

# THE BERNSTEIN REPORT

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Dear Reader,

It has been a relatively quiet summer with respect to serious consideration of new tax legislation. There have been several attempts to form an agreement on the so-called extenders legislation. The failure to enact this before the end of the year would create some problems for taxpayers, specifically those on the threshold of paying an alternative minimum tax (AMT). There is a high probability that many of these provisions will be reinstated for 2010. However, for some of the extender provisions, such as the qualified charitable IRA rollover, the provision is not useful to taxpayers until it is enacted and it's getting fairly late in the year.

There has been discussion for several years concerning a major overhaul of the federal tax system. The President's Economic Recovery Advisory Board (PERAB) released a report last month concerning the options for federal tax reform. Many of the recommendations involve simplification by consolidating tax benefits within specific categories into a more streamlined approach. For example, the many forms of retirement savings vehicles such as IRAs and Sec. 401(k)s would be combined and become available in a single type of plan. Of course, the AMT would be amended and possibly repealed. Finally, a major section of the report deals with corporate taxes and would recommend reduced rates to keep US corporations competitive in international markets.

A bipartisan tax reform bill was previously introduced in the Senate (S. 3018) that would simplify the federal income taxes to a three-bracket (15, 25, and 35 percent) approach and provide a flat 24 percent corporate income tax rate. It is not expected that significant tax reform will occur this year when all of the expiring provisions of the Bush Administration's tax cuts will be addressed before the end of the year.

The repeal of the estate and generation-skipping transfer taxes for 2010 is set to expire at the end of the year. It is less likely at this time that the taxes will be reinstated retroactively to the beginning of the year. 2010 may provide a unique opportunity for making significant gifts. It is not expected that significant tax reform will occur this year because Congress must first address the expiring provisions of the Bush Administration's tax cuts.

Cordially,

*Richard S. Bernstein*

**A Second Opinion Costs You NOTHING,  
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,  
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

## **SOME IDEAS TO REDUCE TRANSFER TAXES ON YOUR HARD-EARNED WEALTH**

When you are ready to pass on all or a portion of your wealth, Uncle Sam looks to get a piece of the pie through the levy of various so-called transfer taxes. These traditionally have included gift tax, estate tax, and generation-skipping transfer taxes (GST). However, 2010 looks to be a unique year in the history of wealth transfer taxes. Legislation passed in 2001 repeals the estate and GST for 2010, but not the gift tax. However, the gift tax rate was lowered to 35 percent in 2010. The sunset provisions of this law would reinstate the estate and GST after 2010 at the 2001 exemption amounts and tax rates, but it is the current thinking that an estate tax reform package will be considered later this year to provide more transfer friendly conditions. Without reform, the current law would reinstate a 55 percent maximum bracket and a \$1 million exemption for gifts, estates and GST in January. It is expected that the debate for any reform package would begin with a maximum rate of 45 percent and an exemption amount of \$3.5 million for estates and GST.

Earlier this year, there was a concern based on statements made by some legislators that the estate and GST would be reinstated retroactively to January 1. However, at this late date in the year, this type of action appears much less likely. From a compliance standpoint, the retroactively reinstated taxes for someone dying on January 1, 2010 would be due at the end of this month. This would create a fairness and compliance debate that Congress would probably not want to entertain.

It is a good time to have a discussion of possible opportunities to take advantage of the unique conditions for 2010. The material is technical and complex at times and someone considering making substantial transfers should watch the legislative developments and take action only with competent advice.

### **WHY MAKE SUBSTANTIAL GIFTS?**

Because there is still a progressive income tax system and a significant estate tax for all years except 2010, gift planning remains essential to reduce transfer and income taxes. There are several reasons to make substantial gifts during your lifetime, including the following:

- To avoid gift, estate, and generation-skipping tax on the appreciation in value of the transferred property
- To avoid state inheritance taxes without paying state gift taxes, because the vast majority of states have no state gift tax
- To take advantage of the exclusions from federal gift tax that are not available under the federal estate tax rules for bequests of your wealth
- To take advantage of the \$1 million gift-tax exemption
- To shift the income-tax responsibility for the income earned on the transferred property to the donee, who might be in a lower tax bracket
- To receive valuation discounts for gifts of an interest in, for example, a family business or real estate venture
- To personally witness the joy of the "grateful living" upon receipt of the gifts
- To provide for the needs of less wealthy and/or younger family members
- To test the waters by watching the ability of your children or grandchildren to manage the assets that you provide to them
- To take advantage of the 2010 lower 35 percent gift tax rate
- To make gifts to grandchildren or great-grandchildren and take advantage of the 2010 repeal of the GST

## TOOLS TO MINIMIZE THE GIFT TAX

Here are some important tools that will help you minimize the gift tax:

