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A report for clients and friends of the firm.

The $3.5 million Question – What is the Future of the Federal Estate, GST and Gift Taxes? **1**

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With over a century of combined experience the lawyers in Proskauer's Personal Planning Department regularly provide their diverse clientele, from business entrepreneurs and corporate executives to sports figures and performing artists, with their Personal Planning Strategies Newsletter, a critical source of information which identifies significant issues of interest to Proskauer's clients. The Personal Planning Strategies Newsletter provides articles addressing the latest statutory changes and developments affecting retirement, estate, insurance and tax planning as well as cutting-edge corporate, real estate and tax concepts.

The $3.5 million Question – What is the Future of the Federal Estate, GST and Gift Taxes?

In 2009, the federal estate tax exemption is $3.5 million. Under current law, the federal estate tax is scheduled to be repealed in 2010 for one year. Accordingly, if current law remains unchanged, there will be no federal estate tax in 2010, and in 2011, the federal estate tax is scheduled to return with only a $1 million federal estate tax exemption.

As we go to press, Congress is still working on passing legislation which would permanently extend the 2009 federal estate tax exemption levels and rates. On December 3, 2009, the House approved the Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Bill of 2009 (HR 4154) which would make permanent the current $3.5 million federal estate exemption and the current 45% top estate tax rate. However, we must now wait to see what happens (if anything) to this legislation in the Senate.

Assuming Congress acts and the federal estate exemption remains at $3.5 million in 2010, if an individual dies in 2010, he or she can transfer up to $3.5 million (less taxable gifts made during his or her life) without paying any federal estate tax.

Married couples should structure their estate plans so that both spouses utilize their exemptions, thereby shielding up to a total of $7 million from federal estate tax. For example, as discussed below, by using a "bypass trust" and properly dividing their assets, both spouses can utilize their federal estate tax exemptions. A "bypass trust" is

drafted in a manner that allows assets to "bypass" the federal estate tax that otherwise would be imposed when the second spouse dies.

Without proper estate planning, a spouse may waste his or her federal estate tax exemption. For example, suppose John and his wife, Jill, live in Florida and have a total of $7 million (each has $3.5 million of assets in his or her own name). Assume John dies and leaves $3.5 million to Jill under his Will (or his revocable trust). John's estate does not have to pay any federal estate tax because the assets that pass to Jill qualify for the unlimited marital deduction. When Jill dies, her estate will be worth $7 million ($3.5 million from John's estate plus her own $3.5 million). Jill's estate can utilize her $3.5 million exemption, but John's $3.5 million exemption will have been wasted. Accordingly, Jill's estate would be subject to federal estate tax of $1,575,000.

With proper estate planning, both spouses can utilize their federal estate tax exemptions. For example, John's Will (or his revocable trust) could direct that $3.5 million be held in a "bypass trust" for the benefit of Jill, and on Jill's death, the remaining assets would pass to their children. Under this example, John's estate could utilize his federal estate tax exemption by funding the "bypass trust" with $3.5 million and Jill's estate could utilize her exemption upon her death. Under this plan, John and Jill could pass $7 million to their children free of any federal estate tax, resulting in tax savings of $1,575,000. In addition, any appreciation on the assets in the bypass trust after Jill's death would also not be subject to estate tax.

Having a Will (or revocable trust) that includes a bypass trust is only the first step. To ensure that the bypass trust can be funded, there are two important considerations. First, each spouse should own sufficient assets in his or her individual name to fund the bypass trust. This means that assuming there will be a $3.5 million federal estate tax exemption in 2010, in order to fully fund the bypass trust, each spouse should have at least $3.5 million of assets in his or her individual name. Second, it is important to identify which assets pass under the Will (or revocable trust) and which assets pass outside of the Will (or revocable trust). For example, certain assets, such as Individual Retirement Accounts, typically pass outside of the Will (or revocable trust) by beneficiary designation and in that event, would not be available to fund the bypass trust. Careful estate planning is required to ensure that such assets are available to fund the bypass trust if necessary.

Will there be a Generation Skipping Transfer Tax in 2010?

