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NEWSLETTER

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ESTATE PLANNING FOR YOUNG ADULTS?

Mary J. Peshel, Esq.

Young adults, including those just turning 18 years old, have the ability to execute estate planning documents and should consider doing so. Such planning need not be complex, but the lack of planning can unnecessarily complicate their lives, and those of their loved ones, in the event of a serious illness, injury or death.

Young adults typically have little in the way of financial assets and thus generally need only a few estate planning documents relating to medical care and privacy.

The Health Insurance Portability and Accountability Act of 2006 (HIPAA) protects the personal health care information of all persons from disclosure to anyone without the patient's express consent. This consent can be obtained in writing prior to an illness or injury, or can be granted orally if the child is able to give consent at the time of the health care crisis. An Authorization to Release Medical Information is a document naming the individuals with whom the young adult's doctor can discuss his/her medical condition. In the case of a young unmarried adult, the document will normally name the parents as persons who can receive this information. An Authorization does not, however, permit the parents to make medical decisions on the child's behalf, but just to obtain information about his or her condition.

An Advance Health Care Directive ("AHCD") (i.e., a health care power of attorney) is used to name an agent to make health care decisions for the young adult in the event he or she is unable to make these decisions. Having an AHCD avoids the necessity of a court appointed Conservator over the young adult's person if he or she becomes incapacitated.

For young adults, with jobs and bills to pay, we recommend also obtaining a General Power of Attorney to allow someone to pay the bills and handle the young adult's assets on his or her behalf while he/she is incapacitated (perhaps during recovery from a serious illness or injury).

Generally speaking, a Will is not required unless the young adult owns assets valued at over $150,000, because California (and many other states) has a simplified and inexpensive probate process for such estates. Without a Will, the assets pass to the individual's legal heirs; for a young adult this is likely to be his/her parents, unless he/she is married and/or has children. Young adults who have more than $150,000 or who wish to specify who receives their assets, should consider creating a Will or revocable trust.

If you have a young adult in your life, we encourage you to speak with him or her about obtaining these important estate planning documents.

SHOULD THE POSSIBILITY OF "CLAWBACK" AFFECT YOUR GIFTING PLAN?

DeEtte L. Loeffler, JD, LL.M. Taxation

2012 is likely to be remembered as the Year of the Gift. When Congress enacted the Tax Relief Act in December 2010, increasing the gift tax exemption from $3.5 million to $5 million and then to $5.12 million, it was anticipating a surge in "reportable gifts" over the next two years. Many individuals have made large gifts in 2011 and 2012, fearing the return of a $1 million estate and gift tax exemption in 2013. However, many have sat on the fence about making such gifts, for fear of the phenomenon commonly referred to as "Clawback."

What is Clawback?

Clawback is not a certainly at this time, but estate planners are concerned it might arise in 2013 unless Congress takes steps to avoid it. Clawback refers to the process by which the estate tax is currently calculated. In this process, reportable lifetime gifts are brought back into the estate of a deceased donor for the purpose of determining the estate tax payable by that estate.

In the past, the estate tax exemption amount has never been less than the gift tax exemption and this meant there was always sufficient estate tax credit to pay tax on gifts that are added back to the taxable estate. However, for 2013, it is possible the estate tax exemption will be less than the gift tax exemption in effect when gifts were made. This raises the possibility that estate tax could be owed on assets that were previously exempt from tax due to a higher gift tax exemption (and lower gift tax rate).

Example

Assume Robert dies in 2013 with a $1 million estate. Since the estate tax exemption is expected to be $1 million, no estate tax would be owed. However, if Robert had gifted $1 million in 2006 and another $1 million in 2011, his estate could incur an estate tax depending on the Clawback rules.

First, the estate would add the $2 Million in gifts to the $1 million remaining estate. The estate tax payable would then be calculated as though the estate was valued at $3 million upon death, resulting in a tentative tax of $1.65 million. From this would be deducted the gift tax payable on each gift. The gift tax payable calculation requires calculating the tentative gift tax twice, first using the estate tax rate effective at death, then offsetting it with a credit based upon the gift tax rate actually in effect when the gift was made. If the gift tax rate was lower when the gift was made, the credit is also lower. (Gift tax rates have been lower since 2002 than the 55% rate expected in 2013). The end result of this complicated tax calculation is a tax could be due at death on assets that were gifted free of any tax when made.

What Might Clawback Apply To?

