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February 1, 2011

TO OUR CLIENTS AND FRIENDS:

THE IMPACT OF THE NEW TAX LAW ON YOUR ESTATE PLAN

As you undoubtedly already know from the extensive media coverage, after nearly a year without an estate tax, on December 17, 2010, Congress passed, and the President signed, the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." Although long in the making, and welcome upon arrival, the 2010 legislation provides only temporary relief. For now, though, the changes are sweeping and significant, impacting and in many ways transforming estate administration and planning in 2010, 2011 and 2012. For example –

- for 2011 and 2012 the gift and estate tax exemptions are "reunified" at a higher exemption amount of $5 million for each taxpayer, indexed for inflation beginning in 2012,
- for 2010, 2011 and 2012, the generation-skipping transfer ("GST") tax exemption is increased to $5 million, indexed for inflation beginning in 2012, and
- for 2011 and 2012, the tax rate for all three taxes is reduced to 35% from the 2009 rate of 45%.

These extensive changes in the law will give taxpayers and their advisors a great deal to think about and many new planning opportunities for at least the next two years. In this letter we would like to highlight some of the changes brought about by the new legislation and to pass along some initial planning thoughts.

2010 Decedents and 2010 GST Trusts. The new legislation made dramatic changes in the rules applicable to estates of 2010 decedents and 2010 generation-skipping transfers. Clients who may be affected by those changes (for example, anyone who made gifts in excess of the annual exclusion to grandchildren or to potentially generation-skipping trusts) and who have not spoken to us in this regard since the new law was enacted should do so as soon as possible.

Portability. Under the 2010 legislation, for deaths occurring after December 31, 2010 and before January 1, 2013, any exemption that remains unused at the death of a first-to-die spouse is generally available to the surviving spouse for use during lifetime and at death, in addition to his or her own exemption. This is a major change and – ***if Congress decides to make it permanent***

after next year – will make it much easier for a married couple to make sure that both of their exemptions are effectively used. Under prior law, the exemption of the first spouse to die was lost if not used, pushing married taxpayers who would have preferred to leave all of their assets outright to the surviving spouse instead to leave property in trust to preserve the exemption of the first spouse to die. Coupled with the $5 million exemption, the new provision will limit the reach of the estate and gift taxes to individuals and married couples with a net worth in excess of $5 million and $10 million, respectively. Although at first blush the portability provision may appear to make trusts created solely to utilize the first-to-die spouse's exemption a thing of the past, there are many tax reasons for continued use of such trusts. For example –

- the temporary nature of this provision makes it applicable only if both spouses die after 2010 and before 2013;
- even if the portability provisions are extended, they do not apply to the GST exemption, which could be fully utilized through appropriate trust planning;
- the deceased spouse's unused exemption amount is not indexed for inflation and relying on the use of a deceased partner's exemption amount will not guard against the estate tax on appreciating assets; and
- to preserve the availability of the predeceased spouse's unused exemption, the personal representative must file a federal estate tax return, even if a tax return would not otherwise be required.

On the other hand, a benefit of portability is that appreciated assets passing outright to the surviving spouse receive a step-up in basis for income tax purposes at the first death, and then, if there is further appreciation, a second step-up at the surviving spouse's death.

Planning

As a result of the increased exemption amounts and portability, the timing of making a gift may be as important as making the gift itself. In 2011 and 2012, the gift, estate and GST tax exemption amounts are $5 million, with a maximum tax rate of 35%.

