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Estate Planning Issues and Opportunities for 2010 and Beyond



The temporary repeal of the federal estate tax and the generation-skipping transfer (GST) tax in 2010 has created uncertainty for families that, in prior years, would have been unaffected by these taxes. Further adding to this dilemma is the likelihood that Congress will reinstate these taxes in 2010, possibly retroactive to January 1. Here is a brief recap of what we do and do not know, along with some issues and opportunities to consider.

What we know

- The federal estate tax and the GST tax (a separate tax on lifetime or at-death transfers to "skip" generations, such as grandchildren) are repealed for 2010, but are set to reappear in 2011 at pre-2001 rates. In 2011, the estate and GST tax exemption amounts will drop to \$1 million (from \$3.5 million in 2009) and the highest tax rate will jump to 55% (from 45% in 2009).
- The gift tax remains in place with a \$1 million lifetime exemption and a tax rate of 35% (down from 45% in 2009).
- In prior years, inherited assets received a step-up in cost basis to the asset's fair market value on the date of death. In 2010, inherited assets generally receive the lesser of the asset's date-of-death fair market value or the decedent's carryover basis. However, estates can exempt up to \$1.3 million of gain for assets left to heirs, and an additional \$3 million exemption can be allocated to assets specifically left to a surviving spouse.

What we don't know

- Will Congress reinstate the estate and GST taxes at their 2009 levels, or will they create a new tax regime?
- Will any changes be retroactive to January 1?
- How will estates be expected to pay any retroactive taxes, especially if assets have already been distributed?
- What will individual states that link their own estate tax systems to the federal estate tax system do?

Issues and opportunities

It's hard to know how to react to the uncertainty presented by the current estate tax situation. Should you change your estate plan and update your estate planning documents when it's possible that your existing plan will once again be appropriate in 2011, or even sooner? For many, the answer is no, but for a few, the answer is definitely yes.

Generally, you should consult an estate planning attorney if:

- You are very old, very ill, or terminally ill
- You have a will or trust that allocates assets based on a "formula clause"
- You want to make gifts to individuals in the "skip generation"—those who are two or more generations below you
- You have assets with an appreciated value in excess of \$1.3 million

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Aged or ill need to review estate plans now

For those who are aged or terminally ill, if the repeal remains effective, your goal may shift from saving estate taxes to saving capital gains taxes. Thus, in response to the modified step-up in basis provision, you may want to reallocate the distribution of highly appreciated assets.

Your will or trust should authorize your executor or trustee to allocate the \$1.3 million basis adjustment and the \$3 million spousal basis adjustment in the most advantageous way, while allowing for the possibility of the reappearance of the estate tax. However, determining how to do so can vary greatly based on many different factors, including:

- Your cost basis in estate property and the amount of gain that would be realized if the property is sold in 2010
- The anticipated tax bracket of the beneficiary inheriting the property--the tax impact may not be as great for beneficiaries in a lower tax bracket
- Whether appreciated property placed in a bypass trust qualifies for the surviving spouse's basis adjustment

- Whether property is expected to be retained by the beneficiary after it's inherited, such as a farm or family business
- Whether capital gains tax can be avoided or minimized through other means, such as charitable gifting
- Whether the \$250,000 federal income tax home sale exclusion applies to estate property that is a principal residence



to your beneficiaries, you can gift to a dynasty trust which directs when beneficiaries are able to access their gifts. However, if the GST tax is imposed retroactively, some of those gifts may be subject to that tax after all. You'll have to weigh this possibility against the potential tax savings of gifting without the GST tax to determine the best course of action for you.

If you've already begun a plan of gifting to grandchildren, either directly or through dynasty trusts, you should review your estate plan. If gifts to your grandchildren are based on your available GST tax exemption, those gifts may not be made if you die in 2010 when the GST tax is repealed. An estate planning professional may be able to amend your documents to include a different formula to account for the possibility that there is no GST tax exemption when allocating gifts to grandchildren.

Review documents for formula clauses

Your will or trust may provide that upon your death, a percentage or fraction of your estate, up to the applicable estate tax exclusion amount, will pass to a family trust (also referred to as a bypass or credit shelter trust) for the benefit of your children, with the balance going to a marital or residuary trust for the benefit of your surviving spouse.

If there is no estate tax at your death, such a formula clause may cause your entire estate to be transferred to your family trust, leaving nothing to the marital trust. If your surviving spouse is the beneficiary of both trusts, there may be no problem, but if your spouse has no right or access to assets in the family trust, then your surviving spouse could be unintentionally disinherited.

In light of these potential issues, it is best to review your estate planning documents with your attorney and make necessary revisions to ensure that your wishes are carried out. Your will or trust should be drafted to clearly reference what should happen if you die when there is no estate tax, or if the exclusion amount is greater or lesser than the 2009 amount (\$3.5 million). Your documents will need to provide flexibility in their distribution provisions to accommodate the possibility of many varied scenarios.

If you're inclined to make large gifts

The temporary repeal of the GST tax provides an opportunity to make gifts to skip beneficiaries free from the GST tax. You can make large gifts to grandchildren, subject only to the gift tax (at a 35% tax rate). If you don't want to make a gift directly

What about state estate taxes?

Some states have their own estate tax, and many estate plans were drafted in contemplation of either or both a federal estate tax and a separate state estate tax. These plan documents also need to be reviewed in 2010. Your will or trust may direct that assets be allocated to a family or bypass trust to minimize the federal or state estate tax, when the capital gains tax is also a real possibility. How should assets be allocated now to take advantage of the repeal of the federal estate tax, to minimize any potential capital gains tax, or to utilize any state estate tax exemption? These questions require careful consideration and planning as there's no "one size fits all" solution.

Conclusion

The tax law changes in 2010 have given rise to much confusion and many issues to consider. Inaction is the least favorable option. Keep abreast of the potential legislative changes that might occur in 2010 and work with your estate planning professional to update your plan documents to best carry out your wishes now and in the future.

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