DAVIDSON, DAWSON & CLARK LLP
COUNSELLORS AT LAW

60 East 42nd Street
New York, NY 10165
212.557.7700
Fax 212.286.8513
www.davidsondawson.com

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Dear Clients and Friends:

Some certainty has finally come to the estate and gift tax laws. The federal estate tax has not been repealed. Rather, new rates and exemptions have been permanently established by the American Taxpayer Relief Act of 2012 ("ATRA 2012"), signed into law by President Obama on January 2, 2013. This letter summarizes the effects of the new law on estate planning, trusts and estates.

- The $5.12 million estate, gift and generation-skipping transfer tax ("GST") exemption remains in effect, and is indexed for inflation, resulting in an exemption of $5.25 million for 2013.

- The estate, gift and GST tax rate that applies above the $5.25 million exemption is now 40% (reduced from the 55% scheduled, but more than the 35% rate in 2012).

- The basis step-up rule for estates and beneficiaries has been retained: pre-death capital appreciation on inherited assets will never be subject to capital gains tax.

- The helpful "portability" rule was made permanent. It allows a surviving spouse to utilize any unused federal estate and gift tax exemption of his or her predeceased spouse. The rule was liberalized to allow an exemption received from a previous spouse to be passed along to a new spouse, as long as the total never exceeds two full exemptions. Note, however, that portability still does not apply to the GST exemption or state estate tax exemptions.

- While not part of ATRA 2012, the gift tax annual exclusion was increased to $14,000 per donee for 2013, or $28,000 per donee for a married couple.

These provisions are now as permanent as tax law can be. Unlike previous legislation, no "sunset" is scheduled.

36 Grove Street New Canaan, CT 06840 203.966.8759 Fax 203.966.7894

## Planning with Wills

Clients who have been deferring reviews of their estate plans for guidance on future tax laws should now proceed. Clients who used substantial parts of their exemptions to make gifts last year may also wish to review their estate plans.

Because the portability provisions have been made permanent, some married clients who do not need trusts for any other reasons may be more inclined to proceed with fairly simple "all to spouse" planning. They can now rely on portability to make both spouses' federal estate tax exemptions available, rather than establishing a "bypass trust" in the first estate. Some clients may prefer the simplicity of this approach even if it is not optimally tax-efficient.

Bypass trusts do have additional tax advantages, however, especially in reducing GST and state estate taxes, and sheltering assets with high growth potential. Clients who want to maximize the benefit of a bypass trust must have an appropriate Will and must have put $5.25 million or more of assets in the separate name of the first spouse to die.

In states with their own state estate taxes, such as New York and Connecticut, reliance on a mixture of portability and a smaller bypass trust may be a good compromise. The bypass trust can be funded to the limited extent of the state estate tax exemption ($1 million in New York and $2 million in Connecticut), and portability can be relied upon to take advantage of the balance of the deceased spouse's unused federal exemption.

## Planning with Gifts and Trusts

Many clients made gifts in 2012 to guard against the possibility that the 2012 exemption of $5.12 million would expire. These gifts will still prove to be advantageous, even though the federal exemption has been extended and increased to $5.25 million. Such gifts escape New York tax entirely, for example, because, while New York has a substantial estate tax, it does not tax gifts. Moreover, lifetime gifts grow in efficacy over time: The post-gift growth and income from the transferred assets escape transfer tax completely, and any gift tax paid is usually also removed from the donor's taxable estate.

Gifts to "grantor trusts" have many additional benefits that accrue over time, rewarding early transfers:

- The donor pays the trust's income tax, allowing the trust to grow tax-free, without any further gift tax implications.

- Grantors of such trusts can exchange assets with the trust, without incurring capital gains taxes, to give the trust more appreciation potential. Grantors may be able to take advantage of valuation discounts when doing so.

- Low-interest loans can be made to such trusts without incurring income tax on the interest payments.

- Sales to grantor trusts can shift additional appreciating assets to the trust after the initial gift without the realization of taxable capital gains.

- A basis step-up can be obtained for most appreciated assets even after they have been given to a grantor trust, by having the grantor re-purchase the assets from the trust, with appropriate safeguards, and transferring them to the beneficiaries through the grantor's estate.

Clients who did not use their full gift and/or GST exemptions in 2012 now may still do so in 2013 and beyond. Moreover, as the exemption continues to rise with inflation, clients can expect to acquire additional gift and GST exemption every year. Note, however, that if a grantor trust or a GRAT is planned, there is some urgency to act. The Administration has proposed new rules which, if passed, would substantially limit these planning techniques.

**2012 Gift Tax Filings**

In light of the large number of gifts made in 2012, there will be an unusually large number of gift tax returns filed this year. Donors should plan to submit their gift information to their tax preparers early in the season, or consider extending, which is not difficult.

Some couples did not make large enough gifts in 2012 to utilize both of their $5.12 million gift tax exemptions fully. In such cases, the usual plan was to have one spouse make a full $5.12 million gift so that, if Congress reduced the exemption, at least one spouse would have fully used the temporary, or expiring, part of the exemption. Now that Congress has not reduced the exemption, it may be preferable, in permitted cases, to make the election to "split gifts" between spouses, thereby using the annual exclusions of both spouses (which were $13,000 each in 2012), and reducing the amount of the gift tax exemption used by the gift.

**Income Tax Changes for Estates and Trusts**

While income tax changes for individuals made most of the headlines, the income tax changes for trusts and estates were even more burdensome.

For trusts and estates, the increased maximum income tax rate of 39.6% begins at only $11,950 of taxable income this year, as does the new 3.8% ACA ("Obamacare") tax. Thus, the top federal rate on undistributed investment income above $11,950 will be 43.4% (not including state income taxes). This low threshold creates an incentive to

distribute trust income to beneficiaries in a lower income tax bracket, even in the absence of non-tax reasons to do so.

The new 20% rate on dividends and capital gains also applies to trusts, but it now begins at only $11,950. Again, this low threshold, particularly for dividend income, encourages distributions to beneficiaries in lower brackets.

**Possible Further Legislation**

ATRA 2012 did not address federal spending cuts, sequestration, the debt ceiling, the continuing resolution to fund government operations, or additional tax changes the President wants. In the transfer tax area, the Administration's past recommendations include restrictions on GRATs, limitations on valuation discounts for intra-family transfers, limits on the benefits of installment sales to grantor trusts, and estate taxation of grantor trusts.

There will no doubt be additional legislative action. As always, your DD&C attorney will be glad to discuss how these rules apply to you, and how they might be used to your advantage in your estate plan.

Sincerely,

DAVIDSON, DAWSON & CLARK LLP

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