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Two Year Window … Congress Provides Opportunity

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In December, in a rare show of cooperation, Congress passed The Tax Relief Act of 2010. Buried amongst the provisions of the bill, the representatives finally addressed the estate tax quagmire left over from their failure to act and provide estate tax guidance in December 2009. This failure to act left advisors and families uncertain about what they should do with their estate plans.

A number of wealthy estate owners passed away in 2010 resulting in a loss to the treasury and a windfall to the families who paid $0 in estate tax to the federal government. This, of course, was highly publicized in the press, most notably as it related to the passing of George Steinbrenner, the owner of the New York Yankees.

Congress took notice and the result was the estate law provisions in the Tax Relief Act for 2011-12. The provisions provide significant opportunities for planning by business owners who are concerned with transitioning successful businesses to the next generation while minimizing the tax impact.

The following chart provides a comparison of the new law's provisions with the law as it existed in 2009 and what would have happened in 2011 had this law not been passed.

	2011/2012	**2009**	**2011***
Lifetime Exemptions	$5.0M**	$3.5M	$1.0M
Gift Credit	$5.0M	$1.0M	$1.0M
Max Tax Rate	35%	45%	55%
Portable Exemption	Yes	No	No
Step Up in Basis	Yes	Yes	Yes

*The provisions under the law as it would have been had new law not been enacted.

**These exemptions are per person, so for a married couple their estate tax life-time gift and estate tax exemption is $10M.

For most advisors, if any one of these improvements had passed, they would have been very happy. For all of them to be included is unexpected, and if acted upon provide opportunities to pass significant wealth to the next generation for business owners and the wealthy. This could and should be a motivator for owners to pass their business interests to the next generation, tax free.

Let's concentrate on three potential strategies to take advantage of this two year window:

First, for business owners, let's compare the use of the lifetime gift exemption under prior law with the opportunity available for the next two years. Under prior law, an owner could gift under two different tax exemptions; the first an annual exclusion that was $13,000 per gift per year. A husband and wife could give $26,000 per gift per year, so for two children, $52,000 per year. In addition there was a lifetime exemption of $1.0M for both husband and wife.

Under the law for the next two years, the annual exclusions remain as described above, but the lifetime exemption for tax-free gifting has been increased to $5.0M. If minority interest stock is gifted, a discount of 30-40% might be achieved and the $5.0M gift might be worth $7.0M in fair market value of the stock. Husband and wife joining together in the gift would increase that number to a possible $14M in fair market value.

A second strategy that is frequently used is also enhanced under the new regulations. To provide liquidity to pay estate taxes, parents often choose to provide life insurance owned by an Irrevocable Life Insurance Trust. The premiums for this strategy are considered a gift against the annual exclusion amount noted above. When they exceeded the annual exclusion capacity, they ate into the lifetime gift exemption, formerly limited to $1.0M per person. Obviously, the increase in the gift exemption to $5.0M offers an opportunity to fund significant life insurance amounts without attracting gift tax.

We recently tested this strategy for a husband and wife at 60 years of age and in good health and the results were impressive: using a $5.0M gift, the trust could purchase over $30M of survivor life insurance on their two lives.

A third strategy is layered with the two noted above. It involves a sale to a special trust of stock in the family business. By having an arms-length transaction with properly valued stock and using the lifetime exemption of $5.0M to give a "seed gift" to the trust, as much as $50M or more of value can be frozen in the parents' estate. This allows the growth of the stock to inure to the next generation of owners. In addition, if the stock is in a "flow-through entity" such as an S-Corp, the distributions can be used to repay the note to parents. The earnings can then be used to purchase life insurance on the parents to pay the estate tax on the $50M and any other assets they have retained.

All of these strategies require careful thought and consideration and the advice and direction of a skilled attorney. But it is worth the effort and time to explore these opportunities while the two year window is open. Who knows where Congress will take this law in 2013???