YOUNG CONAWAY STARGATT & TAYLOR, LLP
Attorneys at Law

Winter 2013

Tax, Benefits, Trusts & Estates Law Update

What The American Taxpayer Relief Act of 2012 Means To You

Introduction

As all of you know, on January 2, 2013, President Obama signed into law the "American Taxpayer Relief Act of 2012". This legislation has a profound effect upon estate planning in general, and most of our clients should review their estate plans as a result of the new law.

The most significant provisions of the new legislation, as they pertain to estate, gift, and generation skipping transfer ("GST") tax include the following:

1. The $5,000,000 exemption amount for estate, gift, and GST taxes is made permanent. This amount is indexed for increases in the cost of living, and for 2013, is $5,250,000. The integration of the estate and gift tax exemptions remains in place, meaning that use of the exemption amount for lifetime gifts continues to have the effect of reducing the exemption available for federal estate tax purposes.

2. The estate, gift, and GST rates are increased from 35 percent to 40 percent. These rates generally apply to assets whose fair market value on the date of the gift or date of death is in excess of the amount of the then relevant exemption amount. Deductions such as the marital deduction and charitable deduction remain available for federal estate and gift tax purposes to reduce the amount of the taxable estate or gift, as the case may be.

3. The ability to elect portability of exemption amounts between spouses has been made permanent. When one spouse dies without fully utilizing his or her estate tax exemption amount, the executor of that spouse's estate may file a federal estate tax in which an election is made to add that spouse's unused exemption amount to the exemption amount of the surviving spouse. Portability of exemption amounts does not apply to the generation skipping tax. Unfortunately, it is not clear whether portability of exemptions applies for purposes of the Delaware estate tax.

The word "permanent" has been and will be used several times in this memorandum. As we know, Congress can change any law at any time. The word "permanent" is used to distinguish the new current law from the law as it had existed since 2001 which specifically had been made temporary in many key respects. The permanence of the portability rules, together with the permanence of the increased exemption levels, allows for modified planning and changes to the estate plans of many clients. The recommendations we will make for each client will depend on that client's situation, so it is impossible to generalize how any particular estate plan will be affected by the new legislation. Nevertheless, the suggestions below will apply to some of our clients.

Married clients

An example of the effect of the portability election to carry over the exemption amount from the first spouse to die to the surviving spouse will make it easier to understand some of the discussion below. Assume husband has $7,000,000 in his own name, wife has $2,000,000 in her own name, and the couple has $10,000,000 of jointly owned assets. Further assume that husband dies first in 2013 and names wife as executor. If husband leaves everything outright to his wife, he will use none of his $5,250,000 exemption, and by filing an estate tax return for husband's estate, wife can add his $5,250,000 exemption amount to her own, so that the first $10,500,000 of her estate will be free of estate tax at her subsequent death. If husband leaves the amount of his estate tax exemption in a trust for his wife which deliberately does not qualify for the marital deduction, such as the residuary trust in the estate plans for many of our clients, or directly to children, then he will have used all of his exemption and there will be nothing to add to the wife's exemption. If husband leaves $3,000,000 of his separately held assets to a credit shelter trust and the rest of his separately-held assets outright to the wife, he will have used $3,000,000 of his exemption, and his wife can add the remaining $2,250,000 to her exemption by making a portability election on the husband's estate tax return. The residuary or credit shelter trust will not be part of the surviving spouse's estate, so except for changes in value of these trusts, the estate tax effect is the same in terms of the amount of tax due when the surviving spouse dies. Of course, it is likely that changes in value may occur, and this consideration needs to be considered as part of the planning.

Married clients will often have estate plans which contain a two share arrangement, with a marital gift or trust for the benefit of the surviving spouse, and a credit shelter trust (referred to as the "Residuary Trust" in many of our documents), which was designed to take optimum advantage of the estate tax exemption of the first spouse to die while also making certain that no federal estate tax would be paid at the first death.

Total Assets Under $5,000,000: Married clients whose combined total assets are unlikely to ever exceed $5,000,000 in the aggregate may want to simplify their estate plans to eliminate the credit shelter trust because it may no longer be necessary to make certain that no estate tax will be payable at either spouse's death. The advantages to eliminating this arrangement include enhanced simplicity in the estate plan, elimination of costs following the surviving spouse's death in maintaining separate accounts for the residuary trust and preparation of income tax returns for such a trust, and the ability to have the assets in the residuary trust receive a new basis equal to their fair market value on the date of the surviving spouse's death. The disadvantages to making such a change include loss of potential creditor protection, and making it easier for the surviving spouse to leave these assets to a new husband or wife if the spouse remarries following the first spouse's death. In addition, if at least one spouse has a child or children who are not children of both spouses, such clients may not want to eliminate the credit shelter trusts from their plans.

