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Legal Matters®

Estate Planning
fall 2012

Huge tax-saving opportunity available only until December 31

An enormous opportunity for families to reduce their estate taxes – and in some cases, save millions of dollars – will end on December 31, 2012. If there's a chance you can take advantage of these savings, it's wise to act immediately, because unless Congress changes the law, the window of opportunity will close permanently when the ball drops on New Year's Eve.

Between now and the end of the year, the lifetime exemption from the federal gift tax is $5.12 million. But on January 1, 2013, this exemption is scheduled to be reduced drastically, to just $1 million.

The gift tax applies anytime you make a gift to someone other than a spouse or a charity. In general, you can give any person (or a trust) up to $13,000 a year without there being a gift tax. But if you give someone more than $13,000 in a calendar year, then the tax applies to the excess.

However, you also have a "lifetime exemption." Over the course of your lifetime, you can make gifts over the $13,000 annual threshold up to the amount of this exemption without paying tax.

(The lifetime exemption isn't a complete "freebie." Any amount you use of your lifetime exemption is subtracted from your estate tax exemption, such that when you die, your estate taxes might be higher. But in general, the tax benefits of using the lifetime exemption far outweigh the disadvantages.)

Since the lifetime exemption is $5.12 million for the rest of the year, you can make gifts of up to $5.12 million this year without paying gift tax. Even if you already used up your lifetime exemption in the past, when the amount was smaller, you can now make very large additional gifts.

But this is true only if you make these gifts before the end of 2012.

Many people can benefit from this situation by putting significant assets into a trust that will pay

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A chance to transfer large assets tax-free is slated to disappear next year.

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New 3.8% tax on investment income takes effect in 2013

A new 3.8% tax on investment income will take effect in 2013, and anyone who has significant investments or who manages a trust should be planning for it now.

The tax was included in President Obama's health care law. (In the past, many people didn't plan for the tax because they thought the law might be struck down by the Supreme Court.)

The tax applies to single filers with adjusted gross income over $200,000 and married filers with adjusted gross income over $250,000. It also applies to trusts (and estates) with undistributed investment income of more than about $12,000 – so the effect could be very great on them.

For single and married taxpayers, the flat 3.8% tax applies to (1) the total amount of investment income, or (2) the amount by which adjusted gross income exceeds the $200,000 or $250,000 thresholds – whichever is less. So for instance, if a single taxpayer has $225,000 in adjusted gross income and $10,000 in investment income, the tax applies to the $10,000. But if the same taxpayer has $225,000 in adjusted gross income and $50,000 in investment income, the tax applies to $25,000 (the amount by which the taxpayer's income exceeds the $200,000 threshold).

Although the IRS hasn't issued regulations yet defining "investment income," it's likely to include dividends, capital gains, rent, royalties, interest (except from municipal bonds), taxable annuities, and passive partnership income. It probably will not include retirement plan payouts, Social Security, life insurance, or veterans' benefits.

In general – all other things being equal – it might be wise in certain cases to accelerate capital gains and other investment income so that they are recognized in 2012 rather than 2013.

For 2013 and beyond, since the 3.8% tax applies to investment income above the adjusted gross income threshold, the strategies for avoiding it are likely to involve (1) reducing what has to be reported as adjusted gross income, and (2) reducing what has to be reported as investment income.

These might include:

- Shifting investments into municipal bonds. This works both ways, since municipal bond income doesn't count toward either adjusted gross income or investment income.
- Giving more thought to trust distributions. If a trustee has discretion over the amount of trust distributions, it might be possible to save taxes by making larger distributions in years when the trust's income is high and the beneficiary's income is low, and smaller distributions in other years.

A case shows the importance of working with an estate planner now, rather than waiting until something happens or relying on highly unreliable forms on the Internet.

Deceased man's sister is sued for interfering with inheritance

When Marc MacGinnis was in the hospital awaiting surgery, he asked his friend Brent to prepare a will for him that would leave half of his estate to Brent and half to Marc's sister, Susan. Brent downloaded some will forms from the Internet, but Susan then suggested that she contact a lawyer to set up a trust instead. She said this would be better because it would avoid probate.

Susan never talked to a lawyer, and Marc died a few days after the surgery. Because Marc never signed a will, his entire $1 million estate went to Susan.

Brent then filed a lawsuit against Susan. He claimed that Susan knew there was a good chance Marc wouldn't survive the surgery, because the doctors had told her so. (They didn't tell Brent because he wasn't a relative.) He also claimed that Susan deliberately lied about talking to a lawyer, because she knew that if Marc didn't sign a will before he died, she would inherit the entire estate.

A judge initially sided with Susan, but on appeal, the California Court of Appeal sided with Brent and said he could take his case to trial.

It's still not clear who will ultimately win, but one thing is clear – whatever the outcome, a significant part of Marc's assets will go toward the cost of litigation.

The case is a good reminder of the importance of speaking to an estate planner now, rather than waiting until something happens or relying on the highly unreliable forms that are found on the Internet. If Marc had spent a short time with an estate planner, he would not only have avoided a nasty lawsuit between his intended heirs, but he would probably have been able to keep his estate out of probate and find other ways to maximize the benefits to the people he cared about.

Huge tax-saving opportunity available only until December 31

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income to their children, and ultimately benefit their grandchildren.

