insights

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Shumaker, Loop & Kendrick, LLP

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TRANSFER TAXES AFTER THE

Taxpayer Relief Act of 2012

The American Taxpayer Relief Act of 2012 (the "2012 Act") had a profound impact on the transfer tax system. I will briefly describe that system and then, by way of background, set the stage for these changes by summarizing where we were on transfer taxes prior to the 2012 Act. I will then describe the major transfer tax changes provided by the 2012 Act and briefly describe the impact of these changes.

By David J. Rectenwald

INTRODUCTION

As you may know, our federal government imposes three types of transfer taxes: a gift tax, an estate tax and a generation skipping transfer or "GST" tax. The gift tax is a tax on gifts made during one's lifetime that are above the annual exclusion amount, which is now $14,000 per donee. The estate tax is a tax on transfers made at one's death. The government provides each taxpayer with an exemption amount from each of these two taxes. These two systems work together in that each dollar of gift tax exemption used by a taxpayer during his or her lifetime reduces that amount of estate tax exemption remaining at such taxpayer's death.

The GST tax is really a second layer of transfer tax designed to discourage taxpayers from skipping one or more levels of estate tax by passing their assets to or in trust for "skip persons," such as grandchildren or more remote issue. The government provides each taxpayer with an exemption amount from this tax too. All such transfers in excess of the GST exemption amount are subject to a GST tax, which is tax imposed at the highest marginal estate tax rate. Thus, such transfers are subject to both the gift or estate tax (depending on when they are made) and the GST tax.

BACKGROUND

Prior to the Economic Growth and Tax Relief reconciliation Act of 2001 (the "2001 Act"), each taxpayer had an exemption amount from gift and estate tax equal to $675,000. These two taxes were tied together under a unified system with a top marginal tax rate of 55%. The 2001 Act substantially increased both tax exemptions over a 10 year period, but at different amounts. While the gift tax exemption amount increased only to $1,000,000, the estate tax exemption amount increased to $3,500,000 by 2009 and became unlimited in 2010. Then, in 2011 the 2001 Act was scheduled to "sunset" and the transfer tax system was scheduled to revert back to where it was in 2001, as if the 2001 Act had never been passed.

Along came the Tax Relief Act of 2010 (the "2010 Act"), which was signed into law the end of 2010 but was made effective retroactive to the beginning of 2010. The 2010 Act delayed the sunset of the 2001 Act for two years. It provided (starting in 2011) for $5,000,000 exemptions from all transfer taxes, indexed those exemptions for inflation, and provided for a top marginal tax rate of 35%. While the change in the tax rate was a significant change, the much more dramatic change was the reunification of the gift and estate tax systems. This change meant that taxpayers received an increase in the gift tax exemption amount from $1,000,000 to $5,000,000, which was both unprecedented and completely unexpected.

The 2010 Act was likewise scheduled to sunset on January 1, 2013. As a result, many taxpayers with substantial means focused in the last two years on making large taxable gifts to GST trusts so they could use their $5,000,000 gift and GST tax exemptions before they were set to expire in 2013.

THE 2012 ACT

Although the 2012 Act provided only a few changes in the transfer tax arena, these changes were extremely potent and very beneficial to taxpayers. These changes include the following:

1. $5,000,000 Exemptions.
The 2012 Act unified all three transfer tax systems, providing for $5,000,000 exemptions from gift, estate and GST taxes.

2. Indexing.
The $5,000,000 exemptions for these three transfer taxes are all indexed for inflation since 2011. The indexed amount for 2012 was $5,120,000. The indexed amount for 2013 increased $130,000 to $5,250,000.

3. Tax Rate.
The top marginal tax rate for all three taxes is now 40%. While this rate is above the 2012 rate of 35%, it is substantially below the 55% top rate that was otherwise scheduled to take effect in 2013 upon the sunset of the prior law.

4. Portability.
The 2010 Act introduced the concept of exemption "portability" between spouses. Portability allows the executor of the first spouse to die to transfer all of his or her unused estate tax exemption amount to the surviving spouse. The 2012 Act retained this concept and made certain technical corrections very beneficial to taxpayers.

5. Miscellaneous Changes.
The 2012 Act included several other miscellaneous provisions, all of which are favorable to taxpayers.
For example, it retained the rules providing for the automatic allocation of GST exemption for gifts to certain GST trusts and the qualified severance of trusts for GST purposes. Both of these concepts were first enacted in the 2001 Act.

6. Permanence.
One thing missing from the 2012 Act is the concept of "sunsetting." All of the provisions are permanent, which means that they will not change unless Congress takes action in the future to pass different legislation. Thus, estate planners and their clients can now plan with a reasonable degree of certainty in the law, something they have not been able to do for over a decade.

7. Chart.
The chart below summarizes much of the foregoing discussion. Specifically, it illustrates what key provisions in the law would have been if the prior two tax acts had in fact sunsetted on January 1, 2013, and compares those provisions to the provisions promulgated by the 2012 Act.

IMPACT OF THE 2012 ACT

It will probably take a year or two for a consensus to build in the estate planning community on how to plan for estates of all sizes. Set forth below are some preliminary thoughts regarding the impact of the 2012 Act.

