Estate Planning

Back to the Future: Estate Planning for 2010 and Beyond

By Katarinna McBride

Estate planners look for ways to use this year's expiration of the estate tax and other byproducts of Congressional disarray to their clients' advantage.

In 2010 the estate tax expired for the first time since 1916. As we head into the third quarter of 2010, projections of Congressional action or inaction on the estate tax front are being whispered across the country. There is a real possibility that we will face another year of Congressional inaction and that the estate tax laws will return to what they were prior to 2001. That would mean the federal estate tax exclusion would return to $1 million and the estate tax rate will return to 55 percent (and 60 percent for estates exceeding $10 million).

Some speculate that Congress will pass legislation that will return the law to what it was in 2009, with a $3.5 million exclusion from estate tax and a top marginal tax rate of 45 percent. Others believe Congress will do nothing in 2010 but will enact some legislation in early 2011. No one believes Congress will have the time or ability in what remains of 2010 to overhaul the entire estate tax system.

On the opposite side of the whispered tones are loud and boisterous proposals of attorneys and advisors shouting *carpe diem* (seize the day)! In other words, take advantage of the gifting and other tax opportunities available in 2010 that aren't likely to reappear in the near future.

**Gifts keep on giving**

Gifts are always the most effective way to transfer wealth, because the donor not only makes the gift but also pays the tax on it. To illustrate, if a donor makes a $2 million gift, the donee receives the entire $2 million because the gift tax is payable by the donor from the donor's other property and assets.

The gift tax is sometimes referred to as *tax exclusive* because the gift is not reduced by the tax. On the flipside, when a transfer or bequest is made at death, the tax is paid from the estate (trust) or sometimes by the beneficiaries, thereby often diminishing the inheritance.

This year the gift tax rate is the lowest that it has been in 75 years. The maximum gift tax rate for gifts is 35 percent. This is 10 percent lower than the 45 percent gift tax rate in 2009, and 20 percent less than what the maximum gift tax rate will be in 2011 (55 percent or 60 percent if the estate exceeds $10 million) if Congress is dormant.

Wealthier families or families with elderly members that will be leaving at least a $1 million estate are taking advantage of this opportunity to maximize transfers to younger generations. In addition, the generation skipping tax has been suspended for 2010, so gifts to grandchildren and beneficiaries entirely avoid the very egregious generation skipping tax.
Skipping the GST

The generation skipping transfer tax is applied to transfers made to generations two or more levels younger than the taxpayer, such as grandchildren. The reason the generation skipping transfer ("GST") tax is the most dreaded and feared is because it is often tax inclusive. When GST tax is applied to the amount distributed or transferred to beneficiaries, tax is charged not only on the amount distributed but on the tax itself. This is often referred to as the "circular tax" or the "tax-on-tax."

But in 2010, just like the estate tax, GST has been repealed. Therefore, there is a tremendous opportunity for donors and trustees alike to make gifts and transfers to beneficiaries without having to plan or consider GST. However, significant care should be taken to avoid making such gifts to trusts or UTMA accounts because distributions from those trusts or accounts made in years beyond 2010 may be subject to GST.

In addition, donors should be cognizant that the three-year look-back rule will apply to gifts (beyond the annual exclusion gift) made within three years of a donor's death, and the gift will be included in the donor's gross estate for estate tax purposes (IRC Section 2035(b)).

GRATifying

Through part of 2009 and all during 2010 Congress threatened to cap the benefits of the grantor retained annuity trust ("GRAT trust"). GRATs are very short-term trusts (usually two to five years in duration) that thrive in low-interest environments.

The simplified idea behind a GRAT trust is that the principal gets returned to the creator of the trust and the growth goes to the (usually younger generation) beneficiaries without any estate or gift tax. The assumption (or at least the hope) is that the GRAT trust assets will outperform the interest rate subscribed to such trusts (the "section 7520" rate, which was 2.4 percent in September 2010, and 2.0 percent in October 2010).

When interest rates hover around two percent, this performance threshold is fairly easy to meet. To prevent this short term hedging and planning that circumvents estate and gift tax, congress has tried to push through legislation that would make the GRAT trust less desirable and less effective, such as requiring a 10-year term or that there be trust remainder (not all principal returned to the settlor). However, the multiple attempts have failed and October 2010, with its 2 percent 7520 rate, may be a wonderful opportunity for clients to fund GRAT trusts.

Opportunities and caveats

There are some great opportunities in 2010 that use the above-described strategies as a foundation. One example, described by wealth strategist Melvin A. Warshaw¹, is to make gifts from a marital QTIP trust.

In his illustration, a decedent left her surviving spouse assets in a marital QTIP trust. The surviving spouse had his own assets, which may or may not be taxable in the future.

Provided there are sufficient assets to support the surviving spouse, it may be optimal for the trustee of the marital QTIP trust to distribute the marital QTIP assets to the surviving spouse. The surviving spouse would then either transfer the assets outright to his children and grandchildren or perhaps place them in an LLC (so as to properly manage the assets for younger beneficiaries).

The gift tax may be paid by the surviving spouse, or perhaps it can be agreed that the gift is a "net gift" and that the beneficiaries pay the tax from the monies they receive. This strategy not only leverages the 2010 gift tax rate of 2010 but also takes advantage of the GST tax freeze.

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¹. Melvin A. Warshaw, A "One of a Kind" Opportunity is Closing: Leveraging Large Taxable Gifts in 2010 with Life Insurance, page 11 (September 2010), available from the author at mwarshaw@fiarch.com.

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