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TO OUR CLIENTS AND FRIENDS:

ESTATE PLANNING AFTER 2012 – NOT SIMPLY BUSINESS AS USUAL

The American Taxpayer Relief Act of 2012 (the "Act") was enacted on January 2, 2013, in order to avoid the so-called "Fiscal Cliff." In addition to the more highly publicized income tax changes, the Act made far-reaching changes to the federal estate, gift and generation-skipping transfer tax provisions of the Internal Revenue Code. As a result of the Act –

- Every individual has a **unified gift and estate tax exemption** (the **"unified exemption"**) in the amount of $5 million, *adjusted for inflation from 2011*. The 2013 exemption amount is **$5,250,000**.
- Every individual also has a separate generation-skipping transfer tax exemption (the "GST exemption") in the same amount as the unified exemption (i.e., **$5,250,000** in 2013).
- A surviving spouse may use a predeceased spouse's unused unified exemption (but not GST exemption) for lifetime gifts or transfers at death, subject to certain election requirements including the filing of a federal estate tax return for the predeceased spouse's estate. This is known as "portability."
- Gifts, estates and generation-skipping transfers are subject to a flat tax rate of **40%** (up from 35% in 2012) once the applicable exemption has been exhausted.

Unlike the similar legislation passed in 2010, the above changes (and other more technical transfer tax changes) have no sunset date and have been referred to as "permanent" because they will continue in effect unless or until Congress decides to change them. As a result, for the first time in more than a decade there appears to be at least a modicum of stability in the federal transfer tax law.

The income tax changes include an increased income tax rate (39.6%) and capital gains rate (20%) for taxpayers with taxable income over $400,000 (single)/$450,000 (married filing jointly). These higher rates were also made applicable to estates and to non-grantor trusts, but with the higher tax rates (and the Medicare surtax of 3.8%) kicking in at just below $12,000.

While these provisions may appear to be straightforward, the combination of stable high unified exemptions, increases in income tax rates and portability is a potential game-changer for clients at all asset levels. It is entirely possible that after considering the impact of the Act you will wish to change your estate plan in significant ways.

For the balance of this letter, we will try to give you a sense of the ways in which the Act may impact certain types of estate planning decisions and a basis on which to decide whether and how soon you would like to make changes to your estate plan in response to the Act. Please keep in mind, however, that the discussion in this letter is general and not a substitute for an individual review of your personal planning. As one might expect, the changes precipitated by the Act will vary greatly depending on your personal circumstances and sentiments.

Testamentary Planning
Some Points To Consider in Planning for Dispositions on Death

- If your estate planning documents include trusts for the sole purpose of utilizing the unified exemptions, you may want to eliminate those trusts. This will most frequently be the case if your combined assets fall below the higher unified exemptions, but may also apply to those with considerably more wealth who have secure marriages and whose desire to benefit a surviving spouse and children far outstrips the desire to benefit more remote descendants. Of course, many clients have included trusts in their documents for compelling non-tax reasons such as protection of beneficiaries from losing trust assets due to immaturity, dangerous lifestyles, incapacity, spendthrift tendencies, or creditors (including spousal creditors in divorce). The point is to take a fresh look at your personal goals and consider whether one or more trusts should continue to be included in your testamentary estate plan, either on the death of the first spouse to die or at all.[1]

- Similarly, if your estate planning documents include generation-skipping trusts to be funded with the maximum GST exemption defined by formula, you may wish to reconsider whether, in light of the increased GST exemption, this continues to strike the appropriate balance between your children and grandchildren. For example, some of our clients have created a generation-skipping trust to hold the full GST exempt amount for the primary benefit of grandchildren and more remote descendants, leaving only the amount in excess of the GST exemption to their children free of trust. This may continue to be appropriate if the $5.25 million inflation-adjusted exemption ($10.5 million for

[1] Clients who reside in states with state estate tax exemptions that are lower than the unified exemptions, including New York or New Jersey, should consider whether to factor state death taxes into this decision in light of the state death tax ramifications.

married couples) is not a substantial portion of the amount passing at the death of the survivor; however, if it is a substantial portion, you may wish to increase the amount passing outright to your children and reduce (or cap) the amount or portion of your estate passing in trust for grandchildren.

- A maximum federal estate tax rate of 40% and high exemptions along with increased income tax rates may refocus planning on minimization of income tax and enabling more assets to obtain a step up in the income tax basis of appreciated property at the death of a surviving spouse.

- Portability is a deceptively simple concept; it is not merely a backstop for failure to plan. With proper planning (both during life and post-mortem), portability can make full use of both spouse's exemptions and still qualify the estate assets for an adjustment in basis at the death of the surviving spouse. Portability warrants revisiting beneficiary designations and asset distribution between spouses. There are risks associated with portability as well. For example, a surviving spouse who remarries and survives a subsequent spouse loses the first predeceased spouse's unused exemption, unless he or she makes a gift using that exemption prior to the death of the subsequent spouse.

