EXPERIENCE THE RIGHT PARTNERSHIP

December 3, 2012 Professional Advisor Forum

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SURVIVING THE FISCAL CLIFF:
CONSIDERATIONS AT PLAY WITH EXPIRING CODE PROVISIONS

Suzanne L. Shier

Julie J. Olenn

W. David Connell

R. Hugh Magill

Northern Trust

Today's Agenda

How Did We Get Here? Where Are We Going?

- 2012 Year-End Tax Planning
- Generation-Skipping Transfer Tax Dilemmas
- Trust Administration Issues: the New Medicare Contribution Tax, GST and Crummey Trusts

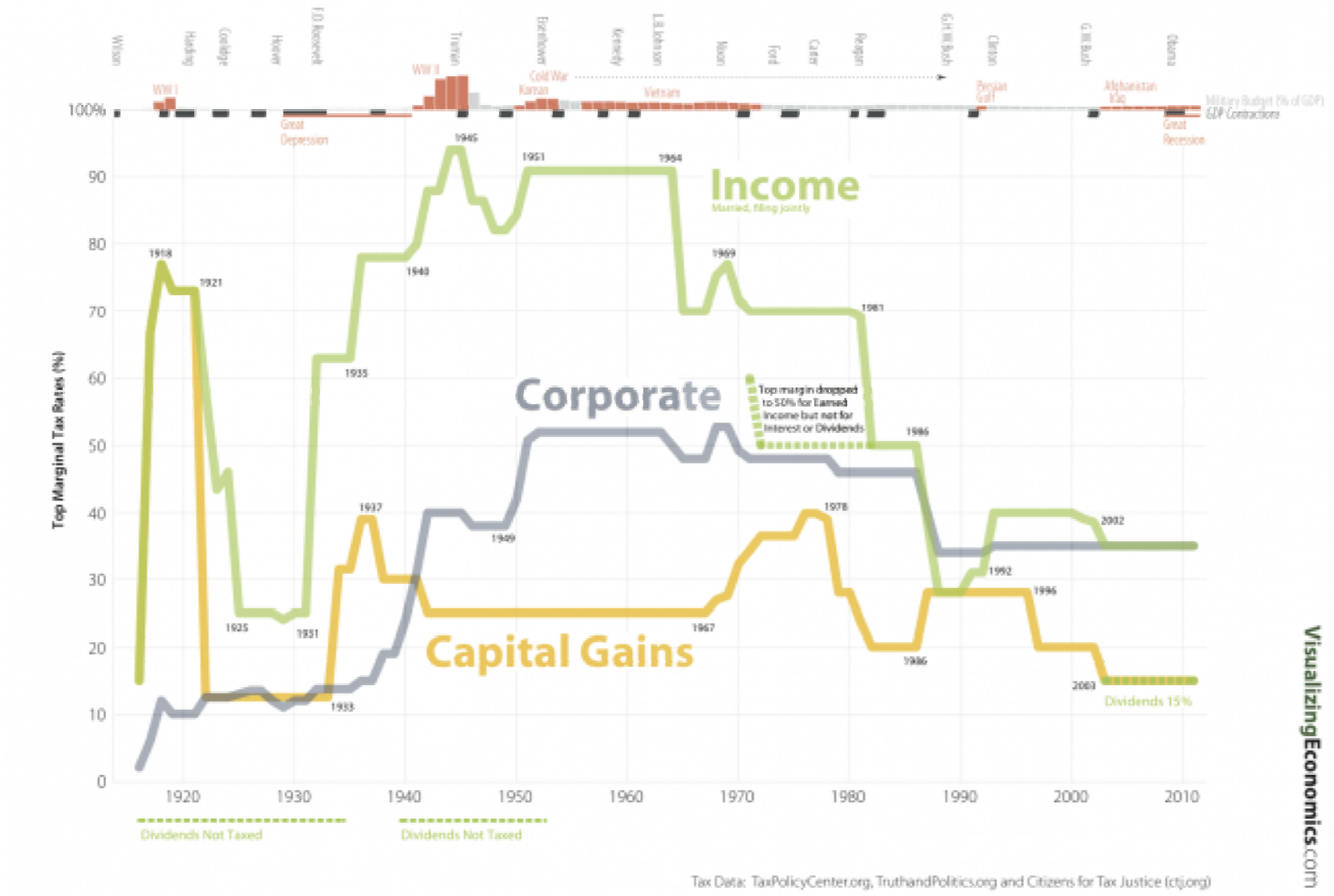
2012-13 Tax Transitions

January 1, 2013

- On December 31, 2012, the Bush-era tax cuts, along with more than 40 federal tax provisions, will expire (absent legislative action, income tax and transfer tax* rates revert to 2001 levels)
- Absent legislation in the lame duck session, on January 1, 2013, top income tax brackets will increase to 36% and 39.6%, qualified dividends will be taxed at ordinary income rates, capital gains will be taxed at 20%, and net investment income for high-income taxpayers will be subject to a 3.8% Medicare surtax
- Absent a retroactive Alternative Minimum Tax (AMT) "patch" for 2012, due to the reduction in the exemption amount, more taxpayers will be subject to the AMT
- Itemized deductions for high income taxpayers may be subject to limitations

***Transfer tax rates include estate, gift and generation-skipping tax rates**

Historical Tax Rates 1916-2011



2012-2013 Income Tax Summaries

Tax rates will increase and deductions will decrease…

INCOME TAX RATE SUMMARY

Tax Rates	Current 2012	2013 With Scheduled Sunset	Democrat	Republican (Pre-Election)
Ordinary Income	10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%	10%, 15%, 25%, 28%, 36%, 39.6%	8%, 12%, 20%, 22.4%, 26.4%, 28%
Qualified Dividends	0% and 15%	Ordinary Income Tax Rates	0% and 15% for lower income taxpayers and ordinary income tax rates for higher income taxpayers	0% for lower income taxpayers and 15% for higher income taxpayers
Long-term Capital Gains	0% and 15%	10% and 20% (and limited 8% and 18%)	0% and 15% for lower income taxpayers and 20% for higher income taxpayers	0% for lower income taxpayers and 15% for higher income taxpayers
Medicare Contribution Tax on Net Investment Income	Not applicable	3.8%	3.8%	Repeal
Itemized Deductions	No separate phase out of Schedule A Itemized deductions	Phase out of up to 80% of itemized deductions for high income taxpayers	Limit benefit of itemized deductions for high income taxpayers	Negotiable

2012-2013 Transfer Tax Summaries

Tax rates will increase and exclusions will decrease…

GIFT, ESTATE AND GENERATION-SKIPPING TRANSFER TAX SUMMARY

Tax Rates	Current 2012	2013 With Scheduled Sunset	Democrat	Republican
Gift, Estate and GST Marginal Tax Rate	35%	55%, with additional 5% estate tax surtax on estates $10,000,000-$17,184,000	45%	35%
Gift and Estate Tax Applicable Exclusion Amount	$5,120,000	$1,000,000	Gift $1,000,000 and Estate $3,500,000	$5,000,000 indexed
GST Exemption Amount	$5,120,000	$1,000,000 (adjusted for inflation)	$3,500,000	$5,000,000 indexed
Portability	Applicable	Not Applicable	Applicable	Applicable

2012 Year-End Tax

Table A1.–Distribution of Estate Tax Liability by Return Type Under Present Law, CY2013-2017
(Size of Gross Estate, Gross Estate, and Tax Liability in millions of dollars)

	2013			2014			2015			2016			2017		
Size of Gross Estate	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability
ALL RETURNS															
Less than 1.0	900	822	35	1,000	869	37	1,100	935	40	1,100	1,005	43	1,200	1,080	46
1.0 - 2.0	68,000	94,781	2,400	72,000	100,259	2,539	77,400	107,778	2,730	83,200	115,907	2,935	89,400	124,529	3,154
2.0 - 3.5	21,800	56,258	7,190	23,000	59,486	7,606	24,800	63,947	8,175	26,600	68,744	8,791	28,600	73,857	9,445
3.5 - 5.0	6,800	28,085	4,351	7,200	29,708	4,603	7,800	31,936	4,947	8,400	34,344	5,320	9,000	36,899	5,716
5.0 - 10.0	6,400	42,924	7,215	6,700	45,404	7,632	7,200	48,809	8,204	7,800	52,491	8,823	8,400	56,395	9,479
10.0 - 20.0	2,300	30,855	5,443	2,400	32,638	5,757	2,600	35,085	6,189	2,800	37,732	6,656	3,000	40,538	7,151
More than 20.0	1,300	90,900	11,008	1,400	96,153	11,644	1,500	103,365	12,517	1,600	111,161	13,461	1,700	119,430	14,462
All Returns	107,500	344,625	37,642	113,700	364,517	39,817	122,200	391,855	42,802	131,400	421,385	46,030	141,200	452,727	49,452
TAXABLE RETURNS															
Less than 1.0	300	294	35	300	311	37	400	335	40	400	360	43	400	387	46
1.0 - 2.0	22,300	33,092	2,400	23,600	35,004	2,539	25,400	37,629	2,730	27,300	40,468	2,935	29,300	43,478	3,154
2.0 - 3.5	17,700	45,831	7,190	18,700	48,480	7,606	20,100	52,115	8,175	21,600	56,046	8,791	23,200	60,215	9,445
3.5 - 5.0	5,900	24,375	4,351	6,300	25,783	4,603	6,700	27,717	4,947	7,200	29,808	5,320	7,800	32,025	5,716
5.0 - 10.0	5,700	38,202	7,215	6,000	40,410	7,632	6,400	43,441	8,204	6,900	46,717	8,823	7,400	50,192	9,479
10.0 - 20.0	2,000	27,910	5,443	2,200	29,523	5,757	2,300	31,737	6,189	2,500	34,131	6,656	2,700	36,670	7,151
More than 20.0	1,200	78,523	11,008	1,300	83,060	11,644	1,400	89,290	12,517	1,500	96,025	13,461	1,600	103,167	14,462
All Returns	55,200	248,227	37,642	58,400	262,572	39,817	62,700	282,264	42,802	67,500	303,554	46,030	72,500	326,133	49,452
NON-TAXABLE RETURNS															
Less than 1.0	600	528	0	600	558	0	700	600	0	700	645	0	800	693	0
1.0 - 2.0	45,700	61,689	0	48,400	65,254	0	52,000	70,148	0	55,900	75,440	0	60,100	81,051	0
2.0 - 3.5	4,100	10,427	0	4,300	11,006	0	4,600	11,832	0	5,000	12,697	0	5,300	13,642	0
3.5 - 5.0	900	3,710	0	1,000	3,924	0	1,000	4,219	0	1,100	4,537	0	1,200	4,874	0
5.0 - 10.0	700	4,721	0	700	4,994	0	800	5,369	0	900	5,774	0	900	6,203	0
10.0 - 20.0	200	2,945	0	200	3,115	0	300	3,348	0	300	3,601	0	300	3,869	0
More than 20.0	100	12,378	0	100	13,093	0	100	14,075	0	100	15,137	0	100	16,263	0
All Returns	52,300	96,398	0	55,400	101,945	0	59,500	109,591	0	64,000	117,830	0	68,700	126,594	0

Note: Details may not add to totals due to rounding. Number of returns ("Nbr") is rounded to the nearest 100.

Source: Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation, Joint Committee on Taxation, JCX-76-12, November 9, 2012.

2012 Year-End Tax

Table A2.–Distribution of Estate Tax Liability by Return Type Under President's Budget Proposal, CY2013-2017
(Size of Gross Estate, Gross Estate, and Tax Liability in millions of dollars)

	2013			2014			2015			2016			2017		
Size of Gross Estate	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability
ALL RETURNS															
Less than 1.0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0
1.0 - 2.0	[1]	30	0	[1]	32	0	[1]	34	0	[1]	37	0	[1]	40	0
2.0 - 3.5	500	1,653	17	600	1,748	17	600	1,879	17	700	2,021	17	700	2,171	17
3.5 - 5.0	6,300	26,016	421	6,700	27,519	434	7,200	29,583	452	7,700	31,814	472	8,300	34,181	495
5.0 - 10.0	6,300	42,742	3,020	6,700	45,212	3,177	7,200	48,603	3,392	7,700	52,269	3,626	8,300	56,157	3,874
10.0 - 20.0	2,300	30,855	3,836	2,400	32,638	4,051	2,600	35,085	4,346	2,800	37,732	4,665	3,000	40,538	5,003
More than 20.0	1,300	90,900	10,866	1,400	96,153	11,490	1,500	103,365	12,346	1,600	111,161	13,272	1,700	119,430	14,254
All Returns	16,700	192,196	18,160	17,700	203,303	19,168	19,000	218,550	20,553	20,500	235,035	22,052	22,000	252,517	23,643
TAXABLE RETURNS															
Less than 1.0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1.0 - 2.0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2.0 - 3.5	100	435	17	100	409	17	100	418	17	100	445	17	100	478	17
3.5 - 5.0	1,700	7,160	421	1,700	7,389	434	1,800	7,812	452	1,900	8,033	472	2,000	8,596	495
5.0 - 10.0	2,900	20,435	3,020	3,100	21,616	3,177	3,300	23,222	3,392	3,600	24,973	3,626	3,800	26,814	3,874
10.0 - 20.0	1,500	20,553	3,836	1,600	21,740	4,051	1,700	23,371	4,346	1,800	25,134	4,665	2,000	27,003	5,003
More than 20.0	900	71,591	10,866	1,000	75,728	11,490	1,100	81,408	12,346	1,100	87,548	13,272	1,200	94,060	14,254
All Returns	7,200	120,174	18,160	7,500	126,882	19,168	8,000	136,230	20,553	8,600	146,133	22,052	9,200	156,951	23,643
NON-TAXABLE RETURNS															
Less than 1.0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0
1.0 - 2.0	[1]	30	0	[1]	32	0	[1]	34	0	[1]	37	0	[1]	40	0
2.0 - 3.5	400	1,217	0	400	1,339	0	500	1,462	0	500	1,576	0	600	1,693	0
3.5 - 5.0	4,600	18,855	0	4,900	20,130	0	5,400	21,771	0	5,800	23,781	0	6,300	25,585	0
5.0 - 10.0	3,400	22,307	0	3,600	23,596	0	3,900	25,381	0	4,200	27,295	0	4,500	29,343	0
10.0 - 20.0	800	10,302	0	800	10,897	0	900	11,715	0	900	12,598	0	1,000	13,535	0
More than 20.0	400	19,309	0	400	20,425	0	400	21,957	0	500	23,613	0	500	25,370	0
All Returns	9,600	72,022	0	10,200	76,421	0	11,000	82,320	0	11,900	88,902	0	12,800	95,566	0

Notes: Details may not add to totals due to rounding. Number of returns ("Nbr") filed is rounded to the nearest 100 and does not include those who file solely to preserve the exemption amount of a spouse.
[1] = less than 50 returns

Source: Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation, Joint Committee on Taxation, JCX-76-12, November 9, 2012.

