Analysis of Selected Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

Summary

On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 was signed into law. Here is our analysis of selected provisions.

Here is our analysis of selected provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act), along with the planning opportunities they present.

I. Marginal Individual Income Tax Rate Reductions, and Dividend and Capital Gains Rates

A. Ordinary Income Tax Rates

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") lowered income tax rates. In 2010, the rates were 10%, 15%, 25%, 28%, 33% and 35%. The rates were scheduled to increase in 2011. Under the new law, the lower rates created by EGTRAA are now extended through 2012.

B. Dividend and Capital Gains Rates

The reduced tax rates for qualified dividend income and long-term capital gain for individuals will remain at 2010 levels until the end of 2012.[1] Capital gain is long-term if the asset sold had been held for more than a year.

The rates for 2011 and 2012 for an individual's qualified dividend income and long-term capital gain are generally as follows: 0% if the ordinary income tax brackets are 10 or 15%; and 15% if the ordinary income tax brackets are 25% or more.

[1] For the purpose of this reduced tax rate, capital gain does not include unrecaptured section 1250 (relating to real estate depreciation) gain and 28-percent rate gain (relating to collectables).

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If the tax rates for the qualified dividend income and long-term capital gain had not been extended for 2011 and 2012, a taxpayer's ordinary income tax rates would apply to dividend income, and a maximum 20% rate would apply to long-term capital gain.

Due to the new law, the 2011 rate table[2] for ordinary and capital gains rates is:

	10%	15%	25%	28%	33%	35%
Single	Up to $8,500	$34,500	$83,600	$174,400	$379,150	Over $379,150
Married, Filing Jointly	Up to $17,000	$69,000	$139,350	$212,300	$379,150	Over $379,150
Head of Household	Up to $12,150	$46,250	$119,400	$193,350	$379,150	Over $379,150
Capital Gain Rates	0%		15%			

II. Overall Limitation on Itemized Deductions and the Personal Exemption Phase-Out

A. Old Law

Prior to 2010, itemized deductions and the personal exemption amount were phased-out for higher income earners. Under EGTRRA, both phase-outs were eliminated in 2010, meaning that in 2010 itemized deductions and personal exemptions were not reduced by the phase-outs. The phase-outs were scheduled to return in 2011.

B. New Law

The elimination of both phase-outs is extended through 2012, allowing taxpayers to take full advantage of their itemized deductions and personal exemptions for two more years.

[2] Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010"*; JCX-55-10 (December 10, 2010).

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III. AMT Patch

An alternative minimum tax ("AMT") patch for individuals is once again provided by Congress. This patch is a two year fix for taxable years 2010 and 2011[3] and increases the AMT exemption – the amount of income exempt from the AMT.

The exemption amounts are as follows:

	Exemption Amounts[4]	
	2010	**2011**
For married individuals filing jointly and surviving spouses	$72,450	$74,450
For other unmarried individuals	$47,450	$48,450
For married individuals filing separately	$36,225	$37,225

Observation: If the law had not been enacted, the exemption amounts for individual taxpayers would have been significantly reduced, as follows:

- $45,000 for married individuals filing jointly and surviving spouses,
- $33,750 for other unmarried individuals and
- $22,500 for married individuals filing separately.

As a result of this AMT Patch, fewer taxpayers will pay AMT and those that do will pay less.

IV. One Year Social Security Payroll Tax Reduction

The Act provides a one year tax reduction in 2011 for social security contributions for employees and self-employed individuals in the amount of 2%.[5]

For employees, this temporary 2% cut reduces the employee's contribution from 6.2% to 4.2% on wages[6] for the old age survivor and disability insurance ("OASDI") under the Federal Insurance Contribution Act ("FICA").[7] The employer's contribution for FICA of 6.2% does not change.[8]

For self-employed individuals, the 2% cut reduces the OASDI portion of the Self Employment Contribution Act ("SECA") taxes from 12.4% to 10.4% on self employment

[3] Title II, Sections 201 and 202 of the Act and §§ 26 and 55 of the Internal Revenue Code.
[4] Title II, Section 201 of the Act and the legislative history for exemption amounts.
[5] Title VI, Section 601 of the Act.
[6] § 3121(a).
[7] § 3101(a).
[8] § 3111(a).

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income.[9]

Observation: A $200 saving occurs for each $10,000 of employment earnings with a maximum savings of $2,136 (2% x $106,800 wage base for taxable year 2011) for employees and self employed individuals.

