DUNSTAN, CLEARY & WEST, LLP

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CLIENT NEWSLETTER

2012 YEAR-END INCOME, ESTATE AND GIFT TAX PLANNING

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Expiring Income, Estate & Gift Tax Cuts

The end of 2012 draws near, and with its passing comes the end of certain "Bush-era" income tax cuts, as well as significant estate and gift tax reductions, the loss of which will dramatically affect the tax liability of many taxpayers in 2013 and thereafter.

This newsletter reviews the soon-to-expire income and estate and gift tax laws and explains the new laws taking effect in 2013, barring Congressional action. Also highlighted are planning opportunities that taxpayers should consider taking by year-end. For many, it may be a "use it or lose it" situation.

Higher Taxes on Capital Gains and Investment Income

Since 2003, taxpayers have enjoyed a 15% maximum tax rate on long-term capital gains. Additionally, dividends have been taxed at the capital gains rate rather than at the higher ordinary income rates. *Beginning in 2013, the capital gains rate will rise to 20%*. Taxpayers in lower brackets who previously did not pay capital gains tax will be subject to a 10% capital gains tax rate. Dividends will be taxed as ordinary income and not as capital gains.

If that weren't enough, under the unearned income Medicare contribution tax set to take effect in 2013, taxpayers with incomes exceeding $200,000 ($250,000 for joint filers) will pay an additional 3.8% tax on certain dividends, interest income, annuities, royalties or property rents.

It should be noted that President Obama's tax proposal would keep the 15% maximum capital gains rate for taxpayers making less than $250,000, and raise the rate to 20% for those making more than $250,000.

In preparation, taxpayers should consider:

- Accelerating the sale of property with built-in gains into this year in order to trigger capital gains, with due regard for market conditions.

- Avoiding recognition of losses on the sale of property until 2013.

Please feel free to contact us to discuss any aspect of this Client Newsletter. We would be glad to be of service to you.

This Client Newsletter is a source of general information for clients and friends of Dunstan, Cleary & West, LLP. It should not be construed as legal advice, and readers should not act upon the information in this Client Newsletter without consulting counsel.

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Lower Estate & Gift Tax Exemptions

Estate and gift tax laws are also set to change significantly (and adversely) in 2013.

Currently, the lifetime estate and gift tax exclusion amount (ie, that amount of property a person can die owning or gift to another and pay no estate or gift tax) is $5.12 million (*the highest level in history*), with a tax rate of 35%. A married couple can combine to shelter up to $10.24 million estate and gift tax-free. Further, any unused estate tax exemption of a deceased spouse is "portable" to his surviving spouse under current law. *Barring Congressional action, the estate and gift tax exemptions will decrease to $1 million per person on January 1st*, and the tax rate will rise to 55% (with a 5% additional tax on certain large estates). In addition, portability of the deceased spouse's unused exemption will terminate.

Helpful to some extent, the federal gift tax annual exclusion amount is $13,000 per person in 2012 and is schedule to be $14,000 per person in 2013.

President Obama has indicated that he supports a $3.5 million ($7 million for married couples) estate tax exemption amount and a 45% tax rate. The gift tax exemption would remain at $1 million under President Obama's proposal.

Considering the great difference between the old and new estate and gift tax exemptions, affected taxpayers should give serious consideration to taking advantage of what may be a once-in-a-lifetime opportunity to pass property to heirs tax-free. Some strategies follow:

- Make Gifts to Children Using Expiring Gift Tax Exemption. Taxpayers with estates likely to exceed the $1 million exemption for 2013 might consider making a gift of property before December 31st which takes advantage of the expiring $5.12 million gift tax exemption. Such a gift could be made either outright or to a trust for the donor's children and still qualify for the exemption. Significant leverage of the higher exemption amount is possible if the donor gifts property with a depressed market value or to which discounts may apply (ex., family limited partnership interests).

- Make Gift to Spouse in Trust. Taxpayers who are unable, or unwilling, to make such a large gift might instead gift property to an irrevocable trust naming their spouse as the primary beneficiary. The idea of such gift is that, while the trust property would be removed from the donor's estate, it would remain available to provide at least an indirect benefit to the donor spouse through the trust's support of the beneficiary spouse.

Such a trust could be designed so that the donor's children and their descendants become beneficiaries after the donee spouse's death. The trust may even be drafted to contain provisions giving the beneficiary spouse, and the children if that spouse becomes incapacitated, the power to transfer the property back to the donor, if ever necessary.

Finally, for administrative ease the trust may be designed as a "grantor" trust, so that its property is treated as being owned by the donor for income tax purposes. As a result, all trust income and loss would be reported on the donor's personal income tax return (or a joint return with his or her spouse).

A gift of property to this type of trust, while providing great potential tax benefits, has several traps for the unwary. It should be used only with the help of a qualified tax attorney.

- Grantor Retained Annuity Trust ("GRAT"). A GRAT is an "estate freeze" technique that can provide for significant transfers of property to family members with no gift tax. Typically, a GRAT is a short-term trust (ex, 2 years) in which a donor transfers property to a trust in exchange for an annuity for a term of years. Following the gift, the trust invests the property and whatever remains after the annuity payments are made goes to the family with no gift tax consequences. The required interest rate built into the annuity payment is established by the IRS. The key is that the trust property must appreciate at a higher rate than the required interest rate. With interest rates currently at historic lows (1.2% for GRAT's established in October 2012), odds are higher that the GRAT will have excess appreciation that can be transferred to the family gift tax-free.

Importantly, President Obama's tax proposal would largely curtail the use of GRAT's in 2013 by requiring a minimum 10-year GRAT term and a positive remainder interest.

- Make $13,000 Annual Exclusion Gifts. Taxpayers with "medium-sized" estates who may have stopped making annual gifts to children and grandchildren with the hope that the $5.12 million estate tax exemption would remain might consider resuming gifts to make maximum use of the current $13,000 per person annual exclusion.

Conclusion

This newsletter is based on current law, and it remains to be seen what action, if any, Congress may take to address the expiring tax laws either this year or next. A lot will probably depend on the results of the November elections.

In any event, any action taken based on the recommendations in this newsletter should be thoughtfully investigated and should make sense given your particular financial situation. We would welcome the opportunity to be of help to you in that process.

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