Clawback would not apply to every lifetime gift, only to those that require reporting on a Gift Tax Return (form 709). Annual exclusion gifts, and qualified payments of tuition or medical expenses, are not included in the calculation, nor are gift taxes paid, provided they were paid more than three (3) years before death.

It is important to note that Clawback would not be an issue just for those making large gifts in 2011 and 2012. Anyone making gifts in excess of $1 million before 2013 could potentially be at risk. Those who relied on the ever increasing estate tax exemption imposed under the Economic Growth and Tax Relief Act of 2001 to avoid additional tax at death may be unpleasantly surprised if Clawback applies to their estates at death. However, it seems unlikely that Congress would encourage lifetime gifting for the last decade (and collect the accompanying taxes) only the slap donors with an increased tax on these gifts at death.

Gifting is Still a Good Idea (Especially GST Gifts)

While Clawback is certainly a potential issue to take seriously, it is not clear if Congress will allow it to become a problem for estates. Many estate planners believe that Congress will grandfather gifts made between 2001 and 2012 to prevent estates from becoming subject to estate tax on gifts that were not taxable when made. There is currently legislation in the House of Representatives (HR 2023) that would eliminate this worry. In addition, Congress is considering several tax bills that would increase the estate tax exemption to an amount in excess of $1 million, thereby reducing the amount of extra tax that could be imposed under Clawback. However, it is impossible, especially in an election year, to predict what laws Congress will adopt before year end.

There is a split within the estate planning community regarding whether the benefits of making large gifts in 2012 (i.e., greater than $1 million) outweigh the risks of having Clawback apply to an estate. Many firms are encouraging clients to make such gifts before the "window of opportunity" closes. Some also recommend the purchase of life insurance as a hedge in case Clawback does apply.

In addition, even if Clawback were to apply to bring lifetime gifts back into an estate for taxes, the general consensus among estate planners is that there are still many good reasons to make lifetime gifts. First, the value of any appreciation in the assets would not be included in your estate, no matter how much they grow after the gift. Second, the amount of any gift taxes you actually pay during life would not be brought back into your estate. Third, Clawback would not apply to the generation skipping transfer tax, so gifts made to GST trusts would remain exempt from this second tax.

For example, in 2012 each person can gift up to $5,120,000 to anyone without incurring a gift (or generation-skipping) tax. If these gifts are made to generation skipping trusts, the assets can be used by the donor's children during lifetime, and the remainder could pass to the donor's grandchildren at the children's deaths without incurring an estate or generation-skipping tax. This can provide a significant benefit for both the donor and the donor's children by reducing the donor's taxable estate and benefitting the issue immediately. At this time, it is expected that the current $5,120,000 generation skipping exemption will not be affected by future changes in the law. Accordingly, gifts to a GST trust can result in a large benefit since assets subject to the GST are double taxed, with a resulting tax rate of nearly 70% expected in 2013 (assuming the tax rates revert to 55%).

If Congress eliminates Clawback, of course, then these benefits will be magnified by the fact that estate taxes will never be payable on the difference between the gift tax exemption available now and the estate tax at the time of your death.

Remaining Risks

The downside to making large gifts may therefore appear to be smaller than the upside. If the assets remain in your estate, they will be subject to estate tax anyway, as will the increase in their value as well as any gift tax you might have paid if the gifts were made during your lifetime. This analysis, however, overlooks the effect of the type of planning used by the donor. Those using martial trust planning, for example, could potentially pay higher overall taxes at the first death than would have been incurred if no gifts were made. In addition, those who are not married run the risk of not having retained sufficient assets in the estate to pay the increased taxes.

Marital Plans

Marital planning is a useful and effective technique whereby tax is postponed at the death of the first spouse by allocating assets in excess of the estate tax exemption amount to a marital trust. To the extent assets are left to or for the sole benefit of the surviving spouse, estate taxes are postponed until the death of the surviving spouse. Such planning generally results in much lower overall taxes being paid by the estates of the couple, especially if the surviving spouse lives long enough to spend down the "excess" assets.

If Clawback applies, however, such planning could potentially result in increased overall taxes. This is because the marital exemption will not apply to shelter previously gifted assets from tax as these assets have not been allocated to or for the sole benefit of the surviving spouse. Moreover, if these gifts exceed the available estate tax exemption, the trustee may have to pay the increased taxes from the assets that would otherwise have been allocated to the marital trust. The funds used to pay the taxes would also not qualify for the marital deduction, so an iterative (circular) tax calculation would occur, resulting in the estate having to pay tax on the estate taxes paid from the marital trust, further reducing those assets available to the surviving spouse. This problem can be minimized, of course, by obtaining life insurance with which to pay the taxes instead. It could also be avoided by Congress affirming there will be no Clawback taxes arising from reliance on the prior gift exemptions available during 2001-2012. While we expect Congress to do this, it is wise to consider ways to prepare for the possibility of Clawback.

