The Estate Planner

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Lifetime gifts are more important than ever

Recent tax law changes have created an unprecedented opportunity for affluent taxpayers to remove substantial amounts of wealth from their estates through lifetime gifts. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 increased the gift and estate tax exemptions to $5 million, and reduced the top rate for these taxes to 35%, but for 2011 and 2012 only.

It's uncertain whether Congress will make the $5 million exemption and 35% rate permanent, allow them to return to levels prescribed by pre-2001 tax law in 2013 or take some other action. So if you have the ability to make large gifts (either outright or using trusts or other estate planning vehicles), doing so this year and next may be beneficial. Let's take a closer look at how to make the most of lifetime gifts.

Maximize nontaxable gifts

As you consider the opportunities the $5 million exemption provides, don't overlook the tax-saving power of annual exclusion gifts and direct payments of tuition and medical expenses. These are true "nontaxable gifts" that can't be exposed to gift or estate taxes.

Gifts within the $5 million exemption, on the other hand, are still considered "taxable." So, for example, they're subject to the "three-year rule," which provides that certain assets transferred within three years before death are included in the deceased's taxable estate.

If you have a large estate, consider making lifetime gifts to take advantage of your $5 million exemption this year and next.

Also, keep in mind that the $5 million exemption is "unified" with the estate tax exemption, meaning that it covers up to $5 million in *combined* lifetime gifts and bequests at death. Thus, if you make $2 million in lifetime gifts, only $3 million will be left to protect your assets from estate taxes. Or, if the estate tax exemption goes back to $1 million in 2013 as scheduled and you die after 2012, *no* exemption will be left.

For these reasons, consider maxing out your annual exclusion gifts and direct payments of tuition and medical expenses before making any "taxable" gifts. Nontaxable gifts can be deceptively effective.

Currently, the annual exclusion is $13,000 per recipient ($26,000 for gifts you split with your spouse). Let's say you and your spouse have three married children and six grandchildren. Each year, you give $26,000 to each child, each of their spouses, and each

Why credit shelter trusts are still a good idea

For 2011 and 2012, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 makes the $5 million estate tax exemption portable between spouses. Portability allows a surviving spouse to add the unused portion of a deceased spouse's exemption to his or her own, and use it to make additional tax-free transfers during life or at death.

To enjoy this benefit, however, the estate of the first spouse to die must elect portability on a timely filed estate tax return. In addition, the remaining exemption must be used up before portability expires or it will be lost.

For many married couples — particularly those whose combined estates are worth more than $5 million but less than $10 million — it will be tempting to rely on portability to simplify their estate plans. But credit shelter trusts continue to offer several advantages. For one thing, a trust may be needed to reduce estate taxes once portability expires at the end of 2012.

To determine whether a credit shelter trust is a good idea for your estate plan, review your overall financial situation, taking into account not only federal gift, estate and GST taxes, but also the potential impact of income taxes, state death taxes and nontax considerations.

grandchild. You also pay $20,000 in tuition for each grandchild. That's a total of $432,000 per year in tax-free transfers without tapping your $5 million exemption.

Take advantage of the $5 million exemption

If you have a large estate, consider making lifetime gifts to take advantage of your $5 million exemption this year and next. Depending on your situation, and your feeling about the likelihood that gift and estate tax rates and exemptions will be reinstated at the pre-2001 levels in 2013, you might even consider making taxable gifts in excess of your available exemption. That way you'll be able to leverage the lower 35% tax rate before it potentially increases to 55% in 2013.

Even if Congress extends the current exemptions and rates, making gifts sooner rather than later can be a good strategy because it removes all future appreciation on the gifted assets from your estate. Remember, though, that assets transferred by gifts aren't entitled to a "stepped-up basis." So be sure to weigh the potential impact of capital gains taxes your heirs will have to pay if they sell the assets against the gift and estate tax savings.

