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Good News About Tax Relief: TRA 2010 Simplified

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On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 (that's the short title!). The act is more simply called the "Tax Relief Act of 2010" or "TRA 2010." It will generally apply in 2011 and 2012. The impact of TRA 2010 may seem as complicated as its title so we will provide you with an overview highlighting the changes below.

Estate and Generation-Skipping Transfer (GST)

TRA 2010 made significant unexpected changes to the estate, gift and generation-skipping rules that affect many taxpayers. The biggest unexpected change was to increase the exemption amount (that is, the amount that can pass free of estate, gift or generation-skipping transfer tax) to \$5 million per person. While the estate and GST exemption amounts reached \$3.5 million for tax year 2009, the gift exemption amount had never been higher than \$1 million. The \$5 million unified exemption amount now provides taxpayers with significant additional gifting opportunities that may have been less attractive in prior years because of the projected gift tax cost.

For example, some taxpayers who might otherwise have gifted significant amounts to children but for the gift tax expense may instead have assisted children by lending money to them at attractive low interest rates. Those taxpayers might now reconsider the strategy and simply gift the notes to their children, eliminating the debt and the interest obligation. It may also be appropriate to seek a valuation opinion to determine whether the face value of the notes should be discounted for gift tax valuation purposes. A lower value would be attractive from a gift tax perspective.



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Personal Residence Trusts and Gifts of Residences

Older taxpayers may have considered and rejected the use of a qualified personal residence trust to transfer the family home to children at a reduced value while retaining a right to reside in the home for a number of years. The strategy might have gone beyond prior exemption limits and taxpayers were not willing to trigger a gift tax. In light of the higher gift tax exemption limits, these strategies might be much more attractive if no gift tax need be paid.

Some taxpayers may own homes that are currently occupied by their children. This could be an opportunity to gift interests in the homes to a child at a time when real estate values are low, locking in the lower value for tax purposes without incurring an actual gift tax liability.

Paying Gift Taxes

The estate, gift and GST tax rates have all been set at 35% for 2011

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and 2012. These are the lowest such marginal rates in history. The 35% gift tax rate is the equivalent of a 26% estate tax rate. So long as one believes that the estate tax will likely always apply and that the applicable estate tax rate will be greater than 26% on the margin, the math may favor making a taxable gift now and incurring a gift tax. This allows the beneficiary of such a gift to begin enjoying the gifted assets now rather than waiting until a parent's death.

Advanced Planning Opportunities Abound

A number of advanced planning opportunities remain available to taxpayers in appropriate circumstances, some of which use very little of the gift tax exemption while creating the potential for significant wealth transfer. Taxpayers have funded grantor retained annuity trusts ("GRATs") which freeze the value of contributed assets, shifting future appreciation in the assets to children or trusts for children, while creating a minimal taxable gift. Proposals were circulated in Washington last year that might have made GRAT planning less attractive, but none of those proposals made their way into the 2010 legislation. GRAT planning remains a powerful tool to transfer the future appreciation in assets to the next generation without a significant transfer tax cost. Other approaches can produce similar economic results.

The Future

Unfortunately, TRA 2010 did not provide us with much clarity about the future of the gift and estate tax system. The generous \$5 million gift, estate and GST exemption amounts and the reduced 35% tax rates are only in effect for tax years 2011 and 2012. We don't know if the new Congress and the Administration will enact more permanent legislation before 2013. If no further tax legislation is enacted before 2013, the estate and gift tax rules are set to revert to the levels that were in effect in tax year 2001 – \$1 million exemption amounts and 55% marginal tax rates.

Uncertainty about the future can motivate two very different behaviors in the estate planning arena – a passive "wait and see" attitude or an opportunistic "carpe diem" approach. The first attitude may be based in a natural reluctance to focus on the chance that we might pass away in the foreseeable future, an unwillingness to consider complicated issues and incur expenses or to a recognition that most estate planning does not benefit the individual client, but instead benefits the client's family or beneficiaries. The second approach is based on a desire and ability to actively direct the passage of wealth to others during and after the individual's lifetime, increasing the amount of funds or assets available to benefit others while reducing the amount to be paid to the government in permissible ways.

Learned Hand, a well respected former Judge of the U.S. Court of Appeals, once wrote: "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that

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pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."

The Tax Relief Act of 2010 actually does provide relief and opportunity to taxpayers who wish to arrange their affairs in ways to reduce the total tax burden on a family's wealth, permitting greater benefits to be enjoyed by successive generations with appropriate planning. Even taxpayers who do not intend to transfer significant amounts to family members should consider reviewing their existing estate plan with their advisors to ensure that the recent changes in the law do not create an unexpected or unwanted distribution pattern in the event of a death in 2011 or 2012.

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- ◆ Durable powers of attorney
- ◆ Health care directives and living wills
- ◆ Life insurance trusts
- ◆ Charitable trusts
- ◆ Planning for qualified plan and IRA assets
- ◆ International estate planning techniques
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- ◆ Family limited partnerships and limited liability companies
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