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Year-End Wealth Planning Considerations—Planning Amidst Uncertainty

With the end of 2011 rapidly approaching, it's important to take a last-minute look at your personal wealth and financial planning objectives to determine if there are additional steps you can take to accomplish your goals. Last year, we wrote you that 2010 had been a unique year for tax planning, with the estate and generation-skipping transfer (GST) taxes temporarily repealed, but reinstated at year end, and the expiration of the Bush tax cuts deferred until the end of 2012 (see *Congress Passes Tax Relief Act: No Tax Increases for 2011 and 2012*).

But 2011 is again a "unique" year, making us wonder whether income and estate tax uncertainty is the "New Normal." As we send this out, the Joint Select Committee on Deficit Reduction of Congress (the Super Committee) has just completed its deliberations without making recommendations to Congress, so that spending and tax reform — and the ultimate future of the Bush tax cuts — is still uncertain as we head into 2012 and a presidential election year. Coupled with the drama in the global markets, long-term planning from both an estate and income tax perspective remains very difficult. But in the short term, there are significant planning opportunities available, many of which are scheduled to expire or change significantly at the end of 2012. The first part of this article will look at the unique gift opportunities provided by the temporarily increased exemption and decreased rates for the estate, gift, and GST taxes. The second part will address routine year-end planning as well as income tax planning opportunities that may come to an end in 2012.

2011 ushered in a year of extraordinarily favorable change for estate planning, while keeping in place many favorable income tax provisions. Have you taken advantage of all of your gifting and investment related tax opportunities for 2011 — and are you prepared for 2012?

SEIZING THE OPPORTUNITY IN 2011

Estate tax relief enacted at the end of 2010 offers unprecedented opportunities for high-net-worth families to transfer wealth through the end of 2012. As shown in Figure 1, the estate, gift, and GST tax exemptions have all been increased to $5 million for 2011 ($5,120,000 as indexed for inflation for 2012), allowing married couples with very high net worth the opportunity to transfer up to $10 million without incurring any tax. And depending on how a gift is structured, the assets can grow free of future wealth transfer taxes, sometimes even perpetually. But there is a sense of urgency around this opportunity: on January 1, 2013, if Congress does not act, the exemptions will fall back to $1 million, and family wealth transfers — whether by gift or at death — above that amount will be taxed at a highest rate of 55%. As discussed below, there are rumors that change could come sooner, so many families are looking seriously at their gifting plans.

Figure 1 **Wealth Transfer Tax Changes 2011–2013**

	2011	2012	2013
Estate and generation-skipping transfer (GST) tax highest rate and exemption	35% $5,000,000	35% $5,120,000 as indexed for inflation since 2010	55%* $1,000,000 (GST indexed for inflation)
Gift tax highest rate and exemption	35% $5,000,000	35% $5,120,000 as indexed for inflation since 2010	55%* $1,000,000
Basis of inherited assets	Fair Market Value	Fair Market Value	Fair Market Value

* A 5% surtax will apply to estates and gifts of $10,000,000 to approximately $17,000,000.

Why Make Gifts Now?

Clearly, the increased exemptions are a critical reason to think about making substantial gifts by the end of 2012. And since most states do not have a gift tax, a lifetime gift not only can take advantage of the increased federal exemption, but can also reduce the size of your estate subject to state estate tax if you live in a state with a state estate tax. Sometimes as important as the gift itself, all future appreciation on a lifetime gift is also removed from your estate. But there are many other reasons for you and your family to engage in lifetime giving, particularly through trusts. Trust planning allows families to think seriously about the legacy to leave future generations, while creating a pool of assets that can protect beneficiaries. Assets in trust, for example, will be protected from a beneficiary's creditors, including a future spouse in the event of divorce.

Deciding how to transfer assets to future generations is one of the hardest financial decisions that wealthy families make. It can take a long lead time for a multi-generational family to come up with the right planning framework that will support the family's vision for the future and carry out its legacy. With the increased exemption scheduled to expire in a little over a year, the time to start thinking through these complex issues is now. The first question, of course, is how much can you afford to give away? While the increased exemption is a tremendous opportunity for some families, others may want to make gifts of a lesser amount, or none at all, in light of the senior generation's needs and/or goals. To learn more about the various structures that can be used to effectively transfer wealth to the next generation, please view our most recent issue of WEALTHtoday.