2012 Year-End Tax

Table A3.–Distribution of Estate Tax Liability By Return Type Under A Permanent Extension of the Tax Relief Act, CY2013-2017
(Size of Gross Estate, Gross Estate, and Tax Liability in millions of dollars)

	2013			2014			2015			2016			2017		
Size of Gross Estate	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability	Nbr	Gross Estate	Tax Liability
ALL RETURNS															
Less than 1.0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0
1.0 - 2.0	[1]	5	0	[1]	5	0	[1]	5	0	[1]	6	0	[1]	6	0
2.0 - 3.5	[1]	72	0	[1]	76	0	[1]	82	0	[1]	88	0	[1]	85	0
3.5 - 5.0	200	1,056	1	200	936	[2]	200	899	[2]	200	732	0	100	599	0
5.0 - 10.0	5,400	37,755	846	5,500	38,935	830	5,800	41,082	831	6,000	42,742	821	6,100	44,208	797
10.0 - 20.0	2,300	30,842	2,244	2,400	32,624	2,330	2,600	35,057	2,461	2,800	37,702	2,590	3,000	40,506	2,712
More than 20.0	1,300	90,900	8,284	1,400	96,153	8,733	1,500	103,365	9,358	1,600	111,161	10,025	1,700	119,430	10,722
All Returns	9,200	160,630	11,375	9,500	168,730	11,894	10,100	180,492	12,650	10,500	192,432	13,436	11,000	204,834	14,232
TAXABLE RETURNS															
Less than 1.0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1.0 - 2.0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2.0 - 3.5	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
3.5 - 5.0	[1]	113	1	[1]	52	[2]	[1]	42	[2]	0	0	0	0	0	0
5.0 - 10.0	1,700	12,792	846	1,700	12,868	830	1,700	13,122	831	1,700	13,206	821	1,700	13,401	797
10.0 - 20.0	1,100	15,514	2,244	1,200	16,361	2,330	1,300	17,453	2,461	1,400	18,702	2,590	1,500	19,983	2,712
More than 20.0	700	62,149	8,284	800	65,716	8,733	800	70,498	9,358	900	75,816	10,025	1,000	81,325	10,722
All Returns	3,600	90,568	11,375	3,700	94,998	11,894	3,900	101,115	12,650	4,000	107,724	13,436	4,200	114,709	14,232
NON-TAXABLE RETURNS															
Less than 1.0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0	[1]	1	0
1.0 - 2.0	[1]	5	0	[1]	5	0	[1]	5	0	[1]	6	0	[1]	6	0
2.0 - 3.5	[1]	72	0	[1]	76	0	[1]	82	0	[1]	88	0	[1]	85	0
3.5 - 5.0	200	943	0	200	883	0	200	857	0	200	732	0	100	599	0
5.0 - 10.0	3,700	24,963	0	3,800	26,067	0	4,100	27,961	0	4,300	29,537	0	4,400	30,807	0
10.0 - 20.0	1,100	15,328	0	1,200	16,263	0	1,300	17,604	0	1,400	18,999	0	1,500	20,523	0
More than 20.0	600	28,751	0	600	30,437	0	600	32,866	0	700	35,345	0	800	38,104	0
All Returns	5,600	70,062	0	5,800	73,733	0	6,200	79,377	0	6,500	84,708	0	6,800	90,126	0

Notes: Details may not add to totals due to rounding. Number of returns ("Nbr") filed is rounded to the nearest 100 and does not include those who file solely to preserve the exemption amount of a spouse.
[1] = less than 50 returns
[2] = less $500,000

Source: Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation, Joint Committee on Taxation, JCX-76-12, November 9, 2012.

2012 Year-End Tax

Table A4.–Number of Estates of Decedents Dying in Calendar Years 2013 Through 2021

	2013	2014	2015	2016	2017	2018	2019	2020	2021
Present Law									
Filers	107,500	113,700	122,200	131,400	141,200	151,700	162,200	173,000	185,100
Taxable Estates	55,200	58,400	62,700	67,500	72,500	77,800	83,200	88,800	95,000
Farming Taxable Estates	2,400	2,500	2,700	2,900	3,100	3,400	3,600	3,800	4,100
Small Business Taxable Estates	2,700	2,800	3,000	3,200	3,500	3,700	4,000	4,300	4,600
President's Budget Proposal									
Filers	16,700	17,700	19,000	20,500	22,000	23,600	25,300	27,000	28,800
Taxable Estates	7,200	7,500	8,000	8,600	9,200	9,800	10,400	11,100	11,800
Farming Taxable Estates	300	300	300	300	300	300	400	400	400
Small Business Taxable Estates	400	500	500	500	600	600	700	700	700
Permanent Extension of Tax Relief Act									
Filers	9,200	9,500	10,100	10,500	11,000	11,400	11,800	12,100	12,500
Taxable Estates	3,600	3,700	3,900	4,000	4,200	4,300	4,400	4,500	4,600
Farming Taxable Estates	100	100	100	100	100	100	100	100	100
Small Business Taxable Estates	200	200	200	200	200	200	200	200	200

Source: Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation, Joint Committee on Taxation, JCX-76-12, November 9, 2012.

GENERATION-SKIPPING TRANSFER TAX DILEMMAS

Northern Trust

EGTRRA Sunset Provisions

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

SEC. 901. SUNSET PROVISIONS OF ACT

(a) IN GENERAL. All provisions of, and amendments made by, this Act shall not apply

…

(2) in the case of title V, to estates of decedents dying, gifts made, or generation-skipping transfers, after ~~December 31, 2010~~ [December 31, 2012].

(b) APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986 … shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

What's Affected?

- Exemption falls to $1 mil., adjusted for inflation (approx. $1.43 mil.)
- Rate rises to 55%
- Section 2642(b) valuation rules no longer use values "as finally determined" for estate and gift tax purposes
- Many Internal Revenue Code (Code) provisions sunset entirely:
  - Section 2604(c) – repeal of state GST tax credit
  - Section 2632(c) – automatic allocation of GST exemption to "indirect skips"
  - Section 2632(d) – retroactive allocation for predeceased descendant
  - Section 2642(a)(3) – qualified severances ("downstream splits")
  - Section 2642(g)(1) – relief from late allocations or elections
  - Section 2642(g)(2) – substantial compliance for Section 2632(c) allocations

Impact on Existing Trusts of Lower Exemption, Higher Rate

- Applicable Fraction = GST Exemption Allocated / Value of Property
- Inclusion Ratio = 1 – Applicable Fraction
- Applicable GST Rate = Maximum Estate Tax Rate * Inclusion Ratio

2012	2013
$5,120,000 / $5,120,000 = 1	$1,430,000 / $5,120,000 = .279
1 – 1 = 0	1 – 0.279 = 0.721
35% * 0% = 0%	55% * 72.1% = 39.655%
$10,000 * 0% = $0.00	$10,000 * 39.655% = $3,965.50

Rules Affecting Transfers After December 31, 2000

- Section 2632(c) Automatic Allocation
  - Rules that automatically allocate to direct skips during life (Section 2632(b)) and to lifetime and deathtime transfers by a decedent (Section 2632(e)) are unaffected by sunset.

- Section 2632(d) Retroactive Allocation
  - May be treated as a late rather than retroactive allocation, for GSTs after 2012.
  - A retroactive allocation can still be made for 2012, which may avoid GST tax on a 2012 transfer, regardless of effect on GSTs after 2012.

Rules Affecting Transfers After September 25, 1985

- Section 2642(a)(3) Qualified Severances
  - Trusts that are severed on an estate tax return (per Treas. Regs. Section 26.2654-1(b)) are unaffected, as well as any other exempt and nonexempt trusts created as separate trusts rather than severed in a qualified severance.
  - Trusts severed in a qualified severance ("downstream split") may each be deemed to have the inclusion ratio of the original trust.

- Section 2642(g) Relief, via Treas. Regs. Section 310.9100-3
  - Relief for late allocations, and for late elections out of automatic allocation to direct skips or indirect skips
    - Proposed Regulations not final
    - Cf., relief for late reverse QTIP elections granted pursuant to Treas. Regs. Section 310.9100-3 (i.e., at Commissioner's discretion)

What We Can Do Now

- For exempt trusts where skip persons have a known or anticipated need for distributions in 2013, consider accelerating distributions into 2012 if needs cannot be met by GST excludible payments.

- For gifts in reliance on Section 2632(c) automatic allocation rules without timely filed Forms 709, consider filing returns now to create a record with the IRS.

- For deaths out of order in 2012, consider filing Form 709 to make retroactive allocation under Section 2632(d).
  - If death triggers a taxable termination in 2012, a retroactive allocation may avoid GST tax.

What to Look for in 2013

- Distributions to skip persons may need to be deferred during any period of uncertainty with respect to the trust's inclusion ratio.
- Similarly, GST reserves may need to be retained in the event of a taxable termination of a trust whose inclusion ratio is uncertain.
  - Also, state reporting may again be required for taxable terminations.
- Contingent general powers of appointment may be triggered if a GST would otherwise be imposed as a result of death, resulting in an estate tax rather than GST tax for a trust whose "exempt" status is affected by sunset.
- For inter vivos gifts in trust other than direct skips, and ETIPs closing after December 31, 2012, donors will once again need to timely file Forms 709 with a Notice of Allocation if they want GST exemption to be allocated, regardless of whether reporting is actually required for gift tax purposes.

Reminder: Some Important GST Provisions Are Here to Stay

- Annual GST exclusion
  - Caveat: outright gifts vs. gifts in trust
- Excludible Payments for Tuition or Medical Care
- Automatic Allocation of GST exemption during life to direct skips, and at death to *both* transfers effective at death for property includible in the gross estate and lifetime transfers not includible in gross estate
- Separate Share Rules
  - Including severance of property includible in the gross estate
- Transferor Move-Down Rule
  - Beneficiaries who are two or more generations removed from the transferor are still often assigned to a nonskip generation.

TRUST ADMINISTRATION ISSUES

Northern Trust

Current Issues in Trust Administration

- Trust Administration and the New Medicare Contribution Tax
  - Applicable to trusts and estates beginning in 2013
  - New (and renewed) ideas for consideration (and reconsideration) for trust administration

New Medicare Related Taxes Effective January 1, 2013: Four Things to Know

1 Additional 0.9% Medicare tax on Wages for High-Income Earners

- Currently, employees pay a Medicare tax of 1.45% on their earned income and employers pay a Medicare tax of 1.45% on employees' earned income.
- On January 1, 2013: Same as above, PLUS a high-income employee will pay an additional 0.9% Medicare tax (for a total of 2.35%) on his or her earned income.

2 Additional 0.9% Medicare tax on high-income self-employed individuals' self-employment income

- Currently, self-employed individuals pay a Medicare tax of 2.9% on their self-employment income.
- On January 1, 2013: Same as above, PLUS a high-income self-employed individual will pay an additional 0.9% Medicare tax (for a total of 3.8%) on his or her self-employment income.

ADDITIONAL TAX ONLY APPLIES TO WAGES IN EXCESS OF THE FOLLOWING DOLLAR AMOUNTS:

- $250,000 for married persons filing jointly
- $125,000 for married persons filing separately
- $200,000 for all others

NOTE: The threshold amounts are NOT indexed for inflation over time.

Example: Single individual, $300,000 in wage income in 2013

Wage Income	**$300,000**
Less: Threshold	**$200,000**
	$100,000

$100,000 X 0.9%= Additional Medicare tax on earnings of $900

New Medicare Related Taxes Effective January 1, 2013: Four Things to Know

3 A new 3.8% Medicare contribution tax on high-income taxpayers' Net Investment Income

- The 3.8% tax is assessed on the LESSER of:
  - Net Investment Income, and
  - The excess of Modified Adjusted Gross Income (MAGI) over a threshold amount ($250,000 for married persons filing jointly or a surviving spouse, $125,000 for married persons filing separately, and $200,000 for all others). **NOTE:** The threshold amounts are NOT indexed for inflation over time.
- Calculating the tax:
  - Step 1 - Determine if your MAGI is below the threshold amount. If it is below the threshold amount, you are NOT subject to this surtax. If it is above the threshold amount, proceed to Step 2.
  - Step 2 - Calculate the amount of your Net Investment Income.
  - Step 3 - Determine which number is lower, the excess of your MAGI over the threshold amount or your Net Investment Income. Multiply the lower of these two numbers by 3.8% --- this is the amount that you owe in tax due to the Medicare surtax on Net Investment Income.

Example: Married couple, net investment income of $100,000 in 2013 along with taxable profit sharing plan distributions of $300,000

MAGI	**$400,000**
Less: Threshold Amount	**$250,000**
Excess	**$150,000**
Net Investment Income	**$100,000**
Lesser of $150,000 and $100,000	**$100,000**

3.8% x $100,000= Additional Tax of $3,800

New Medicare Related Taxes Effective January 1, 2013: Four Things to Know

4 **For estates and trusts, the threshold is much lower**

- The 3.8% Medicare surtax applies to the undistributed net investment income of estates and trusts.
  - For purposes of this tax, business income from a passive activity for the trust or estate will also be considered as net investment income.
- The Adjusted Gross Income threshold is the level at which the maximum marginal income tax rate is reached for an estate or trust ($11,650 in 2012, expected to be slightly higher in 2013).
- For trusts and estates, the 3.8% tax will apply to the LESSER of:
  - The undistributed Net Investment Income, and
  - The excess of Adjusted Gross Income over the dollar amount at which the highest income tax bracket applicable to a trust or estate begins (in 2012, $11,650, in 2013, $11,950).
- Remember: as written, the law does not apply to trusts and estates that are required to distribute, or do distribute, all of their taxable income annually—the law only applies to trusts and estates that are not required to distribute all of their taxable income and do not.

