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WE SURVIVED THE DROP OVER THE CLIFF. NOW WHAT?

Last Tuesday, President Obama signed into law the American Taxpayer Relief Act of 2012 (the "Act"), which was the legislative result of the Federal government's attempt to address the so-called "fiscal cliff." Below is a summary of the provisions of the Act that impact tax aspects of estate planning.

The Act permanently repeals the infamous "sunset" provision in the 2001 tax legislation and provides some degree of stability where, previously, the Federal estate, gift and generation-skipping transfer ("GST") tax rules changed almost annually for more than a decade.

What is Now Permanent:

- <u>Exemption Amounts</u>. The Act makes permanent the amount of the unified gift and estate tax exemption, as well as the GST tax exemption, available to a U.S. citizen or resident. In 2012, these exemptions were $5.12 million per person. The inflation adjusted amount of the exemptions for 2013 is estimated at $5.25 million per person.[1]

- <u>Tax Rates</u>. The Act increases the Federal estate, gift and GST tax rate to 40%. The new rate is higher than the 35% rate in effect last year but also much lower than the maximum 55% rate that would have applied to large estates and gifts in the absence of the Act.

- <u>Spousal Portability</u>. The Act makes permanent the "portability" of the estate and gift tax exemption between spouses. Portability, which was which first introduced in 2010, allows a surviving spouse to apply the unused Federal estate and gift tax exemption of his or her deceased spouse to gifts or bequests made by the survivor, to shelter them from tax. Portability requires an election on an estate tax return of the first spouse to

[1] While not a feature of the Act, a similar inflation adjustment in the annual exclusion amounts for gift and GST tax purposes has increased the amounts to $14,000 per donee (or $28,000 if "gift-splitting" between spouses is in effect).

die and is not available for Federal GST or New York State estate tax purposes.[2]

What has not Changed (for now):

Importantly, the Act did not introduce several changes proposed in the President's 2013 budget (the "Greenbook"), thus allowing, at least for the time being, the continued use of certain popular estate planning strategies. These strategies include:

- Use of Grantor Trusts for Estate Tax Planning Purposes. Properly designed grantor trusts allow individuals to continue to pay income taxes on assets already removed from their taxable estates without gift tax consequences, even though the enhancement of a trust's value by the payment of those income taxes – and the corresponding reduction in size of the grantor's estate – is the equivalent of a tax-free gift to the trust beneficiaries. Grantor trusts also permit leveraging the transfer of assets worth many times the size of the gift tax exemption amount with debt, because neither the transfer nor the payments on the debt have any income tax effect. While the 2013 Greenbook included proposals that would effectively eliminate the income and estate and gift tax advantages of grantor trusts, these were not enacted.

- Use of Short-Term Grantor Retained Annuity Trusts ("GRATs"). Under current law, GRATs can be structured to allow the transfer of the appreciation on an asset in a very short period of time at no gift or estate tax cost. The only risk to a GRAT is the grantor's death during the trust term, in which case the assets of the GRAT are (typically) includible in the grantor's taxable estate. Under current law, that mortality risk may be minimized by creating GRATs as short as two years. The Greenbook proposal sought a minimum ten-year term for GRATs, as well as some minimum gift tax cost upon creation of GRATs. For now, however, the use of short-term GRATs at no gift tax cost remains a viable strategy.

- Valuation Discounts for Intra-Family Transfers. Under current law, the estate and gift tax valuation of partial interests in property, such as non-controlling interests in family LLCs or partnerships, may yield substantial

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2 Our February 8, 2011 and June 27, 2012 Client Alerts discuss portability in greater detail; http://www.leshkowitzlaw.com/2-8-2011-memo.pdf and http://www.leshkowitzlaw.com/6-27-2012-memo.pdf.

discounts from the value of the underlying assets by application of "market" discounts for lack of control and/or marketability. While the IRS perceives these discounts in an intra-family context as manufactured for tax avoidance purposes (and has thus proposed eliminating them), these discounts can continue to be applied, where appropriate, and will generate tax savings.

Clients who were galvanized into completing significant and well-considered estate planning transactions before the end of 2012, because of the uncertain tax environment, have no reason to regret all of that work, and should expect to see the benefits of that planning as transactions mature during the years to come. For clients who have not yet done so, the Act provides greater certainty and continued opportunity for future planning.

We are available to advise our clients in determining what the Act means for their particular situation, or to discuss any other estate planning matter.

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