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PLANNING IN TIMES OF UNCERTAINTY: YEAR-END OPPORTUNITIES TO MINIMIZE FUTURE ESTATE, GIFT, AND GST TAX

By **Dennis M. Mitzel**

The estate tax imposes tax on transfers on death while the gift tax imposes tax on transfers made during life. The generation skipping transfer tax ("GST tax") is an additional tax imposed on lifetime and after death outright transfers and on transfers in trust to beneficiaries more than one generation below the gift-giver's generation, such as gifts to grandchildren. Due to the repeal of the estate and of the GST tax during 2010 and due to the reduced to 35% gift tax rate, there are unprecedented opportunities to minimize the overall effect of these transfer taxes before year-end 2010.

As a result of the 2001 Tax Act, the estate tax exemption gradually increased from below $1,000,000 in 2001 to $3,500,000 in 2009. Ultimately, the estate tax and GST tax were repealed in 2010. A 35% gift tax rate was put in place for 2010. However, since the 2001 Act was not passed by a 60% majority in Congress, the law itself could not be permanently implemented and will expire on January 1, 2011, ten years after its passage. The expiration of the 2001 Tax Act will bring back the old estate tax law, including a $1,000,000 estate tax exemption and a 55% top rate for both estate and gift tax. It will also bring back the GST tax at a rate equal to the 55% maximum estate and gift tax rate.

Congress was expected to address the uncertainty for taxpayers caused by the 2001 Act. Instead, Congress has spent eight years in inaction and indecision. It is currently expected that Congress will restore at least a $3,500,000 exemption for the year 2011 and beyond. As of the date of the writing of this article, this has also not happened. As irresponsible as Congress has been in dealing with the estate tax and GST tax, taxpayers must still cope with this uncertainty in trying to plan their estates to protect their families.

Many taxpayers postponed decisions on their estate plans, hoping that Congress would have acted by now. Although Congress has not given clarity to the tax picture, it is now necessary to evaluate the need for possible estate planning or gifting this year.

Moving Forward with Estate Planning - Some individuals are not certain whether they will escape estate tax liability or whether their estates will be taxed because their assets will exceed the $1,000,000 exemption which will apply if Congress again fails to act. Although it is difficult to predict the amount of the estate tax, it is still necessary to plan for the tax whether the exemption will be $1,000,000, $3,500,000, or some other number. Postponing the implementation of an estate plan can cause exposure to a higher level of estate tax no matter what the ultimate estate tax

continued on page 2

Contents:

PLANNING IN TIMES OF UNCERTAINTY

- from page 1

exemption level. A properly drafted trust will take into account the potential different estate tax levels and will be able to best protect against estate tax no matter what action Congress eventually takes.

Annual Exclusion Gifts – Annual exclusion gifts are one of the simplest and most effective tax planning strategies. Each individual is permitted to make gifts of up to $13,000 per year to any other individual ("donee") without incurring gift tax under the current law. Even when the estate tax and the GST tax are revived in 2011, annual exclusion gifts may be made without incurring GST tax or reducing the estate tax exemption available at death. A married couple is able to give $26,000 per year to any donee.

Prior to making annual exclusion gifts, each individual should determine his or her own needs to make sure sufficient resources will be available for the balance of his or her own lifetime. An individual with a net worth of just over $1,000,000 who relies on his or her accumulated assets for support may not feel comfortable giving assets away. On the other hand, if the $1,000,000 exemption is restored, the individual will risk having an estate tax equal to 41% or more imposed on any excess over $1,000,000.

As year-end approaches, however, it is important to consider whether 2010 annual exclusion gifts are advantageous. If gifts are appropriate, it is normally better to make them in the year 2010 rather than waiting until 2011. By making gifts this year, there is an opportunity to make a second set of gifts in January 2011.

Opportunity for Large Gifts at Temporary 35% Tax Rate – It is important for individuals with substantial wealth to consider making large gifts in the year 2010. In addition to $13,000 per donee annual exclusion gifts, each individual is permitted to give up to $1,000,000 during their lifetime without incurring any gift tax liability. Gifts in excess of $1,000,000 will be taxed at a rate depending upon other lifetime taxable gifts made and upon the gift tax rates in effect at the time of the transfer.

In 2009, the top gift tax bracket was 45%. For 2010, a reduced 35% gift tax rate is in effect. In 2011, if Congress fails to modify existing law, the top gift tax rate will be increased to 55% (the top estate tax rate). For those who anticipate paying a large amount of federal estate tax in the future, this is an excellent opportunity to take advantage of the current 35% rate and save up to 20% of the value of their gifts.

