American Taxpayer Relief Act of 2012

Overview of Provisions and Planning Implications for Estate Planning; Estate, Gift and GST Tax Provisions in Effect in 2012 Made Permanent, Subject to Increase in Tax Rates from 35% to 40%

January 2013

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Brief Synopsis

In the early morning hours of New Year's Day, 2013, the U.S. Senate passed the American Taxpayer Relief Act of 2012 ("*ATRA*"). The bill then went to the House of Representatives and, after a full day of speculation as to whether the House would vote on the bill and, if so, whether it would be amended in the House and, in either case, whether there would be enough support to approve the bill, the House voted to approve the bill shortly before midnight. The President signed the legislation on January 2, 2013.

Highlights of the transfer tax provisions are as follows:

- The estate, gift and generation-skipping transfer tax provisions of 2012 law remain in effect (including the $5 million indexed estate, gift and GST exemption), with several minor modifications (this is accomplished primarily by "sunsetting" the sunset provisions of the 2001 and 2010 Acts);
- The top estate, gift and generation-skipping transfer tax rate is increased from 35% (under the 2012 law) to 40%;
- The portability provision is modified to remove any "privity" requirement (thus adopting the "Example 3" position that appeared in the Joint Committee on Taxation Report to the 2010 Act), effective beginning in 2011;
- Other than the portability provision (which applies beginning in 2011), these provisions apply to estates of decedents dying, generation-skipping transfers, and gifts made, after December 31, 2012; and
- Quite importantly, these provisions are adopted "permanently," rather than merely being extended for several years.

Several other major highlights of the legislation that may be of interest for estate planning purposes are:

- The income tax provisions of the 2001 Act are extended except that the top income tax bracket for individuals is increased to 39.6% for taxable income in excess of indexed threshold amounts, which, for 2013, are $450,000 for married individuals filing joint returns, $425,000 for heads of households, and $400,000 for unmarried individuals (other than surviving spouses and heads of households);
- The phase-out of personal exemptions and itemized deductions (the "PEP" and "Pease" limitations) was reduced under 2001 Act in steps from 2006-2010 (with a total elimination of the phase-out in 2010, extended by TRA 2010 through 2012); ATRA 2012 reinstates the phase-out (as under pre-2001 law) for individuals with adjusted gross income in excess of new indexed threshold amounts ($300,000 for a joint return or a surviving spouse, $275,000 for a head of household, and $250,000 for an unmarried individual other than a surviving spouse or head of household)(the indexed threshold amount would have been about $175,000 under the pre-2001 statutory provisions);
- The 2003 Act reduced the maximum rate on most long-term capital gains to 15% and applied the same 15% rate to "qualified dividends; under ATRA 2012, the rates on qualified dividends and long-term capital gains are adjusted by adding new 15% and 20% brackets (i.e., the top "general" rate is increased to 20%); without this change, all dividends would have been taxed at ordinary income tax rates;
- Permanent alternative minimum tax relief is enacted by providing revised exemption amounts that are indexed for inflation (there will no longer be the need for the annual "AMT patch");
- Extending the deduction of state and local general sales taxes through 2013;
- Extending through 2013 the ability to make tax-free distributions from individual retirement plans to charity (for qualified charitable distributions up to $100,000 for individuals who have reached age 70 ½); rollovers completed by February 1, 2013 can be treated as if made in 2012; a distribution from the

individual retirement plan in December 2012 can be treated as a qualified charitable distribution in 2012 if it is transferred in cash to charity before February 1, 2013;

- Traditional retirement accounts may be converted to Roth accounts (beginning in 2010, distributions from traditional retirement accounts could be contributed directly to an employer-offered Roth account only when the individual separated from service, reached age 59 ½, died or became disabled; ATRA 2012 allows the conversion in all circumstances); and
- Again, quite importantly, these provisions are adopted "permanently" (other than the sales tax and individual retirement plan charitable rollover provisions which, as noted, apply only through 2013).

Brief Background

The debate over extension of the "Bush tax cuts" (primarily in the 2001 and 2003 Acts) has been an integral part of the "fiscal cliff" negotiations. Without further Congressional action, the tax rules would have reverted to the rules that applied prior to the enactment of the ***Economic Growth and Tax Relief Reconciliation Act of 2001*** ("***EGTRRA***"), the ***Jobs and Growth Tax Relief Reconciliation Act of 2003***, and the ***Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*** ("***TRA 2010***"). President Obama campaigned on extending the Bush tax cuts for all Americans except individuals earning more than $200,000 ($250,000 for joint returns and surviving spouses). Republicans have generally strongly opposed *any* rate increases.

