Estate Planning Insights

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THE AMERICAN TAXPAYER RELIEF ACT OF 2012

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 ("ATRA"), which was signed into law by President Obama on January 2, 2013. ATRA retains many favorable tax rules that were about to expire and also provides other significant relief to taxpayers. Of course, ATRA is not all good news. It's just too bad that the estate, gift and Generation-Skipping Transfer Tax changes couldn't have been made in early to mid-2012–that would have eliminated the frenzied "fiscal cliff" gift planning that had lawyers, accountants, appraisers, financial advisors (and estate planning clients) working overtime the latter half of the year.

Highlights of ATRA. Here are *some* of the provisions of the American Taxpayer Relief Act of 2012, applicable for 2013 and later, unless indicated otherwise:

Top Income Tax Rate. "High-income taxpayers" are subject to a new top income tax rate–39.6%. This rate applies to taxable income above specified thresholds: beginning at $450,000 for married couples filing jointly and surviving spouses, at $425,000 for heads of households, at $225,000 for married couples filing separately, and at $400,000 for single persons.

Long-Term Capital Gains Tax Rates. When a capital asset (i.e., an investment) is sold at a price greater than its tax basis, a capital gain is triggered. If the asset was held for more than one year before being sold, the gain is a *long term* capital gain. The long term capital gains tax rate remains at 15% for *most* taxpayers EXCEPT for high-income taxpayers. The long term capital gains tax rate for high-income taxpayers–persons in the ranges shown in the paragraph above–is 20%. Note that, because the 3.8% "surtax" on net investment income added by the Health Care and Education Reconciliation Act of 2010 (a/k/a the "Medicare surtax") is effective this year (at modified AGI levels of $200,000 for individuals and $250,000 for couples), for high-income taxpayers, the rate on net long term capital gains could be as high as 23.8%.

Tax Rates for Qualified Dividends. Prior to the passage of ATRA, dividends from domestic corporations and certain qualified foreign corporations were scheduled to be taxed at *ordinary* income tax rates after 2012 (i.e., 0% through 39.6%, plus the 3.8% Medicare surtax), with a potential maximum dividend tax rate of 43.4%. Per ATRA, the tax rate on qualified dividends for *most* taxpayers remains at 15% EXCEPT for high-income taxpayers. At the thresholds shown in the first paragraph above, qualified dividends are taxed at 20%, plus the 3.8% Medicare surtax noted above, for a total of 23.8%.

Short Term Capital Gains Tax Rate. When "investors" sell capital assets that they have held for less than one year at a gain, that gain is taxable at the short-term capital gains tax rate. Thus, people who buy and sell investment assets frequently had better watch out! For 2012, the highest short term capital gains tax rate was 35%. In contrast, the highest short term capital gains tax rate for 2013, taking into account the change in the top income tax rate and the Medicare surtax, will be 43.4%! If *that* doesn't promote a long-term investment outlook, then perhaps nothing will!

Permanent AMT Relief. The original version of the "Alternative Minimum Tax" ("AMT") was passed into law as part of the Tax Reform Act of 1969 and became effective in 1970. Allegedly, the impetus for the AMT was a report that 155 high-income US households had not paid *any* federal income taxes in the prior year because they had taken advantage of so many deductions (or, what some people refer to as "loopholes"). The AMT is imposed at a nearly flat rate on an adjusted amount of taxable income above a certain threshold. Every year, each taxpayer must pay the greater of his "regular" income tax amount or the AMT. The problem has been that, when Congress originally instituted the AMT, it did not include any *automatic* inflation adjustments to the exemption amounts. Year after year, Congress has passed legislation amounting to temporary "patches," raising the exemption amounts to prevent the AMT from applying to more and more taxpayers, including "middle-class" taxpayers who were never the intended targets of the AMT. Congress did not pass an AMT patch for 2012 and, thus, the 2012 AMT thresholds prior to the passage of ATRA would have been really low (e.g., $45,000 for married couples filing jointly and surviving spouses and $33,750 for single persons and heads of households). ATRA not only *patched* the AMT exemption amounts for 2012, but went further: it made the exemption amounts "permanent" and subject to automatic adjustments for

inflation. Thus, per ATRA, the AMT exemptions for **2012** are $78,750 for married couples filing jointly and surviving spouses, $39,375 for married couples filing separately, and $50,600 for single persons and heads of households (the 2013 amounts will be somewhat higher).

Personal Exemption Phase-out and Itemized Deduction Limitation. For many years, at certain thresholds, the personal exemptions and the itemized deductions of high-income taxpayers were phased out, although, by 2010, the phase-outs were phased out. Prior to ATRA, the phase-outs were scheduled to return in 2013 at their previous levels. Per ATRA, here are the thresholds for the personal exemption phase-out and the itemized deduction limitation: $300,000 for married couples filing jointly and surviving spouses, $275,000 for heads of household, $250,000 for single persons and $150,000 for married couples filing separately.

Qualified Charitable Distributions from IRAs. This is a provision that has been "in" and "out" of the law over the past sixteen to seventeen years. We wish Congress would just make this provision permanent and also expand the allowable recipients beyond public charities to other charitable entities! However, we are thankful for what ATRA provides.

