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NEW TAX ACT – WHAT DOES IT MEAN FOR YOUR ESTATE PLAN?

As you no doubt know, in January President Obama signed the American Taxpayer Relief Act of 2012. The Act includes, among other things, provisions relating to estate, gift, and generation skipping taxes.

In this legal update we discuss those provisions as well as changes you may want to consider making to your estate plan, with the caveat that each person's estate plan is unique and no one size fits all.

Changes to exemptions and tax rates:

- The estate, gift and generation skipping **tax exemptions** remain at $5 million each, adjusted for inflation. In 2013 that inflation adjustment brings each exemption to $5.25 million per person, or $10.5 million for a married couple. Remember that the transfer tax system is unified, meaning that if a person uses some or all of his exemption during his lifetime to "pay" gift tax, the exemption available to his estate at his death will be reduced. Likewise, if a person allocates a portion of his generation skipping ("GST") tax exemption to lifetime gifts, the GST exemption available to his estate will be reduced by the exemption previously used.
- The **tax rate** applied to lifetime gifts or to transfers at death is 40% for gifts or transfers that exceed the exemption amount. So, for a lifetime gift of $7 million in 2013, gift tax would be payable on $1.75 million at a rate of 40%.
- An important planning tool known as "**portability**" was made permanent by the Act. The portability concept applies to married couples and permits the surviving spouse to use his/ her deceased spouse's unused estate tax exemption as well as his/her own estate tax exemption at his/her death. More about portability below.
- The changes made in the Act are said to be **permanent**. What does "permanent" mean? In the tax world, that means for the first time since 2000, we have a gift and estate tax law that is in force for an indefinite period of time, instead of having temporary provisions that "sunset." But, in the federal tax world, even changes described as "permanent" can be changed by Congressional action. So, assume that "permanent" just means "for the time being."

How can you take advantage of these changes?

- If you are one of those who made gifts in 2012 of assets worth $5.12 million and thought you had used up your gift tax exemption forever, because of the inflation adjustment you will gain additional exemption each year and may continue making gifts within the adjusted exemption amount without paying gift tax. And if you passed up the opportunity to make gifts in 2012 or did not use your entire exemption, you have another chance to do that this year.

- Some of our clients who made substantial gifts in 2012 did so in a way that will benefit their grandchildren, making use of the GST exemption. If you did not do so, now that the GST exemption is permanent, you may want to re-consider generation skipping gifts this year. Your GST exemption is not portable, so your spouse cannot elect to use it after your death.

Should you change your estate plan?

If you are a single person, there is no tax reason to change your estate plan, unless the plan includes provisions that measure the amount of a gift to be made at your death by the amount of estate tax exemption or generation skipping tax exemption in effect at your death. If your plan does include such gifts, given the increased exemptions, you should evaluate the impact of on other parts of your estate plan.

If you are married and your estate plan requires an irrevocable trust (often called the Family Trust, sometimes the Bypass Trust) and a revocable trust (usually the Survivor's Trust) to be established at the death of the first spouse to die, **you may want to revise your plan to eliminate the Bypass Trust**. Why? Because of portability. Before portability, in order to use each spouse's exemption from estate tax, it was necessary to create and fund an irrevocable Family Trust with the deceased spouse's assets worth no more than his/her estate tax exemption. That Family Trust, no matter what its value, would not be subject to estate tax at the surviving spouse's death.

With portability, it is no longer necessary to establish a Bypass Trust to utilize the deceased spouse's unused exemption; the surviving spouse can simply file a simplified estate tax return for the deceased spouse and elect to use that spouse's unused exemption at his/her death. The entire trust could continue for the surviving spouse's benefit as a revocable trust, and both spouses' unused exemptions would be available at the survivor's death to reduce or eliminate estate tax liability.

Administration of the revocable trust after the first death would be simplified. With only the Survivor's Trust in place, no separate accounts would have to be maintained for the Family Trust during the surviving spouse's lifetime, and separate income tax returns would not be required for the Family Trust. The beneficiaries of the Survivor's Trust (usually the children) would receive a stepped-up basis in the inherited assets when the surviving spouse died. (That would not be the case if a Family Trust had been established at the death of the first spouse to die. The beneficiaries would receive a stepped-up basis on only the surviving spouse's estate assets.)

Are there reasons not to eliminate the Bypass Trust? Yes, definitely. With a Bypass Trust, each spouse knows that if he or she were to die first, at least the assets in the Bypass Trust would be distributed as he or she wanted at the surviving spouse's death. If all the trust assets were held in the Survivor's Trust, the surviving spouse could amend that trust and direct the assets to anyone … to his or her new spouse, for example. The assets of a Bypass Trust are protected against creditors of the surviving spouse; the assets of a fully revocable trust are not. The appreciation in the value of the Bypass Trust assets during the surviving spouse's lifetime is not subject to estate tax at his/her death. That can be a significant benefit if the value of the Bypass Trust appreciates at a rate greater than the rate of inflation.

Some advisors have suggested that **a married couple with an estate worth more than $10 million** should keep the Bypass Trust as part of their revocable trust because the ability to shield the

appreciation in the Bypass Trust from estate tax at the death of the surviving spouse makes up for the loss of the step-up in basis for Bypass Trust assets. Those advisors also **suggest that a married couple whose combined estate is not likely to ever reach $10 million** could benefit from portability, primarily to take advantage of the benefits of the step-up in basis at the surviving spouse's death.

We like another option… amending the trust to provide that after the death of the first spouse to die, all of the trust assets will be held in the Survivor's Trust unless the surviving spouse chooses to allocate some or all of the deceased spouse's share of the trust assets to a Bypass Trust. This option provides flexibility to deal with changed circumstances, including a reduction of the estate tax exemption or elimination of the portability election. Of course, this option assumes that each spouse is comfortable giving his or her surviving spouse the ability to change the distribution of the trust at his or her death.

If you would like to schedule an appointment to talk with one of us about the impact of the Act on your estate plan, let us know.

Primary Contact

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