- **\$13,000 annual exclusion.** During your lifetime, you can make gifts of up to \$13,000 (the annual exclusion is indexed for inflation and is expected to remain at \$13,000 in 2011) each year to as many different people as you want, and as long as they are "present interest" gifts, they will be excluded from the gift tax. If the donor is married and if his or her spouse is willing to elect to split gifts, the donor can transfer \$26,000 to selected donees.
- **Medical and educational expenses.** In addition to the annual exclusion gifts, you may pay the medical and educational expenses of family members and others directly to the medical facility or educational institution, and such gifts (no matter their amount) will be excluded from the gift tax. These expenses include tuition to educational institutions, regardless of the level of education. The allowable medical expenses include any that would be deductible (ignoring the limitation on itemized deductions) against federal income taxes. For example, a parent or grandparent could pay the health insurance premiums for adult children or grandchildren without gift tax implications.
- **\$1 million exemption shelter.** The gift tax exemption permits a lifetime aggregate of taxable gifts (gifts above and beyond the credits discussed above).
- **Generation-skipping transfers.** Gifts to grandchildren in 2010 are not subject to the second layer of GST tax. Thus, such gifts before the end of the year (or when the GST is reenacted) would simply be treated solely under the gift tax rules discussed above.
- **Valuation discount for gifts of minority interests and lack of marketability in property.** This concept is used primarily with family business entities such as limited partnerships or family limited liability companies. In these techniques, transfers of limited (noncontrolling) interests can be significantly discounted below the value of the proportionate share of the underlying property owned by the entity if the limited owner cannot control the activities of the entity, force liquidation, or freely transfer the ownership interest. The discount is available to transfers of closely held corporate stock if the transferred stock has 50 percent or less of the voting power and is subject to transfer restrictions. Finally, marketability discounts are also available for transfers of joint undivided interests (such as a joint interest in real estate).
- **Grantor-retained annuity trusts (GRATs).** This type of gift permits the grantor to make an irrevocable transfer to a trust while retaining a fixed amount for a specified term of years. The remainder will pass to family members or to a family trust. The GRAT is a great wealth transfer technique in a period of low interest rates, such as the current rates, due to the method of calculating the remainder gift. There has been some yet-to-be enacted legislation to limit the use of shorter-term GRATs, so time may be of the essence.

## UNIQUE CIRCUMSTANCES FOR 2010 PROVIDE OPPORTUNITY

For someone with significant net worth, there is a substantial likelihood that the federal wealth transfer taxes will be imposed at some point; either for lifetime gifts or bequests at death. We don't have a crystal ball to provide us with the details of the reform legislation when it occurs, but it seems safe to assume that an individual with over \$5 million or a married couple with over \$10 million will incur a federal wealth transfer tax at a marginal rate of 35 percent or greater. The planning suggestions start with the premise that the taxes will be imposed sooner or later and that the estate owner is comfortable with making lifetime transfers. This means that there is some wealth that will not be needed for the remaining lifetime of the estate owner and that he or she is comfortable with providing the transfers to selected beneficiaries.

Does it make sense to pay gift taxes in 2010? As of now, the gift tax rate is 35 percent and the expected estate tax rate is at least that high. If the estate tax rate is higher (after it is re-enacted) and the property appreciates substantially after the gift, the payment of gift taxes now could provide for significant total transfer tax reduction and a greater wealth transfer to heirs. The larger the gift, the greater the savings, but, the lower gift tax rate is only available until the end of 2010.

What if the estate owner isn't comfortable with outright transfers? Many feel that transfers in trust are safer for protecting beneficiaries from indiscretions. Trusts can delay distributions until the beneficiaries are older and have spendthrift protection against creditors. Since it makes sense to take advantage of the 2010 gift and GST tax circumstances, it would be beneficial to create new trusts or make large transfers to existing trusts. For example, perhaps an irrevocable life insurance trust (ILIT) already is in place to provide estate liquidity or wealth transfers. Why not make larger gifts in 2010 to provide for additional insurance benefits or reduce the gifts required after 2010 for the future premium requirements of the ILIT.

What about the GST repeal for 2010? The theory behind the GST is that the IRS should collect a layer of wealth transfer tax from wealthier families every generation. If you can skip a layer of tax, a larger wealth transfer will ultimately be available for subsequent generations. If there is no retroactive reinstatement of the GST, it appears a direct gift made now to grandchildren is subject only to the gift tax (again at the favorable 35 percent rate for 2010). However, gifts in trust are more questionable. If the GST is reinstated for 2011, gifts made to a generation-skipping trust in 2010 could create a GST event later. It is possible to make a current gift in trust for grandchildren, but delay the tax result until a time in the future when the new legislation provides the necessary information to complete the decision-making process. For example, a transfer can be made to a trust that first provides income to the transferor's spouse for life, but then is held in trust for grandchildren. The trust can be sheltered from gift taxes by electing to take the gift tax marital deduction. However, this decision can be delayed until the gift tax return is due, including extensions; meaning October 15, 2011. In addition, the recipient spouse could disclaim the income interest and accelerate the transfer to the grandchildren. The recipient spouse has 9 months following the gift to make the disclaimer decision. Certainly, the time windows discussed above should give the advisors time to assess the gift, estate and GST rules that will be imposed on this transfer before making the appropriate decisions.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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