Stepping Stones

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Consider Capital Gains Taxes When Gifting

Marvin S. Silver

With the passage of the American Taxpayer Relief Act of 2012 ("ATRA 2012"), certain provisions of the federal estate tax law no longer have specific expiration dates that would cause them to "sunset". For the first time in a dozen years, the federal estate and gift tax laws are "permanent" subject to any future Congressional action.

With the passage of the 2010 Tax Act, the federal estate tax exemption (which had increased from $1,000,000 in 2002 to $3,500,000 in 2009) and the federal gift tax exemption (which remained at $1,000,000) were again "unified". The new unified exemption protected asset transfers up to values of $5,000,000, the highest level in history. ATRA 2012 retained the high exemption level and provided a mechanism for further increases through annual inflation adjustments. The adjustment in 2013 raises the exemption level to $5,250,000. [1]

With relatively high exemption levels for gift taxes, it is tempting to consider significant lifetime gifting whenever a person is able to retain sufficient assets for his or her needs. However, it is still important to consider which property is appropriate to gift since the choice of property may create adverse income tax consequences for beneficiaries.

When considering the choice of assets to be transferred by lifetime gift, it is important to consider the income tax basis for those assets. When assets are held until the date of death, in most cases (the most notable exceptions are IRA accounts, qualified plans, and annuities), the assets will receive a "stepped-up basis" to the value at the date of death. The stepped-up basis often allows the recipient of an inheritance to escape capital gains taxes on the appreciation in value from the time that the deceased owner acquired the property to the date of the owner's death. On the other hand, when appreciated property is gifted by a donor during his or her lifetime, the recipient receives the cost basis of the donor. (This is often referred to as "carryover basis".) The receipt by the donee of the donor's income tax basis may ultimately result in a significant capital gain when the donee later sells the property. If a taxpayer wants the donee to receive and retain the full value of the gifted property, consideration should be given to gifting property that has little or no appreciation. In light of the recently increased capital gains rates for high income taxpayers and the new health care surcharge, this becomes more important.

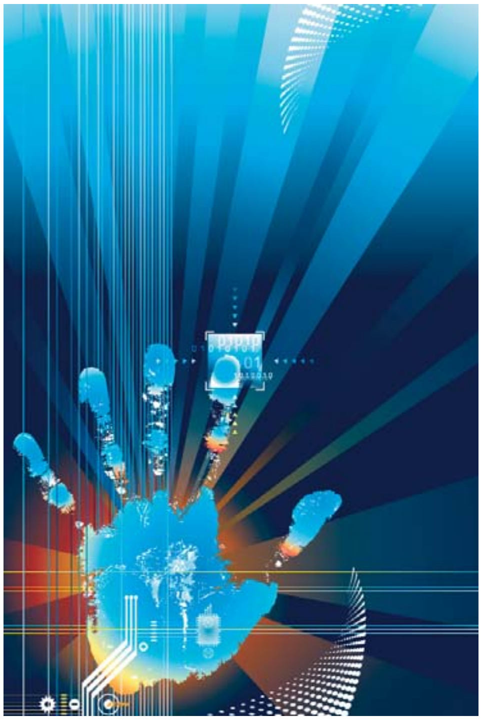
In addition, residents of Massachusetts and Rhode Island must consider the impact of state income taxes. The recognition of capital gains by the donee of gifted property who resides in states with a state income tax, will create additional tax liability.

When making a substantial gift, one should consider not only the present value of the property, but also its cost basis. Consultation with a qualified professional is recommended in order to minimize the impact of all taxes.

[1]ATRA 2012 increased income tax rates, including capital gains tax rates for individuals with taxable income above certain levels. Prior to the new law, most long term capital gains were subject to a 15% federal income tax rate. Under ATRA 2012, a new 20% capital gains rate is imposed beginning in 2013 when taxable incomes exceed $400,000 for single individuals and $450,000 for married couples filing jointly. In addition, the new net investment income tax (sometimes referred to as the "3.8% health care surcharge") will apply to single individuals with net investment income that exceeds $200,000 and for married couples filing jointly with such income exceeding $250,000. This will cause the effective federal capital gains tax rate for these taxpayers to be 23.8% beginning in 2013.

Estate Planning for Digital Assets

Kristin N. Matsko



Planning for digital assets and accounts is becoming more prevalent as an increasing amount of our significant daily activities, such as banking, shopping, and socializing, have moved from bricks-and-mortar to online. This paradigm shift presents issues for clients who want to plan for the disposition of digital assets and accounts. "Digital assets" are files, including emails, documents, audio, video and similar files stored on digital devices such as desktop computers, laptops, tablets and smartphones. "Digital accounts" are email accounts, software licenses, social network and social media accounts, financial management accounts, and other online accounts.

In 2012, rumors circulated that actor Bruce Willis was contemplating filing a lawsuit against Apple arguing that his children should be allowed to inherit his Apple iTunes music collection upon his death. Although no legal action was commenced, Apple remained steadfast that downloaded music is not proprietary and is non-transferable from one user to another, even after death.

Traditionally, many people desire to leave personal items such as books, records and other mementos to loved ones from a sentimental perspective as a part of his or her personal history. In the digital age, users may also wish to pass along their Facebook, Flickr, and Instagram accounts because of their "storytelling" capability.

As indicated, some digital assets are personal; others like online banking, online tax preparation services, and business management accounts, serve a utilitarian function. Access to these accounts can be critical following the account owner's death. Without planning a family member may be unable to access a bank account to pay necessary bills until a significant amount of time has passed and a certificate of appointment is obtained from the probate court.