Also, be aware of a potential "clawback" issue that may arise because of the way estate taxes are calculated under the unified system. Some people fear that, if the estate tax exemption shrinks to $1 million by the time someone dies, any lifetime gifts in excess of that amount (even if they were made in reliance on the $5 million exemption) may be "clawed back" into the person's estate and subject to estate tax (possibly at the 55% rate).

Whether clawbacks are a real concern (many experts argue that they're not), lifetime gifts still offer significant benefits because, even if the date-of-gift value is later subject to estate tax, the post–date-of-gift appreciation is removed from your estate. And if the clawback issue doesn't materialize, you'll have significantly reduced your taxable estate — and the associated estate tax liability.

Look at the big picture

Lifetime gifting can be an effective strategy to remove large sums of wealth from your estate, but it's important to look at the big picture. Don't make decisions on gifts based on tax savings alone. Also consider nontax issues, such as the gift's impact on the recipient and the sufficiency of your remaining resources to finance a comfortable retirement. ✤

Are you protecting your business interests?

If you're a business owner, your company likely is the biggest asset you own, and you know you must account for it in your estate plan. But did you know that there are several business asset-protection strategies you should consider implementing to help ensure that your business will remain a valuable asset for your heirs?

Building an asset barrier

Most asset-protection strategies for businesses involve putting up walls between a company and its assets. One way to do this is to divide the business into separate entities. For example, you may want to form separate entities to conduct any business activities that are riskier than others. Doing so allows you to limit the liability risk associated with them. Provided the entities are structured and operated properly, you can prevent creditors from going after assets owned by other entities within the group, even if they have common ownership.

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Another way to protect valuable business assets is to sell them to another entity created by the company's owners and then lease them back. If done right, these assets no longer belong to your company, so they're beyond the reach of the company's creditors.

You also can strip the company of equity, leaving less wealth exposed to creditor claims. Equity stripping involves pledging company assets as collateral for a loan. The company then lends the funds to its owners, who protect the loan proceeds with their own personal asset-protection arrangements.

Still another option is to distribute accumulated earnings to the owners. So long as the business retains a reasonable amount of working capital, this strategy allows you to shield excess funds against the business's creditors. (This assumes that the business is conducted within an entity that allows your personal assets to be protected from the business's liabilities.)

Finally, it's important to ensure that the company is left with sufficient funds to meet its future operating needs. If a court finds that the company is grossly undercapitalized, these walls may quickly tumble down.

Take the right steps

Owning a business is a huge responsibility, and you want your children to benefit from your hard work after you're gone. Thus, it's important to implement business asset-protection strategies. Because these strategies can be complex, talk to your business, estate planning and legal advisors to determine your best course of action. ✤

Beware of fraudulent conveyance laws

Sometimes timing is everything. And the time to implement asset-protection strategies is well before your company runs into trouble with creditors' claims. Otherwise you could run afoul of fraudulent conveyance laws.

Although specifics vary from state to state, these laws are intended to prevent you from transferring property with the intent to hinder, delay or defraud present or future creditors. The reference to "future creditors" doesn't mean that fraudulent conveyance laws protect anyone that could potentially become your creditor some day. But if someone has threatened a claim or if you have reason to believe that a legal problem may arise in the future, the fraudulent conveyance laws may pose an obstacle to asset protection planning.

2010 Tax Relief act

2 notable omissions provide continuing opportunities

When it comes to estate planning, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 is notable not only for the changes it made, but also for those it omitted to make.

It did *not*, for example, include a proposed minimum 10-year term for grantor retained annuity trusts (GRATs). It also didn't adopt a proposal that would have eliminated valuation discounts for certain intrafamily transfers, including transfers of interests in family limited partnerships (FLPs) and family limited liability companies (FLLCs).

