Proskauer

newsletter

Personal Planning Strategies

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in this issue

A report for clients and friends of the firm.

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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.

Year-end Planning Strategies

We have experienced yet another year of financial instability, both here and across the shores, which continues to engender some degree of anxiety among our clients. 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, Valuation Discounts and the Increased Transfer Tax Exemption Amount

The current Federal estate, gift and generation-skipping transfer tax ("GST") exemption amount is $5,000,000, and will be increased for inflation to $5,120,000 in 2012. However, the legislation under which the exemption amount was increased to that level is set to expire on December 31, 2012 and, unless the law is changed, on January 1, 2013, the estate, gift and GST tax exemption amount will return to its 2001 amount of $1 million, and the tax rate will increase from its present level of 35 percent to the 2001 top rate of 55 percent. Thus, in the existing political and economic climate, it is conceivable that beginning, or even before, 2013, the unified transfer tax exemption amount could be decreased. Therefore, if you are considering making large gifts, you should make them now.

Asset values continue to be depressed, and interest rates remain extraordinarily low. As a result, this is 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. You should discuss with us now how intrafamily loans, sales to intentionally defective grantor trusts, grantor retained annuity trusts and charitable lead annuity trusts can enable you to pass assets to next generations at the lowest possible transfer tax cost (please see the June 2008 issue of Personal Planning Strategies, available on our Web site, for more details about those estate planning strategies).

Moreover, there still exists some concern that Congress, with the support of the White House, could pass legislation that effectively would 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 intrafamily transactions can take into account minority interest and lack of marketability valuation discounts. Typically, those discounts reduce the asset value by 30 percent. Many transfer tax reform proposals that have emerged over the past few years include provisions that would render those discounts impermissible. If any of those were to be adopted into legislation, the purchase price or gift tax cost of intrafamily transactions would be increased by that 30 percent.

It is uncertain how or when the law will change, but if you have been considering a plan to make major gifts or 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 2012, the gift tax annual exclusion amount per donee will remain $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 2011 gift tax exclusion amount so that you can ensure that gifts are "completed" before December 31, 2011.

In lieu of cash gifts, consider gifting securities. The assets that you give away now are likely worth significantly less than they once were (due to the continuing economic crisis) and their value hopefully will increase in the future. In other words, there already is a built-in discount, which should 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 most 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) makes 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 Web site.

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.

2011 Gift Tax Returns

Gift tax returns for gifts that you made in 2011 are due on April 16, 2012 (since April 15 falls on a Sunday). You can extend the due date to October 15, 2012 on a timely filed request for an automatic extension of time to file your 2011 income tax return, which also extends the time to file your gift tax return. If you created a trust in 2011, you should direct your accountant to elect to have your 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 that 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.

In addition, if you make a gift to an "inter vivos QTIP trust" for the benefit of a spouse, you must make a "QTIP election" on a timely filed gift tax return. If you "split" gifts with your spouse, both spouses must file a gift tax return and consent to gift splitting and, if you "front loaded" a 529 plan, a special election must be made to treat the gift as being made ratably over five years. If you have any questions on these issues, please give us a call.

Make Sure that You Take Your IRA Required Minimum Distributions by December 31, 2011

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 (a traditional IRA or a Roth IRA), you must take RMDs by December 31 of each year regardless of your age. The RMDs must be calculated separately 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 percent 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

Currently, there is no income restriction that precludes an individual from converting a traditional IRA (which is funded with pre-tax dollars) to a Roth IRA (which is funded with post-tax dollars) (although income restrictions remain in effect for *contributions* to a Roth IRA). You should consider whether to take advantage of the opportunity to accumulate tax-free income for your descendants in a Roth IRA.

Although income tax will be due on any converted assets, a conversion still may 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 (or other beneficiaries), 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 Web site.

In addition, for conversions that occurred in 2010, Congress provided a special deferral arrangement whereby you could have opted to have one-half of the converted amount taxed in 2011 and the other one-half taxed in 2012. If you did covert a traditional IRA to a Roth IRA in 2010 and deferred the tax, do not neglect to pay the deferred amount in 2012.

Review Your Current Estate Plan

Last year, after having permitted the estate tax lapse for one year, Congress finally did enact legislation that reinstated the Federal estate tax with a unified estate, gift and GST tax exemption amount of $5,000,000 in 2011 (and $5,120,000 in 2012). As noted above, the new legislation is scheduled to expire in 2013, at which point the exemption amount could be reduced drastically. In addition, there exists some fear, albeit doubtful according to our sources, that Congress will take action to reduce the exemption amount earlier than 2013 in order to raise revenue. 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 regardless of political whims.

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 remains as high as $5,000,000.

Even if you are 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 $5,000,000 exemption amounts? If not, any plan to pass to your heirs, tax-free, your combined exemption amounts – $10,000,000 under current law – may fall short of your expectations.

