



## Estate Planning Update

December 12, 2013

### **OPPORTUNITY TO MAKE TAX-FREE DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS TO CHARITY SET TO EXPIRE SOON**

Individuals over age 70-1/2 may make tax-free qualified charitable distributions of up to \$100,000 this year out of their individual retirement plans. This extension only applies through the end of 2013. To qualify, the distributions must be made to public charities (other than supporting organizations or donor advised funds), certain government units, or private operating foundations.

### **EQUAL TREATMENT OF SAME-SEX MARRIAGES UNDER FEDERAL LAW**

On June 26, 2013, the United States Supreme Court ruled in *United States v. Windsor* that Section 3 of the Defense of Marriage Act, which defines marriage as between a man and a woman, is unconstitutional. Shortly thereafter, the IRS released guidance regarding the Supreme Court decision adopting a "State of celebration" rule which provides that same-sex couples legally married in a jurisdiction that recognizes their marriage will be treated as married for all Federal tax purposes. For purposes of Federal taxation, it is irrelevant whether a married same-sex couple lives in a jurisdiction that recognizes their marriage so long as they were married in a state that did.

It is important to note that the new rules do not apply to same-sex couples that are in marriage equivalents, such as domestic partnerships and civil unions.

Beginning with tax year 2013, married same-sex couples generally will be required to file their Federal income tax returns as married. However, if the law of the state of residence of the married same-sex couple does not recognize their marriage, they will have to file their state income tax returns as single. New York, New Jersey, and Connecticut are among the states that currently recognize same-sex marriages.

With respect to qualified retirement plans, married same-sex couples now also have the rights that married opposite-sex couples have enjoyed, including the ability to spread out distributions under more favorable rules than those available to non-spouse beneficiaries. If someone other than the spouse is to be named as beneficiary, spousal consent may be required for certain plans.

All of the Federal estate and gift tax provisions available to married couples apply to same-sex married couples, including the unlimited marital deduction on certain gifts to a spouse during life or at death, portability of unused Federal estate and gift tax exemption, and the ability to "split gifts."

Same-sex spouses who were married prior to the rulings may wish to consider filing amended income, gift and estate tax returns for “open” years (generally the later of three years from the return filing date and two years from the date taxes were paid).

## **ESTATE, GIFT, AND GST TAXES**

On January 2, 2013, the American Taxpayer Relief Act of 2012 (the “Act”) was signed into law, providing a “permanent” Federal estate, gift and generation-skipping transfer (“GST”) tax law for the first time in 12 years.

### *Exemptions*

The Federal estate, gift and GST tax exemptions for 2013 are \$5.25 million (up from \$5.12 million in 2012). The exemptions are indexed for inflation and will increase to \$5.34 million for 2014.

### *40% Rate*

The Act set the top Federal estate, gift and GST tax rate at 40%.

### *Portability*

The Act made portability permanent. Portability allows a surviving spouse to use his or her last deceased spouse’s unused Federal estate and gift tax exemption against the surviving spouse’s own transfers. As noted in our January 18th memorandum, planning is still necessary to fully utilize exemptions given that the GST tax exemption and state level estate tax exemptions are not “portable” to the surviving spouse.

### *Federal Gift Tax Annual Exclusion Unchanged for 2014; Tuition and Medical Payments*

The annual exclusion from Federal gift tax is \$14,000 per individual recipient for 2013 and will remain \$14,000 per individual recipient for 2014. A married couple that “splits” all gifts (i.e. have gifts to others treated as made one-half by each spouse) on gift tax returns for the year may give a total of \$28,000 gift-tax free to any number of individual recipients.

In addition to the annual exclusion, there continues to be an exclusion from Federal gift tax for payment of another person’s tuition or medical expenses (including medical insurance premiums), provided that the payment is made directly to the institution providing education or directly to the health care provider. This exclusion is unlimited both with respect to the amount of the payment and the number of allowable recipients.

## **NEW 3.8% MEDICARE NET INVESTMENT INCOME SURTAX (THE “3.8% TAX”) HAS SIGNIFICANT IMPACT ON NON-GRANTOR TRUSTS**

The 3.8% Tax on net investment income went into effect on January 1, 2013. Individuals (other than non-resident aliens) will pay the 3.8% Tax on any net investment income over \$250,000 (for married couples filing jointly) or \$200,000 (for single persons). The tax is even more harsh for non-grantor trusts, which pay the 3.8% Tax on net investment income over \$11,950 in 2013, and \$12,150 in 2014. (The income of grantor trusts is taxed to the donor and thus the net investment

income of a grantor trust is added to the donor's own net investment income when calculating the 3.8% Tax.)

Below are some strategies that may reduce the 3.8% Tax owed by non-grantor trusts:

- **Distribute trust net investment income:** The trustee might consider distributing out trust net investment income in excess of \$11,950 in 2013, and \$12,150 in 2014 to a beneficiary if and to the extent that the beneficiary's net investment income is below the individual taxpayer threshold. Before making such a distribution, the trustee should consider both nontax and other tax factors, including asset protection benefits and potential estate tax or generation-skipping transfer tax savings of keeping the assets in trust, and whether the age and maturity of the beneficiary lends itself to current distributions.
- **Shift the mix of trust investments:** Shifting to tax-exempt and tax-deferred investments can decrease the tax owed by the trust since tax-exempt investments, such as municipal bonds, are not subject to the 3.8% Tax, and tax-deferred investments, such as tax-deferred annuities, will grow tax-free until payments are received. Additionally, non-dividend growth stocks will not be subject to tax until sold.
- **Make "active" investments:** Trusts owning closely held businesses should note that income from active trade or business activities is not subject to the 3.8% Tax. Complex rules determine whether an activity is passive or active for non-grantor trusts, and is an area of the law that would benefit from IRS guidance. A primary factor that may be considered is the involvement of the trustee in the business activity. In some cases, a restructuring of a closely-held business interest held in trust may enhance the trustee's position that the interest is an active trade or business.

## LOW INTEREST RATE ENVIRONMENT ENHANCES INTRA-FAMILY TRANSFERS

The IRS interest rates that apply to loans to family members and trusts continue to be low for the month of December. For example, the rate is 0.25% for a loan with a term of not more than 3 years; the rate is 1.65% for a loan with a term of more than 3 years but not more than 9 years; and the rate is 3.32% for a loan with a term of more than 9 years. In addition to intra-family loans, these rates apply to sales of assets to family members or trusts in exchange for a promissory note.

In addition, the "7520 rate," which is used for Grantor Retained Annuity Trusts ("GRATs") and Charitable Lead Annuity Trusts ("CLATs") is also low for December – 2.0%. GRATs and CLATs are estate planning vehicles that allow transfers of assets to a trust that pays out an annuity for a fixed term – for the donor's own benefit, if a GRAT, or for charity, if a CLAT – with any amounts exceeding the required payout passing at the end of the fixed term with little or no gift tax to the donor's descendants.

## PROPOSALS REGARDING NEW YORK STATE ESTATE TAX

On December 10, 2013, Governor Andrew M. Cuomo accepted the report of the New York State Tax Relief Commission (the “Commission”) recommending an overhaul of the current New York State tax system. Notable recommendations with respect to the New York State estate tax include the following:

- **Increase the New York State Estate Tax Exemption:** The New York State estate tax exemption is currently \$1 million. The Commission recommends increasing the exemption to the Federal level of \$5.25 million, with indexing for inflation.
- **Lower the Top New York State Estate Tax Rate:** The Commission recommends lowering the top New York State estate tax rate from 16% to 10%.

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