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Hoffman, Sabban & Watenmaker strives to keep its clients and friends informed of important developments affecting their estate, gift and tax planning. This letter summarizes some of those developments.

Estate Planning After the 2012 Tax Act

At the beginning of 2013, the American Taxpayer Relief Act of 2012 ("2012 Tax Act") was enacted, making permanent many of the tax benefits that were scheduled to expire at the end of 2012. The following is a brief summary of the major estate, gift, generation-skipping transfer ("GST") and selected income tax changes in the 2012 Tax Act:

Estate, Gift and GST Taxes

- The lifetime estate and gift tax applicable exclusion amounts (or exemptions) for 2013 are $5,250,000 (up from $5,120,000 in 2012); these amounts will be indexed for inflation in the future.
- The lifetime GST tax exemption is $5,250,000 for 2013 (also up from $5,120,000 in 2012); this amount also will be indexed for inflation.
- Any amount over the above exemptions will be taxed at 40% (up from 35% in 2012).
- Portability of a deceased spouse's unused applicable exclusion amount (for estate and gift tax purposes, but not for GST tax purposes) has been made permanent. Thus, if one spouse dies without using his or her full exemption, and an estate tax return is filed, the unused exemption can be used by the surviving spouse.
- Although not part of the 2012 Tax Act, the gift tax annual exclusion for 2013 is $14,000 per gift recipient (or "donee") (up from $13,000 in 2012).
- The gift tax annual exclusion for gifts to non-U.S. citizen spouses for 2013 is $143,000 (up from $139,000 in 2012).

Income Tax

- The rate for long-term capital gains and qualified dividends increased to 20% (up from 15%) for taxpayers who are in the top income tax bracket (depending on their filing status).
- The income tax rate for trusts and estates reaches the highest rate of 39.6% for those with taxable income over $11,950.
- A 3.8% Medicare surtax is imposed on single taxpayers with investment income exceeding $200,000 (or over $250,000 for married taxpayers filing jointly, or above $11,950 for trusts and estates).
- In addition, the income tax rate for California taxpayers has been increased to as high as 13.3% for those in the highest income bracket.

Retirement Assets

- People who are receiving required minimum distributions (i.e., age 70 ½ or older) may make qualified charitable distributions from their IRA's, up to $100,000 per year.
- Participants of 401(k), 403(b) and 457(b) plans may make direct rollovers to Roth accounts under those plans without meeting the previously required distribution criteria.

Possible Future Changes

The 2012 Tax Act did not address a number of transfer tax issues raised in the President's budget proposal. These issues may be taken up and other possible revenue raising legislation may still be enacted in the upcoming discussion on the debt ceiling and budget debate. Thus, you may want to review your estate plan and take advantage of certain estate and tax planning techniques that are still available under the current law. We highlight some of these techniques below.

- Make Gifts Now. Since the gift tax exemption has increased to $5,250,000, if you wish to make gifts and can afford to do so, the time to make them is now. Even if you utilized all of your available gift tax exemption in 2012, it was indexed for inflation in 2013, giving each person an additional $130,000 of exemption. (The exemption will continue to be indexed for inflation in future years, ensuring that further tax-free gifts will be available from time to time). Also, your family will benefit further from gifts you make during your lifetime because the donee receives all future income and appreciation gift-tax free, and therefore, that income and appreciation will not be taxed in your estate upon your death. One downside to making a lifetime gift is that the donee receives your income tax basis in the gifted asset, rather than receiving a full basis step-up if you were to hold the asset until death.

  Moreover, even if you make gifts in excess of the gift tax exemption and, therefore, have to pay some gift tax, it would still be cheaper to make lifetime gifts than to leave those assets at death, assuming you live for more than three years after the gift. This is because estate taxes are tax inclusive, meaning that your estate will have to pay estate taxes on the cash used to pay the estate tax. On the other hand, if you make large enough gifts to warrant paying a gift tax, it is tax exclusive, meaning that you only pay gift taxes on the portion actually passing to the donee. Thus, even though the nominal gift tax rate on such "excess" gifts is 40%, the "effective" rate is only 28.6%.

