Estate Planning
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Legal Matters®

How the new federal tax law will affect your estate planning

In a big surprise to many people, when Congress passed a law to resolve the "fiscal cliff" in January, it retained the large ($5 million-plus) estate, gift, and generation-skipping transfer tax exemptions that had been available in 2011 and 2012. These taxes will now be 40% of amounts over this exemption.

Without this new law, the exemptions would have dropped to only $1 million at the start of 2013, with a tax rate of 55%.

The exemptions will now be $5 million in 2011 dollars, with adjustments for inflation each year. For 2013, they will be $5.25 million.

This is great news for people who want to transfer wealth to the next generation while avoiding taxes. It means that anyone who didn't use the "window" in 2011 and 2012 to make large gifts without incurring gift tax has a reprieve, and can make those gifts this year.

That makes 2013 a great time to review your estate plan. While it's possible to make large tax-deferred gifts right now, we don't know how long this opportunity will continue, and it's possible that Congress could change the rules again. Also, the Obama Administration has indicated that it wants to restrict some other popular estate planning techniques, including grantor retained annuity trusts, valuation discounts, family limited partnerships, and dynasty trusts. So it might be wise to investigate these options now before they disappear.

How tax-free gifts work

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, in some circumstances, a trust) up to $14,000 a year without there being a gift tax. If you give someone more than $14,000 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 $14,000

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Roth 401(k) plans get a big boost in the new tax law

The new tax law that resolved the "fiscal cliff" issue in January allows employees with a 401(k) plan at work to roll over any or all of the assets in their current plan into a Roth 401(k) plan. This is a big change, and should at least be considered by anyone who is eligible.

In a traditional IRA or 401(k) plan, employees contribute pre-tax earnings to the plan. The assets grow tax-free until retirement age, at which point the employee can withdraw them and pay ordinary income tax on the withdrawals.

With a Roth IRA, though, employees contribute *post*-tax earnings to the account, but when they withdraw the assets years later, the withdrawals are tax-free.

The new Roth 401(k) plans follow the same idea – earnings are contributed post-tax, but withdrawals are tax-free.

Roth 401(k) plans were first allowed by Congress in 2006, but they were more limited, and rollovers of current 401(k) assets were severely restricted. At the time, not many employers bothered to create Roth 401(k) plans. But with the new law, it's likely that many more employers will begin to offer Roth 401(k)s as a result of employee demand.

The law also allows rollovers to Roth 403(b) plans, Roth 457(b) plans, and Roth thrift saving plans.

The trick with a Roth rollover – whether from a traditional IRA or a traditional 401(k) or other plan – is that you have to pay income tax in the year of the rollover on the amount of assets you transfer. Having to pay the income tax now is a drawback, of course, but if you have the assets to do so, a rollover can be very smart. For instance, if you anticipate being in a higher tax bracket when you retire, or if you believe that tax rates in general will go up, then you might want to pay the income tax now at today's lower rates.

Also, if you plan to eventually convert your 401(k) to an IRA and leave it to your heirs, then a rollover might make sense because you'll get the amount of the income tax out of your estate for estate tax purposes, and you'll leave your heirs a better benefit because their withdrawals will be tax-free.

Keep in mind that rollovers are not "all or nothing." You can roll over only a part of your 401(k) account each year, and pay taxes on just that amount.

Another benefit of Roth 401(k)s is that the contribution limits are generally much higher than for Roth IRAs.

You should note that if you roll over a traditional 401(k) into a Roth 401(k), you can't "undo" the conversion the following year, as you can when you roll a traditional IRA into a Roth IRA. (The ability to undo the conversion is a benefit, because if the assets in your IRA incur significant losses after the conversion, you can simply undo it and then redo it the next year while paying less in taxes.)

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Many estates can save by filing 'optional' tax returns

A federal estate tax return doesn't have to be filed every time someone dies. In fact, most estates never have to file one. However, a provision in the new "fiscal cliff" tax law may make it very advantageous to file an estate tax return if the deceased person is survived by a spouse – even if a return is not legally required.