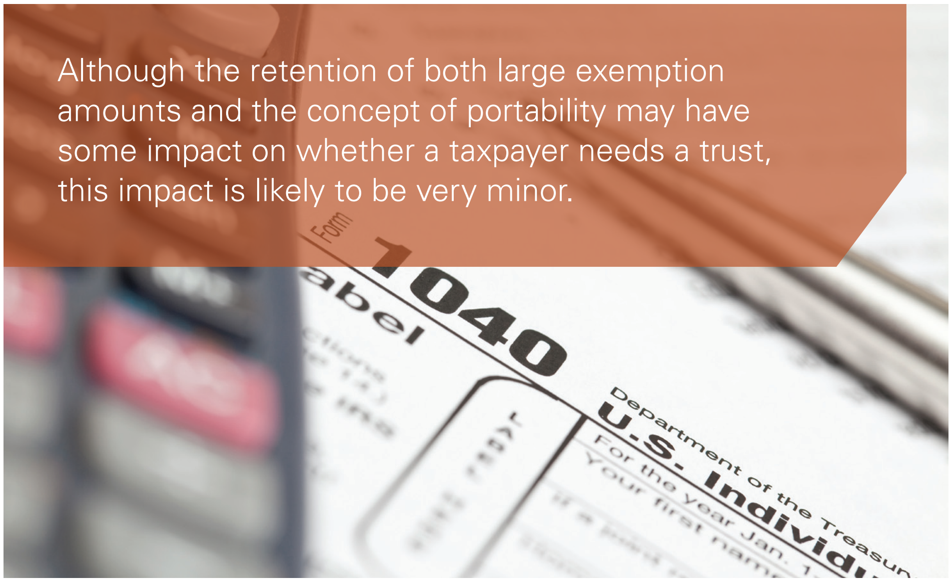
1. Large Gifts.
The fact that the 2012 Act retained large transfer tax exemption amounts, and even indexed these amounts for inflation, will certainly minimize the need for taxpayers to make large gifts during their lifetimes. The fact that donees of gifts inherit the donor's basis, rather than receiving a stepped-up date-of-death basis as they do under the estate tax regime, will further discourage large lifetime gifts. However, taxpayers with very large estates who will face estate tax may still be wise to make a large gift so that all future appreciation of the gifted assets occurs outside of the taxpayer's estate and avoids estate taxation.

2. Sophisticated Planning.
The larger exemption amounts of the 2012 Act will likewise reduce many taxpayers' need for sophisticated estate planning techniques. Many of these techniques are labeled with catchy acronyms such as GRATs, GRUTs, CRUTs, IDITs and QPRTs. The goal of most of these techniques is to leverage the use of a taxpayer's exemption amounts. If the exemption amounts

TOPIC	2013 IF THE LAW SUNSET	2013 AFTER 2012 ACT
1. Gift Exemption	$1,000,000	$5,250,000*
2. Estate Exemption	$1,000,000	$5,250,000*
3. GST Exemption	$1,430,000	$5,250,000*
4. Top Tax Rate	55%	40%
5. Portability	NO	YES
6. Automatic GST Allocation	NO	YES

**Indexed for inflation from 2011*

Although the retention of both large exemption amounts and the concept of portability may have some impact on whether a taxpayer needs a trust, this impact is likely to be very minor.



fully cover a taxpayer's estate, then no leverage is needed and these estate planning techniques will be unnecessary.

3. Trusts.
Although the retention of both large exemption amounts and the concept of portability may have some impact on whether a taxpayer needs a trust, this impact is likely to be very minor. Many couples will still want so-called "credit shelter" trusts to use the exemption amount of the first spouse to die in case the tax laws prove not to be so permanent. They may also want to take advantage of the asset protection afforded by these trusts, since the assets tucked away in a credit shelter trust at the death of the first spouse may be exempt from the creditors of the surviving spouse. No asset protection is afforded when one spouse simply leaves all of his or her assets to a surviving spouse. Trusts also provide other non-tax benefits, perhaps the most important of which is the deferral of distribution of assets to children. This deferral simply cannot be obtained without the use of a trust.

4. Portability.
Many married taxpayers will mistakenly pass all of their assets to their surviving spouse and rely on portability rather than careful trust planning. While this may be less problematic for smaller estates, say those under $1,000,000, it could certainly prove to be a large mistake for those estates between $1,000,000 and $10,000,000. While there are many problems and issues associated with portability, the main one is that it does not extend to the GST exemption. Many clients with this type of wealth should be keeping their assets in trust for several generations and using their GST exemptions, rather than passing these assets out to their children where the assets will be subject to the child's creditors during his or her lifetime and subject to estate taxation at the child's death.

5. Life Insurance.
The 2012 Act will likely not affect an individual's desire to purchase life insurance to provide financial security for a spouse or children. However, it will dramatically affect the second-to-die life insurance market. Second-to-die insurance is insurance that insures two lives, not just one. It is cheaper than single life insurance because it pays out only at the second death. Since this is usually when the estate tax is due for married couples, this insurance is usually purchased for the payment of estate taxes. Again, with the exemptions provided by the 2012 Act being so large and indexed for inflation, most couples will not need such insurance because they will not face an estate tax.

6. Other Planning.
As mentioned briefly above, the 2012 Act will have little or no impact on traditional non-tax planning. Taxpayers will still need to plan for a variety of needs or concerns, including asset disposition, asset protection, disability and incompetency, probate avoidance, business succession, premarital agreements, charitable giving, life insurance, retirement planning, and payment of education.

CONCLUSION

The 2012 Act has in fact eliminated the estate and GST tax for most Americans. It has not, however, eliminated the need for estate planning. The primary focus in most cases will simply shift from tax to non-tax goals, including those described immediately above. Since each person's particular estate planning situation is unique, all individuals would be well advised to consult with an estate planning specialist to analyze the impact of this new law on his or her estate plan.