- If you made large taxable gifts[2] in 2011 or 2012, you should consider whether such gifts are properly integrated with your testamentary documents, including whether the gifts require equalizing provisions, advancement language, or adjustments to formulas that may no longer have the desired result.

Lifetime Planning
Some Points to Consider in Making Gifts and Administering Trusts

If you made large taxable gifts in 2011 or 2012,

- You may wish to re-think certain decisions on which the gifts were premised in light of the continued high exemptions. For example, you may have decided not to treat the gift as if half made by you and your spouse in order to use the entire 2012 unified exemption of one of you before it was reduced. Now that the unified exemption has been made permanent at 2011/2012 levels (and continues to increase by reason of the inflation adjustment), you and your spouse may want to treat the gift you made in 2012 as if made in part by your spouse, to the extent the gift is eligible for such treatment.

- You should be attentive to any further steps that may be required in order to implement, appraise and report your gifts. Gifts of real estate and closely held business interests require appraisals. Although the April 15, 2013 filing deadline

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[2] Taxable gifts would include completed gifts in excess of, or ineligible for, the annual exclusion that do not qualify for the marital or charitable deduction, whether or not the gift also exceeded the unified exemption.

for a federal gift tax return may be extended, any tax due must be paid by April 15.

- For gifts of low-basis assets to grantor trusts that are unlikely to be sold during the grantor's lifetime, you should consider whether a sale to the grantor or a swap, if permitted under the terms of the trust instrument, is desirable so that the benefit of avoiding estate tax on future appreciation is not diluted or eliminated as a result of capital gain taxes incurred by the trust or the ultimate beneficiaries of the trust on pre- (as well as post-) contribution appreciation.

- Because the unified exemptions have increased by $130,000 in 2013, these 2011 or 2012 gifts may be "topped off" if appropriate.[3]

If you did not make taxable gifts in 2011 or 2012,

- Gifts in trust with the $5.25 million per person unified exemption (less prior taxable gifts) continue to be available and attractive for many clients, and these may be structured in such a way that the donor's spouse has access to the funds in the event a need arises.

Whether or not you made taxable gifts in 2011 or 2012,

- You should know that the gift tax annual exclusion has increased to $14,000 per person ($28,000 for gift-splitting by a married couple) in 2013.

- If your spouse died after December 31, 2010 without using his or her entire unified exemption and a portability election was or will be made, you should consider making gifts to maximize the benefit of your spouse's unused exemption and to preserve it in the event that you remarry and survive your subsequent spouse.

- Even if the federal tax exemptions are likely to eliminate any federal estate tax on your estate, you should consider the impact of state death taxes, particularly if you reside in a state with a high state estate or inheritance tax, a low exemption, or both, such as New York or New Jersey, or if you own valuable real property or tangible personal property located in such a state. The estate tax rates in some states can be as high as 16%. Lifetime gifts may avoid or reduce these state death taxes.

- The Debt Ceiling and spending debate have raised concerns that budget proposals that are "revenue-raisers" with respect to gift, estate or GST tax may be adopted. These include proposals to limit the utility of Grantor Trusts, Grantor Retained

[3] Moreover, because the unified exemptions did not decrease, there is no longer even a slight concern that the exemptions used in 2011 and 2012 will be "clawed back" on the donor's death.

Annuity Trusts, and valuation discounts, and to cap the duration for which trusts may be exempt from GST. Taking advantage of these planning opportunities, which we have discussed with many of you and in prior newsletters, should be considered sooner rather than later.

- Because non-grantor, non-charitable trusts are taxed on undistributed income over the $11,950 threshold at the highest rates and are also subject to the Medicare surtax of 3.8%, a combined tax of 43.4% is possible. Therefore, income tax planning is now a more important part of trust administration than it has been in the recent past. It will be important to reconsider whether to distribute income in non-grantor trusts that contemplate or allow for the accumulation of income, even if those trusts are exempt from the generation-skipping tax. Distribution of trust income to a beneficiary will avoid the Medicare surtax to the extent the beneficiary's adjusted gross income, after the distribution, is below the threshold ($200,000 individuals, $250,000 for married filing jointly). Similarly, distribution of ordinary income from a trust to a beneficiary in a lower income tax bracket than 39.6% ($400,000 individual/$450,000 married filing jointly) may result in significantly less tax on that income.

- Depending on the size of your assets and the estate planning decisions you have made in the past, you may want to see if it is possible to terminate trusts previously established, even irrevocable trusts. For example, you may have created an irrevocable life insurance trust to pay federal estate tax when exemptions were lower. If the trust or the policy has become less desirable, you may be interested in taking steps to retain the policy without the trust structure or letting the policy go altogether.

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If you would like us to review your estate documents and/or advise you as to how the Act impacts your situation in particular, please let us know. We look forward to hearing from you.

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