Wealth Transfer Newsletter

CURRENT DEVELOPMENTS: PLANNING OPPORTUNITIES AND UPDATES
Wealth Transfer Team
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In this issue:

- Another Reason to Consider Roth IRA Conversion
- Nothing is Certain Except Death and Taxes . . . Including the Death Tax?
- Timely Opportunities - Gifts and GRATs

Greetings:

The beauty of Spring in the Carolinas is all around us – the blooming azaleas, lush green lawns (and fairways), and warm days and mild evenings – and we welcome it after such a long and cold winter. With the change in the weather and season, we also note a number of significant legislative changes that impact all of us. Congress has passed and President Obama has signed an historic law reforming the Nation's health care system. For many the impact may be minimal, but for a significant number of Americans this legislation will provide benefits to which they have not previously had access to – although not without a substantial tax cost that will be borne by many.

Additionally, and most significantly for our clients, Congress has failed to pass any of the numerous proposed Acts that would have extended the 2009 federal estate, gift and generation skipping transfer tax laws into 2010 (and beyond). Therefore, as we have already advised many of you, at the time of publication of this Newsletter there is neither a Federal nor a North Carolina estate tax. While it is impossible to predict what Congress and the President will do to address this situation, we will outline for you the current state of the law in these areas, what the law will be as of January 1, 2011 if no new law is passed and what the pending proposed Acts that could be signed into law prior to December 31st provide.

Finally, we review a number of planning opportunities that we have addressed previously and that continue to be attractive options for your consideration, particularly considering the current economic and legislative environment.

We hope that you have the opportunity to enjoy the Spring with your families and friends.

Please do not hesitate to contact the members of our team with any questions regarding these important matters.

Neill G. McBryde

Another Reason to Consider Roth IRA Conversion

We have previously advised you of the ability to convert a traditional IRA to a Roth IRA and the expansion of the eligibility rules for such conversions effective January 1, 2010. One of the benefits that has been touted in converting a traditional IRA to a Roth IRA is that a taxpayer can "diversify" their IRA assets by providing the opportunity to take distributions from a Roth IRA, which are not subject to income tax, in order to minimize income taxes in a given tax year. If you believe that income tax rates will be higher in the years in which you will be required to take distributions from your IRA, the conversion of a portion - or all - of your eligible traditional IRA assets to a Roth IRA should yield an income tax benefit. Now consider that Congress has passed, and President Obama has signed into law, a tax increase that will become effective in the year 2013. The Health Care Reform Act contains a 3.8% surtax that is effective as of January 1, 2013.

The surtax is imposed on the lesser of a taxpayer's net investment income and the excess of a taxpayer's modified adjusted gross income (MAGI) over the threshold amount. While IRA distributions are not included in net investment income, distributions from traditional (but not Roth) IRA's are included in modified adjusted gross income. The threshold amount is $200,000 for a single taxpayer and $250,000 for married taxpayers. While this may seem like a fairly complex formula, with technical definitions, rates and "threshold" amounts, the application of the surtax is fairly straightforward. For example, assume that in 2014, Mary, a single taxpayer over the age of 70 , has net investment income (which does not include distributions from her IRA) of $100,000 and receives a distribution from her IRA of $200,000. The application of the surtax is as follows if the distribution is from a traditional versus a Roth IRA:

If the IRA is a traditional account, the $200,000 distribution is included in Mary's modified adjusted gross income so that her MAGI is $300,000, exceeding the threshold amount (of $200,000) by $100,000. However, if Mary's IRA is a Roth IRA, the distribution is not included in Mary's MAGI and she will not be subject to the surtax.

In addition to the surtax, the current income tax rates also are set to expire at the end of the current year and the highest marginal tax rate is scheduled to return to 39.6%, unless Congress and the President act to retain the current tax rates. At a minimum, taxpayers with significant distributions from their retirement accounts can expect as of 2013 to be subject to the 3.8% surtax, which may make incurring the income tax cost of converting a traditional IRA to a Roth IRA worth considering. The members of our team are available to discuss these matters with you and are able to assist you in weighing these costs and benefits.

NOTHING IS CERTAIN EXCEPT DEATH AND TAXES . . . INCLUDING THE DEATH TAX?