With these payroll tax savings, employees who are not contributing the maximum amount to a 401(k) plan should consider increasing their contributions to their 401(k) plan. Doing so could be a painless way to save more for retirement (well, painless so long as the extra contribution doesn't exceed the maximum savings of $2,136).

V. Special Deduction Election for State and Local Taxes Extended

The Act extends for individual taxpayers an election to deduct state and local *general sales* taxes in lieu of state and local *income* taxes under IRC § 164(b)(5). The extension covers taxable years 2010 and 2011.[10]

A general sales tax is a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. State and local income taxes are an individual's income taxes paid to a state or local government.

Without Congress extending this law again, this tax law would have expired on December 31, 2009 and taxpayers could not have deducted state and local *general sales* taxes. However, taxpayers could have continued to deduct state and local *income* taxes.

Observation: This election is advantageous for taxpayers living in states that do not have state income taxes or if the taxpayer's sales taxes paid exceed the taxpayer's state income taxes.

VI. Temporary Exclusion of 100 Percent of Gain on Certain Small Business Stock

The 2010 Tax Relief Act extends the 100% exclusion of the gain on the sale of qualified small business stock (QSBS) for one year. Taxpayers who acquire QSBS after September 27, 2010 but before January 1, 2012 and hold it for five years can exclude 100% of the gain. For a more detailed discussion on this issue, see 100% Exclusion of Gain on Sale of Qualified Small Business Stock Extended Through 2011 (Advanced Planning Bulletin, January 2011).

[9] § 1401(a).
[10] Title VII, Section 722 of the Act.

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VII. Education Incentives

A. Coverdell Education Savings Account

The Coverdell Education Savings Account (CESA) is an account set up by an adult for the benefit of a child that is not taxed as it grows, and which can make tax-free distributions so long as they are used for qualified education expenses.[11]

CESAs were expanded by EGTRRA in 2001 in 2 significant ways:

- the annual contribution limit was increased from $500 to $2,000; and
- the definition of "qualified education expenses" was amended to include not only college expenses, but elementary and secondary education as well.[12]

These two changes were scheduled to sunset after 2010, but the 2010 Tax Relief Act pushed this sunset out to December 31, 2012.

B. Above-the-line deduction for qualified tuition and related expenses

EGTTRA added a deduction for qualified tuition and related expenses. The deduction is limited to $4,000 for a joint-return filer with an AGI up to $130,000 ($65,000 for a single-return filer), and $2,000 for a joint-return filer with an AGI beyond that and up to $160,000 ($80,000 for a single-return filer). There is no deduction at all for taxpayers beyond these latter limits. This deduction was scheduled to sunset after 2009, but the Tax Relief Act pushed this sunset out to December 31, 2011 (i.e., the provision is extended for only *one* year, not two years).

VIII. Charitable IRA Rollover

The charitable IRA rollover first came into existence in 2006, was extended through 2009, did not exist for most of 2010, but under the new law has been reintroduced for 2010 and has been further extended through 2011. Per this rule, an individual can make a lifetime gift of IRA funds from the IRA directly to a qualified charity, without including the amount in income and, of course, without taking a charitable deduction.

Several requirements must be met:

1. The individual must be 70½ or older on the date of the gift.

2. The annual maximum gift is $100,000.

3. The transfer must be made by the IRA trustee, meaning that the funds must not touch the individual's hands. The I.R.S. has ruled that the donor's delivery of a check issued by the IRA custodian to the charity is permissible.[13]

[11] § 530(a).
[12] § 530(b).

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4. The entire payment must be a charitable contribution; if the donor receives a benefit (e.g., a $5,000 donation to attend a dinner where the cost of the dinner is $75), none of the payment qualifies for this treatment.

5. This IRA must be a traditional or Roth IRA; this treatment does not apply to qualified plans. The I.R.S. has ruled that a distribution from a non-ongoing SIMPLE IRA or a SEP-IRA is permissible – defined as one to which employer contributions are not made for that year.[14]

6. The gift must be to a public charity or conduit private foundation; distributions to a donor-advised fund, charitable remainder trust or supporting organization do not get this treatment.

The distribution counts as part of the individual's required minimum distribution (RMD). If the IRA has any non-taxable basis, the contribution is deemed to come first from the taxable portion. If any portion of the distribution is nonetheless from the non-taxable basis of the IRA, the individual can take that amount as a charitable deduction.