Could Change Come Earlier?

For the past month there were many rumors, all unsubstantiated, that the Super Committee would include estate tax changes in its cost savings recommendations to Congress. Although clearly none of those rumors came to pass, we mention them only because some or all of the rumors could make their way into proposals during 2012. The rumors focused largely on four proposals:

(1) reduce the estate, gift, and GST exemptions to $1 million and increase the highest rate to 55%;

(2) reduce the exemptions to $3.5 million and increase the highest rate to 45%;

(3) impose a minimum 10-year term for a grantor retained annuity trust (GRAT); and

(4) impose restrictions on valuation of family limited partnerships.

Most recently, on November 17, 2011, Congressman McDermott, a Member of the House Ways and Means Committee, introduced legislation to reinstate the $1 million exemption (indexed for inflation from 2000) and 55% rate, effective January 1, 2012.[1]

Finally, the Administration's Fiscal Year 2012 Revenue Proposals (the "Greenbook")[2] released on February 14, 2011 (and the McDermott bill) would limit the duration of the GST exemption to 90 years, so that distributions after 90 years would be subject to GST tax.

Because no one can predict what Congress will actually do, or when it might act, some attorneys have recommended completing gifts now to avoid any risk of losing any part of the increased exemption. Despite the rumors of change, most in the estate planning community believe that the 2010 Tax Act still presents enormous opportunities for high-net-worth families to transfer wealth for 2011 and 2012.

Review Your Existing Plan with Your Advisors

In these uncertain times, it's more important than ever to understand how your existing estate plan works and to make sure that it still meets your goals. Many plans are drafted with formula clauses that establish trusts at death based on the maximum estate or GST tax exemptions. With the law scheduled to change dramatically on January 1, 2013, the impact of a formula clause can vary widely depending on the year of death.

It is also important to seek the advice of counsel regarding your specific situation, since estate, gift, and GST planning for 2011 and 2012 can be extremely complex. Although there are opportunities to save tax, if you are planning gifts to take advantage of the unique circumstances of 2011 and 2012, you must be prepared to work closely with your counsel to assess your situation and any upcoming legislative changes. As noted above, although it seems unlikely to most in the estate planning community, it is still possible for there to be changes to the estate, gift, or GST tax rates or exemptions before 2013. Because of the complexity of planning year-end gifts (and even gifts for 2012), it is very important to commence your gift planning now, if you have not already done so. In many cases your team of advisors will need to do extensive work to have a gift in place for year end: some gifts may involve drafting of trust instruments, requiring trustee review as well, and other gifts may require establishing new accounts. If you are considering making a year-end gift, please contact your relationship manager at Wilmington Trust as soon as possible.

Even in a less challenging environment, it is important to review your plan at least every five years, or more frequently, particularly if there are substantial changes in the law, your family situation, your state of residence, or your assets. In addition to reviewing your estate plan, it's critical to include a review of your life insurance coverage. Not only is it important to ensure that you have the appropriate amount of coverage, but you should also review your beneficiary designations to be certain that they continue to be in keeping with your personal circumstances. Keep in mind, too, that if rates and exemptions keep changing, ensuring liquidity to pay estate taxes may become an issue. Insurance and other liquidity planning techniques should be considered as changes continue to occur.

Low Interest Rate Planning

With interest rates near historic lows, estate planning strategies that take advantage of these low rates can be very attractive. Such planning can be as simple as a loan to a family member, set at the "applicable federal rate" issued monthly by the Internal Revenue Service, or it may be more complex, such as the creation of a "charitable lead trust." More detailed information is provided further in this article on interest rate-sensitive vehicles that can be very attractive in these complicated times.

Legislative Change May Also be on the Way for Grantor Retained Annuity Trusts (GRATs)

One of the most attractive vehicles to take advantage of low interest rates is a grantor retained annuity trust (GRAT). The 2010 Tax Act did not change the GRAT rules, so that individuals may currently establish GRATs with short terms. However, there may be a limited window of opportunity for short-term GRATs.