Like the federal estate tax exemption, the federal Generation Skipping Transfer ("GST") tax exemption is $3.5 million in 2009. Under current law, the GST Tax is scheduled to be repealed in 2010 for one year. Accordingly, if current law remains unchanged, there will be no GST tax in 2010, and in 2011, the GST tax is scheduled to return with only a $1 million exemption (indexed for inflation).

The House Bill (HR 4154), discussed above, would make permanent the current $3.5 million GST tax exemption and the current 45% top GST tax rate.

Generally speaking, the GST tax applies when a person transfers property to someone who is at least two generations younger than the transferor (or to a trust which eventually

benefits such individual). The GST tax is designed to tax the transfer of property which effectively "skips" one or more intervening generations.

For example, if a grandparent makes a gift to a grandchild (or to a trust for children which ultimately will be distributed to grandchildren), that gift would be subject to the GST tax since the gift "skips" a generation. Assuming Congress acts and the GST exemption remains at $3.5 million in 2010, a grandparent can make gifts or bequests of up to $3.5 million, in the aggregate, to his or her grandchildren (or trusts for their benefit) free of GST tax. Note that such a gift would still be subject to gift tax to the extent the donor has already used his or her $1 million gift tax exemption (as discussed below).

Gifts

The federal lifetime gift tax exemption remains at $1 million in 2010 and is not scheduled to be repealed. This means that an individual may make gifts (in excess of the annual gift tax exclusion amounts and direct payments of education and medical expenses to the providers) of up to $1 million, in the aggregate, during his or her life before having to pay any gift tax. In 2010, the top gift tax rate drops to 35% (the top marginal income tax rate). In 2011, the gift tax rates revert to pre-2001 levels. If Congress retroactively passes estate tax legislation in 2010, there is a risk that they will also retroactively raise the gift tax rate.

The gift tax annual exclusion remains at $13,000 ($26,000 in the case of a married couple) in 2010.

For gifts made to a spouse who is not a citizen of the United States, the gift tax annual exclusion increases from $133,000 in 2009 to $134,000 in 2010 (unlimited gifts are allowed between spouses when both are U.S. citizens).

Annual exclusion gifts should always be made early in the year. If an individual dies during the year without making his or her annual exclusion gifts, the opportunity is lost. For every $13,000 gifted, almost $6,000 of federal estate tax could be saved. Moreover, making a gift early in the year of property that is likely to increase in value will remove the appreciation from your estate, thus avoiding gift tax on any post-gift appreciation.

Other Estate and Gift Tax Legislation

We continue to monitor a proposal that would effectively disallow valuation discounts of closely-held interests such as family limited partnerships. Under current law, minority interest and lack of marketability discounts typically reduce the fair market value of assets involved in intra-family transactions by 30%. The IRS previously has expressed its desire to change the law to eliminate or reduce such discounts and there is renewed concern that the proposed change in the law may take effect thereby eliminating or reducing such discounts.

State Estate Taxes

In 2010, certain states, including California and Florida, continue not to impose a state estate tax. Other states, including Connecticut, New York, Massachusetts and New Jersey continue to impose a state estate tax. If the federal estate tax remains the same

in 2010 as 2009, the combined top federal and New York estate tax rate will remain at 53.80%.

Effective January 1, 2010, Connecticut will raise its estate tax exemption from $2 million to $3.5 million and will lower its state estate tax rates. Connecticut's top estate tax rate will decrease from 16% in 2009 to 12% in 2010.

	Top State Estate Tax Rate	Maximum Federal Exemption for 2010 Allowable by States
California	0%	N/A
Connecticut	12%	$3,500,000
Florida	0%	N/A
Massachusetts	16%	$ 1,000,000
New Jersey	16%	$ 675,000
New York	16%	$ 1,000,000

As illustrated in the following charts, the estate of a decedent dying in 2010 with a $3.5 million estate would pay no state estate tax if the decedent were a resident of California, Connecticut or Florida.

Year of Death	Value of Gross Estate	California/Connecticut/Florida Estate Tax
2010	$3,500,000	$0

However, if the decedent were a resident of Massachusetts, New York or New Jersey, his or her estate would have to pay a $229,200 state estate tax since those states do not conform to the federal changes. Therefore, whether or not a state follows the federal estate tax changes introduced by the Act can affect the total amount of estate taxes due.

