



LINE OF
SIGHT

2012-2013
Tax Transitions

**Navigating
the Continuing
Complexities
of a Changing
Landscape**

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We hope you enjoy the latest presentation from Northern Trust's *Line of Sight*. By providing research, findings, analysis and insight on the effects and implications of our changing financial landscape, *Line of Sight* offers the clarity you need to make better informed decisions.

2012-2013 TAX TRANSITIONS

Navigating the continuing complexities of a changing landscape

Change is a fact of modern life and is increasingly the norm in the realm of taxation. In 2001 and 2003 when the “Bush-era” tax cuts were enacted, the “fiscal cliff” was not a part of our vocabulary. But once again we are faced with the reality of making tax-planning decisions in a very fluid environment. The uncertainty in the tax arena highlights the importance of focusing our attention on underlying financial goals – to provide for our children’s and grandchildren’s education, set aside a nest-egg for retirement, support charitable endeavors, pass on the family business, transfer wealth to the next generation – and then add tax considerations to our overall financial and wealth transfer planning to achieve our ultimate objectives.

June 2012

With change, come questions:

- How will the tax law changes affect individual taxpayers?
- How will they affect businesses and business owners?
- And finally, how will they affect the transfer of wealth?

GETTING OUR BEARINGS

First, a brief review of how we have come to be where we are now.

- The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) incrementally reduced the top two income tax rates from 36% and 39.6% to 33% and 35%, respectively, provided for “marriage penalty” relief, and phased-out the estate tax.
- Then the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) accelerated the ordinary income tax rate reductions and reduced the long-term capital gain tax rate from 20% to 5% and 15% and a 2008 amendment to JGTRRA further reduced the 5% rate to 0%. Additionally, JGTRRA provided that qualified dividends would be taxed at the same rate as long-term capital gains (0% and 15%) instead of at ordinary income tax rates.
- These Bush-era tax cuts were scheduled to sunset at the end of 2010, but ultimately were extended for two years, expiring December 31, 2012, with the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Act).
- The 2010 Tax Act also reinstated the estate tax, reduced the marginal estate, gift and generation-skipping transfer tax rates to 35%, increased the applicable exclusion and exemption amounts to \$5 million (adjusted for inflation) and provided for “portability” of a deceased spouse’s unused estate tax applicable exclusion amount, but only through December 31, 2012.

In all, more than 40 federal tax provisions will expire by the end of 2012, absent legislative action.

In addition, as of the date this update is published, the 2012 allowable exemption for the alternative minimum tax (AMT), which imposes a minimum tax rate of at least 26%, has fallen back to the much lower 2001 levels. Thus, absent a retroactive AMT “patch” for 2012, it is expected that the base of taxpayers subject to the alternative minimum tax will broaden in 2012.

AMT THRESHOLD SUMMARY

Alternative Minimum Taxable Income Threshold	2011	2012
Married filing jointly or surviving spouse	\$74,450	\$45,000
Married filing separately	\$37,225	\$22,500
Single or head of household	\$48,450	\$33,750

Various AMT proposals have been discussed, including repeal by some and replacement of the AMT with the so-called “Buffett Rule” by others. The Buffett Rule generally provides a minimum effective tax rate of at least 30% and eliminates tax deductions for taxpayers with income in excess of \$1 million.

THE 2013 HORIZON

Income Tax

Looking ahead to 2013, absent changes in the income tax laws that currently have been enacted, the following will occur for 2013:

- The lowest 10% individual income tax bracket will be eliminated and the 33% and 35% tax brackets in effect for 2012 will increase to 36% and 39.6%, respectively.
- The “marriage penalty” relief will expire and the 15% tax bracket for a married couple filing jointly will again be less than twice the bracket for a single taxpayer. In addition, the standard deduction for a married couple will also be less than twice that of a single taxpayer.
- Qualified dividends will be taxed at ordinary income tax rates.
- Capital gain tax rates will increase to 20% (10% for taxpayers in the 15% tax bracket) and 18% (8% for taxpayers in the 15% tax bracket) for assets purchased after December 31, 2000 and held longer than five years.
- Certain itemized deductions for high-income taxpayers will be subject to phase-out of up to 80%.
- Personal exemptions for high-income taxpayers will be subject to phase-out of up to 100%.
- The new 3.8% Medicare contribution tax will be imposed on the excess net investment income of high-income individuals and of estates and trusts.
- The combined marginal income tax and Medicare contribution tax rates will be 43.4%.