Digital service providers each create their own Terms of Service Agreements that users must agree to in order to use the service and each of these agreements is different. There may be little flexibility for the user to make his or her own choices about the disposition of the digital account because he or she may have already entered a binding legal contract with the service provider. Some companies are beginning to offer limited options respecting post-mortem access to decedents' accounts. For example, Facebook offers authorized individuals the option of deleting a member's account or creating a "memorialized" account. In April 2013, Google became one of the first digital service providers to offer users the option of deleting some or all of the account data after a designated period of inactivity, or to pass data from the account along to one or more other designated individuals. Actual control of accounts is not transferred – only the data contained in the accounts.

There are still measures that our clients can take to attempt to address disposition of digital assets:

- Compile a comprehensive list of existing online accounts and passwords.

- Create two (2) separate documents: one with usernames and security questions and a second with passwords and answers. Note whether each account should be deleted, closed, or maintained upon your death or incapacity. Keep the documents in two separate, secure places and tell a family member or friend where the documents are located.
- Talk to your attorney about adding specific language to your financial power of attorney to give your agent access to your online accounts. Consider whether there are any accounts that your agent should NOT access.
- If the fiduciaries you have designated in your estate planning documents are not "tech-savvy", consider designating a knowledgeable family member or friend to assist your fiduciaries in the event of your death or incapacity.

An Alert for Life Insurance Trusts: Administration Counts

Deborah DiNardo

The Internal Revenue Service ("IRS") continues its trend of reviewing the administration of irrevocable life insurance trusts as part of the audit process of gift and estate tax returns. The irrevocable life insurance trust ("ILIT"), known often as a "Crummey Trust", has long been a favorite target for IRS attack. Since 1968, when Mr. Crummey won a significant lawsuit against the federal government, the IRS has tried to eliminate this popular planning vehicle from the taxpayer's tax savings arsenal. Although successful in eliminating other planning vehicles of the period such as the "Crown Trust" and the "Clifford Trust", the IRS has failed to crush the ILIT.

The ILIT is so popular because life insurance owned by an ILIT and payable to the ILIT when the insured dies may be completely excluded from the insured's taxable estate. However, achieving this estate tax savings is dependent in large part on proper trust administration procedures.

The Crummey Trust is sometimes referred to as being more about process than substance. Dotting the i's and crossing the t's has been the hallmark of prudent trust administration for ILITs. The trustee should be diligent about following best practice procedures in administering the trust so that the trustee will be in the best possible position to withstand IRS scrutiny. Failure on the part of the trustee to establish and consistently follow recommended procedures may result in an unintended tax consequence; inclusion of the life insurance in the insured's taxable estate.

We recommend that our clients and their ILIT trustees conduct a periodic review, preferably annually, of the procedures which are being followed by the trustee in the administration of the trust. We urge trustees to improve administration procedures if need be. This is particularly important if the trustee is not a professional trustee and therefore less familiar with the best practices which an ILIT trustee ought to follow to preserve the tax savings goals of the insured.

Many ILIT trustees hire a professional trustee as agent to perform some administrative functions of the trust and thereby relieve the trustee (frequently a family member or friend of the insured) of the stress and burden. Having an appropriate agent (such as an attorney, accountant or trust company) could be well worth the cost, particularly if significant amounts of life insurance are at risk of inclusion in the insured's taxable estate.

In my practice, I have seen too many unfortunate situations where neither the insured nor the trustee followed recommended best practices in the administration of the ILIT and the IRS has been successful in including the life insurance in the insured's taxable estate, much to the dismay of the insured and the beneficiaries.

Highlights of the type of information and detail which the IRS continues to scrutinize include: (1) source of funds used to pay the premiums, (2) location of the original life

insurance policies funding the ILIT and records of trust activity (is the trustee in custody of these important items, or has the insured failed to give up control), (3) to whom are premium notices sent by the insurance company, (4) evidence of the beneficiary notification required whenever a gift is made to the ILIT, and (5) filing of any required federal gift tax returns. (With ILITs, it is particularly important to address the proper allocation of the federal generation skipping transfer tax exemption on a gift tax return; we find this is often overlooked as well.) Often-times clients may feel that the recommended procedures for prudent ILIT administration are unnecessary and labor-intensive. However, the potential estate (and generation skipping) tax savings achievable when an ILIT is properly administered should inspire the insured and the trustee. Under current law, the maximum estate and gift tax rate is 40%. How unfortunate for the beneficiaries to lose 40% of their potential inheritance simply because best practices were not followed in the administration of the ILIT.

All is not lost if you discover that your ILIT may not have been administered as it ought. Appropriate action can be taken to address administration lapses and set the ILIT on a new path to best practices administration. Talk to your personal planning counsel for advice to protect your insurance investments and tax dollars.

Did You Know?

Delta Airlines recently amended its Skymiles Frequent Flyer Program to prohibit transfer of a participant's miles upon his or her death. United, JetBlue and Southwest Airlines have similar policies in place. Currently, US Airways, Alaska and American Airlines still permit frequent flyer miles to be transferred upon death. Rewards program participants should consider using their miles as quickly as possible instead of amassing a large amount of miles that may never be used.

We are Moving to a New Location

Partridge Snow & Hahn LLP celebrates its 25th Anniversary in 2013. We are very proud of this accomplishment and are very thankful for our association and friendship with you. In September, we will celebrate our growth in another way: by moving our Providence headquarters into a much larger space on three floors of the Textron Building at 40 Westminster Street. The move will give us more room for growth during our next 25 years.

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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