Since the extension occurred at such a late date – December 17, 2010 – to take much advantage of this in 2010, the law permits gifts completed by January 31, 2011 to be treated as gifts made in 2010. A donor cannot recharacterize an already-received RMD into a charitable rollover.

Observation: This is great for those taxpayers who:

1. Do not itemize and thus cannot deduct charitable contributions. They will get the benefit of making a charitable gift because they will not include the distribution in income.

2. Do itemize. The income exclusion keeps their AGI lower, which translates to a lower floor for medical expenses (7.5% of AGI, rising to 10% in 2013), non-business casualty losses (10% of AGI) and miscellaneous expenses (2% of AGI).

3. Don't need their RMDs. This change will lower their tax liability, and the charitable contribution will lower the account value, which will result in lower future RMDs.

4. Receive social security benefits. It may help to keep their income low to decrease or even eliminate the portion of social security benefits that are subject to income tax.

5. Live in states without state charitable deductions. This will lower their taxable income while still allowing them to make charitable contributions.

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[13] Notice 2007-7, 2007-5 I.R.B. 395 (January 10, 2007).
[14] Id.

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6. Make charitable gifts greater than the 50% AGI limitation. A charitable IRA rollover will garner a tax benefit without being subject to this limitation.

One word of advice – be sure to comply with all the requirements. Failure to do so will result in having taxable income and a charitable deduction.

One word of hope – this has evidently proved to be a popular provision. It would be nice if it would be made permanent rather than having to resurrect it every two years.

IX. S Corporation Stock Basis Adjustment

Extended through 2011, an S corporation's charitable gift of appreciated property decreases a shareholder's basis by the shareholder's portion of the property's adjusted basis, rather than the fair market value of the property.

Observation: The net result is that, for a charitable contribution of appreciated property, the shareholder's basis will be higher after having been decreased by basis rather than fair market value – a plus in the event of a later stock sale or S corporation distributions.

X. Estate, Gift, and Generation Skipping Transfer Taxes

This legislation sets the gift, estate, and generation skipping transfer tax exemption – the amount each person can give during life or leave at death without transfer tax – to $5 million for 2011 and 2012, with a top tax rate of 35%. In addition to this, it contains provisions that affect many aspects of estate planning for 2010, 2011 and 2012.

Notice that all these changes only last for two years. In fact, Title III of the Act is named "Temporary Estate Tax Relief"

A. The New Law – 2011 and 2012 Changes

1. Gift, Estate, and Generation Skipping Transfer ("GST") Tax Exemptions and Rates for 2011 and 2012

   a. *2010 Law, Prior to the 2010 Tax Relief Act*

Year	Gift and Estate Tax Exemption	Gift and Estate Tax Rate	GST Tax Exemption	GST Tax Rate	Income Tax Basis after Death
2010	• Gift tax – $1 mill • Estate tax – Unlimited (repealed)	• Gift tax – 35%. • Estate tax – 0% (repealed)	Unlimited (repealed)	0% (repealed)	Modified carry-over

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b. *New Law, After the 2010 Tax Relief Act*

Year	Gift and Estate Tax Exemption	Gift and Estate Tax Rate	GST Tax Exemption	GST Tax Rate	Income Tax Basis after Death
2010*	• Gift tax – $ 1 million • Estate tax – $ 5 million	35%	$5 million	0%	fair market value
2011	$5 million	35%	$5 million	35%	fair market value
2012	$5 million **	35%	$5 million **	35%	fair market value
2013 and beyond * **	$1 million	55% maximum	$1 million (indexed from 2001)	55%	fair market value

* for estates of decedents dying in 2010, the executor may elect the previous 2010 estate tax rules (no estate tax and modified carry-over basis) or the 2011 estate tax rules ($5 million exemption, 35% estate tax rate and "step-up" in basis).

** indexed for inflation beginning in 2012.

*** assuming no changes of the law made in the meantime.

For the estates of decedents dying after December 31, 2009, the estate tax exemption is $5 million and the estate tax rate is 35%. For transfers after December 31, 2009, the GST tax exemption is $5 million. For generation skipping transfers in 2010 the GST tax rate is 0%; for transfers after 2010 the GST tax rate is 35%.

Beginning in 2011 and through 2012, the gift and estate tax are once again unified: they have a single exemption of $5 million (indexed starting in 2012) that can be used during life or at death, and a single tax rate of 35%.