INCOME TAX RATE SUMMARY

Tax Rates	Current 2012	2013 With Scheduled Sunset
Ordinary Income	10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%
Qualified Dividends	0% and 15%	Ordinary Income Tax Rates
Short-term Capital Gains	Ordinary Income Tax Rates	Ordinary Income Tax Rates
Long-term Capital Gains	0% and 15%	10% and 20% (and limited 8% and 18%)
Net Investment Income Medicare Contribution Tax	Not applicable	3.8%

Medicare Contribution Tax

Beginning in 2013 the Health Care and Education Affordability Reconciliation Act of 2010 mandates a 3.8% surtax on net investment income that applies to high-net-worth individuals and trusts and estates. The net investment income potentially subject to the Medicare contribution tax includes interest, dividends, annuities, royalties, rents and net gains from investments and other non-business income.

The Medicare contribution tax will apply to the lesser of (i) net investment income for the taxable year or (ii) the excess (if any) of the taxpayer's modified adjusted gross income, over a statutory threshold amount. The threshold amounts for individuals in 2013 will be \$250,000 for married taxpayers filing jointly (or a surviving spouse), \$125,000 for married taxpayers filing separately and \$200,000 for other individual taxpayers. For estates and trusts the tax will apply once the marginal tax bracket is reached, which in 2012 is \$11,650.

Gift, Estate and Generation-Skipping Transfer Tax

Additional changes will occur in the gift, estate and generation-skipping transfer taxes. In 2013 the marginal gift, estate and generation-skipping transfer tax rate will again be 55%, there will be an additional 5% surtax on estates from \$10 million to \$17,184,000, and the exclusion and exemption amounts will fall back to \$1 million (indexed for purposes of the generation-skipping transfer tax).

GIFT, ESTATE AND GENERATION-SKIPPING TRANSFER TAX SUMMARY

	Current 2012	2013 With Scheduled Sunset
Gift, Estate and GST Marginal Tax Rate	35%	55%, with additional 5% estate tax surtax on estates \$10,000,000 – \$17,184,000
Gift and Estate Tax Applicable Exclusion Amount	\$5,120,000	\$1,000,000
GST Exemption Amount	\$5,120,000	\$1,000,000 (adjusted for inflation)
Portability	Applicable	Not applicable

WHERE DO WE GO FROM HERE?

Legislative action is required in order for the various rate increases and deduction limitations not to come into effect January 1, 2013. There has been much discussion by legislators and policymakers of “tax extenders,” “tax expenditures” and, more recently, the “fiscal cliff.” What precisely does this tax jargon mean?

Tax Extenders

There are innumerable provisions of the Internal Revenue Code (Tax Code) that have been enacted on a temporary basis, ordinarily for budget reasons, but historically have been extended, thus the moniker “tax extenders.” Some of the more commonly recognized tax extenders affecting individual taxpayers include the state and local sales tax deduction, the higher education tuition deduction, the increased AMT exemption and the charitable Individual Retirement Account (IRA) rollover. The 2010 Tax Act extended many of these temporary tax incentives through December 31, 2011, but no extender legislation is currently in effect for 2012. Efforts presently are being made in Congress to develop a more systematic approach to keeping and eliminating tax extenders.

Tax Expenditures

“Tax expenditures” are provisions of the Tax Code that provide special tax benefits for certain taxpayers or activities and result in lost tax revenue. There were more than 170 tax expenditures identified in the 2012 federal budget. Reducing tax expenditures has attracted significant attention as a means of simplifying the Tax Code, broadening the tax base and increasing tax revenues. Of particular significance for many high-income taxpayers are the exclusion of interest on state and local bonds from federal income and the charitable contribution deduction.

