

Repeal of Indiana Inheritance Taxes and Other Changes in Tax Laws Requires Review of Existing Estate Plans

STATE DEATH TAXES

State death taxes need to be considered as a part of every estate planning process. The trend among states has been to reduce or eliminate state death taxes, presumably to attract people to move to, or stay in, those states. Effective January 1, 2013, Indiana joined the list of states repealing all state death taxes. Florida and many so-called "sunshine" states have historically been known for having no state death taxes. Some other states, including Illinois, retain a state death tax which may or may not be directly tied to the Federal tax system.

Clients considering a change in residence (domicile) should also consider other taxes and non-tax considerations in changing their domicile. The most common other taxes to be considered are property and income taxes. We can assist clients in evaluating their options and often work with their other advisors to determine what is best for them.

A frequently overlooked aspect of state death taxes is that the location of the person's property determines the state death taxes that apply to that property. We can assist you in planning to reduce or avoid state death taxes in states outside of your current domicile.

FEDERAL TRANSFER TAXES

On January 2, 2013, the American Taxpayer Relief Act of 2012 (the "2012 Tax Act") was enacted. For 2013 and later, it increased gift, estate and generation-skipping tax "GST" exemptions to \$5,250,000 per person with annual inflation adjustments. Also, for 2013 and later, it increased maximum gift, estate and GST tax rates to 40%. These "permanent" changes in the Federal transfer tax laws will have a significant effect on most estate plans requiring at least a review of existing plans.

Many estate plans include "formula clauses" which have distribution provisions tied to estate and GST exemption amounts. The \$5,250,000 (inflation adjusted) estate and GST exemptions were unexpected. This may lead to unexpected and undesirable shifts in distribution of property among spouses, children and grandchildren. All estate formula clauses should be reviewed. The same applies for GST formula clauses.

One particular aspect of the new Federal tax law applicable to married couples is the concept of Portability. The 2010 Tax Act added the term Deceased Spouse Unused Exemption Amount ("DSUEA"). This added the concept of "Portability" to the gift and estate tax exemption of spouses. The 2012 Act made Portability permanent. For both spouses dying in 2011 and later, a spouse MAY leave his/her unused gift and estate tax exemption to his/her surviving spouse. To qualify for Portability, the first spouse's estate MUST timely file a Federal Estate Tax Return Form 706. In some cases, relief from the timely filing requirement may be available by applying to the IRS National Office. The DSUEA estate tax exemption is limited to only one SPOUSE and only from the MOST RECENT deceased spouse, but unlimited for DSUEA gift tax exemptions.

ADVANTAGES TO PORTABILITY

1. Simplicity. In first marriages can leave all to surviving spouse and still receive double estate tax exemption.
2. Avoids Credit Shelter Trust at first estate and related expenses. Size of estate and mortality risk to be considered.
3. Full step-up in income tax basis at second estate.
4. Still may use Marital Trust in first estate and elect QTIP.
5. May avoid higher income trust taxes to Credit Shelter Trust.
6. May avoid elective share issues to surviving spouse.
7. Surviving spouse at time of first estate may be able to disclaim property.
8. With proper planning, "disclaimer trust" may be in place to facilitate disclaimer, but surviving spouse could not hold any power to redirect trust property.

DISADVANTAGES TO PORTABILITY

1. Problems if subsequent spouses.
2. Loss of removing appreciation from death taxes on amount which could have been in Credit Shelter Trust due to no inflation adjustment for intervening increases in exemption amount.
3. Loss of first spouse's GST exemption.
4. Loss of creditor protection on amount not left in Trust.
5. Particularly if a "blended" family, executor may refuse to file election unless required by Will or prenuptial agreement.
6. Cost of preparing and who will pay for Estate Tax Return in first estate.
7. Extended statute of limitations on valuing first estate.
8. Relying upon Portability assumes Congress does not repeal it.

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