Here are some of the benefits of such a trust:

- Suppose you transfer an asset worth $1.5 million to a trust today, and by the time you die, that asset has increased in value to $2 million. The entire increase – $500,000 – will go to your heirs without being subject to estate tax.
- Suppose the asset also generates annual income. For instance, over the course of the rest of your life, it might generate $300,000 in income. That entire $300,000 will also go to your heirs without being subject to estate tax.
- Suppose you set up the trust so that your children receive the income, and when they die, the trust assets go to your grandchildren. The entire trust, regardless of how much it has increased in value, will go to your grandchildren without any estate tax being due when your children pass away.
- You will also have protected your grandchildren, because assets left in a trust for them generally can't be taken away if your children incur debts, are sued in a lawsuit, get divorced, etc.

What assets should you consider putting into a trust? Obviously, ones you don't need to keep for your current or future support. Beyond that, it's a great idea to contribute assets that are temporarily reduced in value and that have the potential for significant appreciation. In the current environment, real estate might be a good example.

Another possibility, if you own a business, is to give a minority interest in the business to the trust. You might be able to discount the value of the minority interest due to a lack of marketability and control – after all, a 49% share of a business is typically worth a lot less than a 51% share. This could allow you to give away more assets tax-free.

In some states, it's possible to create a "dynasty" trust, which continues to exist and benefit future generations such as great-grandchildren.

Remember, too, that the $5.12 million gift tax exemption is per-person. So a married couple could contribute as much as $10.24 million.

If you're in a committed relationship with someone but you aren't married to them, there may be other tax benefits in using the $5.12 million exemption this year in order to share assets with the other person. (Remember that transfers between spouses aren't subject to the gift tax, but transfers between an unmarried couple are.)

There are some possible downsides that should be considered. One is that we don't know what Congress will do after 2012, and there is a theoretical possibility that it will impose a retroactive tax on lifetime gifts over $1 million. There are also state tax issues to think about. And of course, you don't want to make gifts of assets that you will need to live on in retirement.

But in general, the benefits of taking advantage of this tax break before the end of the year are very significant, and should definitely be considered by anyone in a position to do so.

Many people can benefit this year by creating a trust that will pay income to their children and ultimately benefit their grandchildren.

Should a will include children conceived after a parent's death?

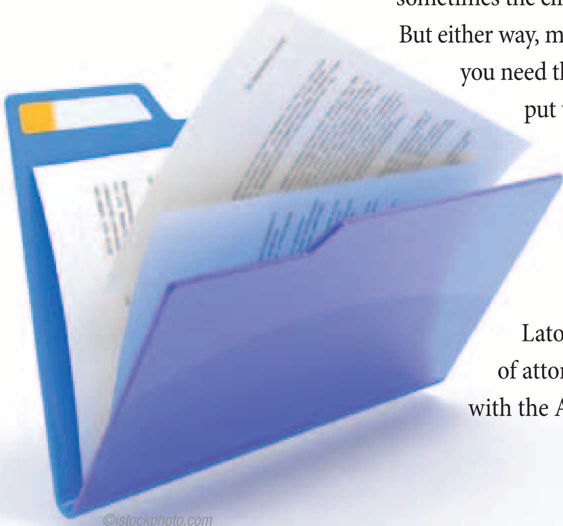
What's the legal status of a child who was conceived after a parent's death? That question would have been ridiculous not many years ago, but with advances in fertility treatments and the ability to freeze embryos and store sperm for later use, a number of children are now being conceived after one biological parent has passed away.

This has created a number of legal issues. For instance, the Supreme Court recently decided whether twins who were born 18 months after a father's death were eligible for Social Security survivors' benefits. (The answer was no, based on the specific language in the Social Security law.)

If someone you know is thinking about freezing embryos or sperm, this may be something to consider in your estate planning. That's because, if you leave assets in your will to your children, your grandchildren, your nephews and nieces, etc., it's not always clear whether children who were conceived after a parent's death will qualify. Not making it clear in your will could potentially lead to a lot of confusion, or even family strife and lawsuits.

This newsletter is designed to keep you up-to-date with changes in the law. For help with these or any other legal issues, please call today. The information in this newsletter is intended solely for your information. It does not constitute legal advice, and it should not be relied on without a discussion of your specific situation with an attorney.

Make sure you can access your power of attorney documents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It's important to have access to the originals of your power of attorney documents, because a photocopy sometimes won't be accepted.

Sometimes an attorney keeps the originals, and sometimes the client keeps them. Both are good ideas. But either way, make sure you can access them when you need them. If you keep them yourself, put them in a safe place. And if your attorney keeps them, be sure you leave enough time to obtain them if you'll need them for a transaction.

This issue came up recently when Latonya Bartholomew signed a power of attorney. She was deploying overseas with the Air Force, and wanted her husband Lyndon to be able to manage their affairs back home in Kentucky. Later, Lyndon refinanced the couple's mortgage. But when it came time to record the new mortgage with the county, the clerk's office refused to do so – because Lyndon couldn't find the original notarized power of attorney, and only had a photocopy.

Lyndon explained that it would be very difficult to get a new power of attorney document when his wife was serving overseas, but the clerk's office wouldn't bend.

Lyndon eventually sued the county, claiming that he suffered damages because he couldn't refinance or sell the property. But a federal appeals court said the county was within its rights, and Lyndon was out of luck.

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