TRUSTS AND ESTATES GROUP | UPDATE DECEMBER 2012
DAVIS MALM & D'AGOSTINE P.C.
ATTORNEYS AT LAW

# Year-End Review and Timely Tax Tips

At the end of each year we like to review what is new and not so new in tax planning and to remind you to reassess your estate planning goals. If there have been significant changes in your family life or in your financial circumstances, it is important to review your plan. Some examples of these triggering events are retirement, divorce, remarriage, the death of a family member, the marriage or divorce of a child, and the birth of a grandchild. If you are anticipating an event that will significantly change your net worth, it is important to plan the strategic use of your lifetime gift-tax exemption and to take steps to freeze the value of your estate, passing future appreciation on to the next generation at a reduced tax cost. If you feel inclined to share your fortune with those less fortunate, now is also an excellent time to consider philanthropic planning.

## To Gift or Not to Gift? Time is Running Out.

On January 1, 2010, the lifetime federal gift tax exemption increased for the first time in many years from $1 million per person to $5 million per person (currently $5,120,000 with inflation adjustments), opening a window of opportunity for significant gifting. That window, however, will shut completely on December 31, 2012, unless Congress acts to extend it, and the lifetime gift tax exemption and the estate tax exemption (which are now unified into one system) will revert to $1 million per person.

Although a lifetime gift will reduce the amount of estate tax exemption that will be available when you pass away, there are several major benefits to making gifts this year. First, if the exemption does drop, and you have taken advantage of the current $5,120,000 level by making significant gifts this year, your ultimate estate tax liability is likely to be greatly reduced. Second, any appreciation in the value of the gifted assets between now and your death will escape estate taxation altogether. Third, Massachusetts does not tax lifetime gifts, so whatever you give away will not be part of the value of your Massachusetts estate for estate tax purposes.

### Is it too late?

No. Despite what you may have heard, it is not too late to make a gift before the end of the year. However, completing the gift will require your focused attention as well as the advice and coordination of your estate planning team—your estate planning attorney, corporate attorney, accountant, financial planner, investment advisor and, in many cases, a professional appraiser.

### Let's start at the beginning.

**Should you consider gifting as a way to reduce your ultimate estate tax?**

This can be a difficult question, and the advice of your estate planning team will be helpful in finding the answer. Even if the current value of your and your spouse's or partner's estate does not exceed the current Federal estate tax exemption ($5 million if you are single and $10 million between you and your spouse if you are married), your estate may grow beyond that amount during your lifetime. Also, as noted, the estate tax exemption, like the gift tax exemption, will drop to $1 million per person at the start of 2013, unless Congress acts to set a higher exemption. Since it is impossible to predict what Congress will do in the future, it is advisable to take advantage of the higher limits available this year, if you are in a position to do so.

**You are concerned about the size of your potential estate tax bill but are not sure you can afford to make a gift.**

If you made a gift, would you feel comfortable that you would be retaining sufficient assets to provide for yourself and your spouse? Would a gift materially reduce the income that supports your lifestyle? Do you own non-income-producing assets—a personal residence, for example—that you would be comfortable gifting? Again, you may need the help of your estate planning team to answer these questions, particularly your accountant and financial planner.

**You think you can afford to make the gift but are not sure you will never need the assets you are giving away.**

This is a common concern for many people. One way to structure a gift for the benefit of your spouse, partner, children, or other intended beneficiaries is to create an irrevocable trust. The trustee can be given the discretion to distribute assets to any

*continued on page 4*

# The New Massachusetts Uniform Trust Code

In 2012, Massachusetts saw some major changes to both probate law and the laws governing the administration of trusts. After two delays, the Massachusetts Uniform Probate Code went into effect on April 1, 2012. The Massachusetts Uniform Trust Code (MUTC) was signed into law on July 8, 2012, and became effective immediately.

The MUTC contains provisions designed to give trustees flexibility in administering trusts, reduce the necessity for court intervention, and clarify the rights of the trust beneficiaries.

## A TRUSTEE'S DUTY TO PROVIDE INFORMATION TO THE BENEFICIARIES

Prior to the enactment of the MUTC, a trustee's duty to provide information to trust beneficiaries was murky, requiring only that the trustee provide sufficient information to enable the beneficiaries to protect their interests. Now, there is a bright line rule requiring a trustee to provide information about the trust *at the request of the beneficiaries*.

Absent a contrary provision in the trust, a trustee is also now required to notify "qualified beneficiaries" of the existence of the trust within 30 days of a trust becoming irrevocable (a revocable living trust becomes irrevocable when the Donor dies) or when a new trustee is appointed. A qualified beneficiary is a permissible recipient of trust income or principal, or someone who would be a recipient of trust income or principal if the trust terminated when a notice is required or an account is requested.

A trustee must also send annual and final accounts to a recipient or permissible recipient of trust income or principal and to other qualified beneficiaries who request them. The accounts may be formal or informal and must include information relating to the trust property, liabilities, receipts, and disbursements, including the trustee's compensation.

