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FORETHOUGHT

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Life After the Estate and Gift Tax Fiscal Cliff: The American Taxpayer Relief Act of 2012

As many of you are aware, the federal estate and gift taxes have been in flux since 2001. On June 7, 2001, President George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") into law. Among other significant changes to the Internal Revenue Code, EGTRRA brought with it sweeping changes to the federal estate and gift taxes, most notably, increased estate and gift tax exemption amounts (and an all out repeal of the estate tax for the year 2010) coupled with reduced estate and gift tax rates. However, that legislation was scheduled to sunset on December 31, 2010, at which time we were to revert to the pre-EGTRRA estate and gift tax scheme. The pre-EGTRRA estate and gift tax scheme would have meant a $1,000,000 unified estate and gift tax exemption amount and a flat 55% rate of tax. Just before the return of the pre-EGTRRA estate and gift tax scheme, on December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act") into law. The 2010 Tax Act was essentially a two year "band-aid" on EGTRRA. The 2010 Tax Act increased the federal estate tax exemption amount to $5,000,000 (up from $3,500,000 in 2009) and likewise increased the federal gift tax exemption amount to $5,000,000 (up from $1,000,000). It also stabilized the estate tax rate at 35% and, for the first time, added the concept of "portability" to the estate tax world. "Portability" allowed a surviving spouse to take advantage of a deceased spouse's estate tax exemption amount merely by making an election on the deceased spouse's federal estate tax return; no sophisticated estate tax planning was required. The 2010 Tax Act was scheduled to sunset on December 31, 2012, and with its expiration, we were to have fallen off the proverbial "fiscal cliff".

In the early morning hours of January 1, 2013, the Senate passed the American Taxpayer Relief Act of 2012 (the "2012 Act"). The House of Representatives passed it later that day and President Obama signed it into law on January 2, 2013. The most significant income tax provisions contained in the 2012 Act include: (1) the permanent adoption of the lower EGTRRA income tax rates for joint filers whose income does not exceed a $450,000 threshold; single filers whose income does not exceed a $400,000 threshold; and married taxpayers filing separately whose income does not exceed a $225,000 threshold, (2) the increase of the top capital gains and dividend tax rates for wealthy taxpayers to 20% (up from 15%), and (3) the reinstatement of the personal exemption and itemized deduction phase-out for married couples earning more than $300,000 and individuals earning more than $250,000.

Most relevant to our world are the permanent changes made to the federal estate and gift taxes. The 2012 Act provides for a $5,240,000 estate and gift tax exemption (indexed for inflation, up from $5,120,000 in 2012). The 2012 Act also increased the top estate and gift tax rates from 35% to 40%. Additionally, the 2012 Act makes permanent the portability provisions (discussed previously), which were first introduced in the 2010 Tax Act.

So: What Does This Mean To Your Estate Plan?

For many of our clients, those with estates that do not exceed $5,240,000, you still need not worry about the federal estate tax. However, for our New Jersey clients who have estates that exceed $675,000, you need not forget that the New Jersey estate tax is still imposed on all estates which exceed a $675,000 exemption amount and, therefore, tax planning remains a critical component of your estate plan. For our Pennsylvania clients with estates that do not exceed $5,240,000 (or, $10,480,000 for married

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New Jersey and the Forgotten Death Taxes

Two things are certain in life for New Jersey residents: Death and Taxes. When a New Jersey resident passes away, their estate will owe the greater of one of two taxes, the New Jersey Inheritance Tax or the New Jersey Estate Tax. The New Jersey Inheritance Tax is imposed based upon the relationship which the decedent had with the beneficiary (e.g., spouse, parent, child, cousin, etc.). The New Jersey Estate Tax is imposed based upon the size of the estate.

The New Jersey Inheritance Tax is imposed as follows: (1) transfers to a parent, grandparent, descendant, spouse, civil union partner, or domestic partner (each known as a Class "A" Beneficiary) are exempt; (2) transfers to a sibling, a son-in-law, or a daughter-in-law (known as a Class "C" Beneficiary) are taxed at rates of 11% to 16%, with the first $25,000 exempt; (3) transfers to any one else are taxed at rates of 15% to 16% (known as a Class "D" Beneficiary); and (4) charitable bequests are exempt.

