

SNIPPETS

AN ESTATE PLANNING AND FINANCIAL PLANNING NEWSLETTER

SPECIAL EDITION - ESTATE TAX ALERT WHAT THE NEW TAX LAW MEANS TO OUR ESTATE PLANNING CLIENTS

As you probably know, Congress avoided the so-called fiscal cliff by passing – at the 11th hour – the American Taxpayer Relief Act of 2012 (the 2012 Tax Act), signed into law by the President on January 2, 2013. The 2012 Tax Act makes several important revisions to the tax code that will affect estate planning for the foreseeable future.

The federal gift, estate and generation-skipping transfer tax provisions were made permanent as of December 31, 2012. This is great news for all Americans; for more than ten years, we have been planning with uncertainty under legislation that contained built-in expiration dates. And while “permanent” in Washington only means that this is the law until the new Congress decides to change it, at least we now have some certainty with which to plan. However, it is important to understand that, although the new legislation is “permanent”, there may soon be a push for additional revenue-raising legislation as Congress begins to address spending cuts and the federal debt limit. Estate and gift taxes have historically been a significant source of revenue, therefore, it is possible that we see further changes with the estate and gift tax provisions, especially since the federal estate tax issue almost appeared to be a deal breaker in the Senate, as the Republicans wanted complete repeal of the estate tax while the President insisted on a 45% rate with a \$3.5 million exemption. What follows is a brief description of the estate and gift tax provisions of the 2012 Tax Act and their impact to our estate planning clients.

2012 TAX ACT – ESTATE AND GIFT PLANNING IMPACT

EXEMPTIONS PREVIOUSLY SCHEDULED TO DECREASE ON DECEMBER 31, 2012 ARE EXTENDED INDEFINITELY. Under the 2012 Tax Act, the favorable \$5 million federal gift and estate tax exemption amounts will continue indefinitely, allowing each individual to transfer that amount during lifetime or upon death without the imposition of federal gift or estate tax. Without action by Congress, the exemption amounts would have reverted to \$1 million per individual. In addition, the \$5 million Federal GST tax exemption will continue, allowing clients to provide for significant generation-skipping transfers without the imposition of tax.

The \$5 million exemption amount for all three taxes is indexed for inflation after 2011. The inflation indexed amount was \$5.12 million in 2012, and the IRS recently announced an increase to \$5.25 million for 2013. Importantly, clients can expect to acquire additional incremental exemption amounts in each new calendar year as a result of this indexing.

This means that the opportunity to transfer large amounts during lifetime or at death remains. A person dying in 2013 can now transfer up to \$5.25 million (\$10.5 million for a married couple) (reduced by lifetime taxable gifts) at death without paying estate tax.

For those of you who hurried to make year-end gifts, we still believe that it was a good idea and that you will realize significant estate tax savings because (1) no one knows what the future may hold in terms of estate and gift legislation for federal and Massachusetts purposes; (2) the Massachusetts estate tax exemption is still \$1 million, therefore, the gifts are removed from your Massachusetts taxable estate; (3) we are coming off an economic period where valuations (non cash gifts) were often times at historic lows; (4) the clock of the valuations for purposes of the statute of limitations with respect to the gift will start when the gift tax return is filed in April 2013 (versus later years); and most importantly (5) any post-gift appreciation and any income earned on the gifted assets will now escape both federal and Massachusetts estate taxation. However, if you did not take advantage of gifting opportunities in 2011 or 2012, you can still do so with significant advantages to doing so sooner rather than later. Also, with the estate tax exemption amount tied to inflation, you can now expect to be able to transfer even more each year in the future.

MAXIMUM ESTATE, GIFT AND GST TAX RATES NOW SET AT 40%. The 2012 Tax Act permanently caps the maximum estate, gift, and GST tax rates at 40%. This 5% increase is higher than the 2012 rate of 35%, but lower than the 55% rate that would have come into effect on January 1, 2013 in the absence of legislation. This top rate will apply to transfers exceeding the exemption amounts described above.

Massachusetts continues to impose a separate estate tax with an exemption of \$1 million and a top rate of 16%. Under the new law, state estate taxes will continue to be deductible from federal estate taxes, resulting in a top combined estate tax rate for Massachusetts residents of 49.6%.

GIFT TAX EXCLUSION. The 2012 Tax Act makes permanent the unification of the gift and estate tax exclusion amounts. This means that in 2013 each person can make lifetime gifts of up to \$5.25 million (\$10.5 million for a married couple) without paying gift tax. However, all gifts that use a portion of this gift tax exclusion will reduce the donor's estate tax exclusion available at death. For example, if a parent makes a \$2 million lifetime taxable gift to a child, the parent's remaining estate tax exclusion amount is reduced by \$2 million at death.

The lifetime gift tax exclusion only applies to gifts in excess of the annual gift exclusion (i.e., the annual amount a person may gift to any person tax-free). For 2013, the inflation-adjusted gift tax annual exclusion amount has increased to \$14,000 (or \$28,000 per married couple) from \$13,000 in 2012. The annual exclusion amount for gifts to a spouse who is not a U.S. citizen has increased to \$143,000.

GENERATION SKIPPING TAX (“GST”) EXCLUSION. The 2012 Tax Act makes permanent the unification of the estate tax and GST tax exclusion amounts. This tax, which is in addition to the federal estate tax, is imposed on amounts that are transferred (by gift or at your death) to your grandchildren and others who are more than 37.5 years younger than you; in other words, transfers that “skip” a generation. Having this exemption be “permanent” means that in 2013 each person can make transfers to grandchildren (or multi-generational trusts) of up to \$5.25 million without paying a GST tax, allowing you to take advantage of planning that will greatly benefit future generations.

