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Year-End Tax and Estate Planning With a Bit of New Legislation Mixed In

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The end of the year is a good time to review and update an estate plan, if necessary and consider income tax planning for the next year. So, as we approach the end of the year, here are some random thoughts that you will hopefully find helpful.

First of all, some new legislation:

Extension of Reduced Social Security "Trust Fund" Contribution Amount

Just before Christmas the President signed into law H.R. 3675, the "Temporary Payroll Tax Cut Continuation Act of 2011." Title I, Sec. 101 of the Act extends the 2 percentage point reduction (from 6.2 to 4.2 percent) in the Social Security tax on wages paid through February 29, 2012. Section 101(b) of the Act puts in place a recapture tax that effectively limits the reduction to $18,350 in wages paid during January and February of 2012. Amounts over that threshold and during that timeframe do not get the 2 percentage point reduction. Instead, the additional amount gets added to the employee's 2012 income tax liability. That is the status of the law at the present time, but it is likely that the "temporary" provision will be extended in late February.

The Act does not contain any extension of expense method depreciation at the 2011 level of $500,000. Instead, the maximum amount of aggregate basis of I.R.C. §179 property that can be placed in service in 2012 is $139,000. Likewise, the Act does not extend bonus depreciation at the 100 percent level. It will be 50% for 2012. On the depreciation provisions, remember that a particular state may not couple with the federal rules.

> **Note:** The Making Work Pay Tax Credit was included as part of the 2009 "stimulus" bill and was set to expire at the end of 2010. As part of the two-year extension of the 2001 tax cuts that was enacted in late 2010, the Congress replaced the Making Work Pay Tax Credit (which now expires at the end of 2011) with a 2 percentage point cut in the employee share of the payroll tax. The Congressional Budget Office has concluded that the payroll tax cut has had little stimulative economic effect.

Section 401 of the Act establishes a new tax on mortgages sold to Fannie Mae or Freddie Mac (which is about 60 percent of all home mortgages) in the form of a "guarantee fee" that is applicable through September of 2021. The additional fee is anticipated to add about $4,000 to a $200,000 mortgage, and make it more difficult for an overhaul of Fannie Mae and Freddie Mac to be accomplished.

Section 501 of the Act requires the President to grant a permit for projects associated with the Keystone Pipeline within 60 days of the Act's enactment unless the President determines the pipeline would not serve the national interest. If such a determination is made, the President is to submit a report within 15 days after making the determination that justifies the decision. The President could make a conditional approval by making it contingent on the State Department's study on alternative routes through Nebraska. If the President takes no action within the 60-day timeframe, the permit is deemed to be in effect.

Estate Planning

What we are not referring to is estate *tax* planning. The federal estate tax is barely a blip on the radar screen for the vast majority of people because of the $5 million exemption and portability of any unused exclusion at the death of the first spouse to the surviving spouse (if certain requirements are met).

It is unknown at the present time what the structure of the federal estate tax will be come 2013. While that may mean no estate tax planning needs to be done in 2012 for most people, some points need to be kept in mind from an overall planning perspective:

- If you got married during the past year, have you executed wills or trusts that leave specific items to each other upon the death of one of you, or specify who gets your property if something would happen to both of you? If not, state law will dispose of the property. A surviving spouse always gets a portion of the first spouse's estate (and that's true even if the first spouse purposely disinherits the surviving spouse), but you can leave the property in the manner that you desire if you leave a will or a trust that disposes of the property.

  It's particularly important to execute estate planning documents if the marriage wasn't your first.

- If you have minor children having a will or trust that names a guardian for them is very important. If you don't have a guardian appointed, a court will appoint one for you. But, it's a legal process that can be avoided and you probably don't want your children and family to have to go through it for numerous reasons.

- Do you have a financial power of attorney and/or health care power of attorney in place? If not, those are good planning documents to have prepared. Ask your attorney about a durable power.