New Medicare Related Taxes: Effective January 1, 2013

	Modified Adjusted Gross Income or Adjusted Gross Income	Net Investment Income
Taxable interest, dividends, annuities, royalties, rents (non-active business)	Include	Include
Tax exempt interest	Exclude	Exclude
Capital gains generally	Include	Include
Capital gain on sale of principal residence excluded from computation of ordinary income tax	Exclude	Exclude
Distributions from traditional qualified retirement accounts (IRA, 401(k), etc.)	Include	Exclude
Distributions from Roth IRAs and Roth 401(k)s	Exclude	Exclude
Income from “passive” trade or business or trading financial instrument or commodities	Include	Include
Income from an active trade or business	Include	Exclude

Current Issues in Trust Administration

- GST and Crummey Trusts
  - Common misunderstandings of generation-skipping transfer tax and annual exclusion gifts
  - Application of generation-skipping transfer tax exemption for gifts to Crummey trusts
    - Rules prior to 2001
    - Rules from 2001 to present
    - Rules to begin in 2013

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Northern Trust Professional Advisor Series

Surviving the Fiscal Cliff: Considerations at Play With Expiring Code Provisions[1]

R. Hugh Magill
Chief Fiduciary Officer

Suzanne L. Shier
Director of Wealth Planning and Tax Strategy

Julie J. Olenn
Tax Counsel

W. David Connell
Advisory Services Practice Executive for the West Region

Amanda C. Andrews
Wealth Planning Associate

December 3, 2012

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Northern Trust

I. 2012 Year-End Tax Planning

A. Year-End Review

We have been anticipating year-end for months and, for better or worse, the end is now in sight. The long-awaited elections are over, and we have no change in control of the White House, Senate or House of Representatives. We anticipate some tax legislation during the lame duck session of Congress, but the timing remains uncertain. Thus, we are faced with the challenge of making tax affected decisions with limited time and incomplete information. Many have already made and implemented strategic 2012 income and wealth transfer tax decisions and are well positioned for the remainder of the year. Others are still weighing their options and counting the days to year-end.

By the end of 2012 approximately 100 categories of tax provisions will have expired, save congressional action. Needless to say, Congress has much to do between now and New Year's Eve. The first post-election date on which both the House and Senate were scheduled to be in session was November 13, and the last currently scheduled date is Friday, December 14.

There remains a broad range of possible tax outcomes. We offer some perspectives for your consideration based on the information presently available in light of the current concern with the "fiscal cliff," including government spending, budget and tax considerations. The landscape changes from day to day, so any tax-related decisions will need to be made based on your and your client's assessment of individual circumstances and what you consider to be the most likely outcomes.

B. Income Taxes

1. Ordinary Income Tax Rates. Absent legislation during the lame duck session, in 2013 the tax rate on the lowest income tax bracket will increase from 10% to 15% and rates on the top two income tax brackets will increase from 33% and 35% to 36% and 39.6%, respectively. A temporary extension of the lower 2012 tax rates for 2013 for low- and middle-income taxpayers is anticipated, but not necessarily for high-income taxpayers.

   Timing of Income. Under these circumstances, it is instructive to assess the impact of accelerating to 2012 ordinary income otherwise anticipated in 2013.

Although it is common to defer taxable income, if you believe a tax increase is in store, the analysis changes.

Roth Conversions. If you are considering converting a traditional IRA to a Roth IRA, compute the comparative tax for a conversion in 2012 and 2013 (taking the new 3.8% Medicare contribution tax into account for 2013). Note that future distributions from a Roth IRA will not be included in the threshold in determining the Medicare contribution tax on net investment income in 2013 and subsequent years. A 2012 conversion can be "unwound" prior to the filing of your 2013 tax return if desired.

Installment Sales. If you have installment sale income, recall that the tax rate in effect in the year an installment is reported is used to determine the tax on the installment. Take potential increases in future tax rates into consideration when evaluating the benefits of installment sales.

2. Qualified Dividend Tax Rates. Qualified dividends are currently taxed at reduced capital gain tax rates (0% and 15%), but are scheduled to be taxed at ordinary income tax rates in 2013. There is discussion of continuing lower qualified dividend tax rates in 2013 for low- and middle-income taxpayers, but allowing at least some increase in the tax rate for qualified dividends for high-income taxpayers (at worst 39.6% plus the 3.8% Medicare contribution tax on net investment income).

   Accelerate Dividends. Where feasible, consider whether dividend income otherwise expected in 2013 may be accelerated to 2012 in light of possible tax rate increases.

3. Long-Term Capital Gain Tax Rates. Absent new tax legislation the top capital gain tax rate of 15% in 2012 will increase to 20% in 2013. Here again, the increase ultimately may only come into effect for high-income taxpayers.

   Harvesting Gains. For those high-income taxpayers who would be affected by increased capital gain tax rates, if near-term sales of appreciated assets are otherwise being considered, evaluate the comparative 2012 and 2013 tax costs. However, paying taxes early, even at lower rates, has an associated cost. But if

"harvesting" gains is desired, note that there is no "wash sale" rule for gain transactions, only for loss transactions.

Preserving Losses. Capital losses are ordinarily of greater tax benefit in higher tax rate years. If you are concerned that tax rates will increase in 2013, consider preserving capital losses for future use.

4. Charitable Giving. Contributions to qualified charities made in 2012 remain deductible subject to long-standing limits based on the donor's adjusted gross income. In 2013 an additional limitation based on the donor's level of itemized deductions is scheduled to be reinstated for high-income taxpayers. In addition, the charitable deduction and other similar "tax expenditures" have been part of broader discussions surrounding tax reform. Although itemized deductions are typically of greater tax benefit in higher tax rate years, the analysis may be complicated by changes in the tax laws in 2013.

   Donor Advised Funds. A contribution to a charitable donor advised fund is deductible in the year of the contribution to the fund. Further distributions from the fund to selected charitable organizations may be made in the current year but may also be made in subsequent years. Thus, a donor advised fund can be a useful vehicle for making current gifts with ongoing benefit to charity.

   Charitable Lead Annuity Trusts. When interest rates are low, the gift tax cost of a charitable lead annuity trust is reduced. The December 2012 Section 7520 rate used for charitable lead trust computations is the very low rate 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.

Summary of Income Tax Rates

		2012 Law	Scheduled 2013 Law	Range of Potential 2013 Outcomes
Ordinary Income Tax Rates		10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%	Lowest rate 10% - 15% Highest rate 35% - 39.6%
Qualified Dividend Tax Rates		0% and 15% tied to capital gain tax rate	Taxed as ordinary income	Continuation of taxation at capital gain rates, intermediate compromise, or taxed as ordinary income (as high as 39.6%) plus 3.8% Medicare surtax
Long-Term Capital Gain Tax Rates		0% and 15%	10% and 20%	Lowest rate 0% to 10% Highest rate 15% to 20%
Medicare Contribution Tax		None	3.8%	N/A
Itemized Deductions		No phase-out for high income	Phase-out for high income	No phase-out, phase-out for high income, or elimination of targeted deductions
Alternative Minimum Tax Threshold	Married filing jointly	$45,000	Same as 2012	Repeal, continuation of low unadjusted thresholds, or increased inflation-adjusted thresholds
	Married filing separately	$22,500		
	Single/head of household	$33,750		

C. Gift, Estate and Generation-Skipping Transfer Taxes

With the continuing post-election split in the Senate (Democratic) and the House of Representatives (Republican) it is increasingly likely that the very favorable low 35% gift, estate and generation-skipping transfer (GST) tax rates, the historically high gift and estate tax exclusion and GST tax exemption amounts ($5,120,000 in 2012), and currently available portability of a deceased spouse's unused exclusion amount will not all continue indefinitely. Although Congress could temporarily extend all of these generous tax benefits as a single package at the last moment, we cannot be assured of that. The two-year window of opportunity that opened at the end of 2010 to make large lifetime gifts free of gift and generation-skipping transfer taxes may, at a minimum, narrow significantly after December 31, 2012. See Section II of these materials for an in-depth analysis of the pending changes in the GST tax law.

Although there are numerous possible combinations of a negotiated compromise that would avoid a return to the pre-2001 tax law wealth transfer tax rates, exclusion and exemption levels presently scheduled to come into effect in 2013, it is possible that there may be estate tax relief but not gift tax relief. Specifically, the estate tax exclusion amount might be maintained at a level, yet to be specifically determined, well in excess of $1,000,000 (possibly the $3,500,000 level in effect in 2009 or even the inflation adjusted $5,000,000 level now in effect), with portability of a deceased spouse's unused exclusion amount, but with a return to the bifurcation of the gift and estate tax exclusion levels (a lower gift tax exclusion than estate tax exclusion).

Lifetime Gifts. Lifetime gifts of high basis assets with significant appreciation potential have a distinct estate tax advantage regardless of changes in the gift and estate tax rates and exclusion levels – any post-gift appreciation is removed from the gift and estate tax regime altogether.

Gift, Estate and Generation-Skipping Transfer Tax Summary

	2009	2012	Scheduled 2013
Highest Marginal Rate	45%	35%	55% and 5% surtax
Gift Tax Exclusion	$1,000,000	$5,120,000	$1,000,000
Estate Tax Exclusion	$3,500,000	$5,120,000 with portability	$1,000,000
GST Tax Exemption	$3,500,000	$5,120,000	Estimated $1,400,000

D. The New Medicare Taxes

Effective January 1, 2013, three new Medicare related taxes come into effect for high-income taxpayers – an additional 0.9% on the employee share of employment taxes for high level wage earners, an additional 0.9% self-employment tax on high level self-employment income earners, and a new 3.8% Medicare contribution tax on net investment income of high income level individuals and marginal tax bracket estates and trusts.

Additional Medicare Tax on Wages

For 2013, an additional hospital insurance (HI) tax of 0.9% on the wages of individuals in excess of a threshold amount comes into effect. The additional HI tax brings the total employee and

employer HI taxes to 3.8% (1.45% employee share, 1.45% employer share, and new 0.9% additional employee share). The threshold wage level for the additional HI tax is $250,000 for married persons filing a joint return, $125,000 for married persons filing separately, and $200,000 for all others. These thresholds are not inflation-adjusted.

The additional tax will be withheld by employers on employee wages in excess of $200,000, without regard to filing status or wages received by an employee's spouse. Employees will be required to pay amounts not withheld by their employer and employees whose additional tax is not covered by withholding may need to include the additional tax in their estimated tax payments to avoid estimated tax underpayment penalties.

Additional Self-Employment Medicare Tax

For the self-employed, the hospital insurance portion of the self-employment tax on self-employment income in excess of a threshold amount will be subject to an additional 0.9% tax. This brings the total hospital insurance portion of the self-employment tax to 3.8% (2.9% "base" and new 0.9% additional). The threshold is self-employment income in excess of $250,000 for a married couple filing jointly, $125,000 for a married couple filing separately, and $200,000 for all others, with no inflation adjustment.

New Unearned Income Medicare Contribution Tax

Beginning in 2013 the net investment income of high-income taxpayers will be subject to an entirely new 3.8% Medicare contribution tax. The new 3.8% tax will apply to "net investment income" of high-income individuals, estates and trusts. Whereas the thresholds for the additional taxes on wages and self-employment income are based on wage and self-employment income levels, the threshold for individuals is based on "modified" adjusted gross income (MAGI) and the threshold for estates and trusts is based on adjusted gross income. The tax for individuals may be expressed as a formula as follows:

> Tax = 3.8% x (lesser of (i) net investment income and (ii) modified adjusted gross income less threshold amount)

Similarly, the tax for estates and trusts may be expressed as a formula as follows:

> Tax = 3.8% x (lesser of (i) undistributed net investment income and (ii) adjusted gross income less the dollar amount at which the highest tax bracket applies for the estate or trust)

There are two circumstances where the additional 3.8% tax will *not* apply. First, when an individual's modified adjusted gross income does not exceed the threshold amount or an estate or trust's adjusted gross income does not exceed the marginal tax bracket threshold. Second, when an individual taxpayer does not have "net investment income" or an estate or trust does not have "undistributed net investment income." In the first circumstance, for individual taxpayers, modified adjusted gross income is adjusted gross income (which appears at the bottom of page 1 of Form 1040) plus, in the case of a U.S. citizen or resident living abroad, any foreign earned income and housing costs that are otherwise excluded from adjusted gross income. The threshold modified adjusted gross income amount is $250,000 for married persons filing jointly or a surviving spouse, $125,000 for married persons filing separately, and $200,000 for all others, with no inflation adjustment. See Section III of these materials for a detailed discussion of operation of the surtax in the administration of trusts and estates.

Medicare Contribution Tax Summary

	Modified Adjusted Gross Income	Net Investment Income
Taxable interest, dividends, annuities, royalties, rents (non-business)	Include	Include
Tax exempt interest	Exclude	Exclude
Capital gains generally	Include	Include
Capital gain on sale of principal residence excluded from computation of ordinary income tax	Exclude	Exclude
Distributions from traditional retirement accounts (IRA, 401k)	Include	Exclude
Distribution from Roth IRA and Roth 401k	Exclude	Exclude

Income from "passive" trade or business or trading financial instruments or commodities	Include	Include
Income from active trade or business	Include	Exclude

E. Corporate Tax 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, 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 a consideration 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 individuals 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 attribution 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 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).

F. Congressional Activity in 2012

Democrats have introduced and passed tax legislation in the Democratic controlled Senate. Republicans have introduced and passed tax legislation in the Republican controlled House of Representatives. However, to date, neither plan has progressed further.

In July 2012, Senate Democrats introduced and passed their Middle Class Tax Cut Act (S.3412), although the bill did not pass in the Republican controlled House of Representatives. The bill extends 2012 income tax rates for one year to low and middle income taxpayers and reinstates inflation adjustment thresholds for 2012. The Democratic plan, S.3412 the Middle Class Tax Cut Act, proposes to patch the AMT for 2012 only, setting the AMT exemption at $78,750 for married couples filing jointly, $50,600 for others. Also, the bill allows personal non-refundable credits regardless of tentative AMT. Furthermore, the Senate Democrats' proposal is silent on estate, gift, and generation-skipping transfer taxes, therefore implies reversion to current law.

The Republican plan, S.3413 / H.R.8, the Tax Hike Prevention Act of 2012 / Job Protection and Recession Prevention Act of 2012,[2] extends the AMT patch for two years, 2012 and 2013,

[2] The Senate Republicans' Tax Hike Prevention Act of 2012 (S.3413) most closely resembles Republican legislation originating in the Republican controlled House of Representatives, H.R.8 Job Protection and Recession Prevention Act of 2012. The Senate Republicans' Tax Hike Prevention Act of 2012 (S.3413) was defeated by the Democratic controlled Senate.

setting the exemption at $78,750 ($79,850 in 2013) for married couples filing jointly, $50,600 ($51,150 in 2013) for others. The plan also allows personal non-refundable credits regardless of tentative AMT for both 2012 and 2013. For estate, gift, and generation-skipping transfer taxes, the bill extends the estate tax exemption of $5 million, indexed for inflation, and a top estate tax rate of 35%.

The Democratic plan also includes extension provisions for one year: the 10%, 25%, and 28% percent statutory marginal tax rates on ordinary income; repeal of the 8% and 18% percent tax rate on capital gains from the sale of assets held for more than five years; 0% tax rate on capital gains and qualified dividends for those who would otherwise be in the bottom two tax brackets; and 15% tax rate on capital gains and qualified dividends for those who would otherwise be in the 25%, 28%, or 33% tax brackets. The rate would be 20% for those in the top two tax brackets. The Republican plan similarly includes extension provisions.

