CUMMINGS & LOCKWOOD LLC

# CLIENT ALERT - ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX

January 2013

**JANUARY 2013 CLIENT ALERT - ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX**

Dear Clients and Friends:

On January 2, 2013, the Federal Government enacted the American Taxpayer Relief Act of 2012 (the “2012 Tax Act”) changing, among other things, the estate, gift and generation-skipping transfer (“GST”) tax regime once again. Unlike the regime which expired on December 31, 2012, this regime is “permanent” in the sense that it is not set to expire on any given date. This letter is not a comprehensive discussion of the 2012 Tax Act, but briefly summarizes the portions of the Act relating to federal estate, gift and GST taxes as well as a few other items which we believe may be of interest to our clients. We also describe some important gifting techniques which may not be available in the future. Should you have questions or desire a more detailed explanation of any of the provisions of the Act or this letter, you should consult with your Cummings & Lockwood attorney.

***EXTENSION OF TAX-FREE DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS FOR CHARITABLE PURPOSES - INCLUDING LIMITED WINDOW TO RETROACTIVELY RE-CHARACTERIZE 2012 DISTRIBUTIONS***

The 2012 Tax Act contains provisions reinstating the ability to make tax-free distributions (not to exceed $100,000 in the aggregate) from an Individual Retirement Account (“IRA”) to qualified charities. The Act applies only to distributions made before December 31, 2013.

The Act also contains two important provisions that apply to 2012. As the ability to make such tax-free distributions was not available in 2012, the Act provides two mechanisms for retroactively treating certain distributions as 2012 tax-free distributions. First, any qualified charitable distribution made from an IRA between January 1, 2013 and February 1, 2013 can, at the taxpayer’s election, be treated as if made on December 31, 2012. Second, any distribution made from an IRA to the taxpayer between December 1, 2012 and December 31, 2012 can be retroactively treated as made to a charitable organization if it would otherwise have qualified as a qualified charitable distribution and if the taxpayer transfers the distribution amount in cash to a qualified charity before February 1, 2013.

***ESTATE, GIFT AND GST TAX RATES AND EXEMPTIONS IN 2013 AND BEYOND***

Under the 2012 Tax Act, the estate, gift and GST tax rates all are set at a maximum rate of 40%. This is an increase from the 2011 and 2012 rates of 35% but still a significant decrease from the 2001 rate of 55%. Furthermore, the 2012 Tax Act makes permanent the increases in the amounts exempt from these taxes to $5,000,000 (indexed for inflation, and set at $5,250,000 for 2013) and permanently unifies the gift tax and estate tax so that the entire exemption can be used during lifetime or, if unused during lifetime, at death. Prior to 2011, only $1,000,000 of the total exemption was available for lifetime use.

For those clients who have not already used their entire gift tax exemption, these increased exemptions offer an opportunity to make additional gifts tax free and to shelter gifts from the GST tax as well. Even for those clients who have used their lifetime gift exemptions, the inflation index makes it possible to make additional gifts in 2013 and future years without incurring a federal gift tax.

When making gifting decisions, remember that if you live in a state that has a separate gift tax system, such as Connecticut, it is important to take state taxes into account as well. For example, Connecticut's gift tax exemption remains at $2,000,000, meaning that if a Connecticut resident makes a $5,250,000 gift in 2013, a tax of $251,700 will be due on the $3,250,000 difference between the federal and Connecticut exemptions.

***EXEMPTION PORTABILITY***

As many married clients are aware, the federal tax system gave each person an estate tax exemption, thus allowing a married couple with a proper estate plan to pass on a total of twice the exemption amount to their beneficiaries. However, until recently, if the first spouse to die lacked sufficient assets in his or her individual name or left his or her assets entirely to the surviving spouse outright, the benefit of the estate tax exemption of the first spouse to die was wasted. In 2011, the federal tax laws provided for the first time that under most circumstances any unused exemption of the first spouse to die could be transferred to the surviving spouse and saved for later use to reduce estate taxes in the surviving spouse's estate. The unused exemption of the first spouse to die was also available to the surviving spouse to shelter lifetime gifts by the surviving spouse. The 2012 Tax Act has made this "portability" feature of the estate tax exemption permanent.

