CHAPTER 1

American Taxpayer Relief Act of 2012

President Obama signed the American Taxpayer Relief Act of 2012 (2012 Tax Relief Act) on January 2, 2013, to avert the impending "Fiscal Cliff." With the expiration of the American Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, many tax provisions originally enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were set to expire on December 31, 2012. The 2012 Tax Relief Act prevented the increase of individual income tax rates for all taxpayers, continued favorable tax rates for net capital gains and qualified dividends, and prevented the basic exclusion amount for the estate, gift, and generation-skipping taxes from reverting to $1 million. Thus, the 2012 Tax Relief Act was a necessity and provided taxpayers with much needed stability, especially in the context of the estate, gift, and generation-skipping taxes.

Although the 2012 Tax Relief Act provided stability to many areas of the tax law, not all the provisions of the 2012 Tax Relief Act are permanent. For instance, the 2012 Tax Relief Act extended the temporary education tax credits through 2017 provided by the American Opportunity Tax Credit (AOTC). Moreover, the 2012 Tax Relief Act reenacted less favorable provisions including limitations on itemized deductions and the phase-out rules for personal exemptions. Taxpayers should become familiar with an overview of the 2012 Tax Relief Act and its effect on income tax provisions, business tax provisions, education incentives, and transfer tax provisions.

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Marginal Ordinary Income Tax Rates

The 2012 Tax Relief Act made permanent the 2012 marginal income tax rates and favorable capital gains and qualified dividends rates for Americans making less than $400,000 ($450,000 for married filing jointly), adjusted for inflation.

The 2012 Tax Relief Act did not increase the marginal tax rates or tax rates on capital gains and qualified dividends for middle-class Americans. The marginal tax rates for middle-class Americans will remain at 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. However, the 2012 Tax Relief Act increased rates on ordinary income, capital gains, and qualified dividends for Americans that earn more than $400,000 ($450,000 for married filing jointly), indexed for inflation. The highest marginal rate for these taxpayers increased from 35 percent to 39.6 percent on ordinary income and from 15 percent to 20 percent on capital gains and qualified dividends. See Table 1.1 for a complete review of the schedule for joint and single tax filers for 2014. The marginal brackets are indexed for inflation and set to increase beginning in 2014.

The 2012 Tax Relief Act reinstated the "Pease" limitations on itemized deductions, although with slightly modified adjusted gross income (MAGI) threshold amounts. Americans with a MAGI above certain threshold amounts will have to reduce their itemized deductions by 3 percent of the amount their income exceeds the threshold amount. Deductions such as medical expenses are not subject to the limitations. Under the 2012 Tax Relief Act, taxpayers must also reduce their personal exemptions by 2 percent for every $2,500 that the taxpayer's MAGI exceeds a threshold amount.

Capital Gains Tax Rates and Qualified Dividends

The Tax Relief Act of 2012 extended the favorable maximum capital gains rate of 15 percent for all Americans making less than $400,000 ($450,000 for married filing jointly), indexed for inflation. For wealthier Americans, the maximum capital gains rate will be 20 percent. Similarly, the 15 percent rate on qualified dividends will apply to taxpayers making less than $400,000 ($450,000 for married filing jointly), indexed for inflation. For taxpayers with incomes above those thresholds, dividends will be taxed at 20 percent.

Educational Provisions

EGTRRA introduced many tax benefits for implementing an educational savings plan. With respect to the 2012 Tax Relief Act, additional benefits were enacted by extending the American Opportunity Tax Credit for Higher Education Expenses through 2017. This tax credit applies to all four years of an undergraduate college education. The amount of the tax credit is generally 100 percent of the first $2,000 in qualifying educational expenses. An additional

TABLE 1.1 Schedule of Individual Income Tax Rates

Year	\$0–\$18,150	\$18,151– \$73,800	\$73,901– \$148,850	\$148,851– \$226,850	\$226,851– \$405,100	\$405,101– \$457,600	\$457,601+
				Joint Filers			
2014	10%	15%	25%	28%	33%	35%	39.6%
Year	**\$0–\$9,075**	**\$9,076– \$36,900**	**\$36,901– \$89,350**	**\$89,351– \$186,350**	**\$186,351– \$405,100**	**\$405,101– \$406,750**	**\$406,751+**
				Single Filers			
2014	10%	15%	25%	28%	33%	35%	39.6%

25 percent of the next $2,000 in qualifying educational expenses is allowed. The maximum credit is $2,500 (which assumes $4,000 in qualifying educational expenses). Qualifying educational expenses include tuition and related course materials, such as books, software, and lab supplies.

