



QUARTERLY NEWSLETTER

2010 WINTER

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We hope you find our newsletter both informative and interesting. Please let us know what you think.

WINTER CALENDAR

WINTER TRIVIA

December 21st ~ First Day of Winter
December 25th ~ Christmas Day
January 1st ~ New Year's Day
January 17th ~ Martin Luther King Day
February 2nd ~ Groundhog Day
February 14th ~ Valentine's Day
February 21st ~ Presidents' Day
March 13th ~ Daylight Saving Time Begins
March 17th ~ St. Patrick's Day

- A. What percentage of fresh snow is composed of air?
B. How many times in one year does the sun set and rise in the Arctic?
C. What determines the shape of a snowflake?
D. Which U.S. city has the coldest winter temperature on average?

A. 80 B. Once C. Temperature D. Barrow, Alaska 4.1° F

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Gift Tax and Generation Skipping Tax

By Don Cooper, CPA

We have all heard about the repeal of the Estate Tax for 2010. The problem with the repeal of the estate tax is that you have to die to take advantage of it. While we all love saving money, sometimes the price just isn't worth it. However, along with the repeal of the estate tax was the repeal of the Generation Skipping Tax (GST). Enacted to discourage the passing of wealth past a generation of potential estate tax, the GST uses up the life-time exemption and then taxes the gift at the highest estate tax level.

Even though the Estate Tax and GST tax are repealed for 2010, the Gift Tax is still taxing gifts in excess of the \$1,000,000 lifetime exemption. The good news is that for 2010 the Gift Tax is lowered from 45% to 35%.

If you have already gifted up to the \$1,000,000 limit before gift tax kicks in and are planning additional gifts or thinking about making a gift in excess of \$1,000,000 you should consider doing so prior to December 31st. With the GST being repealed, coupled with the 35% rate, this is an excellent time to be making major gifts.

Of course, without action from Congress the sunset provisions bring the estate tax back beginning January 1, 2011, and gift tax rates are back to 55%, and GST is back to the 2001 rate of 55% .

Direct gifts to Grandchildren are great. However, you need to be careful about making gifts to trusts. Even though there is no GST now, it is likely that GST will be back and if it is in effect the year of distributions, the distribution could trigger GST in future years.

By making a gift directly to grandchildren you keep it from becoming part of not only your estate, but the estate of your children who may stand to inherit sufficient assets to have their own estate planning issues.

Clients' Interests Come First...Period

By David Lamp, CFP

Clients of BBJs LLP justifiably expect that we put their interests before those of anyone else. This is referred to as a fiduciary standard of care. CPAs and attorneys would have a tough time running their firms if they did it any other way. Operating under a fiduciary standard not only makes good business sense it is common sense.

When hiring a financial advisor you might think they serve in a fiduciary capacity but that may not be the case. In fact, a majority of Americans choose to work with advisors that don't work under a fiduciary standard of care.

Advisors that operate as fiduciaries are called Registered Investment Advisors (RIA's). RIA firms are required to register with the Securities and Exchange Commission (SEC) once they reach a certain size. If the firm is smaller, they will be required to register with the state in which they are domiciled.

Alternatively, Broker Dealers, or Brokers, operate under a suitability standard. Under a suitability standard, the broker only ensures that the investment they recommend is suitable for the client.

This very issue has been a topic of hot debate in our nation's capital recently, and is one of many issues addressed in the Dodd-Frank Financial Reform Bill. Currently, the idea of applying a fiduciary standard to all financial services professionals is being "studied." Not surprisingly, there is substantial resistance to this idea since many of the large wire houses, investment banks and insurance agencies whose focus is sales have business models that would be fundamentally changed if the fiduciary standard were applied.

The changes, if any, which will come from the study, remain to be seen. The good news is that as a consumer, you don't need the study to tell you which business model makes sense for you when you choose an advisor. Many firms already operate under the more stringent rules that a fiduciary standard imposes. You can choose accordingly.

