July 16, 2013

Estate Planning Update - July 2013

FOLLOW-UP TO 2012 GIFTING

Because of the uncertainty over the future of the federal estate, gift and generation-skipping transfer (GST) tax exemptions through the end of last year, many individuals made significant taxable gifts to trusts for their families in an attempt to capture the then current $5,120,000 federal exemption amounts before a possible decrease. As it turned out, those higher exemptions were in fact made permanent by the American Taxpayer Relief Act of 2012, signed into law on January 2, 2013. Now that the dust has settled on these gifts, it is appropriate to review a few planning notes.

- **Trust Assets**. Some of the trusts established at the end of last year were funded with cash, which made the initial transfer simpler and ensured the transfers would be completed before year end. In those cases, this is an appropriate time to review the trust's investments. In many cases, it may be advantageous to "pool" the trust's investment assets with similar investments of other family members, using a limited partnership or limited liability company (LLC) structure. In addition, if the trust is a "grantor" type trust, transactions between the trust and the settlor (the person who set it up) are disregarded for income tax purposes, and assets the settlor owns can be swapped for assets of equivalent value in the trust without recognizing capital gain for any unrealized appreciation.
- **Trust Administration.** It is important for your tax preparer to be aware of the trust, to ensure the trust's income is properly reported. Many of these trusts were established as grantor trusts using the settlor's Social Security number as its taxpayer identification number, meaning a separate trust return is not required but the income must still be reflected on the settlor's individual income tax return. Gift tax returns on extension until October 15, 2013, must be carefully prepared to reflect these gifts, including consideration of the advisability of electing "gift-splitting" between spouses and treatment of generation-skipping transfer tax exemption.
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  In addition, if the trust included provisions qualifying gifts to the trust for the annual exclusion, it is important to confirm any required notices are sent to the trust beneficiaries whenever a gift is made to the trust.
- **Additional Gifting.** The now-permanent federal transfer tax laws provide for an annual inflation adjustment for the estate, gift and GST tax exemptions. Thus, even those who made maximum exemption gifts of $5,120,000 in 2012 have an additional $130,000 of exemption available for use in 2013. (Connecticut residents should consider the effect of Connecticut's $2,000,000 exemption on any additional gifting.)

YEAR-END PLANNING

It is never too early to think about year-end planning strategies, including the following items.

- **Annual Exclusion Gifts.** Annual exclusion gifts, either outright or to appropriate trusts, remain one of the simplest and most effective ways of transferring wealth to your family without transfer taxes. The annual exclusion amount for 2013 has increased to $14,000 per individual. A married person can transfer $28,000 per individual if the gift is reported on a gift tax return that reflects the spouse's consent to gift-splitting.
- **Additional Exemption Available.** The federal estate, gift and GST tax exemption amounts have increased to $5,250,000 for 2013. As noted above, even those who made significant gifts in 2012 to capture their then-available exemption amounts have an additional $130,000 (or $260,000 for a married couple) available for 2013 gifts.

- **<u>IRA Rollover.</u>** The IRA charitable rollover remains in effect for 2013 (but is not presently scheduled to be extended in the future). This provision permits direct distributions from an IRA to be excluded from income and to count as part of the required minimum distribution for individuals over age 70.

LEGISLATIVE DEVELOPMENTS

President Obama's budget plan for fiscal year 2014, released in April of this year, includes a number of proposed changes to the estate, gift and generation-skipping transfer tax laws. **Many of these changes have been proposed in the past without being enacted, and therefore we share these proposals more as a matter of interest than as a warning of likely legislation.** However, because they are part of the president's budget plan, you should be aware of them.

