2010 Year-End Tax and Estate Planning Checklist

As 2010 winds down there is tremendous uncertainty surrounding where various tax rates are headed in 2011 and beyond, which provides individuals and families an opportunity to consider some year-end planning strategies. Below we have summarized the key issues for each of the planning areas most likely to be affected by a changing tax landscape. Please consult with your tax and legal advisors before considering any changes to your financial plan. As always, we are available to discuss and help facilitate any actions that may make sense for your particular situation.

Income Tax Rates

As it stands today, if no legislative action is taken before year-end, the Bush-era tax cuts will expire at the end of this calendar year. As a result, 5 of the 6 existing marginal tax brackets will see increases.

Current	New in 2011
10%	15%
15%	15%
25%	28%
28%	31%
33%	36%
35%	39.6%

With an increase in marginal rates possible, taking advantage of year-end strategies involving income acceleration from 2011 to 2010 should be considered. Because IRS rules governing income acceleration can be complex, these strategies should be discussed with your tax advisor. In addition, strategies for deferring expenses into 2011 to offset higher future taxes should also be considered.

Capital Gains and Dividends

Beginning in 2011, the long-term capital gains tax rate will rise from 15% to 20% (18% if an asset has been held more than 5 years). If the profitable sale of a stock or business is a strategic transaction and the timing can be accelerated, consider taking the gain this calendar year. At best, rates will stay the same.

Dividends will revert back to be being taxed as ordinary income, as opposed to being taxed at the long-term capital gains rate. Individuals in the highest marginal tax bracket will see taxes on their dividends rise significantly from 15% to 39.6%.

Estate Taxes

45% - 0% - 55%: that is the estate tax see-saw we can expect to see from 2009 to 2011 if Congress does not act between now and year-end. In 2009, individuals had a $3.5 million exemption ($7.0 million per couple) and a maximum 45% estate tax bracket. For 2010, the estate tax rate has fallen to 0% for all estates. Thus, an individual's estate, regardless of size, can pass tax-free to one's heirs subject to complicated cost basis rules. In 2011, the estate tax comes roaring back, with the exemption falling back to $1 million per individual ($2 million per couple) and a maximum 55% bracket. In larger estates (over $10 million), there will be a 5% surtax, taking the maximum rate up to 60%.

Roth IRA Conversions

In 2010, the IRS changed the income limitation rules governing Roth IRA conversions. Now, any individual, regardless of income level, can convert existing retirement assets (traditional IRAs and qualified retirement accounts) to a Roth IRA. Amounts converted to a Roth IRA are considered ordinary income for tax purposes. For this reason, individuals should weigh the option of partial conversion versus full conversion in order to mitigate the tax impact.

For 2010 only, the IRS allows the tax liability on the conversion to be reported on 2010 returns and taxed at current rates, or spread out over the next two tax years - 2011 and 2012 - and taxed at rates in effect for those tax years. If taking advantage of the latter, higher rates beginning next year would mean a higher tax liability even though spread out over two years.

Other benefits of converting to a Roth IRA:

- Assets grow tax-deferred in traditional IRAs and other qualified retirement plans, with future taxes being paid on Required Minimum Distributions (RMDs) at perhaps higher rates. Conversely, assets in Roth IRAs grow tax-free, since taxes have already been paid at conversion, and no RMDs are required, allowing for even greater growth.
- If an individual converts a Roth IRA and the account declines in value after the conversion, the individual can unwind the transaction (called re-characterization) as though the tax event never happened, thereby avoiding paying higher taxes on the higher conversion amount. This option is available up to the due date of the tax return. For a taxpayer who has filed an extension for the 2010 tax return, the deadline for re-characterizing a 2010 conversion would be October 15th, 2011.
- For those individuals who have tax losses or other expiring tax credits, these losses can be used to offset some or all of the tax liability resulting from a partial or full Roth conversion.
- At the time of a Roth IRA conversion, an individual locks in a known tax liability, essentially hedging against higher tax rates in the future. Additionally, any future earnings will grow tax-free.

Other considerations for Roth IRA conversions:

- The longer the investment time horizon, the more sense a conversion makes, since there is more time to recoup the tax bite.
- Taxes from conversion should be paid from assets outside of the IRA, thereby allowing more assets to remain inside the IRA to grow tax-free.
- Tax laws, including current rules regarding Roth IRAs, are subject to change.

