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IT ALL ADDS UP.

MP&S TAX ALERT: CURRENT ESTATE TAX LAW UNCERTAINTY SHOULD ALTER YOUR PLANNING STRATEGIES IN 2012

Without congressional action before year end, on Jan. 1, 2013, the current $5.12 million gift and estate tax exemption will drop to $1 million and the top rate of 35% will increase to 55% — as prescribed by pre-2001 tax law.

Many believe Congress will address the expiring estate tax law provisions before year end. But will it extend the current estate tax regime for a set number of years, make it permanent or take a middle-ground approach by, for example, adopting a $3.5 million exemption and a 45% top rate?

This uncertainty can play havoc with estate planning. But with the currently high gift tax exemption and low top gift tax rate, now is a good time to remove large amounts of wealth from your estate with lifetime gifting. In addition, consider adding flexibility to your estate plan to prepare for potentially lower exemptions and higher rates in 2013.

Consider Making Larger Lifetime Gifts This Year

Under the $5.12 million exemption, you have the ability to remove an unprecedented amount of wealth from your Federal estate gift- and Federal estate-tax-free through lifetime gifts — assuming there's no "clawback." Each individual state's law must be considered, for the state impact on the gift.

(Some people fear that, if the estate tax exemption shrinks by the time someone dies, any lifetime gifts in excess of the exemption amount in the year of death — even if the gifts were made in reliance on the $5.12 million exemption — may be "clawed back" into the person's estate and subject to estate tax. But many experts argue that clawbacks aren't a real concern.)

Making gifts sooner rather than later also can be a good strategy because it removes all future appreciation on the gifted assets from your estate. This amount will escape estate tax (even if the gift itself were to be clawed back into the estate).

If you max out your $5.12 million exemption, you can leverage the low 35% top gift tax rate by making taxable gifts in excess of your exemption. Again, you also remove the future appreciation on those assets from your taxable estate.

However, assets transferred by gifts aren't entitled to a "stepped-up basis." Thus, your heirs likely will have to pay more capital gains taxes if they sell these assets than they would if they inherited and sold them. So that needs to be weighed against the gift and estate tax savings.

It's also important to know that the gift tax exemption is "unified" with the estate tax exemption. What this means is that the exemption covers up to $5.12 million in *combined* lifetime gifts and bequests at death. So, for example, if you make $4 million in lifetime gifts, you'll have only $1.12 million remaining to shield from estate tax — if you die while the $5.12 million exemption is in place. Your available exemption could be less (even $0) or more depending on the exemption in place in the year of your death.

You can take further advantage of current law by making gifts this year to your grandchildren or others more than one generation below you. The generation-skipping transfer (GST) tax exemption is also $5.12 million — and the GST tax rate is 35% — through 2012.

Even though gifting now is a favorable strategy to remove large amounts of wealth from your estate tax-free, don't make the decision to do so solely because of the current estate tax law. You

also need to take into account nontax issues such as the gift's impact on the recipient and the sufficiency of your remaining resources to finance your current lifestyle.

Two Strategies to Add Estate Plan Flexibility

Regardless of whether Congress permanently extends the current gift and estate tax exemptions and rates or allows them to lapse and revert to pre-2001-tax-law levels, adding flexibility into your estate plan is smart. It's difficult, if not impossible, to design an estate plan that will accommodate every possible contingency. For example, you might get married (or divorced), have a child, welcome a new grandchild into the family, or see your net worth increase or decrease.

Let's take a closer look at two estate planning strategies that can add flexibility:

Use a credit shelter trust. Along with the higher exemptions and lower rates, the 2010 Tax Relief act introduced estate tax exemption portability between spouses. Portability allows a surviving spouse to add the unused portion of a deceased spouse's exemption to his or her own. He or she can then use it to make additional tax-free transfers during life or at death.

The downside to this provision is that it will expire at the end of 2012 unless Congress extends it. Even when the election is made on a timely filed estate tax return, if the surviving spouse hasn't used the exemption to make lifetime gifts (or hasn't died) before portability expires, the portability of the exemption will be lost.

An effective way to preserve both spouses' exemptions and to hedge against the chance that portability won't be extended to 2013 and beyond is to use a credit shelter trust. A credit shelter trust also protects future appreciation on the trust's assets from estate tax.

If you already have a credit shelter trust in place, be sure to review the trust documents. Does the trust allow your estate to take full advantage of the current estate tax regime? Is it prepared for the possible return of the pre-2001-tax-act law in 2013?

Specifically, the trust should be flexible enough to allow you to gain all available estate tax benefits. For example, check that the language doesn't provide for a fixed dollar amount to go to the credit shelter trust. Such language could cause you to lose out on the ability to shelter the full $5.12 million you might be entitled to should you die this year.

Consider qualified disclaimers. A disclaimer's flexibility lies in the fact that it gives your beneficiaries the power to reject assets that pass to them, when appropriate. With the estate tax exemption set to drop from $5.12 million to $1 million in 2013, using a disclaimer could allow for a significant reduction in the overall estate tax paid by your heirs.

For example, let's suppose that your children have estate tax concerns of their own. Inheriting additional assets from you wouldn't change their lifestyle, and they'd have the challenge of transferring those assets to their children — your grandchildren — with as little tax consequence as possible. Taking advantage of a disclaimer, your children could keep the assets out of their estate and pass them directly to your grandchildren, effectively bypassing one level of estate tax.

More specifically, suppose your children stand to inherit $1 million from you. Assuming a 35% estate tax rate is still in place, those assets could, on their death, be subject to federal estate tax of $350,000. (Should the assets increase in value and/or the tax rate increase, of course, the estate tax liability attributable to those assets could be more.) Thus, your grandchildren would end up with just $650,000. By disclaiming, however, your children could pass the entire $1 million — and all future growth — to your grandchildren.

To avoid negative gift or estate tax consequences, a disclaimer must be considered "qualified." This means that it needs to be in writing, it must be delivered to your estate's representative within nine months after the transfer is made, the person making the disclaimer (the disclaimant)

can’t have accepted the asset or enjoyed any of its benefits, and the disclaimer must result in the property being passed — without any direction from the disclaimant — to someone other than the disclaimant.

Importantly, there is flexibility within the disclaimer itself. So long as it’s done properly, you can generally disclaim some assets while not disclaiming others. The subtle but important distinction is that for the disclaimer to be effective the disclaimaint must relinquish the entire interest *in the property being disclaimed*. The disclaimant, however, isn’t required to disclaim *all* property.

Time to Revisit Your Estate Plan

With some estate tax law provisions expiring after 2012 and the uncertainty over what actions Congress will take regarding estate tax law, you may have concerns about how your estate plan could be affected. We’d be pleased to work with you and your estate planning attorney to ensure that your estate plan 1) takes full advantage of the high exemptions and low rates this year and 2) has the flexibility required to weather future estate tax law changes.