Education IRA

Under prior law, you could make a nondeductible contribution of up to $500 per year to an education individual retirement account (IRA), more commonly known as a Coverdell Education Savings Account. Your earnings grew tax free, and the distributions, when used for qualified educational expenses, were taxed at the student beneficiary's tax bracket. While this education IRA was beneficial, it was only a partial solution to the problem of funding today's education costs.

The Tax Relief Act of 2012 made permanent the benefits of the Coverdell Education Savings Accounts that were significantly enhanced by EGTRRA. The most significant provisions of the benefits that were made permanent include the following:

- Permanently increased the contribution limits from $500 per year to $2,000 per year.
- Distributions, when used to pay for qualified education expenses, are tax free.
- Allowed tax-free withdrawals for elementary (including kindergarten), secondary, and postsecondary school tuition and expenses.
- Included tuition, room and board, tutoring, uniforms, extended day program costs, computer technology hardware and software, Internet access, and special needs services for special needs beneficiary as qualifying expenses.
- The age limit is waived for special needs beneficiaries.
- Contributions can be made until the donor's due date for their federal income tax return.
- For donors who are single tax filers with a MAGI of between $95,000 and $110,000 ($110,000 and $220,000 for married taxpayers filing jointly), the contribution limits are (ratably) phased out. These MAGI thresholds are adjusted annually for inflation.

Tip

If you would like to make a contribution to an education IRA for your child but you do not qualify because your adjusted gross income (AGI) is too high,

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consider having your child contribute to his or her own account. Unlike other IRAs, a person does not have to have earned income to contribute to an education IRA, nor is there a minimum age requirement. Contributions cannot be made for beneficiaries who are 18 years of age or older.

Section 529 Plans

While 529 college savings plans were not affected by the enactment of the 2012 Tax Relief Act, they remain an important tool in estate and gift planning and are covered extensively in Chapter 11.

2012 Tax Relief Act—Miscellaneous Provisions Relating to Education

Several other provisions of the 2012 Tax Relief Act are worth noting:

- The 2012 Tax Relief Act permanently excluded up to $5,250 of education assistance provided by an employer to an employee.
- The 2012 Tax Relief Act permanently allows for the deductibility of student loan interest of up to $2,500 (with a phase-out limitation if a taxpayer's AGI exceeds $75,000 for single taxpayers and $155,000 for married taxpayers filing jointly). Also, taxpayers may now deduct both voluntary and involuntary interest payments.

Business and Corporate Tax Relief

Under prior law, the business taxpayer was allowed to immediately deduct up to $500,000 of business property purchased during the calendar year. Prior law also allowed for 50 percent bonus depreciation for purchases of certain new property. These special tax incentives expired and were not addressed in the 2012 Tax Relief Act, but we anticipate that Congress may reinstitute similar provisions in the future due to their importance in providing economic stimulus. For the latest updates regarding tax law changes, visit the Resource Center at www.welchgroup.com; click on "Links," then "Estate Book Updates." Current law allows immediate expense deduction of up to $25,000 of business property purchased during the calendar year, with the balance subject to the depreciation rules.

Estate, Gift, and Generation-Skipping Transfers

Following years of uncertainty, the 2012 Tax Relief Act provided for a permanent unified transfer tax system. The exclusion amount enacted was $5 million indexed for inflation ($5,340,000 in 2014). The tax rate is 40 percent on estates exceeding the exemption amount (i.e., the "taxable" estate). Moreover,

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TABLE 1.2 2012 Tax Relief Act Applicable Exclusion Amount

Year	Applicable Exclusion Amount	Maximum Estate Tax Rate (%)
2014	$5,340,000	40

the 2012 Tax Relief Act permanently enacted so-called *portability*, which allows the surviving spouse to utilize a predeceased spouse's unused exclusion amount. Therefore, the applicable exclusion amount is now the basic exclusion amount of $5 million (indexed for inflation) plus a *deceased spouse's unused exclusion* (DSUE) amount.

Following is a list of select provisions that could affect your estate planning:

- The 2012 Tax Relief Act raised the maximum estate, gift, and generation-skipping rates to 40 percent (from 35 percent). The 2012 Tax Relief Act also permanently established the amount of assets that are not subject to estate, gift, and generation-skipping taxes at $5 million, indexed annually for inflation (see Table 1.2).
- Portability is now a permanent feature of estate planning. A decedent's applicable exclusion amount is now the basic exclusion amount of $5 million plus the DSUE amount. Congress intended that portability would simplify estate planning. However, as discussed later, merely relying on portability is not the most prudent planning strategy.