In August 2012, the House of Representatives debated the Republicans' Pathway to Job Creation Through a Simpler, Fairer Tax Code Act of 2012 (H.R.6169) alongside H.R.8. The Pathway to Job Creation Act was approved by the House on August 2nd, although it has yet to progress further in 2012. The Act provides for a fast-track process for tax reform in 2013, consolidating the six tax brackets into two brackets of 10% and not more than 25%; reducing the corporate tax rate to not more than 25%; broadening the tax base to maintain revenues at between 18% and 19% of GDP; and changing the worldwide system of taxation to a territorial system. The fast-track process requires the bill to be introduced in the House by the Ways and Means chair no later than April 30, 2013 and to be certified by the Joint Committee on Taxation to adopt certain reform principles.

Separately, more limited extender legislation related to selected expired or expiring tax provisions, the S.3521 Family and Business Tax Cut Certainty Act of 2012, received bipartisan support in the Senate Finance Committee, was introduced to the Senate in August, but has not progressed further to date. See Appendix 1 for further details regarding the bill.

G. The Congressional Budget Office and the Fiscal Cliff

In general, the concept of the fiscal cliff is used to describe the January 1, 2013 impact of the scheduled expiration of the Bush-era tax cuts and the application of certain limitations on the

federal budget and government expenditures. The Congressional Budget Office estimates that the over $500 billion of deficit reduction could cost the economy 2 million jobs. Such major changes in tax and spending policies will help reduce the deficit, but will potentially result in an economic slowdown.

The components of the fiscal cliff are: (1) the expiration of the Bush tax cuts on December 31, 2012; (2) the expiration of the 2 percentage point payroll tax cut on December 31, 2012; (3) the sequestration spending cuts on defense and non-defense spending effective January 2, 2013; (4) the absence of AMT relief for the 2012 tax year; and (5) various other incidental provisions.

On September 22, 2012, the Senate approved a stopgap measure that would fund the Federal government through March 27, 2013 (H.J.Res. 117). The measure extends funding through March 27, 2013 at an annual rate of $1.047 trillion or, in other words, a 0.6% increase over the fiscal year ending September 30, 2012. However, uncertainty still remains regarding numerous tax provisions set to expire in 2013 and sequestration.

The Fiscal Cliff[3]

Major Changes in Spending Policy:

Budget Control Act of 2011 (P.L. 112-25)	▪ Established automatic enforcement procedures designed to restrain discretionary and mandatory spending set to take effect in January 2013.
Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96)	▪ Unemployment compensation will be smaller in 2013 than in 2012.
Medicare	▪ Payment rates to physicians will drop by 27% in January 2013.

[3] The Congressional Budget Office, An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2020.

Major Changes in Tax Policy:

Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312)	▪ Provisions limiting the reach of AMT expired December 31, 2011. The resulting increase in taxes will be seen in 2013, when most taxpayers file their 2012 returns. ▪ Other provisions of the law extended the lower tax rates and the expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27), and the American Recovery and Reinvestment Act of 2009 (P.L. 111-5). ▪ Those provisions are set to expire on December 31, 2012. The increase in individual income taxes will affect tax payments starting in calendar year 2013, when withholding schedules will reflect the higher rates. All in all, those changes in policy scheduled to occur under current law will increase federal revenues by about $225 billion in fiscal year 2013, compared with 2012, CBO projects.
Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96)	▪ Extended through December 31, 2012, the 2 percentage-point cut in the payroll tax that first went into effect in January 2011.
Patient Protection and Affordable Care Act	▪ Increase in the tax rates on earnings and investment income from high-income taxpayers, scheduled to take effect in January 2013.
Other provisions	▪ Mainly, scheduled expiration in December 2012 of rules permitting businesses to partially expense investment property.

II. Generation-Skipping Transfer Tax Dilemmas

A. Background: Sunset of EGTRRA & Impact on GSTs

Before the enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Relief Act"), certain provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") caused much confusion over how the generation-skipping transfer (GST) tax provisions of Chapter 13 of the Internal Revenue Code of 1986 ("Code") might be applied both in 2010, when pursuant to Code Section 2664 added by

EGTRRA the GST tax was repealed for the year, and in 2011, when the provisions added to Chapter 13 by EGTRRA would sunset by the terms of the Act's own Section 901(b):

> EGTRRA SEC. 901. SUNSET PROVISIONS OF ACT
>
> (a) IN GENERAL. All provisions of, and amendments made by, this Act shall not apply…
>
> (2) in the case of title V, to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010.
>
> (b) APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986 … shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

Of course, the dilemmas posed by repeal were front and center until the 2010 Tax Relief Act provided a resolution by, *inter alia*, repealing Code Section 2664 and instead setting a zero percent rate on GSTs for the year. The unhappy prospect of sunset was also moved down the road to 2013, by substituting December 31, 2012 for December 31, 2010 as the date after which the Code would be applied to years, estates, gifts and transfers as though the provisions of EGTRRA "had never been enacted." Now, however, December 31, 2012 is just weeks away, without certainty – at least where transfer taxes are concerned – that a lame duck Congress will act in time to prevent it.

On January 1, 2013, the GST tax exemption amount is scheduled to fall from an inflation-adjusted $5 million to a mere $1 million, while the GST tax rate is scheduled to increase from 35% to 55%. In addition, the following provisions of Chapter 13 of the Code, as well as certain language added by EGTRRA to the valuation rules of Section 2642(b), are scheduled to sunset altogether:

- Section 2604(c) – repeal of state GST tax credit
- Section 2632(c) – automatic allocation of GST exemption to "indirect skips"
- Section 2632(d) – retroactive allocation for predeceased descendant
- Section 2642(a)(3) – qualified severances ("downstream splits")
- Section 2642(g)(1) – relief from late allocations or elections
- Section 2642(g)(2) – substantial compliance allocating pursuant to Section 2632(c)

In the following sections of this outline, we examine these expiring GST tax provisions in turn, and the dilemmas we may face in determining how to best administer "exempt" trusts and advise clients on GST matters in light of EGTRRA's "had never been enacted" language. We also consider certain GST tax provisions that will be unaffected by sunset, which may serve as helpful landmarks when navigating one's way in a significantly changed GST tax landscape.

B. Expiring Code Provisions & Related Uncertainty

With the "had never been enacted" threat of sunset front and center, we turn to the GST tax provisions added by EGTRRA that are scheduled to sunset, the law that replaces them (if any), and the uncertainties faced by donors, planners and trustees that we hope will be resolved sooner rather than later by permanent legislation or, where possible, IRS guidance.

1. GST Exemption Amount & GST Tax Rate – Calculating the Applicable Rate With a Reduced Exemption Amount

If the provisions added by EGTRRA sunset as scheduled on January 1, 2013, the GST tax exemption amount under Code Section 2631(c) will revert to its pre-2001 limit of $1 million, adjusted for inflation from 1997 to an estimated $1,430,000 for 2013[4]. The GST tax rate under Code Section 2641(a) will remain, for property that has an inclusion ratio of one, equivalent to the highest marginal estate tax rate under Code Section 2001, but that estate tax rate is scheduled to revert to 55% for 2013.[5]

The "applicable rate" of tax on GSTs imposed by Section 2641(a) is defined as the product of the maximum federal estate tax rate and the inclusion ratio of the property being transferred. Under Section 2642(a), which is not affected by sunset, the inclusion ratio is equal to one minus the applicable fraction, the numerator of which is the amount of GST exemption allocated, and the denominator of which is the value of the transferred property (as determined under Section

[4] On October 18, 2012, the IRS issued Rev. Proc. 2012-41 setting forth certain inflation-adjusted items for 2013, which did not include an adjustment for several items potentially affected by EGTRRA sunset, including the GST exemption under Code Section 2631(c) as that subsection is scheduled to come into effect on January 1, 2013. An estimated GST per donor exemption amount of $1,430,000 is used herein for the sake of convenience.

[5] Hereinafter, all Sections refer to Sections of the Code, unless otherwise noted.

2642(b)), reduced by any estate or death (but not gift) taxes actually recovered or charitable deduction allowed.[6]

> Example 1. In 2012, T transfers $5,120,000 to a trust for the benefit of her descendants, allocating $5,120,000 of GST exemption to the trust on a timely-filed gift tax return. The applicable fraction is $5,120,000/$5,120,000, resulting in an inclusion ratio of zero for the trust. If the trustee makes a GST taxable distribution on December 31, 2012, the applicable rate of GST tax will be 0%, the product of the maximum federal estate tax rate for 2012 of 35% and the trust's inclusion ratio of zero.

The application of the new GST exemption amount and tax rates in calculating GST tax due on 2013 GSTs from individual donors or estates is not affected by sunset. The complication comes in with respect to existing trusts whose inclusion ratio may be impacted by the "had never been enacted" language of EGTRRA Section 901(b). A literal application of EGTRRA's "had never been enacted" language would mean that the donor never had a GST exemption amount in excess of an inflation-adjusted $1 million, and therefore could not have effectively allocated to the trust more exemption that she had under pre-2001 law. In turn, this may bring into question the inclusion ratio of any trust whose GST tax exempt status depends in whole or in part on the allocation of EGTRRA-era exemption amounts, provided its inclusion ratio has not otherwise been finally determined to be zero for federal tax purposes.

The typical GST formula allocation, whether made on a Notice of Allocation on Form 709, Schedule R of Form 706, or by statutory automatic allocation rules, will generally allocate unused GST exemption to produce an inclusion ratio of zero, or as close to zero as possible. The allocation often occurs prior to any GST taxable event with respect to which the trust's inclusion ratio may be finally determined for federal tax purposes.[7] If sunset occurs in 2013, even if the

[6] This general rule is supplemented by Section 2642(d), which provides the method for recomputing the applicable fraction where more than one transfer is made to trust.

[7] For direct skips, reporting the taxable event on a Form 706 or Form 709 and allocating exemption are normally contemporaneous, so that the statute of limitations on the GST inclusion ratio for such property begins to run at the time the transfer is reported. By contrast, if the initial transfer is an indirect skip, even if exemption is allocated on a Form 706 or Form 709 reporting the transfer, the statute of limitations with respect to the inclusion ratio will not begin to run until a subsequent GST taxable event occurs and is

validity of an earlier allocation is not affected, the amount of exemption deemed to be allocated may be effectively reduced by sunset, and as a result the inclusion ratio of the trust may no longer be zero for purposes of determining the GST tax consequences of a taxable distribution or termination that occurs in 2013.

Thus, for any trust to which the donor allocated GST exemption in an amount that was available under then-existing law, but in excess of what is available post-sunset, the fundamental concern is that the applicable fraction for the trust will be recalculated with respect to GSTs occurring after December 31, 2012. If the applicable fraction has changed for a trust that was otherwise exempt under prior law, so will the inclusion ratio, and therefore the GST tax computation if a taxable distribution or termination occurs under the reinstated pre-EGTRRA law.

> Example 2. The facts are the same as in Example 1 above, except the trustee makes the GST taxable distribution on January 1, 2013, when the per donor GST exemption is approximately $1,430,000. If the "had never been enacted" language effectively limits the value of the denominator of the applicable fraction to the maximum amount of GST exemption permitted under 2013 law, the applicable rate on a taxable distribution from the same trust would be quite different. That is, an applicable fraction of $1,430,000/$5,120,000, or 27.9%, results in an inclusion ratio of 72.1% for the formerly-exempt trust, and an applicable GST tax rate of 39.655% (72.1% x 55%) on the 2013 distribution which could have been made free of GST taxes in the prior year.

For currently exempt trusts whose inclusion ratio may be affected by sunset – due to the reduced exemption amount, as discussed above, and/or any expiration of Code provisions discussed below – consider whether any skip beneficiaries have known needs for distributions that may be accelerated into 2012, when the GST tax consequences are certain. In 2013, consider whether taxable distributions to skip persons may be deferred during any period of uncertainty of the GST tax consequences; and for taxable terminations, be sure to retain sufficient reserves in the event GST tax is due.

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separately reported, generally on Form 706-GS(T) for a taxable termination, or Form 706-GS(D) for a taxable distribution. See Treas. Reg. Section 26.2642-5.

2. Section 2604 – State Death Tax Credit (Reinstated for 2013)

The Section 2604 credit for state generation-skipping transfer taxes payable as the result of a death of an individual was repealed under EGTRRA by a new subsection 2604(c), effective for such GSTs after December 31, 2004. Under pre-EGTRRA law, that credit will be restored beginning January 1, 2013. Although many states decoupled from the federal estate tax system when the federal credit for state death taxes was phased out and replaced with a deduction, no state decoupled for GST purposes. Beginning in 2013, states with a pickup GST tax will again benefit from the federal credit. Although the overall GST tax burden will not change as a result of the reinstatement of the credit, it will be reallocated between the state and federal authorities, and trustees in particular may find their GST reporting obligations significantly increased by this change in the law.

3. Section 2632(c) – Automatic Allocation to "Indirect Skips"

EGTRRA added a new Section 2632(c) to the Code, recodifying the provision that automatically allocates a decedent's unused GST exemption at death at Section 2632(e).

Under pre-EGTRRA law, the only statutory allocation rule for inter vivos transfers was Section 2632(b), which allocates GST exemption to lifetime direct skips, whether outright or in trust, and only to the extent that the transfer does not otherwise qualify for a deemed inclusion ratio of zero under the GST tax annual exclusion rule of Section 2642(c). A transferor who made a transfer to a trust that was not a direct skip trust, but which had the potential for a later taxable distribution or termination with respect to the same transferor, had to specifically allocate exemption on a timely-filed Form 709 for the allocation to be effective as of the date of the gift, and to use gift tax values for purposes of determining the denominator of the applicable fraction. Often, transferors neglected to make such allocations. Prior to EGTRRA, only a late allocation (using date of allocation values for the transferred property, rather than date of gift) was available to remedy the error. In addition, if the error was only discovered once a GST taxable event occurred, even a late allocation would not avoid the tax on that event.

The new Section 2632(c), soon to sunset, automatically and timely allocates a donor's available GST exemption to any gift to a "GST trust," as that term is defined by the statute, that is not a direct skip, and defines such transfers as "indirect skips." (If Section 2632(c) would otherwise

apply to a transfer, or a trust, but such allocation is not desired, the donor is required to affirmatively opt out of the statute on a timely-filed gift tax return.) Available exemption is allocated to the extent necessary to produce a zero inclusion ratio for the transferred property, or all of the available exemption if the gift is in excess of that amount. If the transfer is subject to an estate tax inclusion period ("ETIP"), the allocation is effective at the close of the ETIP.

With the sunset of Section 2632(c), it will again be necessary to affirmatively allocate GST exemption to indirect skips on a Notice of Allocation attached to a timely-filed gift tax return, including to any transfer subject to gift tax prior to 2012 but an ETIP that closes in a subsequent year. (Due to the sunset of other EGTRRA provisions, i.e., Sections 2632(d) and 2642(g), discussed below, a late allocation will once again be the only remedy if the due date for a timely allocation is missed.) This also means that for a donor who makes no taxable gifts, but who makes annual exclusion gifts to a Crummey trust that is intended to be GST exempt and was otherwise a "GST trust" to which such gifts were "indirect skips" under Section 2632(c), it will now be necessary to file gift tax returns simply to make the allocation, even if a gift tax return is not otherwise required to be filed.

