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Trust UPDATE

February 2013

The new estate planning

Q&A on how the resolution of the "fiscal cliff" may affect your estate plans.

Most of the press coverage of the new tax law, the American Taxpayer Relief Act of 2012 (ATRA 2012), focused on where the new 39.6% income tax bracket would start. As important as that may be, other provisions of the new law may prove revolutionary for estate planning.

What happened?

The most important change is that, for the first time since 2001, provisions of the federal estate tax no longer have explicit expiration dates attached to them. They are as permanent as such provisions can be, and so they may be relied upon by estate planners.

The newly permanent provisions include: a $5 million federal estate tax exemption; inflation adjustments; an increase in the tax rate to 40%; and portability of the exemption between spouses.

What is the "portable exemption"?

Each spouse has a federal estate tax exemption. In the past, should the first spouse to die simply leave everything to the survivor, his or her exemption would be wasted. Routine trust planning, such as a "bypass trust," could remedy that problem, effectively doubling the size of a family fortune that could pass free of federal estate tax.

Now such planning is not required. Provided filing requirements are met, any "Deceased Spousal Unused Exemption Amount" (DSUEA) will pass to the surviving spouse.

Continued on next page

At a glance — **The key provisions of the American Taxpayer Relief Act that affect estate planning are:**

- Extension of the $5 million federal estate tax exemption.
- Federal gift and generation-skipping taxes exemption also set at $5 million.
- All exemptions indexed for inflation since 2011. Exemption for 2013 is $5.25 million.
- Estate tax rate increased to 40%.
- Federal estate tax exemption portable for married couples.
- All provisions are permanent; that is, they have no expiration dates.

Source: ATRA 2012; M.A. Co.

Does that mean trust planning is no longer needed?

Not at all. Although estate and inheritance taxes always have been a "hot button" to motivate people to meet with their advisors, in the vast majority of cases taxes have always turned out to be secondary. The larger issue is identifying one's property and one's heirs in order to make arrangements for the timely and problem-free settlement of one's estate. Asset management and asset protection strategies also come into play.

Two routine examples:

- Husband wants to provide for both his second wife and children from an earlier marriage. A QTIP trust may satisfy both desires.
- A bad divorce may prove more disastrous to the family fortune than any death taxes.

I already have a trust plan in my will. Do I need to change it now?

Probably not. Unlike some estate tax reforms in the past, this new law won't create problems or ambiguities in most existing wills or trusts. Although the tax advantages of trust planning have been made unnecessary in some cases, the other trust benefits remain. In particular, bypass trusts offer advantages, such as "estate freezing" and investment management, that the portable exemption lacks.

Still, we always advocate regular estate planning reviews, especially after major tax changes.

I haven't looked at my estate plans since 2001, because I couldn't forecast what death taxes might look like at my death. What should I do?

Make an early appointment with your estate planning advisors. One wag observed that "the procrastinators were rewarded" by the new tax law, because doing nothing turned out to have no penalty. But now there's no longer an excuse for delay. Your economic and family circumstances have doubtless changed since 2001, so will review is in order.

Are there any other estate tax changes on the horizon?

President Obama proposed several changes that would affect specific estate planning tax strategies. These could affect grantor-retained annuity trusts (GRATs) and valuation discounts, for example. These ideas could be revisited in any future tax reform.

A majority of states already have eliminated their death taxes. This came about because of the change from a state death tax credit to a deduction for state death taxes, a change that had an expiration date. Now that this has become permanent also, it's possible that more states will abandon their death taxes, given how few estates will need to file federal estate tax returns.

Is there still a chance that death taxes could be repealed?

Never say "never," but very few think repeal is likely in the near future.

There were two constituencies for eliminating the federal estate tax. The first advocated higher exemptions, so as to excuse more families from the obligation. The second wanted lower tax rates, perhaps the same rate as for long-term capital gains. The first group got what it wanted, the second lost decisively when the tax rate was increased, not decreased. This may be attributable to the fact that so many billionaires, such as Warren Buffett, have been so vocal in publicly advocating for estate taxes.

The combination of a high exemption and inflation indexing probably has taken much of the steam out of the death tax repeal movement, as so many families are now off the hook.

What about the "charitable IRA"?

That's been restored, but only for tax years 2012 and 2013. Under this provision, taxpayers who have reached age 70½ may direct up to $100,000 from their IRAs directly to charity. Such charitable gifts won't be included in income, but they will count as required minimum distributions. The tax effects of non-inclusion are often much better than the alternative of receiving a distribution, including making a charitable gift and taking an itemized deduction for it. For one thing, the direct gift avoids the new reduction in itemized deductions for higher-income taxpayers. See page 3 for additional details.

How can I learn more about how these tax changes may affect me and my family?

Just call on us. Please consider us your number one resource in wealth management. ☐

The new federal estate tax burden

For those who die in 2013, here is the federal estate tax due for various estates. For married couples, both spouses are assumed to die in 2013. Charitable deductions and administration expenses are not taken into account in this table.

