ESTATE PLANNING UPDATE 2013: BACK FROM THE BRINK

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January 3, 2013

Who doesn't love a good cliffhanger — especially one with a (relatively) happy ending? After considerable nail-biting and hand-wringing, on January 1 Congress passed the American Taxpayer Relief Act of 2012 (the "Act"), extending much of the estate, gift, and generation-skipping transfer (GST) tax law developed over the past 12 years and preserving favorable opportunities for individuals and families planning the transfer of their wealth.

Key Provisions of the Act: Estate, Gift and GST Taxes

- *The maximum exemption from federal estate, gift, and GST taxes on December 31, 2012 was $5,120,000 per donor/decedent ($10,240,000 per married couple). As of January 1, 2013, those exemptions increased for inflation (the new exemption amount is anticipated to be $5,270,000, pending official confirmation from the IRS) per donor/decedent and will continue to increase annually.*

- *On December 31, 2012, the estate, gift, and GST tax rate applicable to nonexempt transfers was 35%. As of January 1, 2013, those rates increased to 40%.*

The Act is a fundamental game changer for many families. Had Congress not acted, the gift, estate and GST tax laws would have reverted to the 2001 rules: a $1,000,000 exemption per donor/decedent and a 55% maximum rate. The preservation of the GST exemption and the associated administrative rules is particularly good news for families engaging in multigenerational gift planning, as the Act permits ongoing flexibility and eliminates considerable uncertainty.

- *The "portability" rule, permitting a surviving spouse to inherit a deceased spouse's unused estate tax exemption, has been preserved. For example, assume Husband and Wife (both U.S. citizens) own $10,000,000 of assets jointly with rights of survivorship. Following Husband's death, Wife becomes sole owner of the assets. Under prior law, Husband's federal estate tax exemption would have died with him, but thanks to the portability rule, Wife generally may use both her own exemption and Husband's exemption to shelter lifetime gifts or bequests at death from federal gift or estate taxes.*

As we advised when portability became effective in 2011, portability is neither a panacea nor a substitute for estate planning. Neither the GST exemption nor state death tax exemptions are portable. Moreover, portability merely "freezes" the deceased spouse's unused federal estate tax exemption, while affirmative use of that exemption through a lifetime or testamentary trust permits appreciation during the surviving spouse's life to escape estate tax at the survivor's death. On the other hand, the trust assets will not receive a stepped-up income tax basis at the surviving spouse's death; moreover, the trust assets may depreciate or may be consumed by the surviving spouse. In sum, portability is an option to be considered; it may make sense in some families' estate plans but not in others.

- *Although not part of the Act, the gift tax annual exclusion has increased to from $13,000 to $14,000 per donee (i.e., $28,000 per donee for a married couple) as of January 1, 2013.*

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Donors who make use of their annual exclusions through "Crummey" trusts should review the withdrawal rights in those trusts before making 2013 gifts so that they can ensure optimal use of those annual exclusions.

Key Provisions of the Act: Income Taxes *(Including Medicare Surtaxes)*

The news for taxpayers is not nearly as favorable on the income tax front:

- *New top tax rates on ordinary income (39.6%) and long-term capital gains and dividend income (20%) now apply, starting at income thresholds of $400,000 for individuals, $450,000 for married couples filing jointly, and $425,000 for heads of households. The income threshold for estates and nongrantor trusts with undistributed income remains far less: $11,650.*

- *In addition to those increased "regular" income tax rates, there is now a 3.8% "Medicare" tax on net investment income, as well as an additional 0.9% tax on compensation income. These surtaxes apply at lower thresholds for individual taxpayers: $250,000 for married couples and $200,000 for individuals. The threshold for estates and nongrantor trusts is $11,650.*

- *Qualified retirement income — e.g., distributions from qualified retirement plans and regular or Roth IRAs — is exempt from the Medicare surtax. Taxpayers who participate actively in businesses (other than trading in financial instruments or commodities) generally are also exempt from the surtax, both as to operating income from those businesses and as to gain from the disposition of those businesses.*

For more information on the income tax consequences of the Act to individuals and businesses, see Business Tax Counseling & Structuring Group Alert, dated January 3, 2013, available here.

The increases in the income and estate tax rates make lifetime gift planning with grantor trusts more valuable. An individual is legally obligated to pay the taxes (including the Medicare surtax) attributable to income and gains earned by a grantor trust of which he or she is the grantor; thus, those tax payments do not constitute additional gifts to the trust. In effect, by paying the income taxes the grantor is shifting additional value to the trust for as long as grantor trust status applies (which may be as long as the grantor's life), enabling the trust to enjoy a tax-free return while depleting the grantor's estate. As income taxes increase, the amount of tax-free value transferred increases; as estate taxes rise, so does the ultimate savings associated with such transfers.

Permanence?

The Act is described as "permanent," which means that unlike the past decade's tax statutes, there is no scheduled "sunset" of the Act's provisions. However, further changes remain possible, especially in light of the government's thirst for additional revenue.

In early 2012, the Obama administration published a legislative wish list that featured several estate planning-related revenue raisers. Those proposals included:

- *Restrictions on the use of valuation discounts in family-controlled entities;*

- *A 10-year minimum term for grantor retained annuity trusts (GRATs), along with a requirement that the GRAT remainder have a positive value (so that gift tax return reporting is required) and a prohibition on decreases in the annuity amount during the term;*

- *A 90-year time limit on the applicability of GST exemption to a generation-skipping trust; and*

- *Perhaps most notably, a provision subjecting trusts that are grantor trusts for income tax purposes to estate tax at the grantor's death.*

The proposals lack many key details, but one refreshing feature is that they were all proposed with *prospective* effective dates. Thus, for example, if the grantor trust proposal were enacted, grantor trusts created before the proposal's enactment would not be subject to estate tax under that rule — although post-enactment additions to such trusts likely would create an estate tax concern. None of those proposals was included in the new legislation, but there is no indication that they have fallen off the Obama administration's radar screen for future action as part of a revenue-raising package.

What to Do?

If you made full use of your $5,120,000 ($10,240,000 per couple) gift and GST exemptions through 2012, you should focus on appropriately reporting your gift(s), investing and managing the gift vehicle(s), and strategically using the annual increases in the exemption amounts. You should consider taking advantage of continued low interest rates and favorable asset values by engaging in intrafamily lending and exchange transactions. Zero or near-zero gifting vehicles, such as GRATs and charitable lead annuity trusts (CLATs), also remain viable options that you may wish to explore.

If you have not yet made use of your

exemptions, the Act relieves some of the time pressure applied by the 2013 fiscal cliff — but does not reduce the tax benefits families enjoy through timely lifetime gift planning. Because the continued vitality of tax benefits derived from GRATs, dynasty trusts, and grantor trusts remains in question, it remains a good idea to consider those techniques sooner than later.

As legislative developments proceed, or as circumstances requiring trust and estate planning may arise in your situation, please contact one of the Lowenstein Sandler attorneys listed at right so that we can help you evaluate your options.

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