On the estate tax front, the Administration had proposed a $3.5 million exemption, 45% rate system (the President's Fiscal Year 2013 Budget Proposal called for a return to the 2009 parameters for both the estate and gift tax, which called for a return to the $1 million gift exemption, but there had been no official recent indications whether the Administration was continuing to push for the lower *gift* exemption). Republicans generally have favored the $5 million indexed exemption, 35% rate system, with some continuing to push for repeal of the estate tax.

After negotiations between President Obama and House Speaker Boehner in mid-December broke down without agreement, Rep. Boehner attempted to secure House passage of a measure extending the Bush tax cuts for all Americans except individuals earning more than $1 million per year. However, he was unable to secure sufficient votes and never called the proposal to a vote in the House. At that point, the effort to seek an agreement shifted to negotiations between Vice-President Biden and Senate Minority Leader McConnell. (Interestingly, TRA 2010 also was largely the result of negotiations between those same two individuals.) After several days of negotiations, an agreement was reached between them, and passed by the Senate, early on January 1, 2013, and ultimately approved by the House (after a day of heated debate) later that evening. As an interesting point of Constitutional law and legislative procedure, Art. I, Sec. 7 of the Constitution requires that all bills raising revenue must originate in the House. Therefore, even though the text of ATRA was drafted by the Senate, which was also first to vote on the bill, it could not Constitutionally introduce the legislation as a Senate bill, but instead had to introduce the legislation as an amendment to an earlier House bill, H.R. 8, essentially by deleting whatever was in that bill previously and substituting the text that was eventually passed.

Reports are that one of the major sticking points in reaching an agreement was over the estate tax. A compromise was reached to allow the $5 million indexed exemption (including the gift exemption) that the Republicans wanted, but to compromise between the 35% and 45% rates, at a new maximum rate of 40%.

Overview of Selected Statutory Provisions

1. *Short Title*. Section 1 of ARTA 2012 says the Act may be cited as the "American Taxpayer Relief Act of 2012." Fortunately, we again have a short acronym for the 2012 legislation (to "TRUIRJCA" for the 2010 Act — which is why that Act is abbreviated above as "TRA 2010").

2. *"Sunsetting" the Sunset*. The heart of the transfer tax changes in ATRA 2012 are several brief sentences in Section 101 of ATRA 2012 striking the sunset provisions in EGTRRA and TRA 2010.

   EGTRRA made significant changes to estate, gift and GST tax law, but provided in Title IX thereof (which consisted of a single section--Section 901), the so-called "sunset" provision, that "All provisions of, and amendments made by, this Act [(EGTRRA)] shall not apply . . . to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010," and that thereafter, the Internal Revenue Code would be applied "as if the provisions and amendments [of EGTRRA] had never been enacted."

   TRA 2010, among other provisions, increased the estate, GST ***and gift*** exemptions to $5,000,000, adjusted for inflation after 2011, and brought about "portability" of exemptions beginning in 2011. An important provision in TRA 2010 was to amend the sunset provision in EGTRRA, by providing, in Section 101(a) of TRA 2010, that the "sunset" date in Section 901 of EGTRRA would change from December 31, 2010 to December 31, 20***12***, and all provisions of EGTRRA, as amended by TRA 2010, would apply as if the 2012 sunset date had been included in EGTRRA from the outset. Section 304 of TRA 2010 then provided that the EGTRRA sunset provision (as changed by TRA 2010) would apply to all provisions of TRA 2010 as well, and TRA 2010 would therefore sunset after 2012.

   Now, Section 101(a)(1-2) of ATRA amends EGTRRA and TRA 2010 by striking the sunset provisions of both laws, and Section 101(a)(3) of ATRA states that the provisions apply with respect to decedents dying, and gifts and generation skipping transfers occurring, after December 31, 2012, without any further sunset provision or other "built-in" expiration.

