Legal Matters®

Estate Planning
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Congress creates a 'window' in 2011 and 2012 for big tax savings

Congress has created a temporary "window" – between now and the end of 2012 – in which many people can save a lot of money in estate and gift taxes.

You might be able to take advantage of this opportunity by transferring significant assets to a trust. But as they say on TV, hurry – this is a limited-time offer from the federal government.

During 2011 and 2012, the federal estate tax exemption will be $5 million, meaning the tax will be applied only to estates that are larger than that. Importantly, the lifetime exemption from the federal *gift* tax has also been raised, from $1 million to $5 million.

The gift tax applies to transfers of assets. In general, any person can give any person up to $13,000 a year without there being any gift tax. If you give someone more than $13,000 in a calendar year, then the excess is subject to gift tax.

However, you also have a "lifetime exemption." In the past, this amount was $1 million. That meant that over your lifetime, you could make up to $1 million in gifts over the $13,000 annual threshold without immediately paying a gift tax.

This wasn't a "freebie," however. Any amount you used of your lifetime exemption would be subtracted from your estate tax exemption, such that when you die, your heirs might have to pay more in estate taxes. But in general, the benefits of using the lifetime exemption far outweighed the disadvantages.

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Now that the lifetime exemption has been raised to $5 million, you can make gifts of up to $5 million without immediately paying gift tax. Even if you already used up your $1 million lifetime exemption in the past, you can now make up to $4 million in additional gifts.

But this is true only if you make those gifts in 2011 or 2012. After that, the lifetime exemption goes back to $1 million.

Many people can benefit by putting significant assets into a trust

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…More implications of the new tax law from Congress

The new tax law, which temporarily raises the estate and gift tax exemptions to $5 million, has many important implications. Almost everyone should review their estate plan in light of this change.

Here are just a few of the other important consequences:

• **Many wills that were drafted years ago need to be revised right away.** Frequently, these wills were set up to avoid taxes by giving children an amount of property equal to the estate tax exemption, and having the rest go to the surviving spouse. For instance, if the exemption amount were $600,000, then $600,000 would go to the children (or to a trust for the children), and the rest would go to the surviving spouse (or a trust for the spouse).

But in 2011 and 2012, the exemption amount has been dramatically increased to $5 million. So in some cases, the result will be that the entire estate goes to the children, and little or nothing goes to the surviving spouse.

If you have a will with such a provision, it would be wise to review it now so you don't accidentally disinherit your spouse.

Similarly, if you have a pre-nuptial or post-nuptial agreement with provisions tied to the federal estate tax (such as that one spouse must leave the other a fraction of his or her federal estate), then you might want to have that agreement reviewed as well.

• **Unmarried couples might want to make gifts to each other in 2011 and 2012.**

In general, a person can make unlimited transfers to a spouse without being subject to gift or estate taxes. But the same is not true of unmarried couples; if one partner dies and leaves everything to the other partner, the federal estate tax will apply. So a wealthy partner might want to make transfers to a less wealthy partner before the end of 2012.

A few states allow gay couples to get married under state law, but these couples might want to consider making gifts as well, because they're not considered "married" for purposes of the federal estate tax.

• **Many power of attorney documents allow an agent to make large gifts.** This was often a good idea back when the estate tax exemption was much smaller, because it allowed the agent to use lifetime gifts to avoid taxes. But now that the exemption is $5 million, these gifts might not be as necessary, and you might want to reconsider allowing your agent to have this significant power, at least for now.

• **If you have a very large life insurance policy**, this might be a good time to put it into a life insurance trust. These trusts can be very effective at saving taxes, but in the past many people with large-value policies couldn't transfer them to a trust without incurring gift-tax problems. With the $5 million exemption, this might now be much less of an issue.

• **If you've set up a grantor trust in the past**, you might want to review it. One benefit of a grantor trust is that the trust income can benefit your children or grandchildren, but you can pay the income taxes on it. This effectively reduces your estate tax, because the money for the income tax comes out of your eventual estate. But with the estate tax exemption at $5 million, saving estate taxes might not be such a priority, and you might want to reconsider paying the taxes yourself. For example, if a trust protector has the power to change the income tax treatment of the trust, you could ask that the treatment be changed for now.

• **A number of people recently converted a traditional IRA to a Roth IRA**, and paid the resulting income tax upfront, in order to reduce their taxable estate. Again, with a $5 million exemption, this might not be such a priority, and you might consider undoing the conversion and saving the taxes. (However, before undoing a conversion, please keep in mind that the $5 million exemption only lasts for sure through 2012. After that, it's slated to return to $1 million. Congress might well change that figure – but there's no guarantee.)

• **The very wealthy might want to consider putting more than $5 million into a trust.** They would immediately have to pay a 35% gift tax on any amount over $5 million. On the other hand, that might be preferable to keeping those assets and having them be subject to a possible 55% estate tax when they die.

Many wills that were drafted years ago need to be revised right away as a result of the new law. If an old will isn't revised, a person could end up accidentally disinheriting a husband or wife.

Congress creates temporary ‘window’ for big tax savings

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in 2011 or 2012 that will pay income to their children, and ultimately benefit their grandchildren.

Here are some of the benefits:

• Suppose you transfer an asset worth $1.5 million to a trust today, and by the time you die, that asset has increased in value to $2 million. The entire increase — $500,000 – will go to your heirs without being subject to estate taxes.