It is important to keep in mind that there are some limitations to portability, including the fact that there are currently no states that allow portability of state estate tax exemptions, meaning that state exemptions may be wasted and state estate taxes increased by relying on portability. In addition, the GST exemption is not portable and in most cases the best way to use GST exemption is to combine it with the estate tax exemption when the first spouse dies. Finally, under the traditional system of using the exemption of the first spouse to die at that time, the exempt amount plus all of the appreciation on that amount between the death of the first spouse and the death of the surviving spouse escapes estate tax, whereas portability only protects the unused exempt amount of the first spouse to die from estate tax.

***CHANGES TO ANNUAL EXCLUSION AMOUNTS***

Although not part of the 2012 Tax Act, because of inflation indexing, annual exclusion amounts have increased as of January 1, 2013. The annual exclusion from gift tax, i.e., the amount that each donor can give to any number of people each calendar year without using lifetime gift exemption or incurring a gift tax, has increased to $14,000 per donee. Likewise, the amount an individual can give to his or her non-US citizen spouse per calendar year has increased to $143,000 for 2013.

***GIFTS TO ESTATE REDUCTION TRUSTS FOR SPOUSE AND/OR OTHER FAMILY MEMBERS***

An Estate Reduction Trust is an irrevocable trust created by you for the benefit of your spouse and/or other family members to remove assets and their appreciation from your taxable estate. For married couples, a gift to such a trust can be particularly attractive because your spouse can be the primary beneficiary of the trust, allowing the assets to remain available to your spouse. With careful planning and some restrictions, each spouse can create and fund his or her own Estate Reduction Trust. In addition, if you choose to allocate GST exemption to the gifts to an Estate Reduction Trust, the trust assets and their appreciation can also be removed from the GST tax system for as long as the trust exists, meaning that eventual transfers from the trust to grandchildren and more remote descendants can be made without any tax.

***GIFTS TO DYNASTY TRUSTS***

A dynasty trust is a trust that is designed to benefit multiple generations by continuing to hold property in trust for each generation with the assets in the trust not being subject to estate tax or GST tax. The increased gift and GST tax exemptions present an excellent opportunity to benefit grandchildren, great-grandchildren and more remote descendants by using those increased exemptions to fund a dynasty trust. Estate Reduction Trusts discussed above can be designed as Dynasty Trusts.

***FRACTIONAL INTEREST GIFTS***

The federal gift tax is imposed on the fair market value of the gifted asset. The value of a fractional interest in property or a minority interest in an entity may be discounted in determining the asset's fair market value. This is because a fractional or minority interest often is not freely marketable and the underlying asset is not one that can be controlled by the donee. While valuation discounts may be appropriate in determining fair market value, a professional valuation will normally be required.

***QUALIFIED PERSONAL RESIDENCE TRUSTS***

A Qualified Personal Residence Trust ("QPRT") is a tax-efficient means of transferring a personal residence to your intended beneficiaries. The concept of a QPRT is relatively simple: the owner of the personal residence transfers it to a trust but retains the right to live rent-free in the residence for a specified number of years. At the end of that period, ownership of the residence is transferred to the beneficiaries (or a trust for their benefit) and is removed from the estate of the original owner. At that time, the original owner can rent the property from the beneficiaries if he or she wishes to remain in the house.

The tax advantage of the QPRT comes primarily from the way in which the value of the residence is calculated for gift tax purposes. The value of the gift is not the full value of the residence on the date of the gift, but rather the actuarial value of the beneficiaries' right to receive the residence only after the specified number of years. Nonetheless, no matter how a QPRT is structured to reduce the value of the gift, the value still will be substantial. With the increased gift exemption, QPRTs may be an appropriate vehicle for people who otherwise would not consider such a gift because they did not have enough gift exemption remaining or did not want to use the more limited exemption.

***GRANTOR RETAINED ANNUITY TRUSTS***

The objective of a Grantor Retained Annuity Trust or "GRAT" is to transfer appreciation in value to your beneficiaries free of any gift or estate tax. A GRAT is a trust to which you transfer an asset and from which you receive a fixed amount annually (an "annuity") for a specified number of years. The annuity is calculated using the IRS interest rate in effect at the time of the gift. At the end of the period of years, if you are alive, the trust beneficiaries will receive the assets remaining in the GRAT free of gift and estate tax. The tax advantage of this technique is derived principally from the way in which the value of the gift to the GRAT is calculated. The value of the gift for gift tax purposes is not the value of the assets transferred, but rather is the value of the right of the remainder beneficiaries to receive the assets after the period of years has expired and the annuity payments have been made to you. The GRAT is typically structured so that the combination of the duration of the GRAT and the annuity amount retained reduces the value of the gift on creation to essentially zero. If the assets in the GRAT appreciate at a rate higher than the IRS interest rate used to calculate the annuity paid to you, then on termination there will be assets remaining in the GRAT that will pass tax free to your beneficiaries.

