Stepping Stones

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Planning Under the New Federal Estate Tax Laws

Lawrence D. Hunt

On January 2, 2013, the American Taxpayer Relief Act of 2012 (the "Relief Act") was signed into law. This law was in response to the fiscal cliff which threatened to increase taxes across the board in January. The law makes sweeping changes to a broad range of tax laws, not the least significant of which lends some degree of permanency to estate and gift taxes.

Of note, the gift and estate tax rates were increased from 35% to 40%. The estate and gift exemptions remain at $5,000,000 as well as the generation skipping transfer ("GST") tax exemption. The GST tax is a federal tax designed to ensure that taxes are paid at each generational level and applies to transfers of property to persons who are two or more generations below the transferor. These transfer tax exemptions will not be eroded through inflation since they are scheduled to increase annually. In 2012, the inflation-adjusted exemption amount was $5,120,000. In 2013, this amount is $5,250,000. This inflationary increase provides a unique planning tool. Traditionally, a client who has consumed his or her federal exemption can rely only on the gift tax annual exclusion to make additional gifts to family members. (The annual exclusion was $13,000 in 2012 and is $14,000 for 2013.) However, the annual inflationary increase allows a wealthy client who has consumed all of his or her federal exemption through prior lifetime gifts to plan to make additional, significant gifts in each new year.

Through careful and deliberate planning, wealthy clients can use the opportunities provided by the new law to reduce their taxable estate and provide valuable benefits to their families and loved ones.

The Relief Act also makes permanent the provision which allows a surviving spouse to preserve the unused estate tax exemption of his or her deceased spouse, to be applied to transfers at the survivor's death. This idea of portability was initially introduced in 2011, and until January was scheduled to be eliminated with the sunset provision. While portability could eliminate the need to capture the deceased spouse's exemption through the use of a credit-shelter trust, wealthy individuals should still undertake careful planning. Portability does not account for inflation. On the other hand, not only the principal amount of assets placed in a credit-shelter trust at the death of the first spouse, but also all of the appreciation on those assets, will pass estate-tax free upon the death of the survivor. Furthermore, the GST tax exemption is not portable, and use of trusts could be helpful in reducing or eliminating GST taxes in the right circumstances. Finally, portability does not take into account the non-tax reasons for creating a trust, such as protecting the assets in a divorce or from other creditors.

While the Relief Act makes many changes to income taxes, one in particular is of interest in the context of estate planning. The new law revives the IRA charitable rollover provisions which originally expired in 2011. The IRA charitable rollover allows an individual who is 70½ or older to make a tax-free distribution from his or her IRA directly to a charity through December 31, 2013. Such a distribution will not be included in the individual's income, and is not subject to the charitable giving limit of 50% of adjusted gross income.

Taxes, Taxes and More Taxes: Important Income Tax Law Changes Under the American Taxpayer Relief Act of 2012

David C. Morganelli

The tax law changes under the 2012 Relief Act are not limited to estate, gift and GST taxes. As one might expect, the Relief Act included some significant income tax changes.

Major changes were made to the income tax rates for taxpayers with income over $450,000. Under the Relief Act, the income tax rates for individuals will generally remain at 2012 levels for lower income taxpayers; however, a new top rate of 39.6% now applies to taxable income over $450,000 for married taxpayers filing jointly (this ceiling varies depending on filing status, *e.g.*, married filing jointly, single or head of household). Importantly, long-term capital gains and qualified dividends for taxpayers in the 39.6% bracket will be taxed at a 20% rate.

Itemized deductions may be more limited now. For example, married couples with income of $300,000 or more must reduce their personal exemptions by 3% of the amount by which adjusted gross income ("AGI") exceeds the $300,000 threshold amount. Keeping it simple, if AGI is $500,000 and total itemized deductions for a married couple before the limitation is $100,000, then deductible itemized deductions would be adjusted downward by $6,000 to $94,000 ($500,000 minus $300,000 equals $200,000 x 3% is a $6,000 reduction). A similar phase-out adjustment will also apply to total personal exemptions. The total amount of personal exemptions that can be claimed by a taxpayer subject to the limitation is reduced by 2% for each $2,500 by which the taxpayer's AGI exceeds the applicable threshold. The threshold amounts are the same as those for the itemized deduction limitation. Using the same married couple as before, their total pre-phaseout exemption of $7,800 ($3,900 for each person) would, accordingly, be entirely eliminated.

Alternative Minimum Tax

Importantly, the Relief Act permanently indexed the alternative minimum tax ("AMT") exemption amount for inflation. For 2012, the exemption amounts are $78,750 for married taxpayers filing jointly and $50,600 for single filers. The Relief Act also retains the prior relief from AMT that was provided in 2001 under the Economic Growth and Tax Relief Reconciliation Act for nonrefundable credits.

Planning Techniques

Politically motivated attempts to reduce the use of certain planning techniques, such as the use of valuation discounts on related party transactions, or to extend the minimum term of grantor retained annuity trusts ("GRATs") to 10 years, or even to eliminate the income and gift tax benefits related to use of intentionally defective grantor trusts ("IDGTs") were successfully avoided. In essence, the estate and business succession strategies that have been historically available to the high-net-worth taxpayer appear to still be available and worth consideration.