## VIRTUAL REPRESENTATION

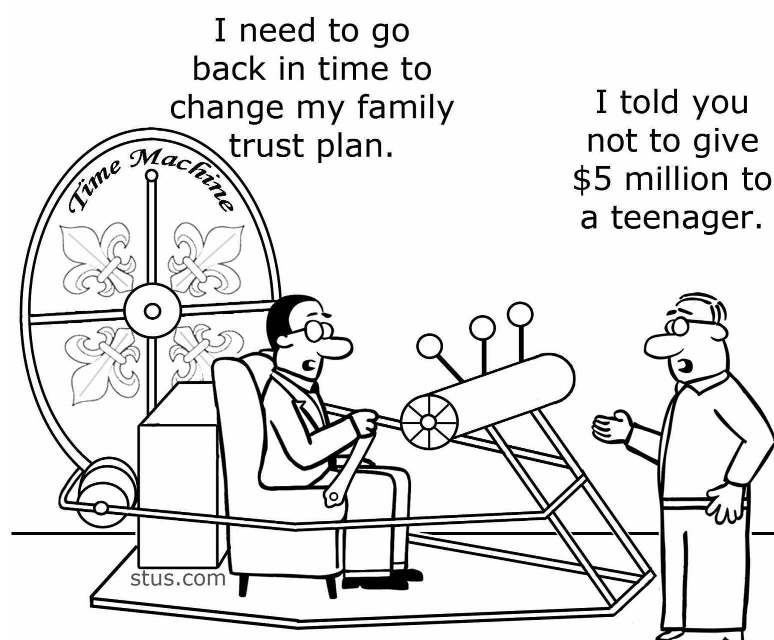
The MUTC develops the concept of virtual representation, which first appeared with the enactment of the Uniform Probate Code. The benefit of virtual representation is the potential to eliminate the need for a court-appointed guardian ad litem to represent minor and unborn issue in trust proceedings. Absent a conflict of interest, parents can represent their minor and unborn children (but not grandchildren or more remote issue). Conservators and guardians can represent a ward/protected person. A beneficiary with a substantially identical interest in the trust can represent unborn and unascertained beneficiaries.

## TIME LIMITS

The MUTC provides updated guidance as to the commencement of judicial proceedings:

1. To contest the validity of a trust that was revocable on the Donor's death, suit must be brought within the earlier of one year after the Donor's death, or 60 days after the trustee sent a copy of the trust, informed the person of the trustee's name and address, and gave notice that the person has 60 days to commence a proceeding.

Stu's Views © stus.com All Rights Reserved



# The New Massachusetts Uniform Trust Code (continued from previous page)

2. To contest a trustee's final account, suit must be brought within six months after the beneficiary receives a final account that fully discloses material matters, or within three years after the beneficiary receives a final account and was informed of the location of the trust records, even if the account does not fully disclose a material matter.

3. A claim against a trustee for breach of trust must be brought within three years after the date the beneficiary, or his or her representative, knew or should have known of the existence of the potential claim for breach of trust.

### NON-JUDICIAL SETTLEMENT AGREEMENTS

In one of the most significant changes to prior law, trustees and beneficiaries may now enter into binding settlement agreements without court involvement to resolve disputes over issues such as interpreting a trust instrument; determining the powers, authority or liability of a trustee; approving accounts; and the resignation or appointment of a trustee. The settlement agreement will be valid if it does not violate a material purpose of the trust and includes terms and conditions that could properly be approved by a court. Because court approval is not required, interested parties now have an efficient, economical way to resolve conflicts, clarify trust terms, and determine trustee powers.

### MODIFICATION AND TERMINATION OF A TRUST

If an available Donor and all beneficiaries of an irrevocable trust consent, a court may approve the modification or termination of the trust, even if it is inconsistent with a material purpose of the trust. If the Donor is no longer available, the court may still terminate or modify an irrevocable trust with the consent of all the beneficiaries if the court concludes that modification or termination is consistent with a material purpose of the trust. These provisions do not apply to charitable trusts.

### COURT REMOVAL OF A TRUSTEE

A trustee can be removed by a court without cause where:

- there is a substantial change of circumstances;
- removal is requested by all qualified beneficiaries;
- removal is in the best interests of the beneficiaries and consistent with a material purpose of the trust;
- there is a serious breach of trust;
- the trustee is deemed unfit; or
- there is a lack of cooperation between co-trustees that impairs administration of the trust.

### MISCELLANEOUS

An exculpatory provision drafted or caused to be drafted by a trustee may be invalid unless the trustee proves its existence and contents were adequately communicated to the Donor. Unless the terms of a trust expressly provide that a trust is irrevocable, a trust is now presumed to be revocable. Absent a contrary provision in the trust, trustees may now act by majority decision. So-called purpose trusts, which have no beneficiaries, are now allowed. A purpose trust operates to further one or more purposes of the Donor, such as maintaining a vacation home in the family. DMD

## DID YOU KNOW?

The Massachusetts Uniform Probate Code went into effect on April 1, 2012 and includes the following changes:

- If you die without a will and leave children, all of whom are from the marriage to your surviving spouse, or if you leave no children and no parent, your spouse will receive the entire probate estate (property held in your own name at death).

- If you die without a will and leave children, and your surviving spouse has children who are not yours, your spouse receives the first $100,000 plus one-half of the remainder of the probate estate. Similarly, if your children are not children of your surviving spouse, your spouse receives the first $100,000 plus one-half of the remainder of the probate estate. In both cases, your children receive the rest.

