Salvatori, Wood & Buckel

ATTORNEYS AT LAW

Estate Planning Client Advisory

WINTER 2010 - 2011

As a valued client of this firm, we are pleased to provide you our winter Estate Planning Client Advisory as a courtesy to keep you abreast of important tax and estate planning issues and opportunities.

The Estate Tax – Holiday Legislation and a Few Years of Certainty?: As many know, under the tax law implemented by President Bush in 2001, the estate tax exemption peaked at $3.5 million in 2009, and was to "sunset" in 2010 and revive in 2011 at the $1 million exemption level and 55% marginal tax rate.

Also, for much of 2010 estate tax professionals and wealthy individuals hoped that Congress would step up to the plate and take action – not only to prevent the imminent return to the unrealistically low $1 million exemption, but also to provide comprehensive tax reform for long-term estate planning purposes.

Fortunately, a modicum of tax certainty and relief was finally obtained on December 17th when President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. Although the 2010 Act deals with a number of tax benefits, the balance of our comments focus on the most significant estate and gift tax changes.

Most importantly, the 2010 Act sets the estate and gift tax exemption at $5 million through 2012 (indexed for inflation in 2012), and the top tax rate at 35%. Also, the generation-skipping transfer tax exemption parallels the estate and gift tax levels through 2012.

Further, the 2010 Act restores the traditional income tax "basis" rules for estates. "Basis" is the measuring point from which taxable income or loss is determined upon the sale of an asset. The traditional (pre-2010) rules generally provide that each estate asset receives a new income tax basis equal to its fair market value at the date of death. The significant benefit of the traditional position is that all pre-death appreciation of an estate asset escapes income taxation upon a post-death sale. Fortunately, the 2010 Act continues the traditional income tax basis rules into all future years.

Interestingly, the 2010 Act also contains a "portability" feature for married couples experiencing a spouse's death in 2011 or 2012. Portability allows the surviving spouse to use the deceased spouse's unused estate tax exemption at the surviving spouse's later death.

However, to claim the portability benefit, the surviving spouse must file a federal estate tax return for the deceased spouse – even if a return is not otherwise required – and affirmatively elect portability.

Like the Bush 2001 Act, the new tax law "sunsets" or expires on January 1, 2013 – and the estate and gift tax exemption reverts to the $1 million level and 55% marginal tax rate – unless Congress takes action in the interim.

Estate Planning Opportunities for 2011 and 2012: Although the 2010 Act offers neither long-term tax planning certainty nor an optimistic taxation outlook beyond 2012, and there are significant ambiguities in the Act which require clarification, for wealthy clients the Act's temporary $5 million exemption appears to present a rare window of opportunity to transfer significant wealth to the next generation free of estate and gift tax.

An Example: Suppose 85 year-old Ms. Miller has a net worth of $10 million. If she dies in 2013, her heirs will owe approximately $3.9 million in estate tax.

However, if Ms. Miller instead gives ½ of her estate, or $5 million, to her children while she is living – and then dies in 2013 (after the 2010 Act has expired), her heirs should pay about $2.2 million in estate tax. Therefore, by Ms. Miller "prepaying" inheritances, her children stand to receive almost $8 million rather than $6 million.

Importantly, there are a number of giving techniques that allow the $5 million exemption to be significantly "leveraged" – and therefore produce more tax savings.

One such technique is the Qualified Personal Residence Trust or "QPRT." Under this technique, the client transfers his primary or summer home to the QPRT and retains the right to reside in the home for a period of years set by the client – with ownership of the home passing to the children at the end of the set period.

Generally a gift of property or money to a trust or to an individual reduces one's exemption on a "dollar-for-dollar" basis by the value of the gift. However, under the QPRT technique, the reduction of the exemption is not the market value of the home (the "dollar-for-dollar" basis), but rather is the market value of the home on the date of transfer to the QPRT minus the IRS stipulated value of the client's right to reside there for the set term of years (since one cannot make a "gift" to oneself).

Thus, the QPRT consumes only a modest amount of the client's exemption (the value allocated to the children), but in reality passes a disproportionate value (the appreciated home) to the children when the QPRT term expires.

An Example: Seventy year-old Dr. Jones' Pelican Bay condo was worth $2 million during the market peak, but is now worth $1 million.

If Dr. Jones dies at age 86 and still owns the condo (and it is then worth its peak value of $2 million), Dr. Jones' heirs may owe more than $1 million in estate tax on the condo.

