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Fiscal Cliff? What Fiscal Cliff?

As you probably know by now, the overhyped and overpublicized fiscal cliff drama ended not with a bang, but with a whimper, on January 1, 2013, when Congress passed the American Taxpayer Relief Act of 2012 (ATRA), signed by President Obama on January 2, 2013.

ATRA, in effect, extended most of the so-called Bush tax cuts passed in 2001 as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) as extended temporarily in 2010, including those related to estate, gift and generation-skipping transfer (GST) taxes.

Brief Overview of Transfer Tax Provisions

The estate, gift and GST tax provisions of the law existing in 2012 remain in effect, including the $5,000,000 exemption, indexed for inflation. Thus, the 2013, estate, gift and GST exemption amount is $5,250,000.

The top estate, gift and GST tax rate is increased from 35% to 40% under ATRA. While this represents an increase from the 2012 rate, this is a significant improvement over the pre-EGTRRA marginal rates of up to 60%, in some cases. Colorado does not have a state estate tax. Had the prior law been allowed to sunset, the Colorado estate tax would have re-emerged. Had Congress not passed ATRA, the estate and gift tax exemption would have fallen to $1,000,000 ($2,000,000 for couples) and the marginal estate and gift tax rate would have jumped to 55%.

Portability (discussed below), and the other provisions discussed above were made "permanent," that is, not subject to the sunsetting provisions that had plagued EGTRRA and the 2010 Act. Therefore, planning can now be undertaken with more certainty than has existed for many years.

A Word About Portability

Portability, a new concept included in the 2010 Act, allows the surviving spouse to use the deceased spouse's unused estate tax exemption, either with gifts by the surviving spouse or on the surviving spouse's death, if a timely election is made. Thus, in some cases, it may not be necessary for estate tax avoidance purposes to do complicated estate planning (via the use of bypass trusts) to utilize both spouse's estate and gift tax exemptions.

However, each plan should be considered on its unique facts, as there are a number of reasons to use trusts on the first death, including the protection of assets from creditors and subsequent marriages, so as to insure that the children of the first spouse to die end up with that spouse's property. Consideration should also be given to the use of bypass trusts to shield appreciation in assets from potential estate taxation in the survivor's estate.

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Assets in bypass trusts will not be included in the survivor's taxable estate. Also, the GST exemption is not portable, so a trust at the first death will be necessary to efficiently allocate both spouse's GST exemption amounts.

Existing Plans

Finally, consideration should be given as to whether existing formula plans, drafted when exemptions were much lower, will still meet your goals. The traditional formula plan which directed an amount of assets up to the decedent's estate tax exemption (now $5,250,000, but as low as $600,000 in the 1990s) to a bypass trust may result in all of the assets of the first spouse to die passing to the bypass trust. While the surviving spouse will usually have rights to distributions from the bypass trust, it may not meet the couple's goals. The surviving spouse may prefer to have the assets outright, rather than in trust, especially if the amounts are not too large. Further, if the assets increase in value between the death of the first and second spouse, assets in a bypass trust would not be entitled to a step-up in basis adjustment, resulting in (potentially) unnecessary capital gains tax on a future sale. Again, these considerations are unique to each couple.

With all of the changes to the law over the last few years, your planning should be reviewed to insure that it still meets your goals and desires. ♦

★★ ROLL CALL ★★

Tom and Jennifer are both listed in the **Colorado Super Lawyers** publication for 2013. This is Tom's eighth consecutive inclusion.

Last fall, **Jennifer** gave a presentation for the Community Foundation Serving Boulder County on the status of the federal estate tax.

Tom attended the National Meeting of the American College of Trust and Estate Counsel (ACTEC) in Washington, D.C. in October of 2012. He continues in his duties as Colorado State Chair of that organization, where he is busy planning and coordinating a Rocky Mountain Regional Meeting in Vail, Colorado, in September 2013. Several national speakers on a variety of tax and estate planning topics have agreed to be part of the event.

What Exactly is Probate?