This famous quote has many estate planners befuddled given the repeal of the Federal estate and generation skipping transfer (GST) taxes, as well as the North Carolina estate tax, effective as of January 1, 2010. While the repeal has been on the horizon since the passage of Economic Growth and Tax Relief Reconciliation Act in

2001 (the "2001 Act"), it was almost universally assumed that Congress would not allow for a repeal of the taxes to be followed by a return of the same at 2001 rates and exemption amounts (maximum 55% tax rate and $1 million exemption per person), which return occurs as a result of the sunset provision contained in the 2001 Act. In fact, no fewer than five Bills were introduced in 2009 that would have eliminated the repeal and retained the taxes and exemptions at 2009 rates and levels (maximum 45% tax rate and $3.5 million exemption per person) or even more taxpayer-friendly.

However, Congress was unable to agree on the various proposed Bills and with all attention on health care reform, 2009 passed without enactment of any legislation. The Bills introduced during 2009 remain pending and Congress has the ability, as upheld in prior Supreme Court cases, to enact retroactive tax law. While some Senate leaders have announced an intention to pass legislation to re-establish the Federal estate and GST taxes retroactive to January 1, 2010, given that more than 4 months now have passed since the beginning of the year, legislation that would retroactively impose taxes seems unlikely.

Following is a summary of the current laws in regard to estate, gift and GST taxes, as well as the most recently proposed Bills that would reinstate the estate and GST taxes.

ESTATE, GIFT AND GST TAXES AS OF JANUARY 1, 2010

• Repeal of Estate and GST Tax in 2010. Pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act"), the estate and GST taxes have been repealed for 2010. However, also under the 2001 Act, the estate and GST taxes are repealed only for 2010 and both taxes will return as of January 1, 2011 at the 2001 tax rates and exemption amounts (maximum 55% tax rate and $1,000,000 exemption per person).

• Carryover Basis Rules in 2010. Since the estate tax is repealed in 2010, the income tax basis rules applicable to persons dying in 2010 will be changed to be similar to the gift tax rules (e.g., property transferred at death will receive a carryover basis instead of a stepped-up basis), but with some opportunities for heirs to increase the basis in inherited assets. For example, it will be possible to increase the basis of inherited assets in 2010 by $1.3 million and by an additional $3 million for assets inherited by a spouse. The previous stepped-up basis rules meant that the new income tax basis in inherited property was the fair market value at the time of the death of the decedent.

• Gift Tax Rules in 2010. The gift tax is not repealed in 2010. Instead, the top gift tax rate is lowered to 35% from 45%. The gift tax exemption remains at $1 million per person. In 2011, the gift tax rates will be unified with the estate tax rates and the top rate would rise to 55%, while the $1 million exemption will remain the same.

PROPOSED LEGISLATION

In prior editions of this Newsletter, we have updated you on the details of the various Bills introduced that addressed the repeal of the estate and GST taxes. While none of the various Bills advanced past committee, they all retain the estate and GST tax structure and provide for an exemption between $3.5 and $5 million and a maximum tax rate up to 55%. The relative consistency among these Bills does seem to indicate a general

Congressional consensus. Further, in the late fall of 2009, Republican and Democratic members of the Ways and Means Committee introduced legislation, H.R. 3905, which would have increased the estate tax exemption and decreased the maximum estate tax rate annually through 2019 when the exemption would be $5 million and the maximum rate 35%. While this Bill has not been advanced on either floor of congress, most think that it is an indication of joint party support for a higher exemption and lower tax rate. However, the Administration's position on estate tax continues to be in support of an exemption amount of $3.5 million and rate of 45% (in other words, 2009 rates and exemption amounts). While it is impossible to predict what action Congress will take this year with regard to the estate and GST taxes, most planners continue to believe that legislation will be passed that will prevent the return of 2001 tax rates and exemptions amounts in 2011 in as much as it is an election year and the Administration supports a reinstatement of the 2009 rates and exemption amount. Of course, we will keep you updated on any proposed legislation in this regard.

WHAT DOES ALL OF THIS MEAN FOR YOU?

While each client's estate plan is unique, there are certain actions that may be undertaken to protect the desired dispositive scheme and potentially take advantage of the repeal in the period before Congress takes action, assuming any Congressional action is not retroactive. Without action, if the estate tax remains repealed for 2010, death in this year could result in a disposition of assets in a manner not intended due to the formulaic nature of most estate plans. Additionally, if an estate plan calls for an outright distribution to a surviving spouse, there may be adverse consequences if the estate plan is not modified to take into account the repealed estate tax and the estate tax is later reinstated. While many states, including North Carolina, are considering legislation that would provide for an interpretation of the funding language of estate planning documents executed prior to January 1st, such legislation may not accurately reflect the testator's intentions. Therefore, we recommend that you discuss these matters with a member of our team to ensure that your documents are in proper order.