Year of Death	Value of Gross Estate	Massachusetts Estate Tax	New York Estate Tax	New Jersey Estate Tax
2010	$3,500,000	$229,200	$229,200	$229,200

The amount of state estate taxes due becomes substantial in large estates. In 2010, the estate of a decedent with a taxable estate of $15 million will pay state estate taxes totaling $1,866,800 if the decedent were domiciled in Massachusetts, New Jersey or New York as opposed to no state estate tax if the decedent were domiciled in California or Florida.

Accordingly, individuals who are domiciled in a state which imposes a state estate tax (such as Connecticut, Massachusetts, New Jersey and New York) and who own a second residence in another state which does not impose a state estate tax (such as California and Florida) should consider establishing their primary residence in the state which does not impose a state estate tax.

How Can You Avoid Death Taxes In A State Where You Are Not Domiciled?

If the determination is made that there will be death taxes owed to a state where real or tangible personal property is owned (*i.e.*, a state other than the state in which you reside), there are steps that can be taken to eliminate tax in such state.

Since only real or tangible personal property (*i.e.*, residences, furnishings, boats, etc.) is subject to death taxes in the state where the property is located, converting those assets into intangible assets may avoid the state death taxes in those states. Therefore, you should consider transferring out-of-state assets to a partnership, limited liability company (LLC) or corporation and retaining an interest in the entity as a partner, member or shareholder, respectively. For example, if you are a Florida resident who owns a second home in New York, you can transfer your New York home to an LLC and retain ownership of that new LLC. Upon your death, your estate only owns an interest in an LLC, which is an intangible asset, and thus should not be subject to New York estate tax.

It is important that a transfer to an LLC is not deemed a nominee or sham that could be disregarded. For example, the New York State Department of Taxation and Finance published an Advisory Opinion last year which raised the question of whether a nonresident decedent's interest in either an S corporation or a single member LLC owning real property in New York is subject to New York State estate tax. According to the Advisory Opinion, if a nonresident of New York owns an interest in an S Corporation (or a single member LLC that elects to be treated as a corporation for Federal income tax purposes) that owns real property or tangible personal property, unless there is a business purpose, the interest in the entity will be included in the nonresident decedent's estate and, therefore, will be subject to New York estate tax.

Additionally, New York State recently amended the definition of New York source income of a nonresident to include certain gains or losses from a nonresident's sale or exchange of an interest in an entity that owns real property in New York State. The covered entities are partnerships, LLCs, S corporations and non-publicly traded C corporations with 100 or fewer shareholders. The amendment applies to a sale or exchange of an interest in an entity that occurs on or after May 7, 2009. Some or all of the gain or loss from a nonresident's sale or exchange of an interest in one of these entities will be considered to be derived from New York sources if the entity owns real property in New York State that has a fair market value that equals or exceeds 50% of the fair market value of the assets that the entity has owned for at least two years as of the date of the sale or exchange. If the entity owns real property in New York and all its assets have been owned for less then two years as of the date of the sale or exchange, then the 50% test is met.

Accordingly, you should make sure to consult a qualified attorney in the jurisdiction in which the property is located before making any transfers.

Another option is to gift the real or tangible property during life to the ultimate recipient. If the property continues to be used by the donor, he or she should enter into an arms-length rental agreement with the donee with respect to the gifted property.

If you have questions pertaining to a particular state's income or death tax regime and how ownership of property in such state may affect your estate plan and potential income and death taxes, please do not hesitate to contact us.

Is Your Life Insurance Policy Healthy?

The dramatic downturn in the stock market from the highs of a few years ago and the decline in interest rates that has been ongoing for years undoubtedly causes many of you to wince when reviewing your monthly portfolio statements. While certainly unwelcome news, the losses and lack of interest shown on your statements is an obvious result of personal finances being subject to market conditions. A much less apparent and potentially more menacing effect of the current economic environment, however, is its impact on life insurance planning (most notably, with universal and variable life policies). As a result, if you have not recently reviewed the health of the insurance on your life, or on the life of someone else that is held in a trust of which you are acting as a trustee, you are not only subjecting yourself and/or your intended beneficiaries to unexpected costs, but also may be exposing yourself to fiduciary liability.

While you should review every type of insurance on your life (whether it be term or permanent) to monitor carrier and policy suitability, certain types of policies require more oversight. In particular, it is important to examine regularly any permanent cash-value policy of which you are the insured or trustee, to ensure that it is functioning as originally anticipated.