Moreover, the "had never been enacted" language of EGTRRA Section 901(b) calls into question whether prior automatic allocations under Section 2632(d) will be recognized at all in a post-sunset world. Whether because of this or for other reasons, many practitioners have chosen not to rely on Section 2632(c) over the years, but to opt out of the statute and affirmatively allocate to the same trust or transfer on a Notice of Allocation. This certainly protects clients if the IRS cannot, or chooses not to, recognize Section 2632(c) automatic allocations once the statute sunsets. However, if the exemption allocated in either case was in excess of the $1,430,000 maximum expected come 2013, the formerly exempt status of trusts may still be negatively affected.

A potential up-side to the sunset of Section 2632(c) is that the definition of "GST trust" is so overbroad that the statute seems to have created a problem for many taxpayers which is essentially the converse of the pre-EGTRRA problem it was enacted to solve. That is, the issue of taxpayers inadvertently failing to allocate GST exemption to trusts they wished to be exempt was arguably replaced, if the frequency with which we see PLRs issued providing relief in this area pursuant to Section 2642(g) is any indication, by taxpayers inadvertently having GST

exemption allocated to trusts that they did not expect to have a future taxable distribution or termination and/or wish to be GST exempt, due to a failure to timely opt out of the statutory allocation regime. Taxpayers on the fence about whether to spend tens of thousands of dollars on a PLR to recoup some of their GST exemption allocated by the statute, or who simply were unaware that exemption was being allocated, may find themselves better off in a post-sunset tax environment.

4. Section 2632(d) – Retroactive Allocation for Predeceased Descendant of Grandparent of Transferor

EGTRRA also introduced an extremely taxpayer-friendly provision under Section 2632(d) that allows a transferor to make a retroactive allocation of GST exemption to a trust in the specific event that a nonskip (present or future) beneficiary who is the lineal descendant of a grandparent of the transferor (or his/her spouse or former spouse) predeceases the transferor. The retroactive allocation has three important characteristics that distinguish it from a late allocation: It (1) uses date of gift values for transferred property for purposes of the allocation, rather than the filing date; (2) is effective retroactively, rather than upon filing; and (3) uses GST exemption available immediately prior to the descendant's death, including allowing the advantage of any increase in GST exemption since the original transfer(s). The retroactive allocation must be made on a Form 709 filed on or before the due date for such return for gifts made within the calendar year that the death occurred.

A retroactive allocation can provide relief in a scenario that the generation-assignment rules do not. That is, the predeceased ancestor rule of Section 2651(e), which effectively steps-up the generation assignment of certain individuals closely related to the transferor whose parent is deceased, applies only where the individual is deceased at the time the transfer is made. By contrast, the retroactive allocation addresses a situation where the individual dies subsequent to the gift.

In addition, because the retroactive allocation is deemed to be effective immediately prior to the descendant's death, it is particularly useful in situations where the descendant's death otherwise triggers a taxable termination. However, even if the death does not otherwise cause a taxable termination, the retroactive allocation is generally useful in any situation where a death out of order actually affects the donor's original decision not to allocate exemption to the trust. Thus,

in contrast with the type of relief available under Section 2642(g), discussed below, the retroactive allocation anticipates that donor's decisions might be different with the benefit of hindsight, and expressly allows that benefit in circumstances where the donor might be expected to suffer quite enough without the threat of an additional and unexpected GST tax being imposed on property transferred in happier times.

> Example 3. In 2000, T transfers $100,000 cash to a trust for the benefit of his child, C, and C's descendants. The trust provides for full withdrawal rights for C at age 60, so T decides not to allocate GST exemption to the trust at the time of the gift. In 2005, C dies in a car accident at age 50, predeceasing T and leaving two living descendants, GC and his child, GGC, who are also the remainder beneficiaries of the trust. C's death triggers a taxable termination of the trust. In 2006, T files a timely Form 709 making a Section 2632(d) retroactive allocation of GST exemption to the trust, in the amount of $100,000, although on the date of allocation the trust's value is $125,000. Because the allocation is deemed to be effective immediately prior to C's death, the trust has an inclusion ratio of zero at the time of C's death, and no GST taxes are owed on the taxable termination.

With Section 2632(d) scheduled to sunset in 2013, this relatively rarely-used but extremely advantageous allocation rule will become unavailable to taxpayers, and once again the opportunities for relief where prior planning is undermined by a death out of order will be limited. A late allocation will generally "cost" more GST exemption, since it uses date of allocation values, and will not avoid GST tax if a taxable termination occurs as a result of the death. Contingent general powers of appointment may avoid a GST tax, but at the cost of estate tax inclusion in a tax environment where rates are scheduled to be higher and exclusions lower than they have been in more than a decade.

In addition, if the provisions of Chapter 13 are applied after sunset as though Section 2632(d) "had never been enacted," it brings into question whether retroactive allocations that were made prior to sunset will be recognized as such. Because the allocation could only have been effectively made on a Notice of Allocation attached to a timely-filed Form 709, the IRS can and likely must recognize the allocation as valid, but not necessarily all of the characteristics peculiar to the sunsetting statute that make it so beneficial. Thus, the allocation may be recognized as

effective only as a late allocation, which was permitted under pre-EGTRRA law. In that event, the relevant value for purposes of allocation would again be date of allocation values. This could affect the inclusion ratio for the trust, the transferor's remaining GST exemption, or both.

> Example 4. The facts are the same as Example 3 above, but in 2013 the trustee makes a distribution to each of GC and GGC. If the retroactive allocation is deemed to be a late allocation, the trustee must recalculate the inclusion ratio affecting the applicable rate of GST tax on the distribution to GGC. If T allocated $100,000 of exemption to the $125,000 trust, then the inclusion ratio will be 20% and the applicable GST tax rate will be 11% (20% x 55%). Alternatively, if T made a formula allocation of the amount of exemption necessary to produce an inclusion ratio of zero, or as close to zero as possible, then the trust should remain exempt as long as T had $125,000 of exemption available on the date of allocation. (Presumably, T correspondingly has $25,000 less exemption available to him for purposes of any and all subsequent allocations.) Note, the distribution to GC will not incur GST tax in either event, as he is assigned to a nonskip generation under the transferor-move down rule of Section 2653(a), which is not affected by sunset.

In addition, if the retroactive allocation is recharacterized as a late allocation, this would also impact the effective date, which would be deemed to be the filing date. However, since the "had never been enacted" complications raised by sunset only apply to GSTs occurring after December 31, 2012, this should not impact the actual GST tax consequences related to taxable terminations or distributions occurring prior to sunset that were exempt only because of the retroactive effect of the allocation. For that reason, for deaths in 2012 that otherwise cause a taxable termination, a retroactive allocation filed this year should still effectively avoid the GST tax due as a result of that death, even if the inclusion ratio of the trust is not deemed to be zero for purposes of post-sunset GST taxable events.

5. Section 2642(a)(3) – Qualified Severance

EGTRRA enacted Section 2642(a)(3), which provides for the "qualified severance" of trusts, as a supplement to the separate share rules under Section 2654(b) and Treas. Reg. Section 26.2654-1. Just as trusts that are created as substantially separate and independent shares, trusts that are

severed in a mandatory severance (after September 2, 2008), or property that is included in a decedent's gross estate and severed in the course of administration are treated as separate trusts pursuant to Treas. Reg. Section 26.2654-1, trusts that have been severed in a qualified severance will also be treated, after the severance, as separate for all purposes of Chapter 13.[8] Any allocations or elections can be separately made to the trusts once severance occurs. Importantly, if GST exemption was allocated to a trust prior to severance but produced an inclusion for the trust greater than zero, a qualified severance enables a severance into separate exempt and nonexempt trusts which are recognized as such by the IRS.

> Example 5. In 2000, T's executor allocates T's available GST exemption of $1,000,000 to Trust, which has a value of $1,250,000 for federal estate tax purposes. In 2007, the trustee severs the original trust, with an inclusion ratio of 20%, in a qualified severance under Section 2642(a)(3). Trust A receives a fractional share of the value of the assets of the original trust equivalent to the applicable fraction of the original trust, or 80%, and is exempt. Trust B receives the balance, and is nonexempt.

Prior to the enactment of Section 2642(a)(3), the IRS was intractably opposed to these so-called "downstream splits." If a trust with an inclusion ratio between one and zero was severed, the IRS recognized two trusts after the severance, but each for GST purposes with the same inclusion ratio between one and zero as the original trust. This IRS position posed a true dilemma for trusts with an inclusion ratio between one and zero, as any distribution to a skip person would be subject to GST tax (albeit at an applicable rate lower than the maximum federal estate tax rate) while any distribution to a nonskip person would effectively squander some of the GST exemption allocated that might otherwise have been utilized for the benefit of present or future skip beneficiaries. Similarly, a contingent general power of appointment might "save" the trust from a taxable termination, but at the cost of estate tax inclusion. If the contingent power is triggered merely by the imposition of a GST tax without regard to overall tax savings, the estate tax burden may exceed any GST taxes that would otherwise have been payable.

[8] Pursuant to amendments to Treas. Reg. Section 26.2642-6(h), trusts that are severed in a nonqualified severance after September 2, 2008 will also be treated as separate trusts for GST purposes, provided the severance is effective under state law. This rule supplements the separate share and severance provisions under Treas. Reg. Section 2654-1, but since it was promulgated with the qualified severance regulations, it is not clear that this stated position on discretionary, nonqualified severances will be binding on the IRS once Section 2642(a)(3) sunsets.

The question post-sunset as to Section 2642(a)(3) is really whether the IRS will change its position on downstream splits for trusts that were earlier severed in a qualified severance, and presumably, for trusts that are severed after Section 2642(a)(3) sunsets in a manner that would otherwise have met the requirements of a qualified severance. Otherwise, trusts that were formerly thought to be exempt as a result of a qualified severance will again be subject to GST at a reduced rate, and trusts that have an inclusion ratio between one and zero will have no remedy.

> Example 6. The facts are the same as in Example 5, but in 2013 the trustee of Trust A makes a taxable distribution to GC, a skip beneficiary. If the IRS readopts the no-downstream split rule, the distribution from Trust A will be taxable at an applicable rate of 11% (20% x 55%).
>
> Example 7. The facts are the same as in Example 5, but in 2013 C, the only nonskip beneficiary of either trust, dies. C's child, GC, is the remainder beneficiary of both trusts. If the IRS readopts the no-downstream split rule, C's death will be a taxable termination of both trusts, taxable at an applicable rate of 11% (20% x 55%). Alternatively, if the trusts provide that C has a general testamentary power of appointment if GST tax would otherwise be due as a result of his death, both Trust A and Trust B will be includible in C's estate, in a tax environment scheduled to have only a $1,000,000 exclusion and a top rate of 55%, plus a 5% surtax on estates over $10,000,000, up to $17,184,000.

6. Section 2642(b) – Valuation Rules

EGTRRA added some language to both Section 2642(b)(1)(A) with respect to lifetime gifts, and Section 2642(b)(2)(A) with respect to transfers at death, to the effect that for purposes of calculating the inclusion ratio of property to which GST exemption was allocated in a timely allocation, the value of such property would be its value "as finally determined" for federal gift or estate tax purposes, respectively. The benefit of this rule is evident when you consider that no statute of limitations begins to run with respect to the inclusion ratio of property until a GST occurs and is reported on the required GST return (i.e., a Form 706, Form 706-GS(D) or Form 706-GS(T), depending on the type of generation-skipping transfer).

For property transferred in trust, a GST may not occur with respect to the trust until many years after the initial transfer. Until this language was added by EGTRRA to the valuation provisions for timely allocations, it was possible that the IRS would get a second bite at the valuation apple for purposes of determining the inclusion ratio, even if the statute of limitations had run on the same values for gift and estate tax purposes. Thus, a transferor who allocated GST exemption in an amount equal to the value of his transfer as finally determined for federal gift tax purposes might yet find the IRS asserting a different value for purposes of calculating the inclusion ratio, such that the allocation results in an inclusion ratio between one and zero. When this language sunsets it will affect all transfers after December 31, 2012, as well as EGTRRA-era transfers as to which the inclusion ratio for such property has not itself yet been finally determined for purposes of Chapter 13, triggered by the filing of the relevant GST return.

7. Section 2642(g) – Relief From Late Allocations or Elections & Substantial Compliance Under Section 2632

As a general rule, the due date for a gift tax return or estate tax return reporting a transfer is the last date on which any timely allocation of GST exemption can be made, as well as the date on which any allocation that has been made – affirmatively on a return, or automatically by statute – becomes irrevocable.

Prior to the enactment of the Section 2642(g) relief provisions, there was no ability to extend the period to make an allocation and have it be treated as a timely allocation. (In the case of a lifetime transfer, a late allocation could be made to transferred property, but a late allocation is generally not as favorable, as it uses the date of allocation for both valuation and effective date purposes.) There also was no ability to extend the time period to elect out of any statutory allocation to property transferred inter vivos, although since the only statute pertaining to inter vivos transfers prior to EGTRRA was Section 2632(b), which allocates to direct skips which would otherwise generate a GST tax liability, this did not represent such a hardship.

The enactment of Section 2642(g) relief for late elections, and codification of a substantial compliance standard with respect to Section 2632(c) automatic allocations, both facilitated the application of the new EGTRRA provisions and provided much-needed relief for pre- and post-EGTRRA taxpayers who, understandably, encountered difficulties successfully navigating the complexities of the GST allocation rules despite their best intentions.

a. Section 2642(g)(1) – Relief From Late Allocations or Elections

Section 2642(g)(1)(A)(i) provides for an extension of time to make a timely allocation to property transferred by gift during life, or at death to property includible in the decedent's gross estate.[9] The extension is available for pre-EGTRRA transfers, so taxpayers have been able to use this provision to "undo" some of their failure-to-allocate errors reaching back as far as the enactment of the current GST tax, with the Tax Reform Act of 1986.

Section 2642(g)(1)(A)(ii) provides for an extension of time to make a timely election out of the automatic allocation rules of Section 2632(b) or Section 2632(c). Again, the usefulness of the ability to elect out of an allocation under Section 2632(b) is limited, since the alternative with a direct skip is to pay the GST tax. (However, since the GST tax imposed on a direct skip is "cheaper" than on either a taxable termination or distribution, an election to pay the tax on a direct skip would not be without benefit in certain scenarios. In addition, with an effective rate of GST tax in 2010 of zero percent, an election out was beneficial in a significantly broader category of circumstances.) By contrast, the ability to gain an extension to make a timely election out of the automatic allocation rules of Section 2632(c) has proved critical, judging by the frequency with which we see these extensions being granted by the IRS.

