January 16, 2013

Estate Planning After the Fiscal Cliff Deal

Now that a deal averting the fiscal cliff has finally been reached, many of the tax and planning issues that have been mired in uncertainty for the past two years (and even longer in some cases) may be resolved. Numerous tax benefits that were scheduled to "sunset" as of December 31, 2012, have been made "permanent" by the American Taxpayer Relief Act of 2012 ("ATRA 2012"). For the first time in approximately 11 years, we do not have to plan with imminent change on the horizon. However, the winds of change may blow once again when Congress and the White House take up broader issues such as the debt ceiling and the related automatic sequester of government funds, which were merely postponed for two months, along with the various tax and planning elements of the President's budget proposal for 2013 that were not addressed by ATRA 2012.

Against this backdrop, the Trusts and Estates Practice at Katten Muchin Rosenman LLP is pleased to provide you with a summary of the most significant estate and income tax changes contained in ATRA 2012, from a personal planning perspective, along with recommendations on how the new law may be used to benefit you with future planning and how it should be taken into account when reviewing existing planning.

Estate/Gift Tax

- The estate and gift applicable exclusion amounts and the generation skipping transfer (GST) exemption amount (the "applicable exclusion amounts") will remain at $5,000,000, indexed for inflation.
- The applicable exclusion amount for 2013 will be $5,250,000.
- The "portability" of a deceased spouse's unused applicable exclusion amount for estate and gift tax purposes has also been made permanent. Note that portability does not apply to the applicable exclusion amount from GST tax.
- The maximum rate for estate, gift and GST taxes will increase from 35% to 40%.
- Though unrelated to ATRA 2012, the amount of the annual gift tax exclusion increased from $13,000 per donee in 2012 to $14,000 per donee in 2013. Thus, a husband and wife together will be able to gift $28,000 to each donee in 2013.
- The amount of the annual gift tax exclusion with respect to gifts made to non-citizen spouses will increase from $139,000 to $143,000 in 2013.

Income Tax

- The rate for long-term capital gains and qualified dividends will remain at 15% (or 0% if the taxpayer's ordinary income is taxed at 10% or 15%), with the addition of a new 20% rate for single taxpayers with taxable income above $400,000 or $450,000 for married couples filing jointly.
- Individual ordinary income tax rates will remain the same, with the addition of a new 39.6% maximum tax bracket for single taxpayers with taxable income above $400,000 or $450,000 for married couples filing jointly.
- Certain itemized deductions, including deductions for mortgage interest, property taxes, state and local taxes and charitable contributions, will be reduced by an amount equal to 3% of the excess of the adjusted gross income (AGI) over a threshold amount, indexed for inflation, but not by more than 80% of the itemized deductions (the "Pease limitation"). The threshold amount for 2013 will be $300,000 for married couples filing jointly, $150,000 for married couples filing separately, $275,000 for heads of households, and $250,000 for single filers.

- The personal and dependency exemptions will be reduced by 2% for every $2,500 or part thereof that the taxpayer's AGI exceeds the same threshold applicable to the Pease limitation (the "PEP limitation").
- Though unrelated to ATRA 2012, a new 3.8% Medicare surtax will be imposed on investment income for taxpayers with income exceeding the minimum threshold ($200,000 for single filers, $250,000 for married filers filing jointly, $125,000 for married filers filing separately, and $11,950 for trusts and estates). An additional 0.9% tax will be imposed on earned income above the same threshold.
- The payroll tax cut of 2% was not extended. Thus, payroll taxes will increase by 2% for all wage earners in 2013.
- Various other itemized deductions, including the deduction for state and local sales taxes, were extended through 2013, but were not made permanent.
- The exemption amount from the alternative minimum tax (AMT) has been set at $80,800 for married couples filing jointly and surviving spouses ($40,400 for married filing separately, $23,100 for trusts and $51,900 for all other taxpayers) and will be indexed for inflation in future years, thus permanently "patching" the AMT.