Upon the acquisition of the policy insuring your life, you should have received a lengthy print-out of projections known as illustrations. In general, these illustrations would have summarized, among other matters, the policy premiums that are expected to be due and the death benefit that is intended to be paid under the policy. The information presented, however, would have been based on any number of assumptions that no longer may hold true. Consider, for example, that many years ago when interest rates and investment returns were much higher than today, universal and variable life insurance policies were being sold with assumed rates of interest and projected investment returns as high as 15% and 12%, respectively.

As you well know, such assumptions are wishful thinking in the current market and hopefully are not being used to illustrate a new policy. However, if an insurance policy was issued on your life in the past, when interest rates and assumed rates of return were high, it may have been illustrated in this manner. As a result, the policy may no longer be earning the returns it needs to pay premiums. The shortfall may result in unintended costs to you and/or your beneficiaries. For example, assume the following:

A universal life policy was issued with a large, well-rated carrier on December 14, 2001, with a death benefit of $1,750,000. The annual premium of $27,556, with an assumed interest rate of 6.35%, projected a death benefit of $1,750,000 at the insured's age of

100. In projections run on November 15, 2009, based on a current assumed interest rate of 4.15%, the policy will lapse at the insured's age of 86. At this point, to keep the policy in force until age 100, the annual premium would need to be increased immediately to $54,019 - an increase of 96%. If the insured did nothing until age 86 (the projected age at which the policy would lapse), to keep the policy in force until age 100, the insured's annual premium would need to be increased to $116,100 per year - an increase of over 321% from the original promised annual premium.

Given the foregoing, do not assume that insurance on your life is paid up or is on automatic pilot so that you will not owe anything more out of pocket. To do so may cause the policy to implode leaving your beneficiaries without the death benefit you had intended them to receive. A regular review of the policy will give you an advanced warning of whether it is headed for trouble and allow you to take the appropriate action.

If you are acting as a trustee of an irrevocable trust that holds insurance on someone else's life (an "ILIT"), you should also regularly examine that insurance. In most states, it is now clear that a trustee of an ILIT has the same fiduciary responsibilities as a trustee of a trust holding other assets. Accordingly, if acting as a trustee of an ILIT, you have a duty to manage the life insurance policy owned by the trust to ensure that the maximum benefit inures to the trust beneficiaries.

A recent case illustrates the claims dissatisfied trust beneficiaries may make. In In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Ind. Ct. App. Mar. 2, 2009), the beneficiaries of an insurance trust sued the trustee for breach of trust for exchanging existing policies the trust held for certain other policies.

In this case, KeyBank was a Trustee of a trust that owned insurance policies with a collective death benefit of just under $5 million. At the recommendation of the insured's insurance advisor, KeyBank exchanged the policies for variable universal life ("VUL") policies having a total death benefit of $8 million. Due to market losses in 2001 and 2002, KeyBank retained an independent insurance consultant to review the VUL polices in 2003. The audit of the policies indicated that they would lapse before the insured reached his life expectancy. It was then decided, based on the eventual recommendation of the insured's insurance advisor and the independent insurance consultant, that the VUL policies should be replaced with a policy having a face amount of just under $3 million guaranteed to age 100. Soon after the purchase of the new policy, the insured died unexpectedly. The trust beneficiaries sued KeyBank for breach of fiduciary duty.

The trial court held in favor of KeyBank. It focused on the prudence of replacing the old policies in general rather than the prudence of choosing the new policy specifically and determined that the change in policies was prudent. The appellate court agreed. Instrumental in this determination, however, was the fact that KeyBank relied on guidance from an outside, independent entity with no financial stake in the exchange to review the policies and the recommendations of the insured's advisor. While the trustee prevailed in the case, the appellate court noted that "the cautious trustee will recognize that the actions of KeyBank were considered by the court to be less than ideal" and that "this case could have easily gone the other way on the issue of prudent process."