   Accordingly, all of the beneficial provisions of EGTRRA and TRA 2010 in effect in 2012 have now become "permanent" provisions that will remain in effect into the future, without the need for any further action from Congress (except that the rate has changed from 35% to 40% beginning in 2013 and the portability provision has been clarified). Therefore, unlike the situation that has existed since 2001, we now know that exemptions will not be reduced, rates will not be further increased, and all of the other helpful provisions of EGTRRA and TRA 2010 will not be lost unless and until Congress is willing to enact new legislation that expressly makes those changes.

3. *Increase Top Rate From 35% to 40%*. Section 101(c) of ATRA increases the effective estate, gift and GST tax rate from 35% to 40%, by re-introducing the 37% ($500,000 to $750,000), 39% ($750,000-$1,000,000) and 40% (over $1,000,000) tax brackets that were eliminated by TRA 2010. From a practical standpoint, however, since the 37% and 39% rates apply to estates, gifts and GST transfers that are below the "exemption" level of $5,000,000 (inflation adjusted) the practical result will be that if the tax is imposed, it will be imposed at 40%.

4. *Technical Correction to Portability Provisions*. The only other change to the estate tax rules brought about by ATRA is a technical correction to the portability rules.

   TRA 2010 provided for portability of estate and gift tax exemptions by modifying § 2010(c)(2) to define the ***basic*** exclusion amount as the sum of the ***applicable*** exclusion amount and the deceased spouse's unused exclusion amount ("DSUE amount"). The key provision, in determining

the amount that could be "ported" to the surviving spouse, is the definition of the DSUE amount. Section 2010(c)(4) defines the "deceased spousal unused exclusion amount" as the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under section § 2001(b)(1)"). The second item is the last deceased spouse's remaining unused exemption amount. It was strictly defined as the predeceased spouse's "basic exclusion amount" less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a "privity" requirement.

ATRA 2012 changes this reference from "basic exclusion amount" in § 2010(c)(4)(B)(ii) to "applicable exclusion amount."

This difference is critical, because an individual's "applicable exclusion amount" includes his or her basic exclusion amount **plus** DSUE amount (in the case of a decedent who is a surviving spouse of a prior decedent who left him or her with a DSUE amount). This adopts the position taken in Example 3 on page 53 of the Joint Committee on Taxation Technical Explanation of TRA 2010.

As an overly simplified example, assume that H1 dies, leaving in unused exclusion amount of $2 million. Assume that W remarries and predeceases H2. In calculating the DSUE amount that H2 receives from W, can the $2 million DSUE amount that W received from H1 be added to her unused exclusion amount? Example 3 of the Joint Committee on Taxation Technical Explanation of TRA 2010 says yes, but that does not appear to be the correct answer under the statutory language. Under the statutory language of TRA 2010, the DSUE amount from W would be her basic exclusion amount less the amount of her taxable estate and adjusted taxable gifts. The DSUE amount that she had from H1 would not enter into the calculation under the statutory language at all. Indeed footnote 1582A added to the technical explanation by the "ERRATA — 'General Explanation of Tax Legislation Enacted in the 111th Congress (ERRATA), JCX-20-11, at page 1, acknowledges that "[a] technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent." By interpreting basic exclusion amount to mean applicable exclusion amount, a computation of the DSUE amount from W would start with her basic exclusion amount plus DSUE amount from H1 (because "applicable exclusion amount" means basic exclusion amount plus DSUE amount), and the DSUE amount from H1 is included in the DSUE amount that H2 receives from W.

This technical correction discussed in that ERRATA report is precisely the technical correction included in ATRA 2012. (The IRS adopted this same position in the temporary and proposed regulations adopted in June 2012, in a rather generous construction of the statutory language of TRA 2010. The technical correction in ATRA 2012 will not have any further impact on the portability temporary and proposed regulations.)

Planning Implications

1. *Highlights of Significant Provisions of EGTRRA* . There were important provisions of EGTRRA (that we now take for granted) in addition to increasing the tax-free amount to $3.5 million (by 2009) and reducing the maximum estate tax rate to 45% (by 2007). These include the following:

   - Increasing the GST exemption to be the same as the tax-free amount for estate tax purposes rather than $1 million indexed for inflation from 1997 (subtitle C of EGTRRA);

- Ending the qualified family-owned business interest deduction after 2003 (how soon we have forgotten the "QFOBI" complexities);
- Converting the state death tax credit over several years to a deduction for state death taxes (subtitle D);
- Deemed allocations of GST exemption to lifetime transfers to "GST trusts" (subtitle G);"
- Qualified severances of trusts for GST purposes (subtitle G);
- "9100 relief" from late GST exemption elections (subtitle G);
- Expansion of conservation easement rules for estate tax purposes (subtitle F); and
- Increasing the number of allowable shareholders or partners for §6166 purposes from 15 to 45 (subtitle H).