Retirement Assets

- Taxpayers over the age of 70½ may now make qualified charitable distributions from their IRAs up to $100,000, retroactive to 2012. There are two ways to take advantage of this change for the 2012 tax year. The first method is to make a qualified charitable distribution directly from an IRA in January 2013. The second method, which applies only to the extent that an eligible taxpayer received IRA distributions in December 2012, is for the taxpayer to contribute a corresponding amount of cash (not stock or other appreciated assets) out of the taxpayer's own funds to charity in January 2013, in which case the distributions received in December 2012 will be treated as if they were qualified charitable distributions. Thus, anyone considering such a distribution should consult an advisor immediately.
- In addition, participants in 401(k) plans, 403(b) plans and 457(b) plans may now make direct rollovers to Roth accounts under such plans without meeting any of the previously required distribution criteria.

Remaining Unresolved Potential Changes

The President's budget proposal for fiscal year 2013 included a number of transfer tax-related items that were not addressed in ATRA 2012. Those items and other revenue-raising provisions may yet be the subject of future legislation resulting from the two-month postponement of the debt ceiling and sequester of government funds or other tax reform initiatives. Thus, we advise you to consider additional planning sooner rather than later. The most significant transfer tax-related items of the President's budget proposal are summarized below.

Change to Treatment of Intentionally Defective Grantor Trusts (IDGTs)

IDGTs are currently used as a central part of much tax planning, as they allow a grantor the ability to be taxed on all of the trust's income, thus allowing more assets to remain for the trust beneficiaries. Under the President's proposal, the assets in IDGTs would be included in the grantor's estate and subject to estate tax. In addition, distributions from an IDGT would be subject to gift tax, and if the trust ceases to be a grantor trust, the remaining assets would be subject to gift tax.

Grantor Retained Annuity Trusts (GRATs) to Be Subject to New Rules

The proposal includes three additional requirements that would be imposed on GRATs: (i) they must have a 10-year minimum term; (ii) they must have a remainder interest greater than zero; and (iii) the annuity amount cannot decrease in any year during the annuity term.

Eliminating Certain Valuation Discounts

The budget proposal adds a new category of "disregarded restrictions" that would be ignored for transfer tax valuation purposes in valuing an interest in a family-controlled entity transferred to a member of the family.

Limiting the Duration of the GST Exemption

Under the proposal, the exclusion from the imposition of GST tax would last only 90 years for additions to preexisting trusts and trusts created after the date of enactment, regardless of whether a trust has a longer duration.

Important Planning Considerations for 2013

File Gift Tax Returns Reporting 2012 Gifts

If you made gifts during 2012 in excess of the annual gift tax exclusion, you must file a federal gift tax return (note that Connecticut gift tax returns may also be required for Connecticut residents and nonresidents who made gifts of property located in Connecticut) by April 15, 2013. Though the due date for the return may be extended to October 15, 2013, any gift tax due must be estimated and paid by April 15, 2013. Married couples may elect to split the gifts (thus applying one-half of the value of the gift to each individual's applicable exclusion amount from gift tax), in which case each individual must file a separate gift tax return. If a gift of property requiring an appraisal (e.g., a gift of real estate or an ownership interest in a closely held business) was made in 2012, such an appraisal should be obtained immediately and be attached to your gift tax return.

Review and Revise Your Estate Plan to Ensure It Remains Appropriate

If you made large gifts before the end of 2012, you should review your estate planning documents, including your wills, to make sure that those documents still make sense in light of your recent gifting. For example, your estate planning documents may assume that you will have a high applicable exclusion amount remaining to be used at the time of your death. If you made large lifetime gifts, that assumption is likely no longer true. You should consider having your documents revised to a "disclaimer plan," which provides the greatest level of flexibility to take into account the possibility of future changes to the applicable exclusion amount. Under a disclaimer plan, your assets pass to your surviving spouse (thus qualifying for the unlimited marital deduction from estate tax if the surviving spouse is a US citizen), subject to your spouse's option to disclaim (i.e., refuse to accept) some or all of such assets, causing the disclaimed assets to pass to a trust for the benefit of your spouse and descendants. The amount of any such disclaimer can be based on your remaining applicable exclusion amounts at the time of your death, as well as your spouse's comfort level with ceding control of the assets to a trustee.