While GRATs require the use of minimal gift tax exemption and are not effective vehicles for GST transfers, as discussed below, there has been much discussion in Congress about eliminating some of the most attractive and effective provisions of the GRAT laws in future years so that these trusts may no longer be available or you may not be able to structure them to achieve the maximum chance of success available now.

***GRANTOR TRUSTS***

To further enhance the potential for appreciation of gifted property outside of the donor's taxable estate, many of the trusts described in this letter can be designed as "grantor trusts" thereby causing the trust to be treated as the grantor for federal income tax purposes making the grantor personally taxable on all income earned by the trust. This relieves the trust from any liability for income taxes during the grantor's lifetime allowing the trust to grow tax free, reducing the grantor's estate without any gift tax consequences to the grantor.

***STATE TAX CONSIDERATIONS***

When making gifting decisions, remember to consider state tax implications, some of which include:

Connecticut has a separate state gift tax with an exemption of only $2,000,000. This means that if a Connecticut resident makes a $5,250,000 gift to take full advantage of the federal gift exemption available this year, a Connecticut gift tax of $251,700 will be due on the $3,250,000 difference between the federal and Connecticut exemptions. Note, however, that this tax can be avoided if the gift involves out of state real property or tangible personal property, since assets located elsewhere are not subject to Connecticut gift tax.

New York has no gift tax but has an estate tax with an exemption of only $1,000,000. This means a New York client can gift $5,250,000 during 2013 and pay no New York tax, while the same gift at death would incur at least a $420,800 New York estate tax.

Florida has no separate state gift or estate tax.

***MORE REASONS TO ACT NOW***

We remain mindful that even “permanent” changes to the tax code are only “permanent” until Congress changes them. In light of the upcoming negotiations on spending cuts and the debt ceiling, it is possible that tax laws could change. Even if the current exemption amounts and rates remain intact, there have been various legislative proposals in recent years, including President Obama’s most recent budget proposal, which would limit certain gifting techniques entirely or significantly curb their effectiveness. These provisions may become a part of any spending cut compromise. These include:

1. Restricting fractional interest discounts for many transfers of non-business assets made to family members.
2. Requiring Grantor Retained Annuity Trusts (“GRATs”) funded to have a minimum term of 10 years and a remainder greater than zero.
3. Imposing a 90 year limit on the protection from GST tax for trusts to which GST exemption is allocated.
4. Severely limiting the use of “grantor trusts” that permit donors to pay the income tax on the taxable income generated by assets gifted into trust without such tax payments being treated as additional taxable gifts and without the trust assets being included in the donor’s taxable estate.

***AN IMPORTANT CONSIDERATION EVEN IF YOU ARE NOT INCLINED TO MAKE GIFTS OR OTHER CHANGES TO YOUR ESTATE PLAN NOW: TAX FORMULA CLAUSES UNDER WILLS AND TRUSTS***

If your current Will or Trust divides your estate so that the share exempt from estate tax passes to a beneficiary other than a trust for the benefit of your spouse or the share exempt from GST Tax passes in a way that bypasses your children, and if you have not done so already, you should contact your Cummings & Lockwood attorney as soon as possible to consider whether the increase of the exemptions to $5,250,000 reduces the property passing to or in trust for your spouse or children to less than you would want.

***CONCLUSION***

The 2012 Tax Act changed the estate, gift and generation-skipping transfer tax regime once again. While this Act has removed the “sunset” or expiration provisions contained in the prior legislation and given us a “permanent” transfer tax regime, we remain mindful that future negotiations on spending cuts, the debt ceiling and other fiscal initiatives creates the possibility of further changes in rates or exemption amounts or the curtailment of certain popular gifting techniques. We will, as always, keep you posted of any major developments in future updates.

CUMMINGS & LOCKWOOD LLC



*In this Update, we have deliberately simplified technical aspects of the law in the interest of clear communication. Under no circumstances should you or your advisors rely solely on the contents of this Update for legal advice, nor should you reach any decisions with respect to your personal tax or estate planning without further discussion and consultation with your advisors.*

*In accordance with IRS Circular 230, we are required to disclose that:  (i) this Update is not intended or written by us to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer; (ii) this Update was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by such materials; and (iii) each taxpayer should seek advice on his or her particular circumstances from an independent tax advisor.*