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Dear Clients and Friends:

As you may know, the federal tax legislation passed in December, 2010 (the "2010 Tax Law") included a number of holiday presents for taxpayers. The exemption from the federal estate, gift and generation-skipping transfer ("GST") taxes was increased to an all-time high of \$5,000,000, and the tax rate on estates and gifts exceeding the \$5,000,000 exemption was set at a historically low 35%. The law also added a new rule (commonly referred to as "portability of exemptions") that benefits married couples who fail to do basic tax planning in their Wills. This rule permits a spouse to, in effect, pass any unused estate tax exemption to the surviving spouse.

Unfortunately, these and other taxpayer-friendly provisions of the 2010 Tax Law (including all the benefits of portability of exemptions) are scheduled to expire on December 31, 2012. After that date, the estate, gift and GST tax exemptions will revert to levels set back in 2001 (\$1,000,000, but with post-2001 inflation adjustments in the case of the GST tax exemption). In addition, the flat 35% tax rate will be replaced with the pre-2001 graduated tax rate schedule that effectively starts at 37% and climbs as high as 55% (plus an extra 5% on estates and gifts between \$10,000,000 and \$20,000,000).

Planning for Changes in the Law

It is possible that new federal legislation will extend or modify all or part of the 2010 Tax Law. Given the polarized political climate, though, it is also possible that the 2010 Tax Law's favorable provisions will indeed lapse at the end of this year. As a result, many estate planning professionals are counseling their more affluent clients to consider making large gifts in 2012 to "lock in" the benefits of the 2012 federal exemption and tax rate levels. Such gifts need not be as high as \$5,000,000 to be effective. They would, however, have to be higher than the post-2012 exemption amount (which, if there is new legislation, may be more than \$1,000,000) to capture any benefit of the current higher exemption amount.

Clients who have very large estates might even consider making gifts in excess of the \$5,000,000 exemption in 2012¹ and paying federal gift tax at the current 35% rate. While such taxable gifts accelerate the time when the transferred property will be subject to tax, the savings could be as much as 20% of each dollar transferred (if the top rate

¹ For simplicity, this letter refers to the current exemption as \$5,000,000, even though it is actually \$5,120,000 in 2012 after an inflation adjustment.

reverts to 55% after 2012). Federal gift taxes paid more than three years before death are excluded from the donor's taxable estate, providing additional estate tax savings.

There are two *caveats* for clients considering large gifts in 2012. First, such gifts will trigger a state gift tax in some states (such as Connecticut, but not New York). For example, a Connecticut resident who makes a \$5,000,000 gift in 2012 would incur a Connecticut gift tax of about \$230,000. For clients with very large estates, however, the state gift tax incurred may be far outweighed by the eventual federal estate tax savings of using the full \$5,000,000 federal exemption.

Secondly, federal budget woes notwithstanding, the campaign to repeal the estate tax entirely could still succeed at some point. In that case, any tax paid on a large gift would be wasted.

Some practitioners warned that any 2012 gift in excess of the future estate tax exemption could, in effect, be subject to estate tax at the donor's death. A careful reading of the estate tax statute, however, contradicts this theory (often referred to as "claw back"). In addition, nothing in the text or legislative history of the 2010 Tax Law indicates Congress intended that result. We believe, therefore, that claw back should not be a concern.

Should Large 2012 Gifts Be Expedited or Delayed?

It may seem prudent to put off large 2012 gifts until late in the year, when the tax laws may be clearer. The problem with this approach is that tax legislation often becomes effective on the date when it is first introduced in Congress. A bill was introduced last November which would accelerate reinstatement of the pre-2001 transfer tax rules to December 31, 2011. The possibility of this bill's passage seems remote (the White House reportedly opposes a return to pre-2001 transfer tax rules), but it is possible that it will be amended, or that a more viable bill will be introduced this year with an immediate effective date. The best that taxpayers can do to protect themselves is to make their large gifts earlier, rather than later, in 2012.

Connecticut's Transfer Tax and Probate Law Changes

Connecticut's estate and gift taxes remain in effect for 2012 and beyond. In May of 2011, the Connecticut legislature lowered the exemptions for those taxes from \$3,500,000 to \$2,000,000. The reduced exemption amount was made retroactive to January 1, 2011, and is scheduled to stay in place indefinitely. Despite this change in the law, Connecticut's \$2,000,000 exemption is among the highest of the current state estate tax exemption amounts. In addition, the tax rates imposed by Connecticut are roughly 25% lower than the rates imposed by most other states that impose a state estate tax.