Although the New Jersey Estate Tax has been around since 2001, many residents remain unfamiliar with it, or don't know it exists at all. Essentially, the New Jersey estate tax is imposed upon all estates that exceed $675,000. In calculating the size of someone's "estate", it is important to remember that all of their assets, including qualified retirement accounts and life insurance policies, count. The rate of tax imposed varies depending upon the size of your estate. For example, the New Jersey estate tax due on a $1 million estate is approximately $33,200; the New Jersey estate tax due on a $3 million estate is approximately $182,000.

One way to help reduce these taxes is to gift assets during your lifetime. As discussed elsewhere in this newsletter, currently the federal gift tax exemption amount is $5,240,000. In addition, you are free to gift up to $14,000 to an unlimited number of individuals on a calendar year basis.

For New Jersey Estate Tax purposes, New Jersey pulls back and includes all prior gifts, whenever made, in a resident's estate. However, prior gifts are taxed at a lower rate. In addition, all appreciation earned on the gifted assets after the date of the gift is excluded from the decedent's estate for New Jersey Estate Tax purposes. For example, an individual with a $1 million estate, who gifts $325,000 during lifetime, will owe $17,000 in New Jersey estate taxes upon their death. Compare that to the $33,200 that same individual would have owed had they died without having made any gifts. Likewise, the individual with $3 million who gifs $1.5 million can reduce their New Jersey estate tax from approximately $182,000 to $64,400.

> ...there is a tremendous potential New Jersey death tax savings to be had by making gifts during your life. The question for you is how to accomplish these gifts.

For New Jersey Inheritance Tax purposes, New Jersey pulls back and includes prior gifts made within 3 years of death. This is consistent with the Federal Estate Tax scheme, which also includes gifts made within 3 years of death. By gifting assets during lifetime and surviving the following 3 years, the entire amount of the gift is excluded from the decedent's estate for New Jersey Inheritance Tax purposes. For example, an individual with a $1 million estate who is leaving his/her entire estate to Class "D" beneficiaries (e.g., nieces, nephews, friends, etc.) would owe a New Jersey Inheritance Tax in the amount of $150,000. However, if that same individual gifts $500,000 to such beneficiaries during his/her lifetime and survives the following 3 years, his/her estate will be reduced, for New Jersey Inheritance Tax purposes, to only $500,000. The New Jersey Inheritance Tax due at their death will be reduced to $75,000 (down from $150,000). This individual will ultimately owe only the $75,000 New Jersey Inheritance Tax and not any New Jersey Estate Tax. Remember, in New Jersey, you are required to pay only the greater of these two taxes. The New Jersey Estate Tax due on this estate (a $500,000 taxable estate with a $500,000 prior gift) will amount to only $10,000, which is less than the $75,000 New Jersey Inheritance Tax.

As illustrated above, there is a tremendous potential New Jersey death tax savings to be had by making gifts during your life. The question for you is how to accomplish these gifts. Many individuals consider making outright gifts to their adult children. However, most of us would prefer to have our assets benefit our grandchildren in the event a child of ours passes away. Likewise, most of us would prefer to not have the assets which we gift to our children either misappropriated or mismanaged, or otherwise lost to children's creditors (including in the event of a divorce). However, by establishing an irrevocable trust during your lifetime for the benefit of your children (or other beneficiaries) is an excellent way to transfer assets out of your estate for death tax purposes, provide for your children (or other beneficiaries), while also protecting the assets for your beneficiaries and, when appropriate, insuring that the assets remain in your bloodlines.

If you are interested in discussing how an irrevocable trust could benefit your estate plan, and reduce your New Jersey death tax exposure, please call the office to discuss the same.

Transfers to Children: How To Keep Your Assets in Your Bloodlines

Most parents want to leave their assets to their children and, ultimately, to their grandchildren. They want to keep the assets in their bloodlines. However, if assets are either gifted to a child during lifetime or transferred to a child upon death, there is no guarantee that the assets will ultimately get to the grandchildren, nor is there any guarantee that the assets will be protected for the child.