- It's also a good time to update an existing estate plan if your spouse died or you got divorced during the past year. Basically, any significant change in the family structure warrants a review of the estate plan.

- If you have a revocable living trust, you may want to check it to see if it contains a clause that protects the trust funds from being grabbed by a beneficiary's creditor in bankruptcy. Some recent cases have provided some guidance for drafting language that works.

- Keep an eye on the growth in value of your assets and investments. While the $5 million exemption will keep the federal estate tax from applying to the vast majority of estates, we still don't know what the exemption level will be in 2013. Relatedly, about half of the states impose taxes at death, and those that do have an exemption that is much lower than $5 million.

  Note: State-level activity on death taxes changes frequently. Presently, our research shows that four states (Indiana, Nebraska, Tennessee and Oregon) are making moves to repeal taxes imposed at death. Recently, Minnesota created an exemption for estates with farm property and Pennsylvania may do the same in its next legislative session.

If the Congress doesn't take action, the federal exemption will be $1 million beginning for deaths in 2013. The estate tax is a net worth concept, so it's important to consider how easy it can be for net worth to add up to $1 million. According to IRS data, the following assets comprise most of the value of estates:

- Home
- Retirement Accounts
- Real Estate
- Business assets
- Automobiles
- Investments and bank accounts

So, if you think the exemption will be going down starting in 2013, you may want to consider some strategies to minimize the potential impact of the federal estate tax:

- Gifts of present interests – the maximum amount that can be gifted without the need to file a gift tax return or have the gift count against the exemption at death is $13,000 for 2012. Spouses can elect to split the gift (on a gift tax return) and get the amount up to $26,000 per donee for 2012. If you exceed the limit or split the gift, Form 709 must be filed.

- If you do have assets that are appreciating in value, there are some techniques that can be used to get that appreciation in the hands of another family member. Talk to your tax and estate planning professional for guidance.

- Trusts can also be used to make gifts. A grantor retained annuity trust (GRAT). A GRAT is a form of an irrevocable trust that is frequently used to make large gifts to family members without the grantor incurring gift tax. During the trust's term, it pays the taxpayer an annuity; after the trust's term, the remaining assets go to the trust beneficiaries. The White House and the Senate have proposed new rules that would limit the planning possibilities of this strategy, but those proposals have little chance of becoming law at the present time.

- For persons of high wealth that are wanting to minimize the potential impact of the estate tax and provide asset protection for generations a dynasty trust can be utilized. The $5 million exemption for 2012 makes this a more attractive technique. To make this technique more attractive, several states have eliminated the rule against perpetuities.

- One technique to transfer ownership of your home to your children is to use a qualified personal residence trust (QPRT). With a QPRT, a homeowner specifies a term under which they manage and live in their home. At the end of the term, the home transfers to the beneficiaries (typically family members) and the taxpayer can pay rent to the beneficiaries to continue living in the home. A QPRT avoids inclusion of the value of the home in the homeowner's estate at death and, at the same time, amounts to a gift of only the remainder interest of the home.

- If you moved to a different state or you haven't had your plan reviewed in several years, it's probably a good time to have a professional take a look at it. A will that was validly executed in one state is valid in the state you move to, but if it's been a while since your plan has been revised, now may be a good time to reexamine it.

- It's probably not a good idea to cancel life insurance policies that were taken out with the purpose of covering estate tax liability at death – at least not yet. At the present time, it is not known what the federal estate tax exemption will be beginning in 2013.

Income Tax Planning

Not only is it unknown at the present time what the federal estate tax exemption will be starting in 2013, there is a tremendous amount of uncertainty surrounding income tax starting in 2013. If the Congress does nothing in 2012, one of the biggest tax increases in U.S. history will occur starting in 2013 resulting in an income tax increase for everyone up and down the income tax scale.

