THE END IS COMING
(of the year that is)

SO REPENT
(your taxpaying ways)

Prepared for the Community Foundation of Broward
by Thomas O. Katz
Katz Baskies LLC

Estate and Gift Tax Planning:

1. Gluttony may be a sin, but stuffing gifts into 2012 may be a virtue.

Currently, every taxpayer can transfer up to $5,120,000 free of federal gift or estate tax (less any taxable gifts made in the past). This is often called the "applicable credit amount". If Congress fails to act, then beginning on January 1, 2013, the applicable credit amount will be reduced to $1 million - the level it was at in 2001. High net worth individuals now have one of the best opportunities in history to take advantage of the increased applicable credit amount by making lifetime gifts prior to 2013. The transfers can be made either outright to one or more individuals or in trust for their benefit.

While outright transfers will freeze the value of the asset transferred and offer a great deal of simplicity, they come with a number of limitations. Property transferred outright to an individual is exposed to the recipient's creditors and may be considered a marital asset upon divorce. Moreover, any income earned on the transferred property will be taxed to the recipient and the transferred property (including any appreciation) will included in the recipient's estate at death. Property transferred to a properly drafted trust for the benefit of another individual will generally avoid all of these limitations.

An irrevocable trust can be drafted in a way that removes any property transferred to it from the transferor's estate while still allowing all of the income earned on the assets within the trust to be taxed to the transferor. These are called "grantor trusts". By structuring the trust in this way, the property in the trust grows tax free (well, not really free, because the grantor is paying the tax), and each income tax payment made by the grantor further reduces the grantor's taxable estate. The IRS has confirmed that the payment of the tax by the grantor, even though a great economic benefit for the trust, is not treated like an additional gift to the trust. A grantor trust can also be drafted in a way that allows the termination of the grantor trust status if the transferor's suffers an economic setback or simply no longer wants to pay the tax on the trust income.

While the benefits of trusts and lifetime gifting have existed for years, they are particularly pronounced now with the scheduled reduction to the applicable credit amount looming on the horizon. While taxpayers can hope that Congress will act and extend the increased exemption for all years going forward, it may make sense for taxpayers to take advantage of the certainty that currently exists in 2012.

2. Mr. Government Man – please don't take my grantor trust away! – The silver lining in higher income tax rates (but beware the estate tax inclusion proposal).

Another item that has created uncertainty with respect to estate planning going forward is whether grantor trusts will be available going forward. President Obama's revenue proposals for 2013 would require assets in grantor trusts to be included in the estate of the grantor at death. That would kill the benefits of grantor trusts completely. Grantor trusts currently offer one of the best estate planning vehicles available for high net worth clients. Assuming that this benefit is not eliminated, then higher rates make grantor trusts all the more valuable, as the tax expense paid by the grantor for the benefit of the beneficiaries reduces the grantor's estate even further (but see below about the Medicare tax).

3. Get GRATing while the GRATing is good.

The utility and flexibility of Grantor Retained Annuity Trusts ("GRATs") may also soon be eliminated. A GRAT is a trust that provides the original transferor with an annuity interest in the property transferred for a period of two years or more. The transferor's retained interest reduces the value of the initial transfer. For example, if the transferor was to transfer a $3 million asset to a GRAT and retain an annuity interest having a value of $2 million, the total taxable gift at the time of funding would only be $1 million. After the annuity terms ends, the property in the GRAT is often held in a trust for the benefit of a spouse and children (and if a grantor trust, all the better).

It is also possible to have the value of the annuity equal the value of the property initially transferred to the GRAT, resulting in an initial gift of zero for gift tax purposes. This is generally called a "zeroed-out GRAT". The value of the annuity is based upon IRS tables and depends on certain interest rate tables published by the IRS (known as the "7520 rate"). Generally speaking, so long as the assets in the GRAT are outperforming the 7520 rate, the excess will pass to the ultimate beneficiaries completely free of estate or gift taxes (assuming the grantor outlives the term of the trust). Because of the poorly performing economy, the current interest rates are at all-time lows, making the use of GRATs more attractive than ever before.

