

WILLMS, S.C.

LAW FIRM

TO: Clients and Friends of Willms, S.C.

FROM: Attorney Andrew J. Willms

DATE: January 31, 2013

RE: The American Taxpayer Relief Act of 2012

On January 2, 2013, the "American Taxpayer Relief Act of 2012" ("ATRA") was signed into law by President Obama. ATRA raises taxes in a variety of ways, including:

- The highest federal income bracket increases to 39.6% for U.S. single individual taxpayers with incomes over \$400,000 and married taxpayers with combined incomes over \$450,000;
- The tax rate for long-term capital gains and qualified dividends increases to 20% for individuals with income over \$400,000/\$450,000;
- The employee portion of the FICA payroll tax reverts to 6.2% from 4.2% on wages up to the Social Security Tax threshold (which is set at \$113,700 for 2013); and
- The maximum federal estate, gift and generation-skipping tax rate increases by 5% to 40% (which is 15% less than what the maximum rate would have been if the Act had not been enacted).

Many of our clients will be positively and negatively impacted by the new law. Proper planning can enable you to accentuate the positive and minimize the negative. The balance of this article discusses planning measures that could prove to be beneficial in light of the new law.

Simplifying your Estate Plan

Revocable living trusts are an integral component of most of our clients' estate plans. Such a trust can help eliminate the need for probate, safeguard a surviving spouse's assets in the event of remarriage, protect an heir's inheritance from claims of their creditors, and encourage heirs to continue to live productive lives after your death. ATRA did not reduce the benefits of a living trust in any of these respects.

Many revocable living trusts created for married persons also include rather complicated provisions that are intended to make sure that estate taxes are kept to a minimum by making sure both spouses' personal exemptions from the estate tax are utilized. In the past this required the creation of an irrevocable trust to be funded with part or all of the marital estate belonging to the first spouse to die.

ATRA may eliminate the need to fund an irrevocable trust when a married person dies for two reasons. First, the amount that can be given away tax free is increased to \$5MM indexed for inflation (which works out to \$5.25MM in 2013). As a result, if a married couple does not expect their combined estates to exceed this amount, then there may be no need to worry about using the estate tax exemption of the first spouse to die.

Second, the unused exemption of a married decedent can now be "ported" to a surviving spouse. That means that if the first spouse to die leaves his or her entire estate to the surviving spouse, the amount that the survivor can give away will be effectively doubled (to \$10.5MM in 2013).¹

As a result, if you have a trust that mandates the creation of an irrevocable trust when you or your spouse dies, you may want to eliminate this requirement in the trust agreement. Instead, the surviving spouse could be given the option to create the irrevocable trust if he or she feels it would be wise to do so depending on the tax laws in effect when the first spouse dies.² There may also be important non-tax reasons for funding an irrevocable trust when the first spouse dies, such as protecting the deceased spouse's share of the marital estate from creditors, predators and remarriage during the surviving spouse's lifetime.

Consider Using your Unified Exemption Amount Now

For the first time in 12 years, we now supposedly have a "permanent" set of rules in place regarding the manner in which gifts and estates are taxed. However what politicians giveth, politicians can also taketh away. Therefore, there is still good reason to consider using the increased gift tax exemption to reduce the size of your taxable estate now.

¹ The exemption amount of the first spouse to die will not be indexed for inflation during the surviving spouse's lifetime.

² The generation skipping tax exemption is not "portable" and therefore clients who are leaving large amounts to grandchildren could benefit from the funding of an irrevocable trust when the first spouse dies.

Of course, making large gifts is easier said than done. There are several reasons why some of our clients are reluctant to use their gift tax exemptions to make large tax free gifts to their future heirs, including:

1. Concern about their personal financial security;
2. Loss of control over the gifted funds;
3. Concern about the way the gifted funds will be used by the recipient; and
4. The loss of the step up in basis at death.

Fortunately, there are tried and true planning techniques that can be used to address all of these issues. As a result, persons who held off on making large gifts in the past may want to reconsider that decision this year.

Consider Using Charitable Gifts to Lower Income Taxes

As pointed out earlier, ATRA includes a variety of tax hikes that are intended to require wealthy Americans to shoulder a larger share of the tax burden. Charitable giving can help lighten this load in a variety of important ways.

First, ATRA extends, the ability of individuals who have attained age 70½ to transfer up to \$100,000 per year directly from an IRA to certain public charities without including this amount in their gross income until December 31, 2013.

A second way to lower taxes is to use appreciated securities, rather than cash, to make charitable contributions. The charitable deduction allowed for income tax purposes is based on the fair market value of the securities given, and the capital gains tax on the unrealized appreciation is avoided.

Appreciated securities can also be used to fund a charitable remainder trust (“CRT”). This type of trust pays an annual amount to the person who creates the trust or other non-charitable beneficiary for a specified period, with the assets that remain in the trust when the annual payments end passing to a charity. A person who contributes appreciated securities to a CRT is entitled to an income tax deduction for the value of the charitable remainder interest, and capital gain taxes are not incurred if the Trust sells the appreciated securities.³ In addition, because CRTs are tax-exempt, they are not subject to the new Medicare surtax.

A charitable lead trust (“CLT”) is a second type of charitable trust that can lessen both income and estate taxes. A CLT is particularly well-suited to persons who traditionally

³ In order to avoid capital gain taxes, there can be no pre-existing legal duty on the Trustee to sell the contributed property.

make gifts to charity each year. This type of charitable trust provides that a percentage of the net fair market value of the trust assets are to be annually paid to a favored charity or charities for a specified number of years. Thereafter, the remaining assets can be distributed to specified non-charitable beneficiaries (such as your children or grandchildren).⁴

When a CLT is created, a charitable deduction is allowed for gift tax purposes equal to the present value of the charitable interest. As a result, the charitable interest reduces the transfer taxes imposed on the amount contributed to the trust, notwithstanding the fact that the trust assets will ultimately pass to non-charitable beneficiaries.

Distribute Trust Income

While the highest income tax rates do not kick in for individuals until taxable income exceeds \$400,000 if single and \$450,000 if married, the same is not true for irrevocable trusts. To the contrary, income accumulated by irrevocable trusts is taxed at the top bracket at a very low level of taxable income (just \$11,950 in 2013).⁵ If, on the other hand the income is distributed to a trust beneficiary, then that income is taxed to the recipient at his or her individual tax rate. As a result, in many cases income taxes can be lowered by distributing trust income rather than accumulating it inside the trust.⁶

Conclusion

As the foregoing discussion indicates, there are lots of new and exciting estate planning opportunities that have been made possible by the American Taxpayer Relief Act of 2012. We would welcome the opportunity to discuss with you how you can best take advantage of the new law.

End of Article

⁴ A CLT can be structured so that none of the trust income is taxable to the donor. In that case there is no upfront income tax deduction. A CLT can also be structured so that the grantor gets an immediate income tax deduction for the present value of the charitable interest, in which case any income earned on the trust assets is reported on the donor's personal tax return.

⁵ Income earned by revocable trusts is taxed to the person who establishes the trust. As a result income earned by assets held by revocable trusts is not subject to the accelerated tax brackets that apply to income that is accumulated by irrevocable trusts.

⁶ The trustee should also consider the risk that distributed income will be misspent by the beneficiary, attached by a creditor or subject to transfer taxes when the beneficiary dies.