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The American Taxpayer Relief Act of 2012: Estate Planning Game Changer?

By Richard M. Morgan & Loraine M. DiSalvo

On January 2, 2013, President Obama signed The American Taxpayer Relief Act of 2012 (the "2012 Tax Act"). Among its many provisions, the 2012 Tax Act provided the first "permanent" estate, gift, and generation-skipping transfer ("GST") tax laws since 2001. The Act was widely viewed as the first step towards preventing the U.S. from falling off the "fiscal cliff" as a number of scheduled tax increases and spending cuts took effect at the beginning of 2013. More steps are expected to come in the next few months, especially as the U.S. approaches its debt ceiling.

Much of the 2012 Tax Act simply made permanent a wide array of tax provisions which existed on December 31, 2012. In addition, the Act made a number of changes, mostly to the income tax provisions which will affect higher income taxpayers. These taxpayers will see their income tax rates increase in accordance with prior law. In addition, higher income taxpayers will begin to see the effect of many new taxes which were enacted as part of the Affordable Care Act in March 2010 but were not scheduled to begin until 2013. These Affordable Care Act related tax provisions include an additional 0.9% tax on higher levels of compensation income and a 3.8% tax on investment (passive) income.

As for the wealth transfer taxes (the gift, estate and generation-skipping transfer taxes), these have now become irrelevant for most taxpayers**. The gift and estate tax exclusions and the GST tax exemption amounts have now been made permanent at $5,000,000 each** (the 2010 Tax Act levels). These exclusions are indexed for inflation after 2011, with the indexed amounts for 2013 set at $5,250,000 each. In addition, the rules designed to allow a decedent's estate and gift tax exclusions to be effectively "portable" to his surviving spouse (which were first introduced in the 2010 Tax Act) have been made permanent as well. The "portability" rules, mean that, as long as the Executor of a deceased married person's estate is willing and able to file an estate tax return in a timely manner after the person's death, the decedent's surviving spouse can use his remaining exclusion, either on lifetime taxable gifts made by the surviving spouse, or, under certain circumstances, at the surviving spouse's death.[1] The portability rules can give married couples access to a combined gift and estate (but not GST) tax exclusion of $10,500,000 for 2013. The GST tax exemption is not portable.

Since income taxes will be increasing and wealth transfer taxes will become irrelevant for most, the estate planning world may be in for significant change. The focus will likely be less on saving wealth transfer taxes, and more on the sometimes competing concerns of protecting assets and reducing income taxes. Many clients will be presented with a choice, in planning their estates, between using trust-based plans to obtain the asset protection[2] and control benefits they can offer or keeping the plans as simple as possible and passing assets outright. Even for wealthier clients who still need to plan to reduce the impact of wealth transfer taxes and will likely still use many traditional estate planning techniques, the clients and their advisors will need to have a heightened sensitivity to income tax considerations in developing and implementing plans.

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One thing to keep in mind, especially for wealthier clients, is that wealth transfer taxes can still be an issue, and wealth transfer tax planning should still continue. While the 2012 Tax Act purports to make the wealth transfer tax rules permanent, **remember that "permanent" means only until the federal government decides to make additional changes in the future.** The federal government currently faces the need to raise trillions of dollars over the coming years to pay for its current and future obligations, even if it can find the fortitude to make many important, but difficult-to-swallow, spending cuts. President Obama has already proposed several significant tax changes that could make it much more difficult to undertake flexible and beneficial wealth transfer tax reduction strategies. In addition, as the states find themselves struggling with their own budget woes, wealth transfer taxes may become an appealing source of revenue, and many states which currently do not have wealth transfer taxes of their own may begin to implement them in the future.

A more expansive view of these changes was covered via a series of seminars delivered this month to a small group of associates and advisors. You may download a copy of the presentation here but for a more comprehensive review of how these changes will impact your estate planning, please contact Scarlett Ollila to schedule an appointment to meet with one of our attorneys.

[1]If the surviving spouse remarries after the deceased spouse's death, the surviving spouse can lose the ability to use the deceased spouse's estate and gift tax exclusions even if the portability election was made with regard to the deceased spouse's estate. This is because the surviving spouse is entitled to use only the exclusion amount left by her "last deceased spouse." If the surviving spouse remarries and then makes a taxable gift during her lifetime, then the taxable gift will use up her last deceased spouse's exclusion before it uses her own gift tax exclusion. In that case, even if the surviving spouse remarries (either before or after making the taxable gift) and then survives her new spouse, the benefit of the first deceased spouse's exclusion has been preserved by the taxable gift. However, if the surviving spouse remarries after the first spouse's death and then her new spouse also dies before her, any exclusion the surviving spouse has received from her first deceased spouse and not used on taxable gifts made during her lifetime will be lost. Instead, the second deceased spouse's Executor will have to file an estate tax return, and make the portability election to allow the surviving spouse to use the second deceased spouse's remaining exclusion.

[2]By "asset protection," we mean using trusts and other traditional- and non-traditional estate planning strategies to allow the beneficiaries of a plan to benefit from wealth while also protecting that wealth from undesirable outsiders, such as the beneficiaries' creditors, from predators, and from the beneficiaries' spouses in divorce situations.