Gifting and Generation Skipping Trusts (GST)

Although Congress repealed the estate tax for 2010, the gift tax was not repealed. Currently, each individual may gift tax-free up to $1 million over their lifetime. In addition to that amount, individuals may gift $13,000 ($26,000 per couple) annually to as many people as they choose. An individual may also pay medical and tuition expenses for any person, without that counting against their lifetime exclusion, as long as the payments are made directly to the medical or educational institutions.

If an individual gifts assets (cash, stocks, property, etc.) beyond their $1 million limit, he or she will be subject to the gift tax. In 2009, the gift tax equaled the top estate tax rate, which was 45%. With the estate tax repealed, the gift tax for 2010 is tied to the top income tax rate, which is 35%. This is very reasonable compared to historical rates. With rates very likely to go up next year for both the estate and gift tax, it makes sense to consider making taxable gifts this year.

For example, assume an individual has used his $1 million exclusion already, and plans to make another gift this year of $1 million. If he gifts the $1 million to his heirs, and pays $350,000 in taxes with other assets, his heirs net $1 million. Alternatively, if he doesn't make the gift in 2010, the $1.350 million remains in his estate. Then, if he dies in 2011, the after-tax transfer to his heirs will be $607,500 (55% estate tax rate), or $392,500 less than under the gift scenario.

Similar to the estate tax, there is no Generation Skipping Tax (GST) this year. A person can bypass gifts to his children and gift directly to his grandchildren and only pay the gift tax. The tax leverage here is significant - by pushing assets down to younger generations and paying the gift tax now at 35%, estate taxes are avoided at the grandparents' and parents' levels.

Applicable Federal Rate (AFR)

Applicable Federal Rates are the IRS's published interest rates typically used between related parties. These rates may be used for intra-family loans, mortgages, charitable remainder trusts (CRT), charitable lead trusts (CLT), qualified personal residence trusts (QPRT), grantor retained annuity trusts (GRAT), etc. For October 2010, the short-term rate for less than 3 years is .41%. The current mid-term rate for 3 to 9 years is 1.73%, and the long-term rate for over 9 years is 3.32%. These historically attractive AFRs increase the probability that the various financial and estate planning strategies mentioned above will have successful outcomes, given the very low absolute hurdle rate.

Grantor Retained Annuity Trusts (GRAT)

At today's low absolute interest rate levels, the Grantor Retained Annuity Trust is an extremely attractive estate planning strategy for transferring wealth to heirs in a tax efficient manner.

The strategy involves a Grantor identifying assets that will appreciate meaningfully (single stock, IPO candidate, diversified stock portfolios, closely held businesses, real estate, private equity, etc.) and placing these assets in a Grantor trust. An annuity (the original value of the assets placed in the trust plus an IRS assumed rate of interest) is then paid back to the Grantor over the term of the trust. Any appreciation in excess of the assumed interest rate is distributed to the Grantor's beneficiaries, with little or no gift tax cost. While the terms of these trusts can be from 2 to 30 years, most GRATs are structured with 2-10 year terms. The assumed rate of interest, which determines the annuity payment, is set monthly by the IRS (and is defined in Section 7520 of the IRS code as 120% of the mid-term AFR). As of October 2010, the IRS rate was 2.0%, the lowest rate in 20 years. This is significant because the low interest rate establishes a low hurdle rate for the appreciating assets within the GRAT. The real value of the GRAT is that any appreciation of the GRAT assets in excess of the hurdle rate passes to the beneficiaries and stays out of the Grantor's estate.

Some other facts related to GRATs:

- If assets inside a GRAT do not appreciate as planned, the GRAT distributes the assets back to the Grantor at the end of the term with no tax consequences.
- If a Grantor dies during the term of the GRAT, the assets are brought back into the estate as though the GRAT had never been established, again with no tax consequences.
- For income tax purposes, all income within the GRAT is taxed to the Grantor, and taxes paid do not count as a gift to the beneficiaries.
- In a successful GRAT, the remainder or appreciated assets are transferred to the Grantor's beneficiaries (or to a trust in the beneficiaries' names) along with the original basis.
- GRATs can be written with substitution powers to exchange low basis assets with high basis assets at the appropriate time, or to lock in appreciation by swapping appreciated assets with more stable assets.

Conclusion

The catalyst to evaluate these topics now is a mix of politics, taxes, and low interest rates. Regardless of what happens in the election on November 2nd, this is an excellent opportunity to actively consider these issues. We would be happy to participate in discussions with your tax and legal team to further explore any of the above.