2. *"Permanent" Changes.* For more than a decade now, planners have had to deal with the constant uncertainty of the estate tax laws, with the realization that the provisions of the 2001 and 2010 Acts would vanish without further Congressional action. Some planners have used rather complicated formula provisions in wills (depending on future laws) and have employed various measures to inject as much flexibility as possible into estate plans, in light of the constant uncertainty hanging over our heads. At last, we have the benefit of some "permanent" provisions (at least as permanent as anything is in the tax world).

3. *$5 Million Indexed Estate, Gift and GST Exemption.* The ability to transfer $5,000,000 (inflation indexed) during lifetime or at death, will continue.

   - Clients who failed to use the entirety of their gift and/or GST exemptions in 2012 still have the opportunity to do so in 2013 and beyond.
   - Moreover, clients can expect to acquire additional gift and GST exemptions in each new year. As we know, the inflation indexed amount for 2012 was $5,120,000, and the inflation indexed amount for 2013 is expected to increase by another $130,000 to $5,250,000, although that number is not yet official. Long-term, the permanent indexing feature of the exemption may have the most dramatic financial impact of the transfer tax provisions in ATRA 2012.

4. *"Buyer's Remorse" Over 2012 $5 Million Gifts.* For some clients, the decision in 2012 to make $5 million (really $5,120,000) gifts was very difficult. Some of those clients did so anyway, because of the possibility that the very large $5 million exemption was a mere window of opportunity that would close after 2012. Some individuals who made the large gifts in 2012 (and may have concerns about whether they may at some point need access to some of those funds) may now wish they had not "pulled the trigger" on the gifts in 2012.

5. *Planning With "Permanent" Large Gift Exemptions.* Now that we know the gift exemption will continue at the high $5 million indexed level, some of the concerns the client struggled with in 2012 and planning alternatives to address those concerns will be ongoing as well. These include:

   - Large gifts combined with sales or other leveraged transactions afford the opportunity of removing huge amounts from the transfer tax base for estate and GST purposes;
   - The use of "spousal lifetime access trusts" (sometimes referred to as "SLATs"), including concerns over whether the donee-spouse can be given a testamentary limited power of appointment broad enough to appoint the assets back into a trust for the original donor-spouse if the donee predeceases, and including potential effects of creditors rights with respect to those trusts;

- The use of "non-reciprocal" trusts if married individuals want to include each other as potential beneficiaries of SLATs;
- Dealing with the complexities of gift splitting in order to take advantage of both spouses' large gift exemption amounts if the marital assets are owned predominantly by one spouse; and
- Concerns over losing a stepped-up basis for gifted assets that are no longer owned by the individual at death.
- A donor may choose to purchase assets from grantor trusts in return for long-term notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step-up at the donor's subsequent death).
- There will continue to be an urgency in creating and funding grantor trusts sooner rather than later in light of the Administration's proposal to restrict the advantages of using grantor trusts that are created and funded in the future and to restrict entity-based valuation discounts.

6. *Gift Splitting Election For 2012 Gifts and Other Gift Tax Return Issues*. In some situations, couples did not make large enough gifts to fully utilize both of their $5.12 million exemptions, and the strategic plan was to have one spouse make a full $5.12 million gift with a lower gift by the other spouse. That way, if Congress had reduced the estate exemption below $5.12 million, at least one of the spouses would have taken advantage of the possibility of removing the additional amount over the reduced estate exemption from the estate tax base without any gift or estate cost. Now that we know Congress did not reduce the estate exemption, making the split gift election may be preferable — for being able to utilize both spouses' gift exemptions in the future and if nothing else for the convenience of keeping track of the gift exemptions (and GST exemptions if appropriate) used by the spouses.

   In light of the large number of gifts made in 2012, there will be a much larger number of gift tax returns filed this year than in the past. Planners will be devoting significant resources toward proper reporting of 2012 gifts.