First, What is a GRAT?

A GRAT is a popular method of transferring the growth on assets held in trust to future generations at a greatly reduced gift and estate tax cost. The donor (grantor) transfers assets expected to appreciate to an irrevocable trust, retaining an annuity stream for a fixed term. At the end of the term the remaining assets pass to family members outright or in further trust.

Because the retained annuity is not treated as a gift, the amount of the taxable gift (or exemption used) may be quite small. If the asset growth outperforms the statutory rate used to calculate the retained value, the additional growth is transferred free of gift and estate tax to the trust's beneficiaries. For December 2011, the statutory valuation rate, often thought of as the hurdle rate, is only 1.6%, close to its historic low of 1.4%, increasing the likelihood of successful investment performance above the hurdle. Setting the length of the GRAT term is critical: the grantor must survive the term for an effective transfer. Because of the survival requirement, GRATs are often established for relatively short terms. Such short terms can also provide better opportunities to capture growth; over a longer period, appreciation may be offset by losses, leaving nothing for the trust beneficiaries.

Figure 2 **Income Tax Changes: 2011–2013**

	2011–2012 Rate	Scheduled Rate for 2013
Income Tax Highest Rate	35%	39.6%
Capital Gains (Long-term)	15%	20.0%
Dividends Highest Rate	15%	39.6%
Surtax on Net Investment Income*	N/A	3.8%
Surtax on Wages and Self-Employment Income*	N/A	0.9%

* Applicable to taxpayers with AGI or wages over $250,000 (married) or $200,000 (single).

The Window for Short-term GRATs May be Closing

Change to the GRAT rules has been proposed a number of times during the past few years. In 2010 the House of Representatives passed three bills that required a minimum 10-year term for GRATs; eliminated "zeroed-out" GRATs, requiring the value of the remainder interest to exceed zero; and prohibited the annuity amount from decreasing during the first 10 years of the GRAT term.[3] None of these bills were passed in the Senate. President Obama has proposed the same requirements in the Greenbook[2], and Congressmen Casey and Brown introduced similar legislation in June 2011, but for the first time with a retroactive effective date of January 1, 2011.[4] Most recently, a 10-year GRAT term was proposed in the McDermott bill, introduced on November 17, 2011, but would not be effective until the date of enactment.[1]

The possibility of future change, coupled with historic low rates and low market values, highlights the importance of GRAT planning sooner rather than later. It is possible that legislative change could be made retroactively, but a GRAT should be able to be drafted to address the possibility, for example, by permitting a disclaimer by trust beneficiaries.

INCOME TAX CHANGE IS ON THE HORIZON FOR 2013

Higher Rates on Ordinary Income, Capital Gains, and Dividends Deferred at the End of 2010 Until 2013

At the end of 2010, the Bush tax cuts enacted in 2001 and 2003, which were scheduled to expire at the end of December 2010, were extended for two years, through the end of 2012. However, effective January 1, 2013, unless Congress acts yet again, the income tax rates for all brackets are scheduled to increase, with the second highest bracket increasing from 33% to 36% and the highest bracket increasing from 35% to 39.6%. The tax rate on long-term capital gains is scheduled to increase from 15% to 20%, and the tax rate on dividends is scheduled to revert to ordinary income tax rates, with the highest rate being 39.6% (see Figure 2).

Income Tax Surtax Coming in 2013

Further, in 2013, pursuant to the health care reform legislation enacted in 2010[5], a surtax of 3.8% on net investment income will apply to taxpayers with adjusted gross income over $250,000 (married) and $200,000 (single). Net investment income includes interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net investment gain. The new tax will apply to trust investment income, but does not apply to income from tax-deferred retirement accounts, such as 401(k) plans or IRAs. A surtax of 0.9% will apply to wages and earnings from self-employment that exceed $250,000 (married) and $200,000 (single).