The above is true despite the addition to the estate tax legislation of portability between spouses of their exemption amounts. Currently, if the first spouse to die does not fully utilize his or her estate tax exemption amount, the unused amount is portable to the estate of the second spouse to die. However, portability may not survive into 2013. In addition, even if portability remains in place, uncertainties are built into how portability ultimately would be implemented if the surviving spouse remarries after the death of the first spouse. Furthermore, relying on portability rather than setting aside your $5,000,000 exemption amount in advance deprives your beneficiaries of any gains to that $5,000,000 during the time between the first and second spouses' deaths, which gain also escapes estate taxation. Finally, most state estate tax laws do not incorporate provisions for portability of exemption amounts between spouses. Thus, it still remains critical that your assets are owned in a manner that permits full use of the exemption amounts of both spouses.

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

Last Call for Lifetime Gifts to Charities from Individual Retirement Accounts?

As we reported in earlier issues of Personal Planning Strategies, the Pension Protection Act of 2006 included a provision that permits a person aged 70 ½ or older to direct distributions of up to $100,000 per year directly from an Individual Retirement Plan ("IRA") to charity. The provision had expired but the 2010 Tax Act reinstated it. However, the latest version of this provision expires at the end of 2011.

The benefit of making a direct distribution from an IRA to charity is that the IRA owner can exclude up to $100,000 of the distribution from his or her gross income, and such distributions are counted as part of their annual minimum required distributions. Because the IRA distribution is excluded from gross income, the IRA owner is not entitled to a charitable income tax deduction for the charitable gift. There are several technical

requirements that must be met in order to ensure that the charitable IRA distribution will be excluded from gross income.

In the past, this provision has been extended after its expiration. However, despite lobbying from many charitable groups, it is uncertain whether this provision will be extended into 2012. Therefore, those who wish to take advantage of this opportunity should do so immediately. Please contact us if you would like our assistance in ensuring the gross income exclusion of your contribution to charity from your IRA.

$5 Million Gift Tax Exemption Still Alive and Kicking

Before the Joint Select Committee on Deficit Reduction, otherwise known as the Super-committee, failed to come to any bipartisan agreement to cut the deficit last month, rumor had it that the committee would propose legislation to reduce the gift tax exemption from $5 million to $1 million. The unsubstantiated rumor claimed that the lower exemption would go into effect on November 23, 2011. That day has come and gone, and the gift tax exemption amount remains at $5 million.

While rumors come and go, we continue to recommend that our clients use the $5 million exemption in 2011 or 2012, since the favorable exemption amount will remain in effect only through December 31, 2012, when the current law allowing the large exemption is scheduled to sunset. Unless Congress acts before that date, the law will revert to the less favorable $1 million gift, estate, and GST tax exemption amount. In addition, the top marginal gift, estate, and GST tax rates will rise from the current 35 percent to 55 percent. That means that an individual who has not used his exemption and makes a gift of $5 million before January 1, 2013 will pay no tax, but if he waits until 2013 to make the same gift, it will be subject to a gift tax to the extent his cumulative taxable gifts exceed $1 million.

The $5 million exemption per person ($10 million for married couples) allows individuals to reduce their estate by simply making direct gifts to their descendants or anyone else they wish to benefit (or to trusts for their descendants). In addition, even if the entire exemption amount was used in previous years, an individual may still take advantage of the additional $4 million increase allowed in 2011 and 2012. By making a gift now, all appreciation and income on the gifted asset will be removed from the estate tax-free. And if the gift is made to a grantor trust so that the grantor pays the income taxes on the trust's income, the income tax paid also is removed from the grantor's estate tax-free!

With the 55 percent rate on the horizon, we recommend that our clients make taxable gifts to take advantage of these favorable laws before they expire at the end of 2012. In addition to paying tax at a lower rate, the gift tax paid is removed from the estate (assuming one lives for three years or more from the date the gift is made), and all the

appreciation and income (and income taxes, if the gift is made to a grantor trust) on the gifted assets is removed from the estate.

For example, a gift of $5 million made in 2012 by an unmarried individual who had used his $5 million gift tax exemption in 2011 would result in a gift tax payable of $1,750,000. In 2013, the same $5 million-dollar gift would result in a gift tax payable of $2,750,000. Moreover, assume that the individual dies in 2020 and that there is 5 percent growth, the gift tax of $1,750,000 and the appreciation of $2,387,277 (compounded annually over eight years) would be removed from his estate tax-free.

There are many ways to maximize the use of the $5 million exemption and 35 percent rate. Please contact us to discuss a structure that works best for you and your family. This could be the best gift you can make during the holiday season!

