# ESTATE AND GIFT TAX UPDATE

Significant changes to the federal estate, gift and generation-skipping taxes (collectively "transfer taxes") were recently signed into law by the President. This update summarizes the changes and highlights the planning opportunities created under the new law.

## *Overview*

- The estate, gift and generation-skipping tax ("GST") exemption amount has been unified and increased for 2011 and 2012 to $5,000,000 (adjusted for inflation after 2011).
- The top marginal gift, estate and GST rate has been unified at 35% for 2011 and 2012.
- A predeceasing spouse's unused estate and gift (not GST) exemption has become "portable"; i.e., they may now be utilized by the surviving spouse. Under prior law any unused exemption remaining at death was permanently lost.[1]
- Finally, unless Congress acts to extend these provisions, in 2013 the law will revert back to a $1,000,000 estate, gift and GST exemption, with a top marginal rate of 55% and no portability of a spouse's unused estate and gift tax exemption.

This two year window creates an expanded--but perhaps a limited--opportunity to transfer assets to children and future generations without attracting transfer taxes, removing future appreciation from the transferor's estate and leveraging such transfers with flexible income tax planning and careful asset selection.[2]

[1] Under the new law, the amount of exemption that a surviving spouse may use is limited to the lesser of the deceased spouse's unused exemption or the exemption available in the year of the subsequent transfer.

[2] We note that there is some concern that in the event Congress in the future sets the gift and estate tax exemption amount below the current $5,000,000 level, the tax benefit of making gifts when the exemption was higher might be "recaptured" in the estate tax calculation when the donor dies. While many believe that this potential recapture of tax benefits was unintentional and will be clarified by subsequent legislation, there can be no assurance this will occur. Even if this recapture were to result, a transferor would not ultimately incur greater transfer taxes. We caution, however, that where a donor spouse's estate suffers recapture, unanticipated estate tax could reduce assets otherwise available to pass for the benefit of a surviving spouse. This issue can be addressed with careful planning and structuring of lifetime transfers.

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***Action Steps***

Lifetime transfers through the use of annual exclusion gifts and utilization of gift tax exemption remains one of the most effective strategies to significantly reduce an individual's federal transfer tax liability. Additional state transfer tax benefits may also be realized for residents of states such as New York that impose an estate tax but do not impose a gift tax.

For those who are contemplating lifetime gifts but are concerned about irrevocable divesture of assets, transferring assets to a lifetime trust incorporating the spouse as a permissible (if not primary) beneficiary is an effective technique to preserve "access" for a married couple. While the primary purpose of the trust is to benefit future generations without incurring transfer tax, including the spouse as a permissible beneficiary provides greater flexibility in the event that financial circumstances change. The trust should also be structured as a "grantor trust" for income tax purposes whereby the grantor is liable for the payment of the trust's income tax liability. Since the payment of the trust's income tax liability is not considered an addition to the trust, the grantor effectively transfers additional value to the beneficiaries of the trust without making an additional gift. This reduces the grantor's estate by the income tax paid while allowing the trust to appreciate in a tax-free environment.

Beyond this, most wealth transfer strategies involve one or both of the following concepts: 1) the technical impairment of the value of an asset currently transferred to later have a beneficiary realize the asset's full market value; and/or 2) interest rate or time-value strategies where the performance of the transferred asset is anticipated to exceed an IRS established hurdle rate. Some of the techniques used to implement these concepts include leveraged inter-vivos credit shelter trusts, Qualified Personal Residence Trusts, Grantor Retained Annuity Trusts and Family Limited Partnerships. Valuation discounts for lack of marketability and/or control may also be available contingent upon the asset being transferred. Use of one (or more) of these techniques enhances the benefit of the increased transfer tax exemption.

There are many personal considerations to address in ultimately deciding on a wealth transfer strategy. The new tax, and its two year window period, provide the impetus to timely address these issues. Your KLS Advisor will work with you to facilitate the decision making process.

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