The Fiscal Cliff

Taxes are part of a much broader economic and fiscal environment. The concept of a “fiscal cliff” that we were introduced to in the spring refers to the confluence of circumstances of the scheduled expiration of the Bush-era tax cuts (and the related tax increases) and the January 1, 2013, effective date of certain limitations on the federal budget and government expenditures. The Congressional Budget Office has projected that fiscal policies, meaning the combined scheduled tax and spending policy changes, will reduce the federal budget deficit by \$607 billion from 2012 to 2013, attributed as follows:

Change in Tax Policy	Deficit Reduction 2012 to 2013
Expiration of AMT relief at the end of 2011 and of tax rate reductions and expanded deductions and credits at the end of 2012	\$221 billion increase in revenue
Expiration of 2% cut in payroll tax at the end of 2012	\$95 billion increase in revenue
Miscellaneous tax provisions expiring at the end of 2012	\$65 billion increase in revenue
Increase in Medicare contribution on earnings and new Medicare contribution tax on net investment income for high-income taxpayers effective in 2013	\$18 billion increase in revenue
Discretionary and mandatory spending limitations effective January 2013	\$65 billion decrease in expenditures
Expiration of extended emergency unemployment benefits at the end of 2012	\$26 billion decrease in expenditures
Reduction in Medicare payment rates for physicians	\$11 billion decrease in expenditures
Additional changes in revenues and expenditures	\$105 billion

The non-partisan Congressional Budget Office opined in May that a simultaneous increase in tax rates and limit on government expenditures is expected to have a dampening effect on the economy notwithstanding any reduction in the federal deficit. Conversely, if all current policies were extended for a protracted period, federal debt held by the public, currently about 70% of Gross Domestic Product (GDP), its highest mark since 1950 – would continue to rise much faster than GDP. A “middle ground” of deferred tax increases and spending cuts has been proposed, but it will take bipartisan legislative action, either prior to the August recess or during the post-election lame duck session, if we are to have clear direction prior to January 2013.

There is a broad range of outcomes under discussion – from reducing the six current individual tax rates to 10% and 25% and eliminating the alternative minimum tax, to a permanent extension of the middle-income tax cuts, with higher taxes remaining in place for 2013 for those earning more than \$1 million, using the additional tax revenue to pay down the federal budget deficit. Presidential candidate Romney also has set forth individual income tax proposals including across-the-board 20% cuts in marginal income tax rates, continuation of the current rates on dividends and capital gains, with elimination of income taxes on interest, dividends and capital gains for married couples filing jointly with adjusted gross income below \$200,000 (\$100,000 for single filers and \$150,000 for heads of household), and repeal of the Medicare contribution tax and the AMT.

THE LEGISLATIVE PROCESS

Recall that generally federal tax legislation only becomes law if it makes its way through a three-step process – passage by the House of Representatives, passage by the Senate and signing by the President. At present the majority of the House of Representatives (55.6%) is Republican, the majority of the Senate is Democratic (53%) and the President is Democratic. In 2012, the entire House of Representatives – all 435 seats – are up for election, and 42 incumbents are retiring – 23 Democrats and 19 Republicans. In the Senate 33 seats are up for election – 23 Democratic and 10 Republican, and it is a Presidential election year.

At the time of publication, the outcome of the elections is not known. What is understood is that the outcome of the elections is expected to have an impact on future tax legislation, both in the “lame duck” session following the November elections and by the new Congress in 2013. Under the present circumstances it is increasingly likely that the most that will be done legislatively prior to year-end is another temporary AMT patch, a temporary extension of the Bush-era income tax rate cuts (possibly for one year) and deferral of the effective date of the new Medicare contribution tax. It is probable that there will be no new legislation with respect to the gift, estate and generation-skipping transfer taxes until after year-end.

HOW DO THESE CHANGES AFFECT INDIVIDUAL TAXPAYERS?

If and when the pending sunset of the Bush-era tax cuts occurs it clearly will affect the after-tax rate of return on investments (and, therefore, the after-tax resources of taxpayers), the tax benefit of deductible expenditures such as charitable contributions for high-income taxpayers, tax-timed sales and exchanges to harvest capital gains or losses, and the significance of where assets are “located” – whether in taxable, tax-deferred or tax-exempt accounts. Planning can only be done at this point based on an informed assessment of probable outcomes. Keep in mind that in a level (or declining) tax rate environment generally speaking deferring income and accelerating deductions is optimal, but for the moment, tax rate increases and certain deduction phase-outs at some point are probable, in which case taking advantage of current rates and deductions could be advantageous in some circumstances.

