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ESTATE PLANNING UPDATE

Significant changes to federal and state law have been enacted in the last year. How do those changes affect your estate planning?

I heard that Congress made changes to the estate tax last year as part of the extension of the "Bush tax cuts." What happened?

The Tax Relief Act passed by Congress in December 2010 establishes a top estate, gift, and generation-skipping transfer (GST) tax rate of thirty-five percent (35%), with an exemption amount of \$5 million per individual, indexed for inflation. This means that if an individual dies with assets worth less than \$5 million and has made no taxable gifts during his or her life, such person's estate will not be subject to federal estate tax. This rule also means that an individual may make up to \$5 million of gifts during his or her life without paying gift tax, though taxable gifts during life reduce the federal estate tax exemption available at death. The Tax Relief Act provisions are the most taxpayer-friendly changes to the estate, gift, and GST taxes in history. For example, as recently as 2001 the estate and GST tax exemption per person was \$675,000, and the maximum rate was fifty-five percent (55%).

Are the \$5 million exemption and thirty-five percent (35%) tax rate here to stay?

While it is difficult to predict what Congress might do in this political climate, the provisions of the Tax Relief Act are scheduled to expire on December 31, 2012. Absent Congressional action, the top rate will be fifty-five percent (55%) and the exemption will be \$1 million as of January 1, 2013. Accordingly, 2011 and 2012 likely present a unique opportunity to make substantial gifts free of gift and GST tax (though in many cases a gift tax return is still required).

How can I take advantage of these taxpayer-friendly rules?

We would be happy to assist you in determining the gifting strategy most appropriate for your situation. Congress has considered limiting some of these methods in the past, so now may be the best time to act. Options include trusts for children or grandchildren, personal residence trusts, and advanced business planning strategies. We are also able to work with you to accomplish your charitable giving goals.

My spouse and I have Wills that use a Bypass Trust to shield a portion of the first spouse's estate (up to the exemption amount) from estate tax at the death of the surviving spouse. Do we still need this type of Will?

A feature of the Tax Relief Act allows the surviving spouse to elect to treat the federal estate tax exemption remaining at the first spouse's death as his or her own, increasing the surviving spouse's effective federal estate tax exemption. For example, if the first spouse dies in 2012 with an estate of \$1.5 million, leaving \$3.5 million of unused exemption, the surviving spouse's exemption at his or her death will be the surviving spouse's own \$5 million exemption plus the deceased spouse's unused \$3.5 million exemption, if the surviving spouse elects such treatment by filing a federal estate tax return. Some commentators have questioned whether this new rule renders Bypass Trust planning obsolete. However, there are several good reasons to continue to include a Bypass Trust in your Wills. Most importantly, the new federal rule does not extend to the Washington state estate tax. Additionally, the new rule is scheduled to expire at the end of 2012. Because Bypass Trust assets are not included in the surviving spouse's estate, such assets will not be subject to audit at the surviving spouse's death. A Bypass Trust also has benefits unrelated to tax planning, such as creditor protection and facilitating transfer of asset management to a child or other trusted person as the surviving spouse ages. For this reason we strongly recommend that married couples continue to use Bypass Trust planning in their Wills or Revocable Trust Agreement.

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Do these changes affect the Washington state estate tax?

No, the Washington state estate tax continues to apply to estates over \$2 million at a maximum rate of nineteen percent (19%). The Washington state estate tax is not scheduled to change in 2013, and, as noted above, the rule allowing a surviving spouse to use his or her deceased spouse's unused exemption amount does not apply for Washington state estate tax purposes.

What other provisions of the Bush tax cuts were extended until January 1, 2013?

The Tax Relief Act also extended all individual income tax rates, including capital gains rates, at their 2010 levels for two (2) additional years. Such rates had been scheduled to revert to 2001 levels beginning on January 1, 2011. Accordingly, the maximum income tax rate continues to be thirty-five percent (35%), and the maximum rate for long-term capital gains and dividends continues to be fifteen percent (15%). In contrast, in 2001 the maximum income tax rate was 39.1%, and the maximum rate for long-term capital gains was twenty percent (20%) (dividends were subject to the higher rate). Like the taxpayer-friendly estate tax provisions, these rates are scheduled to return to 2001 levels as of January 1, 2013. Many commentators believe that the low tax rate climate is unlikely to continue.

Are there other income tax changes I should be aware of?

The federal government currently imposes a Medicare tax of 2.9% on wages received by an employee and on business or farming income earned by self-employed individuals. Starting January 1, 2013, the new federal health care law increases the Medicare tax to 3.8%, and expands it to cover certain investment income of higher-income individuals, trusts, and estates. Generally speaking, the tax applies to income from interest, dividends, annuities, royalties, rents, and capital gains from non-business property and from businesses where the taxpayer is not an active participant. The exclusion for gain on the sale of a primary residence (generally, \$250,000 for a single taxpayer, \$500,000 for married taxpayers filing jointly) applies to the new tax, and distributions from 401(k)-type plans and individual retirement accounts are not subject to the tax. As you may have heard, the federal health care law has been challenged in court, so the future of this tax is uncertain. Nevertheless, clients who are considering selling investments in the near future may find it advisable to do so prior to 2013.

Changes to the Washington Trust Act

The Washington state legislature recently made significant changes to the statutes governing trusts. Washington law now requires a trustee to provide notice to the beneficiaries of certain events, such as when a revocable trust becomes irrevocable. Additionally, Washington law now specifically requires a trustee to keep all "persons interested in the trust" reasonably informed about the trust administration and the material facts necessary for such persons to protect their interests. A "person interested in the trust" is one who is entitled to notice of a judicial proceeding regarding the trust, namely, the trustor, trustee, and all persons beneficially interested in the trust – in other words, all beneficiaries. The new law provides that a trustee satisfies this duty if the trustee provides a report to all interested persons including a statement of the trust's assets, liabilities, income, and disbursements, as well as other information. If you are the trustee of a trust, it is your responsibility to determine which beneficiaries are entitled to receive this notice. Because this determination can be complex, we strongly encourage all trustees to contact our office for assistance.

Please contact the estate planning attorneys at Montgomery Purdue Blankinship & Austin PLLC if you have questions about the changes to federal and state law described in this Update.

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