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Dear Friends:

Permanent (?) $5 Million Estate and Gift Tax Exemption

Maybe taxes are not so inevitable after all, at least not estate and gift taxes. The American Taxpayer Relief Act of 2012 (ATRA), enacted on January 2, 2013, changes the game by permanently extending the ability for an individual to transfer $5 million (inflation indexed) during lifetime or at death, including the ability to transfer that amount to grandchildren or to a multigenerational trust without triggering generation skipping tax (GST). Of course by "permanent", we mean that for the first time in several years, our clients are not facing a December 31 automatic reversion to 2001 rules (with its $1,000,000 exemption amount). But you can bet that the gift and estate tax laws will change again, we just don't know how or when!

Meanwhile, here is the law:

- *Annual Exclusion*. Due to inflation, the gift tax annual exclusion increased to $14,000 for 2013. It will remain at $14,000 for 2014.
- *Transfer Tax Exemptions*. The gift, estate, and generation-skipping transfer ("GST") tax exemption amounts remain at $5 million per person ($10 million per couple). This amount is indexed for inflation, and is $5.25 million for 2013, and will increase to $5,340,000 for 2014.
- *Portability*. The ability of a surviving spouse to utilize any unused estate tax exemption of a predeceased spouse (without the use of a bypass trust) is retained permanently. We do not advise relying on this portability feature in many situations, for reasons discussed below in this newsletter.
- *Transfer Tax Rates*. The top gift, estate, and GST tax rate is now 40% (up from 35%).

The high exemption amount, particularly coupled with the indexing for inflation, will result in very few estates being subject to Federal estate or gift taxation. For most, therefore, estate and gift taxes are now taking a back seat to other planning considerations, such as income tax and trust planning. In particular, personal trusts are looking at considerably higher income tax rates and individuals must decide between the benefits of a trust versus the benefits of stepped-up basis.

Trust Income Tax Considerations

For personal trusts, three new income tax rules will drive a reconsideration of plans for trust investments and distributions. First, the top income tax rate for undistributed trust income is now 39.6% for income exceeding $11,950. Second, undistributed net investment income of a trust is subject to the 3.8% tax under the Patient Protection and Affordable Care Act ("Obamacare") to the extent that AGI exceeds $11,950. In combination, the result is a 43.4% top income tax rate. Third, the capital gains rate for trusts is now 20% instead of 15%, and is actually 23.8% if combined with the 3.8% health care tax.

These higher income tax rates at the trust level should now be a factor that a trustee considers when determining the appropriate amount of trust distributions. Of course, the distributions standards in the trust agreement must be reviewed to see if they allow taxes to be considered. In general, trust distributions allow for the shifting of income to beneficiaries, which may reduce the income subject to the top 39.5%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. Because of the 65 day rule, distribution decisions can be made after the end of the taxable year when financial records for the trust and the beneficiaries are available. Clearly, tax savings through distributions are only realized to the extent the individual beneficiary is not in the top tax bracket ($450,000/$400,000) or if the beneficiary does not have AGI exceeding the thresholds for individuals to be subject to the 3.8% health care tax ($250,000/$200,000).

Higher trust income tax rates also impact a trustee's investment decisions. Analysis should be undertaken to ascertain if a shift in investment strategy could avoid all or some of the 3.8% health care tax.

Tax Advantage of Step-Up in Basis vs. Non-Tax Advantages of Trusts

For decades we have been focused on avoiding the onerous 50% estate and gift tax so placing assets in trusts (bypass and GST trusts) for transfer tax savings was an easy decision. Now, we are focused on whether it makes income tax sense to plan for obtaining a stepped-up basis. The issue is whether to preserve a step-up in basis at the death of each spouse and/or at the death of each level of descendants by including assets in estates of beneficiaries rather than excluding assets. When an individual dies owning appreciated property, the property generally receives an income tax basis equal to the property's fair market value at the date of death. The step-up in basis reduces (or even avoids in the event the property is sold soon after death) capital gains tax on the increase in the property's value that occurred during the decedent's life. When assets are placed in a trust the assets do not receive a step-up in basis at the death of the beneficiary (the surviving spouse in the case of a by-pass trust or the child in the event of a multi-generational trust). Saving future capital gains tax may trump estate-tax concerns if an individual thinks his estate, his spouse's estate, and/or descendants' estates will be worth less than the exemption amount. But tax laws change and trusts have non-tax advantages, so planning must be done cautiously.