Shortly after Section 2642(g)(1) was enacted, the Secretary issued Notice 2001-50 providing that taxpayers could request a private letter ruling ("PLR") using the procedures of Treas. Reg. Section 301.9100-3 to obtain relief from a late allocation or election. Prop. Reg. Section 26.2642-7 was published in the Federal Register on April 17, 2008 to supplant Notice 2001-50, maintaining the PLR process as the mechanism for relief but setting forth standards different from those of Treas. Reg. Section 301.9100-3. The proposed regulation has not become final, so all relief in this area has been requested and granted pursuant to Treas. Reg. Section 301.9100-3.

Each week, seemingly, the IRS issues new PLRs granting taxpayer relief under Section 2642(g)(1). If Section 2642(g)(1) sunsets as scheduled, such relief will no longer be available, and it is not clear whether the IRS can or will honor its determinations with respect to relief already granted.

[9] The statute provides no mechanism to extend the time to make a late allocation or a retroactive allocation, i.e., no remedy for a missed remedy, only a timely allocation.

With respect to relief granted to make a late election out of Section 2632(c) automatic allocation, this apparently will not matter, except perhaps to the taxpayer who already paid good money in filing and legal fees to get the result that sunset itself arguably provides. With respect to relief granted to make a timely allocation, however, the situation is quite different. Similar to the Section 2632(d) retroactive allocation, discussed above, the question will not be whether an allocation was effectively made, but whether it may still be treated as timely, or instead as a late allocation, which in turn may change the inclusion ratio of any affected trust. In addition, if the allocation made pursuant to Section 2642(g)(1)(A)(i) relief concerns an amount of GST exemption in excess of the $1,430,000 available as a per taxpayer maximum in 2013, the IRS may be limited in its ability to give effect to its earlier ruling by the sunset of the EGTRRA-era Section 2631(c) higher exemption amounts.

b. Section 2642(g)(2) – Substantial Compliance

The courts have articulated a doctrine of substantial compliance in many contexts, primarily with making certain tax elections. Literal compliance with procedural directions in Treasury Regulations with respect to making elections is not always required, and the courts may uphold an election where the taxpayer is deemed to have complied with the essential requirements of a regulation, even if she has failed to meet all the procedural requirements. While the IRS may challenge a taxpayer who claims to have substantially complied with a procedural requirement, it has also issued several PLRs over the years finding that a taxpayer has substantially complied with the requirements for allocating GST exemption.[10]

The substantial compliance rule of Section 2642(g)(2), however, is legislative rather than judicial, and unlike a PLR is available to all taxpayers to be used as authority for their position. The statute provides that an allocation under Section 2632(c) that demonstrates an intent to produce an inclusion ratio as close to zero as possible for a transfer will be deemed to do so, taking into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer. Thus, the statute essentially directs the IRS to give effect to the legislative intent underlying Section 2632(c) insofar as facts and circumstances permit, rather than penalize the taxpayer for, e.g., reporting an indirect skip as a direct skip on a Form 709.

[10] See, e.g., PLR 199909034, PLR 200017013, PLR 200227009.

Beginning in 2013, assuming this provision sunsets, taxpayers will no longer be able to rely on Section 2642(g)(2) if they assert substantial compliance with respect to indirect skips. Sunset of this provision would presumably not prevent a court from applying the judicial doctrine of substantial compliance, however. This may be particularly important depending on whether and to what extent the IRS recognizes allocations made under Section 2632(c) once that statute sunsets. A taxpayer who filed a Form 709 reporting a transfer to which the automatic allocation rules purport to apply, and reflecting that in some manner on the return, is likely to be in a better position that the taxpayer who did not file a Form 709, usually because gifts otherwise qualified for the annual gift tax exclusion and no Form 709 was required to be filed to allocate GST exemption, in reliance on Section 2632(c).

Thus, while the sunset of Section 2642(g)(2) will not preclude a court from applying the judicial doctrine of substantial compliance, the taxpayer who asserts substantial compliance will need, at a minimum, to have filed tax records to support his position. For taxpayers who did not file gift tax returns reflecting an allocation under Section 2632(c) but nevertheless intend to rely on that automatic allocation (e.g., for indirect skip gifts to Crummey trusts), it may be advisable to create a record now by filing late Forms 709 for any affected years.

C. Steadfast Rules in a Changing Environment

Although the number and impact of expiring GST provisions is substantial, it is still true that most of Chapter 13 will remain intact for 2013 absent new legislation, and so many related provisions that we rely on will be there, as ever. The annual GST tax exclusion and excludible payments for tuition or medical care may help meet the needs of skip persons during any time it is preferable to delay distributions from a trust that may no longer be exempt post-sunset. Similarly, trusts whose exempt status is based on allocation or separate share rules unaffected by sunset may remain exempt. Finally, GSTs from trusts are less common than one might expect, thanks to the application of the transferor move-down rule of Section 2653(a). A transfer from a trust that looks like a GST at first glance may actually be a distribution to or termination in favor of a nonskip beneficiary, once the operation of this critical generation assignment rule is taken into account. The rule is important to keep in mind in any year, since it impacts the trustee's

(and sometimes, the beneficiary's) GST tax reporting obligations, but will be particularly important to keep in mind in 2013 for any trust whose GST status is questionable post-sunset.

1. Annual GST Tax Exclusion

As the GST exemption falls to an estimated $1,430,000, it is particularly important to keep in mind the extent to which certain GSTs can still be made free of GST tax. Transfers up to the per donor gift tax annual exclusion amount of $14,000 for 2013 can still be made outright to skip persons, free of GST tax and without eating into the donor's remaining GST exemption amount (if it has not yet been exhausted). Section 2642(c)(1). And the same transfer to a trust for the benefit of a skip person that qualifies for the annual gift tax exclusion will also qualify for the annual GST tax exclusion, provided that the skip person is the sole beneficiary of the trust during his/her lifetime, and the trust includible in the beneficiary's estate if he/she dies prior to full distribution. Section 2642(c)(2).

2. Excludible Payments for Tuition or Medical Care

Similarly, any payment made by a transferor directly to providers for the cost of tuition or medical care on behalf of a skip person, is completely excludible from GST tax. Pursuant to Section 2503(e), such a payment is not deemed to be a transfer of property by gift. The same payment made from a trust on behalf of a skip beneficiary is also excludible from GST tax, pursuant to Section 2611(b)(1), which does not sunset in 2013.

3. Other Automatic Allocation Rules

Section 2632(b) which automatically allocates a transferor's GST exemption to direct skips does not sunset. Similarly, Section 2632(e), which allocates any GST exemption remaining upon the due date for a federal estate tax return, after any lifetime allocations by the decedent and posthumous allocations by the executor on a final gift tax return or the estate tax return, will also remain intact. Section 2632(e) (codified at Section 2632(c) prior to the enactment of EGTRRA) allocates remaining exemption first pro rata to any direct skips at death, and then pro rata to any transfers in trust, during life or at death, that have the potential for a future GST with respect to the transferor.

4. Separate Share Rules

Under Section 2654(b), portions of trusts attributable to different transferors are treated as separate trusts for GST purposes (Section 2654(b)(1)), as are substantially separate and independent shares of different beneficiaries (Section 2654(b)(2)). Treas. Reg. Section 26.2654-1(a)-(b) develops these separate share rules. The separate share regulations essentially provide one set of rules under subparagraph (a) applicable to shares that exist from and at all times after the creation of the trust, and another set under subparagraph (b) applicable to property that is includible in a transferor's gross estate and severed into two or more separate trusts in the course of estate administration. Section 2654(b) remains intact when EGTRRA sunsets, as do the regulations promulgated thereunder. Thus, although the qualified severance provision of Section 2642(a)(3) is scheduled to sunset, most trusts that are intended to be separate for GST purposes will still be recognized as such, thanks to careful drafting, estate administration and tax reporting.[11]

In addition, Treas. Reg. Section 26.2654-1(a)(iii) added a "mandatory severance" provision to the separate share rules, for mandatory severances on or after September 2, 2008. Under this rule, if the governing instrument requires the trustee to divide a trust "upon the future occurrence of a particular event not within the discretion of the trustee or any other person" and the severance is effective under local law, then the trusts that result from the severance will also be recognized as separate trusts for GST purposes after the division, on a par with separate shares that exist from and at all times after the creation of the trust. This permits separate GST elections and allocations, as well as separate evaluation of the occurrence and impact of GST taxable events.

5. Transferor Move-Down Rule

Perhaps most important, but most easily overlooked, is the transferor-move down rule of Section 2653(a). Pursuant to this rule, when property is transferred in a GST and immediately thereafter the property is held in trust, for purposes of determining subsequent GSTs with respect to such

[11] As mentioned in n.5 above, while the qualified severance regulations are cross-referenced in Treas. Reg. Section 26.2654-1(a)(1) as distinctly applicable to discretionary severances of property not includible in a decedent's gross estate, it is not clear that the Treas. Reg. Section 26.2642-6(h) stated position on discretionary, nonqualified severances will be binding on the IRS once Section 2642(a)(3) sunsets.

trust (or the portion of the trust attributable to such property), the transferor is reassigned to the generation that is immediately above the highest generation beneficiary of the trust.

Thus, if a transferor makes a gift to a direct skip trust for the benefit of his grandchildren and more remote descendants, Section 2653(a) ensures that for purposes of future distributions from the trust the transferor is treated as assigned to the same generation as his children. This avoids a double-GST for distributions made from the trust to his grandchildren, who are now nonskip beneficiaries of the trust. Similarly, if the transfer was to a trust for the benefit of all descendants, including his only child, and the property stays in trust after a taxable termination at the child's death, the transferor is moved down to his child's generation after such taxable termination, so that going forward the grandchildren are assigned to a nonskip generation for all GST purposes. The caveat in either scenario is that great-grandchildren or more remote descendants (if any) remain two or more generations below the transferor, even after the move-down.

This rule will be especially important to keep in mind during any period of uncertainty introduced by sunset with respect to trusts otherwise exempt from GST under prior law and as a result of expired Code provisions. From Northern's perspective as trustee of tens of thousands of trusts, what we see is that distributions to skip persons, even from exempt trusts, are still the exception rather than the rule, thanks largely to Section 2653(a). Where the grantor has living children and the intention is to provide readily available benefits to his or her grandchildren or more remote descendants, direct skip trusts are more commonly used than indirect skip trusts. Thus, the GST exempt status of a direct skip trust for the primary benefit of grandchildren (or an indirect skip trust after the death of all beneficiaries of the child's generation) may be in question in 2013, but since the grandchildren are all nonskip beneficiaries by reason of the transferor move-down rule, the legal uncertainties are likely to be resolved long before they become an issue.

III. Current Issues in Trust Administration

A. Trust Administration and the New Medicare Contribution Tax

1. Application to Trusts and Estates Beginning in 2013

As outlined, beginning in 2013, as a result of the Health Care and Education Affordability Reconciliation Act of 2010, there is a new 3.8% Medicare surtax which will now apply to the lesser of one's "net investment income" for a taxable year or your excess (if any) modified adjusted gross income over threshold amounts. The threshold is $200,000 for single filers, $125,000 for married taxpayers filing separately and $250,000 for joint filers.

This new tax is of particular significance to us as trustees of irrevocable trusts because it will also apply to all undistributed net income for trusts and estates. For trusts and estates, it will apply to the lesser of (i) the undistributed net investment income and (ii) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to a trust or estate begins. For 2012, the highest trust and estate income tax bracket begins at $11,650. For 2013, the highest trust and estate income tax bracket begins at $11,950.

For purposes of the new tax, investment income generally includes capital gains as well as dividends, interest, rents, royalties and annuities. Also important is that business income from a passive activity for the trust or estate will also be considered as net investment income for this tax. This can (and will) have an obviously meaningful impact on the tax burden of such investments in trusts and fiduciaries will need to consider these costs in the determination of the appropriateness of such investments and the benefits of considering whether there may be a way for the trust or estate to materially participate in such a business as outlined in Section 469 of the Code and thereby reduce the tax.

The law is written to not apply to trusts and estates when they are required to distribute or, in fact, do distribute all of their taxable income annually to its beneficiaries. It only applies to those trusts and estates that are not required to distribute all of their taxable income and don't.

2. New (and Renewed) Ideas for Consideration (and Reconsideration) for Trust Administration

From a trust administration point of view, consideration of the following will be of increased significance when making investments in trusts and estates and in making distributions from trusts and estates:

- With the prospects of the increase in capital gain tax rates and considering this additional tax burden for trusts and estate's capital gains beginning in 2013; perhaps in some instances it will be better for the trust and the beneficiaries to realize certain gains in 2012.

- Be confident that the returns anticipated from passive business interests are able to overcome or justify the additional tax burden. Interestingly, by way of example, the tax does not apply to business income earned by active S corporation shareholders, even if over the threshold amounts. The tax, however, does apply to business income for passive shareholders in an S corporation. Perhaps in some circumstances, the trustee will be able to become active in otherwise passive investments thus removing the income received from being subject to the tax.

- Consider saving losses in the portfolio to be realized in 2013 which can offset more highly taxed capital gains and also avoid those gains avoided from being subject to this new tax.

- Consider distributing capital gains to beneficiaries whose personal tax picture would result in them not being subject to this additional tax at the trust level.

- When determining possible use of municipal bonds in the portfolio, begin to use this additional tax burden in the comparison calculation to taxable investments since municipal interest will not be subject to the new surtax. Historically, the calculation has focused on federal and state income tax rates.

- Take a new look at how "pot" trusts are administered and how distributions are made given that some beneficiaries may not have income above the threshold amounts. This new tax (because it is an additional tax) changes the value judgments that have heretofore

been made relative to the advisability of retaining income in the trust versus its distribution to the beneficiaries.

- Reconsider the retention of income in complex trusts given this new tax burden which may be avoided by distributing to beneficiaries whose income is below the threshold amounts.

- Are there drafting changes for practitioners to consider including in trust agreements which can provide additional flexibility given this new surtax?

- Should new consideration be given as to where certain types of assets are held, i.e, holding stocks in IRAs where the dividends will not come out not subject to the surtax and will now be subject to the same income tax rate as it would be if held outside of the IRA. (This was not previously true since dividends were previously taxed at 15% outside of an IRA but taxed at ordinary income tax rates when distributed from the IRA).

- The 65 day election may become more meaningful to the extent that a beneficiary's tax preparer can determine within that time period the amount of distribution that could be made to the beneficiary and still keep them under the surtax threshold.

As is true with most trust administration much is best decided and best concluded after effective communication with trust beneficiaries. Beneficiaries having a good understanding of the issues that a fiduciary is facing will allow them to understand that many times there are no perfect answers to some questions. What is good for one may not be good for the other. Communication and discussion will facilitate the assessment of what may be the best course of action for a trustee or, at the very least, will help gain an understanding of which beneficiaries may be supportive of a particular direction and those which will not.