Most individuals are reluctant to make large gifts during their lifetime if it would result in payment of gift tax to the Internal Revenue Service. On the other hand, if tax will be payable at death in any event, the ability to pay at a reduced tax rate is an opportunity that should not be overlooked. Some important points to consider when evaluating the possibility of making large gifts are as follows:

1. Taxable gifts should generally not be made until late 2010. If death in fact occurs in 2010, while no estate tax is in existence, then the gift giving strategy would backfire, causing an unnecessary payment of gift tax.

2. Generally, individuals with a net worth between $1,000,000 and $3,500,000 should not seek to incur a present gift tax (annual exclusion gifts are still fine). This is because it is anticipated that Congress will raise the estate tax exemption back to $3,500,000. Payment of gift tax during life could cause the unnecessary payment of tax which would not have been imposed at death.

3. There are a tremendous number of unknowns regarding how the disappearance of the estate tax in 2010 and its reemergence in 2011 will be implemented. Generally, there is a unified rate structure which taxes all lifetime gifts and after death transfers together, so that it makes no difference whether assets are given during life or at death. A tax is generally calculated at death and the deceased individual is given credit for any gift tax paid during life. If gift taxes are paid at the 35% rate during life and a unified tax calculation ultimately taxes all combined transfers at 45% or 55%, then the savings realized by making lifetime gifts at a 35% rate may not be permanent. On the other hand, many feel that the Internal Revenue Service or Congress will implement a system so that individuals making gifts at the 35% rate will realize a permanent tax savings on those gifts.

4. Taxable estates will be reduced by the gift tax paid during life. If an individual chooses to pay gift tax now rather than estate tax at their death, the use of and earnings on the gift tax amount will be lost during life. On the other hand, by prepaying transfer taxes during life, the tax itself will not be included in the individual's taxable estate which will further reduce estate tax liability. For example, if an individual chooses to make gifts in the year 2010 and pays a $1,000,000 gift tax, the taxable estate will be reduced by that $1,000,000, further reducing the individual's estate tax by $450,000 to $550,000 depending on the ultimate top estate tax bracket.

Congress is aware of the ability to turn a transfer tax liability into a deduction by choosing to incur gift tax during life instead of estate tax at death. It is thus necessary to survive 3 years past the date of the gift in order to reduce the taxable estate by the amount of the gift tax liability.

The estate and gift tax situation is unprecedented and complicated. However, for those who anticipate paying a large amount of transfer taxes at death in any event, this may be a one time

continued on page 3

PLANNING IN TIMES OF UNCERTAINTY

- from page 2

opportunity to dramatically reduce their total transfer taxes.

Temporary Repeal of the GST Tax – As a result of the temporary repeal of the GST tax, another one-time opportunity for individuals with substantial wealth is the possibility of making substantial distributions directly to grandchildren or to grandchildren's trusts in 2010.

For example, Mr. Smith has already used all of his lifetime gift tax exemption and is in the top estate tax bracket. Mr. Smith's will or trust provides for a transfer of $1,000,000 to a grandchild. If he dies in the year 2011 or beyond (and Congress has not fixed the reemergence of the $1,000,000 GST tax exemption and the 55% GST tax rate) his estate could pay $550,000 of estate tax and $550,000 of GST tax for a total of $1,100,000 in taxes on the $1,000,000 transfer to his grandchild.

In contrast, if the $1,000,000 transfer was instead made by way of gift in the year 2010, a gift tax would be assessed at 35%, or $350,000. This is a $750,000 savings over the same gift taking place at death if the 55% estate tax and GST tax rates are reestablished in 2011.

In addition, if Mr. Smith lives more than 3 years after the gift, his estate tax will be reduced further by 55% of the $350,000 gift tax paid. This $192,500 additional savings brings the total savings to $942,500 on the $1,000,000 gift. If the tax rate is restored at the 45% level, then the savings are reduced to just over $700,000, still an incredible amount of tax savings because of the reduced gift tax rate and the temporary repeal of the GST tax in 2010.

While most estate planners feel that an outright distribution to grandchildren would safely avoid the GST tax, some are concerned that a transfer into a grandchild's or grandchildren's trust may be resubjected to the GST tax when the tax reemerges in the year 2011. This is because although a transfer to a grandchild's trust may be made in 2010 when the GST tax does not exist, the ultimate distribution from the trust to the grandchild may take place in 2011 and future years when the GST tax has been revived. As confusing as this is, it is once again an opportunity that may not be available at any time in the future. This is definitely a planning problem since few individuals are able to make gifts of this size and even fewer are willing to make outright gifts to grandchildren.

