THE BERNSTEIN REPORT

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RICHARD S. BERNSTEIN

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Dear Reader,

There is little talk of tax changes now that many of the tax relief provisions have been extended for two years. The specter of the Congressional repeal of the health care legislation is not a serious item with the likelihood of a veto by President Obama. However, the state constitutional challenges to the health care legislation present a more compelling issue, particularly with the recent Florida case (Florida v. HHS, 107 AFTR 2d 2011-416 (DC FL 1/31/2011).

The recent changes to the federal wealth transfer system were certainly not the final word on these taxes. The lesson of the 2010 repeal is that we cannot be certain of the timing and result of the legislation at that time. The chart below reveals the dramatic swings and instability of these tax systems.

Federal Wealth Transfer Tax System Figures

Year	Gift & GST Annual Exclusion	Gift Tax Exclusion Amount	Estate Tax Exclusion Amount	GST Exclusion Amount	Maximum Rate
2001	$10,000	$675,000	$675,000	$1,060,000	55%
2002	$11,000	$1 million	$1 million	$1,100,000	50%
2003	$11,000	$1 million	$1 million	$1,120,000	49%
2004	$11,000	$1 million	$1.5 million	$1.5 million	48%
2005	$11,000	$1 million	$1.5 million	$1.5 million	47%
2006	$12,000	$1 million	$2 million	$2 million	46%
2007	$12,000	$1 million	$2 million	$2 million	45%
2008	$12,000	$1 million	$2 million	$2 million	45%
2009	$13,000	$1 million	$3.5 million	$3.5 million	45
2010	$13,000	$1 million	$5 million/0***	$5 million***	35/0%***
2011	$13,000	$5 million	$5 million	$5 million	35%
2012	$13,000*	$5 million*	$5 million*	$5 million*	35%
2013	$13,000*	$1 million**	$1 million**	$1,060,000*	55%**

*** Indexed for inflation**
****Based on current law**
*****With an election to be subject to estate and GST tax systems or to accept estate and GST (but not gift) tax repeal with modified carryover basis. The GST exemption is $5 million for 2010 for the purposes of allocating exemption to GST trusts, but the tax rate is zero in 2010 for GST transfers taxable in 2010.**

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 Do’s and Don’ts & the New Estate Tax Rules

The federal wealth transfer tax changes enacted at the end of last year contained some surprises and have presented some uncertainty with both obvious and hidden complexities. The changes created the higher exemption and the exemption portability provision and might create some misconceptions. Now that we've had some time to digest the details of the legislation and the planning implications, we'd like to present some do’s and don’ts with respect to the impact of the new legislation on your estate plan.

Don’t: Procrastinate and assume the large wealth transfer tax exemption amounts will protect your estate from shrinkage. A wait-and-see approach might become wait-and-pay. The current larger exemptions are scheduled to sunset after two years. There are state inheritance or estate taxes in a large number of states with significantly lower exemption amounts. In addition, there are many other causes of estate shrinkage.

Do: Take proactive steps to evaluate the potential risks facing your estate and determine whether the new estate tax rules will necessitate a change in your current plan. Items that should be evaluated include an inventory of assets and how they are titled, terms of your will and any living trusts, powers of attorney, and beneficiary designations under your life insurance, annuities, employee benefits, and any other financial accounts passed through beneficiary designations.

Don’t: Assume the government is finished with tax reform and that the uncertainty has been eliminated.

Do: Adapt to the current playing field with the $5 million exemption, but remember the change is temporary. It would have to be renewed or further revised for 2013 to avoid a substantial increase in wealth transfer taxes. Any planning should include the appropriate amount of flexibility.

Don't: Believe that estate planning is only for the wealthiest Americans just because the $5 million exemption seems to relieve approximately 99 percent of the population from the federal estate tax burden.

Do: Understand that taxes should not be the motivation for estate planning. It is important to evaluate the potential scenarios for your estate. How will you provide for your surviving spouse or other heirs? Do you or any of your heirs have creditor concerns? Are there marriages in the family that may become problematic? Do any heirs have special needs? Do you live or own property in a state that has an inheritance or estate tax? Are you concerned with the expenses and delay of probate and want your assets distributed as quickly and efficiently as possible? Do you have any charities that you wish to benefit? These and other questions can only be answered by appropriate estate planning.

Don't: Forget that gift or estate tax returns might be required.

Do: Remember that any property gratuitously transferred to someone may trigger the need for a gift tax return. A gift tax return is required for "taxable" transfers. These are transfers that are not excluded under the $13,000 annual exclusion or deductible as a qualifying transfer to a spouse or a charity. The IRS is currently working on a gift-tax compliance project because they are aware that many real estate transfers to children and grandchildren have been completed without gift tax returns. A gift split with your spouse under the gift-splitting provisions requires a return to indicate consent. An estate tax return should be considered at the death of most married individuals even if the deceased spouse has far less than the $5 million exemption equivalent in assets because the unused exemption can only be transferred to the surviving spouse on a timely filed return.