- If you die without a will and leave no children but leave a surviving parent, your surviving spouse receives the first $200,000 plus three quarters of the remainder of the probate assets, and your surviving parent receives the rest.

- A will made prior to your marriage is no longer automatically revoked on the wedding day.

- Existing Massachusetts law that revokes a prior will provision in favor of a former spouse is extended to cover any disposition of property, including nonprobate property, and grant of a power of appointment or fiduciary nomination in favor of your former spouse or a relative of your former spouse.

# To Gift or Not To Gift (continued from page 1)

one or more of the beneficiaries, so distributions can be made to your spouse or partner in the event funds are needed in the future. Including your spouse or partner as a beneficiary in a properly drafted and administered trust will not cause the remaining trust assets to be included in either your taxable estate or that of your partner or spouse. This "safety valve" may give you added comfort, but there are two major problems: first, on the death of your spouse or partner, distributions may only be made to your children or other beneficiaries—you cannot re-acquire the assets; and second, if there is a divorce, the divorced spouse will still be a beneficiary of your trust.

Another solution would be for both you and your spouse or partner to create similar, but not identical, irrevocable trusts for each other in which each of you would be the beneficiary of the trust created by the other. Trusts such as these, carefully constructed and administered with the advice of your estate planning attorney, may provide the comfort needed to make a large gift.

**You can afford the gift and are not concerned about needing the gifted assets in the future, but you are not comfortable giving the assets to your children or other intended beneficiaries outright.**

You may be worried that a large gift will have a negative impact on your children's future ambition, or that your beneficiaries are simply too young or inexperienced to handle a significant gift, or that a gift will disqualify a beneficiary from asset- or income-based government benefits.

Although making outright gifts is an appealing, simple approach, such concerns are not unfounded. Making gifts to an irrevocable trust for the benefit of a beneficiary or a group of beneficiaries allows you to take advantage of the $5,120,000 exemption while protecting your intended beneficiaries.

Despite their perceived complexity, irrevocable trusts provide a uniquely flexible structure. They can be set up and administered to reserve all distribution decisions to the sole discretion of a trustee, effectively substituting the trustee's judgment for the beneficiary's judgment; or to provide funds for a beneficiary while still maintaining his or her government benefits. Within limits, the very existence of such a trust can even be kept quiet until an appropriate time in a beneficiary's life.

Irrevocable trusts can also protect assets from a beneficiary's creditors or, to some extent, in the event of a beneficiary's divorce. These trusts can shelter trust assets from estate taxes on the death of the beneficiary, and often on the death of subsequent generations of beneficiaries. Finally, using irrevocable trusts as gifting vehicles allows you to determine the class of individuals who can benefit from the trust after the death of your primary beneficiaries (such as children and grandchildren rather than spouses of beneficiaries).

| TYPE OF TRANSFER TAX | | 2009 | 2010 | 2011–12* | 2013* |
|---|---|---|---|---|---|
| GIFT TAX | Exemption | $1,000,000 | $1,000,000 | $5,000,000 | $1,000,000 |
| | Top Rate | 45% | 35% | 35% | 55% |
| ESTATE TAX | Exemption | $3,500,000 | $5,000,000 | $5,000,000 | $1,000,000 |
| | Top Rate | 45% | 0% | 35% | 55% |
| GST TAX | Exemption | $3,500,000 | $5,000,000 | $5,000,000 | $1,400,000 |
| | Top Rate | 45% | 0% | 35% | 55% |
| ANNUAL GIFTS (Untaxed) | | $13,000 | $13,000 | $13,000 | $14,000 |

* If not extended or amended by 12/31/2012.

## Some thoughts on special assets.

Certain categories of assets require special handling or specialized appraisals. A non-exhaustive list includes real estate, closely-held business interests, and artwork or collectibles. Appraisals must be done by qualified professional appraisers to determine the gift tax value of the gifted assets. In the case of partial interests or closely-held business interests, determinations must be made of the "discounts" (minority interest discounts, for example) that can be applied to the full underlying value of the property to determine the final value for gift tax purposes. In addition, governing documents for business interests may require the consent of other owners before assets can be transferred, and business structures may need to be altered to allow for complete gifts of such interests. The time needed to obtain appraisals, restructure business entities, and obtain transfer consents must all be considered.

*continued on page 10*

# Executive Corner: December 31 Deadline to Amend Many Executive Agreements

### BACKGROUND

IRC §409A is the 2004 tax statute that was meant to regulate deferred compensation earned by employees and specified independent contractors. There is an important December 31 deadline. Any 409A plan or agreement that requires a service provider to execute a release or other commitment before payment <u>must be amended by December 31, 2012</u>. In addition, <u>the tax return of the "service recipient" which pays the deferred compensation must contain a schedule</u> advising that the amendment has been executed. Without that two-step process, which the IRS considers a correction, there can be serious penalties for the service provider of at least 20% of the amount involved, in addition to regular taxes. The IRS concern is that service providers can time the receipt of deferred compensation, either by signing releases quickly or delaying signature so that the release or commitment is not effective until a later year.