Estate-Planning Issues under the 2012 Tax Relief Act

Because of the relative stability provided by the 2012 Tax Relief Act, everyone should review their estate plan to ensure that it is designed to work harmoniously with its new provisions. An approach we favor is for the client to contact one of their professional advisers on the estate-planning team, whether the estate-planning lawyer, financial planner, life insurance agent, accountant, or trust officer. Authorize that team member to assemble the team in a preliminary meeting to review the listing of the assets and liabilities (financial x-ray), review the current documents, and then meet with the client and the client's spouse to make team recommendations. This approach maximizes the creative input and communication and often aids in identifying important new alternatives to consider. The financial x-ray would show what assets are titled in the name of each spouse; what, if any, assets are titled in joint names; and, ideally, what assets are in the children's names.

Understand that payment of estate or death taxes is largely elective. By making annual gifts during your lifetime, then transferring the maximum tax-free amount (applicable exclusion amount) to your children and grandchildren at death, and finally bequeathing your remaining estate to a family charitable foundation, your estate tax would be zero. For example, Raymond and Laura

Gold have a $25 million net worth. Each year, they make maximum annual gifts to their two children and their spouses, plus maximum annual gifts to 529 plans for each of their grandchildren. Their wills direct the maximum to legacy trusts (Chapter 11) for the children, with the balance to a private foundation (Chapter 12) where the children (and eventually grandchildren) will serve as trustee. If they died in 2014, the disposition of their estate would look as follows:

$25,000,000	Total estate
–10,680,000	Exemption amount (2014) to legacy trust
$14,320,000	Directed to private foundation
$ 0	Estate tax

So here's the question: Is $10,680,000 "enough" to leave to your children? If not, you can still achieve "zero" estate taxes by employing additional strategies outlined throughout this book.

Here are two areas to focus your attention on:

1. With the advent of portability, does the plan provide the most flexibility while simultaneously taking advantage of the permanently enacted favorable transfer tax provisions and achieving the best result from an income tax perspective?
2. As discussed later in this chapter, does the estate plan and overall tax plan adequately prepare for the new 3.8 percent tax on net investment income that began in 2013 under the Affordable Care and Patient Protection Act?

Planning with Portability Under 2012 Tax Act

Congress enacted portability as a means of simplifying estate planning. Prior to the enactment of portability, the goal was to ensure that each spouse used his/her applicable exclusion amount; otherwise, it was wasted (i.e., "use it or lose it"). Therefore, a great deal of emphasis was placed on titling assets in each spouse's individual name, so that the first spouse to die could utilize the exclusion amount. Portability now allows the second spouse to die to use the DSUE amount from the first spouse to die.

For example, assuming a couple where the husband has $1 million of assets in his name while the wife has $9 million in her name (combined estate of $10 million). Assuming a $5 million exclusion amount, under prior law if the husband died with $1 million of assets titled in his name (and payable to wife), then $4 million of his exclusion was wasted. This is because at her subsequent death, her now $9 million estate would be eligible for only her $5 million exclusion amount, thus her taxable estate would be $4 million. Portability will now allow the surviving wife to use the $4 million DSUE amount of her deceased husband plus her own $5 million exclusion amount. Thus, she could transfer $9 million tax free at her death.

DANGERS OF RELYING ON PORTABILITY

While the estate-planning community of professionals is delighted to have portability as another tool in their toolbox, it comes with a number of "hazardous to your wealth" warnings.

- It's extremely important to note that the DSUE amount is not indexed for inflation. Over the years, the value of the DSUE amount will diminish as inflation persists.
- Portability does not apply to the generation-skipping transfer tax, only the estate and gift tax. As you'll learn later in this book, utilization of generation-skipping transfer tax strategies can have a tremendous impact on family wealth transfers.
- To take advantage of portability, the executor of the deceased spouse must timely file an estate tax return and must make an election on the return. This is a deadline you can't miss and creates, in some cases, unnecessary legal expenses.
- A surviving spouse will not lose the DSUE amount of a predeceased spouse if the surviving spouse remarries. However, the DSUE amount is available only for his or her *most recent* deceased spouse. For example, assume that Wife A predeceases Husband in 2014 and dies with taxable estate of $2.5 million. Wife A leaves her entire estate to Husband. Husband receives the DSUE amount from Wife A of $5,340,000, which would allow Husband to transfer up to $10,680,000 tax free in 2014.