Don’t: Leave all your assets to your spouse without considering the possibilities of the "deceased spousal unused exemption amount (DSUEA)". The new law does permit (for two years anyway) the surviving spouse to increase his or her available exemption by the amount unused by the deceased spouse. This could provide a potentially incorrect assumption that traditional planning involving marital deductions trust and unified credit (exemption) trusts is a thing of the past.

Do: Have a thorough analysis of your estate plan in conjunction with your advisors and discuss the possibilities of applying your exemption in the appropriate manner. A simple "I love you" will with your surviving spouse may or may not be appropriate in your case. A family trust may be appropriate if you, for example, have children from a prior marriage. In some instances, there may be tax economic reasons to create an exemption trust. For example, the DSUEA left to a surviving spouse is not indexed for inflation, but an exemption trust funded with up to $5 million would be able to grow to any amount by the second death without estate taxes.

Don’t: Believe that trusts are just tax-saving vehicles for the wealthiest Americans.

Do: Understand the benefits of trusts and create trust funds as appropriate. For estates above the exemption amounts, trusts are potentially the most appropriate vehicle to provide transfer-tax savings. However, trusts also are beneficial for other reasons. For example, trusts provide creditor protection, the ability to limit a beneficiary's access to funds, accumulation for the future, probate avoidance, and many other purposes.

Don't: Believe that a $5 million estate tax exemption eliminates the benefits of lifetime gifts.

Do: Take advantage of the $5 million gift tax exemption to the extent appropriate. The five-fold increase in the gift tax exemption for 2011 and 2012 is, perhaps, the single most important opportunity in estate planning in the last 30 years. If you have the wealth and flexibility to make substantial gifts, this opportunity should be discussed with advisors as soon as possible. The larger exemption amount can be used in a number of manners. Interests in the family business can be transferred to the next generation. Or, a $10 million generation-skipping (GST) trust can be created for the next generations. Substantial life insurance transfers can be made with premiums above the annual exclusion amounts. The use of valuation-discounting techniques can be used to further leverage the $5 million exemption.

The majority of lifetime estate-planning techniques are more beneficial if they are implemented earlier. For example, techniques like qualified personal residence trusts (QPRTs) or grantor-retained annuity trusts (GRATs) provide the greatest benefit if the grantor has a significant retained term and lives beyond the termination of the trust. The cost of life insurance increases if the insured’s age or health status is less favorable at the time of application. Gifts are most effective if substantial appreciation has occurred after the gift is completed. Furthermore, the $5 million exemption is currently available only until the end of next year. The wealth-transfer opportunities created by the increased gift-tax exemption are most valuable if you act quickly.

Don’t: Assume that the need for life insurance protection has diminished because of the higher exemption amounts or that your current life insurance policies are structured appropriately for the new wealth transfer tax rules.

Do: Understand the value of life insurance as both a risk transfer device and an asset class. The lessons learned from recent economic uncertainty amplifies the value of the security provided by life insurance products. This is an excellent time to perform a "life insurance audit" to determine if your existing coverage is structured properly or if changes should be made.

Recent Cases and Rulings

Taxpayer Victory in Limited Liability Company (LLC) Appellate Decision

The Court of Appeals for the Ninth Circuit examined the district court's grant of summary judgment to the IRS with respect to a disputed discount for contributions of interests in a family LLC. (Linton v. US, 107 AFTR 2d 2011-565) The taxpayer created an LLC in November 2002. In January, the taxpayer and his attorney prepared several documents with respect to the LLC. The documents included deeds of transfer of property to the LLC, trusts for children, and transfers of interests in the LLC to the children's trusts. After completing the documents, the attorney dated all documents with the same date in January. The attorney later testified that the transfers to the trust should have been dated several days afterwards. The District Court granted the government's motion for summary judgment with respect to two issues. First, the transfers to the LLC of property were, in effect, an indirect transfer to the children's trust since the gifts were made before the LLC was effectively funded. Second, even if the gift was appropriately timed, it was part of a step transaction that creates the same result of the direct gift of the property to the children's trust. The net result is that the LLC gifts were not subject to any minority interest or marketability discounts since the gift is treated as a direct transfer of the property used to fund the LLC.

The appellate court reversed the grant of summary judgment and remanded the case to the District Court to examine the issues concerning the timing of the completed gift. The step-transaction doctrine has generally applied to income tax issues and is not often used effectively with respect to wealth transfer taxes. Although we don't know the final result when the District Court fully examines the issues, the case does present some guidance. First, it is recommended that the creation and funding of a family limited partnership or LLC should precede the gifts of the interest in the entity by some period of time. Second, it is extremely important to complete the appropriate documents on a timely basis and have perfect records of the details of such transfers.

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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