After-Tax Returns

Higher tax rates mean lower after-tax returns for investors. For example, if current legislation is allowed to sunset, and assuming a 2% dividend yield, the after-tax return of an investor in the highest marginal income tax bracket in 2013 would be 0.57% lower than in 2012 simply due to the dividend tax rate increase – after-tax dividend yield is 1.70% using a 15% tax rate and 1.13% using a 43.4% tax rate.

	2012	2013
Dividend	\$200	\$200
Tax Rate	15%	43.4%
Tax	\$30	\$87
After-Tax	\$170	\$113

Tax-Timed Sales – Harvesting Gains and Losses

Due to the significant impact of higher tax rates, some investors are wondering whether now would be a good time to realize long-term gains. Realizing long-term gains in 2012 would step-up the cost basis of the portfolio while long-term capital gain tax rates are still at the lower 15% (or 0%) rate. Other investors are wondering whether they should more aggressively harvest losses now to use in future years since these losses will become more valuable in the coming years if tax rates increase.

This decision depends on several factors that are unique to each individual investor's circumstances. Specifically, an investor must make certain assumptions based on overall investment and tax strategies including future market returns and tax rates, the current composition and market value of the investor's portfolio and the value of any unrealized gain position. An investor's tax and investment situation will have a meaningful impact on whether the step-up strategy is beneficial. However, investors need not be concerned with "wash-sales" of appreciated assets as the wash-sale tax rules apply to capital losses, not to capital gains.

For a detailed discussion of modeling done by Northern Trust's Tax Advantaged Equity Team in the face of the expiring tax laws in 2010 and again this year see "[Market Commentary as of 2012: An Increasing Tax Landscape Yet Again?](#)" This modeling generally demonstrates that with low-to-moderate return assumptions, it could be beneficial to step-up the basis of an investor's portfolio if tax rates in fact increase as scheduled. However, the benefit of the step-up does not necessarily last over longer time periods, and if an investor passes away shortly following a taxable step-up, he or she will have lost the benefit of the income tax-free basis step-up at death. Any tax-timed transaction should be carefully analyzed in the specific context of each individual investor in light of the investor's individual investment objectives and circumstances.

Installment Sales

For any installment sales, consideration should be given to the economics of tax deferral in light of increasing tax rates. Although a sale transaction occurs in a low tax rate year, the deferred amounts will be taxed at the rates in effect in the year the deferred amounts are recognized. Thus, for a sale that occurred in a 15% capital gain tax year, any amount recognized in a 20% or 23.8% tax year will be taxed at the higher rate.

Ownership of Assets

The previous discussion regarding after-tax dividend yield and the consequences of tax-timed sales highlights yet another relevant factor – where assets are held and the benefits of taking a holistic approach to asset allocation and ownership. Dividends in a taxable revocable trust account will be taxed currently. Dividends in a tax-deferred individual retirement account will not be taxed currently. Tax-exempt investments in a taxable revocable trust account will reduce the investor's tax burden, whereas tax-exempt investments in a tax-deferred individual retirement account will produce no additional tax benefit.

Tax Benefits of Tax Deductible Expenditures – Charitable Contributions

What about planning for tax-deductible expenditures such as state income taxes, real estate taxes and charitable contributions in a changing tax environment? There are competing considerations here. First is whether the expenditure is lost for purposes of the alternative minimum tax, such as state income taxes and real estate taxes. If it is, bunching payments in a high ordinary income tax year may have no net tax benefit due to the alternative minimum tax.

Second is whether the expenditure will be subject to phase-out in future years. Take the charitable contribution deduction for example. A contribution of cash to a public charity of up to 50% of adjusted gross income may be fully deducted in 2012, and any excess contribution may be carried over for up to five years. The same contribution within the 50% of adjusted gross income limitation by a high-income taxpayer in 2013 may be subject to an additional phase-out of 3% of adjusted gross income in excess of an inflation adjusted threshold level, up to 80% of itemized deductions. So, although tax rates are scheduled to be higher in 2013, making a charitable contribution more valuable in 2013 taking rates alone into account, the impact of the phase-out of itemized deductions also should be considered.