Medicare Surtax

The Relief Act contains a 3.8% Medicare surtax that applies to investment income when established income levels are satisfied depending on filing status – for example, the tax kicks in when married couples filing jointly have AGI of $250,000 or more. Investment income includes interest, dividend, capital gains, and some passive income. Investment income does **not** include wages, income from a nonpassive business, social security benefits, tax exempt interest, self-employment income, or distributions from qualified retirement plans, 401(k) plans, and IRAs. Net investment income gains include gains from the sale of stocks, bonds, and mutual funds; capital gain distributions from mutual funds; and gains from real estate and certain business interests. The tax also applies to the gain on the sale of a personal residence to the extent the personal residence exemption from capital gains does not apply (the personal residence exemption is $250,000 for individuals and $500,000 for married couples). Investment income is reduced by eligible investment expenses for purposes of the surtax.

The surtax applies to the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount. Again, using the same example of a married couple filing jointly with AGI of $500,000, subject to an AGI threshold of $250,000, investment income of $60,000 and investment advisory fees of $10,000, the Medicare surtax would be applied to the lesser of $250,000 (*i.e.*, $500,000 minus the $250,000 threshold) or net investment income of $50,000 (*i.e.*, $60,000 minus $10,000 in advisory fee expenses). In this example, the surtax would be $1,900 ($50,000 x 3.8%).

Additional Medicare Tax on Earned Income

Beginning in 2013, individuals will pay an additional 0.9% Medicare Hospital Insurance Tax on wages and self-employment income on amounts earned above the same threshold amounts applicable to the Medicare surtax. If income exceeds the threshold amount, the employee's share will increase by 0.9%. Note that the total Medicare Hospital Insurance Tax was formerly 2.9%, shared between employer and employee at 1.45% apiece. If the income thresholds are triggered, the employee's share will increase by 0.9%, and for self-employed individuals, the rate will increase from 2.9% to 3.8%.

A Life Insurance Review Can Provide Positive Investment and Planning Results

Deborah DiNardo

Old life insurance policies are often overlooked assets. Permanent life insurance contracts (whether whole, universal or variable) can be valuable investments into which you have poured significant premium payments over the years but to which you may have paid little or no attention. Unlike other investments such as your business or stock portfolio which you likely monitor regularly (if not daily!), your investment in life insurance might not get the same attention. The policy may be left in a drawer or safe deposit box and the only contact with the policy is that pesky premium notice!

We find that clients are often surprised when they undertake a review of their old life insurance policies. Internal growth in the value of the contract may have increased to such an extent that further premiums are unnecessary. Sometimes, clients learn that their "old" permanent life insurance contracts are no longer efficient.

For instance, changes in mortality tables and interest rates over the years enable clients who remain insurable (and therefore able to be underwritten for a new contract) to use the equity in "old" policies to purchase new ones which are more cost-effective and obtained at a more favorable cost. Other clients have taken the step of converting policies to "paid up," using the current equity in their policies to secure a certain death benefit while eliminating the need for more premium payments. Clients have used the increased internal value of "old" life insurance contracts to pay tuition expenses for children and grandchildren, as well as for their own enjoyment in retirement when the full amount of death benefit is no longer needed or desired.

These opportunities may apply whether you own your life insurance contracts individually or they are owned by an irrevocable life insurance trust (commonly known as an ILIT).

Clients sometimes cancel life insurance for various reasons – due to changes in circumstances over the years when tuitions have been paid, the house mortgage is paid, or they have sufficient liquidity to pay estate taxes. Before cancelling a permanent life insurance policy, care should be taken. Not all permanent life insurance policies grow internally in value as clients may have anticipated when they purchased this form of insurance. If the internal value of the policy (generally known as the "surrender value" or "cash value") is less than the total premiums paid into the contract over the years, you may not deduct this "investment loss" on your personal income tax return or utilize it to offset other investment gains. However, you may preserve this investment loss for potential future use if, rather than cancelling the insurance policy, you transfer the remaining internal value into an annuity. People are not aware that it is possible to effect a tax-free exchange from a life insurance policy to an annuity, as well as from one life insurance policy to another.

The Internal Revenue Code includes several provisions which may enable you to make better use of this "old" insurance without adverse tax consequences. Start with a thorough review of your old contracts, which your insurance advisor can readily provide. Then, confer with your accountant and legal advisors to find out if your insurance policies can be better utilized as part of your overall personal plan.

Announcements

As President of the Board of Trustees for the Zeiterion Theatre Performing Arts Center in downtown New Bedford, **Lawrence D. Hunt** is helping to secure a long sought-after contract from the City of New Bedford to manage the city-owned theatre building. This contract will provide funding for management of the theatre for use by other arts and culture organizations in the SouthCoast region.

Linda G. Sears, Senior Paralegal, is Chair of the PS&H CFS Committee, established to support the local nonprofit organization, Children's Friend and Service (CFS). In January, the Firm donated 25 coats for 25 children served by CFS as part of the PS&H 25/25 initiative to celebrate the Firm's 25th Anniversary.

Marvin S. Silver was named Worcester Regional Chamber of Commerce Ambassador of the Month for December/January.

Referrals Welcome

Our Firm relies on satisfied clients as an important source of new business.
We welcome and value your referrals. Thank you for your consideration.

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Contact your attorney in the Trusts & Estates Group for a consultation on how these issues may impact your situation. Our attorneys are admitted to practice in Rhode Island, Massachusetts and Florida. Through our association with Meritas, an organization of worldwide independent law firms with broad-based practices, Partridge Snow & Hahn LLP offers its clients access to quality legal services on a national and international basis.

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