Federal Estate Tax Updates 2013©

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Summary:

1. **Federal Estate Tax: an overview**
2. **Current Law**
3. **How to calculate the amount due**
4. **Portability**
5. **Death of DOMA**
6. **Obama's 2014 budget proposal**

1. Federal Estate Tax: an overview.

- According to the Internal Revenue Service (IRS), the estate tax is a tax on an individual's right to transfer property at his or her death.
- Through the Tax Reform Act of 1976, Congress reshaped the estate tax into its current form that provides a unified system to tax all types of wealth transfers.
- The current form of the federal estate tax includes:
    1. Traditional estate tax;
    2. Gift tax; and
    3. Generation-skipping transfer (GST) tax.
- Traditional Estate Tax is the tax on all assets owned by the decedent or in which the decedent has an interest such as joint tenancy or a power of appointment.

- The gift tax requires that all taxable gifts made by the decedent during his or her life (actually since 1977) be included in the value of the estate for tax purposes.
- The GST is a tax imposed on outright gifts and transfers in trust for the benefit of individuals two or more generations younger than the decedent.

2. Current law:

- Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) the maximum tax rate was 55%. The exclusion was $675,000. Beginning in 2002 the top rate was reduced incrementally to 45% in 2007. In 2004, the exemption for estate taxes (but not for gift taxes) began to increase incrementally until it was $3.5 million in 2009, and the GST tax exemption and rate became unified with the estate tax exemption and rate. During the post-EGTRRA period through 2009, the gift tax exemption remained $1 million. Under EGTRRA, for 2010, the estate tax was replaced with carryover basis treatment of bequests, the GST tax was not applicable, and the gift tax was to remain in effect with $1 million exclusion and a 35 percent tax rate. The EGTRRA provisions were scheduled to expire at the end of 2010, meaning that the estate tax and GST tax would be inapplicable for only one year.
- The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 retroactively changed applicable law for 2010 by providing a top estate tax rate of 35 percent for taxpayers electing estate tax rather than carryover-basis treatment. It retroactively reinstated the GST tax and unified the exemption for estate, GST, and gift taxes beginning in 2011 with $5 million total lifetime exclusion for all three taxes (indexed after 2011 for inflation from 2010). The Estate Tax Rate through 2012 was 35%.
- The American Taxpayer Relief Act of 2012 (ATRA) raised the estate, GST, and gift tax rate to 40 percent, and each individual has lifetime exclusion for all three types of taxes of $5 million (currently: $5.25 million, indexed for inflation from 2010). These changes were made “permanent”.

Comparison of Transfer Tax Exemption and Rates		
Federal Transfer Taxes	**2012 Law**	**2013 Law**
Federal estate tax exemption	$5.12 million	$5.25 million
Federal gift tax exemption	$5.12 million	$5.25 million
Federal GST exemption	$5.12 million	$5.25 million
Estate, gift and GST top tax rate	35%	40%

3. How to calculate the amount due:

- Decedent’s "Gross Estate" is calculated on IRS Form 706 by listing all assets in which decedent held in interest in Schedules A-I.
- Once the Gross Estate is determined, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at the "Taxable Estate." These deductions may include mortgages and other debts, estate administration expenses, and property that passes to surviving spouses and qualified charities. The value of some operating business interests or farms may be reduced for estates that qualify.

- After the net amount is computed, the value of lifetime taxable gift (beginning with gifts made in 1977) are added back to this number and the tax is computed.
- The tax is then reduced by the available unified credit.