Pursuant to this provision, taxpayers who are at least 70½ years old may direct up to $100,000 from their IRA to qualified charities. The amount so directed, called a "Qualified Charitable Distribution" ("QCD"), qualifies as the taxpayer's minimum required distribution ("MRD") for the tax year, up to the $100,000 limit. There is no charitable deduction for the QCD (approximately 2/3 of all taxpayers take the standard deduction and would not obtain a charitable deduction anyway). Instead, the QCD reduces the amount of the taxpayer's MRD (up to the limit) for the tax year. Since income taxes have to be paid on MRDs, QCDs reduce the amount upon which income taxes must be paid. Thus, this provision provides direct benefits to charity, using funds that many taxpayers don't need, and reduces the taxable income of these charitable taxpayers at the same time. This is a "win-win."

There were three separate ways that eligible taxpayers could take advantage of this provision in ATRA *for the year 2012.* Since all of these 2012 provisions have already expired, we will not explain them in this newsletter. ATRA also allows eligible taxpayers to make QCDs from their IRA for 2013. However, at the end of this year, this provision will expire again! So, those IRA owners over 70½ who are charitably inclined are urged to consider taking advantage of this provision for 2013.

Other Income Tax Provisions. There are many other income tax (and other) provisions in ATRA, which we are not going to discuss in this newsletter.

ATRA's Estate, Gift and GST Tax Provisions. In general, we are pleased with the provisions in ATRA dealing with the estate tax, gift tax and Generation-Skipping Transfer Tax ("GST tax"). First, ATRA made $5,000,000 the "permanent" and "unified" exemption amount and provided that such exemption would be indexed for inflation (starting from the year 2011). Thus, for 2013, the estate, gift and GST tax exemption amount is $5,250,000. ATRA also made the "portability option" permanent (more on this later). While ATRA made the estate, gift and GST tax rate 40% (higher than the 35% rate that applied in 2012), this is still better than what the "law on the books" would have provided for the top transfer tax rate if ATRA had not been passed (i.e., 55% and even 60% in some cases). Thus, a 40% tax rate, coupled with the "pleasantly high" $5,000,000 exemption amount, indexed for inflation, is a pretty good deal.

So, what do these new estate, gift and GST tax provisions mean for clients? First, be sure you have an accurate idea of the total value of your estate. For this purpose, include the *fair market value* of real estate, stocks, bonds, mutual funds, other investments, business interests, retirement plans and IRAs, tangible personal property (household furnishings, personal effects and vehicles), the proceeds of life insurance that will be paid upon your death (not the policy's cash value), and all other assets or interests in assets you own. Your financial advisor or accountant can help you prepare a net worth statement if you don't know how. Keep in mind community property laws, too. In Texas, when evaluating the assets owned by a married couple, the name shown in the title of the asset does *not* tell us the owner of the asset, only the manager of the asset. Other questions have to be asked to determine the ownership of a Texas married couple's assets. Basically, all assets acquired during the marriage by either spouse, except those acquired by gift or inheritance, are going to be community property, owned one-half by each spouse, even if only one spouse is the "named owner" (i.e., the manager) of the asset.

Ignoring all other estate planning considerations, here is how we see clients "lining up" as far as estate tax planning in their Wills or in their (Joint) Revocable Trust:

Couples Under $4,000,000. Married couples with a combined net worth of less than $4,000,000 do not need a Bypass Trust, *unless their estate is still growing due to compensation income and/or business income.*

Couples Between $4,000,000 and $6,000,000. Married couples with a combined net worth between $4,000,000 and $6,000,000 ought to at least include an *option* for the surviving spouse to create a Bypass Trust on the first spouse's death. The goal is to keep the assets taxable in the surviving spouse's estate under one exemption amount at the time of her death. Some couples in this range may

want a Bypass Trust whether it's needed for estate tax purposes or not because of the "non-tax" benefits a Bypass Trust provides (such as creditor protection, "remarriage" protection, and more income tax options).

Couples With $6,000,000 or More. Married couples with a combined net worth greater than $6,000,000 probably ought to have a "tax formula" in their Wills or Joint Revocable Trust that creates a Bypass Trust on the first spouse's death.

Single People Under $4,500,000. Most single people with a net worth under $4,500,000 do not have to worry about estate taxes, *unless their estate is still growing*.

People with Larger Estates. Single people with $5,000,000 or more and married couples with $10,000,000 or more will usually need to take one or more "next steps up the estate planning ladder" if they are serious about transferring wealth at the lowest possible estate, gift and GST tax cost.

As already noted, the above breakdown by net worth completely ignores other important factors that affect an estate plan, such as whether a couple is in a second marriage/blended family situation, whether one spouse is already disabled or has a disease that is likely to render him disabled, whether a person is a professional with a high risk of liability, etc. Of course, a client's age, health, and life expectancy, as well as the type of investments owned, are relevant, too. Each individual's and couple's estate planning situation is unique and, therefore, each couple's/individual's estate plan needs to be tailored to their particular situation, based on a comprehensive, holistic analysis, and not solely based on net worth.

