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Significant changes in the tax laws are scheduled to take effect in 2013. The below summary highlights some of the more important changes, including modifications to the estate and gift tax laws, as well as a few tax planning strategies to consider before year end.

Expiration of Favorable Gift and Estate Tax Laws

The end of 2012 signals the end of the generous gift and estate tax laws that were put into effect by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act"). As you may be aware, the IRS imposes a gift tax on the right to transfer property during one's lifetime. The law allows taxpayers to make annual exclusion gifts of up to $13,000 to as many individuals as the taxpayer chooses (or $26,000 for gifts made by married couples), subject to certain exceptions, without being subject to the gift tax.

In addition to the $13,000 annual exclusion per donee, the current tax laws provide each taxpayer with a lifetime exemption amount of $5.12 million (or $10.24 million for married couples). This amount (which was $5 million in 2011 and indexed for inflation) can be given away by a taxpayer during his or her lifetime (or at death) without incurring any gift (or estate) tax. Gifts or transfers at death made in excess of the $5.12 million amount are taxed at a rate of 35%. The Act also includes a portability provision, which allows the first to die of a married couple to pass any unused portion of his or her $5.12 million exemption amount to the surviving spouse.

Unless Congress acts to extend the current gift and estate tax laws, including the exemption amount, the ability to give up to $5.12 million free of any federal gift or estate tax will expire on December 31, 2012. After that date, the federal exemption amount will revert back to $1 million ($2 million for a married couple). In addition to the reduced exemption amount, the estate and gift tax rate imposed on transfers will revert back to the earlier, graduated tax rate, which reaches a maximum marginal rate of 55%. Moreover, the portability provisions of the exemption amount will expire as well. As a result, transferring wealth to one's heirs becomes significantly more costly.

Estate Planning for 2013 and Beyond

There is a good possibility that the laws will be modified by December 31, 2012. If history is any indicator as to when Congress will address the state of limbo of the estate and gift tax laws, chances are slim that it will occur before the November 2012 elections. In other words, taxpayers may have a limited window of opportunity to react to the anticipated changes to the estate and gift tax laws.

The simplest way for a taxpayer to take advantage of the favorable estate and gift tax laws currently in effect would be to make taxable gifts up to $5.12 million before year's end in order to use up the current lifetime exemption amount, especially since it is anticipated that Congress will reduce the lifetime exemption amount.

Because some taxpayers are reluctant, however, to gift such a large sum of money outright to a beneficiary, there are other alternatives. Another way to plan for the uncertainty would be to establish a trust in the next few months, but wait until after Congress acts (assuming it will do so before the end of 2012) to determine whether to fund the trust. However, if changes to the federal estate and gift tax laws happen after the November 2012 elections as is anticipated, there will be a very short window of time to have a trust agreement drafted, signed, and funded.

By setting up a trust now that is designed to take advantage of the current $5.12 million exemption amount, a taxpayer can dictate who the trust beneficiaries will be, as well as when the beneficiaries are entitled to receive the trust funds. For example, assume a wealthy parent who has not made any prior taxable gifts creates a trust for the benefit of his or her children. The trustee of the trust can be given the discretion to distribute both the income and the principal of the trust to or for the benefit of the taxpayer's children for their health, education, maintenance and support. The trust instrument can specify at what age the children will receive distributions of principal. The children will also benefit from any appreciation of the trust assets.

As a variation, a taxpayer could establish a trust for the benefit of the taxpayer's spouse and children and name the spouse as a trustee. The spouse/trustee can be given a lifetime income interest in the trust, and the trustee can be given the discretion to invade the principal of the trust for the spouse and children's health, education, maintenance and support. Upon the death of the spouse, the trust assets can be distributed to the taxpayer's children. By doing this, the taxpayer, through the spouse as the beneficiary, retains indirect access to the trust funds.

As stated above, the funding of a trust does not have to occur immediately; rather, the taxpayer can wait to see what changes, if any, Congress makes to the estate and gift tax laws before making the decision. If the current $5.12 million exemption amount is extended, whether permanently or for another year or two, a taxpayer may either postpone or decide not to fund the trust in order to retain full control of his or her money. If, however, the lifetime exemption amount is reduced to $1 million, a taxpayer may choose to fund a trust before the end of 2012 in order to take advantage of the current $5.12 million exemption. As long as the trust agreement and necessary arrangements are already in place, transferring assets to the trust can be done late in the year.

Expiration of Other Bush-Era Tax Cuts

In addition to the expiration of the 2010 Act's favorable estate and gift tax laws, there are several other income tax laws that are set to expire at the end of 2012 unless Congress acts before the end of the year:

- The top income tax rate will increase to 39.6% beginning January 1, 2013
- The tax on long-term capital gains will increase from 15% to 20% effective January 1, 2013
- The preferential 15% tax rate on qualified dividends will expire (qualified dividends will be taxed at the same rate as ordinary income)

Tax Hikes Associated with the Health Care Reform Act

As you may be aware, the Supreme Court recently upheld the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act ("Health Care Reform Acts") enacted by Congress. While Congress has been indolent with regard to extending various federal, income, gift and estate tax laws discussed above, it did approve a series of tax increases necessary to fund the Health Care Reform Acts. These tax increases will impact predominantly high earned income/high adjusted gross income ("AGI") taxpayers, defined as individuals with annual earned income and/or AGI greater than $200,000 ($250,000 for married couples filing jointly). Specifically, the changes to the tax law that take effect on January 1, 2013 include the following:

- 0.9% increase in payroll tax on wages and self employment income for high-earned income taxpayers
- 3.8% surtax on net investment income, including interest, dividends, rents royalties, capital gains and gross income from passive business activities for high AGI taxpayers
- Deduction for medical expenses that exceed 7.5% of AGI is allowed only-for taxpayers over age 65; all other taxpayers' medical expenses must exceed 10% of AGI to be deductible
- Contributions to health flexible spending accounts will be capped at $2,500
- Deduction for the Retiree Drug Subsidy is eliminated entirely

Further tax increases are scheduled to take place in subsequent years in order to fund the Health Care Reform Acts, including the highly publicized penalty tax on uninsured individuals.

If you are considering portfolio diversification of appreciated securities, selling appreciated real estate, exercising a stock option or executing any other significant income tax generating transaction, and if you can control the timing of the event, the year 2012 may be the more beneficial year to do so from an individual income tax perspective. Conversely, if you are considering a large charitable deduction or other Schedule A itemized deduction (excluding medical expenses for those under age 65), you may be better off deferring the deduction until 2013.

Summary

As indicated in this Update, there are many changes to the tax laws that will take effect at the end of 2012, but with proper planning, one can prepare for the uncertainty surrounding the income tax and wealth transfer tax laws. For any questions with regard to your alternatives, or any questions relating to the content of this article, please feel free to contact us at any time.