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Foulston Siefkin Issue Alert
Estate Planning

Impending Estate & Gift Tax Changes in 2013

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The Estate Planning Department of Foulston Siefkin LLP believes this fall is a critical time for a large number of individuals to review their estate plans with their estate planning legal counsel. In addition to the normal advisory to review estate plans at least every two years (for the effect of possible changes in the law, changes in the family, and potential changes in bequests and fiduciaries, etc.) , and using federal gift tax exclusions on an annual basis to reduce estate taxation in larger estates, there are unique current circumstances, including impending changes in tax laws that are slated to occur the first of next year, which make it particularly important that such review take place prior to the end of this year. Such circumstances, which could affect not only large estates, but also many small and moderate estates as well, are discussed below. Such discussion extends beyond simply providing a "broad brush" notice, which would not provide adequate information for individuals to be able to determine the issues involved, the current estate planning and tax legislative climate, and most importantly, whether their particular circumstance merits scheduling a review of their current estate plan with estate planning counsel prior to the end of this year.

LARGER ESTATES

For individuals having larger estates that might be subject to estate taxation, it is important for them to review their estate plan prior to the end of the year with an estate planning attorney. Unless Congress acts this year, the federal gift and estate tax "exemption," currently at $5.12 million, will revert back to $1.0 million due to the automatic expiration of the so-called "Bush tax cuts" at the end of this year. One million dollars is the level such exemptions would have been had the "Bush tax cuts" not been enacted in 2001. Moreover, the top gift and estate tax brackets, which were reduced to 35% by Congress two years ago, will similarly revert back to the much higher 55% bracket they were at prior to such 2001 legislation.

Thus, for single individuals who have taxable estates in excess of $1.0 million, and married persons cumulatively in excess of $2.0 million who do not already have an estate plan which ensures that each spouse has planned to fully utilize their $1.0 million exemption, it is quite important to have their estate plan reviewed. Consideration should be given to possibly making gifts (beyond the annual gift tax exclusion which is currently $13,000 per person per year) this year in order to utilize the greater gift tax exemption available this year that might be unavailable at its current level in subsequent years. In addition to "locking in" the current gift tax exemption, such gift would have the additional benefit of removing all future income and appreciation in the gifted property from the donor's estate for estate tax purposes. Such gift would have to be in excess of $1.0 million to get any potential benefit due to the reversion of the exemption back to the $1.0 million level, for any taxable gift which uses the gift tax exemption reduces the estate tax exemption available against their estate. Consequently, the potential benefit in making such a large gift, as well as the willingness of an individual to make such a large gift, will be directly related to the value of the estate which is in excess of such exemption level.

Potential Estate Tax Benefits in Making Large Taxable Gifts in 2012

An example of the potential estate tax benefits in making significant taxable gifts in 2012 within the exemption for very large estates would be helpful. If the exemption should "permanently" revert back to $1.0 million and a $5.12 million gift was made that would otherwise have been fully taxable in the donor's estate with only a $1.0 million exemption, but is not subject to gift tax due to being covered by the current gift tax exemption, the estate tax savings on the $4.0 million difference at a 55% top marginal estate tax rate would be quite substantial, $2,111,000. That would be the maximum potential estate tax benefit due to using the full gift tax exemption this year, assuming the exemption in 2013 reverts to $1.0 million and Congress does not increase it. On the other hand, if Congress sets the exemption at the $3.5 million amount it was in 2009 (prior to being increased to its current level by Congress in 2010 for a two year period only) with the same marginal estate tax rate of 45% that was in effect in that year, there would be a much reduced estate tax savings on utilizing such $5.12 million gift tax exemption of only $1,220,000.

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For a married couple such potential tax savings would double. As noted above, in either event there also would be additional estate tax savings due to the subsequent income and appreciation on the gift also being removed from the donor's taxable estate.

Considerations in Making a Large Taxable Gift in 2012

Nonetheless, prior to the making of any substantial gift in 2012 in excess of the $1.0 million exemption, there must be a comfort level with the amount of the gift. The smaller the estate, the more reluctant one is to part with any loss of control over, or access to, property which has been gifted out of the estate. Second, the potential for Congress, either late in 2012 or early in 2013, to enact legislation to maintain the exemption at or near its current level must be assessed. This is particularly true for individuals having estates not significantly beyond the current exemption who would not have made the gift in the absence of the exemption reverting back to $1.0 million and then staying there for an extended period of time.

There is a significant possibility, if not a high probability, that Congress will, if not in the "lame duck session" following the election, at least early next year when the new Congress convenes, enact legislation that will retroactively increase such exemption to at least $3.5 million (President Obama's proposal throughout his administration), if not back to the current $5.12 million level or higher (the Republican position). This is because the significant automatic "across the board" spending cuts (the so-called "sequestration") already in the law under the 2010 Congressional budget compromise, as well as the expiration of the "payroll tax cut" and the substantial income tax increases that will occur for all taxpayers with the expiration of the "Bush tax cuts," are predicted (including by the non-partisan Congressional Budget Office) to severely impact consumer spending and detrimentally affect the economic recovery, perhaps putting the country back into a recession. This "perfect storm" of pulling money out of the economy is putting tremendous pressure on Congress to enact a "grand bargain," addressing not only such budget issues, but comprehensively address tax issues, in order to avoid such result.

