The American Taxpayer Relief Act of 2012: A (Mostly) Happy New Year for the Estate, Gift and GST Taxes

The nation having stepped off the dreaded fiscal cliff at the end of 2012, Congress immediately pulled the ripcord, passing the "American Taxpayer Relief Act of 2012" (the 2012 Act) on New Year's Day. President Obama signed the 2012 Act into law on January 2, 2013. The new law has important – and mostly positive – consequences for the federal estate, gift and generation-skipping transfer (GST) taxes. First and foremost, the 2012 Act prevents the reinstatement of the pre-2001 estate, gift and GST tax exemptions and rates that would have occurred automatically under prior law. But for the 2012 Act, the estate, gift and GST tax exemptions, which had increased to $5 million apiece (indexed for inflation) under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, would have reverted to approximately $1 million apiece, and the 35% maximum rate for each of those taxes that was effective in 2011 and 2012 would have jumped to 55%.

The 2012 Act

The 2012 Act provides the following:

- For decedents dying after December 31, 2012, the estate tax exemption is set at $5 million, indexed for inflation from 2010. The inflation-adjusted estate tax exemption for decedents dying in 2013 is expected to be $5.25 million.
- The gift and GST tax exemptions are also set at $5 million, indexed for inflation from 2010. Thus, the 2013 gift and GST tax exemption amounts are expected to be $5.25 million per taxpayer ($10.5 million for married couples who elect to split gifts).
- The maximum estate and gift tax rates have increased to 40%. The GST tax rate, which is keyed to the maximum estate tax rate, is also set at 40%. This uptick in rates, which is far smaller than that scheduled to occur absent the new legislation, is perhaps the only negative aspect of the transfer tax provisions in the 2012 Act.
- After more than ten years of self-adjusting and sun-setting exemption amounts and rates for the estate, gift and GST taxes, the 2012 Act makes the above exemption and rate structure permanent – at least until Congress changes it again.
- In addition, the 2012 Act makes the concept of estate tax exemption "portability" permanent. Introduced into law in 2010, portability of exemption permits a surviving spouse to apply the unused estate tax exemption of the first spouse to die to the surviving spouse's own lifetime or testamentary transfers. (Historically, the first spouse's unused exemption would have been lost if the first spouse had not created an estate plan designed to use it.)

Planning Considerations

While many individuals made significant gifts in 2011 and 2012 to take advantage of the increased gift and GST tax exemptions before their scheduled expiration at the end of 2012, individuals who have not used their exemption amounts for lifetime transfers have the ongoing opportunity to do so. Making lifetime gifts has myriad benefits, including the ability to grow the transferred assets free of gift, estate and GST taxes for multiple generations. Those who have already used their lifetime exemptions from the gift and GST taxes will have the ability to "top up" their prior gifts as the exemptions are indexed for inflation.

In addition, there continue to be opportunities to transfer assets to future generations without making a taxable gift, including through the use of grantor retained annuity trusts (GRATs), sales of assets to "intentionally-defective" grantor trusts, and charitable lead annuity trusts (CLATs). These techniques can be particularly effective in a low-interest-rate environment like the current one.

Particularly because it is now permanent, portability of the estate tax exemption offers useful planning opportunities after the death of the first spouse to die. Its use requires the filing of a federal estate tax return at the first spouse's death and an affirmative election on that return. Portability does have limitations, however. For example, the deceased spouse's unused estate tax exemption amount is not indexed for inflation; the first spouse's GST exemption is not portable; and portability is not currently available for state estate tax purposes. While portability provides a helpful safety net for married couples who have not created an estate plan while both spouses are living, for all the reasons described above, it is not a substitute for thoughtful, affirmative planning.

Because many states, including Massachusetts and New York, have "decoupled" their state estate taxes from the federal tax, the 2012 Act does not affect most state estate tax issues. The Massachusetts and New York estate tax exemptions each remain at $1 million, with applicable rates ranging from 6% to 16%.

The 2012 Act has no impact on the annual exclusion from the federal gift tax. Thanks to inflation indexing, however, the amount that each taxpayer may give to a donee (without using lifetime gift tax exemption or incurring gift tax) in 2013 has increased from $13,000 to $14,000 ($28,000 per donee for married couples who elect to split gifts).

To Be Continued…?

Several estate planning techniques that have been targeted by proposed legislation in the last few years are not addressed in the 2012 Act. For example, proposals have been floated to impose a mandatory minimum term for GRATs, curb valuation discount planning, limit the duration for which a so-called "dynasty" trust will be exempt from the GST tax, and limit or end a donor's ability to make a completed gift to a trust and thereafter pay the trust's income taxes as if they were the donor's own. As Congress turns to the difficult task of reducing the federal deficit, we continue to monitor those proposals, any or all of which could be enacted to raise needed revenues.

We would be happy to talk with you about the effect of the 2012 Act on your situation and the planning opportunities it may present for you. Please contact your advisor at Ropes & Gray with any questions.

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