You should also review any provisions in your wills and trust agreements that distribute assets according to tax formulas and/or your applicable exclusion amounts to ensure that the provisions, when taking into account the higher applicable exclusion amounts, continue to reflect your desires and take full advantage of your applicable exclusion amounts, as appropriate under the circumstances.

Other provisions that should be reviewed include the allocation of the GST applicable exclusion amount. If you are married, you should carefully review the provisions regarding your applicable exclusion amount from GST tax because the portability provisions discussed above do not apply to the GST tax. In addition, whether single or married, if you did not have sufficient GST applicable exclusion amount to exempt all of your prior gifts to a trust from GST tax, that trust will only be partially exempt from GST tax. In order to avoid the expense and administrative difficulty of a trust that is only partially exempt from GST tax, you could consider making a "qualified severance" of the trust into two trusts, one of which is entirely exempt from GST tax, and the other of which is non-exempt from GST tax.

If you were the beneficiary of lifetime gifts made by someone else, you should review your estate planning documents to ensure that they take such gifts into account and take full advantage of your applicable exclusion amounts.

Consider Distributing Trust Income to Beneficiaries

A trust with undistributed annual income over $11,950 will be subject to the new 3.8% Medicare surtax. However, some or all of the Medicare surtax may be avoided by distributing such income directly to beneficiaries who are below the individual net investment income threshold amount for the Medicare surtax ($200,000 for single filers, $250,000 for married couples filing jointly, and $125,000 for married couples filing separately). Careful evaluation and tax calculations should thus be made to determine whether trusts should distribute or retain their income.

Select a Fiscal Year End for a 2012 Estate That Minimizes the Medicare Surtax

Estates with a fiscal year end beginning in 2013 are also subject to the 3.8% Medicare surtax at the same threshold that applies to trusts. However, for the estates of decedents who died in 2012, careful selection of the estate's first fiscal year end may avoid some or all of the surtax until December 2013.

Make Gifts to Take Advantage of the Increased Applicable Exclusion Amount

You now have a total of approximately $5,250,000 ($10,500,000 for a married couple) that you can gift in the aggregate during your lifetime, subject to reduction for any gifts in excess of the annual gift tax exclusion amount you have previously made. Gifts in excess of $5,250,000 ($10,500,000 for a married couple) are subject to a maximum federal gift tax rate of 40%. If you are a surviving spouse and your deceased spouse left you with unused applicable exclusion amount from estate tax, you may add such unused applicable exclusion amount to your own applicable exclusion amount from gift tax, thus permitting you to make larger lifetime gifts without paying gift tax. It is always cheaper to make lifetime gifts rather than making gifts at death. This result occurs because you do not pay a tax on the dollars used to pay gift tax, but you do pay estate tax on the dollars used to pay estate tax. In addition, you will benefit by getting any income and appreciation on the gift out of your estate. Note that your applicable exclusion amount will increase by approximately $130,000 ($260,000 for a married couple) in 2013. Therefore, even if you used some or even all of the applicable exclusion amount available to you before the end of 2012, you may still make additional gifts in 2013 without paying any gift tax. Your applicable exclusion amount will also be adjusted for inflation in future years. Thus, you may "max out" your applicable exclusion in 2013 and still make additional gifts in 2014 and subsequent years to take advantage of the increased applicable exclusion amount available in each year.

Grantor Retained Annuity Trusts (GRATs)

GRATs remain one of our most valuable planning tools, particularly in this time of historically low interest rates and depressed asset values. Because of the continuing possibility that legislation may soon pass changing how GRATs may be structured and that interest rates may rise, GRATs should be created as soon as possible. An important point to note is that GRATs may currently be structured without making a taxable gift, so even if you have used all of your applicable exclusion amount, GRATs may be used without incurring any gift tax.

