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Estate Plans Should be Reviewed and Revised as a Result of the Fiscal Cliff

Estate plans for couples and individuals should be reviewed and revised because of The American Taxpayer Relief Act of 2012 (the “Act”). The Act, enacted on January 1, 2013, to avert the so-called “fiscal cliff,” contains a number of significant estate and gift tax provisions including:

- A unified estate and gift tax exclusion of \$5,000,000 indexed annually for inflation. For decedents dying after December 31, 2012, the exclusion amount, as adjusted for inflation, is \$5,250,000 per individual.
- The Act also made permanent “portability” between spouses. Portability essentially allows the unused estate tax exclusion of a deceased spouse to be used by the surviving spouse.
- The Act also provides for a 40% estate and gift tax rate on the estate in excess of the exclusion amount of \$5,250,000.

Prior to the Act, a typical estate plan for a husband and wife involved a trust that was created during the couple’s lifetime. Upon the death of the first spouse, the trust was either divided into two trusts (an A Trust and a B Trust) or divided into three trusts (an A Trust, and a B Trust, and a QTIP Trust).

In a typical AB Trust plan, on the death of the first spouse, the deceased’s share of the estate, but not more than the exclusion amount, would be held in an irrevocable trust (often referred to as the “exemption trust” or the “bypass trust”) for the benefit of the surviving spouse, and the rest of the estate would continue to be held in a revocable trust for the benefit of the surviving spouse.

In a typical AB Trust plan, there was no estate tax due on the death of the first spouse, and the amount held in the exemption trust was not subject to estate taxes on the death of the surviving spouse. The surviving spouse’s share of the estate that was held in the revocable trust for the benefit of the

surviving spouse (sometimes called the “A Trust” or the “Survivor’s Trust”) would be subject to estate tax and an estate tax would be due if the value of the survivor’s estate exceeded the estate tax exclusion in effect on the death of the surviving spouse.

As a result of the Act and the \$5,250,000 estate tax exclusion and portability, most couples will not need to use an exemption trust to prevent an estate tax from being imposed. A couple with a combined estate of not more than \$10,500,000 can retain the deceased’s share of the estate in a revocable trust, elect portability on the death of the first spouse, and leave their entire estate to their children estate tax free on the death of the surviving spouse without using an exemption trust if the entire estate does not exceed \$10,500,000 on the death of the surviving spouse. An estate tax return on the death of the first spouse is required to elect portability.

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A significant advantage to electing portability is that the entire estate on the surviving spouse's death will receive a step up in basis. Receiving a step up in basis on the death of the surviving spouse has the potential for reducing income taxes when assets are sold after the death of the surviving spouse. Another advantage of portability and leaving the entire estate to the surviving spouse in a revocable trust, is that it eliminates the exemption trust and the need to prepare an income tax return each year for the exemption trust.

There are situations in which an exemption trust still should be used on the death of the first spouse. For example, if the couple's estate will continue to grow and will likely exceed the combined \$10,500,000 exemption of both husband and wife, then an exemption trust is likely to be appropriate. Also, an exemption trust may be appropriate to avoid increases in property taxes as a result of changes in ownership where the couple's real property value exceeds their residence and \$1,000,000 of property tax value at the date of the first spouse to die. The use of an exemption trust is still appropriate where there are concerns of protecting assets from creditors, a remarriage by the surviving spouse, or concerns about management of assets by the surviving spouse or other beneficiaries. The exemption trust must still be used to have the benefit of the generation skipping transfer tax exemption for both spouses.

As a result of the changes in the estate and gift tax laws by the Act, individuals and couples should review and update their estate plans. **P**