• Suppose the asset also generates annual income. For instance, over the course of the rest of your life it might generate $300,000 in income. That entire $300,000 will also go to your heirs without being subject to estate taxes.

• Suppose you set up the trust so that your children receive the income, and when they die, the trust assets go to your grandchildren. The entire trust, regardless of how much it has increased in value, will go to your grandchildren without any estate taxes being due when your children pass away.

• You will also have protected the assets for your grandchildren, because they can’t be taken away if your children incur debts, are sued in a lawsuit, get divorced, etc.

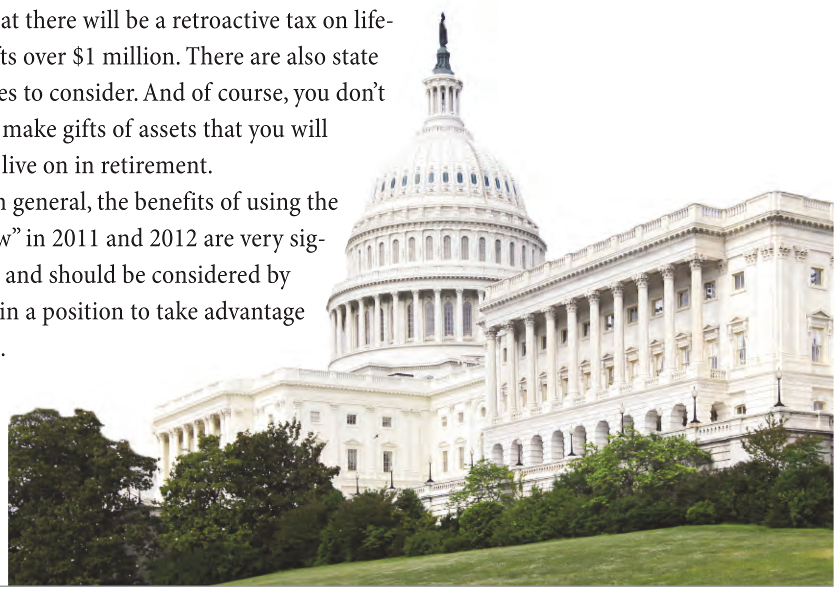
What assets should you consider putting into a trust? Obviously, ones you don’t need to keep for your current or future support. Beyond that, it’s a great idea to contribute assets that are temporarily reduced in value and that have the potential for significant appreciation. In the current environment, real estate might be a good example.

In some states, it’s possible to create a “dynasty” trust, which continues to exist and benefit future generations such as great-grandchildren.

Remember, too, that the $5 million gift tax exemption is *per-person*. So a married couple could contribute as much as $10 million.

One possible downside is that we don’t know what Congress will do after 2012. There is a small possibility that there will be a retroactive tax on lifetime gifts over $1 million. There are also state tax issues to consider. And of course, you don’t want to make gifts of assets that you will need to live on in retirement.

But in general, the benefits of using the “window” in 2011 and 2012 are very significant and should be considered by anyone in a position to take advantage of them.



Here’s yet another example of why trusts are a good idea

In a recent case, a Texas man inherited $400,000 in cash from his aunt. The man’s ex-wife went to court and claimed that as a result, his child support payments should be increased.

The Texas Court of Appeals agreed with the ex-wife. It said that even though the $400,000 wasn’t wages or earnings, it was still a “resource” that had to be considered in determining how much the father had to pay for his two children.

Now, we don’t know what the aunt’s feelings were. It’s entirely possible that she was happy to use her money to take care of her nephew’s children. However, she probably never considered that after her death, a large portion of her assets would end up under the direct control of her nephew’s ex-wife.

It’s a good bet that the aunt might have been happier if she had put the $400,000 into a trust that would benefit the nephew and his children. In that way, *she* would have had control over how the money was spent for their benefit – rather than the ex-wife.

In addition, the nephew wouldn’t have had to go to court to fight over who got the money.

Trusts can be an excellent way to protect assets if you’re considering leaving an inheritance to someone who might otherwise lose the property for any number of reasons, including divorce, lawsuits, business problems, addiction, or simply a lack of investment acumen.

A trust lets *you* decide how your assets will be used…rather than, say, a beneficiary’s ex-spouse.

Do surviving spouses have a right to a 401(k) or an IRA?

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When choosing a beneficiary for a retirement plan, it's important to understand how your spouse will be treated under the plan. The rules are different for 401(k)s and IRAs.

With a 401(k) plan, a surviving spouse is the *automatic* beneficiary of the plan. If you want to name someone other than your spouse as a beneficiary, your spouse must agree to this in writing.

There are some exceptions; for example, the rule might not apply if you and your spouse have been married for a very short time. But in general, it's a strict rule. In fact, even if your spouse signed a prenuptial agreement saying that he or she has no right to your 401(k), that might not be good enough, because he or she wasn't your "spouse" at the time of the signing.

On the other hand, this rule is not true for an IRA. Surviving spouses are *not* automatic IRA beneficiaries.

In a recent case, a husband rolled his 401(k) into an IRA after he retired. He named his children as the IRA's beneficiaries. After he died, his wife claimed that she was entitled to the account funds as his surviving spouse. She argued that because her husband had rolled his 401(k) into the IRA, she should receive the same protections that the 401(k) had given her.

But a federal appeals court in California disagreed, deciding that the IRA rules applied even if the funds originated in a 401(k).

In general, whether you have a 401(k) or an IRA, it is important to regularly check your beneficiary designations to make sure they are current and fit with the rest of your estate plan.

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