The term "probate" refers to the court process of determining whether a decedent died with a valid will and the appointment of a personal representative (in the past this position was often called executor, executrix or administrator). However, the term is frequently used to encompass the entire estate administration process.

Probate is required when the decedent owns more than $63,000 of probate assets and/or is the sole owner of any real estate. Probate will occur whether or not a decedent had a will. In the absence of a will, the Colorado statutes provide a default distribution scheme for probate assets. Probate assets are: (1) assets owned solely by the decedent without a named beneficiary or with the decedent's estate named as beneficiary; and (2) assets co-owned by the decedent and one or more other persons in tenancy in common. ♦

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IRAs and Your Estate Plan

Your IRA (individual retirement account), 401(k) plan or similar asset may be a significant portion of your estate.[1] If that is the case, it is especially important to consider the beneficiary designation, and how that designation coordinates with your estate plan. The named beneficiary of your IRA will receive your IRA at your death, regardless of the directions in your will.[2]

The selection of the appropriate beneficiary is made more complicated due to income tax considerations. Distributions from an IRA (other than a Roth IRA) are subject to ordinary income tax, regardless of whether you take the distributions during your lifetime or your beneficiary takes the distributions after your death. Your beneficiary may be required to begin taking distributions right away, even if you were not yet required to take distributions.

How rapidly distributions must be made from the IRA after your death depends in part upon who is named as beneficiary. The following are some examples:

Spouse: If you are married, you may want to name your spouse as primary beneficiary. There are several advantages to naming a spouse as beneficiary. One of the primary benefits is that the spouse can rollover the IRA into the spouse's own IRA. Also, there are favorable minimum required distribution rules available to a spouse. Keep in mind that once the surviving spouse receives the IRA, he or she will choose who to name as beneficiary of the IRA at the surviving spouse's death; this may not be desirable, especially in the case of a second marriage.

The Roth IRA was introduced as part of the Taxpayer Relief Act of 1997.

Children: You may want to name your children as the contingent beneficiaries of your IRA if you are married, or as primary beneficiaries if you are not married. Your children can then take distributions over their life expectancies, or at least over the life expectancy of the oldest beneficiary. In naming your children as the beneficiaries, you should be aware of how the IRA will be distributed if a child predeceases you. Unless otherwise specified, the share of a deceased child may be distributed to your surviving children, even though you may want that child's share to pass to his or her children (your grandchildren).

Minors: It is problematic to name minors as beneficiaries, because a guardian or conservator will probably need to be appointed by a court to take the distributions on their behalf. It may be preferable to instead name a trust, even though the income tax consequences may not be as desirable.

The traditional IRA was introduced with the Tax Reform Act of 1986.

Trusts: There are many reasons why your estate plan may include the creation of trusts. For example, trusts may be created for minor children, or for the surviving spouse, or even for adult children for a variety of tax and non-tax reasons. If you name your spouse or children as beneficiaries of your IRA, the IRA will not be held in trust regardless of the directions in your will. You can instead name the trust as beneficiary of your IRA. However, the trust will generally be required to take distributions more rapidly than if an individual is named as beneficiary. For example, the trust may be required to withdraw your entire IRA within five years following your death. Choosing between naming a trust as beneficiary or naming individuals requires a careful analysis of the income tax considerations and your overall estate planning goals.

Charity: If you want to leave assets to charity at your death, consider naming the charity directly as the beneficiary of your IRA. A qualifying charity will receive your IRA income tax free.

This article contains some general information about IRAs. The selection of the appropriate beneficiary for your IRA is an important decision, and needs to be considered in the context of your particular estate plan. ♦

Total U.S. retirement assets were **$19.5 trillion** as of December 31, 2012.
Source: Investment Company Institute
http://www.ici.org/research/stats/retirement/ret_12_q3

[1] These accounts are often referred to as qualified plans (or assets). They are allowed to grow tax free until withdrawn. This article references IRAs, but is applicable to other qualified plans.

[2] Your will controls the distribution of your IRA if your estate is named as beneficiary, but naming your estate as beneficiary is generally not recommended.