

2010 END-OF-YEAR ESTATE PLANNING: PLANNING AHEAD TO CONFRONT UNCERTAINTY

It is now common knowledge that the federal estate tax and the generation-skipping transfer tax (GST) are repealed for 2010. Along with the repeal, the federal gift tax rate for 2010 is decreased to 35%, a significant reduction from the prior top rate of 55%. The provisions of the law creating the repeal and the reduced gift tax rate will “sunset” on December 31, 2010. When the sun rises on January 1, 2011, the federal estate tax and GST will be reinstated, estate and gift tax rates will increase to a top rate of 55% and the exemption equivalent from estate tax will be at its 2001 level of \$1 million.

The temporary repeal and the reduced gift tax rate may seem like good news. However, since they became effective, there has been concern that Congress would pass a retroactive reinstatement of the estate tax and GST, and an increase of the gift tax rate. As a result, there is uncertainty surrounding the implementation of any planning techniques that attempt to take advantage of the repeal and reduced rates.

Despite this uncertainty, due to the potential benefits that most likely will expire by the end of the year, there are planning options that may be appropriate for consideration. *Many of these options (which are enhanced by low-interest rates and depreciated asset values) can be analyzed now, but should not be fully implemented until late December, after the Congressional session ends. At that time, there should be less uncertainty about retroactive legislation.*

Below is a brief summary of a few of the planning options that you may wish to consider. Please feel free to contact any of us to discuss these and other options.

As noted above, without action by Congress and the President before January 1, 2011, the estate tax law on that date will revert to the law in place in 2001. Not only will tax rates increase, but the most significant effect for many taxpayers will be the elimination of the \$3.5 million credit exemption equivalent (\$7 million for a married couple), and the reinstatement of a \$1 million exemption (\$2 million for a married couple). While most wills are written to adjust automatically to such tax law changes, the imposition of significant tax on estates that previously would have been exempt may require a review of your planning.

EXAMPLES OF PLANNING CONSIDERATIONS

Traditional Gifts

In 2010, you may give up to \$13,000 to any person without incurring gift tax and without using any of your \$1 million lifetime gift tax exemption. Gifts in excess of those exclusions will be subject to gift tax. Unless Congress retroactively imposes a higher rate, any taxable gifts made prior to January 1, 2011, will be at the 35% rate. This amount is lower than the 55% rate that is anticipated to be imposed in 2011. Further, if the donor of the gift survives three years from the date of the gift, the amount of the gift tax paid will not be included in his or her taxable estate, a significant benefit making lifetime gifts less expensive from a tax perspective than the same gifts under a will.

Gifts may be made outright or in trust. Also, unless the GST is retroactively reinstated for 2010, outright gifts made to grandchildren in 2010 will not be subject to GST. In 2011, it is anticipated that the top GST rate will be reinstated to 55%.

Intra-Family Loans

In light of current low interest rates, there are planning opportunities associated with loans to your family members or other individuals. The current annual Applicable Federal Rates for November are .35% for short-term loans of three or fewer years, 1.59% for mid-term loans in excess of three years and fewer than nine years, and 3.35% for long-term loans in excess of nine years.

The loan documents could provide for a balloon payment at the end of the loan term. If the return on the principal amount loaned exceeds the interest owed on this amount, then the borrower will receive a tax-free gift of the excess return. Although interest will be due during the term of the loan, you can forgive this repayment as a gift to the borrower. However, in most cases you will still have to pay income tax on the amount of interest that you would have received.

Any loan outstanding now may be forgiven prior to the end of 2010 to take advantage of the 35% gift tax rate (but only after it becomes certain that the gift tax rate will remain at 35% for 2010).

Of possibly greater planning significance to some will be the use of loans in connection with the sale of assets to trusts for the benefit of family members. Favorable investment returns compared to the hurdle rate associated with the low rates of interest, combined with favorable income tax attributes, make sales to trusts an important planning tool, especially at this time.

GRATs

Similar to the intra-family loan and asset sales to trusts, implementing a Grantor Retained Annuity Trust (GRAT) is a worthwhile consideration in a low interest rate environment. Generally, a GRAT involves making a gift to a trust in exchange for an annuity. If the grantor of the trust survives the annuity term, any amount remaining in the GRAT after the annuity is paid can be distributed to the remainder beneficiaries or held in trust for their benefit.

The present value of the remainder interest of a GRAT is a gift to the remainder beneficiaries. However, a GRAT can be structured so that the remainder interest as valued for IRS purposes is close to zero, and no meaningful taxable gift is made. One way to accomplish this is to use a short-term GRAT that, for example, provides an annuity with a term of three years. Assuming that

the growth of the GRAT assets is in excess of the IRS rate for this purpose (which is 2% for GRATs created in November), at the end of the annuity term, the grantor will have made a tax-free gift of the excess growth to the remainder beneficiaries.

Along with the sunset provisions regarding the repeal of the estate tax and GST, the benefits available with short-term GRATs may end as well. Presently there is legislation in Congress that would prohibit a GRAT from having a term of less than 10 years.

UNCERTAINTY /INACTION

It is an understatement to say we live in uncertain times; that uncertainty is very apparent when it comes to the estate and gift tax laws. But uncertainty does not translate into inaction; let us know if you believe the time is appropriate to utilize some of the tools mentioned above. We all hope for clarity, and it may be just ahead of us.

As always, we also are available for any questions you may have with regard to your gift and estate planning.

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