Unless the federal government passes new transfer tax legislation in the next two years, in 2013 the exemption amounts and rates revert to their 2001 levels:

- the gift and estate tax exemption goes back to $1 million with a maximum tax rate of 55%, and
- the GST tax exemption reverts to $1 million – indexed for inflation – with a flat 55% tax rate.

2. Return of Basis "Step-up" at Death

The estate tax laws that had been in effect for 2010 (before the passage of the 2010 Tax Relief Act) provided for a "modified carry-over basis" rule, under

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which assets received from a decedent have an income tax basis equal to the lesser of the decedent's basis or the fair market value of the property at the decedent's death. The executor was able, however, to allocate an increase in the basis of this property up to $1.3 million. The executor could also allocate an additional $3 million of increased basis to property passing to the surviving spouse. This provision has been viewed as a nightmare to administer.

The 2010 Tax Relief Act repeals the above-described "modified carry-over basis" rules of 2010. Beginning in 2010, a recipient of property from a decedent will receive a basis equal to the property's fair market value at death (as was the case before 2010). We've typically referred to this as a "step-up" in basis, although given the current economic climate, it could also be a "step-down" in basis.

3. Deduction for State Death Taxes

Before 2005, estates received a federal estate tax credit up to a certain limit for estate tax paid to a state. This credit was then changed to a deduction. The new law extends through December 31, 2012 the ability to *deduct* the amount of any estate tax paid to a state on a decedent's federal estate tax return. Keep in mind that a deduction is not as good as a credit of the same amount. A deduction reduces the amount of the estate subject to tax, while a credit reduces the tax.

4. Estate Tax Exemption Portability

The legislation includes a provision allowing for portability; that is, the executor of a deceased spouse can elect to transfer any unused portion of the deceased spouse's estate tax exemption to the surviving spouse.

A spouse may only take advantage of his or her *last* deceased spouse's exemption and that exemption is not indexed for inflation after received. In addition, the first deceased spouse's executor will need to make an affirmative election to allocate the exemption to the surviving spouse on a timely-filed estate tax return (Form 706). Even if it doesn't appear necessary for the surviving spouse's estate (i.e., it's not large enough to attract an estate tax), the executor should consider electing to allocate the estate tax exemption to preserve the option for the surviving spouse to have the additional exemption (just in case the widow or widower later wins the lottery).

B. Option for Estates of Those Who Died in 2010 to Elect Old Rules

For the estates of people who died in 2010, the "new" rules ($5 million estate tax exemption, 35% estate tax rate and "step-up" in basis) normally apply. But the executor can elect to use the "old" 2010 rules (no estate tax whatsoever, with a modified carry-over basis).

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Fiduciaries (executors and trustees) handling 2010 estates will need to compare the results of choosing the "old" rules over the "new" rules, including how those alternatives impact beneficiaries (or groups of beneficiaries).

1. <u>"Small" Estates, below $5 million</u>

   Estates of less than $5 million will want to stick with the "new" rules of $5 million estate tax exemption and "step up" in basis. This will result in no estate tax because the value of the estate is less than the exemption and will result in a higher basis for the heirs (unless the fair market value of the assets is below the income tax basis on the date of death but in that case, such a "step-down" is basis would've happened under the old rules anyway).

2. <u>"Large" Estates, above $20 million</u>

   Large estates, say those over $20 million or so, will almost always want to elect the "old" rules of no estate tax and modified carryover basis. A current estate tax of up to 35% on the full value of the estate is probably going to be more costly on a present value basis than a future capital gains tax on the gain (reduced by the modified step-up available – $1.3 million or $4.3 million, depending on whether the estate passes to a surviving spouse). This is even more likely if it is probable that the spouse or child receiving the asset will also die owning it, resulting in a step-up in basis and a complete avoidance of the capital gains tax.

3. <u>"Mid-level" Estates</u>

   The toughest decisions are going to be for estates between $5 million and $20 million (or so). In this range, the fiduciary administering the estate will need to evaluate the "cost" under each option. The estate tax calculation is pretty straightforward. But the income tax calculation is more complicated, because it's a projection that requires quite a bit of information and a number of assumptions:

   - Basis of estate assets
   - Life expectancy of heirs
   - Portion of estate assets that will not receive a "step-up" (e.g., qualified plans)
   - Appreciation expected on estate assets
   - Liquidity needs of heirs and expected sale dates of assets
   - Future capital gain rates
   - Probability that heir will hold assets until death
   - Type of property involved
   - Heir's income tax planning

   Depending on the outcome of this analysis, the decision could go either way: stick with the "new" rules or elect the "old" rules.

