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To our Clients and Other Friends

Last January we sent a letter (copy enclosed) in which we described some significant changes to the federal estate tax, gift tax and generation-skipping transfer ("GST") tax laws for those who die or make gifts in 2010. At that time, we noted the possibility that Congress might retroactively change the 2010 laws. However, as of this mailing Congress has not done anything. Although there is much talk about the need to "fix" the 2010 tax laws – as well as the provisions slated to take effect in 2011 described below – we currently have no clear sense of whether or when or what Congress may do.

Despite these uncertainties, as we fast approach the end of 2010 we are writing to highlight some planning options and issues, as follows:

1. For the estates of those who die in 2010, we are carefully monitoring the issue of the possible retroactive imposition of the federal estate tax. We are also carefully evaluating the issue of the tax cost basis of the decedent's assets in light of the temporary repeal of the step up in basis rule.

2. Clients might want to consider making taxable gifts during 2010 to take advantage of the low 35% gift tax rate that is scheduled to increase on January 1, 2011, perhaps back to 45% or perhaps to as much as 55%. There are many issues to consider in deciding whether to make such gifts, including the possibility that there will be no federal estate tax in the future, the availability of cash to pay tax and the possible retroactive increase of the gift tax rate.

3. Clients should consider whether to make transfers to grandchildren and other persons in the grandchild generation to take advantage of the repeal of the GST tax during 2010. The issues to consider are similar to those pertaining to the decision to make taxable gifts. In addition, there are complex legal questions regarding how to take advantage of the GST tax moratorium but avoid incurring that tax in later years.

4. In our January letter we emphasized that wills and trusts are often structured by reference to provisions of the Internal Revenue Code, many of which were repealed for 2010. We told you that those provisions might be interpreted in a way that would change how an individual's estate is divided. This is most commonly an issue in the allocation of assets between marital and non-marital trusts created for a surviving spouse and other family members. Pennsylvania now has a new statute, enacted on October 27th, that in general provides that wills and trusts of Pennsylvania residents dying in 2010 will be interpreted as if the 2009 federal estate and GST tax laws were still in effect for purposes of division and distribution. The result is that for an individual who dies in 2010, his or her estate will essentially be distributed as if he or she died in 2009 (with a $3.5 million federal estate tax exclusion amount and GST exemption), even though no federal estate or GST tax will be imposed. This statute does not apply to wills or trusts written or amended in 2010.

5. Unless Congress enacts different laws for 2011, the federal estate tax, gift tax and GST tax laws are scheduled to come back into effect as of January 1, 2011, but with exemptions and rates that were in effect in 2001. As a result, the federal estate and gift tax exclusion is scheduled to be $1 million (as compared to $3.5 million in 2009) and the estate, gift tax and GST tax rates on assets in excess of the exclusion will be imposed on a graduated schedule topping

out at 55% (compared to a flat 45% rate in 2009). The GST tax exemption amount will be $1,360,000 and the GST tax rate will be 55% (also compared with $3.5 million and 45% in 2009). These changes will raise a number of issues:

a. Many of our clients have planned to take advantage of the 2009 tax laws by making sure that both husband and wife (in the case of married clients) own assets in such a way as to take advantage of his or her respective $3.5 million estate tax exclusion. Others with more modest estates may have decided not to adjust the ownership of their assets, given the possibility that a single $3.5 million exclusion would result in no tax being paid on their entire combined estates. When we know what the law will be, possibly by the first of the year, it may be necessary for married couples to revisit how their assets are owned as between husband and wife.

b. If the estate tax exclusion is reduced to $1 million on January 1, 2011, then some clients may need to reconsider not only their estate plans in general, but also whether or not they want to implement additional planning options to reduce overall federal estate tax, including simple steps, such as making annual exclusion gifts (now $13,000 per donor per recipient), removing life insurance from taxable estates (often through the use of an irrevocable life insurance trusts), and other techniques.

c. Some clients planned their estates based on federal estate tax and GST tax exclusions of more than $1 million. For example, a client may envision passing an amount equal to the estate tax exclusion directly to children or in a non-marital trust, on the assumption that the exclusion amount would be $2 million or $3.5 million. These clients should review their estate plans.

6. While not directly related to the 2010 tax law "hiatus", we bring to your attention the fact that Congress has been considering whether to modify the laws pertaining to "Grantor Retained Annuity Trusts" ("GRATs"). Under current laws, GRATs may have a minimum term of 2 years. Under proposals being discussed, the minimum term for a GRAT may be increased to 10 years and there may be other changes to the required terms that may reduce their effectiveness as an estate planning technique. If you have considered or are considering using this technique, time may be of the essence.

7. Clients with retirement accounts may want to consider converting IRA assets to a Roth IRA. Taxpayers who convert IRA assets will owe federal income tax on the converted assets. However, once in a Roth IRA the assets will grow free of income tax (and free of any required minimum distribution requirement) for the remainder of the taxpayer's life and the spouse's life if the spouse is the beneficiary. After the taxpayer's or spouse's death the named beneficiaries must start taking required minimum distributions, but with a correctly prepared beneficiary designation the distributions can be stretched across the beneficiary's lifetime, and the growth inside the Roth IRA will continue to be free of federal income tax. Making the decision to convert can be complicated, and requires considering the taxpayer's age, anticipated need for the assets during lifetime, age and anticipated tax bracket of the beneficiaries of the account, and whether the taxpayer has cash available to pay the income tax due on conversion. The opportunity to covert IRA assets to a Roth IRA does not expire at the end of 2010 and will be available in 2011 and subsequent years (unless Congress changes the law), but at the income tax rates in effect in those years. Because under current law the income tax rates for high income taxpayers are scheduled to increase in 2011 (although there is much discussion in Congress about repealing this rate increase), clients should consider converting IRA assets in 2010, before any increase in tax rates.

We understand that the unsettled tax issues are confusing and frustrating. We encourage you to contact HTT&S to review and discuss these issues and how they may affect your own planning.

Sincerely yours,

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