Total Assets Between $5,000,000 and $10,000,000: Married clients whose total combined assets are between $5,000,000 and approximately $10,000,000 might wish to simplify their estate plans for the same reasons as apply to clients with lower total combined asset amounts. Nevertheless, in making planning changes, such clients need to consider that the portability of exemptions does not apply to the GST tax. In addition, the increase in value of a credit shelter trust between the death of the first and second spouse will be protected from estate tax at the surviving spouse's death. Nevertheless, if instead of a credit shelter trust, there is an outright gift to the surviving spouse when the first spouse dies, the increase in value of such gift will be protected from estate tax only to the extent that the estate does not exceed the sum of the surviving spouse's exemption amount plus the unused exemption of the first spouse. Since only the unused exemption amount of the most recently deceased spouse can be used, remarriage by the surviving spouse followed by death of the new spouse before the surviving spouse will cause loss of the unused exemption of the first spouse, with the unused exemption amount, if any, of the new spouse being available only if an estate tax return is filed for that spouse's estate. Some clients in this asset range will want to consider this factor in determining whether to rely on portability as part of their estate planning.

As mentioned, one of the potential advantages to consider in not fully utilizing the federal estate tax exemption amount of the first spouse to die, such as by providing for an outright bequest to the surviving spouse and making a portability election, is that it may well be possible to obtain a stepped-up basis, for income tax purposes, for more assets at the death of the surviving spouse if the values of assets have increased between the date of death of the first spouse and the date of death of the second spouse. This memorandum has already set forth certain other very relevant non-tax considerations as to why this may not be the best approach. This memorandum has also indicated that if assets appreciate too much, it could cause the imposition of a federal estate tax in certain situations where it might not otherwise be imposed. On the other hand, depending upon the amount of the potential basis step-up, and depending upon the then applicable capital gains rates, even the imposition of a small amount of additional federal estate tax may be outweighed by a potentially larger amount of long-term capital gains taxes that might have otherwise been avoided. As you can see, while estate planners are almost universally grateful for the "permanency" aspect of the new legislation, there are still many variables that must be considered in connection with the estate plans of many clients.

Total Assets Over $10,000,000: Married clients whose assets exceed $10,000,000 are less likely to want to simplify their estate plans, but there are still many planning considerations for such clients, some of the considerations discussed above also being applicable. For those married clients whose assets exceed $10,000,000, such clients should continue to consider estate and gift planning ideas and approaches which will minimize the possible imposition of the federal estate tax.

Although this will probably not apply to too many of our clients, it needs to be mentioned that those clients who have credit shelter trusts governed by a formula which leaves the credit shelter trust assets to someone other than the surviving spouse should consider the impact of the new legislation, with the "permanently" increased exemption amount, as it will impact who receives how much under their estate plan. Our firm had previously mentioned this issue when the temporary estate tax legislation was enacted at the end of 2010, but this would be a good time for those clients in this situation to again consider this issue.

State estate tax and inheritance tax considerations will influence how estate plans of married couples should be changed. The Delaware estate tax, Pennsylvania inheritance tax, Maryland estate tax, and New Jersey estate tax are examples of taxes imposed by area jurisdictions which should be considered.

Clients who are single, divorced, or widowed

The issues concerning portability of exemptions will not apply to such clients except for those whose spouses have died very recently. However, clients whose assets may or now exceed $5,000,000 should contact us to discuss specialized estate planning such as certain types of lifetime gifts and trusts which in some circumstances may help reduce federal estate tax liability. Such clients who have provisions for generation skipping trusts for children or grandchildren funded in an amount determined by formula referring to the amount of the generation skipping tax exemption should contact us so that we can be sure their documents continue to reflect their intent in light of the significant increase and potential continuing increase in the amount of the exemptions.

Contact information

Please contact the attorney with whom you have been working or any of the undersigned to further discuss your estate planning.

Timothy Snyder, Esquire
tsnyder@ycst.com
302.571.6645

Joseph Nicholson, Esquire
jnicholson@ycst.com
302.571.6653

Jerome Grossman, Esquire
jgrossman@ycst.com
302.571.6685

Richard Popper, Esquire
rpopper@ycst.com
302.571.6652

Evangelos Kostoulas, Esquire
ekostoulas@ycst.com
302.576.3589

David Hansen, Esquire
dhansen@ycst.com
302.571.6565