For individuals considering making higher levels of gifts in 2012 there are many available strategies – a donor advised fund, a charitable lead annuity trust or a combination of types of gifts and charitable recipients to maximize charitable giving opportunities.

Donor Advised Fund

A donor advised fund is a charitable giving vehicle that allows a donor to make a contribution (cash, long-term appreciated securities, etc.) to the fund in the current year and obtain the associated charitable income tax deduction under the laws in effect at the time of the contribution. The donor may make recommendations as to the sponsoring charity's distributions from the fund to selected charitable organizations. Distributions from the fund may be made in the current year or spread out over subsequent years. In short, the donor may lock-in the benefit of the current charitable income tax deduction under the tax laws presently in effect and also benefit charities of choice over a longer timeframe.

Example: In 2012, when high levels of income are concentrated in anticipation of future increases in income tax rates the donor with \$1 million of adjusted gross income makes a gift of \$100,000 cash to a donor advised fund. The donor can deduct the entire \$100,000 in 2012 with no phase-out. Under the law scheduled to be in effect in 2013, the same contribution would be subject to phase-out of 3% of adjusted gross income in excess of a yet-to-be determined inflation adjusted phase-out threshold, up to 80% of the donor's itemized deductions.

Charitable Lead Annuity Trust

A charitable lead annuity trust is an irrevocable trust for the current benefit of charity and future benefit of family or other non-charity beneficiaries. An annuity is paid to charity for a selected time frame, either a term of years or the lives of one or more individuals, and at the end of the charitable term the remainder is distributed or held in further trust for non-charity beneficiaries. When interest rates are low, the gift tax cost of a charitable lead annuity trust is reduced. In June 2012 the Section 7520 rate used for charitable lead trust computations was at a historic low of 1.2%, making a charitable lead annuity trust a particularly attractive charitable gift vehicle. If a charitable lead annuity trust is designed as a grantor trust, the donor is entitled to a current income tax charitable deduction for the present value of the annuity for charity and is taxed on the taxable income of the trust during the charitable term. If a charitable lead annuity trust is designed as a non-grantor trust, the donor is entitled to a charitable gift tax deduction but not a charitable income tax deduction (however, the trust will be entitled to an annual charitable income tax deduction), and the donor is not taxed on the income of the trust.

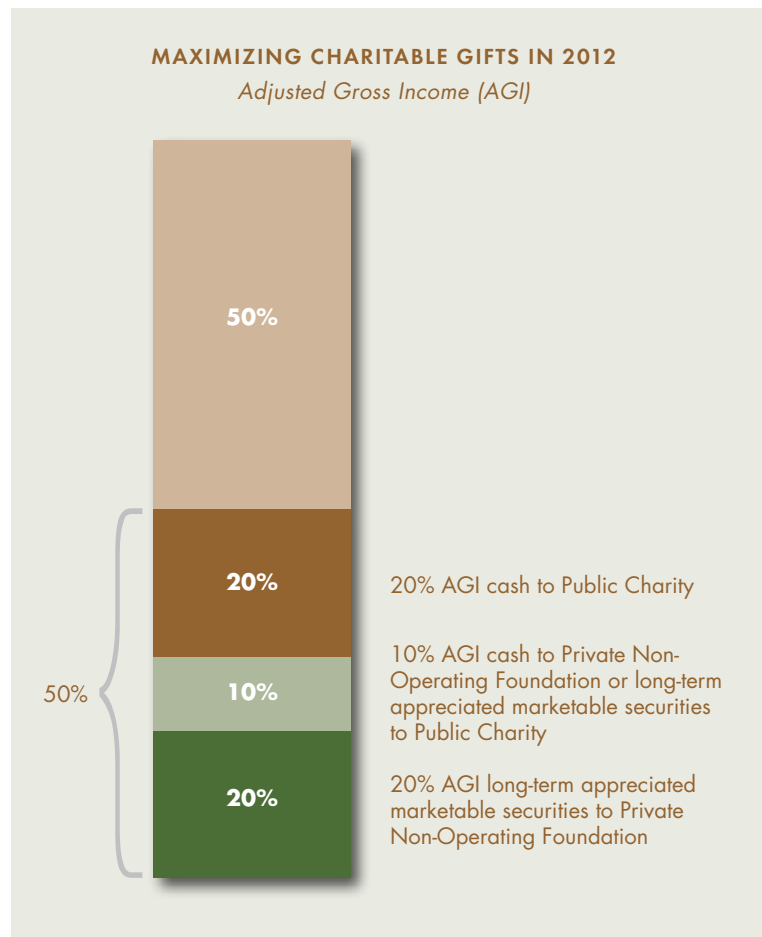
Example: Donor contributes \$1 million cash to a non-grantor 20-year term charitable lead annuity trust in June 2012 when the Section 7520 rate is 1.2%. The trust's actual after-tax growth rate is assumed to be 6.5%. Annual annuity payments of \$56,538 will be paid to the charity and at the end of the 20-year term, under the assumed growth rate, \$1,328,550 will pass to the remainder beneficiaries with zero gift tax cost.

