insights

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ESTATE PLANNING IN 2012 AND BEYOND

Navigating through the fog

For the last several years, Americans have faced an uncertain environment for estate and gift planning that is likely to continue as we slog through this election year. The estate and gift tax landscape is clouded by a Congress that seems unable to make up its mind about taxing the transfer of wealth. Despite all of the uncertainty, two things remain certain--death and taxes. We cannot avoid the first, but by taking steps today, most of us can dodge the second. To help you navigate through the fog, what follows explains where we are, where we are headed, where we want to be and how to get there.

By Stephen A. Rothschild

Where are we?

On December 17, 2010, the President signed into law a new Act (the "2010 Tax Act") that creates extraordinary opportunities for trust, estate and gift planning. Among the highlights of the 2010 Tax Act are the following:

1. An increase in the estate, gift and generation-skipping tax ("GST") exemptions to $5.12 million in 2012;
2. The reunification of the estate and gift tax exemptions so that a person can give away during life or at death up to $5.12 million free of estate or gift tax;
3. A reduction in the estate tax, gift tax and GST rates to 35%; and
4. Portability, which gives the second spouse to die the ability to use the unused portion of the first spouse's estate and/or gift tax exemption during their lifetime or at their death to reduce the size of their estate that might be subject to tax.

The new higher gift exemption amount means that a husband and wife can potentially gift up to $5.24 million without triggering **any** gift tax. And, using other techniques, taxpayers can gift appreciating assets and protect even a greater amount of assets from future estate taxes. In addition, during 2012, each taxpayer continues to have the ability to gift up to $13,000 per year without using up any of their gift exemption amount. Husbands and wives can split their gifts and give up to $26,000 to a single recipient without triggering any gift tax.

The ability to use portability is not automatic but must be elected. In other words, the executor of the first spouse decedent's estate must make an affirmative election to preserve the unused exempt amount on a timely filed estate tax return. Therefore, even if an estate tax return is not required because the first spouse to die does not have a taxable estate, it may be prudent to file an estate tax return for those spouses dying in 2012 in order to preserve that spouse's unused exemption for the second spouse.

Where are we headed?

Without some action by Congress, when the clock strikes midnight on December 31, 2012, the golden carriage that allows married couples to deliver over $10 million to their beneficiaries and heirs tax free will turn back into a pumpkin. On January 1, 2013, estate, gift and GST tax rates will all return to the amounts set by the 2001 Tax Act. Simply put, that means that the $5.12 million estate, gift and GST exemptions will disappear, the exemption amounts will return to just $1 million and portability vanishes too. Worse yet, the estate and gift tax rate will increase from 35% to 55% (or more for larger estates).

Adding to the confusion, the President has released 2013 revenue proposals that would vastly change the estate planning landscape if enacted. Virtually, all of the President's proposals are aimed at increasing federal revenue. First, the President has proposed a return to the unified 2009 estate tax and GST exclusion amounts of $3.5 million with a maximum estate, gift and GST rate of 45%. Further, the lifetime gift exemption amount would drop to just $1 million but portability would be made permanent.

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Second, the President's proposal would eliminate valuation discounts in connection with transfers of interests in family-controlled entities like closely held corporations, limited liability companies and partnerships. These valuation discounts are currently used to reduce the value of current gifts while transferring assets that are anticipated to appreciate in value outside of the donor's estate. With such discounts currently ranging between 20-40%, the tax savings on transferred value can be substantial. Of even greater concern, the IRS has hinted that it might pass regulations immediately that would prohibit the use of such discounts.

Third, the President's proposal would eliminate the GST exemption after GST exempt trusts have been in existence for 90 years. In those states that have abolished the rule against perpetuities or that permit trusts beyond 90 years, such a proposal would eliminate some of the benefits of dynasty trust planning.

Fourth, the President's proposal would require a grantor of an intentionally defective grantor trust ("IDGT") to include in their estate the value of the trust. Currently, an IDGT is an irrevocable trust that allows the grantor to remove assets from the grantor's estate while allowing the grantor to continue to pay income tax on the trust's income. The payment of taxes by the grantor is not considered a gift and allows the grantor to further reduce their own taxable estate by using the grantor's assets to pay the taxes. The President's proposal would create estate tax inclusion for all grantor trusts and could eliminate the tax-favored status of asset sales to IDGTs.

Where do we want to be and how do we get there?

In this uncertain environment, existing estate plans need to be as flexible as possible. Presumably, everyone wants an estate plan that meets their tax and non-tax planning intentions. Generally, this means planning that reduces taxes while providing reasonable "no-strings" control over assets for spouses and future beneficiaries. Current plans need to be reviewed to consider the impact of the current and potential laws on tax formula funding clauses to make certain that credit shelter, marital and/or family trusts are funded in accordance with intentions and expectations. Formula clauses that were drafted when the exemption amounts were $3.5 million as in 2009, $1 million or less, could leave trusts under or over-funded.

Moreover, even for those clients with assets under $5 million, appropriate estate planning including the use of trusts remains a necessity to protect loved ones from potentially unnecessary taxes and estate administration expenses. This is especially the case if exemption amounts automatically revert to the $1 million level.

In conclusion, the current fog of our transfer tax system should not be used as a excuse to avoid planning all together. A proper estate plan includes more than just a will and a trust. Regardless of the taxable or non-taxable status of an estate, everyone should meet with their estate planner to discuss appropriate wills, trusts, living wills, durable powers of attorney for healthcare and the nomination of appropriate guardians. With appropriate planning and flexibility, plans can be developed now to fulfill your goals.