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Higher Tax Rates and Lower Exemptions on the Horizon

On January 1, 2013, the federal estate, gift and generation-skipping transfer ("GST") tax exemption amounts are set for a significant reduction, limiting the tax saving opportunities currently available. Proposed legislative changes may also limit other estate planning opportunities available under current law. With these potential changes on the horizon, you should use the remainder of this year to review your estate plan.

Federal Estate, Gift and GST Tax Exemptions Set for Significant Reduction

Use of Exemptions in 2012

In 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"), which made significant changes to the estate, gift and GST tax laws.

The Act consolidated the gift and estate taxes, creating an applicable exclusion amount of $5 million with a maximum tax rate of 35% on lifetime gifts or bequests at death in excess of the exclusion amount. For 2012, the exemption is indexed for inflation, increasing the exemption amount to $5.12 million. This means that you can gift cash or assets valued at $5.12 million without paying gift tax. This is in addition to the so-called "annual exclusion gifts" in the amount of $13,000 that you can make each year free of gift tax. Even if you have already made taxable gifts and used the full $1 million gift tax exemption amount under the prior law, you now have an additional gift tax exemption of $4.12 million available.

In addition to gift and estate taxes, there is a GST tax that applies to gifts to grandchildren or to trusts for the benefit of grandchildren and more remote descendants. Each individual has an exemption against the GST tax, and the Act also increased this exemption amount to $5 million (similarly adjusted for inflation for 2012). The Act reduced the maximum GST tax rate to 35% as well. All of these exemption amounts apply to individuals and may be doubled in the case of married couples who agree to "split" their gifts.

If Congress takes no action, on January 1, 2013, the exemptions for estate and gift taxes will return to $1 million, and the maximum tax rate will return to 55%. The exemption for GST taxes will return to $1 million indexed for inflation, or approximately $1.39 million, with a maximum tax rate of 55%. Although the current exemptions and rates may be extended into 2013, it is impossible to predict with any certainty at this point, especially given the upcoming election.

In light of the uncertainty, you should consider making gifts that will take advantage of the current $5.12 million exemption amounts. An effective use of both the gift and GST exemption amounts is to make a transfer to a trust that can benefit current and future generations of your descendants, as this type of trust can maximize the period for which the trust assets are exempt from gift, estate and GST taxes. Even if you do not feel comfortable making a gift of the full $5.12 million ($10.24 million, for a married couple), it may still be advantageous to take advantage of the increased exemption amount by making a gift of some portion of it.

Potential Drawbacks of Gifting

A benefit of making a gift during your lifetime is that any appreciation on the property is removed from your taxable estate. For example, if you make a gift of $5 million this year and the property appreciates in value to $10 million by the time of your death, that $5 million of appreciation will not be subject to estate or gift tax. A potential drawback to making lifetime gifts, however, is that the reverse is also true—if the property goes down in value, in hindsight you will have "lost" part of your exemption.

Another consideration is that, in general, the recipient of a gift of appreciated property receives the property with what is called a "carry over" tax basis. For purposes of calculating capital gains, the recipient's basis is the same as your basis when you made the gift. Thus, the gift recipient will essentially step into your shoes for income tax purposes and have a potential deferred capital gains tax liability when the property is eventually sold.

There is also the possibility that, if the exemption amount is reduced and is less than $5.12 million at the time of your death, your estate may have to pay a "clawback" tax on the difference between the amount gifted and the amount of the exemption in effect at the time of your death. It is unclear if this was the intended result of the Act, but even if it is, your estate will not pay more estate tax than if you had not made the gift (unless the gift assets decline in value). The estate tax on the difference between the exemption amounts is, in effect, deferred interest free and is paid on the date of death rather than on the date the gift is made. In addition, any future appreciation on the gift will not be included in your estate.

Administration's Proposed Changes Impacting Estate Planning

New Limits May Be Placed on the GST Tax Exemption for Trusts

President Obama's 2013 Revenue Proposals would impose a 90-year limit on GST tax exemption for trusts. This new restriction would apply to trusts created after the proposed legislation is enacted or funds added to existing trusts after the date of enactment.