Recognizing the potential for serious trustee liability with respect to ILITs, a few states have passed legislation that reduces the trustee's fiduciary responsibility for life insurance as an investment. For example, in Florida, a trustee is permitted, after written notice to the beneficiaries, to delegate investment management of life insurance to others, including the grantor or the trust beneficiary. Assuming all requirements of Florida law are satisfied, the trustee should not be responsible for the investment decisions or actions or omissions of the selected agent. This delegation authority could be a very powerful tool to remove liability from the trustee while imposing a fiduciary duty on the agent (assuming the agent agrees to accepts the delegation).

Not all states, however, have enacted such protective statutes. Accordingly, in those states, it is crucial that a trustee of an ILIT have some documented review process when managing the insurance held in trust and the help of an appropriate expert to make sure the process is effective.

Whether on behalf of you and your family or in your capacity as a trustee of an ILIT, a review of an insurance portfolio should be a frequent and regular habit, especially in light of the challenging markets we now face. In-force policy illustrations can inform you of both the size of any needed premium adjustment as a result of interest rates that have declined or investment performance that has not met expectations and the consequences of failing to make such adjustments.

Year-End Planning Strategies

As you look back upon this year–and forward to the next one–you will most likely experience some degree of anxiety. You could not control the forces that led to the financial crisis, and it is difficult to determine whether a lasting recovery is at hand. However, even in these uncertain times, there are year-end planning strategies you can employ to take charge of your family's future.

Take Advantage of Low Interest Rates and Valuation Discounts

The current combination of depressed asset values and low interest rates makes this a perfect time to implement wealth transfer strategies that are designed to exploit future appreciation. Several techniques rely on investment returns that outpace the interest rates set by the Internal Revenue Service. Therefore, you should discuss with us, now, how intra-family loans, sales to intentionally defective grantor trusts, grantor retained annuity trusts and charitable lead annuity trusts can enable you to pass assets to the next generations at the lowest possible transfer tax cost (please see the June 2008 issue of Personal Planning Strategies, available on our website, for more details about those estate planning strategies).

Moreover, there exists some concern that Congress, with the support of the White House, could pass legislation that would effectively eliminate valuation discounts of closely-held interests such as family limited partnerships. Currently, the appraisals required as evidence of the fair market value of assets involved in intra-family transactions can take into account minority interest and lack of marketability valuation discounts. Typically, those discounts reduce the asset value by 30%. Under current

proposals, these discounts would no longer be permissible, and the purchase price or gift tax cost of intra-family transactions would therefore be increased by that 30%.

There is no certainty that the law will change, but if you have been considering a plan to give or sell interests in a closely-held business or family limited partnership to your family members, this may be the most favorable time to move forward.

Exploit the Gift Tax Annual Exclusion Amount

In 2010, the gift tax annual exclusion amount per donee will remain the same at $13,000 for gifts made by an individual and $26,000 for gifts made by a married couple who agree to "split" their gifts. If you have not already done so, now is the time to take advantage of your remaining 2009 gift tax exclusion amount, so that you can ensure that gifts are "completed" before December 31, 2009.

In lieu of cash gifts, consider gifting securities or interests in privately held companies or other family-owned entities. The assets that you give away now are likely worth significantly less than they once were (due to the economic crisis), and their value will hopefully increase in the future. So the $26,000 gift that you and your spouse make today has a built-in discount that the Internal Revenue Service cannot reasonably question, which will inure to the benefit of your beneficiaries when the economy fully recovers.

Your annual exclusion gifts may be made directly to your beneficiaries or to trusts that you establish for their benefit. It is important to note, however, that gifts to trusts will not qualify for the gift tax annual exclusion unless the beneficiaries have certain limited rights to the gifted assets (commonly known as "Crummey" withdrawal powers). If you have created a trust that contains beneficiary withdrawal powers, it is essential that your Trustees send Crummey letters to the beneficiaries whenever you (or anyone else) make a trust contribution. For a more detailed explanation of Crummey withdrawal powers, please see the December 2004 issue of Personal Planning Strategies, available on our website.

If you have created an insurance trust, remember that any amounts contributed to the trust to pay insurance premiums are considered additions to the trust. As a result, the Trustees should send Crummey letters to the beneficiaries to notify them of their withdrawal rights over these contributions. Without these letters, transfers to the trust will not qualify for the gift tax annual exclusion.