### THE FIX

Determine whether the Plan or agreement is under 409A and whether the service provider can be required to sign a release or other commitment before payment. If so, the required amendment should provide for one of two fixes, each of which prevents the service provider from timing the year of the payment:

The amendment should designate a 60- or 90-day period following the event that triggers the payment (such as termination of employment or change in control). If the designated period overlaps the end of a calendar year, the payment cannot be made until the later year and still must be paid within the designated 60- or 90-day period.

Alternatively, if the designated period overlaps the end of a calendar year, the amendment can provide for payment precisely on the 60th or 90th day. Because no one is always precise, this choice actually permits payment in the 30 days preceding the designated date or at any time after the designated date, but not later than two and a half months after the year of that designated date. To get this extra flexibility, it must be clear that the service recipient makes the decision rather than the service provider.

In either case, the amendment can provide that these special timing rules do not apply if the service recipient decides not to require a signed release, even if permitted to do so under the plan.

### EXECUTIVE TIP:

It's up to the service recipient to take the corrective actions, although written approval of the service provider may also be required for an amendment (if the arrangement is in an employment contract, for example). Because the penalties affect the service provider, it may not be on the radar of many service recipients who pay the deferred compensation. If you are a service provider who thinks your arrangement is covered by this new 409A rule, and if your arrangement has not been amended, do not be bashful. Ask your service recipient if an amendment is necessary, because the December 31, 2012 date is a firm deadline and applies to payment events that precede it. The IRS has also stated that the administrative procedures for this new rule should have been in place for 2011 events where the designated 60- or 90-day period extended into 2012, and the December 31, 2012 amendment should reflect those procedures.

### 409A IS COMPLICATED

Tax lawyers know that 409A is terribly complicated, and the potential penalties are draconian. This new rule is only a small facet of 409A compliance. The problem is that 409A covers many arrangements that ordinary persons would not consider "deferred compensation," and the rules span hundreds of pages. For non-complying plans, there are correction procedures that may reduce or eliminate penalties. DMD

### TYPICAL PLANS UNDER 409A

(not an exhaustive list)

- An involuntary severance arrangement that pays beyond the second year following the termination year
- An involuntary severance arrangement that pays more than $510,000 (indexed) and is not paid within 2½ months following the termination year
- An elective deferred compensation arrangement, regardless of amount and payment schedule, unless "qualified" under 401(k), 403(b), or 457(b)
- Some performance plans that pay bonuses based on multi-year performance, or that provide for payments more than 2½ months after the year in which the right to the bonus is "vested"
- Virtually all SERPs and plans that pay for voluntary separation
- Endorsement split dollar insurance agreements and non-complying "loan regime" agreements
- Options granted at a discount or on preferred stock
- Options, even ISOs, where prices and exercise periods are reset counter to the rules
- Stock appreciation rights providing for extended time to settle
- Some change in control agreements with extended payment terms

# Planning For New Medicare Taxes

Beginning in 2013, the *Patient Protection and Affordable Care Act of 2010* (ACA) imposes new and increased Medicare taxes on higher-income individuals. An additional tax of .9% will be imposed on wages and self-employment income above a certain threshold, and the net investment income of individuals, trusts and estates with total income above a certain threshold will be subject to a new tax imposed at the rate of 3.8%.

## TAX ON EARNED INCOME

The new Federal Medicare tax imposed on earned income applies to an individual's wages and self-employment income that exceed a certain threshold amount. The new rate is nine-tenths of 1% (.9%). The threshold amounts are:

- $250,000—married couples filing jointly/widows
- $125,000—married couples filing separately
- $200,000—other individuals

These threshold amounts will not be adjusted for inflation. Because the applicable threshold amount for married couples is not twice the amount for unmarried individuals, the tax imposes a "marriage penalty" on married taxpayers.

Effective planning by taxpayers now can help minimize the adverse impact of the new Medicare tax imposed on earned income in 2013 and later years. Accelerating wages and self-employment income into 2012 may reduce 2013 wages and self-employment income below the applicable threshold amount, thus eliminating the tax altogether in 2013. For example, if your business usually accrues bonuses in one year and pays them in the next year, consider paying accrued 2012 bonuses in 2012 instead of 2013.

Cash basis sole proprietors and professional organizations that file as partnerships can explore accelerating or decelerating the timing of receipts into 2012 or 2014. The tax accounting rules are complicated, so it is important to consult with your tax advisor before taking such actions.

## TAX ON NET INVESTMENT INCOME

The new Federal Medicare tax imposed on net investment income applies to the net investment income of individuals (other than nonresident aliens, who are exempt), estates and trusts. The tax is 3.8% multiplied by the lower of the:

- net investment income for the year; or
- modified adjusted gross income over the applicable threshold amount for the taxpayer as set forth above.

For taxpayers other than U.S. citizens living abroad who exclude foreign earned income from gross income, *modified* adjusted gross income is equal to adjusted gross income (i.e., the last line on page 1 of Form 1040).

