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2011 Year-End Estate Planning: What to Do in Uncertain Times

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Congressional gridlock, along with political bickering and gamesmanship, persists as 2011 comes to an end. While Congress struggles to deal with the economy, jobs and the federal deficit, there remain uncertainties surrounding the estate, gift and generation-skipping transfer (GST) tax laws. Rumors of what the Joint Select Committee on Deficit Reduction (the so-called Super Committee) might do have stirred the confusion even more. In this complex environment, planning is all the more important.

Status of Estate, GST and Gift Taxes

At the end of 2010, Congress surprised everyone. Rather than letting the estate tax exemption (and the GST tax exemption) fall to $1 million, Congress increased it to $5 million ($5.12 million in 2012 based upon the inflation adjustment)—its highest level ever—and reduced the rate of tax to 35%. However, without further Congressional action, as of January 1, 2013, the federal estate tax will again be effective with a $1 million exemption and a 55% top marginal rate. The 2010 Tax Act also unified the gift tax exemption with the estate and GST tax exemptions, allowing donors to use their full exemption either at death or during lifetime, to make aggregate gifts of $5 million ($5.12 million in 2012) without incurring a tax. It also reduced the top gift tax rate to 35%. Again, these changes are scheduled to expire on January 1, 2013. Without further legislation, after 2012, the top gift tax rate will be 55% and the gift exemption will be $1 million.

What the federal government gave us, the Illinois government in essence took back. Illinois reinstated its estate and GST taxes, only allowing for a $2 million exemption, with rates on taxable estates ranging from 8% to 16%. However, Illinois also now allows a marital deduction solely for state transfer tax purposes for assets passing in qualifying trusts for surviving spouses.

Despite economic and legislative uncertainty, it is wise to consider the following transfer tax planning opportunities:

- Annual Exclusion Gifts
- Tuition and Medical Gifts
- Lifetime Utilization of New Transfer Tax Exemption
- Taxable Gifts
- Generation-Skipping Transfer Tax Planning
- Making Use of the Economy
- Illinois QTIP

Annual Exclusion Gifts

Making use of your annual exclusion gifts remains one of the most powerful—and simplest—estate planning techniques. For 2011 and 2012, individuals can make an unlimited number of gifts of up to $13,000 per recipient, per year. Over a period of time, this approach can result in substantial transfer tax savings, as both the gift itself and its income and growth are removed from the donor's estate. This strategy also allows you to avoid paying gift tax or using any transfer tax exemption (discussed below). However, if annual exclusion gifts are not made by the end of the year, that year's exclusions are lost.

Tuition and Medical Gifts

You can still make unlimited gifts on behalf of individuals by paying their tuition costs directly to the school or their medical expenses directly to the health care provider (including the payment of health insurance premiums).

Lifetime Utilization of New Transfer Tax Exemption

The new $5 million exemption opens a new paradigm of planning. The ability to transfer $5 million ($10 million per couple)—after annual exclusion and medical and tuition gifts, and without having to pay gift taxes—paves the way for many transfer planning opportunities. When combined with valuation discounting and leveraging strategies (e.g., family partnerships, sales to grantor trusts, GRATs, etc.), tremendous amounts of wealth may pass for many generations free of federal and Illinois transfer taxes. Lifetime gifts utilizing the exemption will almost always result in overall transfer tax savings (unless the gifted assets decline in value). The main reason is the removal of the income and growth on the gifted assets from the taxable estate. Under current law and based on the inflation adjustment, individuals who used their transfer tax exemption in 2011 will be able to, and should, make additional gifts of $120,000 (in excess of the 2012 annual exclusion gifts).

- **Benefits of Acting Early:** The main benefit of making gifts that utilize the transfer tax exemption is to remove from the taxable estate the income and appreciation on those assets from the date of the gift to the date of death. Therefore, the sooner the gifts are made, the more likely that additional income and growth will escape taxation. Because the exemption amount will decrease, under current law, to $1 million on January 1, 2013, there may be a relatively short window of opportunity to utilize the increased exemption amount.
- **Benefits of Acting Even Earlier:** The decision to raise the exemption to $5 million was extraordinarily contentious, and Congress could change it at any time before 2013. Although the Super Committee is not scheduled to release its proposals until November 23, 2011 (and members of the committee have been tight-lipped regarding their progress), one rumored proposal would accelerate the reduction of the current $5 million exemption to $1 million—possibly as early as the November 23, 2011 release date (or as of January 1, 2012). Based upon Congressional gridlock, it seems unlikely that any proposals will emerge from the Super Committee, let alone be enacted by Congress. Until we know for sure, however, the risk of losing the exemption remains. Therefore, anyone who has postponed making these gifts may want to move forward quickly to avoid losing the benefits of the $5 million exemption.

Taxable Gifts

Although no one likes paying a tax, taxable gifts in 2011 and 2012 may prove to be very beneficial. For example, those who believe they will be in a taxable situation no matter what action Congress takes will be taxed at a 35% rate for any gifts they make this year. If they make the same gifts (or die with the assets) in 2013, a 55% tax may be imposed. Thus, there is a 20% tax savings for those who make gifts by the end of 2012. (Additional benefits are also obtained if wealth is transferred by lifetime taxable gifts, rather than at death, based on the differing manner in which the gift and estate taxes are computed and paid.)

Generation-Skipping Transfer Tax Planning

In order to ensure a death tax at each successive generational level, the generation-skipping transfer tax is imposed on transfers to grandchildren or more remote descendants. However, because every individual also now has a $5 million GST exemption, it is wise to consider making gifts to—or in trust for—grandchildren or more remote descendants (or to children in a manner that applies and preserves the GST exemption).

Making Use of the Economy

Market volatility, depressed asset values and historically low interest rates continue to create an environment ripe for estate planning and transferring wealth to descendants on a tax-advantaged basis. Assets with values that are temporarily depressed due to current economic conditions but are expected to recover would be good targets for gifts. Based on the current applicable laws, the increase in value when the economy recovers and the appreciation thereon would pass to the donees free of gift tax. The lower current applicable federal interest rates also make gifting through a grantor retained annuity trust (GRAT), a charitable lead trust (CLT), intra-family loans, and the "sale to grantor trust" techniques even more beneficial.

As the economy moves in cycles, it is likely that asset values and interest rates will eventually increase again.

When they do, the opportunity to reduce—or even eliminate—your transfer taxes on such favorable terms may be gone. But prompt action to implement these techniques may be prudent for two reasons: (1) market conditions may change, making such planning less attractive, and (2) Congressional action may negatively affect such planning. Legislation was previously introduced that, if enacted, would (1) place substantial limitations on the use of valuation discounts in connection with family-controlled entities, and (2) restrict the use of the highly recommended short-term zero-gift GRAT by requiring GRATs to have a 10-year minimum term (increasing mortality risk) and a taxable gift upon formation (although the amount of the required taxable gift was not specified).

Illinois QTIP

Given the disparity between the $5 million federal exemption and the $2 million Illinois exemption, married couples domiciled in Illinois should revise their estate plans to take advantage of Illinois' QTIP marital deduction. Otherwise, an estate plan that is designed to fully utilize the federal $5 million exemption can inadvertently cause a $352,158 Illinois estate tax.