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C. Filing Deadlines

For decedents dying in 2010, the deadlines for filing a federal estate tax return and the payment of tax have been extended to 9 months from the enactment of this law (September 17, 2011, but because this is a Saturday, the due date is Monday, September 19, 2011). The deadline for disclaiming assets from 2010 decedents has also been extended, but only to September 17, 2011.

D. Credit Shelter Planning

It would seem, at first blush, that portability would reduce or eliminate the need for credit shelter planning. Consider a married couple, where the husband dies first. Portability allows the couple to use their combined exemptions even if all of the husband's assets pass to the surviving wife instead of having some of the assets pass to a credit shelter trust. What's more, at wife's later death, an apparent advantage of using portability (in lieu of a credit shelter trust) is that the assets included in the wife's estate receive a new basis equal to the date of death value at *her* death, i.e., a second "step-up" in basis. Assets in a credit shelter trust would not receive this second basis step.

Nonetheless, people rarely should rely on portability. In most planning situations it will continue to make sense to use credit shelter planning for a number of reasons.

First, portability, like most all the provisions of the new legislation, is only available for two years. So, if the law stays as it is now, one spouse would have to die in 2011 or 2012 in order for the first deceased spouse to transfer any unused exemption to the surviving spouse, *and* the surviving spouse would also have to use that exemption – either through gifts or dying herself – in 2011 or 2012. It's unlikely that both of those things would occur in the next two years.

Second, a credit shelter trust serves many purposes beyond taking advantage of the first deceased spouse's estate tax exemption. For example:

1. <u>Shelter growth</u>. Assume the estate tax exemption is $5 million per person, husband's estate is valued at $5 million, and wife has $5 million of her own assets. If he passes his $5 million of assets, along with his unused estate tax exemption, to wife, she'll be able to leave the assets from husband to the kids at her death free from estate tax just as if they had used a credit shelter trust, right? In most cases, wrong! If husband's $5 million of assets appreciates between his death and wife's death, she will not be able to shelter the growth on that value from the estate tax because husband's unused estate tax exemption (passed to wife through portability) is not inflation indexed after his death. But if husband instead uses his estate tax exemption and leaves that $5 million to a credit shelter trust, those assets *along with any appreciation* after his death will pass to the trust beneficiaries at wife's death free of estate taxes.

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2. Creditors. At husband's death, assets passing outright to wife are available to wife's creditors (unless they are held as exempt assets). If those assets instead pass to a credit shelter trust, they are generally protected from wife's (and other trust beneficiaries') creditors.

3. Control disposition. Assets passing outright to wife become her assets. That is, at her death, she is free to pass those assets to any recipient she chooses – even if husband wouldn't approve. Instead, husband could have left those assets to a trust with wife as a beneficiary for her lifetime and his intended beneficiaries (maybe his kids from a previous marriage) as the ultimate trust beneficiaries. This type of arrangement sounds a lot like the situation in which we've typically used a marital trust (and most commonly a qualified terminable interest property (QTIP) trust). But here, we don't have to worry about qualifying the trust for the marital deduction (at least for assets up to husband's estate tax exemption amount) and therefore need not be limited by the requirements necessary to qualify for the marital deduction.[15]

4. GST. Husband's GST tax exemption, if unused, cannot be passed to wife. If he wishes to take advantage of the exemption, it must be allocated to transfers he makes which escape inclusion in the wife's estate.

For all these reasons, it makes sense to continue to use credit shelter planning for most clients. If clients are leaning toward continuing an estate plan that passes assets to a credit shelter trust at husband's death, they may be concerned that this puts the wife at a disadvantage in terms of control and benefit of those assets. But this disadvantage really isn't as bad as it sounds. The trust can be drafted to provide the wife an interest that is similar to outright ownership without including the trust assets in her estate. For example, if wife is the trustee of the trust, she will have the right to control the trust property. If she is a trust beneficiary, she will also have enjoyment rights in the property.[16] In addition, the trust can give wife the power to transfer the property to others either in her capacity as trustee (a distribution) or beneficiary (a power of appointment).[17]

In deciding whether the husband should pass assets to a trust or pass them outright to wife along with his estate tax exemption, one other factor will play a role: *state* estate taxes. Passing assets at the first death to a trust that doesn't qualify for the marital deduction may trigger state estate tax at the first death. Consider whether the issues discussed above outweigh this cost at the first death.