Taxable estate	Single	Married couple
$5,000,000	$0	$0
$8,000,000	$1,100,000	$0
$10,000,000	$1,900,000	$0
$12,000,000	$2,700,000	$600,000
$14,000,000	$3,500,000	$1,400,000
$16,000,000	$4,300,000	$2,200,000
$18,000,000	$5,100,000	$3,000,000
$20,000,000	$5,900,000	$3,800,000

Source: ATRA 2012; M.A. Co.

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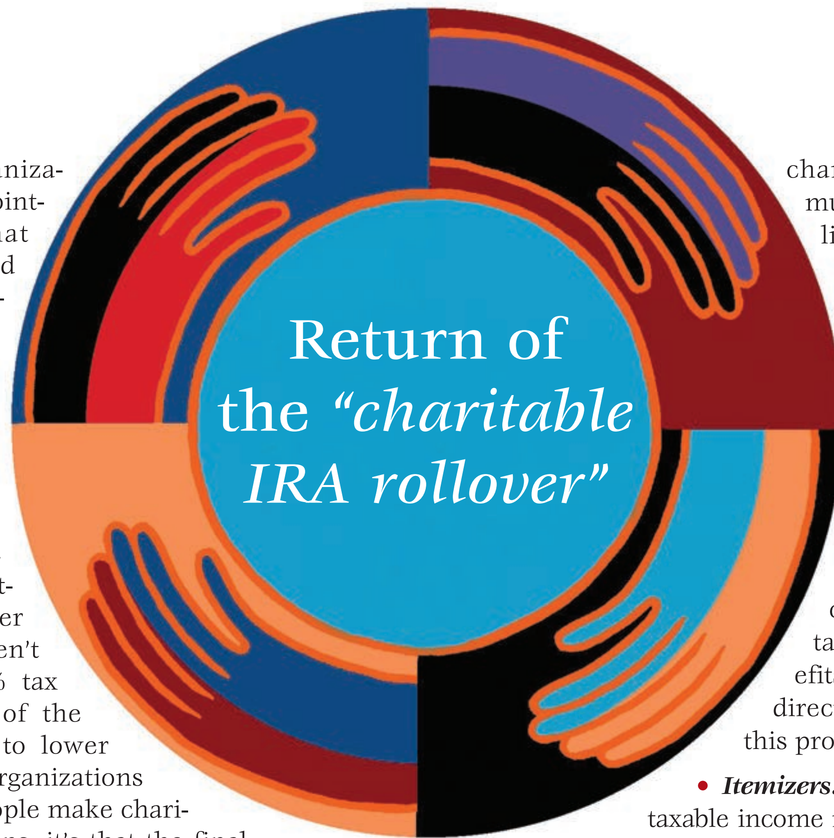
Return of the *“charitable IRA rollover”*



Many charitable organizations expressed disappointment in January that Congress had restored the reduction in itemized deductions for higher-income taxpayers. Deductions begin to phase out (but not more than 80%) for single taxpayers with more than $250,000 in adjusted gross income and marrieds filing jointly at $300,000. In other words, folks who haven’t yet reached the 39.6% tax bracket. Impairment of the deduction could lead to lower charitable gifts, the organizations reason. It’s not that people make charitable gifts for tax reasons, it’s that the final size of the gift is often linked to its after-tax “cost.” Reductions in deductions necessarily increase that cost.

On the other hand, charities were greatly cheered by the restoration of the “charitable IRA rollover.” This provision, first enacted in 2006 and consistently renewed since, allows some retirees to make direct transfers to charities from their IRAs. Unfortunately, this tax-saving opportunity was renewed only through 2013. Once again, the charitable community will have to fight for this tax provision to be extended to future years.

Conditions and benefits

The charitable IRA rollover is available to those who have reached age 70½. Up to $100,000 may be directly transferred by the IRA custodian to the charity. When handled properly, there are two favorable tax consequences: The gift is not included in the donor’s taxable income, but it does count toward his or her required minimum distribution (RMD) for the year. In past years, many retirees have simply directed their RMDs to charity.

The income tax exclusion for a transfer to charity from an IRA might not seem like such a big deal. After all, one always has been allowed to follow an IRA withdrawal by a charitable contribution and claim an income tax deduction. But it *is* a big deal, because the full benefit of that deduction is not available to all taxpayers.

- ***Nonitemizers.*** Roughly two-thirds of taxpayers do not itemize their deductions, even in the upper tax brackets.
- ***Big donors.*** Percentage limits on the charitable deduction mean that some donors can’t take a full charitable deduction in the year that they make a gift. They can carry the deduction forward to future years, but the charitable IRA rollover is much better. No percentage limits (just the $100,000 cap), and the excluded amount is not aggregated with other charitable gifts for the year in determining whether the percentage cap has been breached.
- ***Social Security recipients.*** An increase in taxable income may cause an increase in the tax on Social Security benefits for some taxpayers. The direct gift from an IRA avoids this problem.
- ***Itemizers.*** An increase in adjusted taxable income raises the floor for deductions of casualty losses, medical and dental expenses, and miscellaneous itemized deductions. The direct gift isn’t brought in to these calculations.