Another reason for making gifts now is that the President, under his budget proposal, wants to eliminate fractional interest discounts for gift or estate tax purposes for transfers between family members of partial interests in family-controlled entities. If this proposal is approved, it would eliminate the ability to leverage your gift and estate tax exemptions for transfers of certain business and real estate interests to family members, resulting in higher gift and estate taxes.

- Establish GRAT's. A Grantor Retained Annuity Trust ("GRAT") is a trust which provides you (the grantor) with an annual payment (annuity) for a specified term of years (selected by you). You are deemed to make a taxable gift to the "remainder beneficiary" equal to the present value of that remainder interest. A typical GRAT, however, would be designed so that the value of the remainder interest would be zero. The annuity amount includes an IRS approved rate of return (this rate is equal to 1.4% in April 2013), which is the rate that the GRAT must outperform for it to provide any benefits to your named beneficiaries. This is because at the end of the GRAT term, any assets remaining after the annuity payments have been made to you will pass to your beneficiaries gift-tax free. However, if you were to die before the end of the GRAT term, then all or a portion of the GRAT assets will be includible in your estate for estate tax purposes.

  The President's budget proposal also contains the following requirements for a GRAT: a minimum term of 10 years (thus, eliminating short-term GRAT's), a remainder interest greater than zero (eliminating zeroed-out GRAT's) and the annual annuity amount cannot decrease during the GRAT term (eliminating "shark fin" GRAT's).

  Given that these favorable aspects of GRAT's may soon be eliminated, the current historically-low interest rates and the relatively depressed value of certain assets, this may be an ideal time to establish GRAT's. Even if you already utilized most of your gift tax exemption in 2012 (or prior years), you still may create GRAT's without having to pay any gift tax, depending on how they are structured.

- Use IDGT's. Another effective estate planning technique is the use of intentionally "defective" grantor trusts ("IDGT's") to hold gifts for the benefit of children and grandchildren. These trusts not only allow you to take advantage of all of the tax benefits of lifetime gifting (as described above), but they also permit you, as the grantor, to continue to pay income taxes attributable to the contributed assets gift-tax free. Thus, the assets in the IDGT can grow for the trust's beneficiaries without being depleted by any income tax liability. In addition, any transaction (such as a sale or exchange) between the grantor and the IDGT will not be considered a taxable event, so a sale, for example, will not incur any capital gains tax. If at some point you tire of incurring the income tax liability, you can terminate the grantor trust status of the trust by releasing certain powers; however, this release may be a taxable event and can trigger any deferred capital gains tax at that time.

Another proposal in the President's budget is to have the assets in an IDGT be includible in the grantor's estate for estate tax purposes. Also, his proposal would make any distributions from the IDGT become a taxable gift.

In light of these proposals and the current low interest rate and depressed asset value environment, you should consider selling income-producing assets (that you do not need) or assets that are likely to appreciate in value to an IDGT. The sale would require a reasonable downpayment (between 10% and 20%) and a promissory note for the balance. The minimum interest rate required by the IRS in April 2013 is 0.22% for loans of three years or less. After the sale, all income attributable to the assets purchased by the IDGT, as well as their appreciation, passes to the IDGT beneficiaries gift-tax free.

- Use CRT's. Charitable Remainder Trusts ("CRT's") may increase in popularity with estate planners, due to higher capital gains rates and the imposition of the new Medicare surtax. Assets that you transfer to a CRT can be sold by the CRT with no capital gains tax due to its charitable status. You would receive an annual payment from the CRT for a specific number of years, or for your lifetime (either a stated annuity amount or a percentage of the value of the assets in the CRT). The assets remaining at the end of the CRT (i.e. at your death or the end of the selected term of years) pass to one or more charities you name. When you first set up the CRT, the value of that charitable remainder interest is calculated, which you can claim as a charitable deduction on your current income tax return to offset your income and other capital gains.

  With the top federal capital gain rate of 20%, California State tax rate of 13.3%, and the Medicare surtax of 3.8%, you may be much better off selling assets with considerable built-in gains in a CRT where none of these taxes would apply. The annual payments you receive from the CRT would likely be subject to some taxes, but the overall tax savings may still be significant.

We are happy to discuss with you the best options for taking advantage of any of the opportunities described above. If you are interested in discussing these opportunities or in reviewing your estate plan to ensure that it meets your current objectives, please contact us.