4. Portability:

- Portability was introduced as part of the Tax Relief, Unemployment Insurance Re-authorization and Job Creation Act of 2010.
- Prior to Portability, estate planning at the federal level required the creation and funding a credit shelter trust at the death of the first spouse to protect as much of that spouse's unified credit as possible. Some of that credit was wasted if there was not assets equal to or greater than the credit held in the name of the decedent.
- Portability is available to the surviving spouse of a person who dies after December 31, 2010. Portability increases the surviving spouse's exclusion amount for estate and gift tax purposes by the portion of the deceased spouse's exclusion that remained unused at the deceased spouse's death.
- As a result of the passage of the 2012 ATRA, Portability is now a permanent fixture in the transfer tax system.
- For those dying in 2011 and later, if a first-to-die spouse has not fully used the estate tax exclusion, the unused portion (technically called the "Deceased Spousal Unused Exclusion Amount," or "DSUE amount,") can be transferred or "ported" to the surviving spouse. Thereafter, for both gift and estate tax purposes, the surviving spouse's exclusion is the sum of (i) his/her own exclusion (as such amount is inflation adjusted), plus (ii) the first-to-die's ported DSUE amount.
- Notes Regarding Portability:
    - <u>Election required</u>. In order for the surviving spouse to be able to use the DSUE amount, the executor of the first-to-die's estate must make an election on a timely-filed estate tax return. This could necessitate the preparation and filing of a return just to make this election when a return might not otherwise be needed.
    - <u>Extended Statute of Limitations</u>. Normally the statute of limitations for a properly filed estate tax return is three years. However, if the estate tax return includes an election to allow portability of the DSUE amount to the surviving spouse, then the time limit on when the IRS can review the first-to-die's return is extended until the statute of limitations runs on the survivor's estate (i.e., generally three years after the estate tax return is filed for the survivor's estate).
    - <u>Only last deceased spouse's DSUE amount is portable; however, there is a special rule when there were multiple spouses</u>. The general rule is that the surviving spouse can use the DSUE amount of his/her last deceased spouse.
    - A spouse who remarries may want to use the Portability of the prior deceased spouse prior to the death of the "new" spouse by gifting assets.
    - <u>Does not apply to GST.</u> By its terms, portability does not apply to GST tax, and thus to the GST exemption. If the first-to-die spouse does not fully use his/her GST exemption, it is wasted.

- No state Portability: Portability is a purely federal concept. To date, no state has adopted portability.
- Other Benefits:
    1. Step up in basis at second death as opposed to second death with credit shelter trust
    2. Assets protection: Marital Trust can be partial
    3. State Estate Taxes- First spouse leaves assets in marital trust. Surviving spouse gifts assets in Trust using First spouses "partial" exemption

5. Death of DOMA:

- DOMA was a federal law that required same sex spouses to be treated as unmarried for purposes of federal law, including but not limited to federal tax matters, regardless of the recognition of same sex marriage under a number of state laws. This law was overturned in Supreme Court Case, *Windsor v. U.S, 833 F.Supp.2d 394 (S.D.N.Y.2012), aff'd. 699 F.3d 169 (2nd Cir Oct. 18, 2012) aff'd. 570 U.S. __(June 26, 2013).*
- The facts in *Windsor* were that a same sex couple, Windsor and Spyer, had lived together for 30 years when they registered as domestic partners in New York City and then married in Canada in 2007. Spyer died in February 2009 and left her estate to Windsor. Because of DOMA, no estate marital deduction was allowed and estate taxes of about $363,000 were incurred. Windsor paid the estate tax and brought a suit in the Southern District of New York, saying DOMA violated the Equal Protection Clause of the Fifth Amendment. The Federal District Court and the Federal Court of Appeals held in favor of Windsor. The case went to the Supreme Court where a majority of the Court held that Section 3 of DOMA was unconstitutional.
- For the 15 states (including Maine) that recognize same sex marriage, *Windsor* results in a couple's benefitting from federal benefits and exemptions in the same way as a married husband and wife.
- On August 29, 2013, the United States Department of Treasury and IRS announced that all legal same sex marriages would be recognized for federal tax purposes.
- Under Revenue Ruling 2013-17, the terms "husband and wife", includes an individual married to a person of the same sex if they were lawfully married in a state whose laws authorize the marriage of two individuals of the same sex, and the term "marriage" includes such marriages of individuals of the same sex.
- However, Revenue Ruling 2013-17 also made it clear that for federal tax purpose, the terms "spouse", "husband and wife", "husband", and wife" do not include individuals (whether of the opposite sex or of the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under that laws of that state, and the term "marriage" does not include such formal relationships.
- Same sex couples, or a same sex surviving spouse, should consider amending tax returns or the filing of "protective claims" to avoid any lapse of statute of limitations to take advantage of gift and estate tax marital deductions and joint tax returns now available to them.
- Estate Tax Benefits-
    1. Unlimited marital deduction;
    2. Naming spouses as beneficiaries on retirement plans and spousal rollovers of accounts on death; and
    3. Electing federal Portability;
- Maine also offers state estate tax benefits to same sex couples. So for Maine estate tax purposes, married same sex couples are treated the same as heterosexual married couples.