- **<u>Return to 2009 Transfer Tax Levels.</u>** The federal estate and generation-skipping transfer tax (GST) exemptions would be lowered to $3,500,000, and the gift tax exemption would be lowered to $1,000,000. (All three exemptions are $5,250,000 for 2013 and indexed for inflation in future years.) In addition, the tax rate would be increased to 45 percent from the current 40 percent. Although this proposal has appeared before, it is striking for two reasons: (1) The tax law passed in 2012 made current rates permanent, and many assumed there would be no further legislative activity in this area; and (2) the changes would not go into effect until January 1, 2018.
- **<u>Minimum GRAT Terms.</u>** Grantor-retained annuity trusts (GRATs) funded after the date of enactment would be required to have a minimum term of 10 years and a remainder value greater than zero (currently there is no stated minimum value). This proposal increases the possibility that the person setting up the GRAT would not survive the GRAT term. Because surviving the GRAT term is required in order to achieve the tax benefits of a GRAT, a 10-year minimum term would make "mortality risk" a significant consideration to weigh in deciding whether to use GRATs in the future.
- **<u>Limit Duration of GST Exemption.</u>** For transfers on or after the date of enactment, the GST-exempt status of a trust would terminate after 90 years. After that time, transfers from the trust would again be subject to transfer taxation. This change would have little effect on trusts established in jurisdictions that currently have similar limitations on the duration of trusts, including Connecticut, Massachusetts and New York. For trusts established in jurisdictions that have extended or even eliminated the maximum term of a trust, including New Jersey, Florida and Delaware, the tax planning benefits of these trusts would be limited to no more than two or three generations, in most cases.
- **<u>Coordinate Income and Transfer Tax Rules Applicable to Grantor Trusts.</u>** Certain trusts are now treated as being owned by the person setting them up (the grantor) for income tax purposes but are not included in the grantor's estate at death. Earlier proposals had effectively called for a broad elimination of these so-called grantor trusts, which would have severely limited the effectiveness of many common estate planning techniques, including insurance trusts. The current proposal is more narrowly tailored and only affects grantor trusts that engage in a sale transaction with the grantor. In that case, the portion of the trust involved with the sale transaction will be included in the grantor's estate and subject to estate tax. This proposal would be effective for sales on or after the date of enactment, presumably including those involving trusts previously established, although there is regulatory authority to create exceptions.
- **<u>Limitation on HEET Trusts.</u>** Gifts made by a donor directly to a medical or educational provider for the benefit of a grandchild are excluded from both gift and generation-skipping transfer (GST) taxes. This exclusion currently applies to transfers from a trust. This makes a Health and Education Exclusion Trust (HEET), which permits distributions to medical or educational providers or to charity, an effective vehicle to provide for future generations without using GST tax exemption. The current proposal, introduced for the first time in the 2014 budget plan, would eliminate the GST exclusion for trust distributions for trusts created after the date the bill is introduced and for transfers after that date to existing trusts. Existing HEETs would continue to operate as intended, but care should be taken before making any additions to those trusts. Those individuals interested in establishing a HEET may wish to take steps to complete and fund the trust promptly.

These proposals have not yet been introduced as legislation, so no immediate action is necessary. However, if you have not updated your documents in the last few years, this may be an appropriate time for a review of your estate plan to ensure it still meets your estate planning needs and objectives in light of the current tax laws and these proposals.

SUPREME COURT DOMA RULING

On June 26, the Supreme Court released its decision in *United States v. Windsor*. The Court held that Section 3 of the Defense of Marriage Act (DOMA), defining "marriage" as exclusively a union between a man and a woman and "spouse" as a person who is married to someone of the opposite sex, is unconstitutional. The Court explained that the states have the primary role in regulating domestic relations and that, therefore, the federal government must generally look to state law in determining a couple's marital status for purposes of administering federal benefits incident to marriage.

As a result of this decision, legally married same-sex couples living in one of the 13 states (including Connecticut, Massachusetts and New York) and the District of Columbia that recognizes same-sex marriage will now have access to more than 1,000 federal benefits that turn on the definition of "spouse," including the ability to file joint federal income tax returns, to claim a marital deduction for gift and estate tax purposes, to split gifts, to "roll over" qualified retirement plans into the surviving spouse's own account, to receive employer-provided medical insurance premiums gift tax free, and, for a non-U.S. spouse, to be eligible for a green card. The impact of the decision on other same-sex couples may vary depending on where the couple married, where they currently live and how a federal benefit is administered. Individuals who are affected by this decision should review their estate plan, the manner in which they hold title to their assets, and their beneficiary designations for qualified retirement plans (such as 401(k)s, 403(b)s or IRAs) and insurance policies.

GREENWICH OFFICE MOVE

Day Pitney is pleased to announce its new location in Greenwich, Connecticut. Scheduled to open in July, our new office is located at 24 Field Point Road, just a few blocks from Town Hall. With our move to this new location in Greenwich and the recent renewal of our Stamford office lease, we celebrate 35 years of service in Fairfield County.