Recharacterizing Roth IRA Conversions

Introduction

Beginning in 2010, many of our clients became eligible for the first time to convert their traditional individual retirement accounts or other qualified retirement plans ("Traditional IRAs") to Roth individual retirement accounts ("Roth IRAs") as a result of changes enacted under the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"). TIPRA removed the income limitations on conversions effective as of January 1, 2010; previously, an individual could not convert to a Roth IRA if his adjusted gross income exceeded $100,000. With this limitation removed, banks and financial services firms holding IRA assets have reported that the number of conversions increased significantly in 2010 and it is expected that this trend will continue in the future.

As more Traditional IRAs are converted to Roth IRAs by individuals taking advantage of the new law, the "recharacterization" rules (which permit the owner of a Roth IRA to "adjust" or "recharacterize" all or part of the assets previously converted) will be an important planning tool to consider. Recharacterization allows an individual to reverse a previous Roth IRA conversion. Following the owner's recharacterization election, Roth IRA assets will be transferred to either a new or existing Traditional IRA and it will be as though the conversion to the Roth IRA never occurred. Once the recharacterized Roth IRA assets have been transferred to a Traditional IRA, the owner may, after the applicable waiting period, "reconvert" those assets once again by transferring them to a Roth IRA.

The ability to recharacterize an IRA contribution is available to anyone, for any reason. In a typical example, as a result of the volatile financial markets in 2010 and 2011, many of the individuals who converted to Roth IRAs found that their Roth IRAs lost value after conversion. Unfortunately, the conversion to a Roth IRA forces the taxpayer to realize

ordinary income based on the value of the Roth IRA as of the date of conversion. Undoubtedly, many of those individuals whose Roth IRAs lost value after conversion chose to recharacterize their Roth IRAs back to Traditional IRAs because without recharacterization they would have paid income taxes based on the higher fair market value of their Roth IRAs at the time of conversion (i.e., they would pay less taxes if they converted at the current lower value than when they originally converted). They may, after observing applicable waiting periods, reconvert their recharacterized Traditional IRAs to back to Roth IRAs.

Basics of Traditional IRAs and Roth IRAs

In a Traditional IRA, the owner makes contributions with "pre-tax" dollars. This means that the investment will grow on a tax-deferred basis since amounts earned, including the initial contributions and appreciation, in a Traditional IRA are not taxed until distributions are made to either the owner or another beneficiary. Traditional IRAs are subject to distribution requirements when the owner reaches age 70 ½, also known as "required minimum distributions" or RMDs. In general, the owner must begin taking RMDs no later than April 1 of the year after the calendar year in which he reaches age 70 ½. The forced distributions from the Traditional IRA result in income tax for the owner each year after he reaches age 70 ½ while continuously diminishing the tax-deferred amount remaining in the account.

Conversion of a Traditional IRA to a Roth IRA offers a number of benefits to an IRA owner and his beneficiaries. First, the appreciation inside a Roth IRA grows tax-free. This is because, upon conversion, the converted amount is treated as a distribution from the Traditional IRA and is generally taxable as ordinary income in the year the conversion occurs. Thereafter, there is no income tax when distributions are made from the Roth IRA. If the taxpayer has the ability to pay the tax on conversion out of other assets, the IRA owner will in effect make a gift to the Roth IRA of the amount of the income tax. In addition, the pre-death RMD rules imposed on Traditional IRA owners do not apply to Roth IRA owners and the owner will not be required to take RMD during his life from the Roth IRA. This is the most attractive aspect of converting to a Roth IRA because it allows the Roth IRA owner to leave his full Roth IRA for his beneficiaries to inherit with the advantage of decades of growth in the Roth IRA not being subject to income tax. Although the owner will cease to be subject to the RMD rules after a conversion, a beneficiary receiving the Roth IRA account after his death will be required to take RMDs over his or her life expectancy. However, unlike a Traditional IRA, because the owner recognized ordinary income on the assets converted to the Roth IRA, distributions received by beneficiaries from an inherited Roth IRA will not be subject to income tax when received.

Recharacterizations Generally

Despite the advantages of converting to a Roth IRA, there may be circumstances, as noted above, where it is advantageous for an individual to reverse a conversion to a Roth IRA. The owner of a Roth IRA may recharacterize a conversion by transferring all or a portion of the converted amount, plus the net income attributable to that amount (the "NIA"), from the Roth IRA to a Traditional IRA. By recharacterizing, an IRA owner will in effect cancel the conversion, treating it as never having been made at all. If he wishes to recharacterize the entire Roth IRA and keep the account with the same trustee, he may also effect a conversion by instructing the trustee to simply redesignate the account as a Traditional IRA. The recharacterized amount that is transferred to a Traditional IRA does not need to be recognized as income by the IRA owner in the year of the conversion and, as part of the Traditional IRA, it will regain its "pre-tax" status.