## WHAT IS "NET INVESTMENT INCOME?"

Net investment income includes interest, dividends, capital gains, annuities, royalties and rents that are not derived in the ordinary course of a trade or business, and pass-through income from businesses operated by S-corporations and partnerships, which are passive activities with respect to the recipient. Net investment income also includes all income derived in the course of a business of trading in financial investments and commodities. However, net investment income does not include capital gain from the sale of an interest in an S-corporation or a partnership that is not a passive activity with respect to the seller. Distributions from (1) qualified pension, profit sharing and stock bonus plans; (2) qualified retirement annuities; (3) IRAs; (4) Roth IRAs; and (5) deferred compensation plans of state and local governments and tax-exempt organizations are excluded from net investment income. Nontaxable veteran's benefits and capital gains excluded from the sale of a principal residence are also excepted.

As with the new Medicare tax imposed on earned income, effective planning by taxpayers now can help minimize the adverse impact of the new Medicare tax imposed on net investment income in 2013 and beyond. Taxpayers who recognize net gains from the sale of property in 2012 rather than 2013 can reduce both net investment income subject to tax and the applicable threshold amount that determines whether other net investment income will be subject to the new tax in 2013. Choosing investments that defer recognition of gain until the asset is sold or that do not generate net investment income (e.g., tax-exempt state and municipal bond interest) is an effective strategy. Taxpayers who maximize their excludable 401(k) plan/deductible IRA contributions in 2013 and reduce their adjusted gross income below their applicable threshold amount will avoid the new tax altogether. When it comes time to take required retirement plan distributions, as noted above, the amounts distributed are not treated as net investment income subject to the new tax.

Estates and trusts are subject to the new tax on *undistributed* net investment income to the extent adjusted gross income exceeds $11,950. The new tax applies regardless of whether the income beneficiary would have been subject to the new tax had the trust distributed income to the beneficiary in full. DMD

# 2013 Income Tax Changes
# Tax Rates, Exemptions and Deductions.

Under current law, regular 2013 income tax rates will increase for everyone except businesses taxed as C corporations. The favorable income tax rates applicable to net capital gains and qualified dividends are also going up in 2013. Personal exemptions and itemized deductions will be partially or completely phased out for taxpayers with adjusted gross incomes above certain threshold amounts. And the exemption amount will be reduced for taxpayers who are subject to the alternative minimum tax.

Except for special rates applicable to capital gains and qualified dividends in 2012 and the individual alternative minimum tax, the United States tax code embodies a progressive tax rate structure. As a taxpayer's taxable income increases above certain thresholds, the percentage rate at which the next dollars are taxed also increases. The range of income subject to each particular rate is called a "bracket." For example, a married couple filing a joint 2012 income tax return will be taxed at the rate of 10% on the first $17,000 of taxable income (the "10% bracket"), at the rate of 15% on the next $52,000 of taxable income (the "15% bracket"), and so on through the 25%, 28%, and 33% brackets, until they reach the current top bracket of 35% for taxable income over $379,150.

Under current law, the 10% bracket will be eliminated in 2013, and married taxpayers filing jointly will be taxed at the rate of 15% on the first $60,550 (estimated) of taxable income. With differing threshold amounts for each of the remaining brackets, the 25% bracket will become the 28% bracket, the 28% bracket will become the 31% bracket, the 33% bracket will become the 36% bracket, and the 35% bracket will become the 39.6% bracket.

The favorable income tax rate applicable to net capital gains recognized during 2012 also increases automatically in 2013, from 15% to 20%. And if such gains also are subject to the new 3.8% Medicare tax imposed on net investment income, the 2013 tax rate applicable to such income will be 23.8%.

Qualified dividends (e.g., dividends received from publicly traded companies) will not be taxable at favorable income tax rates in 2013. If such dividends are subject to the new 3.8% Federal Medicare tax imposed on net investment income and the taxpayer reaches the highest income tax bracket of 39.6%, the 2013 tax rate applicable to such income will be 43.4%.

Effective tax rates in 2013 will be even higher if the increase in taxable income that will result from the phase-out of personal exemptions and itemized deductions is considered. The partial and complete loss of these exemptions/deductions is estimated to be the equivalent of an additional 1.2% increase in the applicable tax rate.

All the planning strategies that a taxpayer can employ to accelerate amounts of net investment income and earned income into 2012 and out of 2013 also are effective in managing the tax rates imposed on net capital gains, qualified dividends and other taxable income subject to tax rate increases that will automatically take effect in 2013. Accelerating 2013 income into 2012; deferring 2012 expenses until 2013; deferring 2013 income into later years; accelerating expenses from later years into 2013; and converting investments that pay taxable income annually into life insurance, tax-deferred annuities, investments that defer taxes until disposition, and investments that pay tax-exempt income are all effective strategies.

Unlike income tax rates applicable to individuals, estates and trusts, Federal income tax rates imposed on businesses taxed as C Corporations are not increasing in 2013. One effective strategy to reduce corporate income taxes this year is to lock in 50% bonus first-year depreciation by buying depreciable property and placing it into service in 2012.