Lifetime Gifts. Because of the "reunification" of the estate and gift tax, for the first time in some years individuals again have the option of exhausting their entire exemption through lifetime gifts with no gift tax liability. The $5 million exemption makes possible much larger lifetime gifts, without gift tax, than have ever been possible in the past. For those who, because of reluctance to pay gift tax, have hesitated to transfer business assets, vacation homes or other valuable assets that they would otherwise like to pass on to children or others during their lifetimes, the new law presents an unprecedented opportunity. Moreover, because it is entirely possible that estate tax rates will increase after 2012 (the law now on the books calls for reversion to a marginal 55% rate in 2013), paying gift tax on gifts in excess of the exemption, at

the lower 35% rate now in effect, may provide significant savings in comparison with the eventual estate tax due if the same assets are held until death. Keep in mind that because the gift tax is "tax exclusive" (tax is assessed only on what the recipient of the gift receives) while the estate tax is "tax inclusive" (meaning that tax is paid not only on what the heirs receive, but on the dollars used to pay the tax), a 35% gift tax rate is the equivalent of an estate tax rate of approximately 29.5%.

The bottom line is that, depending upon your personal circumstances, including the potential appreciation of the gifted assets and the size of your estate, there may be considerable advantages to making large lifetime gifts in 2011 or 2012.[1] Furthermore, as mentioned above, the portability provisions do not apply to a person's GST exemption. As a result, lifetime gifting and/or use of trusts in estate planning will continue to be important in maximizing the use of your increased GST exemption if gifts to grandchildren or multi-generational trusts figure significantly in your estate plan. For unmarried clients as well, planning for use of the increased gift tax exemption allows much greater tax benefits than were available before.

Estate Freezing Transactions. An estate "freezing" transaction involves a transfer of a client's assets, typically to a trust for the benefit of family members, to "freeze" the value of the transferred asset at its value on the transfer date. Frequently, to avoid gift tax an annuity-type interest is retained in the trust for a term of years or a portion of the assets are transferred for fair market value consideration. While there were several legislative proposals last year to reduce the benefits of some of these transactions, none of these limitations were included in the 2010 legislation. As a result, estate freezing techniques such as so-called "GRATs" (grantor retained annuity trusts), installment sales, and even intra-family loans, remain beneficial estate planning options and are particularly attractive when interest rates are low, as they are now. The increased gift tax exemption will make use of certain of these techniques easier for some clients. ***The possibility that the limiting legislation will be revived, along with the short life span of the increased exemption, are reasons to consider such techniques sooner rather than later.***

Review Tax-Driven Estate Plans. Given the increased exemption amounts, it may again be appropriate (and in some cases quite important) to review tax-driven formulas and bequests based on the federal estate tax or GST exemption amounts, to ensure your documents reflect your current wishes – especially if your documents have not undergone a thorough review since 2001,

[1] Unfortunately the new law, which was written rather hurriedly, has what seems to be an unintended technical glitch that may allow the IRS to argue that amounts gifted may be "clawed-back" into a client's estate if and when the estate tax exemption is reduced below the current exemption amount. If the IRS in fact takes that position (which is not clear at the present time) and it is sustained, it could result in some of the benefit of such gifts being lost to increased estate tax at the taxpayer's later death. That risk will have to be assessed and taken into account in each individual situation. Our initial analysis, however, is that in many cases the gifts would still be advantageous even in this worst case scenario.

when the exemptions began to increase significantly -- otherwise you may find, for example, that a larger share of your estate than you originally intended bypasses your spouse or your children.

Sunset. As indicated above, on January 1, 2013 the new legislation is scheduled to sunset, with a reversion to a $1 million estate and gift tax exemption, and a generation-skipping transfer tax exemption of $ 1,360,000, subject to an inflation adjustment, with a 55% maximum tax rate (which increases to 60% for certain estates to undo the benefit of lower rates and of the exemptions).

* * *

The new legislation has provided valuable planning opportunities, with a narrow window for execution. If you would like us to review your personal situation to consider whether any planning options might result in significant tax savings for you or your family, please let us know. We look forward to hearing from you.

Sincerely yours,

Christopher H. Gadsden — Pam H. Schneider

W. Steven Woodward — Tracy Blake DeVlieger

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As mentioned in the mailing we sent out in December, we would like to keep you informed of new developments by email. If you would like to receive such email updates, please "Join Our Mailing List" at our website www.gswlaw.net.

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