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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.

Now is the Time to Take Advantage of Changes to the Federal Gift and Generation-Skipping Transfer Taxes in 2010

Two changes to the Federal wealth transfer system that were enacted pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”) during President Bush's first year in office create, at least in the absence of retroactive legislation, a favorable environment in 2010 for gift planning. As further discussed below, with less than three months left in 2010, the window is shortening to implement a couple of "once in a lifetime" gifting opportunities.

First, under the 2001 Act, the Federal gift tax rate was reduced to 35% for gifts made in 2010 (as compared to the 45% gift tax rate applicable in 2009 for most gifts). The lifetime exemption from the gift tax is unchanged and remains at $1 million for 2010. Second, the 2001 Act repealed the generation-skipping transfer (“GST”) tax for 2010. The GST tax is a transfer tax in addition to the estate and gift tax that is imposed on transfers by a donor to an individual who is more than one generation younger than the donor (*i.e.*, a grandchild) or who is unrelated to the donor and more than 37 ½ years younger than the donor. The GST tax is designed to prevent families from avoiding the estate tax by “skipping” generations and making gifts directly to grandchildren.

The 2001 Act sunsets at the end of this year and will be treated as never having been enacted; at that point, the Federal wealth transfer tax system as it existed in 2001 will be reinstated. As a consequence, in 2011, the highest gift and estate tax rate will return to 55% and the GST tax will return at a 55% rate unless further changes are made by Congress.

Legislative Activity and Potential Retroactive Application of Gift and GST Taxes

It is unclear what actions, if any, Congress will take in the remaining months of this year to enact legislation adjusting the gift tax rate or reinstating the estate and GST taxes for 2010, and whether such legislation will be effective retroactively to January 1, 2010, as of the date of enactment or as of another specified date. On July 28, 2010, it was reported that the House Ways and Means Committee Chairman Sander Levin stated that he was still undecided about whether the estate tax should be made retroactive to the beginning of 2010. The day before it was reported that on the Senate side, Finance Committee Chairman Max Baucus stated that he sees it being unlikely that the estate tax will be retroactively imposed in 2010 because Congress has waited so long to act. While a number of commentators have noted that Congress is unlikely to implement retroactive legislation at this point because it has waited too long to act, it is not certain that such legislation will not be enacted. Note, however, that our sources in Washington are confident that we will not see retroactive legislation but anything can happen on the Beltway!

Gift Planning Opportunities in 2010

Although one must remain cautious that any actions taken before Congress addresses the gift and GST taxes could have unanticipated consequences if Congress retroactively restores the gift tax to the 2009 level of 45% or reinstates the GST tax for transfers in 2010, it may still be beneficial while the 2001 Act is in effect to make gifts in 2010 that take advantage of either or both the reduced gift tax rate and the repeal of the GST tax.

Make Gifts to Take Advantage of the 2010 Gift Tax Rate of 35%

Under the 2001 Act, the gift tax remains with a $1 million lifetime exemption at a rate of 35% in 2010 (as compared to the 2009 maximum gift tax rate of 45%). Once the 2001 Act sunsets on December 31, 2010, the gift tax is scheduled to increase to a maximum rate of 55% in 2011, although the lifetime exemption amount will remain at $1 million. The reduction in the gift tax rate to 35% — the lowest rate since 1934 — may be an opportunity to make larger gifts that are subject to gift tax, especially because it seems unlikely given the current political and economic environment that future gift tax rates will be lower. It is also unlikely that the gift tax exemption will be increased above $1 million, even if the estate tax exemption is reinstated at its 2009 level of $3.5 million. This concept, known as "reunification," has been discussed, but does not seem to have much support.

For example, a gift in 2010 by an individual of $1 million in excess of his $1 million lifetime exemption and the $13,000 annual exclusion would result in a Federal gift tax liability of $350,000. The same gift made in 2009 or 2011 would result in a gift tax of $450,000 and $550,000, respectively. It should be noted that if a donor were to die within three years of making a taxable gift, the amount of the gift tax paid will be included in his estate and subject to estate tax. This estate tax inclusion will not, however, completely erode the benefit of the lower gift tax rate applicable to gifts in 2010. In addition, while the tax may be added back to the estate, any appreciation on the gifted asset will escape estate tax.

Of course, if someone makes a gift this year to take advantage of the lower gift tax rate and lack of GST tax and then dies before the end of 2010, that person would have effectively incurred a 35% gift tax where, if they'd just died and allowed the asset transfer to take place this year as a result of their death, the transfers could have taken place with a 0% transfer tax rate. For this reason, it may make sense to wait until the end of

December to make taxable gifts. There are also other techniques that may be used to ensure that a gift is not made until it is known that the donor lived through the end of 2010. Please feel free to call us to discuss these options in more detail.