Combined Contributions

Charitable gifts are subject to income tax deduction limitations based on the donor's adjusted gross income, the type of property contributed and the type of charity to which the contribution is made. Generally, gifts of cash to a public charity are limited to 50% of adjusted gross income, gifts of cash to a private non-operating foundation are limited to 30% of adjusted gross income, gifts of long-term appreciated assets to a public charity are limited to 30% of adjusted gross income, and gifts of long-term appreciated property to a private non-operating foundation are limited to 20% of adjusted gross income. Excess amounts may be carried over for up to five years, during life.

A donor who wishes to maximize tax deductible gifts in 2012 can combine his or her gifts to fully utilize the 50% level in 2012.

Example: In 2012 when high levels of income are again concentrated in anticipation of increases in income tax rates, donor has \$1 million adjusted gross income. Donor contributes \$200,000 long-term appreciated marketable securities to private non-operating foundation, \$100,000 cash to private non-operating foundation and \$200,000 cash to public charity (or instead of the \$100,000 cash to private non-operating foundation, \$100,000 long-term appreciated marketable securities to public charity). Donor may deduct \$500,000 in 2012.



Individual Retirement Accounts

Retirement planning remains an important objective for many people, regardless of the changes in the tax laws. The choice of type of retirement savings vehicle, whether to convert from one type to another, how to take any required minimum distributions and how to structure beneficiary designations for inheritance depend, in part, upon expectations regarding future income and estate tax rates and the intended use of the retirement savings. Considerations of particular significance in 2012 include:

- **Roth IRA conversion**

If you are considering converting a traditional IRA to a Roth IRA, the income tax cost of the conversion at the 2012 tax rates likely will be less than the tax cost of the conversion at higher 2013 tax rates. If you convert in 2012 and choose to, you may unwind (“recharacterize”) any part of or all of your 2012 conversion prior to the filing of your 2012 income tax return in 2013, as late as October 15, 2013 with extensions.

- **Required IRA minimum distributions**

If you are planning to make charitable contributions and are required to take a minimum distribution from your IRA, consider waiting until later in the year to take your required minimum distribution. If later this year Congress extends the \$100,000 charitable IRA rollover for 2012, and you have taken your required minimum distribution prior to the change in the law, it is likely that you will not be able to take advantage of the change retroactively as the contribution is required to be made directly to the charity to qualify. You will still be able to make your charitable contribution, but not with the benefit of the charitable IRA rollover treatment.

INCOME TAX CONSIDERATIONS FOR BUSINESSES AND BUSINESS OWNERS

Business owners have expressed to Congress their strong desire for more certainty and continuity in the tax area to facilitate strategic planning and risk management. Taxes are a significant expense and uncertainty raises obstacles to long-term planning. Nonetheless, numerous pending tax law changes will affect businesses and business owners including the changes in dividend and capital gain tax rates discussed above, changes in the relative individual and corporate tax rates affecting the selection of flow-through corporate tax structures and various tax credits, deductions and alternative minimum tax preference items.