However, if Dr. Jones instead transfers his condo to a QPRT and retains the right to reside there for 15 years, the gift value

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is only $323,000 – but upon the expiration of the 15 year term (assuming the condo has returned to its prior value) the condo will be worth $2 million, and will pass to his children tax free. Not a bad deal – Dr. Jones' children receive the $2 million condo but Dr. Jones only uses $323,000 of his exemption.

State Budget Woes, Florida Residency and Snowbird Vigilence: *TopRetirements.com* recently issued a report identifying the 10 worst states for retirees, with majority consideration being given to each state's tax burden and fiscal health. Eight of the 10 states are located in the eastern U.S., which are Connecticut, Illinois, Massachusetts, New Jersey, New York, Ohio, Rhode Island and Wisconsin. Leading the pack is Illinois – largely due to its increasing personal tax burden coupled with a $13 billion budget deficit in 2010.

As we have previously written, with limited exception northern states continue to increase the personal tax burden upon their residents – notwithstanding the numerous studies which indicate that state tax increases result in a migration of wealthier residents to more favorable states and, with that, decreased state revenue collections. Not surprisingly, several recent *Wall Street Journal* articles point out the obvious – that significant state tax increases also result in net state-wide job losses as well as a lesser state gross product in comparison with other states.

In light of the foregoing, and of our anticipation of continued efforts by northern states to tax their seasonal residents' income and estates, we continue to urge our seasonal clients to ensure that a sound Florida tax residency plan is in place to avoid potential resident taxation from their northern state.

Low Interest Rates Provide Tax Planning Opportunity: For the client interested in transferring money to his or her children free of gift and estate tax, one ideal technique is the "Intra-Family Loan" or IFL.

Federal tax law generally treats a loan to a child as a taxable gift to the extent of the unpaid interest – even if the loan is interest-free. However, an IFL, if set at the promulgated IRS interest rate, can serve to transfer tremendous value to one's heirs without gift tax consequences. And the IFL is particularly powerful in today's low interest rate environment.

<u>An Example</u>*: In January 2011 Mrs. Smith loans her son, Joe, $1 million in exchange for a 2 year promissory note bearing the IRS promulgated January interest rate of 0.43% annually. Joe then takes the $1 million and invests it to produce $200,000 over the 2 year period. Joe pays his mother $4,300 each year in interest, plus the $1 million at the end of year 2 – but Joe keeps over $191,000 – earned by the loan.*

However, if Mrs. Smith had not made the loan, but instead held "Joe's" $200,000 until her death, and then bequeathed it to him in 2013 – an extra estate tax of about $100,000 would have been generated.

$100,000 IRA Charitable Gifting Available for 2011: The 2010 Act extended through 2011 a tax provision allowing taxpayers over 70½ to transfer up to $100,000 directly from an IRA to a public charity without owing income tax on the transfer and yet counting the transfer toward the taxpayer's annual required minimum distribution. Clients who intend to make charitable gifts in 2011 should find this to be a positive tax savings opportunity.

A Word about the Internet Age and Passwords: With increasingly more people conducting their business and personal activities over the internet, if one experiences diminished mental capacity, this can result in many of one's affairs grinding to a sudden and disruptive halt.

Although most companies have procedures to handle the transmission of account control to one's legal representative or power of attorney if incapacity occurs, these procedures often are cumbersome and time-consuming, and may unduly delay a client's affairs that require prompt attention.

Therefore, if maintaining immediate continuity of on-line financial or other affairs in the event of diminished capacity is of concern, our recommendation is that you consider creating a list of your passwords and security codes for the internet services you use, and then provide it to your primary Power of Attorney. This simple "pre-planning" act may work to circumvent a variety of problems at an already difficult time.

A Granddaughter's Memories: Jennie Eisenhower, granddaughter of Richard and Pat Nixon, and great-granddaughter of Dwight and Mamie Eisenhower, shares her thoughts on a family heirloom. "My family has passed down countless heirlooms, but one in particular plays a role in my daily life. It's a blue and white sugar bowl, part of a glazed tea service owned by my grandmother, Pat Nixon. In fact, every piece had "Pat" written on it in script. I don't serve much tea and have no use for a giant sugar bowl, so I put it on my dresser and use it to keep spare change in. You wouldn't think that item would be so special, but every time I see it (and throw in a nickel), I think fondly of my grandmother."

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