*continued on page 11*

## Medical Flexible Spending Account Cap

A medical flexible spending account (FSA) allows an employee to set aside a portion of wages to pay for qualified medical expenses free of Federal income taxes. Beginning in 2013, the amount that can be set aside in a medical FSA is capped at $2,500. Families that rely on such accounts to pay for extraordinary qualified medical expenses with pre-tax dollars will instead be forced to deduct those marginal expenses as an itemized deduction—if they qualify. The threshold for deducting qualified medical expenses as an itemized deduction is scheduled to increase from 7.5% of adjusted gross income in 2012 to 10% of adjusted gross income in 2013. Medical expenses that are not reimbursed through a medical FSA in 2013 must exceed the higher threshold amount before the first dollar will be deductible, and then only if the taxpayer itemizes deductions.

## Same Sex Married Couples Are Advised to File Protective Tax Claims

Two Circuit Courts of Appeal have now held that the Defense of Marriage Act (DOMA) is unconstitutional. DOMA defines "marriage" and "spouse" as limited to one man and one woman and bars federal recognition of all same-sex marriages. This is the grounds for denying all types of federal benefits to spouses of same-sex marriages who live in states such as Massachusetts where same sex marriages are recognized. This issue will very likely be decided by the United States Supreme Court in the next term.

Married same-sex couples may pay thousands of dollars a year in extra income tax because their marriages are not recognized at the federal level. This number can go way up, for example, if a primary residence owned by one spouse is sold, in which case the couple can then only benefit from a $250,000 exclusion from capital gains rather than the $500,000 exclusion enjoyed by heterosexual married couples.

Advisors are now recommending that same sex married couples file a protective claim for refund with the IRS. Filing a protective claim protects a taxpayer's right to claim a refund if DOMA is found to be unconstitutional. Ordinarily, a three-year statute of limitations applies to claims for refunds, but filing a protective claim will extend that period.

# The IRS Increases Limits For 2013

The federal government has released the 2013 CPI adjustments, which affect many tax-favored employee benefits. Key provisions for retirement plan sponsors are in the following chart below, and the full list can be found at, **http://www.irs.gov/uac/2013-Pension-Plan-Limitations**. If you need historical data, the IRS also maintains a helpful table showing yearly adjustments to most limits since 1989, including the 401(k) deferral limit in that year of only $7,627! That table can be found at **www.irs.gov/pub/irs-tege/cola_table.pdf**.

| | 2013 | 2012 |
|---|---|---|
| Social Security taxable wage base | **$113,700** | **$110,100** |
| Defined contribution 415 limit | **$51,000** | **$50,000** |
| Defined benefit 415 limit | **$205,000** | **$200,000** |
| Maximum compensation | **$255,000** | **$250,000** |
| Individual deferral limit 401(k), 403(b), and 457(b) | **$17,500** | **$17,000** |
| Age 50 Catch-up deferral limit 401(k) and 403(b) | **$5,500** [no change] | **$5,500** |
| Highly compensated employee* | **$115,000** (for 2014 plan years that use 2013 as the "look back" year) | **$115,000** (for 2013 plan years that use 2012 as the "look-back" year) |

* A person is deemed to be a "highly compensated employee" based on the compensation for the plan's "look-back" year and the IRS limit in effect at the beginning of the look-back year. Generally, the prior plan year is the look-back year. However, a fiscal year plan may instead use the calendar year ending within the plan year as the look-back year. This technique is called the calendar year data election. (For a calendar year plan, the look-back year is always the preceding calendar year.) Remember that persons who own more than 5% of a business, either in the current plan year or the look-back year, are also highly compensated employees, regardless of compensation. More information about the look-back year data election can be found at www.theworkplace.biz/files/Notice_97_45.pdf. If elected, it must apply to all of an employer's plans.

# GRATS
# A Powerful Planning Tool

Grantor Retained Annuity Trusts, or GRATs for short, have been and continue to be a powerful estate planning tool, regardless of the size of the gift tax exemption. GRATs are particularly effective in the current low-interest-rate environment where most assets (closely held business interests and real estate and investment portfolios, for example) are at historical low values. However, the simplicity of this "gift tax free" technique has been overshadowed by the rush to utilize the individual $5,120,000 gift tax exemption before the end of 2012. Whether used as a complement to a large exemption gift or as an alternative to a large exemption gift, the GRAT may be a useful technique.

A GRAT is gift-tax-free way of removing the investment return or appreciation earned on a particular asset from your taxable estate. As an estate planning technique, GRATs work exceptionally well when using an asset that has the potential to produce a significant return in the near future—real estate or an investment portfolio with a currently depressed value or stock in a closely held company expected to be sold at a premium in the near future.

So, how do they work?

You first transfer assets to an irrevocable trust. The trust then pays you an annual annuity during the term of the trust (typically a two-year term) equal to the value of the assets at the time you transferred them, plus an assumed investment return set by the IRS. Since you are getting back the full value of the asset plus the investment return assumed by the IRS, you have theoretically transferred no value to the trust and therefore the value of the gift to the GRAT is zero. If the assets transferred to the trust appreciate at a greater rate of return than the assumed rate of return set by the IRS, the appreciation passes gift tax free to the beneficiaries named in the trust. It is that simple. In addition, you can serve as the sole trustee of the trust and, for income tax purposes, you are treated as though you continued to own the assets individually.

The success of the GRAT depends on two things. First, you must survive the term of trust; and second, the assets transferred to the trust must appreciate by more than the rate of return set by the IRS. These concerns are minimized by the facts that the trust term is typically short and the current rates of return, like interest rates, are at historical lows. However, even if the GRAT does not succeed, you will have lost nothing more than the costs of setting up and administering the GRAT. Let's look at a concrete example.

