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PRACTICE ALERT

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Congress Makes Estate and Gift Tax Changes Permanent

By: Alan K. Davis, Eric D. Marchand, Matthew S. Beard and Charles J. Allen

While it may have sounded like a half-hearted thud with respect to repairing the nation's growing debt problems and income tax issues, H.R.8, given the short title the "American Taxpayer Relief Act of 2012" (the "2012 Act"), appears to finally provide certainty in the areas of federal estate, gift, and generation-skipping transfer ("GST") taxes more than a decade after the 2001 Act was passed.

On January 1, 2013, the Senate passed the 2012 Act by a vote of 89 to 8. Later the same day, the House of Representatives passed the 2012 Act by a vote of 257 to 167. President Obama signed the 2012 Act into law on January 2, 2013.

The 2012 Act permanently extends P.L. 107-16, the "Economic Growth and Tax Relief Reconciliation Act of 2001" also known as "EGTRRA") (the "2001 Act"), and P.L. 111-312, the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (the "2010 Act"), and strikes the sunset provisions of the 2001 Act and 2010 Act. The 2012 Act also establishes new tax rates for estate, gift, and GST taxes.

This discussion first summarizes the impact of the 2012 Act by describing the transfer tax system for 2013 and future years, and then provides a more detailed summary of the various components of the transfer tax system as represented by the 2001 Act, 2010 Act, and 2012 Act.

<u>Summary of Transfer Tax System for 2013</u>

	Exemption*	Top Rate
Estate	$5,000,000	40%
Gift	$5,000,000	40%
GST	$5,000,000	40%

* These exemptions are all indexed for inflation with a 2010 base year, which is estimated to be approximately $5.25 million.

For 2013, the estate tax exemption is $5,000,000, indexed for inflation, per person with a maximum estate tax rate of 40%. The exemption may be used by certain surviving spouses under the "portability" rules.

For 2013, the gift tax exemption is $5,000,000, indexed for inflation, per person with a maximum gift tax rate of 40%. Each donor also has an annual exclusion that has increased to $14,000 per donee in 2013.

For 2013, the GST exemption is $5,000,000, indexed for inflation, per person with a maximum GST tax rate of 40%. The portability rules are not applicable with respect to the GST exemption.

If you compare this new law to the law in effect during 2012, essentially the only change is that the rates are revised at various levels with the maximum rate increasing from 35% to 40%. That's about it.

If you compare this new law to what would have been the law in 2013 without the 2012 Act, there is a significant difference. The law was scheduled to revert to pre-2001 levels, which would have included a $1,000,000 per person exemption for estate, gift, and GST tax with a maximum rate of 55% and no portability of estate tax exemption.

Summary of 2001 Act

The 2001 Act substantially changed the transfer tax system. Prior to 2001, essentially every person had a $1,000,000 estate, gift, and GST tax exemption and a maximum tax rate for all three taxes of 55%. The 2001 Act generally provided, over a several year span, for increasing estate and GST exemptions and decreasing maximum tax rates applicable for all three taxes. Because the gift tax exemption remained at $1,000,000 during this period, many advisors described the 2001 Act as uncoupling or de-unifying the exemptions. The 2001 Act also made significant changes and additions to the GST tax provisions. Specifically, the 2001 Act provided automatic allocations of GST exemption for certain lifetime transfers and taxpayer friendly relief provisions for missed GST allocations. The 2001 Act was scheduled to sunset on December 31, 2010, with a provision that treated portions of the 2001 Act "as if never enacted."

Summary of 2010 Act

The 2010 Act, passed on December 17, 2010, temporarily (1) extended the 2001 Act; (2) increased exemptions to $5,000,000, indexed for inflation; (3) decreased the maximum tax rates to 35%; and (4) introduced portability. However, like the 2001 Act, the 2010 Act was scheduled to sunset on December 31, 2012, and, thus, return the transfer tax system to pre-2001 rules.

Planning After the 2012 Act

The 2012 Act extends the taxpayer favorable provisions of the 2001 Act and 2010 Act *without* a sunset provision. This permanent extension thus reintroduces some semblance of order for the tax regimes and makes planning more certain.

As with all tax laws, what is not contained in the 2012 Act may be more important than what is contained in the 2012 Act. The 2012 Act did not address any of the following issues identified by President Obama as areas for modification:

1. The 2012 Act does not remove or eliminate valuation discounts for closely held entities, such as family limited partnerships or other family owned businesses. President Obama's proposal would have limited these discounts to entities carrying on an active trade or business.

2. The 2012 Act does not limit the term of GST trusts. Under President Obama's proposal, the GST inclusion ratio for a trust would reset to one once a trust exists for 99 years.

3. The 2012 Act does not limit the use of "grantor trusts." President Obama's proposal would cause all grantor trusts to be included in the grantor's estate.

4. The 2012 Act does not mandate that a grantor retained annuity trust, also known as a "GRAT," have a minimum term of ten years and a mandatory gift element. Again, President Obama's proposal would have required GRATs to include such provisions, which would reduce the effectiveness of these powerful planning tools.

While the 2012 Act does not address these items, it is not at all certain that they are no longer being considered. Quite to the contrary, it is very possible that legislation addressing the issues could be introduced in the near future.

The tax laws have been in flux over the past decade. Many clients delayed their planning matters during this time until the transfer tax rules became more permanent. The 2012 Act provides permanent extension of the 2001 Act and 2010 Act. Thus, at this very early stage of 2013, we anticipate many clients will decide to now solidify their planning matters in response to these new permanent rules, and before the additional issues identified by President Obama have been removed.

If Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P. can be of assistance to you with regard to any of these topics, please contact one of the following attorneys.

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