A GRAT provides you with a fixed annual amount (the annuity) from the trust for a term of years (currently as short as two years). The annuity you retain may be equal to 100% of the amount you use to fund the GRAT, plus the IRS assumed rate of return applicable to GRATs (which for transfers made in January 2013 is 1%). As long as the GRAT assets outperform the applicable rate, at the end of the annuity term you will be able to achieve a transfer tax-free gift of the spread between the actual growth of the assets and the applicable rate. Because you will retain the full value of the GRAT assets—as calculated using the IRS's assumptions for growth—if you survive the annuity term, the value of the GRAT assets in excess of your retained annuity amount will then pass to whomever you have named with no gift or estate tax, either outright or in further trust.

Sales to "Defective" Grantor Trusts

Because the President's budget proposals eliminating the benefit of grantor trusts may still be enacted, we recommend implementing these trusts as part of immediate planning.

You would sell assets likely to appreciate in value to the trust in exchange for a commercially reasonable downpayment and a promissory note for the balance. From an income tax perspective, no taxable gain would be recognized on the sale of the property to the trust because the trust is a defective grantor trust, which makes this essentially a sale to yourself. For the same reason, the interest payments on the note would not be taxable to you or deductible by the trust.

If the value of the assets grows at a greater pace than the prevailing applicable federal rate (which for sales in January 2013 is as low as 0.87%), as with a GRAT, the appreciation will pass free of gift and estate tax. The current record-low interest rates make sales to defective grantor trusts most opportune to structure now.

Consider a Swap or Buy-Back of Appreciated Low Basis Assets from Grantor Trusts

Some of you sold or gave (through a GRAT or other grantor trust) an asset with a low basis. If the asset is sold at a gain, the gain will trigger capital gains tax. However, if you purchase the asset back from the grantor trust for fair market value, no gain or loss is recognized. The trust would then hold cash equal to the value of the asset that was repurchased, leaving the same amount to escape estate tax. Alternatively, many grantor trust instruments give the grantor the power to substitute the trust's assets with other assets, which would allow the low basis assets to be removed from the trust in exchange for assets of equal value that have a higher basis.

The advantage is that, on your death, the purchased or reacquired asset will be included in your taxable estate and will receive a step-up in basis equal to fair market value. This means that the capital gains tax on sale of that asset is eliminated and the beneficiaries still benefit from the grantor trust's cash.

Use Intra-Family Loans

Because interest rates are so low, many techniques involving use of intra-family loans should be considered, including the following:

- Forgiving loans previously made to family members. The amount that is forgiven in excess of the annual gift tax exclusion amount will be a gift, and thus will use a portion of your applicable gift tax and/or GST tax exclusion amount. Note that forgiveness of debt that is a gift is not treated as taxable income of the borrower.
- The purchase of life insurance on the life of one family member by an irrevocable life insurance trust, with premium payments funded by loans from other family members.
- The creation of trusts by older generation members for the benefit of younger family members, to which the older generation members loan funds. The spread between the investment return earned by the trust and the interest owed will create a transfer tax-free gift.

Consider Charitable Planning

A variety of planning tools are available for the charitably inclined. One planning tool that is very effective in a low interest rate environment is a CLAT, which combines philanthropy with tax planning. A CLAT is an irrevocable trust that pays one or more named charities a specified annuity payment for a fixed term. At the end of the charitable term, any remaining assets in the CLAT pass to the remainder, non-charitable beneficiaries. As with a GRAT, to the extent the assets outperform the IRS assumed rate of return (1% for January 2013), those assets can pass transfer tax free to whomever you would like. Like GRATs, CLATs can be "zeroed out" so that there is no taxable gift.

In addition, taxpayers over the age of 70½ should consider making up to $100,000 of qualified charitable distributions from IRAs for tax years 2012 and 2013, as discussed above.

Further, giving appreciated assets directly to charity has always been an effective means to avoid capital gains tax on the donated assets. Now it is also an effective way to avoid the 3.8% Medicare surtax. The income tax deduction for charitable gifts may also be worth more as a result of the higher tax rates. Note that the Pease limitation described above, if applicable, may reduce the amount of the deduction for charitable gifts.

We Can Help

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any member of Katten's Trusts and Estates Practice.

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