The fate of the federal gift and estate tax exemption will be part of any such agreement. Due to the relatively little additional federal revenue to be gained by maintaining the estate tax exemption at $1.0 million, the "across the board" unpopularity of the estate tax among the general public, and the severe adverse political consequences to both parties that would occur should they fail to substantially increase the exemption, conventional political wisdom would appear to be that there is only a very small possibility that the federal estate tax exemption would be less than $3.5 million for 2013 and subsequent years, and a good chance that it will remain at least at its current level. If the President is re-elected, certainly the chances of the exemption being no greater than the $3.5 level in 2013 would be greater, while on the other hand, if the Republican nominee is elected, the chances of the exemption in 2013 being at least at its current level would be enhanced. All of this assumes such pressures will force both Democrats and Republicans to reach a consensus on this issue in a manner which will avert having the exemption remain at $1.0 million in 2012. If not, it is almost a certainty that neither side will be able to force their agenda no matter what the outcome of the November elections. This is because any such tax legislation will likely require at least sixty votes in the Senate, the votes necessary to override a filibuster. Neither party is projected to even come close to having that number of Senators in the 2013 Congressional session.

In addition to the uncertainty as to whether the current exemption will ultimately be maintained by Congress and the loss of control and flexibility issues that inevitably accompany a gift of property, consideration must be given to any possible income tax detriments, such as the loss of the so-called "step up in income tax basis" to fair market value in otherwise eligible gifted property that would have been the case had such property been retained by the donor until the donor's passing. If substantial gifts are to be made, there would also need to be a discussion on the best manner to make such gifts, e.g., whether outright or in trust. The vast majority of our clients choose to make gifts in trust for spouses and descendants for asset protection purposes, i.e., protection from divorce claims of spouse, protection from creditor claims, maximizing governmental resource benefits such as Medicaid (for long term care), and keeping the property from being included in the beneficiary's estate for federal estate tax purposes. If there are no concerns with respect to the beneficiary's management of the gifted property, the beneficiary can be named trustee and have almost the same amount of control as outright ownership without adversely affecting the desired asset protection.

If gifts are being made of hard to value assets, such as interests in land or entities, there are strategies which can be employed with the advice of sophisticated estate planning counsel to reduce not only the chance of an audit, but to ensure that any audit would result in a higher value being attributed to such gift so as to go beyond the exemption and create an actual gift tax liability.

Retaining Some Measure of Control and Flexibility with Respect to Gifted Property

With respect to married couples, such gifts need not be made to children or trusts for their benefit to utilize the current exemption so as to incur the total loss of parental control or access to the gifted assets should there be a later need not satisfied with their remaining assets. For example, such gifts can be made in trust where the donee spouse is the trustee and not only has full management authority and access to the trust estate with respect to any support or maintenance need of such

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spouse or descendant, but could also be given the authority to direct how the trust estate passes to the couple's descendants, spouses of descendants and charities at the death of the surviving spouse. There is another technique whereby a spouse can place assets in trust for the benefit of the other spouse and wait until late next year (when Congress will hopefully already have addressed the issue) to determine whether such transfer are to be considered a taxable gift for gift tax purposes. With respect to single individuals, such gift can be made in trust for family members which removes the property from the donor's taxable estate while the donor retains the right to designate or change the trustee governing such assets and can have access to the trust estate with respect to substituting assets of equal value for that in the trust or authorizing the trustee to make a loan to the donor under "arm's length" terms, with the trust assets only passing to descendants upon the death of the donor.

Potential Loss of Other Major Estate Tax Savings Techniques

Our Department is also concerned that if a "grand bargain" is reached between Republicans and Democrats, either in late 2012 or more likely early in 2013, which is expected, addressing both the automatic spending cuts and the expiration of the "Bush tax cuts," some quite valuable estate planning techniques could become casualties in the process. These include the potential loss of significant "lack of control" discounts in families with regard to valuing interests for gift and estate tax purposes in entities such as family limited partnerships or family limited liability companies, as well as undivided interests in property such as farm land. They also include the use of so-called "intentionally defective" grantor trusts whereby the income of irrevocable trusts which are the recipients of gifts for family members is taxed back to the donor, thus permitting the assets in the trust to grow estate tax and income tax free outside of the donor's taxable estate. Coupled with a sale of interests in such entities or land to such trusts at historically low interest rates (with no adverse income tax consequences to the seller who is the grantor or the trust) so as to minimize the value of the note and payments which would be in the seller's estate for estate tax purposes, these techniques have been a very powerful technique in reducing gift and estate taxation.