Here's why: Generally, when a person dies, his or her estate can give an unlimited amount to a surviving spouse. After that, if the person's bequests (plus large lifetime gifts) total more than a certain "exemption amount," then an estate tax is due. For 2013, the exemption amount is $5.25 million.

Traditionally, the exemption amount applied separately to each spouse. So if a husband died first, his estate could use his exemption amount, and when his wife died later, she would get her own exemption amount.

But under a change in the law starting in 2011, if the first spouse to die doesn't use all of his or her exemption amount, the difference can be passed along to the other spouse. (The 2011 law was temporary, but the new "fiscal cliff" law makes it permanent.)

So suppose a husband dies and doesn't use any of his $5.25 million amount (because he leaves every-

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annual threshold up to the amount of this exemption without paying tax.

The lifetime exemption isn't necessarily 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 $5.25 million for the rest of this year, you may be able to make gifts of up to $5.25 million this year without paying gift tax. Even if you already used up part or all of your lifetime exemption in the past, when the amount was smaller, you can now make very large additional gifts.

Many people can benefit from this situation by putting significant assets into a trust that will pay 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 may also be able to 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 children and grandchildren, because assets left in a trust for them generally can't be taken away if your children or grandchildren incur debts, are sued in a lawsuit, get divorced, etc.

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.

Remember, too, that the $5.25 million gift tax exemption is *per person*. So a married couple could contribute as much as $10.5 million.

Also, if you're in a committed relationship with someone but you aren't married to them, there may be significant tax benefits in using the $5.25 million exemption in order to share assets with the other person. (Remember that transfers between spouses aren't generally subject to the gift tax, but transfers between unmarried couples are.)

How estate and gift taxes have changed

Year	Exemption Amount	Top Rate
2001	$675,000	55%
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	Repealed	—
2011	$5 million	35%
2012	$5.12 million	35%
2013	$5.25 million	40%

'Optional' tax returns

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thing to his wife). When the wife dies, her exemption amount will be her own $5.25 million *plus* the $5.25 million that the husband didn't use. So instead of being able to leave $5.25 million tax-free to her heirs, she can leave $10.5 million tax-free – a potential savings of millions of dollars.

However, *this only works if the husband's estate filed an estate tax return* and elected to pass the exemption amount on to his wife. If the husband's estate didn't file a return (because it wasn't legally required), then all the potential tax savings are lost.

This means that it's almost always a good idea to file an estate tax return for anyone who dies and is survived by a spouse.

Even if it seems highly unlikely that a surviving spouse will be worth more than $5.25 million when he or she dies, it's still a good idea to file a return, because Congress could always change the exemption amount. In fact, if not for the "fiscal cliff" law, the exemption amount this year would be only $1 million.

Annual gift tax exemption has been increased to $14,000


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The annual gift tax exemption has been increased to $14,000 in 2013, up from $13,000 last year. That's due to an adjustment for inflation.

This means that you can give any person $14,000 this year without any gift tax liability at all. Making annual gifts of the exemption amount is one of the best and easiest forms of estate planning, because it transfers assets from one generation to the next without any tax liability whatsoever.

If you have multiple heirs, the amount you can give away tax-free multiplies quickly. For instance, if you have two children, and each child is married and has two children, you can give $14,000 to each child, spouse and grandchild. That's eight recipients at $14,000 each, or a potential maximum gift of $112,000 a year.

Keep in mind that a spouse can also make gifts. If your spouse gave an additional $14,000 to each recipient, that would be $224,000.

> If you're thinking about making regular annual gifts, you might want to consider setting up trusts for the beneficiaries.

If you're thinking about making regular annual gifts, you might want to consider setting up trusts for the beneficiaries and making gifts to the trusts – especially if your grandchildren are young.

Making annual gifts to trusts is more complicated, and there are special techniques that usually must be followed in order to obtain the best tax treatment. However, there are many practical as well as tax benefits to making gifts by means of a trust, and doing so can further increase the value of your gifts.

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