

**WEALTH PRESERVATION AND TAX PLANNING ALERT**

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January 2011

**Transfer Tax Planning Strategies Under the 2010 Tax Relief Act**

Last month, we summarized some of the more important tax law changes made by the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* ("2010 Tax Relief Act") which was signed into law by President Obama on December 17, 2010. These tax law changes provided significant estate, gift and generation-skipping transfer ("GST") tax relief through 2012, as well as extending the Bush-era income tax cuts and providing new income tax breaks for individuals and businesses through, generally, 2012.

This month (and in the next few months) we will focus on some of the estate, gift and GST tax planning opportunities and strategies under the 2010 Tax Relief Act. These tax planning opportunities and strategies include: (i) increased utilization of lifetime gifting opportunities (including gift-splitting opportunities) in light of the increased estate, gift and GST tax exemptions for the next two years; (ii) leveraging the increased estate, gift and GST exemptions through the use of dynasty trusts, grantor retained annuity trusts (GRATs), intentionally defective grantor trusts and irrevocable life insurance trusts; and (iii) increased use of valuation discount planning. While there are estate, gift and GST tax planning opportunities available under the 2010 Tax Relief Act, there are also potential traps or pitfalls which must be considered before embarking on these tax planning opportunities.

In this month's issue of our Wealth Preservation & Tax Planning Alert, we will begin by discussing some of the lifetime gifting opportunities presented by the 2010 Tax Relief Act, as well as some of the potential traps or pitfalls which may result, especially if the changes made by the 2010 Tax Relief Act are allowed to expire at the end of 2012. Please note that for purposes of this discussion (i) we will assume that the taxpayers are U.S. citizens or U.S. resident aliens since there are special rules (which will not be discussed herein) which apply to persons who are non-resident citizens of the U.S.; and (ii) we will not discuss any specific state inheritance tax consequences that may apply to a particular decedent.

**Making Increased Gifts During 2011 and 2012**

Last year, the maximum lifetime gift tax exemption amount was \$1 million. Due to the re-unification of the estate and gift tax under the 2010 Tax Relief Act, the maximum gift tax exemption in 2011 and 2012 is \$5 million which is also the maximum estate and GST tax exemption for those years. In 2013, barring any subsequent tax legislation, the maximum estate, gift and GST tax exemption is scheduled to go back to \$1 million (which is where it would have been this year but for the 2010 Tax Relief Act).

Accordingly, taxpayers may want to consider making increased gifts this year and/or next year in order to take advantage of this "temporary" increased gift tax exemption (\$5 million) which is scheduled to expire at the end of 2012. Couples who have not made taxable gifts in prior years will now be able to make taxable gifts totaling \$10 million without adverse gift tax consequences. Similarly, for example, persons who made taxable gifts of \$1 million last year may now be able to make an additional \$4 million in taxable gifts between this and next year without adverse gift tax consequences. Such gifts can be made either outright or through an irrevocable lifetime credit shelter trust created by the donor for the benefit of one or more beneficiaries of the trust.

**Potential "Clawback" Issue**

Taxpayers should be aware that there is a potential "claw-back" issue if a donor makes use of his or her maximum gift tax exemption (e.g., \$5 million), thereby significantly depleting the donor's taxable estate, and the donor later dies in a year when the donor's estate tax exemption is significantly lower than the donor's prior gift tax exemption. For example, assume that a donor makes taxable gifts in 2011 of \$5 million (and never made any additional taxable gifts) and later dies in 2013 with a taxable estate of \$100,000 at a time when the estate tax exemption has been reduced to \$1 million and the maximum estate tax rates are

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increased to 55%, the decedent's net estate tax would be computed as follows:

Taxable Estate	\$ 100,000
Plus Adjusted Taxable Gifts	<u>\$5,000,000</u>
	\$5,100,000
 Tentative tax on \$5,100,000 equals:	 \$2,445,800
 Less: Tax which would have been payable on the Adjusted Taxable Gifts	 <u>\$ 0</u>
 Gross Estate Tax:	 \$2,445,800
 Less: Unified Credit on \$1 million exemption	 <u>\$ 345,800</u>
 Net Estate Tax:	 \$2,100,000

Thus, even though the decedent died with a taxable estate of only \$100,000, the net estate tax owed by the decedent's estate is \$2.1 million. This result is caused by the manner in which the net estate tax is computed under current estate tax law: the net estate tax is determined using the estate tax exemption in effect at the time of death even though the applicable gift tax exemption may have been higher when the taxable gifts were made. Donors need to be aware of this potential "clawback" issue. While it appears that this "clawback" affect may not have been intended by the drafters of the 2010 Tax Relief Act, it nonetheless remains a potential problem for the donor's estate.