Planners are hopeful that any transfers into a trust solely for grandchildren will continue to be fully protected from the GST tax even if that tax is restored in a future year. If that is the case, a transfer into trust for grandchildren may be a more appealing alternative than an outright distribution. A trust can maintain the funds under the control of a trustee who can limit a young grandchild's access to the funds, thus taking advantage of the potential tax savings while still maintaining family values and asset protection.

These are clearly confusing and complicated times. The issues related to the estate, gift, and GST tax are unprecedented. Planning was difficult in 2010 in light of the uncertainty regarding Congressional action. On the other hand, planning in the last few weeks of 2010 may present opportunities that should be seriously considered and may never be available again.

If you have questions, Berry Moorman's estate planners can assist you in implementing an estate plan or making year-end decisions.

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2010 YEAR-END INCOME TAX CONSIDERATIONS

By **George H. Runstadler, III**

The midterm elections have changed the chemistry of the US Legislature, but taxpayers will have to wait to see what that change will generate in the area of income taxation. Traditional year-end tax strategy centered around accelerating deductible expenses and deferring taxable income. In December 2010, taxpayers may be wise to take the opposite approach.

Without Congressional action, the "Bush tax cuts" are scheduled to expire on January 1, 2011. Both Democrat and Republican legislative leaders have stated that these tax cuts should be extended for the "middle class." However, some more conservative factions in Washington, DC are proposing to hold hostage the extension of tax cuts to middle class taxpayers as a means to force the extension of those cuts to all taxpayers. The only thing that is certain is that the tax rates will not be reduced in 2011. In addition, interest rates are now low. As a result, the opportunity cost to taxpayers of paying taxes early is minimized. These facts considered, increasing taxable income in 2010 may be better than deferring income and paying taxes on that deferred income in 2011.

Below is a comparison of the 2011 tax rates and limitations for medium and higher income taxpayers filing joint returns under various scenarios:

Tax Rate	Bush Cuts Extended	Bush Cuts Not Extended	Obama's Proposal
25%	$69,000 - $139,350	--	$69,000 - $139.350
28%	$139,350 - $212,300	$57,650 - $139,350	$139,350 - $237,300
31%	--	$139,350 - $212,300	--
33%	$212,300 - $379,150	--	--
35%	$379,150 +	--	--
36%	--	$212,300 - $379,150	$237,300 - $379,150
39.6%	--	$379,150 +	$379,150 +
Long-term Capital Gains Rate	15%	20%	20%
Qualified Dividend Rate	15%	At normal rates	At normal rates
Personal Exemption	Not limited	2% phase-out @ $255,000	2% phase-out @ $250,200
Itemized Deductions	Not limited	3% phase-out @ $170,000	Capped at 28% for 36% and 39.6% taxpayers

It is clear that tax rates will not decrease. The conventional plan of accelerating deductions and deferring income into the next year may not be appropriate for 2010.

There are other provisions to consider beyond the general tax rate. Following is a brief summary of some of the tax related items to evaluate as 2010 comes to a close.

Alternative Minimum Tax

A separate tax regime exists which computes an "alternative minimum tax" ("AMT") at 26% or 28% of alternative minimum taxable income. The taxpayer pays the higher of the AMT or the regular income tax. Alternative minimum taxable income is regular taxable income increased by tax preference items such as tax-exempt interest, accelerated depreciation, and other items. The exemption from AMT is $45,000 for 2010. In 2009, the exemption was $71,000. The $26,000 decrease in the exemption will catch an estimated additional 27 million taxpayers in the AMT trap in 2010. If AMT could be a problem, income in various categories should be estimated and controlled to minimize the AMT impact. Also, the AMT must be considered when estimating taxes for 2010.

IRAs

- Contribution. Those taxpayers who do not participate in an employee pension

continued on page 5

INCOME TAX CONSIDERATIONS

- from page 4

plan, have modified adjusted income of less than $89,000 (joint filers) or $56,000 (individual filers), and who are less than 71 years of age may make a tax deductible contribution to a traditional IRA of $5,000 plus another $1,000 for those over age 50. Contributions for 2010 must be made by April 15, 2011.

• Spousal. Contributions for an unemployed spouse can be made even if the other spouse is a participant in an employee pension plan.

