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ESTATE PLANNING & TAX UPDATE

Significant changes to federal tax law have been enacted or go into effect this year. How do those changes affect your estate and tax planning?

I heard that Congress made some changes to the estate tax early this year as part of the "fiscal cliff" negotiations. What happened?

On January 2, 2013, the American Taxpayer Relief Act of 2012 (the "2012 Tax Act") was signed into law. Under the 2012 Tax Act, the top estate, gift and generation-skipping transfer (GST) tax rate is 40%, representing an increase from the prior top rate of 35%. However, the 2012 Tax Act also made permanent the $5 million estate, gift and GST tax exemptions originally enacted in 2010, indexed for inflation. This means that if an individual dies with assets worth less than $5.25 million ($5 million indexed for inflation) 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 $5.25 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 inflation-indexed $5 million exemption is the highest exemption in history. For example, as recently as 2001 the estate and GST tax exemption was $675,000 per person. In addition to the 2012 Tax Act changes, the federal gift tax annual exclusion increased from $13,000 in 2012 to $14,000 in 2013. As a result, any individual may gift up to $14,000 to another person without having to file a gift tax return or use any portion of the donor's lifetime gift tax exemption (now $5.25 million).

Are the $5 million exemption and 40% tax rate here to stay?

It is always impossible to predict what Congress might do. However, unlike previous major estate tax legislation, the 2012 Tax Act is not scheduled to expire or change at a later date. That said, there have been discussions in Washington about restricting certain advanced estate planning strategies, including valuation discounts for closely-held business assets and grantor retained annuity trusts (GRATs). We would be happy to assist you in determining the strategies most appropriate for your situation.

Do these changes affect the Washington state estate tax?

No, the Washington state estate tax continues to apply to estates over $2 million (not indexed for inflation) at a maximum rate of 19%. 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.

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?

Beginning in 2011, a new provision of federal law allowed 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. While this provision was scheduled to expire on December 31, 2012, Congress made it permanent in the 2012 Tax Act. 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, including, importantly, that the new federal rule does not extend to the Washington state estate tax. (CONTINUED ON BACK)

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. Moreover, all post-death appreciation of Bypass Trust assets is sheltered by the first spouse's estate tax exemption, which results in greater leveraging of exemptions when assets increase in value. 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.

What changes did the 2012 Tax Act make to federal income tax law?

While the 2012 Tax Act did not change income tax rates for most taxpayers, those individuals with incomes over $400,000 and married couples filing jointly with incomes over $450,000 are now subject to a highest marginal rate of 39.6%, up from 35%. A 20% rate now applies to long-term capital gains and dividends of these higher income taxpayers, though taxpayers with incomes below the $400,000 (for individuals) and $450,000 (for married couples filing jointly) continue to be subject to 15% and 0% rates on capital gains and dividends, depending on their taxable income. Combined with the new 3.8% Medicare tax on investment income discussed below, the maximum rate on long-term capital gains and dividends can now be as high as 23.8%.

How do these changes affect charitable giving?

The reinstatement of the "Pease" limitation on itemized deductions described above applies to the income tax deduction for charitable gifts, reducing the total amount of deductions available. Some commentators believe that this change will adversely affect charitable giving. However, other analysts point out that the increase in the highest marginal income tax rate causes charitable gifts to result in more tax savings than under prior law. The income tax consequences of a charitable gift must be evaluated on a case-by-case basis. Please note, however, that there have been no changes to the estate or gift tax charitable deductions. In addition, a provision allowing individuals over age 70 ½ to give up to $100,000 from an IRA without taking the amount into income has been extended through 2013 only.

Is there a tax increase associated with the 2010 health care law?

Starting January 1, 2013, the federal health care law passed in 2010 increases the Medicare tax from 2.9% to 3.8%, and expands the tax from covering only wages and certain income of self-employed individuals to cover certain investment income of higher-income individuals, trusts, and estates. Generally speaking, the tax now 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.

If you wish to learn more about the topics discussed in this Update and other estate planning news, please visit our firm's blog at http://www.mpba.com/blog/. Please contact the estate planning attorneys at Montgomery Purdue Blankinship & Austin PLLC if you have any questions.