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Re: Estate Tax Provisions of the American Taxpayer Relief Act of 2012

Dear Clients, Friends and Colleagues:

On January 1, 2013, Congress, in a late-night session, approved the American Taxpayer Relief Act of 2012 (herein "ATRA") by a vote of 257 to 167 in the US House of Representatives. (The bill was signed into law by President Obama on January 2, 2013.) Generally, the ATRA extends the "Bush Era Tax Cuts," a nickname for the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (both of which had significantly lowered income and estate tax rates).

Because ATRA does not raise sufficient revenue, the non-partisan Congressional Budget Office (the "CBO") estimated that ATRA will result in increased budget deficits over the next 10 years.[1] ATRA also postponed – for two months – "sequestration" – the term for the Congressionally mandated government spending cuts; this means we will be treated to more vitriolic Washington drama for the next several months, at which time, Congress will either resolve the problem or kick the can down the road – again – by extending the sequestration deadline (as the next debt ceiling debacle looms.) Unfortunately, ATRA has <u>not</u> addressed the real economic issues and budget problems facing our nation. (Our Country's growing debt – and our politicians in Washington who seem unwilling to engage in timely compromise –

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[1] Responsive to political pressure, the CBO subsequently restated its original forecast that ATRA would <u>increase</u> the deficit to a forecast wherein ATRA <u>reduces</u> the deficit by focusing away from the tax law that, but for ATRA, would have been in effect in 2013. Rather, the revised CBO forecast compares ATRA to "the current tax policy" which was defined, instead, as the tax rates in effect during 2012. Voilà: ATRA increased taxes from 2012, and thus the revised CBO score shows ATRA <u>decreasing</u> the deficit!

are becoming a real geo-political risk to our Country.) One only has to look at the plaintive cries of Governors Christie and Cuomo to Congress for Sandy Relief to understand how difficult it will be to balance the expenditure and revenue (tax increase) equation.

Here are the estate and gift tax highlights of ATRA, all effective in 2013:

- The exemption from the Federal Estate, Gift, and Generation Skipping Transfer ("GST")[2] taxes is maintained at the amount in effect on December 31, 2012. As of January 1, 2013, the exemption actually increases to $5,250,000 per person based on an annual increase reflective of inflation. Had ATRA not been passed, the Gift, Estate and GST tax laws would have reverted to the 2001 rules: a $1,000,000 exemption per donor/decedent and a 55% maximum rate. The substantial lifetime exemption maintained by ATRA presents significant transfer planning opportunities. The preservation of the GST exemption is good news for families engaging in multigenerational gift planning as ATRA permits ongoing planning flexibility.

- On December 31, 2012, the Estate and Gift and GST tax rate applicable to transfers was 35%. As of January 1, 2013, the tax rate increases to 40%. (This new rate, while an increase, is still significantly below the rate in effect before the Bush Era Tax Cuts.)

- As of January 1, 2013, the annual gift tax exclusion has increased from $13,000 to $14,000 per donee (i.e., $28,000 per donee for a married couple). This non-ATRA change enables taxpayers to make gifts to children, grandchildren and friends without having to keep track of their gifts.

- The so-called "portability" rule, which permits a surviving spouse to use his or her deceased spouse's unused estate tax exemption, has been preserved. Under the "portability" rule, the unused exemption of a deceased spouse is "beamed over" to the

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[2] For those of you who have an interest, in a nutshell, here is a summary of the Generation Skipping Tax:

The Generation Skipping Tax is a special tax in addition to the Estate and Gift Tax which taxes assets when they skip a generation – (hence, the name "Generation Skipping Tax"). If a person gifts assets to the next generation, there is never a Generation Skipping Tax. If a person gifts assets to his or her grandchildren, then he/she is skipping a generation, and the transfer may be subject to the Generation Skipping Tax in addition to the Estate and Gift Tax. The main purpose of the Generation Skipping Tax is to thwart estate planning, whereby one places assets in trust for multiple generations, thereby avoiding the intervening imposition of the Estate and Gift Tax (as Congress desires) in between each generation.

surviving spouse based on an election and timely filed estate tax return. (This was an Obama Administration proposal which, previously, had been effective for only 2011 and 2012.) Under the new portability rule, if a Husband and Wife have $10,000,000 of real estate and securities owned jointly with rights of survivorship, on the Wife's death (assuming she dies first), the Husband becomes owner of all of the assets. (There is no estate tax on the death of Wife because of the so-called marital deduction.) Under the old law, the Wife's unused federal estate tax exemption was lost; under the portability rule, in this case, the Husband may use both his exemption and Wife's estate tax exemption to shelter bequests at death (or gifts during lifetime) from federal estate and gift taxation.

Portability preserves the deceased spouse's unused federal estate tax exemption, whereas affirmative use of that exemption during a lifetime (or through a testamentary trust) permits appreciation during the surviving spouse's life to escape all estate tax. Moreover, in New Jersey the state death tax exemption is not portable. To complicate the analysis equation, note that the testamentary trust's assets do not receive a "stepped-up" income tax basis at the surviving spouse's death. While portability is an option to be considered, it is not a substitute for good estate planning. Also, if one relies on "portability" and Congress changes the law, then the portability benefit may be lost.

The increased exemption and portability rules of ATRA likely succeed in rendering the estate and gift tax component of the IRS a money losing operation! Reason: Many more zero revenue estate tax returns will be filed to take advantage of the portability exemption. Nevertheless, the IRS will have to track and record them.

Congress has advertised all of the above changes as "**permanent**." This means, unlike the past decade's Estate and Gift Tax statutes, there is no scheduled "sunset" of the ATRA's provisions. However, in our opinion, "**permanent**" means "until the next time Congress tinkers with the estate and gift tax law." While it is nice to have a sense of "permanence," we do not think, for a moment, that the Estate and Gift tax has come to a resting point. Indeed, given the economic morass and the significant shortfall of revenue necessary to balance the budget, we think it is possible that later this year, there will be a change in the estate and gift tax law; a change that will assist in balancing the budget.

On the Horizon:

Several estate planning strategies had been targeted by the Obama Administration as "loopholes" and the Administration proposed legislation to close the loopholes and raise revenue. These include:

- Restrictions on valuation discounts in family-controlled entities;

- A 10 year minimum term for grantor retained annuity trusts ("GRAT"): a tax requirement that the GRAT remainder have a positive value (so that gift tax return reporting is required);

- A 90 year time limit on the applicability of the GST exemption to a Generation-Skipping Trust; and

- A provision subjecting so-called "grantor trusts" (commonly used for estate planning purposes) to estate tax on the grantor's death.

None of the above proposals made it into ATRA. But rest assured, they have not fallen off the Obama Administration's radar scope for future action, possibly later this year as part of a revenue raising package.

What to Do?

If you made full use of your $5,120,000 ($10,240,000 per couple) gift and GST exemptions through 2012, you have done well for your family.

You should consider taking advantage of continued low interest rates and favorable asset values by engaging in intrafamily lending and exchange transactions.

If you have not, as yet made use of your exemption, ATRA relieves some of the time pressure surrounding the 2013 fiscal cliff, but it does not reduce the tax benefits families enjoy through timely lifetime gift planning. Because the continued vitality of tax benefits derived from GRATs, dynasty trusts, and grantor trusts remains a big question, it remains a good idea to consider those techniques sooner rather than later, especially the "permanence" of the beneficial Estate and Gift Tax Provisions of ATRA which may become ephemeral.

Income Tax

If you wish to receive our commentary of ATRA's Income Tax provisions, please email mpetit@clynelaw.com.