As noted above, however, there may be some risk that Congress will retroactively raise the gift tax rate for gifts made in 2010. For this reason, some individuals may wish to delay all gifts until there is certainty in the law while others may wish to attempt the technique described below under "*Make Gifts to Disclaimer Trust for Spouse*."

Make Gifts to Take Advantage of the Repeal of the GST Tax in 2010

Under the 2001 Act, the GST tax was repealed for transfers made in 2010. In 2011, with the sunset of the 2001 Act, the GST tax will return at a 55% tax rate and an exclusion amount of approximately $1.3 million (as compared to a 45% tax rate and $3.5 million exclusion amount in 2009). Coupled with the lower gift tax rate, the repeal of the GST tax presents an opportunity to make gifts to grandchildren and more remote descendants. Although gifts to a grandchild in 2010 will still be subject to the 35% gift tax discussed above, they will not be subject to any additional GST tax; in comparison, a gift to a grandchild in 2011 in excess of the donor's gift and GST tax exclusion amounts will be subject to both gift and GST tax, each imposed at a 55% rate.

It is clear under the 2001 Act that an outright gift to a grandchild in 2010 will not be subject to a GST tax. A gift in trust in 2010, however, may be more problematic since under current law, future distributions from that trust to the grandchild may be subject to a GST tax. Therefore, to avoid potential GST tax liabilities in later years, donors should make outright gifts to grandchildren this year rather than gifts to trusts. However, the potential tax savings must be balanced against non-tax issues. For instance, if the grandchild has creditor issues or other problems, an outright distribution may not be prudent.

Making gifts to minor grandchildren in 2010 may not avoid the one year lapse in the GST tax regime; under current law, a gift to a vehicle that can hold property for the benefit of a minor grandchild, such as a uniform transfers to minor's account, is deemed to be a gift to a trust and, therefore, the transfer may be subject to the GST tax in a subsequent year. Consequently, the one year lapse in the GST tax, will be advantageous in 2010 for gifts to grandchildren that are made outright and that are also limited to adult beneficiaries.

If a donor is uncomfortable making an outright gift to a grandchild because the grandchild is too young or unsophisticated to manage the assets, he may request that the grandchild subsequently transfer the gift into a "self-settled" trust for the grandchild's benefit which can provide any safeguards that are desired (*e.g.,* the appointment of a trustee to handle all investment decisions or permitting withdrawals and distributions of trust assets only with the consent of the trustee). If the grandchild agrees, the "self-settled" trust may be established by the grandchild in advance of the gift and the grandchild may simply direct that the gift from the donor be made to the trust rather than to the grandchild. It should be noted that this trust will not provide asset protection in most jurisdictions because the grandchild will be the grantor of the trust. For the same reason, it will be includible in the grandchild's estate and, as a grantor trust, the trust's income will be taxed to the grandchild.

As noted above, there is some risk that Congress will retroactively apply a GST tax to gifts made in 2010. For this reason, some individuals may wish to delay all gifts until

there is certainty in the law while others may wish to attempt the technique described below under "*Make Gifts to Disclaimer Trust for Spouse*."

Make Gifts to Disclaimer Trust for Spouse

An individual who wishes to make gifts in 2010 to take advantage of the lower gift tax rate and the repeal of the GST tax but would prefer some protection against the negative tax consequences that might arise from the retroactive imposition of gift and GST taxes may consider disclaimer-based planning. A disclaimer technique combining the use of a disclaimer and the gift tax marital deduction for gifts to spouses in trust will permit a donor to take advantage of the 35% gift tax rate and the repeal of the GST tax for transfers made in 2010, while allowing some flexibility to avoid negative tax consequences if retroactively effective legislation is enacted.

Specifically, a donor using this disclaimer-based planning technique will make a gift in 2010 to a trust for the benefit of the donor's spouse, with the donor's adult grandchildren as the remainder beneficiaries. The trust should provide the spouse with a "qualified income interest" in the trust (among other things, the spouse should receive all trust income currently) so that it can qualify as a marital QTIP trust. A marital QTIP trust will be eligible for the marital deduction and, therefore, no gift tax will be due on the transfer from the donor to the spouse.

The terms of the trust will also permit the spouse to disclaim (renounce) the gift to the trust, in which case the trust assets would pass to the donor's grandchildren. Under current law, if the spouse makes a "qualified" disclaimer within nine months of the gift without having received any benefits from the trust, the gift will be treated as coming directly from the donor to the grandchildren and will be deemed to be made on the original date of the transfer to the trust in 2010. Consequently, although the spouse may potentially disclaim in 2011 when the status of the law is more settled, the gift to the grandchildren will be deemed to be made in 2010 and will have the benefit of the 35% gift tax rate and the repeal of the GST tax.