The Payroll Tax Holiday Ends on January 1, 2012

On January 1, 2012, the one year reduction of the employee portion of Social Security payroll taxes and self-employment taxes from 6.2% to 4.2% will expire. As we write this, efforts are underway to extend and expand the payroll tax cut to 2012; however, Congress will have to come to terms with whether or how to finance such a cut.[6]

Exclusion of Small Business Stock Capital Gains Expiring at Year-End

At the end of 2010, Congress extended the exclusion of 100% of the capital gains on the sale of qualified small business stock held for at least five years. Unless further extended by Congress, this exclusion expires on December 31, 2011.

Income Tax: What's Likely to Happen in 2013?

As is evident to anyone reading the popular press, the expiration or continuation of the Bush tax cuts beyond 2012 is an area of great disagreement in Congress. Many Republicans are seeking a permanent extension of all of the Bush tax cuts, while many Democrats seek permanent relief only for lower and middle income taxpayers. But as with the estate tax standoff in 2009, if the parties cannot come to agreement, increased rates, many not favored by either party, will come into effect automatically in 2013.

Investment Planning: What Should be Considered for 2011 Year End?

In light of the year-end expiration of the 100% exclusion on gains from the sale of small business stock, if you are considering selling such stock relatively soon, it would be wise to consider selling by year end.

Taxable investors should consider recognizing tax losses in 2011. Another idea is to wait and recognize losses in 2013 and beyond, where they can be used to offset gains subject to possibly higher rates. We prefer not to wait because unrecognized tax losses are a potentially wasting asset since, over time, asset prices tend to increase, erasing the loss. We believe that continually recognizing and using tax losses tends to add more value than attempting to time losses, since the size of the loss, or even the loss itself, is at risk. For that reason, we recommend loss harvesting as part of a quarterly review process and not just a year-end consideration. Beware of acquiring "substantially identical" shares of stock or securities 30 days before or 30 days after their sale or disposition, a transaction known as a "wash sale." Any loss generated on such a transaction will be disallowed.

Given the expectation that one will be able to make changes to portfolios in 2012 in advance of changes in tax rates effective 2013, we do not feel an urgency to act in 2011. This is especially true given the uncertainty associated with the 2012 elections.

"EVERY DAY PLANNING"

Even in the midst of change, routine year-end planning is still important. For many clients, this is a good time to reassess goals for gifting to individuals and charities and to review your overall income tax planning. The continuing low interest rates this year, coupled with still reduced market values, continue to provide some additional planning opportunities that may not be available in future years. Highlighted below are some important planning considerations you may wish to explore before the year ends, and to start thinking about for 2012. Income tax planning is very specific to an individual's or family's circumstances, so it important to consult your advisor.

Gifting to Families and Individuals

Annual Exclusion Gifts

In 2011 and 2012, individuals are permitted to make outright gifts of $13,000 to an unlimited number of recipients without incurring any gift tax or using any part of the lifetime gift exemption. This is known as the annual gift exclusion. Gifts above this amount count toward the lifetime gift exemption (currently set at $5 million). It is important that any gift be "completed" for gift and estate tax purposes. Generally, any checks issued to individuals must be cashed prior to the year's end. Reminder: payments on behalf of another to health or education institutions (if made correctly) are already exempt from gift tax, so funds destined for such needs generally would not be appropriate for annual exclusion gifts.

Gifts may be made directly to individuals, in trust, or in educational vehicles, such as 529 Plans. Gifts in trust need careful consideration, as certain rights, benefits, and/or administrative requirements may need to be written into the trust's document to ensure that the gift receives favorable tax treatment.

Although year end is a good time to make sure that you have taken advantage of the annual exclusion, there is no reason to wait until year end. Consider making your 2012 annual exclusion gifts early in the year, so that the benefits of transfer will be realized by both you and the beneficiary sooner. In addition, for taxpayers who need to "gift split," making gifts early in the year is particularly important if either spouse is in poor health. In order to "gift split," both spouses must be alive on the date of the gift. When spouses "gift split," one spouse makes the whole gift from his or her assets, and the other spouse consents to the gift on the gift tax return. Further, all gifts for the year must be gift split.

