



WEALTH PRESERVATION AND TAX PLANNING ALERT

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U.S. Estate Planning—Transfer Tax Planning

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A Very Brief Background on Death and Taxes

The concept of estate planning is broad and can encompass a number of topics. At the most personal or fundamental level, the estate planning process addresses potential incapacity, the transfer of assets at death, probate planning, and related topics.

At a more involved level, estate planning also can encompass U.S. (Federal, and certain States within the U.S.) transfer tax planning. The U.S. imposes a gift tax, an estate tax, and generation-skipping transfer tax ("GST") which may apply to the privilege of transferring one's property to family members and other beneficiaries either during life, at death, or even thereafter (via transfers in trust).

The U.S. has imposed an estate or death tax in various versions and during various periods since 1797, and an estate tax has been in effect consistently since 1916. Ben Franklin is attributed the famous quote from over 200 years ago as to the vagary of life except for death and taxes.

Although this axiom remains as true as ever today, Congress has injected its own brand of suspense in determining whether, and to what extent, the overall U.S. regime will include transfer taxes. The House of Representatives passed a bill as recently as 2006 for the full repeal of the estate tax. Moreover, Congress seems intent on deferring action on the pending one-year, and one-year only,

elimination of the estate tax and GST in 2010 until the latter stages of the current legislative year or beyond.

As suggested by the scheduled repeal of two substantial taxes for only one year, the U.S. transfer tax system is in a somewhat disjointed state. Congress enacted the current structure in 2001 with the intention on revisiting it with a more permanent solution. That solution, long in the making, is approaching. We address below where we are now, and where we might be going in this regard.

The Current System

Briefly summarized, the gift tax applies at progressive rates up to a maximum rate of 45% in 2008 to net taxable gifts made during lifetime, with the gift tax rate scheduled to decrease to 35% in 2010. Every individual may make net taxable gifts of U.S. \$1 million of wealth during lifetime before being subject to the gift tax.

Additionally, the estate tax applies at progressive rates up to a maximum rate of 45% in 2008 to one's net taxable estate at death. As of 2008, every individual may transfer U.S. \$2 million of wealth at death (assuming no prior taxable gifts) before being subject to the estate tax, with this exemption scheduled to increase to U.S. \$3.5 million in 2009.

Under current U.S. law, the estate tax is scheduled to be repealed entirely in and for 2010. However, if Congress does not act to make

this repeal permanent, the estate tax is scheduled to be reinstated in 2011 at the rates and exemptions in effect as of 2001.

To supplement the gift and estate tax regime, the GST applies generally to transfers to grandchildren or other persons substantially younger than the donor. As of 2008, the GST applies at a flat rate of 45% to taxable transfers in excess of U.S. \$2 million (an aggregate exemption for all prior transfers), with this exemption scheduled to increase to U.S. \$3.5 million in 2009.

As with the estate tax, the GST is scheduled to be repealed entirely in and for 2010. However, if Congress does not act to make this repeal permanent, the GST is scheduled to be reinstated in 2011 at the rates and exemptions in effect as of 2001.

The Future

The Senate Finance Committee recently has held a series of meetings in reviewing alternative structures for the U.S. transfer tax system going forward. Although no consensus has emerged, it seems highly unlikely that Congress will repeal the estate tax and GST permanently.

Significantly, it has been estimated that full repeal of the estate tax would reduce Federal tax revenue by nearly U.S. \$500 billion over the next ten years. The estate tax generated revenue of U.S. \$23 billion in 1998, and U.S. \$22 billion in 2005.

Also, in 2003, total charitable contributions in the U.S. exceeded U.S. \$240 billion. The Congressional Budget Office has estimated that full repeal of the estate tax would reduce total contributions to charity (both during life and at death) by 6% to 12%.

These factors, coupled with the substantial national deficit, suggest that taxpayers will continue to be subject to the estate tax and GST indefinitely. Congress is fully aware that the current state of the U.S. federal transfer tax law complicates the planning process, and it has begun work towards potential solutions.

As part of the FYE 2009 budget negotiations, the House of Representative's resolution included a substantial increase in the estate tax exemption amounts. The corresponding activity in the Senate has been more restrictive. For example, the Chairman of the Senate Finance Committee (Max Baucus, D-MT) has proposed the perpetuation of the U.S. \$3.5 million exemption per-person (U.S. \$7 million per married couple). Another member of the Senate Finance Committee (Jon Kyl, R-Ariz.) has stated that the Committee also is reviewing a potential exemption of U.S. \$5 million per-person (U.S. \$10 million per married couple), or indexing it to inflation, and potentially removing primary residences from the estate tax base.

The hearings and review in Congress will continue.

Summary

The legislative resolutions and

proposals in process are not binding. Nevertheless, they strongly indicate that the estate tax and GST will remain in force and effect in 2010 and beyond. They also indicate that the Senate may not be inclined to increase the estate tax exemption materially from the U.S. \$3.5 million already scheduled under current law to become effective in 2009.

It is advisable to review existing estate documents from time to time in order to ensure the most optimal use of exemptions and other planning strategies. In the case of a married couple, this includes the use of the transfer tax exemptions of **each** spouse. For example, it is not uncommon for a married couple to hold assets jointly as "tenants by the entireties." Many perceive "tenants by the entireties" as a superior form of ownership for asset protection purposes. We pause briefly here to note here that, although joint ownership as "tenants by the entireties" might provide certain protection in this regard, it may well not be the preferred choice of ownership due to, among other factors, its ineffectiveness against the claims of joint creditors, and also mortality risk. (If the non-debtor spouse passes away, all the assets revert to the sole ownership of the debtor spouse.)

Aside from asset protection issues, joint ownership as "tenants by the entireties" might not be favorable for transfer tax purposes. Depending on the total assets held by each spouse, "tenants by the entireties" may fail to utilize the estate tax exemption of the first spouse to pass away. That is,

the jointly-held assets would pass to the surviving spouse, without any portion of these assets being transferred (either directly or in trust) to the decedent's children. This may waste the estate tax exemption of the first spouse to pass away. Thus, it remains crucial to establish the proper title and ownership structure of the couple's assets.

Additionally, under current law and under most proposals now before Congress, the use of inter vivos or lifetime gifts remains a tremendously effective strategy for transfer tax purposes. A donor may attain material tax savings, in present value terms, by making irrevocable transfers of property during lifetime. The use of trusts and other legal entities in this regard may enable a donor to make such gifts and yet still accomplish his or her objectives with respect to the management of, cash flow from, and charitable contributions of the transferred assets.

Finally, for those who are not U.S. citizens or U.S. domiciliaries, it remains imperative to implement planning strategies and reduce the future U.S. transfer tax base before establishing residency in the U.S. One may implement U.S. transfer tax planning simultaneously with U.S. immigration planning in order to achieve the most efficient estate plan. ■

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