Individual and Corporate Tax Rates

Relative individual and corporate tax rates and multiple levels of taxation are considerations in the selection of the tax structure of corporate entities. Lower relative individual income tax rates have increased the attractiveness of S-corporation elections and partnership and limited liability tax structures in recent years. To the extent that there is a shift of the relative rates of individual and corporate income tax rates (from individual rates that are

lower than corporate rates to individual rates that may be higher than corporate rates), there may be shifts in choices as to the selection of corporate form or tax elections (possibly reducing the relative attractiveness of flow-through structures such as S-corporations, partnerships and limited liability companies). If dividends are taxed at the same rates as compensation, there may be shifts in how payments are made to employee shareholders. For corporations with the ability to time dividend and bonus compensation payments, if the qualified dividend rate expires at year-end and marginal tax rates increase, consideration may be given to making payments in 2012 as opposed to 2013.

S-corporation Built-in Gain

Corporations that make an S-corporation election in 2012 and future years and have gain attributable to pre-election appreciation of property commonly will be subject to tax on built-in gain at the corporate level for property disposed of within 10 years. This 10-year look back period replaces the shortened seven-year period in effect for 2009 and 2010 and the five-year period in effect for 2011.

Small Business Stock AMT Preference

As a tax incentive to investment in small business, under Section 1202 of the Internal Revenue Code, non-corporate investors may exclude a portion of the realized gain on the taxable disposition of qualifying small business stock. The percentage that may be excluded from taxable income varies based on the acquisition year. In addition, the extent to which gain that is excluded from ordinary income is included as an alternative minimum tax preference item varies. From 2012 to 2013, the amount of excluded gain that is included as an alternative minimum tax preference item generally will increase from 7% to 42% (or 28% in limited circumstances).

Insourcing, Outsourcing, U.S. Jobs and Small Businesses

Recurring themes from Washington are to create jobs in America, discourage “outsourcing” and encourage “insourcing.” Proposals include having American companies pay a minimum tax on overseas profits, thus eliminating any tax disparities arising from lower tax rates of other countries; eliminating deductions related to costs of closing domestic operations and moving overseas; a new tax credit to cover relocation expenses for companies that close overseas operations and commence domestic operations; and tax credits to increase manufacturing jobs in the U.S and to encourage hiring veterans.

Small business incentives under discussion include a credit for small employers providing health care coverage, a 10% credit for small businesses that create new jobs or increase wages in 2012, extension of the 100% bonus depreciation deduction through 2012 and a 20% tax cut for small businesses.

WEALTH TRANSFER TAX CONSIDERATIONS

In 2012 the exclusions and exemptions from the gift, estate and generation-skipping transfer (GST) taxes are all \$5.12 million and the rate for the taxation of transfers above the \$5.12 million level is 35%. This is a historic combination of high exemption and exclusion and low-rate levels that is scheduled to expire at year-end. In addition, the surviving spouse of a person who passes away in 2011 or 2012 may be eligible to increase the surviving spouse's exclusion amount by the portion of the predeceased spouse's exclusion that remained unused at the predeceased spouse's death (commonly referred to as "portability").

Absent changes in the law as currently enacted, in 2013 the gift and estate tax exclusion will drop to \$1 million with no portability and the GST exemption will decrease to somewhere around \$1.4 million (this exemption is inflation adjusted, and we do not yet know the exact level where it will be in 2013). The marginal gift and estate tax rates and the GST tax rate will each increase to 55%, and there will again be an additional 5% surtax on estates between \$10 million and \$17.184 million. On a more technical note, certain helpful GST tax provisions that permitted the severance of trusts for GST purposes, expanded the ways for allocating exemption and allowed for relief from unintended GST elections and allocations will expire. Although there has been much discussion of the modifications of the gift, estate and GST tax provisions that will come into effect in 2013, it is not expected that we will have definitive guidance in this regard prior to year-end.