ESTATE PLANNING IN UNCERTAIN TIMES

BY: DAVID KEENE, CPA

The federal estate tax system is in a state of uncertainty. There is no estate tax in effect for 2010, however, if Congress does nothing the estate tax law that existed in 2001 will come back into existence in 2011. Under that law estates over \$1 million will be subject to tax (i.e., the exemption amount will be \$1 million) and the rate of tax will be as high as 55%, plus estates over \$10 million will also be subject to an additional 5% surtax. During 2010 various proposals were discussed in Congress to replace this \$1 million exemption/55% tax rate scheme for the estate tax in 2011 and going forward. While no one can legitimately predict what – if anything – Congress may do, many of the 2010 proposals discussed were similar in design to the law that existed in 2009; where the exemption amount was \$3.5 million and the highest tax rate was 45%. Washington's estate tax system subjects estates in excess of \$2 million with a tax starting at a 10% rate, progressing to a 19% rate for estates exceeding \$11 million. For better or worse Washington law is unlikely to change in the near future.

The uncertainty in the future of the federal estate tax system has caused many taxpayers to put off any estate planning actions. However, if you believe – as we do – that some form of federal estate tax will exist in the future then there likely will be opportunities for acting now that will serve to reduce estate taxes and avoid problems for your heirs in the administration of your estate. Though each person's situation will be different, the following suggestions will likely benefit anyone expecting to have a taxable estate.

Gifts

For decades the federal estate tax system allowed so-called annual exclusion gifts to be made without any gift or estate tax liability being generated. The annual exclusion amount for 2010 is \$13,000 per recipient; i.e., a taxpayer can give that amount to as many recipients as he wishes without generating any gift tax being due and without counting against the lifetime \$1 million exemption of the taxpayer. The threshold question, of course, is can you afford this. This is certainly a personal question, but if you can afford to do a \$13,000 gift but skip doing so for a year then you have effectively decreased what eventually will pass to your heirs by at least \$13,000 multiplied by the estate tax rate that your estate will be subject to. This is because the \$13,000 that remains in your estate (by passing on doing an annual exclusion gift) will be subject to estate tax. But there is more...

- Not only is your estate larger by the \$13,000 foregone gift but any growth and income that amount would have generated from the date of gift until your demise will also be in your estate's tax base.
- Since the annual exclusion amount is allowed for each recipient, a taxpayer could give a total of, say \$39,000 (e.g., \$13,000 to each of 3 children), and have that amount totally protected from estate or gift tax.
- And since each spouse of a married couple is considered a separate taxpayer under the annual exclusion rules, a couple with 3 children could benefit under this exception to the extent of \$78,000/year (6X\$13,000).

The future growth and income removed from an estate by an annual exclusion gift of \$13,000 is considerable when such annual gifts are repeated year-to-year. To fully appreciate this, the chart below attaches some amounts to this. In this chart, we will presume annual exclusion gifts of \$13,000; if the proposed gifts were not made the funds would grow at either 4% or 8% annually within the taxpayer's estate, a blended tax rate applicable to this growth (on ordinary income and capital gains) of 30%, and the relevant statistic is the amount that will be excluded from the taxpayer's estate by making these gifts.

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Reduction In Estate Due to Annual Exclusion Gifts		
Facts and Assumptions:	1) Annual exclusion gifts = \$13,000	2) Income tax on growth/income of funds if not gifted = 30%
<i>Time Period After 1st Annual Exclusion Gift</i>	<i>Excluded from Estate if Funds Grow @ 4% per annum</i>	<i>Excluded from Estate if Funds Grow @ 8% per annum</i>
10 Years	\$151,800	\$177,583
20 Years	\$351,879	\$483,807
30 Years	\$615,593	\$1,011,862

This simplified and conservative analysis presents a powerful case for continuing annual exclusion gifts. It is worth noting that taxpayers who would consider annual exclusion gifts to two recipients would be able to reduce their estate by twice the amounts shown above, and so on, depending on the number of recipients of gifts.

Taxpayers with larger estates may be interested in giving more than the annual exclusion amount and though these larger gifts will reduce the taxpayer's \$1 million lifetime exemption (above which a gift tax will be due), there exist advantages for such a more aggressive strategy as well. The advantages include:

- Future income and appreciation on gifted amounts is removed from the taxpayer's estate.
- Though the federal tax system may tax these gifts, Washington State does not tax gifts.
- For 2010 the gift tax rate is only 35% – a low rate as compared to past tax rates and unlikely to be repeated in future law.

The use of trusts and other more sophisticated strategies than those discussed above are issues we help clients investigate and manage. However, taking advantage of these straightforward suggestions is something we encourage all clients to consider.