Under the disclaimer-based technique, the spouse will determine whether or not to disclaim the trust assets based on legislation passed by Congress:

- If Congress passes legislation retroactively and increases the gift tax rate or reinstates the GST tax, the spouse will not disclaim the gift in favor of the grandchildren. Because the trust will be a QTIP trust, no gift taxes will be imposed on the gift by the donor to the spouse (note that a QTIP election must be made on a timely filed gift tax return in order for the gift to qualify for the gift tax marital deduction). The property held in trust for the spouse can continue to be held in trust or can be distributed to the spouse, including distributing all or a portion of the trust property to the spouse, the effect of which will be the same as if no trust was ever created.
- If, instead, Congress allows the 2010 gift tax rate of 35% and repeal of the GST tax to stay in effect, the spouse will disclaim the gift made to the trust. As a result of the spouse's disclaimer, the trust property will be deemed to pass directly from the donor to the donor's grandchildren as of the date of the original gift. The gift to the trust will thus be subject to gift tax at a 35% rate and since there is no GST tax in 2010, the gift will not be subject to GST tax.

The same technique can also be applied if one wishes to only make gifts to children.

The ability to avoid negative tax consequences that could result from retroactively effective legislation may be worth the complexity of a disclaimer-based planning technique.

Accelerate Distributions from trusts that are not protected from the GST tax

Many of our clients have existing irrevocable trusts that allow distributions to children, grandchildren or more remote descendants. Although distributions from these trusts do not usually result in gift tax consequences to the beneficiaries, distributions may give rise to GST tax if the distributions are made from trusts that are not exempt from GST tax (an example is a continuing trust from a successful GRAT). The trustee of a trust that is not protected from the GST tax (technically referred to as a trust with a GST inclusion ratio above zero), may simply want to make outright distributions to grandchildren from the trust before the end of the year since such distributions next year may be subject to GST tax at a 55% rate.

Using Charitable Giving Techniques to Offset Income Tax from Roth IRA Conversions

Introduction

In our June 2009 issue of Personal Planning Strategies, we explained that, beginning in 2010, all taxpayers, regardless of their income levels, will be eligible to take advantage of the opportunity to convert some or all of their traditional individual retirement accounts or other qualified retirement plans ("IRAs") to one or more Roth IRAs. Additionally, on September 20, 2010, President Obama signed into law the Small Business Jobs Act of 2010, which authorizes 401(k) plans to allow participants to rollover pre-tax 401(k) accounts into Roth 401(k) accounts. This will allow all of the Roth IRA advantages to be made available to 401(k) participants (in the rest of this article we will refer only to Roth IRAs but the same rules are applicable to rollovers to Roth 401(k) plans). As explained in our June 2009 issue, the one major drawback of converting an IRA to a Roth IRA is that the entire conversion amount is taxable. Despite the taxable income, many clients have already converted their IRAs and many plan to do so prior to the end of the year. In this issue, we explain how you can use certain charitable giving techniques to offset that taxable income, thereby enhancing the benefits of a Roth conversion.

Revisiting the Benefits of Roth Conversions

With a traditional IRA, you make contributions with “pre-tax” dollars, and your investment is allowed to grow on a *tax-deferred* basis; that is, amounts earned, including the contributions, earnings and appreciation, are not taxed until distributions are made. Traditional IRAs are subject to mandatory distribution requirements when the account owner attains age 70 ½, also known as “required minimum distributions” or RMDs. The forced distributions result in income tax to the account owner each year after attaining age 70 ½, while continuously diminishing the tax-deferred amount remaining in the account (subject to offsetting earnings and growth).

On the other hand, contributions to Roth IRAs are made with “after-tax” dollars and, as a result, the appreciation inside a Roth account grows *tax-free*. Therefore, there is no income tax when money is distributed from a Roth account in retirement or when distributions are made to the account owner or the beneficiaries. In addition, Roth IRAs are not subject to RMDs when the account owner attains age 70 ½. Consequently, if the account owner converts a traditional IRA to a Roth IRA, he or she will not be required to

take RMDs during life. After death, a beneficiary receiving a Roth account will be required to take RMDs over his or her life expectancy. However, unlike a traditional IRA, distributions received by beneficiaries from an inherited Roth IRA will not be subject to income tax when received (they are income tax-free)! Thus, after death, the heirs, if they wish, will be able to keep utilizing the Roth IRA as a "tax shelter" and obtain tax-free growth within the IRA during their lifetimes and not pay any income tax on the RMDs that they receive each year over their lifetimes.

Under prior law, a traditional IRA could be converted to a Roth IRA only when the account holder's modified adjusted gross income was $100,000 or less. Beginning in 2010, the income limit no longer applies. Thus, all individuals are now entitled to convert a traditional IRA to a Roth IRA. If you convert, you generally must include the conversion amount in your gross income in the year of the conversion. However, if you convert in 2010, you are eligible to pay one-half of the taxes related to the converted amount in 2011 and the other half in 2012.