If you transfer an asset to a two-year GRAT in November 2012, the IRS would assume a 1% return on the asset over the two-year term. Assuming the value of the transferred asset is $10 million, you will be paid an annual annuity of $5,075,112 for two years, for a total return to you of cash or in-kind assets of $10,150,224. Let's assume that the assets appreciate or earn 10% per year during the same two years. At the end of the GRAT's two-year term, approximately $1,442,266 would pass gift tax free to your beneficiaries, either outright or in further trust for their benefit.

The same transaction with increasing return rates looks like this:

| Rate of Return | Value at End of GRAT Term |
|---|---|
| 15% | $2,313,509.95 |
| 20% | $3,234,754.37 |
| 30% | $5,227,243.20 |

The type of asset used to fund the GRAT, the timeline of its expected appreciation and the current and future expectations regarding interest rates will all impact the design of the trust. In addition, the use of "rolling GRATs," where each annuity payment is subsequently transferred to a new GRAT to continue to capture appreciation, maximizes the value of the technique.

While there may be no need to rush into a GRAT before year-end, a number of congressional proposals in recent years have been designed to reduce the effectiveness of the technique. Concern that one of these proposals may finally be signed into law, along with an ideal GRAT environment (low interest rates and depressed asset values), has many clients seriously considering this technique. DMD

## DID YOU KNOW?

In Cornwall, a law dating back to medieval times dictates that the Prince of Wales inherits the estates of people who die without a will. Over the past six years, Prince Charles has received over 1 million pounds from people who died without a will. Notably, Charles donates all of the money he receives from these estates to charity.

# What's Mine is Yours: The Spousal Elective Share

Massachusetts, like most states, has a statute that permits a surviving spouse (referred to here, for convenience, as the wife) to make an election to give up her inheritance under her husband's will and instead take a "statutory share" of her husband's estate. If the husband had children, the statutory share under current law would be $25,000, plus a life estate in one-third of the husband's personal property (both tangible, such as collections, and intangible, such as a brokerage or bank account), plus a life estate in one-third of the husband's real estate. If the husband had no children, the wife would receive $25,000 plus a life estate in one-half of the real estate and one-half of the personal property. A life estate is the right to use and benefit from the property for life. For example: with a home, it's the right to live in it; with bonds, it's the right to the income generated by the bonds.

The rule applies regardless of the relative values of the estates of the two spouses. For example, if the wife has assets of $10 million and the husband's children stand to inherit only $75,000, the wife can still claim her statutory share—$25,000 plus a life estate in $16,666.

Although the rule is relatively simple to state, it is often very difficult to apply. The first issue is determining what is included in the pot to be divided. Until 1984, the pot was the equivalent of the husband's probate estate. In that year, the Supreme Judicial Court ruled that the pot would also include assets transferred by the husband to a revocable trust during the husband's lifetime. The court ruling left open other questions, such as the treatment of life insurance or retirement benefits, and the court asked the legislature to enact more comprehensive legislation to govern the application of the elective share. To date, the legislature has not acted.

Determining the practical application of the wife owning a life estate in one-third of the real estate can also be tricky. For example, if the husband owned three properties, does that translate to the wife receiving a 100% life estate in one property, the right to live in all three properties for four months per year, or the right to live in one-third of all three properties all year, along with the remainder beneficiaries under the husband's will? Regardless of the interpretation, it will not be possible for the remainder beneficiaries to sell the real estate during the wife's lifetime, and one-third of the liquid assets will have to remain invested for the wife's benefit for her lifetime as well. As said in a well-respected treatise on Massachusetts probate law, "It is in the havoc which it works on the rest of the will that the devastating effects of a waiver become apparent… The testator's scheme of distribution is completely shattered, and the court must work out a solution for putting the scattered parts together as well as it can."

Spouses can waive their rights to claim a statutory share in a prenuptial or postnuptial agreement. If you have no prenuptial or postnuptial agreement and have decided to leave your estates to others (children from a first marriage, for example), it is important to memorialize that agreement in a binding written contract. Otherwise, you should always keep in mind the possibility of a waiver and make sure that your will or trust is satisfactory to your spouse.

The Massachusetts, Boston, and Women's Bar Associations have agreed on proposed legislation to submit to the legislature which, if passed, would completely revamp the spousal share. The overall effect of the new legislation would be to treat the couple as if they were divorcing. The length of the marriage will be taken into consideration, along with the combined assets of both parties and gifts made to others in the two-year period before the first spouse dies. The legislation also includes a roadmap to determine the source of the funds to be used to satisfy the spousal share. Stay tuned for possible developments in this area. DMD

# To Gift or Not To Gift (continued from page 4)

In certain cases, obtaining final appraisals in time to make gifts by year-end may be difficult or impossible. Tools are available to determine the current value of these gifts for gift tax purposes in order to complete the appraisal in the early months of 2013. These "tools," however, are complex and should not be used as a reason to delay. They do, however, provide additional options as we head to the end of the year.