TIMELY OPPORTUNITIES - GIFTS AND GRATS

While many may consider lifetime transfers – more commonly referred to as gifts – unattractive under the current status of the estate tax law, given the scheduled return of the estate tax in less than 8 months, it may be wise to consider some of the advantages currently applicable to gifts, which advantages may expire with the repeal of the estate tax.

CURRENT FAVORABLE GIFT TAX RATE

First, under prior law, the tax rates for both transfers at death and during life are unified. In other words, the maximum estate tax rate (45% in 2009 and scheduled to be 55% in 2011) is also applicable to taxable gifts made during life. Next, the gift tax exemption amount has been set at $1 million, which, if used through lifetime transfers, reduces the amount of the transferor's available estate tax exemption. Thus, to the extent that taxable gifts are made during life in excess of $1 million, a gift tax will be payable at the maximum rate and the transferor's available estate tax exemption will be reduced by $1 million. Because of the repeal of the estate tax, it may seem counterproductive to make a taxable gift in the current year, incurring the imposition of a gift tax, when a transfer of the same asset at death may not result in an estate tax liability. This conclusion is

accurate, if you assume that the estate tax will remain repealed and/or that the transferor will not otherwise be subject to the estate tax (such as by application of a higher estate tax exemption amount). However, with regard to persons with estates in excess of the estate tax exemption amount (again, scheduled to return to $1 million in 2011 and if proposed legislation is enacted, may be as high as $3.5 or $5 million), then taxable gifts can provide a greater benefit to the ultimate recipients of the transferred property and particularly in the current year when the maximum gift tax rate is at an historically low rate of 35%.

Most estate planners advocate for their clients to make taxable gifts during life, as the gift tax is tax exclusive, whereas the estate tax is tax inclusive. To demonstrate, assume that a client has $10 million of property, the gift tax exemption is $1 million, the estate tax exemption is $3.5 million and the maximum estate and gift tax rate is 50%. Assume the client is considering making a taxable gift of $3 million of property during his life, the aggregate estate and gift tax paid and the net value received by his heirs if he makes the gift versus not is as follows:

Now take this same example and assume that the gift tax rate is currently 35%, but that any future transfers will be subject to tax at a rate of 55%. The net potential transfer tax savings in the above example increases to $300,000. Thus, for those taxpayers who likely will have a taxable estate, making current transfers and incurring gift tax at the current rate of 35% may be a strategy to consider.

GRATS

As we have previously highlighted, use of a Grantor Retained Annuity Trust (“GRAT”) currently can efficiently – from a gift tax perspective – transfer wealth to the next generation. Specifically, under the terms of a GRAT, the grantor retains the right to receive an annuity for a fixed term of years, following which the remainder will pass to specified successor beneficiaries. Under current law, a GRAT may be structured such that at the time of funding the value of the remainder interest, which is a taxable gift, is zero (or an amount less than $1). Additionally, there are no requirements regarding the length of the annuity term such that it may be 2 years, which term increases the likelihood that the grantor will survive the annuity term and thus increases the likelihood that the gift strategy will be successful. However, as we advised, there has been considerable speculation that applicable law may require GRATs to have a minimum annuity term and/or require that the remainder gift have a minimum value. On March 24th, the House of Representatives passed H.R. 4849, The Small Business and Infrastructure Jobs Tax Act of 2010 (the “2010 Jobs Tax Act”), which contains a number of “revenue raising” provisions, including a modification to the provisions of the Internal Revenue Code governing GRATs.

Under the 2010 Jobs Tax Act, a GRAT will be required to have a minimum term of 10 years and the value of the remainder interest must be “greater than zero.” Additionally, this legislation, if enacted, would prevent the annuity payments from being structured in such a way that the initial payments exceed the payments in subsequent years, which payment structure often is used when a realization event is anticipated with regard to the assets transferred to the GRAT. Thus, the 2010 Jobs Tax Act contains a number of provisions that would severely curtail the potential effectiveness of GRATs in future planning. Therefore, we encourage those of you considering a GRAT transaction to contact a member of our team to further discuss the potential current implementation of this planning option.