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[15] § 2056(b).

[16] If wife is both trustee and beneficiary, her ability to make distributions to herself must be limited by an ascertainable standard – typically, health, education, maintenance and support – in order to avoid inclusion of the trust assets in her estate. § 2041 and Treas. Reg. § 20.2041-1(c)(2).

[17] To avoid inclusion of the trust asset's in wife's estate, any power of appointment given to wife as should be a limited (rather than general) power of appointment, that is, she may appoint the property to anyone *other than* herself, her creditors, her estate or the creditors of her estate. Treas. Reg. § 20.2041-1(c)(1).

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E. Disclaimers

A compromise solution may be to use disclaimer planning. That is, draft the estate planning documents to provide that at husband's death, all assets pass to wife unless she disclaims, in which case the disclaimed assets automatically pass to a credit shelter trust with wife as a beneficiary. This arrangement has the advantage of allowing wife and her advisors to consider the situation after husband's death and make the best decision at that point. Contrast this with a typical formula funding provision which inflexibly funds the credit shelter trust with the current estate exemption amount. Disclaimer planning has the disadvantage, however, of requiring wife to do something affirmatively within a relatively short period of time (nine months after husband's death) and won't protect husband's intended distribution of the assets at wife's death if she decides instead to keep the assets. In addition, if the trust receives assets through her disclaimer, wife cannot be given a power of appointment in the trust, and her ability as a trustee to make distributions of those assets to the trust beneficiaries must be limited by an ascertainable standard.[18]

F. Existing Planning

It is important for advisors to review all existing estate plans with their client. The knee jerk reaction to new estate tax legislation may be that much of the estate planning done in the past is no longer necessary. Don't jump to this conclusion; many traditional techniques are still useful. What's more, *this is a prime opportunity for you to talk with your clients and review their plans* – something that should be done periodically anyway. A change in the law provides the push.

In particular, formula clauses in existing estate planning documents should be reviewed to ensure that they "work" no matter when the client dies and what the estate tax law is at that point. Advisors will want to make sure that the desired amount funds a credit shelter trust (or passes to children) and passes to a marital trust (or outright to a surviving spouse).

Given that the current legislation only provides for 2011 and 2012, and the vast majority of clients won't die in that time period, it will make sense to keep (or continue with) most planning.

G. Using the $5 Million Gift Tax Exemption

If you want a fantastic wealth transfer technique, here it is. For 2 years only (unless extended), the gift tax exemption will be $5 million, meaning that anyone can give up to $5 million ($10 million for a married couple) without any gift tax.

Wow! Does that mean it just got easier to pay large premiums on a trust-owned life insurance policy? Absolutely.

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[18] Treas. Reg. § 25.2518-2(e).

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Trust-owned life insurance is essential in many estate plans because, among other things, it provides liquidity without triggering estate tax. The reason it doesn't trigger estate tax is because the irrevocable trust is outside the insured's estate. The difficulty arises when large premiums need to be paid on the policy because the grantor normally must make a gift to the trust so it can pay the premium, and that can trigger gift taxes. Sure, annual exclusions can be used, but when the premium is larger than the annual exclusions available, the gift tax exemption is used. When gifts are made after the exemption is exhausted, gift tax is owed.

1. Cash Gifts. Previously (i.e., when the gift tax exemption was $1 million), great effort was often expended structuring the premium payments without triggering a gift tax – adding annual exclusion beneficiaries, private split dollar, private loans, etc. Now that the exemption is $5 million, many can ignore these complexities and simply make a gift of cash to the trust to pay the premiums, not worrying about the gift tax cost until a married couple gives more than $10 million. A large up-front gift can be made to the trust (or over the next two years), and then the trustee can decide how to use those funds. For example, they could be used to pay a one-time premium on a single premium life insurance policy, or pay multiple annual premiums on a traditional policy.

2. Gifts of Assets. Taking this one step further, consider giving an income-producing business interest to the trust that holds a life insurance policy. Thereafter, the trust can use the income from the business to pay the periodic premiums on the policy. This becomes an even more powerful strategy when the irrevocable trust is designed as a grantor trust (that is, the grantor is the owner for income tax purposes, but the trust is outside the grantor's estate) because the grantor pays the tax on the income earned by and paid to the trust. This leaves all the income in the trust, unreduced by income taxes, to pay premiums or be accumulated for the trust beneficiaries. It's as if the grantor was able to make an additional gift to the trust, not subject to the gift tax, to pay the trust's income tax bill.