## Final Thoughts.

There is precious little time left to take advantage of the current $5,120,000 gift tax exemption. Taking a systematic approach to the question of whether "to gift or not to gift," along with the help of your estate planning team, will help you find the right answer for you and your family. DMD

# Take My Exemption, Please. Portability Under The New Estate Tax Law

When the $5 million exemption from Federal estate tax was implemented in 2010, a new and revolutionary concept was included in the legislation—"portability." A surviving spouse can now benefit from the unused estate tax exemption of his or her last deceased spouse. This means that if the first spouse to die makes no lifetime gifts, the surviving spouse's estate will have, under current law, a $10,240,000 (indexed for inflation) exemption from estate tax.

Let's assume a husband predeceases his wife. Prior to 2010, the husband's estate tax exemption was lost if the couple owned most of their property jointly, or if the wife received property through a beneficiary designation (such as life insurance or retirement accounts). In the past, we always advised our clients to separate their assets rather than owning them jointly, and we carefully reviewed beneficiary designations for life insurance or IRAs to ensure, to the extent possible, the efficient use of the deceased spouse's estate tax exemption.

When the majority of the couple's assets were retirement assets, the planning became very complicated. Without portability, the only way to take full advantage of the husband's exemption was to name his estate planning trust as beneficiary of his retirement plans (specifically, the share of his trust that receives his tax-exempt assets). This definitely saved estate taxes for the family unit by keeping the retirement plans out of the wife's estate, but caused a significant loss of income tax benefits. There was no spousal rollover for retirement benefits left to a trust and no stretch payout over the children's life expectancy, even after the wife's later death. Instead, the entire IRA was transferred to the deceased husband's trust over the single life expectancy of the wife, often a relatively short period of time.

Clients in that situation had to make a hard choice: to opt for the income tax benefits of the spousal rollover by leaving the entire IRA outright to the surviving spouse, or to save estate taxes by leaving the benefits to a trust but give up the long-term deferral that would otherwise be available via the spousal rollover.

Now, with portability, the husband can leave his IRA outright to his wife, and his executor can *also* elect to transfer the husband's $5,120,000 estate tax exemption to the wife. The wife can now receive the income tax benefits *without* having to waste her husband's estate tax exemption.

BUT, BEFORE YOU GET TOO EXCITED, there are two issues to be aware of. First, portability will expire on December 31, 2012, unless it is extended by Congress. Most commentators now believe that Congress will not enact permanent fixes to the estate tax laws before the end of the year (including the amount of the exemption, which will plummet to $1 million on January 1 if no action is taken), but there is a reasonable chance that a fix will be put in place sometime in 2013 and be made retroactive. Second, the benefits of portability are lost if the wife remarries and her second husband also predeceases her. In that case, the exemption left to her by her first husband will be lost. Although we cannot plan around that contingency, if portability is ultimately extended by Congress, it will be important for you to revisit beneficiary designations on your retirement accounts to see if a change is called for to ensure your planning is as tax-efficient as possible. DMD

# 2013 Income Tax Changes (continued from page 7)

The bonus deduction is determined without proration based on the length of the tax year and is available even if the taxpayer operates the qualified property for only a few days during 2012. It applies to all qualified property unless the taxpayer elects out. The election out may be made for any class of property for any tax year.

If your company is deciding whether to make a substantial purchase of qualifying property, consider whether to make the purchase in 2012 or 2013. For businesses that file as a partnership, S corporation or sole proprietorship, it may be beneficial to defer acquiring qualified property until 2013 to maximize the available deduction in subsequent tax years when tax rates are expected to be higher. In contrast, businesses that file as C corporations will not be subject to higher tax rates in 2013, and should consider whether an enhanced depreciation allowance in 2012 will produce a favorable tax result. DMD

## TRUSTS AND ESTATES AT DAVIS MALM

The trusts and estates attorneys at Davis Malm counsel individuals on legacy planning, wealth management, family business succession, and achieving philanthropic goals. Our estate planning and probate practice handles estates of all sizes and complexity, and we are sensitive to personal needs and family relationships. Estate planning is part of a broader practice that includes income tax planning, planning for disabled persons, administration of trusts and estates, and planning associated with executive compensation and benefits. If you would like to discuss any of these topics or any other tax or planning strategies in more detail, please contact one of our Trusts and Estates attorneys.

**Marjorie Suisman**
617.589.3836
msuisman@davismalm.com

**Brian L. Gaudet**
617.589.3850
bgaudet@davismalm.com

**John T. Lynch**
617.589.3852
jlynch@davismalm.com

**Donna M. White**
617.589.3812
dwhite@davismalm.com

**George L. Chimento**
617.589.3847
gchimento@davismalm.com

**Laura A. D'Anca**
617.589.3811
ldanca@davismalm.com

DAVIS MALM & D'AGOSTINE P.C.
ATTORNEYS AT LAW

ONE BOSTON PLACE • BOSTON • 617.367.2500 • www.davismalm.com

© 2012 Davis, Malm & D'Agostine, P.C. This publication may constitute advertising under the Rules of the Supreme Judicial Court. It should not be considered as a substitute for legal advice on particular fact situations.
IRS Circular 230 Notice: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. Taxpayers should seek professional advice based on their particular circumstances.