Recharacterization Requirements and Rules

The following requirements must be met if you wish to undo a Roth conversion:

Identification of Assets. First, you must identify the assets that you wish to recharacterize. You are not required to recharacterize the entire amount that you originally converted and may elect to recharacterize only a part of a Roth IRA. However, you may not cherry-pick assets so as to recharacterize only those assets that lost value since the conversion – the regulations require you to choose by date and dollar amount which contributions will be recharacterized. You may not select specific assets to recharacterize.

For example, if you originally converted a Traditional IRA that holds two assets, Company A shares and Company B shares, to a Roth IRA and the shares of Company A appreciate after conversion while those of Company B lose value, you may not now recharacterize only the Company B shares. Instead, the entire account must be recharacterized. You can avoid this problem by initially converting the Traditional IRA into multiple Roth IRAs, each holding different assets or asset classes (e.g., one Roth IRA to hold Company A shares and another for Company B shares). In that case, the regulations specifically permit you to recharacterize one of the conversions without undoing both of them. Converting to multiple Roth IRAs, therefore, will provide you with much more flexibility. If you choose to establish multiple Roth IRAs, you should be careful not to transfer assets among them because commingling assets among separate Roth IRAs will jeopardize the ability to recharacterize one or more of them but not all of them.

Notifications and Timing. You must notify the trustee of the Roth IRA and the Traditional IRA of your election to recharacterize all or a part of the Roth IRA before your income tax filing deadline (including any extension) for the taxable year in which you converted from the Traditional IRA to the Roth IRA. The recharacterization election also must be reported on that return when filed. For example, if you converted assets in March 2011, the latest

date on which you may recharacterize those assets is April 15, 2012 (or October 15, 2012, if you request an extension for filing your 2011 income tax return).

In addition, the trustee must actually transfer the recharacterized amount, together with earned income on that amount, to a Traditional IRA prior to the tax filing deadline (including any extension). You may not revoke a recharacterization election once the transfer to the Traditional IRA has been made.

It is important to note that while filing an extension allows you additional time to recharacterize, any income tax on the original conversion from a Traditional IRA to a Roth IRA still must be paid by the income tax filing deadline (i.e., April 15).

Trustee-to-Trustee Transfer. The taxpayer must recharacterize the Roth IRA through a direct "trustee-to-trustee" transfer, i.e., the recharacterized amount must be distributed directly from the Roth IRA account to a Traditional IRA. A rollover will not meet the requirements of a recharacterization and is not permitted.

"Net Income Attributable." Recharacterization of all or part of a Roth IRA requires that both the recharacterized conversion amount and the NIA be transferred to the Traditional IRA. Of course, if the entire balance of a Roth IRA is being recharacterized, there is no need to calculate the NIA; the transfer of the entire account to the Traditional IRA will satisfy the requirement. However, if less than an entire Roth IRA is being recharacterized, NIA must be calculated and transferred to the Traditional IRA.

The IRS provides a special formula for calculating the NIA. Generally, it is determined by allocating to the recharacterized amount a pro rata portion of the income accrued by the Roth IRA. Under the regulations, the NIA is permitted to be a negative number.

You may be able to avoid unnecessary NIA calculations by converting a Traditional IRA into multiple Roth IRAs, each holding different assets or asset classes. This will provide greater flexibility as to recharacterization since the regulations specifically permit the taxpayer the recharacterization of one or more of the conversions without undoing all of them.

Possible RMD Required Following Recharacterization. Because a recharacterization reverses the conversion, it will, in effect, reset the clock to the year of the original conversion. Therefore, if you have attained the age of 70 ½, after the recharacterization of the Roth IRA back to a Traditional IRA you will be required to take any required RMD for that year.

Reconversion following Recharacterization

If you recharacterize all or part of a Roth IRA to a Traditional IRA, you may reconvert the recharacterized assets back to a Roth IRA. However, you may not do it immediately – the

regulations require you to wait for 30 days (or until January 1 of the year after the initial conversion, if later) before reconverting the recharacterized amount. Any attempt to reconvert before the end of the waiting period would be a failed or ineligible conversion. Obviously, the waiting period increases the risk that the value of the IRA will increase between the recharacterization and the reconversion, as well as the risk that applicable tax rates will increase in the new year when the assets are reconverted.

It should be noted that the waiting period to reconvert is applicable only to Traditional IRAs that hold recharacterized assets. Therefore, if you convert only part of a Traditional IRA to a Roth IRA and then choose to recharacterize the Roth IRA, you may still convert the assets remaining in the original Traditional IRA before the end of the waiting period as long as it does not hold any of the recharacterized Roth IRA assets. You can take advantage of this by transferring the recharacterized amounts to a new Traditional IRA rather than an existing Traditional IRA.

Conclusion

The ability to recharacterize a Roth IRA is a powerful tool which should always be considered in the year after you convert a Traditional IRA to a Roth IRA.

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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