B. GST Tax and Crummey Trusts

1. Common Misunderstandings of GST Tax and Annual Exclusion Gifts

One of the things that we frequently see as a corporate fiduciary is a common misunderstanding of how the GST exemption works relative to annual exclusion gifts made to Crummey trusts. Part of this misunderstanding is due to the fact that intuitively clients (and some practitioners!) think that a gift that is a present interest gift and therefore not a taxable gift would also always be

GST tax exempt. Part of the common misunderstanding is due to the fact that the rules changed beginning in 2001. The changes made which were effective in 2001 as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), as previously discussed, will now, unless Congress acts, disappear on January 1, 2013. Following is a review of the history of how this has worked over the past couple of decades and how it will now, unless Congress acts, work beginning in 2013.

2. Application of GST Tax Exemption for Gifts to Crummey Trusts

    a. Rules Prior to 2001

As we entered the GST world in the 1980's, the rule was that an annual exclusion gift would carry with it GST exemption when the gift was a direct gift to the skip person or, of course, was a gift to a Section 2503(c) trust which gives the single beneficiary of that trust a general power of appointment over the trust. Both of these methods still work. What these two methods have in common are that the gift is to a single individual and is included in the estate of that individual. That is the feature to keep in mind as one thinks about how GST exemption historically worked for gifts of a present interest made to Crummey trusts. Prior to 2001, if a gift was made to a trust for which a Crummey power of withdrawal was given in order to qualify that gift for the annual exclusion, it would be subject to GST unless: (1) during the lifetime of the individual beneficiary of the trust, no corpus or income could be distributed to anyone other than the beneficiary; and (2) if the beneficiary died before the termination of the trust, the assets of the trust would be included in the gross estate of the beneficiary. Such trusts are described in, and commonly referred to as Code 2642(c) trusts. From a GST standpoint, it really was not that much different than making a gift to a Code Section 2503(c) trust except that one could make gifts to beneficiaries over the age of majority and could have the trust last longer than age 21 by its terms.

In our experience, it is fairly rare for Crummey trusts to have such provisions. In fact, by far the majority of the Crummey trusts we see take the form of an Irrevocable Life Insurance Trust (ILIT), which almost never have such provisions. Normally an ILIT will be for a class of beneficiaries; like the children or grandchildren or both. Under those circumstances, annual exclusionary gifts do not carry GST exemption with them. So, the way that a Settlor could (prior to 2001) make such a gift GST exempt was to file a Gift Tax Return Form 709 and allocate GST

exemption to the gifts made even though those gifts were not taxable gifts, qualifying for the annual exclusion. Of course, some practitioners simply drafted documents that would create separate shares for each beneficiary which, as mentioned, would fit the criteria. The problem with that method, however, was that more times than not, the general power of appointment that needed to be granted to the single beneficiary of the separate share did not fit the objectives of the Settlor.

b. Rules from 2001 to Present

What then happened with EGTRRA was that the rules changed beginning January 1, 2001. Beginning on that date, any such gifts made to a "GST Trust" as defined in the regulations, with Crummey powers of withdrawal would carry with them an automatic allocation of the Settlor's GST exemption. This, of course, reversed what previously needed to be done. Now, with such trusts, in order for the gifts to not carry GST exemption one had to file a return to "opt out" of the automatic allocation where before, if you wanted the gift to be GST exempt, you had to file a return to allocate the exemption.

As we become involved in Crummey trusts which have been in existence for a while but for which we are now serving as trustee (again, almost always such trusts are ILITs), perhaps as a successor trustee, we begin to have conversations with our Settlors in an attempt to determine the GST status of the trust and what returns were filed either to allocate exemption or to "opt out." It is probably fair to say that almost always the clients' eyes glaze over and we are referred to their (or request permission to speak to their) tax and legal advisors in an effort to determine what has occurred. Were 709's filed in the 1990's to allocate exemption? Were 709's filed since 2001 opting out? What is the GST intent of the trust? Sometimes advisors are well aware of the intent and how things have been managed in that regard but more often the legal advisor may know what the original intent may have been but is not aware of whether the correct allocations or "opt outs" have occurred since they drafted the document. If all of this has not had the proper attention through the years, advisors and beneficiaries could be surprised when an estate plan contemplated using all of the decedent's GST exemption in the creation of a trust at their death only to find out that they don't have as much left as they thought because of the automatic allocation of exemption to gifts made to their Crummey trust. The key consideration in managing this issue is what the highest and best use of GST exemption may be. For clients who

have no intention of using GST exemption in any resulting trusts for their family after their death, then the fact that some of it was automatically (and perhaps unknowingly) utilized by gifts to their Crummey trust wouldn't defeat their estate plan.

c. Rules to Begin in 2013

Now, beginning on January 1, 2013 due to EGTRRA's Section 901(b) "had never been enacted" rule, any gifts made to Crummey trusts for which an automatic allocation was contemplated and/or utilized, will no longer be GST exempt without the additional step of going back and allocating that GST exemption. One question is whether it may be wise for the Settlor to consider making an affirmative allocation of their current GST allocation available in 2012 (before it is reduced and not relying on an automatic election). Another significant question is whether, after the GST exemption goes down to the approximate $1.4 million in 2013 they will have any exemption left at that point left to use in 2013 to attempt to make those past gifts GST exempt. Query whether if the trust was not subject to the automatic allocation rule and allocation was made for the gifts through the filing of a 709, would that allocation still be effective to the extent that exemption was utilized when it was greater than the anticipated $1.4mm. Think of this as the "clawback" question relating to the use of GST exemption allocation.

This presentation is meant only as a general overview of these issues for Crummey trusts. There are predeceased ancestor exceptions to consider, the possibility of multiple transferors to these trusts if the trusts do not have hanging powers and the amounts that beneficiaries can withdraw are more than the statute provides, retroactive allocations, late allocations, the list goes on.

Once we know what 2013 will bring, it will be a service to your clients to work with them to make sure that you (and they) understand the "real" GST status of their Crummey trust which will allow you to better advise them as to what (if anything) may need to be done to get the GST inclusion ratio where it is intended to be.

Appendices

Appendix 1: Family and Business Tax Cut Certainty Act of 2012, S.3521, Extension Provisions

The Family and Business Tax Cut Certainty Act of 2012 extends relief for the AMT for two years. Previous AMT relief expired on December 31, 2011. For 2012, the bill would raise the AMT exemption amount to $50,600 for individuals and to $78,750 for married couples filing jointly from the current amounts of $33,750 and $45,000, respectively; it also would allow nonrefundable personal credits against the AMT. For 2013, the exemption amounts would be $51,150 for individuals and $79,850 for married couples.

The bill also would extend for two years the provision of the current tax code that allows individuals to claim state and local sales taxes as an itemized deduction in lieu of state and local income taxes in calculating their individual income tax liability. Further extensions include deduction for state and local general sales tax, and tax-free distribution from an IRA for charitable purposes.

In early September, Senate Democrats suggested that bringing the Senate Finance Committee's $205 billion tax extenders bill to the floor would be stalled by Republican filibusters. At this date, the bill had not been brought to the floor.

Appendix 2: Democratic Proposals from General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals

The General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (the "Green Book") released on February 13, 2012, includes numerous tax proposals. Of particular interest are the proposals with respect to the income taxation of "upper-income" taxpayers and proposed modifications to the gift, estate and generation-skipping transfer taxes. Other proposals include taxing carried (profits) interest as ordinary income and eliminating the deduction for contributions of conservation easements on golf courses. The following are selected proposals:

Payroll Tax Cut

The Administration proposes to extend to December 31, 2012, the 2% Social Security payroll tax cut for employees (from 6.2% to 4.2%) and the corresponding Social Security tax on the self-employed (from 12.4% to 10.4%) for the first $110,100 of taxable wages or self-employment earnings received in 2012.

Upper-Income Taxpayer Income Tax Provisions

The Administration proposes numerous income tax provisions affecting "upper-income" taxpayers, meaning married taxpayers with income in excess of $250,000 and single taxpayers with income in excess of $200,000.

- Reinstate the Phase-out of Itemized Deductions
- Reinstate the Personal Exemption Phase-out for Upper-Income Taxpayers
- Reinstate the 36-Percent and 39.6-Percent Tax Rates for Upper-Income Taxpayers
- Tax Qualified Dividends as Ordinary Income for Upper-Income Taxpayers
- Tax Net Long-Term Capital Gains at a 20-Percent Rate for Upper-Income Taxpayers

Continuation of Certain 2012 Expiring Income Tax Provisions

The Administration proposes to extend a number of expiring provisions through December 31, 2013. For example, the optional deduction for State and local general sales taxes; the deduction for qualified out-of-pocket classroom expenses; the deduction for qualified tuition and related

expenses; the Subpart F "active financing" and "look-through" exceptions; the modified recovery period for qualified leasehold, restaurant, and retail improvements; and several trade agreements would be extended through December 31, 2013.

Gift, Estate and Generation-Skipping Transfer (GST) Tax Provisions

Modify and Restore the Gift, Estate and GST Taxes

Until the end of 2012, the current gift, estate and GST tax rate is 35 percent, and each individual has a lifetime exclusion or exemption for all three types of taxes of $5 million (indexed after 2011 for inflation from 2010, $5.12million in 2012). The surviving spouse of a person who dies after December 31, 2010, may be eligible to increase the surviving spouse's estate tax exclusion amount by the portion of the predeceased spouse's exclusion that remained unused at the predeceased spouse's death (in other words, the exclusion is "portable"). However, after 2012, the tax rate and tax brackets, the amount of the exclusions and exemption, and the law governing these three types of taxes will revert to the law in effect in 2001, as if the EGTRRA of 2001 had never been enacted. Portability of the exclusion between spouses for both gift and estate tax purposes, enacted as part of the TRUIRJCA of 2010, also will no longer apply.

The proposal would make permanent the gift, estate and GST tax rates, exclusions and exemptions as they applied during 2009. The top tax rate would be 45 percent and the exclusion/exemption amount would be $3.5 million for estate and GST taxes, and $1 million for gift taxes. The portability of unused gift and estate tax exclusion between spouses would be made permanent. The proposal would be effective for the estates of decedents dying, and for transfers made, after December 31, 2012.

Require Consistency in Value for Transfer and Income Tax Purposes

This proposal would impose both a consistency and a reporting requirement. The basis of property received by reason of death under Code section 1014 must equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor must equal the donor's basis determined under Code section 1015. For 2010 decedent's, the basis of property acquired from a decedent to whose estate Code section 1022 is applicable is the basis of that property, including any additional basis allocated by the executor, as reported on

the Form 8939 that the executor filed. This proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary valuation and basis information to both the recipient and the Internal Revenue Service.

Modify Rules on Valuation Discounts

In response to planning around the limitations of the Code section 2704(b) valuation limitations with respect to "applicable restrictions", this proposal would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or to hold an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family.

Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of Code section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

Require a Minimum Term for Grantor Retained Annuity Trusts (GRATs)

This proposal would require, in effect, some "downside risk" in the use of grantor retained annuity trusts by imposing the requirement that a GRAT have a minimum term of 10 years and a maximum term of the life expectancy of the annuitant plus 10 years. The proposal also would

include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. Although a minimum term would not prevent "zeroing-out" the gift tax value of the remainder interest, it would increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit. This proposal would apply to trusts created after the date of enactment.

Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption

At the time of the enactment of the GST tax provisions, the law of most (all but about 3) states included the common law Rule Against Perpetuities (RAP) or some statutory version of it. The RAP generally requires that every trust terminate no later than 21 years after the death of a person who was alive (a life in being) at the time of the creation of the trust. Many states now either have repealed or limited the application of their RAP statutes, with the effect that trusts created subject to the law of those jurisdictions may continue in perpetuity. As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with $1 million (the exemption at the time of enactment) and a maximum duration limited by the RAP, to trusts funded with $5,120,000 and continuing (and growing) in perpetuity.

This proposal would provide that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust (as defined in Code section 2642) to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from a different grantor are deemed to be held in a separate trust under Code section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under Code section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts will be deemed to have the same date of creation as the initial trust, with one exception. If, prior to the 90th anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as described in Code section 2642(c)(2) (a qualified direct skip nontaxable gift trust), the inclusion ratio of the distributee trust will not be changed to one (with regard to the distribution

from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on the beneficiary's death will be included in the beneficiary's gross estate for Federal estate tax purposes. The other rules of Code section 2653 (taxation of multiple skips) also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. This proposal would apply to trusts created after enactment, and to the portion of a preexisting trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).

Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

The grantor trust income tax rules are separate and independent from the gift, estate and GST tax rules, but may be used under current law to establish what is commonly referred to as an "intentionally defective grantor trust", treated as owned by the grantor for income tax purposes, but as a completed gift for gift, estate and GST tax purposes. Transactions between the trust and the deemed owner are ignored for income tax purposes.

To the extent that the income tax rules treat a grantor of a trust as an owner of the trust, the proposal would:

(1) include the assets of that trust in the gross estate of that grantor for estate tax purposes;

(2) subject to gift tax any distribution from the trust to one or more beneficiaries during the grantor's life; and

(3) subject to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the trust for income tax purposes.

In addition, the proposal would apply to any non-grantor who is deemed to be an owner of the trust and who engages in a sale, exchange, or comparable transaction with the trust that would

have been subject to capital gains tax if the person had not been a deemed owner of the trust. In such a case, the proposal would subject to transfer tax the portion of the trust attributable to the property received by the trust in that transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction. The proposal would reduce the amount subject to transfer tax by the value of any taxable gift made to the trust by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Code, including without limitation the following: grantor retained income trusts; grantor retained annuity trusts; personal residence trusts; and qualified personal residence trusts.

The proposal would be effective with regard to trusts created on or after the date of enactment and with regard to any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment. Regulatory authority would be granted, including the ability to create transition relief for certain types of automatic, periodic contributions to existing grantor trusts.

Extend the Lien on Estate Tax Deferrals Provided under Code Section 6166

This proposal would extend the estate tax lien under Code section 6324(a)(1) throughout the Code section 6166 deferral period. The proposal would be effective for the estates of all decedents dying on or after the effective date, as well as for all estates of decedents dying before the date of enactment as to which the Code section 6324(a)(1) lien has not expired on the effective date.

Tax Relief for Small Businesses

Under the Small Business Jobs Act, taxpayers other than corporations may exclude 100 percent of the gain from the sale of qualified small business stock acquired after September 27, 2010 and before January 1, 2011 (extended to January 1, 2012 under the TRUIRJCA of 2010) and held for at least five years, provided various requirements are met. A related provision, Code section 1045, allows investors that sell qualified small business stock held over six months to defer recognition of capital gain by reinvesting the sales proceeds in new qualified stock within 60

days. Under this rollover provision, the investor's basis in the new stock is reduced by the amount of the deferred gain.

