the ability for a surviving spouse to preserve and use a deceased spouse’s federal estate exemption (“portability”).

TAX-FREE IRA PAYMENTS TO CHARITIES FOR THOSE AT LEAST 70 1/2

Since 2006 the tax law has provided an option for individuals who have reached age 70½ to use funds from their IRA accounts in order to make a direct contribution to charity. Before 2006, any amounts withdrawn from an IRA and then contributed to charity were first included in the account owner's income and then reported as an itemized deduction. The new law permitted an individual to make contributions of up to \$100,000 from an IRA account directly to qualified charities (not including private foundations and donor-advised funds). The amount the charity receives from the IRA is counted as part of the account owner's minimum required distribution but it is not included in the owner's taxable income and does not generate a charitable income tax deduction. The 2010 Tax Act extended this tax benefit until December 31, 2011; however, without further Congressional action this tax benefit will not be available in 2012 and beyond.

UPDATE ON FOREIGN TAX REPORTING

Congress has been focused on taxpayer reporting of foreign bank and financial accounts for the last two years, worried that offshore tax evasion is widespread. During 2009, the IRS began diligently pursuing taxpayers who failed to file information reports called "FBARs" (Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts"). In March 2010, the President signed the Foreign Account Tax Compliance Act ("FATCA") into law. FATCA includes additional reporting requirements applicable to individuals, trustees, private foundations and public charities. Now, in addition to filing an FBAR with the Treasury Department to report an interest in a foreign bank or brokerage account or a foreign mutual fund or trust, information must be attached to the taxpayer's income tax return regarding those interests if the aggregate value of all the foreign assets exceeds \$50,000. Although the FBAR filing threshold is \$10,000, certain interests, such as those in foreign trusts and foreign entities (e.g., hedge funds), not subject to FBAR will be caught under the new reporting requirements.

FLORIDA POWERS OF ATTORNEY

Florida changed its law regarding Powers of Attorney effective October 1, 2011. While Powers of Attorney signed in Florida or signed by Florida residents before October 1, 2011 remain valid, Powers of Attorney signed after that effective date must comply with the new law. Although the new law reinforces the use of a Power of Attorney as a practical estate planning device, it may alter the operation and effect (but not validity) of a Power of Attorney executed prior to October 1, 2011. It may also affect the rights and obligations between a principal and an agent. Because of the various changes to the Powers of Attorney law, if you are a Florida resident now may be an opportune time to review your existing documents and discuss each power (and its implications) with your Cummings & Lockwood attorney.

UPDATE ON FLORIDA SINGLE MEMBER LIMITED LIABILITY COMPANIES

Creditor protection is a principal benefit of establishing a limited liability company (“LLC”). Generally, a creditor with a “charging order” will have the right to receive the member’s share of any distribution made by the LLC. Effective May 31, 2011, Florida law provides that a charging order is the “sole and exclusive” remedy for a creditor of a multi-member LLC. For a single-member LLC, the statute provides that a charging order is the sole and exclusive remedy unless the creditor can demonstrate that the creditor’s judgment will not be satisfied within a reasonable time. If a creditor can establish this, the LLC interest would be subject to foreclosure. If you are the sole member of a Florida LLC, talk to your Cummings & Lockwood attorney about structuring a sale and/or gift to an additional member or a possible merger or conversion to a more favorable jurisdiction or business format.

PALM BEACH OFFICE OPEN

Cummings & Lockwood has opened a Florida east coast office. We are 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.

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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.

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