FROM THE J.P. MORGAN ADVICE LAB

in your interest

NEW TAX RELIEF ACT CREATES DRAMATIC GIFTING OPPORTUNITIES

There also may be pitfalls. It is imperative that all wealthy individuals review their estate plans as soon as possible

The Tax Relief Act that is now in effect requires an immediate review of your estate plan. Wills and trusts need to be analyzed to ensure that they still meet your objectives – and to take full advantage of new opportunities.

In particular, higher exemption levels, for both estates and gifting, create the possibility of transferring substantial sums transfer tax-free. But, because these provisions of the Act are scheduled to sunset on January 1, 2013, this may very well be a "use it or lose it" opportunity.

NEW RULES

The new law, formally called the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, has received a great deal of press because it extends current income tax rates for all taxpayers through 2012.

But the Act also profoundly affects estate, gift and generation-skipping transfer (GST) taxes:

- For 2011 and 2012, the lifetime gift and estate tax exemptions are reunified with an exemption of $5 million for individuals (up to $10 million for a married couple – and any unused exemption may be portable; see below). Additionally, an individual's GST exemption will be $5 million (up to $10 million for a married couple).
- Estate, gift and GST tax rates are 35% in 2011 and 2012.
- A new "portability" provision enables an executor to transfer any estate tax exemption not used by a deceased spouse to the surviving spouse.

Note: There is no change to rules that apply to non-domiciliaries of the United States. For instance, assets of such individuals' estates that are subject to U.S. estate taxes still are covered by a very limited $60,000 exemption.

ACT NOW

If Congress does not act to prevent the Tax Relief Act's new rules from sunsetting, there will be a reinstatement in 2013 of pre-2001 rates (55% for estates and lifetime gifts) and exemptions ($1 million for estate and gift taxes, and approximately $1.35 million for GST taxes).

This means the opportunities created by the Act may be time-limited. And, as the new law already is in effect, it is very important that you consult with your legal and tax advisors as soon as possible.

Specifically, you may want to:

Take advantage of new gifting opportunities. The increase of the lifetime exemption from 2010's $1 million level to $5 million in 2011 allows individual taxpayers to transfer $4 million more than they could have in 2010 without incurring any gift tax. (A married couple can transfer $8 million more than in 2010.)

- The additional tax-free amount can be used either for outright gifts or for transfers to trusts, including generation-skipping trusts (see "dynasty trusts" below).
- It is a fundamental tenet of good estate planning to use exemptions early because once assets are gifted, future income and growth are not included in your future taxable estate. Now, the Act's five-fold increase in your

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gift exemptions creates a chance to remove five times the income and growth from your future estate.[1]

- Consider forgiving loans as another alternative use of the increased gift exemption.

Make the most of your exemptions; consider:

- Giving assets that have strong return potential.
- Transferring assets that can be discounted for gift tax purposes.
- Giving to irrevocable "grantor" trusts that allow you to pay the ongoing income tax liabilities on trust investments, maximizing the return to your heirs.
- Giving assets with higher cost basis (when possible), because donees receive your cost basis.

Exercise caution by reviewing your estate plan.
It is imperative that you have your estate-planning documents, including life insurance and beneficiary designations, examined to ensure that, under the new rules, they are still effective and consistent with your objectives.

- **Impact on heirs** The new exemption levels may significantly affect "formula clauses" that apportion assets between spouses and other beneficiaries. In particular, it's important to carefully review bequests to so-called "credit shelter trusts," which use available exemptions to shield assets from estate taxes. This is especially the case for smaller estates, as formula clauses could overfund credit shelter trusts at the expense of a surviving spouse.
- **New option** Consider using the new portability rule to create choice. Your will or revocable trust can be drafted to give a surviving spouse the option of applying the deceased spouse's exemption to assets of the estate or, instead, to use the exemption him/herself later, for example, through gifting.
- **Payment of state estate taxes** Taxpayers in states that have a separate state estate tax may find that amounts owed to states are now significant, given the potential difference between many states' exemption amounts (sometimes as low as $1 million) and the new federal exemption of $5 million. In addition, formula clauses regarding the payment of state estate taxes need special attention now, as standard directions may leave a significant portion of the federal exemption unused and, inadvertently, leave a credit shelter trust underfunded if the gap between federal and state exemptions is high enough.

Individuals should make informed decisions about the amount and timing of the payment of both federal and state estate taxes.