Section 529 Plans

Gifts to educational vehicles such as 529 Plans have become a popular way to pay for college, as the income from the plans will not be subject to income tax if it is used to pay "qualified" higher education expenses. Many states also provide an income tax deduction for contributions. Note that a transfer to a 529 Plan must be made in cash. Transfers to 529 Plans count toward the annual gift exclusion, but under special rules a donor may transfer five times the annual gift exclusion to 529 Plans ($65,000 in 2011 or 2012). However, in that case a donor may not make other annual exclusion gifts to the beneficiary of the plan for the next four years. Despite the income tax advantages of 529 Plans, it is important to consider whether a gift to a 529 Plan is the best use of the annual gift exclusion. For many wealthy families, it is preferable to pay tuition for children and grandchildren directly to the private school or college. Such tuition payments have an unlimited exclusion from gift or estate tax, leaving the annual gift exclusion available for gifts to children and grandchildren that will grow over time.

Charitable Giving

Charitable Contributions: Deductions and Delivery

Gifts to charity are excluded from the gift tax, regardless of the amount. In many cases, they are also deductible for federal income tax purposes. The amount of the potential tax deduction depends on the type of property given (stock, tangible personal property, or cash); the type of charity (e.g., public charity or private foundation); and the donor's adjusted gross income. Subject to certain limitations, amounts that are not currently deductible may be carried forward for 5 years, so it is a good idea to review your last year's tax return before year end to determine if any charitable contribution carryover deductions exist. In planning charitable gifts for 2011 (and 2012), it is worth noting that the deduction phase-out rule that has applied in past years to reduce otherwise permitted deductions is not applicable, potentially making charitable gifts this year and next more valuable from an income tax perspective (see discussion below on accelerating deductions). However, for taxpayers subject to the Alternative Minimum Tax (AMT), the value of the deduction may again be different than under the regular tax (see AMT discussion below). Because of the complex rules governing deductibility of charitable gifts generally and the additional rules regarding donations of stock and tangible personal property, it is important to consult your tax advisor to determine the actual, as opposed to potential, income tax benefit of a charitable contribution.

Unlike gifts to individuals, a gift made by check to a charity need only be mailed by year end. If you are making the contribution close to year end, it is a good idea to mail the checks Certified or Registered Mail with a return receipt requested or to charge the gift to a credit card. A gift of stock to a charity is made when the stock certificate is "delivered." If a donor mails an unconditionally endorsed stock certificate to the charity or the charity's agent, the mailing date is treated as the date of the gift, as long as the certificate is received by the charity in the ordinary course of the mail. However, for certificates that a donor delivers to the issuing corporation, or to his or her bank, broker, or other agent, or for stock not held in certificate form, delivery is not completed until the stock is transferred to the charity's name on the corporation's books. Because of these delivery issues, it is important to allow plenty of time when gifting stock.

A Reminder to Document Charitable Gifts

Since 2007, donors have not been permitted a charitable deduction for any contribution of cash or check unless the donor maintains a bank record of such transaction or a written communication from the charity showing the name of the organization, the date, and the amount of the contribution. A written log kept by the donor will no longer suffice. If you have not maintained such records this year, it is still possible to obtain acknowledgements from the charitable recipient, but you are required to do so before filing your 2011 tax return. In addition, donors of contributions of $250 or more must obtain a written acknowledgement from the charitable recipient.

IRA Charitable Rollover and Enhanced Deduction for Conservation Easements Extended Again

Two important charitable giving opportunities expired at the end of 2009, but at the end of 2010, they were again extended and are available through 2011 only. The IRA charitable rollover provision permits individuals aged 70½ or older to transfer up to $100,000 directly from an IRA to "qualified" charities. Qualified charities do not include donor advised funds or most private foundations and supporting organizations. The transfer is not included in income or permitted as a deduction and does not reduce the amount of charitable contributions the donor could otherwise deduct. A distribution to a qualified charity will also count toward meeting the required minimum distribution from the IRA.

Through 2011, qualified conservation contributions, such as a conservation easement, still benefit from an enhanced deduction. These gifts are deductible up to 50% of the donor's adjusted gross income, rather than 30% as is generally applicable to gifts of appreciated property. If the donor receives at least half of his or her income from farming or ranching, the gift is deductible to the extent of 100% of the donor's adjusted gross income. In addition, any unused deduction is permitted a 15-year carry-forward, rather than the standard 5-year carry-forward.