  Husband marries Wife B, who has a $6 million estate payable to her children. If Wife B then predeceases Husband, he has now lost the DSUE amount from Wife A.

Tip

Using the DSUE amount upon remarriage?

If a spouse receives a DSUE amount from a predeceased spouse and the surviving spouse remarries, the surviving spouse should consider using the DSUE amount to shelter lifetime gifts from gift tax.

The purpose of portability was to provide a level of simplicity to estate planning. For couples with a combined net worth of less than the exemption amount this may be true, assuming the net worth does not grow faster than the inflation-adjusted exclusion amount. Couples with a combined estate of this size may rely on portability to minimize or eliminate estate taxes. For high-net-worth couples, relying on portability for tax planning is not the best option. Moreover, there are several tax and nontax advantages to incorporating a plan that uses traditional credit shelter and marital trust planning to be used in conjunction with portability. First, appreciation in the assets is protected from estate taxes on the death of the second spouse to die. Second, the use of trusts will protect the assets from potential creditors of the beneficiaries and safeguard the assets in the event the surviving spouse remarries.

Despite the advantages of portability, solely relying on portability is a recipe for disaster. The key to a solid estate plan is flexibility. Therefore, an ideal plan should build in the flexibility to defer the decision of whether to rely on portability or traditional credit shelter and marital trust planning until the death of the first spouse.

Planning Considerations under 2012 Tax Act

With the stability provided by the 2012 Tax Relief Act, you have an opportunity to revisit your own estate plan in light of a recently passed estate tax law that offers many opportunities for business owners and wealthy families, as well as the "not yet wealthy." Here's a quick review of the major provisions of the new law as well as several planning strategies worth considering:

- *Up to \$5 million (inflation adjusted annually) exempt from estate taxes.* **Planning point:** Many wills use a formula that states that the maximum amount allowed under law first goes to fill up the family trust, with the balance going either outright or in trust for the surviving spouse. With this higher limit, it means that in many cases all of the assets will go to the family trust and none to the surviving spouse either outright or in the marital trust. For many families, this is an unintended consequence.

  For example, John and Sue had their wills drawn back when the applicable exclusion amount was \$1 million. Under John's will, he used a formula that stated that the maximum exclusion amount would go to a family trust to benefit his children from his first marriage with the balance going to a marital trust for Sue's support. His intention for his \$4 million estate was to have \$1 million go to the family trust benefiting his children and \$3 million go to the marital trust to benefit Sue during her lifetime. Unfortunately, if John died today, because of the formula in his will, 100 percent of his \$4 million estate would go to the family trust, leaving Sue nothing!

  Have your attorney review your documents to determine if changes are warranted.
- *Portability of exemption amount.* **Planning point:** Theoretically, the activity of equalizing the estates between spouses is no longer necessary since the surviving spouse now "inherits" the DSUE amount. However, if the surviving spouse remarries and that new spouse dies, the exemption of the first deceased spouse would be lost forever. Relying solely on portability is not an ideal strategy, and building a plan with flexibility is the best course of

action. When you review your estate documents, determine the impact that portability will have on your plan in light of your personal circumstances.

- *Make gifts during your lifetime.* **Planning point:** If you are a small business owner who would like to make certain the business stays in the family, now may be an excellent time to gift some of your business ownership to children. You may get a double benefit, due to timing the gift at the end of the recent Great Recession whereby business valuations are still low. Then as the economy continues to recover, the appreciation of the transferred business interests will accrue to the new owners, which helps you reduce your future estate as well. And this is not just for business owners. If you have an estate that significantly exceeds the exemption amount, you may want to consider making tax-free gifts to family members using assets that you believe will appreciate in value in the years ahead.
- *Heirs receive a new tax basis for transfers at death.* (This is not new but is a point worth making.) **Planning point:** You face a trade-off in deciding whether to make transfers during your lifetime versus transfers at death. The recipient of a gift during your lifetime gets your same tax basis so that a future sale would be potentially subject to capital gains taxes. With the exclusion amount now exceeding \$5 million, the income tax consequences of receiving a step-up in basis may be a more important factor than the transfer tax consequences.

The 3.8 Percent Tax on Net Investment Income

In 2010, Congress passed the Health Care and Reconciliation Act (HCRA), which amended the Patient Protection and Affordable Care Act. Section 1402 of the HCRA imposed a new 3.8 percent surtax on *net investment income* (NII), which became effective in 2013. The new tax is found in Section 1411 of the Internal Revenue Code. The effect of the tax is that taxpayers in the highest income brackets (39.6 percent for ordinary income and 20 percent for net capital gains) may be subject to an additional 3.8 percent tax on income that meets the definition of NII.

