KATZ BASKIES & WOLF PLLC

Trusts & Estates, Tax & Business Law

GENERAL NEWS

Client Update (January 2013) - Highlights of the American Taxpayer Relief Act

People will continue to debate whether we have or have not avoided some fiscal cliff with the recent passage of the American Taxpayer Relief Act, but at least there is some certainty as to tax rates beginning January 1, 2013. From a planning perspective, it is helpful that the rates are stated to be permanent (although "permanent" seems to be a relative term in Washington – we'll see what happens when Congress actually addresses the spending side of government). This is a good time to look ahead to 2013, and to look back a bit on what happened in 2012.

The highlights of the American Taxpayer Relief Act include the following:

• The estate, gift and generation skipping tax exclusion amounts will remain at $5,000,000 (indexed for inflation – which puts the amount at $5,250,000 for 2013), but the highest marginal rate will rise from 35% to 40%.

• "Portability" of the gift and estate tax exclusion amount, where a surviving spouse can take advantage of the unused exclusion of a deceased spouse, has been made permanent.

• High income individuals (joint filers with income in excess of $450,000, or single filers with income in excess of $400,000) will have a top marginal rate of 39.6%. The dollar amounts are inflation adjusted after 2013.

• The personal exemption has a new phaseout rule, which reduces the benefit of the personal exemptions by 2% of each $2,500 in excess of specified threshold amounts ($300,000 for joint filers; $250,000 for single filers).

• Itemized deductions are reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount, but the phaseout cannot exceed 80% of the total itemized deductions. The threshold amount is $300,000 for joint filers and $250,000 for single filers, indexed for inflation.

• Dividends and capital gains will be taxed at the same rate, which is now 20% for high income taxpayers (also defined as joint filers with income in excess of $450,000, or single filers with income in excess of $400,000). The rate will stay at 15% for those with income in excess of $72,500 (for married, filing jointly) but less than the $450,000/$400,000 levels.

• Higher exemption amounts are provided for the Alternative Minimum Tax, and are indexed for inflation.

• The ability to make charitable distributions from IRAs has been extended through 2013. Charitable distributions made prior to February 1 will count towards 2012.

• Taxable rollovers will continue to be permitted from qualified plans to Roth accounts.

Uncertain of whether Congress would act, many of our clients took advantage of the opportunity available in 2012 to gift up to $5,120,000 per person. No doubt, one or two of them may be wondering if the rush to act was worthwhile. Although each person's situation is different, the following general rules continue to be applicable:

• The earlier one can gift, the better. By gifting assets, all future appreciation is kept out of the estate. Assume that a $5,000,000 gift is made, that future after-tax appreciation in the gifted assets is 5%, and the taxpayer lives 10 years. The growth in value – over $3,000,000 – will be outside of the taxpayer's estate. At a 40% bracket, that saves the family $1,200,000 in taxes. For a family involved in multi-generational planning, the savings in generation skipping tax is also considerable.

• The stock market has shown a strong recovery since the darkest days of 2009, but many other asset classes have not fully recovered. Gifting assets with depressed values may have the potential for significant appreciation in the future.

• Many clients have created trusts that are treated as “grantor trusts” for income tax purposes (these types of trusts are also known as “defective” trusts, although there is nothing defective about them). This type of trust allows the grantor to pay the income tax on trust income while keeping the trust assets out of the grantor’s estate. Using the example from above of the $5,000,000 gift, assume that the pre-tax appreciation is 7%, while the after tax appreciation is 5%. If the trust pays the tax, then after 10 years the trust grows to $8,000,000. But if the trust grows at 7%, that value increases to more than $9,600,000. The difference is that the grantor has been paying income taxes *out of funds that would otherwise have been subject to the estate tax upon death*. Put another way, it is as if the IRS has been paying 40% of the income taxes each year (with 40% being the marginal rate on estate taxes).

• For nearly 20 years there has been talk in Washington about curbing the use of discounts for gifts of closely-held interests among family members (to limit the use of family limited partnerships or other family investment entities). Although that topic also came up in the latest round of negotiations, no provision dealing with this was enacted. Therefore clients should continue to consider the discounting opportunities available with gifting restricted, closely-held entity interests and/or interests in real property.

What is ahead for 2013? High net worth taxpayers that have not used up their gifting exemption should continue to consider ways to do so. But the main focus will likely be on the income tax aspects of planning. Items to consider include the following:

• The Obamacare taxes are in addition to the tax increases imposed under the current legislation. That means that there will be an additional 3.8% tax on the passive income of high income taxpayers, and an additional 0.9% tax on the earned income of such taxpayers. Some clients may wish to explore ways of “converting” passive income to active, earned income.

• Clients should consider the income tax benefits of charitable remainder trusts and charitable lead trusts.

• High income taxpayers need to carefully consider the timing of itemized deductions, such as charitable contributions, so as to maximize the tax benefits. This may mean “bunching” contributions in some years to a philanthropic or donor advised fund and distributing the funds in future years.

We at Katz Baskies will continue to monitor future tax law changes. Despite the planning fatigue that many people feel, we urge clients to do what has always made sense – shift wealth prudently and efficiently in a manner that maximizes the protection for your family. We thank you for the opportunity to be of service to you, and look forward to working with you in the future.

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