Figure 3 **Applicable Federal Rates (AFR) and Section 7520 Rates for December 2011***

Date	Short-term AFR (0–3 Years)	Mid-term AFR (3–9 Years)	Long-term AFR (Over 9 Years)	Section 7520 Rate
December 2011	0.20	1.27	2.8	1.6

* Based on Annual Compounding

Unfortunately, as with most other items that Congress extended at the end of 2010, these two provisions are scheduled to expire at the end of 2011, again leaving taxpayers uncertain as to their availability for future years.

Low Interest Rate Planning

As referenced earlier, interest rate-sensitive vehicles can be very attractive in these complicated times, particularly when funded with assets that have a depressed value and are likely to appreciate.

- The interest rates for intrafamily loans and for valuing annuities are at close to historic lows, providing opportunities that may not be available in the future (see Figure 3).
- Low interest loans, when properly structured, are not treated as gifts and provide credit or investment opportunities for family members.
- Installment sales to "grantor trusts" also take advantage of low-interest rates and are typically structured with only a small gift.
- A GRAT also typically involves a minimal gift and provides an opportunity to transfer appreciation free of estate and gift tax. As noted above, there may be changes to the GRAT rules ahead.
- A Charitable Lead Trust (CLT) can also provide an opportunity similar to a GRAT to transfer appreciation, and in some cases, to leverage the GST exemption. Unlike a GRAT, the income interest of a CLT goes to charity, rather than to the grantor. If the CLT is a "grantor trust" taxed to the settlor, an income tax charitable contribution deduction is also available.

For more detailed information on planning strategies that can be used in a low interest rate environment, please view our Issues and Insights article *Planning in a Low Interest Rate Environment.*

Additional Income Tax Considerations for the High-Net-Worth Taxpayer

IRA Conversion Opportunity

2010 ushered in a significant change to the IRA conversion rules for taxpayers with modified adjusted gross income of $100,000 or more. Starting January 1, 2010, the IRA conversion rules changed to permit taxpayers to convert a traditional IRA to a Roth IRA regardless of their income level.

- *What's the Difference Between a Traditional IRA and a Roth IRA?* The most significant difference between traditional and Roth IRAs is that contributions to IRAs are generally deductible, subject to certain limits, and all investment earnings and the amounts attributable to tax deductible contributions are taxable at ordinary income tax rates when withdrawn. Contributions to Roth IRAs are not deductible, but withdrawals are tax-free, subject to age and holding period limitations. Further, traditional IRAs are subject to required minimum distribution rules, while Roth IRAs generally are not.
- *What is the Consequence of Conversion?* When a traditional IRA is converted to a Roth IRA, all of the income tax that would otherwise be paid over time as the IRA is distributed is due in the year of conversion. Some states may also tax the conversion, so it's important to consult your tax advisor about your state's tax treatment. However, once this "conversion tax" is paid, future amounts distributed from the Roth IRA generally will be tax-free. Note that the special rule for 2010, deferring the income recognized to 2011 and 2012, does not apply to post-2010 conversions. If you made a 2010 conversion, unless you elected out of this rule, your income from conversion will be recognized equally in 2011 and 2012.
- *Estate Tax Considerations.* For high-net-worth taxpayers, traditional IRAs can be burdened with two taxes: the income tax on distributions and the estate tax. Because of this high tax burden, a traditional IRA is an ideal asset to leave to charity. If a traditional IRA will go to charity, it will not be subject to income tax, and would therefore generally

not be a good candidate for a conversion. If a traditional IRA is intended to benefit your family, converting the IRA to a Roth IRA and paying the tax on conversion is in effect a tax-free gift to your beneficiaries. The size of your taxable estate will be reduced by the income tax paid, and the beneficiaries will not be required to pay income tax on distributions.