3. Dynasty Trust. In addition to a $5 million gift tax exemption, each person has a $5 million GST tax exemption. By making the gift in trust and allocating GST tax exemption to the trust, assets in the trust can remain in trust and escape gift, estate and GST tax for multiple generations. Life insurance in the trust on either the grandparents' or parents' lives makes this an even more powerful strategy.

4. Terminate Existing Premium Funding Arrangements. Clients may have existing premium funding arrangements such as private split dollar, private loan or premium financing arrangements they would like to terminate. Before the $5 million dollar gift tax exemption, unless some other exit strategy was planned when the arrangement was designed, this often would have involved a large gift that would have triggered gift tax. Clients in this situation can now consider using the $5 million gift tax exemption as a way to terminate these funding

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arrangements without any gift tax (e.g., the grantor/lender could forgive any debt owed to him by the trust).

Of course, clients still have to feel comfortable giving a large amount away. Make sure they can live without it. But for those wanting to get assets out of their estate, this new law is a valuable tool.

H. What About "Clawback"?

A note of caution. Some commentators are concerned that, if the scheduled sunset of the 2010 Tax Relief Act comes to pass – dropping the estate tax exemption back to $1 million – the making of a gift over $1 million in 2011 or 2012 might result in additional estate tax for those dying in 2013 or beyond. The fear here is based on the fact that, when determining a person's taxable estate, one of the steps is adding to the estate any gifts that were made that did not fit within a gift tax exclusion or deduction ("taxable gifts").[19] So, the thought goes, if a $5 million gift is made is 2011 and escapes current gift tax due to the increased exemption, but death occurs in a future year when the exemption is merely $1 million, it seems $4 million (the taxable gifts covered by the gift tax exemption) that we thought would escape transfer tax will now be "clawed back" and subject to estate tax. While this result does not appear to be what Congress intended with this new law, and most commentators believe additional guidance will be issued fixing the problem, it is worth informing clients of this risk.

Nonetheless, *even if "clawback" occurs, for virtually all clients making large gifts that take advantage of the current $5 million exemption is probably still a good idea*. Among other reasons:

1. Appreciation out of estate. Any appreciation of the asset after it is given and before death is removed from the donor's estate. Since we don't know when death will occur (5 years later? 10 years? 30 years?) this growth could be substantial. If the gift isn't made, but the money or asset is instead held until death, its current value *plus* the appreciation will be estate taxed.

2. Postpone tax until death. Estate tax on $4 million many years from now will almost assuredly be much lower (under a present value calculation) than gift tax on that $4 million today. In the very least, then, this new law permits someone to make a gift now, but postpone the payment of any transfer tax until death. So if paying a gift tax currently has been the cause of a client's reluctance to make a large gift, that impediment is now removed.

[19] Gift tax exclusions include the annual exclusion ($13,000 per donee per year) and the medical or educational expense exclusion; gift tax deductions include those for gifts to charities or spouses. Gifts that don't fall within these categories are labeled "taxable gifts," even though no out-of-pocket gift tax is owed until the taxable gifts exceed the lifetime gift tax exemption ($5 million in year 2011). This estate calculation procedure of "adding back in" the gifts made previously is essentially a way to ensure that there is only one "run" up the transfer tax brackets and that those using the exemption to shelter lifetime gifts from tax are not allowed to use the same amount of the exemption again to shelter assets held at death from the estate tax (to do otherwise would permit doubling-up on the exemption).

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And if clawback does not occur – sometimes justice prevails – then clearly it'd be wise to make large gifts today. Also, the exemption might not go back down; clawback becomes an issue for a client only if the estate tax exemption drops below the amount of that client's taxable gifts.

Of course, this clawback concern only makes it clearer that clients must work with knowledgeable legal counsel to evaluate and implement these strategies, as they always should do whenever large gifts are being considered.

But make sure clients hear about these strategies very soon. The $5 million exemption is on the books, for certain, only until the end of 2012. Don't let your clients miss the opportunity to transfer large amounts of wealth to loved ones without incurring any tax pain for years to come (if ever).

Source: Advanced Planning Bulletin, February 2011

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