2009 Gift Tax Returns

Gift tax returns for gifts that you made in 2009 are due on April 15, 2010. You can extend the due date to October 15, 2010 on a timely filed request for an automatic extension of time to file your 2009 income tax return, which also extends the time to file your gift tax return. If you created a trust in 2009, you should direct your accountant to elect to have your generation-skipping transfer ("GST") tax exemption either allocated or not allocated, as the case may be, to contributions to that trust. It is critical that you not overlook this step, which must be taken even if your gifts do not exceed the annual gift tax exclusion

and would, therefore, not otherwise require the filing of a gift tax return. You should call one of our attorneys if you have any questions about your GST tax exemption allocation.

Start Taking Your IRA Required Minimum Distributions Again in 2010

In response to the economic crisis–and the attendant loss of value in most IRAs–Congress gave IRA owners the option of suspending their required minimum distributions ("RMDs") for 2009. However, this one-time dispensation expires at the end of the year, and RMDs will again be obligatory in 2010.

If you are the owner of a traditional IRA, you must begin to receive required minimum distributions from your IRA and, subject to narrow exceptions, other retirement plans, by April 1 of the year after you turn 70 ½. You must receive those distributions by December 31 of each year. If you are the current beneficiary of an inherited IRA, you must take RMDs by December 31 of each year regardless of your age. The RMDs must be separately calculated for each retirement account that you own, and you, not the financial institution at which your account is held, are ultimately responsible for making the correct calculations. The penalty for not withdrawing your RMD by December 31 of each year is an additional 50% tax on the amount that should have been withdrawn. Please consult us if you need assistance with your RMDs.

Convert Your Traditional IRA to a Roth IRA in 2010

Currently, an individual with adjusted gross income of $100,000 or more is precluded from converting a traditional IRA (which is funded with pre-tax dollars) to a Roth IRA (which is funded with post-tax dollars). Beginning in 2010, this income restriction for conversions is eliminated (although other income restrictions remain in effect for *contributions* to a Roth IRA), creating an excellent opportunity to accumulate tax-free income for your descendants.

In addition, for conversions that occur in 2010, Congress has provided a special deferral arrangement whereby you can opt to have half of the converted amount taxed in 2011 and the other half taxed in 2012. *This tax deferral benefit applies to 2010 only*.

Although income tax will be due on any converted assets, a conversion may still be advantageous, since assets in a Roth IRA grow tax-free and are not subject to required minimum distributions during your lifetime. This allows a Roth IRA to act as a "tax shelter" to hold wealth for your descendants, particularly if you will not need to withdraw income from your Roth IRA during your retirement. More information on the benefits of a conversion to a Roth IRA may be found in the June 2009 issue of Personal Planning Strategies, available on our website.

Review Your Current Estate Plan

The transfer tax regime is currently in flux due to statutory sunset provisions that mandate a one-year repeal of the estate tax in 2010, followed by a return of the tax in 2011 at a $1,000,000 exemption amount. However, it is anticipated that Congress will pass legislation by the end of the year that will, instead, maintain the current $3,500,000 estate and GST tax exemptions into 2010. Given the uncertain future of the transfer tax

regime, it is vital to review your wills, revocable trusts and other documents to ensure that they will be successful in achieving your estate planning goals.

For instance, do your estate planning documents account for the differences between Federal and state laws? If you reside in a state such as New York, which imposes a tax based on a significantly lower exemption amount than that afforded under the Federal regime, and you do not have a will that adequately plans for that difference, your estate could unnecessarily owe $229,200 in state estate taxes.

Another consideration is how your existing estate plan utilizes your Federal estate tax exemption amount. For instance, an estate plan drafted in 2002 that bequeaths to your children an amount equal to the Federal exemption amount (which was then only $1,000,000) may no longer make sense if the exemption amount remain as high as $3,500,000.

Even if you remain satisfied with the provisions in your current estate planning documents, do you and your spouse each hold individual title to sufficient assets to utilize your $3,500,000 exemption amounts? If not, any plan to pass to your heirs, tax-free, your combined exemption amounts – likely $7,000,000 – may fall short of your expectations.

If you have not recently updated your estate plan or considered the strategies discussed in this article, we encourage you to call us.

The Personal Planning Department at Proskauer Rose LLP is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

If you have any questions regarding the matters discussed in this Newsletter, please contact any of the lawyers listed below:

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