7. *Consider Appropriate Leveraging Transactions With 2012 Gifts.*

   - Consider sales to grantor trusts that received large gifts in 2012 to shift even more future appreciation to the trust in the future.
   - In light of the time crunch at the end of 2012, some clients made gifts of easy-to-value and easy-to-transfer cash or cash equivalents in 2012. Consider exercising substitution powers or sales to swap in assets with more appreciation potential and that may be able to take advantage of valuation discounts.
   - In doing that, leave sufficient time between funding and transferring interests in entities to avoid step-transaction arguments under the *Holman/Gross/Linton/Heckerman* theories.

8. *Portability*. Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. Planners know that there are a variety of advantages of employing trusts at the first spouse's death, but many clients may opt for the "cheapest" (and perhaps more important, the *simplest*) alternative.

   In addition, relying on portability may be a simpler way to utilize bypass trust planning for clients who live in states with decoupled state death taxes. A standard bypass trust could be funded to the extent of the state estate tax exemption, and portability might be used to take advantage of the balance of the first deceased spouse's exemption amount.

9. *GST Relief.*

- *No Loss of Previously Allocated GST Exemption.* Planners no longer need be concerned about the meaning of the "as if it had never been enacted" provisions of the EGTRRA sunset provision, and whether that might cause previously allocated GST exemption to magically disappear in the future.
- *Qualified Severances.* Clients will continue to be able to divide mixed inclusion ratio trusts by means of a "qualified severance," both with respect to such trusts not already severed and trusts which become less than entirely exempt in the future.
- *Deemed Allocations of GST Exemption.* Clients who fail properly to allocate GST exemption on timely filed gift tax returns will continue, in some cases, to benefit from the automatic allocation of GST exemption to "indirect skip" gifts to "GST trusts."

10. *No "Clawback" Concerns.* Planners no longer need be concerned about whether an automatic reduction in exemptions will result in any "clawback" in the future with respect to higher exemptions used currently with gifts. Of course, it is always possible that Congress could pass additional legislation with lower exemptions and fail to address the potential clawback issue, but that is unlikely at least through inadvertence, since the tax writing committees would no doubt be reminded of the need to address this issue.

11. *Charitable Giving.* The reinstitution of the phase-out of itemized deductions may have an impact on decisions of clients to make large charitable gifts. The otherwise available charitable deduction may be cut back by as much as 80% under § 68.

12. *Net Investment Income.* In addition to the increase in the maximum income tax rate to 39.6% for high income earners (i.e., generally joint filers earning more than $450,000 and $400,000 for single filers), a new 3.8% Medicare tax applies beginning in 2013 to net investment income if the adjusted gross income (without regard to the foreign earned income exclusion) exceeds $250,000 for joint filers and $200,000 for single individuals. Therefore, the top federal rate on investment income for high earners will be 43.4% (not including state income taxes).

    The 3.8% tax on net investment income will also impact trust administration planning. The 3.8% tax applies to the *undistributed* net investment income of trusts in excess of the income level at which the highest trust rate applies ($11,950 for 2013).

13. *Annual Exclusion Gifts.* While not part of ATRA 2012, the gift tax annual exclusion has increased to $14,000 in 2013 under the normal indexing provisions.

Possible Further Legislation

ATRA did not address all of the "fiscal cliff" issues, most notably spending cuts, and which was a sticking point with Republican lawmakers in both houses, and threatened to derail the legislation in the House of Representatives. Spending cuts issues will be central to the negotiations over sequestration (automatic military and domestic cuts were deferred only to March 1, 2013), and the fast approaching debt limit. Moreover, President Obama did not achieve the income tax increases on couples with incomes in excess of $250,000, as he had hoped. ATRA 2012 raises less revenue than even House Speaker Boehner offered in the negotiations at one point ($800 billion over 10 years, although it is not clear that he could get the House to approve those revenue increases.) Accordingly, as debate ensues about spending cuts, there will no doubt be a push for additional "revenue raisers."

While the issues of exemptions, tax brackets, and tax rates appear to be off the table, for the time being, there are still numerous other methods of raising revenue that are under consideration, and that should be expected to be debated in the near future.

In the wealth transfer tax arena, such measures will likely include provisions that President Obama has already identified in his "Green Book" recommendations, including minimum terms for GRATs, limitations on (or elimination of) certain entity-based valuation discounts for intra-family transfers, limiting (or eliminating) the benefits of installment sales to grantor trusts, and other modifications to the grantor trust rules. Additionally, other revenue raisers may be proposed that have not yet been widely discussed.