But, for married couples with A.G.I. over $250,000 the increases are significant. Here are some of the major ones that we covered at the tax schools:

- Top marginal rate increases from 35% to 39.6%.
- Earned income hospital insurance from 1.45% to 2.35%.
- Capital gains from 15% to 23.8%.
- Dividends from 15% to 43.4%.
- Passive income from 35% to 43.4%.

In addition, the lack of permanence of so many tax provisions makes tax planning more difficult.

We covered these at the tax schools this fall, but if you didn't make it to one of the schools, here's a list of some major provisions that expire at the end of 2011:

- Credit for certain non-business energy property
- Personal tax credits allowed against regular tax and the alternative minimum tax
- Expanded adoption credit and adoption assistance programs
- Credit for construction of new energy efficient homes
- Credit for energy efficient appliances
- Alternative motor vehicle credit for qualified alternative fuel vehicles
- The Volumetric Ethanol Excise Tax Credit
- Work Opportunity Tax Credit (except the provisions of the Vow to Hire Heroes Act)
- Increased AMT exemption amount
- Deduction for certain expenses of elementary and secondary school teachers
- Premiums for mortgage insurance deductible as qualified residence interest
- Deduction for state and local general sales taxes
- 15-year straight line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements
- 100 percent bonus depreciation (decreases to 50 percent starting in 2012)
- $500,000 maximum amount of expense method depreciation (decreases to $139,000 starting in 2012, and real estate category no longer applicable)
  - Increase in amount allowed as deduction for start-up expenditures
- The special rules that apply for contributions of capital gain real property made for conservation purposes
- Enhanced charitable deduction for contributions of food inventory, and the provision providing an enhanced charitable deduction for contributions of book inventories to public schools
- Enhanced charitable deduction for corporate contributions of computer equipment for educational purposes
- Above –the-line deduction for qualified tuition and related expenses
- Tax-free distributions from IRAs for charitable purposes
- Treatment of certain dividends of regulated investment companies
- The special rules for qualified small business stock
- The rule providing for a basis adjustment to stock of S corporations that make charitable contributions of property
- The reduced S corporation recognition period for built-in gains tax

That's a lot of change for 2012 in terms of provisions that no longer will be in play. So, what should you do from a planning standpoint? Maybe about the best that can be done is some general stategizing. For example, if you think that your effective rate will be lower in 2012 than in 2013, consider the following:

- Push off whatever deductions you can from 2012 to 2013 and accelerate income to 2012. But, the technique can be complicated by the alternative minimum tax, so engage in this approach only upon the advice of a tax professional that has examined your particular situation.

- It's probably always a good idea to max out retirement plan contributions. There are still murmurs in D.C. about the federal government taking over private retirement accounts, but it seems to have quieted down a bit over the past year.

- If it fits with your overall tax and estate plan, you may want to consider making present interest annual exclusion gifts. As noted above, the maximum amount per person per year is $13,000 for 2012. While it's not a pure income tax strategy, gifting income producing assets to family members that are in a lower income tax bracket can achieve income tax savings for the family as a whole.

- Take a look at your level of charitable gifting and how it fits into your overall planning strategy? Here are some pointers on charitable giving:

    - IRA owners who are over 70 ½ years old can transfer up to $100,000 per year directly to an eligible charity. But, again, as of right now, this provision is only good through the end of 2011. The amount transferred is not taxable and no deduction is available as long as the IRA trustee contributes the funds to an eligible charity directly.

    - If you claim a deduction of more than $500 on donated household items or clothing, technically the donated items are to be in usable condition. There have been some instances in recent years where the IRS has looked at this issue closely.

    - Remember, if you are seeking a deduction for a cash donation, you need either a cancelled check or a written acknowledgement from the charity indicating the amount that you donated, the charity's name, and the date of the donation. In addition, you have to file Schedule A (itemized deductions) to get the deduction.

So there it is - some thoughts on how to deal with all of the uncertainty surrounding tax and estate planning. Do you have something that should be included in the list?

Have a great 2012.

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