The reason for such concern is that these techniques, due to both their effectiveness in lowering gift and estate taxation and being viewed as lacking a substantive underpinning beyond mere tax avoidance, have been on the "hit list" by recent Democratic administrations as well as some Democrats in Congress. They also may well be the very type of "loopholes" some leading Republicans, including the Republican nominee, have been discussing in a general sense they would consider eliminating in a tax compromise with Democrats. This conflation possibly could result in their elimination as part of the "grand bargain" in achieving an exemption level acceptable to both parties. The effective date for such elimination may be the date of introduction of the governing legislation, not the passage date, thus providing little to no opportunity for taxpayers to implement such techniques prior to their abolition. Thus, for individuals to avail themselves of such techniques with some level of assurance, gifting and sale strategies using these techniques would have to be implemented prior to Congress introducing any such legislation, which is unlikely to occur prior to 2013. Such proposals, if enacted into law, would not adversely affect any transactions which occurred prior to their effective date.

Summary

For estates that are significantly over the current federal estate tax exemption of $5.12 million, there would likely be a significant estate tax savings in making the gift irrespective of whether the exemption remains at its current level after 2012 due to future income from, and subsequent appreciation on, the gifted property being removed from the donor's estate. Moreover, any concerns related to loss of control of, or failure to have access to, the gifted property is mollified by the fact that donors in such situations will still have a substantial amount of remaining property. Thus, there would be no reason to wait until the end of the year to make such substantial gifts.

For estates of a lesser amount which could be subject to estate taxation should the exemption revert to $1.0 million on a long-term basis, but are not substantially over that amount, the issue can be much more complex, for loss of both control and access to the gifted property issues become more paramount and any potential estate tax benefit may not be realized or be offset by an income tax detriment. Thus, whether to make a significant gift in 2012 will require a thorough analysis of the complex "pros and cons" applicable to the particular circumstances with estate planning counsel prior to individuals making the determination whether such a gift is merited in their situation. Even if it is decided to make a significant gift over $1.0 million in order to utilize some or all of the current gift tax exemption, most such individuals will choose to wait until the end of the year to make such gift in order to see if Congress in the "lame duck session" enacts any tax legislation that affects their decision.

It is worthy of mentioning that some married couples may choose a "hedging strategy" in this uncertain environment where by only one spouse uses his or her gift tax exemption. This ensures at least one spouse will have the benefit of utilizing the 2012 gift tax exemption should Congress fail to significantly increase the exemption beyond $1.0 million for 2013.

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In any event, for all estates currently in excess of $1.0 million, and particularly those in excess of $5.0 million, the potential loss of the other above-noted estate planning techniques in 2013, perhaps retroactively to introduction of the governing legislation, militates in favor of at least considering whether it would be appropriate to implement them in 2012.

OTHER ESTATES

For all estates, irrespective of size, consideration should be given to selling capital gain property this year when the maximum capital gain rate at the federal level is 15%, as opposed to the 20% rate when the "Bush tax cuts" expire at the end of this year. This is particularly true with respect to property that is already being considered to be sold. There is no assurance that such low rate will be retained in future years, even as part of the anticipated "grand bargain." This includes as part of a business succession plan involving business or farm assets with respect to which it is being contemplated that such assets would be sold to children to provide liquidity to parents. It is also important to note that any such sales, if made on an installment basis, are currently highly favored by historically low interest rates which the IRS requires to be charged on installment sales to avoid the imposition of greater interest income. The current rate is less than 1% for installment sales of nine years or less and approximately 2% on sales extending over a greater than nine year period. However, this would not protect installment payments made in subsequent years from being subject to the then current capital gain rates.

In addition, as there are likely to be substantial budget cuts next year as part of a "grand bargain," albeit probably much less than the automatic cuts scheduled under current law for January of 2012, the current level of Medicaid benefits may be substantially reduced. If so, this could adversely impact current estate planning techniques authorized under current law, mostly applicable to smaller estates, which can substantially accelerate eligibility for Medicaid benefits to pay for long-term care, as well as reduce so called "estate recovery" claims for Medicaid benefits against their estate or the estate of their surviving spouse. Thus, individuals of moderate means who are not currently receiving Medicaid benefits but who are currently either receiving long-term care or who have a disability such that they may have to go into a long-term care facility in the foreseeable future, or who have a spouse with such a disability, should consider possibly implementing such Medicaid eligibility strategies this year, for it may be too late to do so if such decision is deferred beyond this year.

CONCLUSION

All individuals who have not had their existing estate plans reviewed in the last two years, or who are in any of the foregoing circumstances so as to possibly be adversely affected by changes in tax or estate planning laws which are either already slated to go into effect in 2013 or could be enacted into law next year and who have not already discussed such changes with their estate planning legal counsel, should make an appointment to do so prior to the middle of November. By so doing, if any change is then deemed warranted or an appropriate estate planning strategy is in need of being implemented prior to the end of the year, there will be sufficient time to do so.

For Further Information

Foulston Siefkin regularly counsels clients on issues relating to Estate Planning and Probate. If you are interested in additional information regarding these matters, please visit our website at **www.foulston.com** or if you would like to discuss specific ways in which Foulston Siefkin can help you, contact **Tim O'Sullivan** at tosullivan@foulston.com or (316) 291-9564 or **Stewart Weaver** at sweaver@foulston.com or (316) 291-9736.

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