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*See tax notice below.*

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TO OUR CLIENTS AND FRIENDS:

**ESTATE PLANNING IN 2012 – CONSIDER TAXABLE GIFTS NOW**

In 2012 the estate, gift and generation-skipping transfer tax legislation enacted in 2010<sup>1</sup> remains the law, and provides that each taxpayer has –

- “Reunified” gift and estate tax exemptions at the highest ever amount of **\$5,120,000** (increased from the \$5 million exemptions effective in 2011 due to an inflation adjustment),
- A generation-skipping transfer tax (“GST”) exemption of **\$5,120,000** (also increased for inflation), and
- A maximum rate of **35%** for all three taxes.

*However, on January 1, 2013 the 2010 Legislation is scheduled to sunset, with a reversion to a \$1 million estate and gift tax exemption, a GST exemption of \$1,390,000 (plus a potential inflation adjustment) and a 55% maximum tax rate (which increases to 60% for certain estates to undo the benefit of lower rates and of the exemptions). As there is no way to know if Congress and the President will act to change this, planning should assume that the favorable provisions of current law will disappear on January 1, 2013.*

With the sunset less than 11 months away, clients who have not made large gifts should consider the valuable and short-lived wealth transfer opportunities offered by the increased exemptions and decreased rates. In this instance, the timing of making a gift may be as important as the gift itself. In this letter we offer some thoughts for planning in 2012 and discuss “portability,” an addition to the tax law introduced by the 2010 Legislation.

**Lifetime Planning**

Each individual has the option of using his or her entire exemption amount through lifetime gifts with no gift tax liability. By making possible much larger lifetime gifts without gift tax, the

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<sup>1</sup> The “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” signed into law on December 17, 2010 (the “2010 Legislation”).

\$5,120,000 exemption amount provides a strong incentive to those who might otherwise wish to make significant cash gifts or to transfer business assets, vacation homes or other valuable assets to or for the benefit of children, grandchildren or others during their lifetimes, but have hesitated because of unwillingness to pay gift tax. The increased gift tax exemption also may be put to good use in “cleaning up” prior family transactions, such as by forgiving intra-family loans or equalizing prior gifts among family lines. Furthermore, the increased exemptions will allow clients to engage in “dynastic” planning by creating trusts designed to last for multiple future generations protected by the GST exemption from future transfer taxes.<sup>2</sup>

Moreover, for those uncomfortable with giving away the full lifetime exemption amount, gifting a lower amount may still be advantageous. At the other end of the spectrum, because it is entirely possible that estate tax rates will increase next year, making gifts in excess of the exemption and paying gift tax at the current 35% rate may generate significant savings in comparison with gifts in later years or the eventual estate tax due if the same assets are held until death.

***The bottom line is that, depending upon your personal circumstances, including income needs, the size of your estate, potential appreciation of the transferred assets and the basis of those assets for income tax purposes, making large lifetime gifts in 2012 may provide significant tax advantages.***<sup>3</sup>

We are happy to discuss strategies to mitigate some, if not all, of the potential downsides of lifetime gifting, including loss of control, loss of income, the risk that transferred assets will decline in value before death, and the loss of step-up in basis at death on transferred assets that increase in value.

Another factor to consider in making gifts this year is that Congress has shown an interest in reducing the benefit of certain techniques that employ discounting of the value of family businesses or investment partnerships and estate “freezing.” An estate “freezing” transaction involves a transfer of assets, usually to a trust for the benefit of family members, to “freeze” the value of the retained assets that will be includable in the client’s estate, thereby removing future appreciation from the estate. Estate freezing techniques, including grantor retained annuity trusts (“GRATs”), installment sales and intra-family loans, are particularly attractive when interest rates are low, as they are now.

***The short remaining life span of the increased exemption, along with the possibility that Congress will revive previously introduced legislation***

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<sup>2</sup> Many states, including Pennsylvania, no longer limit the duration of this type of trust.