ESTATE AND GIFT TAX EXCLUSION PORTABILITY. The 2012 Tax Act makes permanent the concept of estate and gift tax exclusion portability. Portability means that spouses, under certain circumstances, can share their unused \$5.25 million estate and gift tax exclusion with each other. This portability allows spouses to effectively use a combined \$10.5 million exclusion. Portability allows a surviving spouse to elect to use any exclusion unused by his/her last deceased spouse in addition to his/her own \$5.25 million exclusion. For example, if a husband dies in 2013, having made \$2 million in lifetime taxable gifts and leaving his entire \$8 million estate to his wife, no estate tax is due at the husband's death. If an election is made on the husband's estate tax return to allow his wife to use his \$3.25 million unused estate tax exclusion, the wife's available exclusion amount (which can be used for lifetime gifts or for estate taxes) is increased to \$8.5 million — her \$5.25 million plus her husband's unused \$3.25 million.

It is important to note that portability is not available for Massachusetts estate tax purposes and is only available for federal estate tax purposes if a timely election is made on the deceased spouse's estate tax return. This means that portability does not affect traditional credit-shelter trust planning for Massachusetts residents. Also, portability is not available for the GST tax exemption. Further, in the event of a remarriage and subsequent death of the new spouse, the surviving spouse will no longer have access to the unused estate tax exclusion of the first deceased spouse.

IRA CHARITABLE ROLLOVERS. The IRA charitable rollover (permitting direct distributions from an IRA to be excluded from income and count as part of the required minimum distribution) has been extended to apply to IRA distributions made in 2012 and 2013. Because of the late enactment, special provisions are included to permit 2012 income rollover treatment for distributions made before February 1, 2013 (including withdrawals made in December 2012 that were subsequently transferred to a charity during January 2013)

ESTATE PLANNING OPPORTUNITIES FOR 2013 AND BEYOND

While the 2012 Tax Act claims to make permanent changes that will affect many estate plans, taxpayers should not be lulled into complacency. Leaders in both the House and Senate have acknowledged that the new law is only the first step toward fixing this country's fiscal problems. As Congress takes its next steps to address our country's fiscal challenges and looks for alternative sources of revenue, additional legislation designed to raise revenue is anticipated. This legislation may include provisions that severely limit the ability to transfer wealth to children and future generations. As a result, there still remains significant tax and non-tax reasons to have a properly designed estate plan in place and reviewed periodically.

GRATS, GST TRUSTS, PLANNING WITH DISCOUNT ENTITIES, AND GRANTOR TRUSTS. The use of these powerful estate planning tools may be restricted or eliminated in the future. Now is the time to take advantage of these estate planning techniques before they are legislated out of existence.

LOW INTEREST RATES AND DEPRESSED ASSET VALUES. Lifetime giving is especially advantageous in the current low-interest-rate environment. Low interest rates enhance the benefits of the various estate planning techniques that attempt to transfer assets at reduced gift tax values, such as low interest intra-family loans, installment sales, GRATs, private annuities, self-canceling installment notes, and charitable lead annuity trusts.

INCOME TAX PLANNING. Income tax planning is now more important than ever. The top income tax rate is increased to 39.6% from 35%, applicable to married taxpayers earning more than \$450,000, heads of household earning more than \$425,000 and single taxpayers

earning more than \$400,000 (with each of these thresholds subject to inflation adjustment in the future). For estate and trust income taxes, the top tax bracket is also 39.6%, applicable to estates and trusts earning more than approximately \$12,000 of income. Any taxpayers subject to the 39.6% income tax rate will also be subject to a 20% tax rate on both long-term capital gains and qualified dividends (increased from 15% in 2012). These increased income tax rates are in addition to the previously enacted 3.8% Medicare surtax on investment income, so that the top tax rate for long-term capital gains and qualified dividends is now 23.8%.

FUNDING A BYPASS TRUST. Although portability is permanent (or as permanent as the tax laws can be), there are still a variety of advantages to using a bypass trust (also called a "credit shelter trust" or a "family trust") at the death of the first spouse. Funding a bypass trust reduces estate tax owed at the surviving spouse's death by keeping appreciation out of the surviving spouse's estate. A bypass trust also gives the deceased spouse control over the disposition of the trust assets and provides asset protection to the surviving spouse and other trust beneficiaries. Also, since Massachusetts does not allow portability and the GST exclusion is not portable for federal purposes, creating a bypass trust is still the best option for many Massachusetts married couples and clients wishing to maximize their GST planning. Additionally, as explained above, the assets held in a bypass trust can appreciate in value over time, therefore eliminating estate tax on any post-death appreciation of those assets, whereas the unused exemption is a fixed amount.

NON-TAX REASON TO HAVE AN UPDATED ESTATE PLAN. For many Americans the 2012 Tax Act has removed the emphasis on estate tax planning and put it back on the real reasons to do estate planning: taking care of ourselves and our families the way we want. Those who might be tempted to skip estate planning because their estates are less than the \$5 million range should remember that proper estate planning provides peace of mind by allowing you to:

- Avoid probate, which can be quite expensive and time-consuming in some states;
- Ensure that your assets are distributed the way that you want;
- Protect an inheritance from irresponsible spending, a child's creditors, and from being part of a child's divorce proceedings;
- Provide for a loved one with special needs without losing valuable government benefits;
- See that control of your assets remains in the hands of a trusted person;
- Provide for minor children or grandchildren;
- Help protect assets from creditors and frivolous lawsuits (especially important for professionals);
- Protect yourself, your family and your assets in the event of incapacity; and
- Help create meaningful charitable gifts.

Thus, if you have not reviewed your estate plan lately, now is certainly the time to schedule an appointment to see how the new estate tax law will affect your estate. Please schedule an appointment today by calling our office at (781) 848-5028.