Estate Liquidity

Federal and Washington State law require the estate tax to be paid 9 months following the date of death. This can be a problem if an estate does not have sufficient liquid assets to pay this bill. For instance, if an estate consists of a significant amount of expensive real estate but little cash and marketable securities (stocks and bonds) the executor may be forced into what amounts to a fire sale of the real property in order to raise the cash to pay estate taxes.

A service we have provided for clients is an assessment of the liquidity position of their estate. This is based on spreadsheets we have developed to compute the federal and Washington estate tax liability and to also model how the existing assets would be applied to paying the estate tax and fulfilling bequests to the estate's beneficiaries. This process is complicated due to the uncertainty of the estate tax law that may exist in the future. Our solution to this dilemma is to provide two answers; one based on the law that will exist if Congress takes no action (giving the \$1 million exemption and 55% rate discussed above) the other answer based on the estate tax law as existed in 2009 (with a \$3.5 million exemption and 45% rate, also discussed above). The underlying premise of this two answer solution is that the final law will be one of the two being reflected or somewhere between these two ex-

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ESTATE PLANNING IN UNCERTAIN TIMES

To illustrate the liquidity analyses for an estate the charts below reflect the situation of a hypothetical taxpayer, Mary Smith. Mary is an 80 year-old widow with three children whose estate plan is to bequeath her estate after taxes equally to her three children, Sally, David and Michael. Additionally, Mary has made lifetime gifts totaling \$700,000 – which will affect the final estate taxes due. (For federal estate tax computations, lifetime gifts are added into the tax base to compute the initial estate tax with a credit given for gift taxes paid to arrive at the final estate tax bill. This computation is not shown and is computed in a separate spreadsheet.)

Estate Disposition if Estate Tax Laws of 2009 Exist					
<i>Description</i>	<i>Total Estate</i>	<i>Estate Tax (WA + Federal)</i>	<i>Sally 1/3 Share</i>	<i>David 1/3 Share</i>	<i>Michael 1/3 Share</i>
Cash in banks	100,000	100,000			
Marketable securities	900,000	669,250	76,917	76,917	76,917
IRA account	700,000		233,333	233,333	233,333
Residence	1,000,000		333,333	333,333	333,333
Vacation property	1,500,000		500,000	500,000	500,000
Totals	4,200,000	769,250	1,143,583	1,143,583	1,143,583

Estate Disposition if Estate Tax Laws of 2001 Exist					
<i>Description</i>	<i>Total Estate</i>	<i>Estate Tax (WA + Federal)</i>	<i>Sally 1/3 Share</i>	<i>David 1/3 Share</i>	<i>Michael 1/3 Share</i>
Cash in banks	100,000	100,000			
Marketable securities	900,000	900,000			
IRA account	700,000		233,333	233,333	233,333
Residence	1,000,000	980,750	6,417	6,417	6,417
Vacation property	1,500,000		500,000	500,000	500,000
Totals	4,200,000	1,980,750	739,750	739,750	739,750

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ESTATE PLANNING IN UNCERTAIN TIMES

As can be seen from the above chart for Mary's estate if future estate tax laws follow what existed in 2009, the estate's liquid assets (cash and marketable securities) would be sufficient to cover the estate taxes that would be due (9 months after the date of death). However, if the future estate tax laws follow what existed in 2001 (which would occur if Congress does nothing, as explained above), either the residence or vacation property would have to be sold to cover the estate tax bill. Mary has a range of choices from doing nothing and hoping the future tax laws turn out more favorable than the 2001 law going back into effect, to selling the vacation property so as to avoid the chance that a fire sale would have to occur later.

In spite of the uncertainty caused by the federal government's inaction on estate tax law, there are basic estate planning options which will be successful strategies in any future tax environment. Many clients should be able to take advantage of the gifting strategies discussed above. We can also present more sophisticated solutions, if requested.

CONGRESS HAS DECIDED....

Well, actually nothing. As of this publication nothing has been done. The best the President and Senate leadership have done is come up with a plan that is meeting with a lot of objections. What amazes most people is that Congress doesn't seem to realize that people are putting off making decisions until they know what Washington is going to do. We have been putting off this newsletter because we wanted to wait and give you the latest developments. There is no reason to wait any longer. We encourage you to check with our website www.bbjsllp.com and we will keep you updated with the latest tax changes. If you have specific questions about anything you read or hear, please give us a call.

Disclosure

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