<sup>3</sup> As we stated in last year’s newsletter, the new law has what seems to be an unintended technical glitch that may allow the IRS to argue that amounts transferred may be “clawed-back” into a client’s estate if and when the estate tax exemption is reduced below the current exclusion amount. If the IRS in fact takes that position (which is unlikely) 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 analysis, however, is that in almost all cases the gifts would still be advantageous even in this worst case scenario.

***attempting to limit discounts and estate freezing techniques, are reasons to come in sooner rather than later to plan to use the 2012 gift exemption, rather than to wait to see whether there may be new legislation later this year.***

### **Portability**

***If Congress decides to make it permanent***, “portability” will make it easier for a married couple to make sure that both spouses’ exemption amounts are effectively used. Introduced in the 2010 Legislation, but only for deaths occurring after December 31, 2010 and before January 1, 2013, portability of transfer tax exemption allows the exemption that remains unused at the death of a first-to-die spouse generally to be available to the surviving spouse for lifetime gifts or transfers at death, in addition to his or her own exemption, but only if certain requirements are met, including the filing of an estate tax return. Although at first blush portability may appear to make unnecessary trusts created solely to preserve the first-to-die spouse’s exemption (often referred to as “credit shelter trusts”), many reasons remain for continued use of such trusts, including that portability does not apply to the GST exemption of the first-to-die spouse. Because it is potentially very valuable, the portability election is something to be considered in the administration of the estate of any 2011 or 2012 decedent who has a surviving spouse. While there are also potential estate planning advantages, ***the one thing we know for certain about portability is that no one’s plan should rely on it unless and until it is made permanent.***

### **Review Tax-Driven Estate Plans**

Given the increased exemption amounts and the state of the economy, it may be appropriate to review tax-driven formulas and bequests based on the federal estate tax exemption or GST exemption amount. The exemptions have grown quite significantly since 2001, and it is possible that in light of the current exemptions, future uncertainties and the current value of your assets, documents not reviewed recently may no longer accurately reflect your estate planning goals.

For example, imagine Client A signed a Will when her assets were worth \$15 million and the GST exemption was \$1 million. With those numbers in mind, Client A’s Will provides a gift equal to her remaining GST-exemption amount (\$1,000,000) to her grandchildren, with the residue of her estate (\$14 million) left in trust for her husband during his lifetime, and then to her children. Client A passes away in 2012 after her estate has shrunk to \$5 million. Instead of the trust for her husband receiving \$14 million and her grandchildren receiving \$1 million, her entire estate passes in trust for her grandchildren. This may not have been what she intended when she signed her Will. With tax laws in a state of flux and the downturn in the overall economy, failing to review estate planning documents prepared years ago could yield unwanted results.

### **Income Tax Planning**

Under the 2010 Legislation, not only will transfer tax rates increase (and excluded or exempt transfer amounts be much smaller) in 2013, income tax rates also will increase. As a result, this year provides an opportunity for income tax planning. In particular, certain property, such as a retirement account, is taxable in an estate at its full value without taking into account the income

tax due upon distribution. This is one reason retirement accounts are a good choice for funding gifts to charities – both income and estate taxes are avoided as charities do not have to pay income tax and the account is not taxed in the estate. Another option for those who have sufficient funds outside their retirement accounts to pay the income tax at 2012 rates on the amount in an IRA (without compromising lifestyle) is to convert a regular IRA to a Roth IRA. A conversion under this scenario would allow the IRA account to grow income-tax free after conversion for enjoyment by children or more remote descendants. In most cases, all post-conversion income and growth can be sheltered from future income tax. If the account suffers post-conversion losses, the option to undo a conversion is open until the filing date of the individual income tax return for the year of conversion, including extensions. Deciding whether to convert requires a detailed analysis of assets, the income-tax effects and cash flow needs.

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The 2010 Legislation has provided valuable planning opportunities, with a closing 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.

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