The legislative news in Connecticut was not all bad in 2011. For the estates of decedents who die on or after January 1, 2011, the basis for calculating the statutory probate fee will not include real estate or tangible personal property located outside Connecticut. For estates of Connecticut residents which include sizable out-of-state assets, this could mean thousands of dollars in savings for the beneficiaries. The same is true for the beneficiaries of

estates of affluent nonresidents which contain relatively modest amounts of Connecticut-based property.

New York Estate Tax and Trust Law Changes

Unlike Connecticut, New York does not impose a tax on lifetime gifts. New York does, however, impose a state estate tax which currently provides for an exemption of \$1,000,000 per taxpayer. A bill was introduced on January 4, 2012, which would increase the state exemption amount by \$1,000,000 each year from 2012 (when the exemption would be \$2,000,000) through 2015 (when the exemption would be \$5,000,000).

New York law has long included a statute which permits, to a limited degree, the transfer of assets from one trust to another. Often referred to as "trust decanting," this procedure in effect allows the trustees and beneficiaries of a trust with an undesirable feature (e.g., strict limitations on acceptable trust investments) to "rewrite" its terms by transferring the trust assets to a new trust with more favorable terms. The statute was amended in 2011 to make trust decanting more accessible than was the case previously. The procedure is now available to a wider variety of trusts. It should be noted that the Internal Revenue Service is currently examining how trust decanting should be treated under the estate, gift and GST taxes.

New York's "Marriage Equality Act"

Same sex marriage became legal in New York State with the passage of the Marriage Equality Act (the "MEA"), which was signed into law on June 24, 2011, and became effective on July 24, 2011. With the passage of this legislation, New York joined six other jurisdictions (Connecticut, Massachusetts, Iowa, New Hampshire, Vermont and the District of Columbia) in granting same sex couples the same legal rights and obligations associated with marriage *at the state level* as are enjoyed by opposite sex couples.

Passage of the MEA essentially granted spouses in same sex marriages the same property rights in each other's estates as spouses have in opposite sex marriages. For instance, a surviving spouse in a same sex marriage will now inherit all or part of the estate of his or her deceased spouse if the deceased spouse leaves no Will, and if the deceased spouse does leave a Will the surviving spouse will have the right to a minimum share of the estate regardless of the terms of the Will.

The rights and powers granted in the MEA are limited to those matters governed by New York law. Rights and benefits granted to spouses in opposite sex marriages under federal law (such as the unlimited marital deduction under the federal estate tax) are not currently extended to spouses in same sex marriages, despite the provisions of the MEA. Federal law may often override New York law on certain points, as does the "Health Insurance Portability and Accountability Act of 1996" ("HIPAA") when it comes to the release of medical information. Therefore, spouses in same sex marriages should take all possible steps to preserve their rights under federal law (e.g., executing health care proxies to each other which comply with all the requirements under HIPAA).

Similarly, the laws of many other states do not recognize the validity of same sex marriages entered into in a jurisdiction which permits same sex marriages. Thus, spouses in a same sex marriage could lose the rights they have in each other's estates by changing domicile from New York to, for example, Florida. To minimize the legal impact of changing domicile, spouses in same sex marriages should consider establishing their estate plans under "revocable living trusts" which provide that the law of the state where they were married governs the trust's administration.

Estate Planning Options Going Forward

In addition to the discussion above regarding planning for the possible expiration of the 2010 Tax Law provisions, our advice remains the same: If your Will was drafted more than a few years ago, you should reexamine it in light of recent changes in the law and any significant changes in your financial or family situation. It is possible that the tax planning provisions in your Will could be simplified due to the increased exemptions. If you are married and reside in a state with a state estate tax, it might be wise to adjust the tax planning provisions to insure that the larger federal exemption does not change the disposition of your assets in a way that triggers an unintended state estate tax at the death of the first spouse to die.

For those considering making gifts in 2012, we suggest you review our memorandum, "A Brief Survey of Current Techniques for Estate and Gift Tax Reduction," at our website: www.davidsondawson.com. Please let us know if you would prefer to receive a copy by email or regular mail. If you would like more information regarding these possibilities, or if you would like to discuss planning techniques tailored to your particular situation, please contact one of your DD&C attorneys.

Sincerely,

Davidson, Dawson & Clark LLP

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