The proposal would make the temporary Code section 1202 100-percent exclusion for qualified small business stock permanent and would repeal the AMT preference item for excluded qualified small business stock gain. In addition, the time for an investor to reinvest the proceeds of sale of small business stock in a Code section 1045 transaction would be increased to 6 months for qualified small businesses the taxpayer has held for more than 3 years. The proposal would only be effective for qualified small business stock acquired after December 31, 2011.

R. Hugh Magill

R. Hugh Magill is an Executive Vice President at The Northern Trust Company, Chicago, where he serves as Chief Fiduciary Officer and Global Director of Trust Services. In this capacity he is responsible for Northern's fiduciary services to private clients nationally and internationally.

Prior to joining Northern Trust in September, 1989, Magill practiced law privately in Chicago, and worked in the Trust Department at The First National Bank of Chicago where he served as Assistant to the Chief Investment Officer.

Magill received a B.A. degree, cum laude, from St. Olaf College in Northfield, Minnesota, and a J.D. degree from the University of Minnesota Law School, where he was named a distinguished alumnus in 2005.

Magill is a member of the Chicago, Illinois and American Bar Associations, the Chicago Estate Planning Council, and the Christian Legal Society. He is licensed to practice law in Illinois and Minnesota and admitted to practice before the United States Tax Court. He is a faculty member of the American Banker's Association National Trust School and has lectured for the Illinois Institute for Continuing Legal Education, the Notre Dame Tax and Estate Planning Institute, the Chicago Estate Planning Council, the Family Office Association, Northwestern University's Center for Family Enterprises, regional bar associations and estate planning councils, and Northern Trust on estate and charitable planning, trust management, family governance, and fiduciary risk management.

He serves on the Boards of the Block Museum of Art, Ministry Mentors, The Chicago Sunday Evening Club, several foundations, and the Advisory Council of the University of Minnesota Law School. He serves on the Editorial Board of Trusts & Estates magazine, the executive council of the Trust Management Association, and has authored articles for Trusts & Estates, Trust & Investments, and Wealth magazines. He and his wife reside in Winnetka, Illinois with their three children.

Suzanne L. Shier

Suzanne L. Shier is the Director of Wealth Planning and Tax Strategy for Personal Financial Services at Northern Trust. In this capacity, she is responsible for leading the Personal Financial Services wealth planning group and for providing thought leadership on federal tax issues of interest to clients, with a special emphasis on tax policy and legislation, charitable giving, cross-border trust design and fiduciary law.

Prior to joining Northern Trust, Ms. Shier spent 26 years as a partner at Chapman and Cutler LLP in Chicago, ultimately leading the firm's Trusts and Estates Practice Group, representing individuals, charitable organizations, and corporate fiduciaries in a full range of estate planning and fiduciary services, including cross-border planning, and fiduciary administration matters.

Ms. Shier is an adjunct professor in the Master of Laws in Taxation Program at Northwestern University Law School and also a frequent speaker and author. She has been quoted in publications such as the Wall Street Journal and Bloomberg and has received numerous professional honors and recognitions.

Ms. Shier earned her bachelor's degree with distinction in economics and sociology from the University of Michigan in 1982. She received her law degree, cum laude, from the Loyola University Chicago School of Law in 1985 and a master of laws in taxation from the DePaul University College of Law in 1997.

In the Chicago civic community, Ms. Shier is actively involved in many women's, diversity and education initiatives, including serving on the Boards of Directors of Gads Hill Center and the Chicago Coalition of Women's Initiatives in Law and as Chairperson of the Board of Directors of Chicago Scholars, a college access program for high potential urban students.

Ms. Shier is a fellow of the American College of Trust and Estate Counsel where she is a member of the International Committee and a member of the International Bar Association, the Society of Trust and Estate Practitioners, the American Bar Association and the Chicago Estate Planning Council.

Julie J. Olenn

Julie J. Olenn is Tax Counsel at The Northern Trust Company, Chicago, where she is responsible for Global Client Tax Services' advice and procedure related to generation-skipping transfer (GST) taxes. As Tax Counsel, Julie works closely with trust professionals on the resolution of GST and other transfer tax issues that arise in the context of trust and estate administration. She is also a frequent contributor to various education, training and thought leadership initiatives of PFS Advisory Services related to transfer tax issues and wealth transfer strategies of interest to partners and clients.

Prior to joining Northern Trust as Tax Counsel, Julie concentrated her practice in estate planning and trust law with the firms of Levin, Schreder & Carey Ltd., and Sidley Austin LLP. Julie received her B.A. degree with honors from St. John's College of Annapolis, Maryland, and her J.D. from the State University of New York, magna cum laude.

W. David Connell

W. David Connell is Senior Vice President and Advisory Services Practice Executive for the West Region of The Northern Trust Company.

Connell holds a Bachelor of Science Degree in Business Administration from the University of Nebraska in Lincoln, Nebraska and is a graduate of the Pacific Coast Banking School, University of Washington, Seattle.

From 1975 to 1982, David was involved in various family businesses which included Pepsi Cola Bottling Company of Grand Island, Nebraska, Farvel Properties, Incorporated (Real Estate), Connell Radio West, Inc. (KMCX-FM) and Equity Title Company, Inc. (Abstracting and Title Insurance).

In 1982, he became Trust Officer for Overland National Bank of Grand Island, Nebraska where he was responsible for the trust function for the bank. From 1983 to 1995, Connell was with the trust division of First Interstate Bank of Arizona, N.A., during which time his responsibilities included personal trust administration as well as managing both the trust real estate department and the Phoenix trust office. In 1995, he joined Northern Trust. In 1998 he was named the Division Manager for Trust Administration, in 2001 became Managing Director for the West Valley, was named Chief Fiduciary Officer in October of 2005, and Advisory Services Practice Executive in 2012.

David served on the Board of Directors of The Phoenix Symphony from 2002 to 2007. He is a Trustee and Past Chairman of The Board of Trustees of the Museum of Northern Arizona in Flagstaff, Arizona and also a Director and past President of the Board of Directors of The Museum of Northern Arizona Endowment Foundation. In 2011, Connell was elected to The Board of Directors of The Arizona Community Foundation.

Amanda C. Andrews

Amanda C. Andrews is a Wealth Planning Associate in the Personal Financial Services division at Northern Trust. Andrews recently completed her Master of Laws in Taxation at Northwestern University School of Law, where she worked as a research assistant to Professor Philip F. Postlewaite.

She received her law degree from Loyola University Chicago School of Law in 2010 and earned her Bachelor of Arts in English from Davidson College. Prior to law school, Andrews worked at Sotheby’s in their Private Client Services group in New York.

Overview of Legislation and Tax Policy[1]

[1] These materials do not constitute and should not be treated as legal, tax or other advice regarding the use of any particular tax, estate planning or other technique, device, or suggestion, or any of the tax or other consequences associated with them. Although reasonable efforts have been made to ensure the accuracy of these materials and the seminar presentation, neither R. Hugh Magill, Suzanne Shier, Julie Olenn, W. David Connell, Amanda Andrews nor The Northern Trust Corporation assume any responsibility for any individual's reliance on the written or oral information presented during the seminar. Each seminar attendee should verify independently all statements made in the materials and during the seminar presentation before applying them to a particular fact pattern, and should determine independently the tax and other consequences of using any particular device, technique, or suggestion before recommending it to a client or implementing it for a client.

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Overview of Legislation and Tax Policy

	2012 Law	Scheduled 2013 Law	Democratic Proposals	Republican Proposals (Pre-election)	Democratic H.R. 3412: Middle Class Tax Cut Act of 2012	Republican H.R. 8/H.R. 6169: Job Protection and Recession Prevention Act of 2012/ Pathway to Job Creation through Simpler, Fairer Tax Code Act of 2012
General Overview	• Lower rates with special treatment of qualified dividends and capital gains • No Medicare surtax • AMT thresholds reverted to 2001 levels in January 2012	• Higher individual income tax rates with lower AMT threshold (unless another extender is enacted, which appears probable, but the timing and duration are not known) • New Medicare surtax pursuant to the Patient Protection and Affordable Care Act	• Allow 2001-03 tax cuts to expire for high income taxpayers (AGI $250,000 married, $200,000 individual) but extend for lower income taxpayers • Continue AMT but at higher indexed thresholds	• Permanently extend 2001-03 tax cuts • Further reduce individual tax rates • Reduce tax preferences • Eliminate taxation of investment income for lower income taxpayers • Repeal AMT and new Medicare surtax • Reduce corporate income tax rate	• Extension of the 2012 income tax rates for 1 year for low and middle income taxpayers • Reinstate AMT inflation adjustment thresholds for 2012	H.R.8 • Extension of 2012 income tax rates for 1 year for all taxpayers • Reinstate AMT inflation adjustment thresholds for 2012 and 2013 H.R.6169 • Expedited, comprehensive tax reform in 2013 • Consolidate the six tax brackets into two brackets • Reduce the corporate rate to not greater than 25%

	2012 Law	Scheduled 2013 Law	Democratic Proposals	Republican Proposals (Pre-election)	Democratic H.R. 3412: Middle Class Tax Cut Act of 2012	Republican H.R. 8/H.R. 6169: Job Protection and Recession Prevention Act of 2012/ Pathway to Job Creation through Simpler, Fairer Tax Code Act of 2012
Ordinary Income Tax Rates	10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%	10%, 15%, 25%, 28%, 36%, 39.6%	8%, 12%, 20%, 22.4%, 26.4%, 28% and eliminate tax on investment income (long-term capital gains, dividend, interest) for lower income taxpayers ($200,000 married, $100,000 single, $150,000 head of household)	Extend the 10%, 25%, 28%, 33% marginal tax rates	H.R.8 • Extend current rates through 2013 for all taxpayers H.R.6169 • Consolidate into two brackets, 10% and not higher than 25%
Marriage Penalty Relief	Married 15% bracket twice single bracket	Married 15% bracket less than twice single bracket	Extend relief, married 15% bracket twice single bracket		Extend relief, married 15% bracket twice single bracket	Extend relief, married 15% bracket twice single bracket

	2012 Law	Scheduled 2013 Law	Democratic Proposals	Republican Proposals (Pre-election)	Democratic H.R. 3412: Middle Class Tax Cut Act of 2012	Republican H.R. 8/H.R. 6169: Job Protection and Recession Prevention Act of 2012/ Pathway to Job Creation through Simpler, Fairer Tax Code Act of 2012
Dividends	0% and 15%	Ordinary income tax rates	• 0% and 15% for lower income taxpayers • Ordinary income tax rates for high income taxpayers	• Eliminate for lower income taxpayers • 0% and 15% for high income taxpayers	• 0% for the bottom two brackets • 15% for the 25%, 28%, and 33% brackets • 20% for the top brackets	0% and 15%
Capital Gains	0% and 15%	10% and 20% (and limited 8% and 18%)	• 0% and 15% for lower income tax payers and • 20% for high income taxpayer • Tax carried interests as ordinary income	• Eliminate for lower income taxpayers • 0% and 15% for high income taxpayers	• 0% for the bottom two brackets • 15% for the 25%, 28%, and 33% brackets • 20% for the top brackets	0% and 15%

	2012 Law	Scheduled 2013 Law	Democratic Proposals	Republican Proposals (Pre-election)	Democratic H.R. 3412: Middle Class Tax Cut Act of 2012	Republican H.R. 8/H.R. 6169: Job Protection and Recession Prevention Act of 2012/ Pathway to Job Creation through Simpler, Fairer Tax Code Act of 2012
Medicare Contribution Tax on Net Investment Income	None	3.8% for net investment income above applicable individual modified adjusted gross income thresholds ($250,000 married filing jointly, $125,000 married filing single, $200,000 other) and for trusts and estates in marginal tax bracket in 2013 (estimated $12,000)	Continue in effect	Repeal	N/A	Repeal of the 3.8% for net investment income set to take effect in 2013

	2012 Law	Scheduled 2013 Law	Democratic Proposals	Republican Proposals (Pre-election)	Democratic H.R. 3412: Middle Class Tax Cut Act of 2012	Republican H.R. 8/H.R. 6169: Job Protection and Recession Prevention Act of 2012/ Pathway to Job Creation through Simpler, Fairer Tax Code Act of 2012
AMT Threshold		Same as 2012		Repeal	Patch for 2012 only	A two-year patch, then repeal[2]
• Married Joint/ Surviving Spouse	$45,000		$74,450		2012: $78,750 2013: N/A	2012: $78,750 2013: $79,850
• Married Separate	$22,500		$37,225			2012: $39,375 2013: $39,925
• Single / Head of Household	$33,750		$48,450		2012: $50,600 2013: N/A	2012: $50,600 2013: $51,150
Social Security Payroll Tax Relief	2% reduction for 2012 (employees 6.2% to 4.2% and self-employed 12.4% to 10.4%)	Reduction expires	No specific change is proposed	No specific change is proposed	No specific change is proposed	No specific change is proposed
Itemized Deductions	No additional high income taxpayer phase-out	Phase-out up to 80% above applicable thresholds	Phase-out up to 80% for high income taxpayers		Phase-out up to 80% for high income taxpayers	No additional high income taxpayer phase-out

[2] Senate Bill 3521: Family and Business Tax Cut Certainty Act proposes the same AMT thresholds

	2012 Law	Scheduled 2013 Law	Democratic Proposals	Republican Proposals (Pre-election)	Democratic H.R. 3412: Middle Class Tax Cut Act of 2012	Republican H.R. 8/H.R. 6169: Job Protection and Recession Prevention Act of 2012/ Pathway to Job Creation through Simpler, Fairer Tax Code Act of 2012
Marginal Tax Rates			Revert to 2009 levels with 45% marginal rates	Repeal estate tax	Silent on estate, gift and GST taxes, implying a reversion to 2009 levels[3]	Extend current 2012 tax rates of 35% and $5 million exemption and exclusion amounts, indexed for inflation
• Gift	35%	55%				
• Estate	35%	55% and 5% surtax				
• GST	35%	55%				
Exemption/ Exclusions			Revert to 2009 levels with $3,500,000 estate and GST exemption and exclusion amounts ($1,000,000 for gift tax), but with portability	Repeal estate tax		
• Gift	$5,120,000	$1,000,000				
• Estate	$5,120,000 with portability	$1,000,000				
• GST	$5,120,000	$1,400,000 (estimated)				
GRATs	Short-term permitted; zero remainder permitted	No change	Require minimum 10-year term and that the remainder value be greater than zero			
Dynasty Trusts	Long-term permitted	No change	Limit duration to which GST exemption applies to 90 years			
Defective Grantor Trusts	Permitted	No change	Inclusion of trusts taxed as grantor trusts in taxable estates			

[3] In an earlier version of the bill, S.3393, Democrats included language to extend the 2009 estate tax law.

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