6. Obama's 2014 Budget Proposal:

- The new budget plan proposes to change the **estate tax** by (1) increasing the estate tax rate from 40% to 45% and lowering the per-person estate and GST tax exemption from $5 million to $3.5 million. It also lowers the gift tax exemption to $1MM (effective in 2018). The estate tax exemption amount will not be indexed for inflation. This means that as inflation increases the amount of money taxpayers have in their estates, a greater number of smaller estates would be subject to the estate taxes.
- **Generation Skipping Transfer Tax-exempt Dynasty Trust** This Trust is utilized by a taxpayer to pass on wealth generated from assets that appreciate in the trust to beneficiaries, generations later. Since GST tax-exempt dynasty trusts are in essence perpetuities with no definite end, they can be an attractive estate planning tool. The new budget plan, however, proposes limiting the existence of a dynasty trust to 90 years. Although this may still be an attractive and appropriate estate planning tool, taxpayers planning on utilizing these trusts indefinitely may need to reexamine their estate planning strategies.
- **Grantor Retained Annuity Trusts** are also subject to changes under the new budget plan. Grantor retained annuity trusts (GRATs) are typically short term trusts composed of quickly appreciating assets. GRAT's retain an income interest that is received by trust beneficiaries as an annuity payment. The gift tax is determined at the beginning of the trust term and appreciated value is distributed to the beneficiaries without additional taxes if the taxpayer is still alive at the end of the trust term. This is an attractive estate planning tool since it allows taxpayers to minimize transfer taxes while still distributing assets to beneficiaries. However, the new budget plan would potentially eliminate this type of trust's attractiveness by requiring a minimum trust term of 10 years, thus increasing the possibility that the grantor would pass away, returning the trust assets to his or her estate for estate tax purposes and not passing them directly to the beneficiaries.
- **Intentionally Defective Grantor Trusts** (IDGT) are a special type of grantor trust where the trust is a separate entity from the taxpayer and allows the taxpayer to exclude some of his or her taxable estate. These trusts are not treated as a separate entity for income tax purposes. This means the taxpayer is paying income taxes on the appreciated assets in the trust, allowing more value to be distributed to beneficiaries. The proposed budget eliminates this tax separation, requiring instead that a gift tax be paid upon distribution from the IDGT and all value would be considered part of the estate for estate tax purposes when the grantor passes away. Since the purpose of an IDGT is to minimize the taxable estate while increasing amount distributable to beneficiaries, this new proposal would eliminate the value in using IDGTs as an estate planning strategy.
- **Discounting gifts using Limited Liability Companies (LLCs), Limited Partnerships, and gifts of undivided fractional ownerships:** While the issue of discounting fractional interests in LLCs is not specifically addressed in the President's proposed budget, the IRS is taking a hard line on discounting and may limit or even deny some discounting allowances which have been acceptable in the past.

See slides on next page

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Overview

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- Current Law
- How to calculate the amount due
- Portability
- Death of DOMA
- Obama's 2014 budget proposal

Transfer Tax Exemption and Rates for 2013

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Portability

- For those dying in 2011 and later, if a first-to-die spouse has not fully used the estate tax exclusion, the unused portion, technically called the "Deceased Spousal Unused Exclusion Amount," or "DSUE amount," can be transferred or "ported" to the surviving spouse. Thereafter, for both gift and estate tax purposes, the surviving spouse's exclusion is the sum of (i) his/her own exclusion (as such amount is inflation adjusted), plus (ii) the first-to-die's ported DSUE amount.

Death of DOMA

- In *U.S. v. Windsor* , the U.S. Supreme Court declared that Section 3 of the Defense of Marriage Act ("DOMA") was unconstitutional
- On August 29, 2013, the United States Department of Treasury and IRS announced that all legal same sex marriages would be recognized for federal tax purposes.
- Under Revenue Ruling 2013-17, the terms "husband and wife", "husband" and "wife" include an individual married to a person of the same sex if they were lawfully married in a state whose laws authorize the marriage of two individuals of the same sex, and the term "marriage" includes such marriages of individuals of the same sex.

Obama's 2014 Budget Proposal

- The new budget plan proposes to change the **estate tax** by (1) increasing the estate tax rate from 40% to 45% and lowering the per-person estate tax exemption from $5.25 million to $3.5 million.
- Some techniques that could no longer be available are:
    - Short term Grantor Retained Annuity Trusts ("GRATs");
    - Sales to Intentionally Defective Grantor Trusts;
    - Discounting gifts using limited liability companies (LLC)s, limited partnerships, and gifts of undivided fractional ownerships; and
    - Use of Dynasty Trusts