Client Alert

New Tax Act Provides Long-Awaited Clarity and Certainty on Estate, Gift and Generation-Skipping Transfer Taxes, and Income Tax Rates

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On January 1, 2013, the Senate and the House of Representatives passed the American Taxpayer Relief Act of 2012 (ATRA), averting the so-called "fiscal cliff." The legislation, which was signed by President Obama on January 2, 2013, includes several major changes to the Internal Revenue Code. Following is an overview of those aspects of ATRA that are expected to be most relevant to clients of our Trusts, Estates and Non-Profit Organizations group. Of greatest significance, ATRA finally made permanent (subject to any future legislative changes) taxpayer-favorable wealth transfer tax exemptions that had applied temporarily in recent years, accompanied by a relatively modest tax rate increase for transfers that exceed the exemption.

ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

Continues Same (High) Exemption Amount; Increased Maximum Tax Rate. ATRA provides that the estate, gift and generation-skipping transfer (GST) tax applicable exclusion amount—often referred to as an "exemption" amount—are unified at $5 million, indexed for inflation after 2011, with a maximum increased tax rate of 40%. (The maximum tax rate was 35% in 2011 and 2012.)

As a result, in 2013, every US citizen or resident taxpayer has a total exemption of $5,250,000 (up from $5,120,000 in 2012) that can be used on cumulative lifetime and testamentary gifts before the gift tax or estate tax will apply to their transfers. And a married couple will be able to transfer $10,500,000 before gift tax or estate tax will apply to their transfers. This historically large exemption amount will exempt an estimated 99.8% of US decedents' estates from federal estate tax.

The GST tax is an additional wealth transfer tax imposed on transfers (including transfers in trust) in excess of a GST exemption amount to family members and persons two or more generations below the transferor. Because the GST exemption amount remains the same as the gift and estate tax exemption amount, it is possible to establish trusts for the benefit of several generations with up to $5,250,000 (or $10,500,000 for a married couple) worth of property, and shield that property, plus future income and appreciation with respect to such property, from any further estate or GST tax for generations.

Because of the inflation adjustment feature of these provisions, an individual who used the full exemption amount on transfers in 2012 is now able to transfer an additional $130,000 (or $260,000 for a married couple) in 2013 without paying any gift, estate, or GST tax.

The annual gift tax exclusion amount, which was not changed by ATRA, has also increased from $13,000 in 2012 to $14,000 in 2013, due to the inflation adjustment.

Portability. The "portability" feature, which allows a surviving spouse to take advantage of the unused estate (but not GST) tax exemption of a predeceased spouse, has also been made permanent by ATRA. The portability feature requires the filing of an estate tax return for the deceased spouse in order to utilize the amount of his or her unused exemption. (A return might not otherwise be required if the deceased spouse's gross estate is under $5,250,000 in value.)

While portability simplifies the estate planning options for couples with a combined estate under $10,500,000 in value, it still makes sense in many cases to create an estate plan that includes a credit shelter or disclaimer trust upon the death of the predeceased spouse to allocate his or her GST exemption amount to such trust and shield that amount, plus future income and appreciation with respect to the trust property, from any further estate or GST tax for generations.

INCOME TAX PROVISIONS

Increases Marginal and Effective Tax Rates. ATRA increases to 39.6% the top marginal tax rate on ordinary income of single taxpayers and married joint filers having taxable income above $400,000 and $450,000, respectively, and limits certain itemized deductions (including deductions for mortgage interest, state and local taxes and charitable gifts) for single taxpayers and married joint filers having taxable income above $200,000 and $250,000, respectively. Although favorable tax rates are retained for long-term capital gains and qualified dividend income, the maximum rate on such income is increased to 20% for individuals with taxable income above the $400,000 or $450,000 threshold, as applicable.[1] These increases in the top marginal tax rates also apply to the undistributed net income of trusts and estates.

The ATRA changes, together with the new Medicare tax that took effect on January 1, 2013 imposing a 3.8% surtax on net investment income of individuals, trusts and estates, can result

1 These and many other income tax provisions in ATRA are discussed in some detail in our prior client alert, "American Taxpayer Relief Act of 2012 Finally Settles Individual Federal Income Tax Rates for 2013 and Beyond."

in significant income tax increases for taxpayers having income above the thresholds identified above.[2] In addition, the recent legislative changes are likely to further complicate decision-making regarding charitable gifts, at least to the extent motivated by potential tax savings. Modeling of the expected tax impact of charitable giving will therefore become especially critical for 2013 and later years.

Extends Numerous Incentive Provisions. ATRA provided some good news on the income tax front, in the form of limited extensions of a variety of taxpayer-favorable provisions that had expired at the end of 2011.[3] Following are some of the extensions that may prove relevant to our individual clients and their closely held businesses:

- Taxpayers age 70½ or older will continue to be able to make tax-free distributions from individual retirement plans directly to charitable organizations through the end of 2013. Special transition rules permit taxpayers to elect (i) to treat January 2013 retirement plan distributions to charity as if made during 2012, and (ii) to treat retirement plan distributions that were made directly to the taxpayer during December 2012 as if they had instead been made directly to charity, provided the distribution is in fact transferred to charity, in cash, by the end of January 2013 and otherwise meets the requirements for tax-free treatment.

- Enhanced charitable deductions remain available through the end of 2013 for qualified contributions of capital gain property for conservation purposes.

- A favorable rule generally equalizing the tax consequences of charitable contributions made indirectly through S corporations and direct contributions by individuals has been extended through the end of 2013.

- The 100% exclusion for gain on "qualified small business stock" has been extended to investments made through the end of 2013.

- The five-year reduced recognition period for the S corporation built-in gains tax has been extended for tax years beginning in 2012 and 2013. In addition, eligible installment sales made during those years will continue to benefit from the favorable shortened recognition period as installment gain is recognized in later years.

- Certain provisions favorable to foreign shareholders in regulated investment companies have been extended through tax years ending in 2013.

If you have questions about your specific estate plan, or want to ensure that your plan will still operate as intended under the new laws, please call us for a review and analysis.

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2 Specifically, the increased Medicare tax equals 3.8% of the lesser of net investment income or modified adjusted gross income over $200,000 (in the case of an unmarried taxpayer) or $250,000 (for married couples filing jointly). In the case of estates and those trusts subject to the tax, the tax is 3.8% times the lesser of (i) their undistributed net investment income for the year or (ii) the excess of their adjusted gross income over the dollar amount at which the highest marginal rate of income tax for trusts and estates begins to apply.

3 Many of the extensions are described in our prior client alerts, "American Taxpayer Relief Act of 2012 Finally Settles Individual Federal Income Tax Rates for 2013 and Beyond" and "American Taxpayer Relief Act of 2012: Extends Production Tax Credit for Wind and Many Other Cleantech Tax Incentives."

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