

December 12, 2012

Estate Planning Update - December 2012

FEDERAL TAX UPDATE

Following the reelection of President Obama last month, Congress has turned its attention to the "fiscal cliff." This includes the scheduled "sunset" of the Bush-era tax cuts effective January 1, 2013, which would impact the federal estate, gift and generation-skipping transfer ("GST") taxes as well as federal income taxes, along with a variety of mandatory spending cuts across the budget. As we approach the end of 2012 and with the continued flux in the federal tax landscape, it is appropriate to consider the planning impact of these scheduled tax changes as well as any potential "compromise" in Washington.

Income taxes

The current income tax rate structure provides for rates at the 10, 15, 25, 28, 33 and 35 percent levels. After sunset, these would be replaced by the higher pre-Bush era rates of 15, 28, 31, 36 and 39.6 percent. In addition, capital gains rates will increase from 15% (or zero for lower income taxpayers) to 20% (or 10% for lower income taxpayers). Qualified dividends, which have been taxed at the more favorable capital gains tax rates, would be taxed at regular income tax rates.

The new year also brings the imposition of the 3.8% Medicare contribution tax on the unearned income of higher-income individuals, estates and trusts. This new tax, part of the healthcare reform package of two years ago, is imposed on a taxpayer's net investment income, including interest, dividends, annuities, royalties, rents and capital gains (but not on income derived from a trade or business, from the sale of property used in a trade or business, or distributions from qualified retirement plans and IRAs).

The combined effect of these changes is that the top income tax rate for qualified dividend income would increase from 15% to 43.4%.

Over and above these tax rate increases, lack of congressional action will mean a return to the phase-out of personal exemptions and itemized deductions for higher income taxpayers that existed before the Bush-era tax cuts went into effect.

Planning for these changes means considering the possibility of accelerating income into the current year in order to take advantage of the lower tax rate levels under current law, where practical. In some cases, it may also make sense to defer deductions until next year when they would serve to offset income at higher income tax rates. However, this benefit could be offset by the reintroduction of the phase-out of itemized deductions or, as is more likely the case, the possible capping or phase-out of itemized deductions that could occur under compromise legislation, so any decision to defer paying items that could qualify as itemized deductions should be undertaken carefully.

Transfer taxes

The current federal transfer tax laws provide for estate, gift and GST tax exemptions of \$5,120,000 and a tax rate of 35%. If the current laws are allowed to sunset for 2013, the estate and gift tax exemptions will be reduced to \$1,000,000 and the GST exemption will be reduced to \$1,430,000, all with a top tax rate of 55%. In between these extremes, President Obama, in his last several budget proposals, has proposed for 2013 a reversion to the 2009 exemptions of \$3,500,000 for estate and GST tax and \$1,000,000 for gift tax, all with a 45% top rate. Although many in Congress on both sides of the aisle would prefer to avoid the sunset of the transfer tax provisions in some fashion, it seems clear that the transfer taxes will be part of the resolution of the overall fiscal cliff. Whether Congress will reach a compromise on the complex issues involved before the end of 2012 remains unknown. It is even possible that we will begin next year with continued uncertainty (and the scheduled lower exemptions and higher rates in place, at least temporarily), with the resolution enacted retroactively early next year.

Many commentators have suggested that a compromise is likely, and indications from Washington are that there is support for at least a temporary agreement on extending the tax cuts (say by a temporary extension of six months or a year). We will continue to monitor the developments in Washington and follow up with an update as soon as an agreement is reached.

As consistently advised since the transfer tax laws last changed in 2010, any new transfer tax legislation that includes a lowered gift tax exemption amount would create a potential tax savings opportunity for those with the means and inclination to make substantial taxable gifts in 2012, including transfers of illiquid assets such as real estate and business interests, and many have already taken steps to do so. The window of opportunity to make such a gift in trust is swiftly closing, in light of the lead time necessary to prepare an appropriate instrument and transfer property, so please let us know immediately if you would like to discuss this further.

INFLATION ADJUSTMENTS

Even in the absence of permanent federal tax legislation, certain estate, gift and generation-skipping transfer ("GST") tax figures are subject to inflation adjustments. For 2013, the annual exclusion amount for gifts will increase from \$13,000 to \$14,000. In addition, the annual exclusion amount for gifts made to a non-citizen spouse in 2013 is increased to \$143,000 from \$139,000. Finally, as noted in detail above, the inflation-adjusted GST exemption amount is scheduled to be \$1,430,000 in 2013, absent further congressional action.

YEAR-END CHARITABLE GIFTS

Many charitable gifts are made close to the end of the year, so it is timely to recall some points that can make a difference to an income tax charitable deduction.

Except for smaller contributions, such as cash gifts under \$250 to a charity, the donor is responsible for getting an **acknowledgment letter** before filing a tax return and deducting the contribution.

- The letter should come from the charity that received the gift and should state the date of the gift, describe the gift and indicate whether the donor received anything of value in return.
- These letters can look like polite "thank-you" notes, but they have an important tax significance. A donor who does not have an acknowledgment letter in hand risks having a deduction denied - even when there is no question that a charitable gift has been made.
- An acknowledgment letter is needed even for donors who give to their own private foundation, and even when the donors manage the foundation.

In addition to the acknowledgment letter requirement, many **noncash charitable contributions need to be supported by a special form** filed with the donor's federal tax return.

- The form needs to be signed by the donor, by the charity receiving the gift and in many cases by an appraiser valuing the contributed property. The signatures can take time to get, so donors should plan ahead.
- The form (numbered 8283) has just been revised. Donors should be sure they are using the "December 2012" version.

Charitable gifts made by **checks written and sent in 2012** count as 2012 deductions even if the check is deposited in 2013, as long as the check clears "in due course," as the IRS puts it.

- The rules for last-minute electronic transfers to charity are less clear. The relevant regulations were written before those transfers became as common as they are today. If timing is an issue, a paper check may be a better way to make a last-minute charitable gift a 2012, rather than a 2013, deduction.