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## ESTATE AND TAX PLANNING

### Federal Estate and Gift Tax Rules Made “Permanent”?

Legislation passed by both Houses of Congress, and then signed by the President on January 2, 2013, has fixed the applicable Federal estate and gift tax exemption at \$5 Million, indexed for inflation. The top applicable estate and gift tax rate has been increased from 35% to 40%. Details relating to the new law, The American Taxpayer Relief Act of 2012 (the “Act”), remain to be stated in Regulations.

\* \* \* \*

**Background:** For more than 10 years, our Federal estate and gift (and generation skipping transfer) tax rules have been in flux. Starting in 2001, the estate tax exemption was increased in stages to \$3.5 Million over nine years and the top rate reduced in stages to 35% while the separate gift tax exemption remained at \$1 Million. The Federal estate tax was eliminated entirely in 2010, then restored retroactively subject to a carryover basis income tax option. In 2011, the exemption for both estate and gift tax purposes was increased to \$5 Million and the maximum rate lowered to 35%. **This regime was scheduled to sunset on December 31, 2012 and revert to the 2001 position (a \$1 Million exemption and 55% top rate). This is the way things stood until action was taken earlier this month.**

The primary focus of the Act was the extension of certain Bush-era tax provisions, and a patch for the alternative minimum tax rules. Yet, the estate, gift and generation skipping tax provisions are especially welcome for taxpayers hoping to avoid a significant reduction in the applicable transfer tax exemption. The Act will relieve certain families with businesses from pressure that might otherwise have been exerted to sell those businesses shortly after the death of the senior family member.

The new legislation avoids the potential “claw-back” or “recapture” problem. A claw-back could hypothetically have occurred if a taxpayer had made substantial gifts during lifetime using the \$5 Million gift tax exemption and then died in a year in which the estate tax

exemption had been reduced to less than \$5 Million. The applicable exemption has never been reduced in the history of our Federal transfer tax, so the question could not be resolved by simply consulting precedent.

Another positive feature of the Act is that the estate and gift tax exemptions (\$5 Million indexed for inflation) will continue to be unified. This provides some clarity for planning purposes and in certain instances may neither encourage nor discourage larger lifetime gift-giving. There is still, however, the important notion that while the Federal estate tax is tax-inclusive, the gift tax is tax-exclusive; this makes gift-giving more tax efficient. Lifetime gift-giving also has the advantage of avoiding transfer tax on any future appreciation in the subject of the gift.

The “Portability” feature, first added to the law in 2011, allows for any unused portion of a spouse’s exemption to be transferred to his/her surviving spouse. This useful feature has been retained in the Act. This in effect means that married couples can pass up to \$10 Million (indexed for inflation) without Federal transfer tax consequences. Estate tax returns need to be filed for estates below the exemption in order to elect Portability.

Many practitioners were concerned about the intentions previously expressed by the Administration to change or limit a number of tax planning options, chief among them being the Grantor Retained Annuity Trust (“GRAT”), the intentionally defective grantor trust and valuation discounts. None of these existing strategies have been affected by The American Taxpayer Relief Act of 2012.

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### **In Brief: To summarize, this is where we stand as we head into 2013:**

- The Federal estate, gift and generation skipping tax exemption continues to be \$5 Million indexed for inflation (approximately \$5,250,000 in 2013), and the top applicable tax rate will be 40%.

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- Portability of the unused exemption continues to be available for married couples provided an estate tax return is timely filed upon the death of the first spouse.
- A potential “claw-back” when larger lifetime gifts are made will not be a concern.
- Existing planning options such as GRATs and intentionally defective grantor trusts can still be used. For a taxpayer who has fully used his or her exemption on prior gifts, the GRAT continues to be highly attractive due to the low applicable IRS interest rate and the ability to virtually zero-out for gift tax purposes.
- Qualified Personal Residence Trusts can still be created and are attractive for property that is expected to appreciate.
- The Federal gift tax annual exclusion has been \$13,000 per donee for several years. This exclusion was indexed for inflation and rises in 2013 to \$14,000 per donee. Gift tax exclusions continue to be available for direct transfers to qualifying service providers for medical expenses and educational tuition payments.
- Planning is especially needed at the state level in those jurisdictions where the applicable state estate tax exemption is lower than the Federal exemption. This will be the case for taxpayers in states such as New York (\$1 Million exemption), New Jersey (\$675,000) and Connecticut (\$2 Million). Connecticut is the only state with a gift tax, to which the \$2 Million exemption also applies. New Jersey has a separate Inheritance tax with no applicable exemption.
- The IRS applicable interest rate is again at an all-time low -- 1.0% -- a rate that encourages certain planning strategies.
- **The media refer to the Act as having made “permanent” changes in our transfer tax rules. Many experienced tax practitioners simply cannot in good conscience use that word to describe the provisions of the Act.**

*As always, we recommend that clients review their estate plans periodically and/or whenever a significant life event occurs (e.g., birth of a child, death of a spouse, purchase of new home, change of state of residence, etc.). Individuals with substantial amounts of wealth or with closely-held businesses may still consider whether to take further advantage of the current \$5 Million gift tax exemption. Lifetime gifts continue to be important because property values are largely depressed, interest rates are at an historic low and valuation discounts may not be available in the future.*

*Reid Glynn, LLP aims to keep you abreast of the ever-changing tax laws. Please do not hesitate to contact us with any questions that you might have or if you would like to discuss your estate plan in light of this Report.*

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