• Roth. After-tax contributions to a Roth IRA can be made instead of a contribution to a traditional tax deferred IRA. A Roth IRA grows tax-free and is distributed tax-free if distributions are made as the law permits. There is no age limit. The maximum contribution begins to phase-out for joint filers with income of $167,000 and $105,000 for individual filers.

• Roth Conversion. Beginning in 2010, the previous income limitation of $100,000 was lifted for converting traditional IRAs to Roth IRAs. The amount converted will be subject to income tax but the tax will be spread between 2011 and 2012. The values of some IRA accounts have decreased from their previous highs and are expected to regain value in the future. This might be an advantageous time to convert. To be truly effective, the income taxes incurred as a result of conversion should be paid from other sources.

• RMDs. Unlike 2009, some taxpayers are required to take the "required minimum distributions" ("RMDs") for 2010 from traditional IRAs, 401(k) accounts, and other plans. Taxpayers subject to the RMD provisions are generally beneficiaries of the plans, principally those aged 70 1/2 and older, and others who may have received the plan benefits from a person who is now deceased.

Other Tax Favored Plans

• The limits for contributions to pension, profit sharing, and 401(k) plans are the same for 2011 as for 2010. The amount contributed to all tax favored plans including flexible spending accounts, 401(k) plans, and cafeteria plan elections should be reviewed each year-end to take maximum advantage of the tax deferral opportunities available.

Capital Transactions

• Net capital losses may be used to offset capital gains and $3,000 of other income, with unused losses carried over to future years. A review of capital transactions for 2010 should be made to take current advantage of any loss. Take note that a current sale of a stock made for the purpose of recognizing gain or loss will be deemed a "wash sale" if the stock is reacquired within 31 days of the sale.

• Net short-term capital gains are taxed at ordinary income tax rates. To get the favorable long-term rates, the asset must have been held for at least 12 months.

• It is almost assured that capital gains rates will increase in 2011. From a tax standpoint, a sale in 2010 would be more advantageous than a sale in 2011.

• In 2011, it is likely that qualified dividends will lose the favorable 2010 tax rate of 15%.

Other Income Items

• Passive losses and portfolio deductions are only deductible against passive income and portfolio income, respectively. Cash basis taxpayers may have an opportunity to adjust income or deductions to prevent the loss or deferral of full current benefits.

• For low income taxpayers receiving Social Security payments, the amount of income (including tax-exempt income) received could determine how much of their benefit is taxed. If income can be accelerated to 2010 or deferred to 2011, the amount of Social Security benefit taxed in the reduced income year could be decreased below the 85% maximum.

Deduction Planning

• Medical expenses are deductible to the extent they exceed 7.5% of "adjusted gross income" ("AGI"). Taxpayers should consider deferring or accelerating payment of medical expenses and health insurance premiums so the bulk of such expenditures occur in one year. Other itemized deductions that are limited are "miscellaneous deductions" (deductible only in excess of 2% of AGI), casualty losses (excess of 10% of AGI), and student loan interest.

• State and local taxes, including property taxes, are deductible in the year paid. Most local income and property taxes can be paid in 2010 or 2011. Taxpayers who itemize should determine when the payment would be most advantageous.

• Payment of deductible expenses in 2010 by credit card or check (if paid prior to January 1, 2011) could give the taxpayer a 2010 deduction.

• Charitable contributions are subject to income limitations but are deductible in the year made.

• It is almost assured that itemized deductions will be limited in 2011 for high income taxpayers (see chart above).

Considerations for 2013

The health care reform package recently enacted by Congress includes a provision imposing a 3.8% Medicaid surtax on "net investment income" effective in 2013. This tax is an important factor in making current investment decisions. The tax would apply to joint taxpayers with "modified adjusted gross income" ("MAGI") in excess of $250,000, and for individual taxpayers with MAGI in excess of $200,000. For trusts and estates, the MAGI limitation is about $13,000.

"Net investment income" includes all investment income such as dividends, royalties, passive income, and gains from non-transaction business assets. Most are distributions from IRAs and qualified plans and earned income.

In addition, the health care reform package includes a 0.9% (9/10ths of 1%) Medicare surtax on earned income above $250,000 for joint filers and $200,000 for individual filers.

CONCLUSION

Obviously, the foregoing will impact each taxpayer differently. Tax planning in December 2010 is more of an exercise in prognostication than in planning. However, plan we must because the exercise may result in significant tax savings. We at Berry Moorman are always available to provide guidance and direction through this maze of opposing concerns and shifting tax laws.

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