CLIENT STRATEGIES:
SOME DO'S AND DON'TS & THE NEW ESTATE TAX RULES

Congressional repeal of the federal health care legislation is not a serious item given the likelihood of a veto by President Obama. However, the state constitutional challenges to the health care present a more compelling issue, particularly with the recent Florida case (*Florida v. United States Department of Health and Human Services*, 107 AFTR 2d 2011-416 (DC FL 1/31/2011), which generally declared the entire health care act void. There certainly will be appellate review of these cases, which suggests the Supreme Court will eventually have to rule on the issues.

The recent changes to the federal wealth transfer system were certainly not the final word on these taxes. The uncertainty and complexity has not gone away and this issue will be taken up again in approximately two years; with the 2012 election having an impact on the result. The lesson of the 2010 repeal is that we cannot be certain of the timing and result of the legislation at that time.

This month's Tax Letter provides some additional analysis of the new estate and gift tax laws and some practical tips on estate planning under the new rules.

Sincerely,

John Meisenbach
President

The federal wealth transfer tax changes enacted at the end of last year contained some surprises and have presented both obvious and hidden complexities. Now that we've had some time to digest the details of the legislation and the planning implications, we'd like to present some do's and don'ts with respect to the impact of the new legislation on your estate plan.

Don't: Procrastinate and assume the large wealth transfer tax exemption amounts will protect your estate from shrinkage. A wait-and-see approach might become wait-and-pay. The current larger exemptions are scheduled to sunset after two years. There are state inheritance or estate taxes in a large number of states with significantly lower exemption amounts.

Do: Take proactive steps to evaluate the potential risks facing your estate and determine whether the new estate tax rules will necessitate a change in your current plan. Items that should be evaluated include an inventory of assets and how they are titled, terms of your will and any living trusts, powers of attorney, and beneficiary designations under your life insurance, annuities, employee benefits, and any other financial accounts passed through beneficiary designations.

Don't: Assume the government is finished with tax reform and that the uncertainty has been eliminated.

Do: Adapt to the current playing field with the $5 million exemption, but remember the change is temporary. It would have to be renewed or further revised for 2013 to avoid a substantial increase in wealth transfer taxes. Any planning should include the appropriate amount of flexibility.

Don't: Believe that estate planning is only for the wealthiest Americans just because the $5 million exemption seems to relieve approximately 99 percent of the population from the federal estate tax burden.

Do: Understand that taxes should not be the motivation for estate planning. It is important to evaluate the potential scenarios for your estate. How will you provide for your surviving spouse or other heirs? Do you or any of your heirs have creditor concerns? Are there marriages in the family that may become problematic? Do any heirs have special needs? Do you live or own property in a state that has an inheritance or estate tax? Are you concerned with the expenses and delay of probate and want your assets distributed as quickly and efficiently as possible? Do you have any charities that you wish to benefit? These and other questions can only be answered by appropriate estate planning.

Don't: Forget that gift or estate tax returns might be required.

Do: Remember that any property gratuitously transferred to someone may trigger the need for a gift tax return. A gift tax return is required for "taxable" transfers. These are transfers that are not excluded under the $13,000 annual exclusion or deductible as a qualifying transfer to a spouse or a charity. The IRS is currently working on a gift-tax compliance project because they are aware that many real estate transfers to children and grandchildren have been completed without gift tax returns. A gift split with your spouse under the gift-splitting provisions requires a return to indicate consent. An estate tax return should be considered at the death of most married individuals even if the deceased spouse has far less than the $5 million exemption equivalent in assets because the unused exemption can only be transferred to the surviving spouse on a timely filed return.

Don't: Leave all your assets to your spouse without considering the possibilities of the "deceased spousal unused exemption amount "DSUEA". The new law permits (for two years) the surviving spouse to increase his or her available exemption by the amount unused by the deceased spouse. This could lead taxpayers to incorrectly assume that traditional planning involving marital deduction trust and unified credit (exemption) trusts are a thing of the past.

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Do: Have a thorough analysis of your estate plan in conjunction with your advisors and discuss the possibilities of applying your exemption in the appropriate manner. A simple "I love you" will with your surviving spouse may or may not be appropriate in your case. A family trust may be appropriate if you, for example, have children from a prior marriage. In some instances, there may be economic reasons to create an exemption trust. For example, the DSUEA left to a surviving spouse is not indexed for inflation, but an exemption trust funded with up to $5 million would be able to grow to any amount by the second death without estate taxes.

Don't: Believe that trusts are just tax-saving vehicles for the wealthiest Americans.

Do: Understand the benefits of trusts and create trust funds as appropriate. For estates above the exemption amounts, trusts are potentially the most appropriate vehicle to provide transfer-tax savings. However, trusts also are beneficial for other reasons. For example, trusts provide creditor protection, the ability to limit a beneficiary's access to funds, accumulation for the future, probate avoidance and many other purposes.

Don't: Believe that a $5 million estate tax exemption eliminates the benefits of lifetime gifts.

Do: Take advantage of the $5 million gift tax exemption to the extent appropriate. The five-fold increase in the gift tax exemption for 2011 and 2012 is, perhaps, the single most important opportunity in estate planning in the last 30 years. If you have the wealth and flexibility to make substantial gifts, this opportunity should be discussed with advisors as soon as possible. The larger exemption amount can be used in a number of ways. Interests in the family business can be transferred to the next generation. Or, a $10 million generation-skipping (GST) trust can be created for the next generations. Substantial life insurance transfers can be made with premiums above the annual exclusion amounts. The use of valuation-discounting techniques can be used to further leverage the $5 million exemption.

The majority of lifetime estate-planning techniques are more beneficial if they are implemented earlier. For example, techniques like a qualified personal residence trust or grantor-retained annuity trust provide the greatest benefit if the grantor has a significant retained term and lives beyond the termination of the trust. The cost of life insurance increases if the insured's age or health status is less favorable at the time of application. Gifts are most effective if substantial appreciation has occurred after the gift is completed. Furthermore, the $5 million exemption is currently available only until the end of next year. The wealth-transfer opportunities created by the increased gift-tax exemption are most valuable if you act quickly.

Don't: Assume that the need for life insurance protection has diminished because of the higher exemption amounts or that your current life insurance policies are structured appropriately for the new wealth transfer tax rules.

Do: Understand the value of life insurance as both a risk transfer device and an asset class. The lessons learned from recent economic uncertainty amplifies the value of the security provided by life insurance products. This is an excellent time to perform a "life insurance audit" to determine if your existing coverage is structured properly or if changes should be made.

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