The current Administration has proposed making permanent the gift, estate and GST tax rates, exclusions and exemptions as they applied during 2009. The top tax rate would be 45% and the exclusion/exemption amount would be \$3.5 million for estate and GST taxes and \$1 million for gift taxes. In addition, the portability of unused gift and estate tax exclusion between spouses in effect in 2011 and 2012 would be made permanent. Additional limitations on specific planning strategies have been proposed including a minimum 10-year term for grantor retained annuity trusts, as well as a maximum term of the life expectancy of the annuitant plus 10 years; an effective 90-year limit on GST tax exemption for dynasty trusts; and limitations on the estate planning use of irrevocable trusts taxed as grantor trusts for income tax purposes.

WEALTH PLANNING STRATEGIES TO CONSIDER IN 2012

The combination of the low estate, gift and GST tax rates, high exclusion and exemption levels, and low Tax Code Section 7520 interest rates make lifetime gift planning uniquely attractive in 2012. The high gift tax exclusion level can be used to forgive family loans where repayment either is no longer desired or realistic. It can also be used to equalize gifts among family members, in both traditional and blended families, or to make a gift to a life-partner. Those with significant wealth may consider establishing a long-term dynasty trust for several generations, utilizing both the increased gift tax exclusion and the GST exemption. For a married couple who would like to make a gift but is unsure of future economic circumstances, with careful planning a lifetime gift trust that includes the spouse as a permitted beneficiary may be designed.

The low Tax Code Section 7520 rate makes charitable lead annuity trusts (discussed previously) and grantor retained annuity trusts particularly attractive. At a lower rate the discounted gift tax value of the remainder interest may be reduced, potentially to zero, and smaller annuity payments made to charity or the grantor.

Example: Donor contributes \$10 million to a 9-year grantor retained annuity trust (with payments to the grantor during the annuity term increasing by 20% each year) in June 2012 at the 1.2% Tax Code Section 7520 rate and assumes an after-tax growth rate of 6.5%, with the remainder “zeroed-out” for gift tax purposes. Compare this gift to the same gift when the Tax Code Section 7520 rate is 3%.

Grantor Retained Annuity Trust	3.0% Section 7520 Rate	1.2% Section 7520 Rate
Year 1 Annuity to Grantor	\$575,385	\$517,259
Total Annuity Payments to Grantor 9-Year Term	\$11,967,382	\$10,758,429
Remainder to Beneficiaries at End of 9-Year Term	\$3,146,410	\$4,609,119
Additional Transfer to Remainder Beneficiaries	\$1,462,709	

The low applicable federal rates used for determining the threshold interest rates for family loans may also make family loans attractive. The rate required in order for a loan not to be considered “below market” for gift and income tax purposes will depend on whether the loan is a demand loan or a term loan and, if a term loan, the length of the term. However, all of these rates are presently quite low in a historic context.

Making gifts of assets expected to appreciate, whether outright or in trust, will effectively remove the post-gift appreciation and income from the donor’s gross estate for estate tax purposes. In addition, if assets with a fair market value of less than their basis (depreciated assets) are available for gifting, income taxes to the donee can be minimized. This is because the donee of a gift generally receives a carryover basis, whereas assets transferred at death receive a date of death value basis (or alternate valuation date basis, where elected), even if the decedent’s basis was higher – a basis step-down.

Example: Donor gives donee marketable securities with a basis of \$20,000 and a fair market value on the date of the gift of \$10,000. The basis of the stock for purposes of computing the gain on a future sale by the donee for in excess of the donor’s basis will be the donor’s basis carried over to the donee. So, if the stock is sold for \$30,000, the gain will be \$10,000 (\$30,000 – \$20,000), not \$20,000 (\$30,000 – \$10,000).

PARTNERING WITH TAX AND INVESTMENT PROFESSIONALS

With uncertainty surrounding the tax landscape, it is essential to stay focused on core wealth accumulation and wealth transfer objectives and to stay informed of potential tax law changes. Conferring with tax and legal advisors along with investment professionals early will be of increased benefit as the 2012 tax-year end approaches and we navigate the transition to 2013.

FOR MORE INFORMATION

Northern Trust's Personal Financial Services team can provide the analysis needed to help you make informed wealth accumulation and transfer planning decisions in the current tax environment. To learn more, please contact your relationship manager.

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