January 28, 2013

The American Taxpayer Relief Act of 2012

After teetering at the edge of the fiscal cliff, Congress pulled back at the last moment and passed The American Taxpayer Relief Act of 2012 (ATRA), signed into law by the President on January 2, 2013. ATRA maintains the favorable framework for estate, gift and generation-skipping transfer (GST) taxation established under the 2010 Tax Relief Act, which had been set to expire on December 31, 2012.

Key Provisions

The Taxpayer Relief Act of 2012 puts in place the following key provisions:

- The $5,000,000 estate, gift and GST exemptions have been retained, indexed for inflation. The inflation adjusted exemption was $5,120,000 in 2012 and in 2013 is expected to be $5,250,000 for a single taxpayer ($10,500,000 for married taxpayers).

- The spousal "portability" provisions, newly adopted under the 2010 Tax Relief Act, have been kept in place, allowing a surviving spouse to use his or her deceased spouse's unused gift and estate tax exemption.

- In an unfavorable change for taxpayers, the top estate, gift and generation-skipping tax rate has been increased from 35% to 40%.

No Sunset Clause

The provisions of ATRA are "permanent" in the sense that, unlike the two preceding federal tax law overhauls enacted in 2001 and 2010, the law does not include a "sunset" clause and therefore will not automatically expire. To change the law, Congress would need to pass and the President to sign new legislation.

Planning Considerations Under ATRA

The adoption of ATRA is a welcome relief for taxpayers and planners. Its relatively taxpayer friendly provisions will reduce the transfer tax burden of many taxpayers and its permanence should facilitate prudent estate planning.

Taxpayers who may consider the provisions of ATRA to be so favorable that it allows them to set aside gift and estate planning considerations should be mindful of several important considerations.

- Portability Election. For a surviving spouse to take advantage of portability, an election must be made on the federal estate tax return of the deceased spouse. The election, which is irrevocable, may not be made if the return is filed after the time for filing the return (including extensions). This means that to take advantage of portability, the executor of the deceased spouse's estate must file a federal estate tax return and make the election. To mitigate the filing requirement when the estate is not otherwise required to file a return, the executor may in some instances use a simplified procedure.

- Credit Shelter Planning. A cornerstone of estate planning for married couples has been the use of testamentary "credit shelter" or "by-pass" trusts established by the first spouse to die, to reduce the overall estate taxes payable upon the death of the surviving spouse. The high federal exemption amount of $5 million, indexed for inflation, coupled with the spousal portability provisions, are structured so that a married couple can shelter from federal estate tax over $10 million without having to create complicated trust instruments. Despite these features, credit shelter planning nevertheless remains an important planning tool.

  ♦ State Estate Taxes. New York, like many states, has its own estate, gift and GST system. While based in large part on federal tax laws, New York's exemptions and rates are significantly different from those under federal law.

    ◊ While New York has repealed its gift tax, its estate tax exemption is only $1 million and the law does not include an inflation adjustment provision.

    ◊ New York has not adopted spousal "portability" provisions to allow a surviving spouse to use his or her deceased spouse's unused gift and estate tax exemption.

      - A simple example demonstrates the potential impact of New York State estate taxes and the possible benefit of straightforward credit shelter planning. Assume two married couples with combined assets of $5.25 million, in each case with the surviving spouse dying in 2013. The first couple had simple "I Love You" Wills leaving all assets to the surviving spouse. If the surviving spouse were to die in 2013 with an estate valued at $5.25 million, an estimated NYS estate tax of approximately $420,000 would be imposed. The second couple, in contrast, had Wills under which the first to die had established a credit shelter trust for the survivor in the amount of the NYS exemption of $1 million. The NYS estate tax liability generated on the survivor's estate dying in 2013 with an estate of $4.25 million would be approximately $307,600, resulting in NYS tax savings to the heirs of more than $100,000.

  ♦ Caution-Potential Overfunding of Credit Shelter Bequest. The federal exemption amount has increased dramatically in the last sixteen years (rising incrementally from $600,000 in 1997 to its present level of $5 million, indexed for inflation). Married couples with existing Wills containing federal credit shelter formula bequests should review their plans to confirm that the credit shelter bequest is not overfunded, leaving the surviving spouse with too little in assets and potentially generating an unwanted State estate tax upon the death of the first spouse.

  ♦ Asset Appreciation. The potential for asset appreciation is an important consideration which runs across a range of planning concerns. Establishment of a credit shelter trust can prevent the post-transfer appreciation in the value of the assets from being subject to estate tax on the death of the survivor, effectively ensuring that the trust assets will not be subject to any future transfer taxes regardless of how much those assets increase in value. In contrast, the spousal portability provisions transfer to the surviving spouse an unused exclusion amount, essentially a fixed amount which may not be sufficient to shield post-transfer appreciation from tax.

  ♦ Trust Protection. Establishment of any trust, credit shelter or otherwise, can provide added protections that are not present with outright ownership by a surviving spouse. These include protecting assets from a spendthrift spouse, protection against creditors and providing greater assurance that the remainder beneficiaries (children and grandchildren) will receive an inheritance, rather than a second spouse and the heirs of a second spouse.

- Advantages of Lifetime Gifts. Gifting of assets, whether outright or in trust, can bring substantial tax savings for numerous reasons. For states like New York which impose an estate tax but not a gift tax, gifts can result in a substantial reduction in State estate tax liability. Additionally, the concept of asset appreciation is important in the context of gifting, as gifts remove the post-transfer appreciation in the value of the assets from the donor's estate. Many gifting vehicles, moreover, offer discounting advantages that are absent from or less effective than those related to testamentary transfers. In assessing the benefits of lifetime gifts, it is important to note that since the recipient of a gift receives the donor's income tax basis in the gifted assets as opposed to the recipient of a testamentary transfer receiving an income tax basis as of the date of death, any proposed gift must measure the potential capital gain consequences as against potential gift and estate tax savings.

The Taxpayer Relief Act of 2012 should as its name suggests provide a significant measure of taxpayer relief, particularly when contrasted to the estate and gift tax provisions which would have returned without its enactment. While the new law may be permanent, however, the points outlined above show that it did not sweep away gift, estate and GST tax planning concerns. It should be noted also that proposals to limit several popular and effective planning vehicles have been lurking for years. On the list are curtailment of the tax benefits associated with family limited partnerships and intentionally defective grantor trusts, restrictions on the usefulness of Grantor Retained Annuity Trusts (GRATs) by necessitating at least a 10 year term and requiring a remainder with some reportable value (that is, prohibiting "zeroed-out GRATs"), and imposing a limit on the period of time that intergenerational dynasty trusts may be exempt from GST tax. These planning tools remain presently available but may be eliminated or restricted in future tax reform legislation.

A review of existing estate plan documents for possible changes prompted by ATRA or implementation of planning opportunities offered under present law are prudent steps you should take to assure a sound and up to date estate plan.

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