Using Charitable Giving Techniques to Offset Income Tax

Because the conversion to a Roth IRA will generate taxable income, you may want to consider using one or more charitable giving techniques to offset the income. The type of charitable giving technique you choose will depend on your charitable goals and the amount of income you will need to recognize as a result of the Roth conversion.

The simplest method is an outright gift to charity of cash or property. Keep in mind that there are certain limitations on how much of the gift you can deduct in any given year. Generally, you may deduct up to 50% of your adjusted gross income for cash gifts and 30% for gifts of property, such as stock. Also, generally speaking, any amounts in excess of the limitation may be carried over as a deduction in the five succeeding years. Thus, if you had excess contributions in the last five years, you can use the carried-forward amount to offset all or a portion of the income on the Roth conversion.

Another option is a charitable gift annuity. Generally, a charitable gift annuity is a transaction in which you transfer cash or property to a charitable organization in exchange for the charity's promise to make fixed annuity payments to you for the rest of your life, or to you and your spouse for the rest of your lives and the life of the survivor. Payments can begin immediately or can be deferred for a period determined by you and set forth in the annuity contract. The charitable gift annuity is treated, in part, as an outright charitable gift, and, in part, as the purchase of an annuity contract. You receive an up-front charitable deduction for the gift portion of the amount transferred, which is equal to the excess of the fair market value of the property transferred over the present value of the annuity, as determined under IRS tables. A portion of the annuity payment is taxable as ordinary income, but the remaining portion is considered a tax-free return of principal. Charitable gift annuities may be particularly attractive if you are looking for income to replace some or all of the RMDs you would have otherwise received from your traditional IRA.

A charitable remainder trust ("CRT") works very similar to a charitable gift annuity, but typically is used when more substantial gifts are planned. A CRT is a trust to which you contribute assets and which pays you and/or your spouse a fixed dollar amount (or a fixed percentage of the value of the CRT assets) for a specified number of years not to exceed 20 years, or for the rest of your life or lives. At the end of the term, the assets remaining in the trust pass to one or more charities. The annual amount paid to you must be at least 5%, but not more than 50%, of the initial fair market value of the trust's assets.

And, the value of the remainder interest passing to charity, as determined under IRS tables, must be at least 10% of the initial fair market of the trust's assets. You receive a current income tax deduction equal to the value of the remainder interest. Your annuity payment is treated as a combination of ordinary income, capital gain, tax-exempt income and a return of capital, depending on a variety of factors. Similar to the charitable gift annuity, the CRT is a good technique for those who wish to generate a current income tax deduction to offset income from a Roth conversion and also want to replace some or all of the RMDs they would have otherwise received from the traditional IRA.

Another available technique is a "grantor" charitable lead annuity trust ("CLAT"). A CLAT is a natural choice if you already plan to make significant gifts to charity over the next several years. By using a CLAT, you can accomplish that goal while accelerating the income tax deduction in the year you create the CLAT and, in most cases, passing wealth to your children and grandchildren, or other non-charitable beneficiaries, estate and gift tax free. A CLAT is a trust to which you contribute assets, and which pays a fixed dollar amount (or a fixed percentage of the value of the CLAT assets) to one or more charities for a specified number of years. You receive a current income tax deduction equal to the present value of the interest passing to charity. At the end of the annuity term, the assets remaining in the CLAT pass to one or more non-charitable beneficiaries, such as your children or grandchildren, or trusts for their benefit. When you contribute assets to a CLAT, you make a taxable transfer equal to the present value of the remainder interest that will pass to the non-charitable beneficiaries. The value of the remainder interest is calculated by using the "7520 rate" in effect in the month you transfer the property to the CLAT (or, if you elect, the 7520 rate in effect for either of the two months preceding the transfer). The CLAT can be structured so that it is "zeroed out," thereby resulting in a small or non-existent gift to the non-charitable beneficiaries. If, over the annuity term, the CLAT generates total returns higher than the applicable 7520 rate, the excess growth passes to the non-charitable beneficiaries estate and gift tax free. The lower the 7520 rate, the greater the charitable deduction will be and the greater the potential will be for a tax-free wealth transfer. Thus, because the 7520 rate is currently at its historical low, and it is anticipated to increase in the coming years, now is the ideal time to do a CLAT, particularly if you can use the charitable deduction to offset income from a Roth conversion.

Conclusion

The forgoing techniques are but a few of the ways to use charitable giving to offset the income tax that you would otherwise incur by converting your traditional IRA to a Roth IRA. You should consult with an attorney who is familiar with IRAs and charitable giving techniques to implement the techniques that are available to you to achieve your specific goals. By utilizing these techniques and others, you can realize the benefits of Roth IRAs—tax-free growth with no RMDs—while minimizing or eliminating the income tax drawbacks of converting.

The Personal Planning Department at Proskauer 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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