Current and Year-End Estate Planning Issues

December 17, 2009

UNCERTAINTY REGARDING THE FEDERAL ESTATE TAX AND APPLICABLE EXCLUSION AMOUNT

Under current law, the maximum amount an individual can shelter from Federal estate tax at death (the "Federal Applicable Exclusion") is $3.5 million for individuals dying in 2009; any amount in excess of $3.5 million that does not otherwise qualify for a deduction is subject to Federal estate tax. The Federal estate tax is set to be repealed in 2010 only to then return in 2011 with a Federal Applicable Exclusion of $1 million. The gift tax will remain in effect during 2010, with a $1 million exemption amount.

It appears unlikely that Congress will act on the estate tax before adjourning for the holidays. It is therefore likely that estate tax repeal will occur on January 1. Congress may restore the tax retroactively in 2010; however, several bills have already been proposed to alter the current law, including possible options such as making permanent the current $3.5 million Federal Applicable Exclusion and maximum estate tax rate of 45%, permanently increasing the Federal Applicable Exclusion to $5 million, lowering the maximum estate tax rate to 35%, and indexing the Federal Applicable Exclusion for inflation.

NEW YORK ESTATE TAX AND THE EFFECTIVE COMBINED ESTATE TAX RATE FOR NEW YORK RESIDENTS

The New York Applicable Exclusion is expected to remain at $1 million. Therefore, if you are a New York resident, New York estate tax will be imposed on any amount over $1 million that does not pass in a manner that qualifies for a New York marital or charitable deduction.

The following chart shows the combined effective Federal and New York estate tax maximum marginal rates for the current year through 2011 in the absence of new legislation:

CALENDAR YEAR	MAXIMUM FEDERAL RATE	MAXIMUM NEW YORK RATE	EFFECTIVE COMBINED MAXIMUM RATE AFTER DEDUCTION OR CREDIT OF NEW YORK ESTATE TAX
2009	45%	16%	53.80%
2010	0%	16%	16%
2011[1]	55%	16%	55%

PROPOSED MINIMUM TERM REQUIREMENT FOR GRANTOR RETAINED ANNUITY TRUSTS

A Grantor Retained Annuity Trust (“GRAT”) is a trust to which you transfer assets and retain the right to receive an annual payment for a fixed term of years. At the end of the term, any assets remaining in the GRAT pass to remainder beneficiaries (e.g., descendants). When you transfer assets to a GRAT, you make a taxable gift with respect to the portion of the transfer that is attributable to the remainder interest in the GRAT (which may be a small percentage of the total value of the assets transferred). The value of the remainder interest is determined using the IRS interest rate for the month in which the GRAT is created. All appreciation (income and growth) in excess of the annual payments due to you are preserved for the remainder beneficiaries free of gift and estate tax, provided you survive the term of the GRAT.

President Obama’s 2010 Budget Proposal suggested a minimum term requirement of ten years for GRATs. Because the transfer tax benefits of establishing a GRAT may be lost if the donor dies during the GRAT term, individuals frequently structure such trusts with short terms, such as two years. GRATs with terms of less than ten years would be disallowed under the proposed rule, increasing the likelihood that assets transferred to a GRAT will be included in the donor’s estate. It is considered unlikely that the proposal will be enacted into law before 2010, and, as currently proposed, would apply only to GRATs established after the date of enactment of the statute.

1 Under current law, in 2011, there will be an additional 5% Federal estate tax on the portion of the taxable estate between $10,000,000 and $17,184,000. If the total amount of the taxable estate is within this range, the effective combined maximum estate tax rate will be 60%. The effective combined maximum estate tax rate for estates over $17,184,000 will be 55%.

Currently, the IRS-determined interest rate that a GRAT's investment return must exceed in order to pass assets on to descendants gift-tax free is relatively low (3.2% for December 2009). This low rate and the possible future imposition of a ten-year minimum term may suggest a current impetus to create a GRAT.

CHANGES TO NEW YORK POWER OF ATTORNEY LAW

Significant changes in the New York law governing powers of attorney went into effect on September 1, 2009. As well as requiring additional formalities for proper execution, under the new law if an individual wishes to enable his or her agent to make major gifts (gifts over $500) and other transfers, a Statutory Major Gifts Rider must be executed along with the power of attorney. If a Statutory Major Gifts Rider is not executed, the agent will only be authorized to make small gifts (not to exceed $500 per year per recipient) if such gifts would have been customarily made by the principal. In addition, unless explicitly allowed in a Statutory Major Gifts Rider, an agent will not have the authority to make gifts to him or herself.

The statute does not affect the validity of powers of attorney properly executed prior to September 1, 2009. However, the law does provide that the execution of a power of attorney on or after September 1, 2009 revokes any and all prior powers of attorney executed by the principal unless specifically provided otherwise.[2] Therefore, in executing a new power of attorney, care should be taken to avoid unintentionally revoking a prior power of attorney, particularly when a new or prior power of attorney was executed for a limited purpose, such as to sign tax forms or complete a real estate transaction.

ROLLOVER TO ROTH IRAS

A traditional IRA allows an individual to make tax deductible contributions and delay the payment of income tax until distributions are made in retirement. Unlike a traditional IRA, a Roth IRA is funded with after-tax dollars, but if certain requirements are met, distributions from a Roth IRA will not be subject to income tax.[3] In addition to the tax-free distributions, Roth IRAs have no minimum distribution requirements once the participant reaches age 70 and the participant can continue to make contributions after he or she attains age 70 ½.

Prior to 2010, traditional IRA to Roth IRA conversions were available only to individuals whose modified adjusted gross income was less than or equal to $100,000. Additionally, the conversion was not available to married taxpayers filing separately. Beginning January 1, 2010, both these limitations on Roth conversions disappear permanently (although income limits on contributions remain the same), making anyone eligible for conversion, regardless of income or

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2 There are indications that the New York legislature may eliminate this automatic revocation provision as it revises the new law.