Retain Adequate Funds

Another practical issue involves who will have to pay the increased tax. If the donor fails to retain sufficient assets in the estate, and/or has insufficient life insurance, the IRS will collect the tax from those who received the lifetime gifts. This means that the donees, often the donor's children or trusts for their benefit, will not be able to fully utilize the gifts they receive for fear of incurring a large tax upon the donor's death.

Planning for Possible Clawback

So what is the "right answer" for those potentially facing Clawback? Unfortunately it is impossible to know. Certain precautions can be taken, however, to minimize potential adverse effects.

First, since annual gifts and payments of qualifying tuition and medical expenses are exempt from gift tax (and hence also from Clawback), such gifts should be maximized.

Second, gifting less than $1 million per donor should avoid the Clawback, since it is highly unlikely that Congress will enact an estate tax exemption that is lower than $1 million. This very conservative approach, however, is considered by many estate planners to be a waste of the opportunity that Congress provided in the 2010 Tax Relief Act, and seems unlikely to be necessary.

Third, donors can gift whatever they determine they can afford to gift, provided they either retain sufficient assets to pay any increased tax that may be generated, or obtain sufficient amounts of life insurance to pay any tax incurred. This approach, while less conservative, should be sufficient to meet the needs of most individuals and couples.

Finally, for those willing to gamble that Congress will increase the estate tax exemption, or grandfather gifts made before 2013, larger gifts certainly offer great potential to reduce estate taxes. If either the estate tax exemption is increased for 2013 and beyond or gifts are grandfathered to prevent Clawback, estates that are willing to take this gamble could experience significant benefits. How much? The projected estate tax on an estate valued at $6,120,000, with a $1,000,000 exemption, would be $2,816,000. If the individual had gifted the full $5,120,000 available during lifetime, and Clawback did not apply, the estate would instead owe an estate tax of $0. If Clawback did apply, but the exemption were instead increased to $3,500,000, the tax would not exceed $1,440,000.

If you have questions regarding how Clawback might apply to your estate, or wish to make additional gifts in 2013, we would be happy to assist you.

LEGISLATIVE UPDATE: Shifting Attitudes?

The deadlock in Congress over federal tax reform seems to be lessening, with recent proposals by both parties aimed at avoiding the "fiscal cliff" in January of 2013. The fiscal cliff refers to the combined impact of the expiration of numerous tax cuts, and the imposition of draconian budget cuts, which is expected to sharply increase taxes next year. Leaders in both parties have begun to suggest extending current tax levels into 2013 so long as the extensions are tied to a structure requiring broad based tax reforms. The goal is to keep the economic recovery from faltering by providing certainly to the markets and small businesses. This is a hopeful sign given the hard line rhetoric from both parties so far in 2012.

California's financial situation remains dire, however, with no concessions in sight. In June, Governor Brown and the legislature announced a new budget deal whose success depends heavily on voter support for the Governor's proposed tax increases in the November election. The Governor's plan would increase taxes on Californians' earning more than $250,000 and would impose a "temporary" quarter cent increase in the sales tax. Californians already pay one of the highest sales taxes in the nation. The new taxes, if passed by voters, are anticipated to raise $5.9 million in 2013. If the measure fails, almost $6 million in automatic cuts to schools and universities will go into effect. The governor's tax plan is one of several competing tax initiatives on the November ballot.

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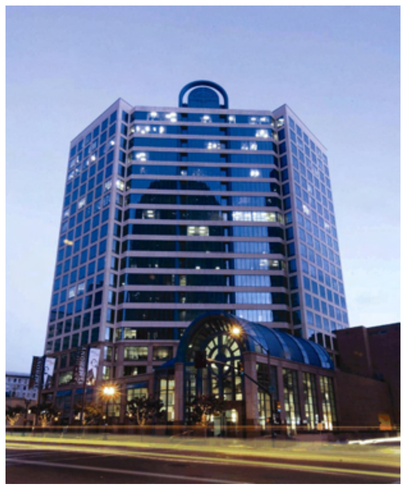

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