To be subject to the 3.8 percent tax on NII, two initial requirements must be met: (1) the taxpayer's income must be above the "threshold amount," and (2) the taxpayer must have income that meets the definition of NII.

For individual taxpayers, the 3.8 percent tax will apply only if the taxpayer's MAGI exceeds the threshold amount. For individuals, the threshold amount is as follows:

- Unmarried taxpayer: \$200,000
- Married taxpayer filing jointly: \$250,000
- Married taxpayer filing separately: \$125,000

The threshold amount for estates and trusts is the dollar amount at which the highest marginal taxable rate applies—in 2014 an amount of $12,150. The 3.8 percent tax is imposed on the *undistributed NII* of estates and trusts. However, the rules for individuals apply to trusts that are treated as "grantor trusts" for income tax purposes.

Once a taxpayer's MAGI exceeds the threshold amount, the taxpayer must have income that meets the definition of NII. There are three potential types of NII:

- *Category 1:* The *gross income from interest, dividends, annuities, royalties, and rents,* other than such income derived in the ordinary course of a trade or business that is not a passive activity or is not derived from the trade or business of trading in financial instruments.
- *Category 2: Gross income other than interest,* dividends, annuities, royalties, and rental payments that is derived from a trade or business that is either (1) a passive activity under Section 469 or (2) the trade or business of trading in financial instruments. This "other income" is subject to the 3.8 percent tax if the income is derived from a trade or business that is either a passive activity or is the trade or business of trading in financial instruments.
- *Category 3:* The *net gain from the disposition of property* if the gain is derived from property held in a passive trade or business.

The 3.8 percent tax is imposed on the lesser of (1) the taxpayer's total NII or (2) the difference between the taxpayer's MAGI and the threshold amount. The 3.8 percent tax does not apply to a taxpayer who does not have net investment income or who has an adjusted gross income below the threshold amount. For example, assume that an individual taxpayer is married and files a joint income tax return with the taxpayer's spouse. The taxpayer's MAGI is $1 million, which is composed of a qualified dividend in the amount of $800,000 and $200,000 of ordinary income. In addition to the 20 percent of tax imposed on the qualified dividend, the 3.8 percent tax is imposed on $750,000 (the lesser of the difference between the taxpayer's MAGI of $1 million and the threshold amount of $250,000 or the total NII of $800,000). As a result of the 3.8 percent tax, the taxpayer will pay an additional $28,500 in tax (3.8 percent × $750,000). The dividend results in a total tax of $188,500 (20 percent × $800,000 + 3.8 percent × $750,000).

The 3.8 percent tax is applicable at much lower income levels for trusts. Assume the same facts in the preceding example except that the taxpayer is a trust that receives an $800,000 dividend, which is the trust's only income. Assume that the trust makes an income distribution to its beneficiary of $200,000. The trust will be subject to the NII tax on $587,850 (the lesser of the amount of the undistributed NII of $600,000 or the difference between the trust's AGI of $600,000 and the threshold amount of $12,150).

NOTICE

As we are sure you are aware, Congress frequently changes tax law that can significantly impact your estate, retirement, and tax planning. To stay apprised of the latest changes that affect you, visit the Resource Center at www.welchgroup.com; click on "Links," then "Estate Book Updates." Posted content will focus on tax law changes that affect this book's content as well as changes we believe are most important to our readers.

Although the NII tax is harsh, there are some planning opportunities to minimize the tax. Individuals that own an interest in a trade or business should consult their tax professionals to ensure that the requirements of active participation are satisfied. For instance, an individual will generally materially participate in the business if the individual spends more than 500 hours a year on activities related to the business. Distributing NII from trusts will lower the amount of the NII tax imposed on trusts. Thus, if the beneficiary's MAGI is less than the threshold amount (taking into account the distribution from the trust), distributing the NII will avoid the tax. However, there may be nontax reasons to not distribute the income to a beneficiary—for instance, to protect the distribution from creditors or provide incentive to the beneficiary.

If you feel your estate is not large enough to take advantage of any of these strategies, be clear that, at a minimum, you need at least a basic estate plan, which would include a will, durable power of attorney, and an advanced health care directive.

In this chapter, we have provided an overview of the current estate tax laws as well as actions you should consider taking now. In our next chapter, we will delve deeper into the importance of developing your estate plan and planning opportunities under the 2012 Tax Relief Act.