Modify Estate and Gift Tax Treatment of Grantor Trusts

The Administration's proposals would substantially modify the gift and estate tax treatment of a trust when the grantor of the trust is treated as the "owner" of the property for income tax purposes. Under this proposal, among other changes, during the grantor's lifetime, distributions from the trust may be subject to gift taxes, and the trust property may be subject to gift tax if the grantor ceases to be treated as the owner of the trust for income tax purposes. If the grantor is treated as the owner for income tax purposes at the time of his death, the assets held in the trust would be includible in the grantor's gross estate for estate tax purposes. This proposal would be effective for trusts created on or after the date of enactment and to any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment.

Changes to Grantor Retained Annuity Trusts

The Administration's proposals would place new limits on grantor retained annuity trusts (or "GRATs") by requiring a minimum 10-year term and a remainder interest greater than zero. This proposal would apply to GRATs created after the date of enactment.

Limitations on Valuation Discounts

The Administration's proposals would modify current gift tax valuation rules by creating a category of "disregarded restrictions" that would be disregarded for gift tax purposes when valuing relevant interests in family-controlled entities.

Changes Ahead in Income Tax Rates

Income Tax Rate Increases

The income tax cuts passed in 2001 and 2003 are set to expire in 2012, absent legislative action. If taxes revert to pre-2001 levels, taxpayers in the current 35% top bracket, meaning those with a taxable income greater than $390,050, will see their rate rise to 39.6%. Joint filers with AGI above $250,000 and single filers with AGI above $200,000 will also be subject to a new 3.8% Medicare tax on investment income, such as capital gains, dividends, interest, annuities, royalties and rents.

Scheduled Rise in Capital Gains Tax

In 2003, the top long term capital gains tax rate for assets held longer than one year was set at 15%. Since 2008, taxpayers in the 15% and 10% brackets have paid no capital gains tax. Absent legislative action, rates are set to revert in 2013 to their pre-2003 levels. For all taxpayers in the 15% bracket and below, long term gains would be taxed at 10%. The rate would remain at 15% for single taxpayers with taxable income below $200,000, head of households below $225,000 and joint filers below $250,000. Taxpayers with income levels higher than these amounts would have a 20% long term capital gain tax rate, plus the 3.8% Medicare tax noted above.

Scheduled Increase in Tax on Qualified Dividends

Prior to 2003, dividends were taxed at an individual's ordinary income tax rate. In 2003, the maximum qualified dividend tax rate was set at 15%, and since 2008, taxpayers in the 15% bracket or below have paid no tax on qualified dividends. Absent legislative action, in 2013, taxpayers will see all dividends once again taxed at their ordinary income tax rate. Therefore, the top rate on dividends will be 43.4%, after application of the 3.8% Medicare tax.

The Administration's proposals would keep the current dividend rate of 15% but only for individuals not considered upper-income taxpayers. Upper-income taxpayers include single taxpayers with taxable income above $200,000, head of households above $225,000 and joint filers above $250,000.

Value of Itemized Deductions May Be Limited to 28% Bracket

Itemized deductions allow taxpayers to reduce their taxable income by deducting amounts greater than the standard deduction. This category of deductions includes charitable deductions, mortgage interest, state and income taxes. The effect these deductions have on tax liability is greater for individuals in higher tax brackets, since the amount deducted is based upon their tax rate. If an individual deducts a $1,000 charitable donation, for example, this amount will be multiplied by their tax rate to determine their savings, and an individual paying a 35% rate will save $350. However, under the Administration's proposals, the value of itemized deductions for upper income taxpayers, as defined above, would be capped at 28%. This means that in the above example, the tax savings of $350 would fall to $280.

Further, a limitation on itemized deductions which was eliminated in 2010 is scheduled to return in 2013. This limit reduces most itemized deductions by 3% of the amount by which an individual's AGI exceeds a certain threshold up to a maximum of 80%. Combined with the 28% maximum itemized deduction limit, this limitation may significantly reduce deductions for higher income taxpayers.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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