USEFUL GIFTING TECHNIQUES

Many techniques that allow for tax-efficient transfers of appreciation on assets are still viable under the new law and may even be enhanced:

- **Grantor retained annuity trusts** GRATs are still an excellent wealth transfer tool despite a recent increase in the hurdle rate to 2.4% for January 2011 GRATs. The new law does not affect GRATs.
- **Sales to irrevocable grantor trusts** You also may want to consider other techniques such as asset sales to irrevocable grantor trusts, which can be funded at higher levels given the increased gift and GST exemptions applicable in 2011 and 2012.
- **Dynasty trusts** 2011 and 2012 present a window for creating GST trusts. The unification of the gift and GST exemption at $5 million creates an unprecedented opportunity to significantly fund trusts that have the potential to benefit multiple generations. By applying GST tax exemption to the trust, future distributions to grandchildren and later generations will be free of GST taxes.

CAUTION

The new law also presents a number of other issues that need to be carefully considered:

- **Gift tax returns** It is important to ensure that 2010 gift tax returns are prepared correctly, especially regarding gifts to grandchildren. Because the GST tax rate was zero in 2010, in some cases you may not need to allocate the GST exemption to 2010 transfers to grandchildren. But – be aware – that exemption will be allocated automatically unless you elect out of this automatic GST allocation on your 2010 gift tax returns.
- **State estate taxes** You will want to check the state estate tax laws in your home state, most notably the available exemption. The exemptions against these taxes did not

[1] There is also some (but not a full) benefit attributable to using new, higher exemptions if in the future they revert back to lower levels, as some of the benefit may be "recaptured" due to the unified estate and gift calculations applicable to estates.

always conform to existing federal levels before the new law was enacted, and that problem has been exacerbated now that the federal estate tax exemption is increased to $5 million. For instance, New York's exemption level is $1 million. As a result, married couples in states that still have estate taxes may have to decide whether it is worth paying state taxes to maximize the value of the federal exemption, or whether it is better to avoid state taxes by not using the entire federal exemption.

- **Limits of the new portability** Portability of unused exemptions does not extend to GST taxes. In other words, while a surviving spouse can use any unused exemption for gift and estate taxes, he or she will not be able to use any unused GST exemption. This reinforces the importance of maximizing available GST exemptions now.

- **Special rules for 2010 estates** The new law allows executors of estates whose decedents died in 2010 to choose either (a) this year's rates (a 35% estate tax rate and $5 million exemption) or (b) the repeal rules that were in effect in 2010. The tradeoff for *not* applying the new estate tax is that inherited assets above certain thresholds would not receive a "step-up" in their income tax basis, meaning that heirs could face considerable embedded capital gains taxes. These complex rules require careful individual consideration.

INCOME TAX OPPORTUNITIES

In addition to changes to the wealth transfer regime, the Tax Relief Act also significantly affects income taxes. Here, too, there are some important opportunities to note:

- **IRA rollovers to charity in 2011** Provisions for fulfilling required minimum distributions by transferring assets up to $100,000 directly from an IRA to a public charity have been renewed through 2011. So taxpayers interested in fulfilling philanthropic intentions and avoiding recognizing more ordinary income can do both by making a direct rollover from their IRAs to charity.

- **Conservation supported in 2011** Provisions expanding the rules for qualified conservation contributions also have been extended through 2011, providing continued opportunity for taxpayers interested in donating real property interests to either philanthropic organizations or government entities for conservation purposes.

- **Roth IRA conversions** Keep in mind that there continue to be no income limits for conversions of traditional IRAs to Roth IRAs. The recognition of income from conversion can no longer be deferred as it was for 2010 conversions, when half of the income from the conversion was scheduled to be recognized in 2011 and half in 2012. But for those contemplating conversion, the extension of reduced income tax rates continues to make conversion attractive. And for those who did complete a Roth conversion in 2010, the extension of the reduced income tax rates makes deferring the income recognition until 2011 and 2012 more attractive.

WE CAN HELP

While the Tax Relief Act has created what may be a temporary tax landscape that requires your immediate attention, your wealth advisors and private bankers at J.P. Morgan are ready to work with you and your advisors to help you to make the most of these new rules' opportunities – and to help avoid their pitfalls.

NEW RATES AND EXEMPTIONS UNDER TAX RELIEF ACT OF 2010

As of January 1,	2010	2011	2012	2013
Top income tax rate	35%	35%	35%	39.6%
Capital gains tax rate	15%	15%	15%	20%
Qualified dividend tax rate	15%	15%	15%	39.6%
Social Security payroll tax rate	6.2%	4.2%	6.2%	6.2%
Estate tax rate	35%	35%	35%	55%
Estate tax exemption	$5mm	$5mm	$5mm*	$1mm
Gift tax rate	35%	35%	35%	55%
Gift tax exemption	$1mm	$5mm	$5mm*	$1mm
GST tax rate	0%	35%	35%	55%
GST tax exemption	$5mm	$5mm	$5mm*	$1mm*

*To be adjusted for inflation
Source: J.P. Morgan

THIS PAPER IS WRITTEN BY
THE ADVICE LAB
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