These omissions provide continuing tax-saving opportunities. But there's no guarantee that Congress won't revisit these proposals in the future. Plus these strategies may be even more powerful while the gift tax exemption is $5 million. (See "Lifetime gifts are more important than ever" on page 2.) So if you're considering setting up a GRAT, FLP or FLLC, it's a good idea to do so sooner rather than later.

Now's the time to consider short-term GRATs

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A GRAT consists of an annuity interest, retained by you, and a remainder interest that passes to your beneficiaries at the end of the trust term. When you establish a GRAT, the value of the remainder interest may be subject to gift tax (depending on your available exemption).

The value of the remainder interest is calculated using an assumed growth rate prescribed by the IRS. If the GRAT assets outperform that rate — which is easier to do in a low-interest-rate environment — the GRAT can transfer substantial wealth to your beneficiaries gift-tax-free. If you die during the trust term, however, the assets will be included in your taxable estate, erasing the GRAT's benefits. (This is known as "mortality risk.")

A popular strategy in recent years has been to use a series of short-term GRATs (two years, for example). This strategy takes advantage of tax-free growth by capturing the upside of market volatility, but minimizes the mortality risk associated with longer-term GRATs. If you're considering this strategy, act soon. If Congress imposes a minimum on GRAT terms, the window of opportunity will close.

FLPs and FLLCs remain viable — for now

These entities are popular estate planning vehicles because they allow you to transfer wealth to your children or other family members at a discounted value for gift and estate tax purposes.

Here's how it works: Rather than transferring business interests or other assets outright, you place the assets in an FLP or FLLC and transfer limited partnership interests or LLC membership interests to your beneficiaries. Provided that the FLP or FLLC has a bona fide, nontax business purpose and meets certain other requirements, these interests generally qualify for valuation discounts for lack of control and lack of marketability, which reduces their value for gift tax purposes.

As a result, such gifts can use less of your gift tax exemption or, if you've already used up your gift tax exemption, they'll be subject to less gift tax.

Some lawmakers have proposed eliminating these valuation discounts for intrafamily transfers when the family as a group controls the entity before and after the transfer. Congress's omission of this proposed change means that FLPs and FLLCs will continue to be viable estate planning tools. But don't be surprised if lawmakers introduce similar proposals to limit valuation discounts in the future.

Review your plan

The Tax Relief act provides a little breathing room after years of uncertainty, but don't get too relaxed. As things stand today, the federal estate tax regime will change dramatically in less than two years. And if you think short-term GRATs, FLPs or FLLCs should be part of your estate planning arsenal, consider deploying them soon and be sure to monitor Congressional activity to see whether lawmakers revive proposals that would reduce or eliminate their benefits. ✤

Estate Planning Red Flag

Your estate plan contains a formula clause

If your estate plan contains a formula clause tied to the federal estate tax exemption, it's a good idea to review it in light of changes made by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. In some cases, formulas will need to be adjusted to avoid unintended results.

For example, a common strategy married couples use to minimize estate taxes is for each spouse's will or trust to include a formula clause under which an amount up to the currently applicable estate tax exemption is automatically allocated to a credit shelter trust, with the balance going to the surviving spouse, either outright or in a marital trust.

Suppose that your estate is worth $5 million. If you created your estate plan back in 2008, when the federal estate tax exemption was $2 million, a basic formula clause would have funneled $2 million into a credit shelter trust, with the $3 million balance going to your spouse or to a marital trust.

The Tax Relief act set the federal estate tax exemption at $5 million for 2011 and 2012. So if you die during one of those years, the formula that made sense in 2008 will transfer your entire estate to the credit shelter trust. The trust will distribute its income to your spouse and can allow principal distributions as needed to maintain his or her lifestyle. But your spouse won't have unlimited access to the funds, which might be contrary to your wishes.

Also keep in mind that, even though formulas can minimize estate taxes, they're not for everyone. For example, a formula may not be appropriate if you have other estate planning goals that are more important than saving taxes, such as ensuring that control of a family business or other assets is maintained by particular family members.