3 "Qualified distributions" from a Roth IRA will be exempt from taxation. In order to be "qualified," a distribution must be made (i) after the participant reaches age 59½, (ii) to a beneficiary (or estate of participant) on or after the participant's death, (iii) to a disabled participant, or (iv) for a "qualified special purchase" (first time homebuyers). Further, the distribution must be made more than five years after the creation of the Roth IRA.

tax filing status. Further, a special exception eliminates the 10% early withdrawal penalty fee when a traditional IRA distribution is rolled over into a Roth IRA.

The conversion from a traditional IRA to a Roth IRA is taxable, although you do not have to convert your entire IRA all at once. If you have made all deductible contributions to your traditional IRA, then the entire amount of the rollover is taxable and will be treated as ordinary income. Normally, the entire amount of the rollover will be includable in income for the year of the conversion, although for conversions made in 2010, unless elected otherwise, the income will be spread over two years; half will be reported in 2011 and half in 2012. This special rule applies only to conversions made in 2010. For conversions made in 2011 and any year following, the entire amount of income will be includable in the year of the conversion. The rules for income tax upon conversion differ if the contributions to a traditional IRA were not income tax deductible when made.

Whether it is advantageous to roll over a traditional IRA to a Roth IRA depends on a number of factors, such as your current tax bracket, your expected tax bracket at retirement, and whether you have sufficient liquid assets to pay the conversion taxes without tapping into the Roth IRA. Also consider that investing in a Roth IRA has the potential to reduce your estate tax liability. Although both a traditional IRA and a Roth IRA will be fully included in your gross estate, your beneficiaries will be required to pay income tax on the traditional IRA in addition to the estate tax. Therefore, by pre-paying the taxes in a Roth IRA, you are effectively reducing the size of your estate, without diminishing its value.

EXPIRING EXCLUSION: TAX-FREE DISTRIBUTIONS FROM IRAS TO QUALIFYING CHARITABLE ORGANIZATIONS

The Emergency Economic Stabilization Act of 2008 extends through December 31, 2009 the exclusion from gross income of up to $100,000 per year of otherwise taxable distributions from certain IRAs, provided the distributions are made directly to a qualifying charitable organization (under prior legislation, this exclusion expired on December 31, 2007). The following conditions apply: (1) distributions must be to certain public charities (and, notably, cannot be to donor-advised funds); (2) the IRA owner must have attained age 70½ at the time the distributions are made; and (3) the distributions must be made before 2010. Whether it makes sense to use this exclusion will depend on a number of factors, including income level, assets available for charitable giving, and the level of an individual's charitable giving.

FEDERAL GIFT TAX ANNUAL EXCLUSION UNCHANGED; TUITION AND MEDICAL PAYMENTS

The Federal gift tax Annual Exclusion will remain $13,000 per individual recipient. A married couple can continue to "split" all gifts on gift tax returns for the year and may give a total of $26,000 gift-tax free to any number of individual recipients.

In addition to the Annual Exclusion, there continues to be an exclusion from Federal gift tax for payment of another person's tuition or medical expenses (including medical insurance premiums), provided the payment is made directly to the institution providing education or directly to the health care provider. This exclusion is unlimited both with respect to the amount of the payment and the number of allowable recipients.

AUTOMATIC ALLOCATION OF FEDERAL GST TAX EXEMPTION

Generation-skipping transfer ("GST") tax is a tax imposed on transfers by gift or upon death or transfers from trusts to persons two or more generations below the person making the transfer or who created the trust. The Federal GST tax exemption for each individual, currently $3.5 million, will, in the absence of new legislation, be unlimited in 2010 and fall back to $1 million in 2011. In other words, without new legislation, the GST tax is repealed for generation-skipping transfers made in 2010. The possibility of new legislation being passed before the end of the year is unlikely, but Congress may restore the tax retroactively in 2010.

The GST tax exemption is valuable because if GST tax exemption equal to the value of the transferred property is allocated to a trust transfer, the transferred property and post-transfer income and appreciation should be exempt from any further gift, estate or GST tax for the term of the trust. Prior to 2001, GST tax exemption was allocated to a trust transfer if the donor allocated GST tax exemption on his or her gift tax return. Since January 1, 2001, however, GST tax exemption is automatically allocated to all transfers to certain types of trusts, unless the donor affirmatively opts out of automatic allocation on his or her gift tax return.

Each year, you should alert your accountant to transfers you make to trusts (including life insurance premiums paid with respect to insurance trusts) and determine whether you should opt out of, or into, allocation of GST tax exemption (and whether to opt out or in on a permanent basis) so that your gift tax return, which is due on April 15th of the year following the year of the transfer, can be prepared appropriately.

GIFTS OF ASSETS WITH LOW VALUES AND CONTINUED LOW INTEREST RATES

The continuing market turmoil may create an opportunity for making transfer tax efficient gifts. Giving assets with low current values may mean that more future value can be transferred at a lower gift tax cost or with less use of the Annual Exclusion or Federal lifetime gift tax exclusion ($1 million per individual) if the values of the transferred assets increase after the gift is made.

Now may also be a good time to consider making an intra-family loan or selling assets in exchange for a promissory note. The IRS-determined interest rates that must be charged on a promissory note in order to avoid the imposition of gift tax are low (for December 2009, 0.69% for a note with a term of up to three years, 2.62% for a note with a term of three to nine years, and 4.13% for a loan with a term longer than nine years).

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If you have any questions about the estate planning issues described in this update, please contact Pamela L. Rollins, Laura Twomey or any other member of our Personal Planning Department.

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