Even with historically low interest rates, financial modeling tells us that GRATs (like most individual portfolios) perform best when the assets transferred to them perform very well in the early years. One way of minimizing the risk of poor performance early on is to fund a zeroed-out GRAT and set the annuity term for only two years. If the funds fail to adequately perform, the transferor simply recovers the assets originally transferred and gets to try again, all on a tax free basis. Heads you and your family win, tails the government gets nothing more. Under the administration's current proposal, GRATs would have a minimum term of ten years. This means that great early performance could be wiped out by later poor performance, and early poor performance makes it harder to make up even by later great performance.

Income Tax Planning:

1. Supremes sing a song of woe – the Medicare tax invades your life!

Beginning in 2013, two additional Medicare taxes will apply to all taxpayers earning over a certain amount ($200,000 for single filers, $250,000 for married couples filing jointly and $125,000 for married couples filing separately). First a 0.9% Medicare surtax will be imposed on the earned income of these individuals. Additionally, a 3.8% Medicare tax will apply to any interest, dividends, capital gains, annuities, royalties and rents received by these individuals. One strategy for some taxpayers will be trying to figure out how to convert unearned income to earned income. For example, for taxpayers that own rental real estate, a payment to a management company may reduce the overall tax burden (essentially, shifting income away from the new 3.8% tax and to the new 0.9% tax on earned income).

2. Wait a second – I thought you were supposed to defer income.

In addition to the Medicare taxes described above, individual income tax rates are expected to rise, with a maximum rates rising from 33% to 36% and 35% to 39.6%, capital gains rates of 20% and dividends taxed as ordinary income. For “qualified” dividends, that means an increase from 15% to over 43% (and worse for those who live in states with an income tax)!! Additionally, the standard deduction for married taxpayers will cease to be calculated as 200 percent of the amount available to unmarried filers and will return to a level of about 167 percent of the unmarried amount. Given the scheduled rise in income tax rates beginning in 2013, now may be an excellent time to cash in any deferred gains at the existing more favorable rates.

3. Take your deductions when the benefit is greatest – Who doesn’t love a plug for the Community Foundation of Broward?

On the one hand, higher income tax rates would mean that deductions, such as charitable gifts, are more valuable. On the other hand, there are two things that may make 2012 a better year to give to charity. First, we have been on “holiday” the last several years from the insidious “phase out” of itemized deductions – the law that eliminates much of the benefit of itemized deductions for high income taxpayers. Second, the Obama administration has repeatedly proposed reducing the amount wealthy donors are able to deduct for gifts to charities. Therefore, as with all other tax planning that is about to become very uncertain, it may make sense to make charitable contributions now while the benefits are best. That may mean that taxpayers should establish a philanthropic Fund at the Community Foundation of Broward, and make a significant contribution in 2012. Recommendations could then be made from the Fund at their own pace, to organizations chosen by the client --- and there is the benefit of tapping into the philanthropic resources of the Community Foundation.

4. AMT

The Alternative Minimum Tax (“AMT”) will affect twenty-five million more taxpayers in 2013 with an estimated $118 billion in higher taxes if Congress fails to act. The AMT was originally passed to ensure that wealthy individuals paid their fair share and did not eliminate their tax bills with deductions. AMT limits the deductions certain taxpayers are permitted to take. Individuals affected by the AMT calculate their taxes normally and then calculate them again under the AMT rules. If the tax computed under the AMT is higher, then that is the amount owing. Generally, the AMT limits the types of deductions available (for example, deductions for state income taxes and miscellaneous itemized deductions are not allowed) and then imposes a flat-tax of 26 to 28 percent. AMT has become an issue over the last several years because the exemption amounts were never indexed for inflation. Often, at the end of each year, Congress enacts a “patch” that adjusts the AMT thresholds for that year for inflation but has never permanently fixed the issue.