- *Who Should Convert?* It can be difficult to determine whether a conversion from a traditional IRA to a Roth IRA is the right decision for you. Factors to consider include whether:
  - You expect to be in a higher or lower income tax bracket when you retire.
  - You will need to make withdrawals within the next five years.
  - You expect to have deductible medical expenses that will offset the income from IRA withdrawals.
  - You plan to make a charitable bequest of some or all of your IRA.
  - You have the liquidity to pay the income tax on conversion.
  - You expect to have unusual income tax deductions, such as a charitable donation or losses, that could offset the additional income from conversion.
  - Your IRA is depressed in value relative to its future appreciation potential.
  - Your IRA likely will be spent and not increase the size of your taxable estate.
- *Recharacterization.* It is also possible to "recharacterize" a conversion, in effect undoing it, provided that you do so by the time you file your 2011 tax return, including extensions. Recharacterizing can be helpful, for example, when the asset value of an account has dropped post-conversion, so that you can avoid paying income tax on amounts that have since declined in value.

"Kiddie Tax" Planning

Under the so-called Kiddie Tax, most unearned income of a child (amounts above $1,900 for 2011) is taxed at his or her parents' tax rate, if that rate is higher than the child's tax rate. The Kiddie Tax applies to children under age 18 and to 18 year-olds and full-time students aged 19 to 23, unless the child provides at least half of his or her support from earned income. The Kiddie Tax does not apply to a child with no living parents or to a married child filing a joint return.

For wealthy families, the Kiddie Tax eliminates the income tax benefit of transferring appreciated assets to children who might have otherwise sold them and paid capital gains tax at a lower rate than their parents. However, children over age 23 (and some 18–23 year olds) will still be taxed at their own income and capital gains tax rates. Even for a child subject to the tax, all of his or her earned income is taxed at the child's rate, and the first $1,900, as reduced by the child's standard deduction, is taxed at the child's rate. More importantly, the Kiddie Tax does not eliminate the gift and estate tax benefits of transferring assets likely to appreciate to the next generation. A married couple may continue to give annual exclusion gifts ($26,000 for 2011 and 2012) to each of their children without being subject to the gift tax or reducing their lifetime gift exemptions, and the appreciation on such lifetime gifts will never be subject to the parents' gift or estate tax. Although we are unsure of future gift and estate tax rates, it is likely that for many high-net-worth families, saving on these taxes will be more beneficial in the long run than saving on the income tax, particularly when coupled with the permanent removal of the appreciation on gifts from either gift or estate tax.

Should You Consider Accelerating or Deferring Deductions in 2011 and 2012?

As we wait to see if there will be serious tax reform discussions in 2012, and whether the scheduled tax increases for 2013 will actually take effect, it is worth considering for 2011 whether to accelerate or defer deductions that are discretionary, such as charitable contribution deductions, or that may be pre-paid, such as state and local property taxes. Arguably, such deductions will be more valuable in future years, if income tax rates increase. However, in light of the continued temporary phase-out for 2011 and 2012 of the limitation on deductions for some high income taxpayers, deductions may be more valuable in 2011 and 2012, even if the tax rate for those years turns out to be lower than for 2013. When in effect, this limitation can reduce allowable deductions to 20% of the amount otherwise permitted. It was phased out as part of the Bush tax cuts, and eliminated temporarily for 2010 through 2011. However, the limitation is scheduled to be reinstated for 2013. Any assessment of the tax benefit of deductions, however, must also take into account the impact of the Alternative Minimum Tax, discussed below.

Alternative Minimum Tax (AMT) Planning
The AMT is a "parallel" tax system with different rates, permitted deductions and credits, and exemption amounts. Taxpayers are required to calculate both the regular tax and the AMT and pay whichever tax is higher. When taxpayers are subject to the AMT, traditional planning ideas, such as accelerating deductions in the current tax year, may not provide the tax benefit expected. Deductions such as state and local taxes, certain miscellaneous itemized deductions, and certain interest on second mortgages are disallowed under the AMT. Additionally, interest on certain tax-exempt private activity bonds is subject to the AMT. Thus, it is important to have your tax professional analyze your current year's income tax data to determine the AMT impact. Another area where you should obtain professional advice is on the exercise or possible exercise of incentive stock options (ISOs), which may trigger substantial AMT consequences. At the end of 2010 Congress enacted a "patch" increasing the AMT exemption amount roughly to 2009 levels for 2010 and 2011, keeping approximately 21 million taxpayers out of the AMT for 2010 and 2011. Unfortunately, however, Congress has not yet addressed the exemption for 2012, so many taxpayers will still be uncertain whether they will be subject to the AMT in 2012.