A key decision for clients with less than $5,300,000, therefore, will be whether to use trusts for non-tax reasons. There are numerous reasons that trusts remain attractive vehicles for assets, primarily: i) asset protection - trusts provide creditor protection; ii) asset preservation - trusts allow for control over disposition of assets at the death of the primary beneficiary (spouse or child); iii) management protection - trusts allow for management of assets in the event of incapacity; iv) divorce protection - trusts provide for divorce protection by placing a wrapper around separate property assets inherited from family.

Portability vs. a Bypass Trust

With portability now permanent, it is also possible for a married couple to take advantage of the full $10.5 million in estate tax exemption available to them jointly without the use of a tax-planned Will utilizing a bypass trust. For example, if an individual dies in 2013 owning $7 million and leaves all of his or her assets to a spouse, then at the spouse's later death he or she would have $10.5 million of estate tax exemption available (his or her $5.25 million and the decedent's $5.25 million), and his or her estate will pay no more estate taxes than would have been payable if the first spouse had left the $5.25 million in estate tax exemption into a bypass (family) trust. While this "I give everything to my surviving spouse Will" is simpler, the traditional bypass trust planning continues to have benefits. In addition to those non-tax benefits listed above, these advantages include the following:

- If an estate is under the exemption, no estate tax return will be required to be filed for a tax-planned Will. If the surviving spouse's estate is also under the exemption available at his or her death, no estate tax return will be required then either. On the contrary, both spouses' estates must file an estate tax return to take advantage of portability.

- *A bypass trust allows for the use of the first deceased spouse's GST exemption, providing the opportunity for assets to pass to multiple generations free of estate tax. GST exemption is not portable.*

- A bypass trust ensures the use of the first deceased spouse's exemption amount. If a surviving spouse remarries and also survives that spouse, the exemption amount ported from the first deceased spouse is lost.

- *A by-pass trust shelters the appreciation in value of the trust assets between the deaths of the spouses.* At the death of the first spouse, the joint estate may appear to be under the estate tax exemption, but depending upon how long the surviving lives, the value of the assets may appreciate, creating an estate tax that would not have existed if the assets of the first spouse were held in a by-pass trust.

It is important to know that there are ways that Wills can be prepared to provide flexibility – giving the surviving spouse the opportunity to decide whether or not to utilize portability. Particularly for a blended family, however, the non-tax benefits of a by-pass trust may be essential, and relying on portability or flexibility to avoid estate tax may result in inequities that would be unacceptable. Every family's circumstances will be unique and require careful consideration of all factors involved.

Estate Taxes Can Still Take a Bite

Of course there are clients for whom estate taxes will continue to be a significant concern. And those of you who raced to make gifts in 2012 of $5 million to take advantage of the potentially expiring gift tax exemption will benefit from the time value of money increasing the value of assets outside of your taxable estate. Additionally, there remains the possibility that future legislation could restrict certain transfer tax planning techniques, so it may be prudent to take advantage of them in the short term. On the near horizon is the possibility that the duration of a GST exempt trust may be limited to 90 years from the date of creation. In connection with GRATs (grantor retained annuity trusts), proposals include setting minimum lengths for GRATs at ten years and requiring a remainder value (the gift portion) to be at least 10%. There might also be some limit set on the ability to use valuation discounts passed in future legislation. Finally, on the further horizon are proposals that negatively impact the ability to realize tax savings with sales to intentionally defective grantor trusts.

2013 has marked the beginning of a new era in estate planning – please call us if you would like to review your estate plan in light of the new tax laws.