OLD WILLS NEED TO BE CHANGED NOW! Many married couples have Wills that were prepared when the estate tax exemption amount was much, much lower than it is now. These Wills are likely to have a "tax formula" in them that *will require a Bypass Trust to be established* on the first spouse's death, whether or not a Bypass Trust is still needed or desired. When a decedent's Will calls for the creation and funding of a Bypass Trust, the Executor cannot just ignore those provisions and distribute all of the deceased spouse's assets directly to the surviving spouse. Doing that would be a clear breach of fiduciary duty. Thus, when a married person dies with a really old Will that calls for the funding of a Bypass Trust and the surviving spouse is "unhappy" about that, the only way to *ignore* what the Will says is for the Executor, the surviving spouse and all of the couple's children (and sometimes all of the couple's grandchildren) to execute a "Family Settlement Agreement." A Family Settlement Agreement is a legal document (which should be prepared by a lawyer) designed to *override* the terms of an irrevocable document, such as the Will of a deceased person. Note that it is more expensive to obtain a Family Settlement Agreement *after* the first spouse dies than it is for a couple to obtain new Wills without a Bypass Trust in them *before* the first spouse dies. Thus, couples with a "non-growing" estate worth less than $5 million who have "really old Wills" that create a Bypass Trust on the first spouse's death should come in *now*, before the first spouse dies, to obtain new "simple" Wills if they don't want a Bypass Trust. This is an example of the adage, "An ounce of prevention is worth a pound of cure."

Portability. As noted above, ATRA made "permanent" the portability election first added to the law by the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." Portability is a post-death technique that can be used in a case where a married couple did not "plan ahead" and the estate tax exemption of the first spouse to die is being wasted, in whole or in part. As a reminder, if the first spouse dies and leaves all of his assets directly to the surviving spouse, assuming the surviving spouse is a US citizen, no immediate estate taxes have to be paid on that transfer because of the unlimited marital deduction. However, the first spouse to die is "wasting" his entire exemption from the estate tax by leaving what he owns directly to his spouse. Now, the surviving spouse owns *all* of the assets and when that spouse dies, since she is just one decedent, her estate is only entitled to one exemption from the estate tax, not two. This is a "marriage penalty at death" resulting from the marital deduction that many people do not understand.

Portability provides a way for couples in this situation to get two exemptions from the estate tax when the second spouse dies, rather than just one. To make the portability election, however, the Executor of the first spouse's estate must prepare and file with the IRS a Form 706, US Estate Tax Return ("Estate Tax Return"). Note that the first spouse's unused estate tax exemption amount that is *transported* to the surviving spouse as a result of the Executor filing the Estate Tax Return to elect portability can be "lost" if the surviving spouse does not use it during life and then remarries a new spouse who dies before her, with no unused estate tax exemption amount that can be transported to her. In that case, the time, effort and expense of filing the Estate Tax Return will have been wasted. Thus, we view portability as a "remedial" measure and not as a planning technique.

Some people may view portability as "simpler" than doing estate tax planning before death because no Bypass Trust has to be created on the first spouse's death. However, the cost of preparing an Estate Tax Return is greater than the cost of obtaining Wills with a Bypass Trust in them. And, of course, Bypass Trusts provide non-tax benefits, too. So portability is not a panacea.

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Final Thoughts. A recent public speaker noted that the tax code is now 6 times as long as the Bible with no "good news" in it. While that may be true, we believe that ATRA does provide *some* good news. Making $5 million the "permanent" estate, gift and GST tax exemption amount and providing for automatic inflation adjustments (starting from 2011) is pretty good news, despite the increase in the tax rate from last year's 35% to this year's 40% (it could have been much worse). So, many couples and single persons can now create an estate plan without regard to federal estate tax issues. That is real "testamentary freedom."

Because of ATRA, there is likely to be more emphasis on non-tax issues in estate planning, such as (i) creditor protection, (ii) remarriage protection, (iii) ultimate control, (iv) asset management, and (v) disability planning. Also, in many client situations, there is likely to be a shift in focus from estate tax issues to income tax issues. Further, we like ATRA because of some things it *didn't* do: it did not "shut down" the use of intentionally defective grantor trusts (IDGTs), short-term GRATs, and discounts for gifts of interests in closely held entities, just to mention a few.

2013 Gift Tax Exclusion Amount. Due to inflation adjustments, the annual gift tax exclusion amount for 2013 is $14,000 per donor (gift-giver) per donee (gift recipient). Persons with taxable estates should always consider making "annual exclusion gifts" and other "tax-free gifts" (such as direct tuition payments on another's behalf) to reduce the size of their estate.

Time for an Estate Planning Check Up? If it has been *more than 5 years* since your estate plan was created or last reviewed, you are "due" for a check up. If you want to change your tax-planned Wills to "simple" Wills, please make an appointment to come in for an estate planning check up. Or, now that we "know what the rules are," if you are ready to take a "second step" up the estate planning ladder, please call for an appointment.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above. You can also reach us by email addressed to:

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