INCOME TAX CHANGES EXPIRING IN 2011 THAT IMPACT THE CLOSELY HELD BUSINESS OWNER

A number of favorable deductions and credits for businesses are scheduled to expire on December 31, 2011. It may make sense for some businesses to accelerate expenditures and new hires to qualify for these expiring tax breaks. These actions will not be appropriate for all businesses, however, and each business will need to look at its current situation to determine what is best.

Tax Deductions

- *Bonus Depreciation:* For qualified property acquired and placed in service after September 8, 2010 and before January 1, 2012, the bonus depreciation allowance is 100%, dropping to 50% for qualified property placed in service during 2012.
- *Expensing Allowance:* The increased expensing allowance of $500,000 through 2011 will drop to $125,000 for 2012. An investment ceiling of $2,000,000 for 2011 reduces the allowance dollar for-dollar once the ceiling is reached. The ceiling drastically drops to $500,000 in 2012.
- *Enhanced Charitable Contribution:* C Corporations may receive an enhanced deduction for charitable contributions of "wholesome" food inventory, book inventory to certain public schools, or computer technology or equipment to schools or libraries for use in the U.S. for educational purposes.
- *Charitable Contributions by S Corporation:* Through 2011, shareholders of an S Corporation that has donated appreciated property to charity are required to reduce their basis in their S Corporation stock only by their pro rata share of the adjusted basis of the donated property, rather than by the full fair market value of the donated property. The smaller basis reduction permits greater income tax deductions by the shareholder, as S Corporation shareholders generally may only deduct contributions to the extent of their basis in the stock.
- *Empowerment and Enterprise Zone Deduction:* To foster the business environment in specific areas of poor economic growth, special tax incentives for businesses and individual residents are available through 2011.

Tax Credits That Will Expire at the End of 2011

- *Research Credit:* This credit allows businesses a credit on qualified research expenses of 20% over a base amount.
- *Work Opportunity Credit:* The work opportunity tax credit, aimed at adding unemployed veterans and disconnected youth to the workforce, allows employers a credit against income tax of a percentage of first-year wages.
- *Differential Wages Credit:* Eligible small business employers that pay differential wages (payments to employees on active military duty for more than 30 days) may take a credit up to 20% of eligible wages.
- *Energy Efficient Credit:* An eligible contractor can claim a $2,000 credit for a qualified new energy-efficient home that achieves 50% energy savings for heating and cooling, if it is acquired by sale or lease from the contractor for use as a personal residence prior to December 31, 2011.

To learn more about income tax and other changes that may impact the closely held business owner, please read our following Issues and Insights publications:

Highlights of Key Tax Provisions in the Small Business Jobs and Credit Act of 2010

Highlights of Key Tax Provisions of Interest to High-Net-Worth Individuals and Business Owners in the 2010 Health Reform Legislation

The past year has been a good reminder that wealth planning is an ongoing process. It's important to collaborate regularly with your team of advisors to ensure that your plan addresses today's changing environment while fulfilling your goals for the future.

Please do not hesitate to contact your Private Client Advisor or Relationship Manager if you have any questions or would like assistance with your year-end and future planning needs.

Also, please visit our website library, www.wilmingtontrust.com/library to access all of our Issues and Insights publications.

FOOTNOTES

1 The Sensible Estate Tax Act of 2011, H.R. 3467, introduced on November 17, 2011.

2 The Treasury Department's General Explanation of the Administration's Fiscal Year 2012 Revenue Proposals, issued February 2011 (Greenbook).

3 The Small Business and Infrastructure Jobs Tax Act of 2010 (H.R. 4849), passed on March 24, 2010; Small Business Jobs Tax Relief Act of 2010 (H.R. 5486), passed on June 15th; amendment to H.R. 4899, a supplemental spending bill, passed on July 1st.

4 Trade Adjustment Assistance Extension Act of 2011, S. 1286, introduced on June 28, 2011.

5 Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010.

6 "GOP Set to Back Payroll-Tax Cut," *The Wall Street Journal*, p. A4, November 30, 2011.

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