**Significant Benefits to Gifting Notwithstanding Potential "Clawback" Issue**

It should be noted that notwithstanding this potential "clawback" issue, there may still be significant benefits to making large taxable gifts during 2011 and 2012 which are sheltered from gift taxes due to the increased gift tax exemption for these years. First and foremost, these gifts may result in the removal of future appreciation from the donor's estate. Second, to the extent any gift taxes are paid by the donor, if these gifts are made more than 3 years before the donor's death, these gift taxes will not be brought back into the decedent's taxable estate but rather will escape

estate taxation when the donor dies. Also, if the gifts are made to a grantor trust which is deemed wholly-owned by the grantor for federal income tax purposes, any income taxes paid by the donor for the benefit of the grantor trust's beneficiaries will avoid any estate or gift taxes to the donor.

**Dealing with Potential "Clawback" Issue**

The potential "clawback" issue may be addressed in the estate tax apportionment provisions in the donor's testamentary documents if there is a state law apportionment statute that allows or requires estate taxes to be apportioned to the recipients of taxable gifts which resulted in the estate taxes. This would result in the donor's estate being able to seek collection of the apportioned estate taxes caused by the "clawback" issue. Alternatively, this "clawback" issue could be addressed by having the donor enter into a net gift agreement with the donee whereby the donee agrees to reimburse the donor's estate for that portion of the estate tax attributable to the inclusion of the adjusted taxable gifts made to that donee in the event of a subsequent reduction in the estate tax exclusion amount. It should be noted that there are certain transferee liability rules in the tax code which may assist the government in its collection efforts against the donees.

In addition, the above-referenced "clawback" issue can be ameliorated by leveraging the gifts in connection with either a sale to an intentionally defective grantor trust or in connection with life insurance planning. For example, the increased gift tax exemption amount in 2011 and 2012 allows a taxpayer to significantly increase the "seeding" of a grantor trust, on a gift tax-free basis, which then enables the taxpayer to structure an estate planning transaction involving a large sale of discounted property by the taxpayer to the grantor trust. Similarly, the increased gift tax exemption amount in 2011 and 2012 offers the taxpayer a unique opportunity to acquire a significant amount of life

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insurance through an irrevocable life insurance trust created and funded by the taxpayer, the proceeds of which can then pass free of any estate or GST taxes to younger generations. We will discuss the estate, gift and GST tax benefits of these estate planning transactions in a subsequent Wealth Preservation & Tax Planning Alert.

### Gift-Splitting

The increased gift tax exemption amount in 2011 and 2012, when coupled with gift-splitting, also allows a couple (where one of the spouses has most of the assets) to benefit from this increased gift tax exemption by making a gift-splitting election. This "gift-splitting" election allows a spouse who makes gifts of his or her assets to treat those gifts as if they were made one-half by each spouse, thus allowing the spouse who does not own the assets being gifted to utilize his or her increased gift tax exemption.

### Summary

The above summary is not intended to be an exhaustive explanation of the lifetime gifting opportunities presented by the 2010 Tax Relief Act, but rather is intended to highlight some of the more important strategies, as well highlight some of the potential traps or pitfalls which may result, especially if the changes made by the 2010 Tax Relief

Act are allowed to expire at the end of 2012. It is important to note that estate planning involves more than just transfer tax planning and includes a variety of family planning issues.

Next month, we will be issuing a Wealth Preservation & Tax Planning Alert which will discuss in more detail some of the leveraging transactions utilizing the increased lifetime gift tax exemption, and will explore other estate, gift and GST tax planning strategies and opportunities under the new law. If you would like to learn more about any of these provisions and how they may affect your particular situation, please do not hesitate to contact any member of our Wealth Preservation and Tax Planning Group listed below. ■

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