Watch out

A few caveats to keep in mind.

- The donor may not receive anything of value in exchange for the gift from the IRA. If something of value—even as little as $25—is received, the entire exclusion from income is lost.
- The gift must happen *after* the donor has reached age 70½, and not merely be made during the year the donor reaches that age (which is the rule for required minimum distributions).
- The exclusion is only available for direct charitable gifts from traditional and Roth IRAs, not from 401(k) plans, Keoghs, or other tax-qualified retirement plans. Even those plans that are built on IRAs, such as SEPs and SIMPLE retirement plans, are not included. However, it may be possible to arrange a tax-free rollover from such plans to a traditional IRA, and from there make the charitable gift.
- Married couples may exclude up to $200,000 for direct gifts, but only if each spouse has an IRA as the source of the donation.
- Inherited IRAs may have RMDs for younger taxpayers. They don’t get the benefit of this charitable transfer rule. A charitable rollover may be made from an inherited IRA, but only if the beneficiary has reached age 70½.

Be sure to consult with your tax advisors before making any decisions that you might not be able to reverse.☐

Stolen identity refund fraud

Stolen identity refund fraud (SIRF) has become a major headache for the IRS. There were 51,000 confirmed cases in 2008, and that exploded to 1.2 million in 2012. An estimated $20 billion in fraudulent refund claims were blocked in the first ten months of the year. The IRS has doubled the number of personnel dedicated to just this problem and trained an additional 35,000 agents on how to help the victims of this crime.

Remarkably, many of the frauds originate in prisons! For example, on January 16, 2013, a Georgia inmate pled guilty to claiming $3.4 million in fraudulent tax refunds. He was in jail for filing a fraudulent state tax return. The IRS had paid him $2.8 million before he was caught. Fraudulent tax returns from prisoners doubled from 45,000 in 2009 to 91,000 in 2010, according to a January report by the Treasury Inspector General.

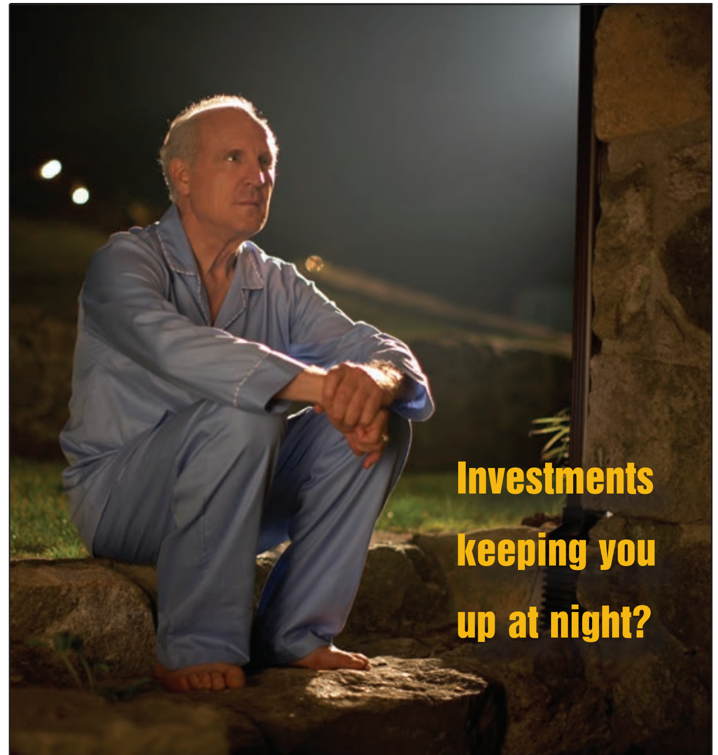
The extra steps that the IRS is taking to screen for identity theft, coupled with the very late tax changes from Congress, could delay refunds this year.

Volatility in tax collections

Federal tax receipts spiked in December, amid the uncertainty of the "fiscal cliff" resolution. They were up by 10% compared to December 2011. The reason was a record number of special dividends, 1,056 from public companies, according to Standard & Poor's. Some 483 of these came in December, more than three times the year-earlier level. One prominent example was Costco, which borrowed $3.5 billion to pay a special dividend of $3 billion. These actions locked in a 15% tax rate for shareholders, many of whom are looking at a 23.8% rate on dividends this year.

Tax receipts may be expected to fall, because the special dividends are not likely to be repeated. What's more, the interest on borrowings by companies such as Costco is deductible, and dividends are not, so the tax base shrinks.

Another reason to expect falling federal tax revenue is that after the income limits were dropped on conversions of IRAs to Roth IRAs, hundreds of thousands of account holders reportedly took advantage of the opportunity in 2011 and 2012. They paid income taxes in those years for the privilege, but they won't be paying income taxes again on distributions from these accounts. ☐



Are you managing your investments, or does it seem that they are managing you?

Some folks are able to manage their careers, their families, their health and their investments without ever breaking a sweat. If you are not in that select group, if your portfolio management would benefit from the assistance of an experienced, unbiased and professional team, please call upon us. That's the kind of investment service that we provide.

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