If a child survives you and you have left that child his or her share of your estate, outright, then your Will no longer controls such assets. Once the child receives his or her share, then the child's Will controls where the inherited assets will pass upon the child's death. Typically, a child's Will leaves his or her assets to the child's spouse if the child is married. This may be inconsistent with your estate planning objectives if you want the assets you leave to your child to pass to your grandchildren, rather than a daughter-in-law or son-in-law. Likewise, if you gift assets to a child during your lifetime, you no longer control such assets. Upon the child's death (whether or not he/she survives you), the assets will pass to the beneficiaries named in the child's Will and, typically, be distributed to the child's spouse if he/she is married.

Again, if you leave assets to a child at your death, or if you gift assets to a child during your lifetime, you no longer control such assets. Accordingly, if that beneficiary child has creditor issues, or if that child gets divorced, the assets which the child received from you are at risk.

Perhaps the most efficient way to guarantee that the assets you leave your children will ultimately pass to your grandchildren—and, therefore, stay in your—bloodlines, is to bequeath/gift your assets to your children, in trust for the child's lifetime. Such a Trust can be established irrespective of the ages of your children, and can be established either during your lifetime or upon your death. Parents often establish trusts for minor children, but think that they would be insulting

their adult children by leaving assets to such children in trust. However, with a Family Protection Trust, the parent can place assets in a trust for the child's benefit (either during lifetime or upon death) and designate the child as Trustee of the trust. That way, the child can have direct access to the Trust income and principal (subject to certain limitations). The Trust can also specify that, upon your child's death, any assets that remain in the Trust will pass to their children (i.e., your grandchildren). Also, by leaving assets to your children in trust, rather than outright, you can better protect their inheritance from creditors they may have now or in the future. Finally, by leaving assets to your children in trust, rather than outright, you can potentially protect the assets passing to your children in the event a child of yours gets divorced at some future point in time.

Lastly, when your child passes away, any assets then remaining in the trust will generally not be included in the child's estate for death tax purposes. If a child receives assets from you, outright, then such assets will increase the size of the child's estate and could result in an increased estate tax bill upon the child's death.

If you are concerned about preserving your assets for your children and grandchildren, a Family Protection Trust (established and funded either during your lifetime or upon your death) is a terrific option. If you are interested in learning more about Family Protection Trusts, please contact our office to schedule an appointment.

Life Requires Planning...

For those of you who have visited our website, www.fendrickmorganlaw.com, you have seen us use the term: "Life Requires Planning." We say it, and we believe it. Clients come to see us most frequently as their lives evolve: marriage, children, grandchildren, retirement, incapacity, death. Whether the life event is welcomed or feared is not relevant; clients seek advice and the legal tools needed to navigate the way. The clients for whom we can provide the greatest benefit are those clients that plan, rather those clients who come to see us before crisis hits.

Most of us would rather put our heads in the sand and ignore both the possibility that we may, one day, require long term care and the inevitability of death. Life planning is a chore that seemingly can be—and often is—postponed until later. We would rather devote our time, money and attention to living life rather than planning for it. But experience tells us that the failure to plan creates crises for our loved ones that might have been avoided had we planned.

The most familiar client comment we hear in an elder law crisis conference (as opposed to planning) is "We should have done this years ago". The problem with waiting until a crisis occurs is that it's often too late. If no planning has been done, the questions erupt. Who is in charge? How do they get legal authority to act? How will medical services, nursing homes be paid for? How do you take care of an elderly parent who remains at home? The family scrambles to understand and to protect the patient's health and finances. Everything is more complicated than they dreamed. Often there is needless expense and frustrating delay. Family relations may be harmed and feelings sometimes hurt. The options for care may be limited and disappointing.

Once you prepare for these life events, you can put the nagging worry away. You can't see into the future, but you can prepare for it. This old adage holds true in estate and elder planning: "Prepare for

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the worst and hope for the best". Do you buy insurance for your house? Of course. What is the chance that your house will burn down compared to the chance you will need long term care in your home or in a facility in later years? Nursing home costs average between $9,000 and $12,000 a month, and can easily wipe out life savings. We encourage clients to purchase long term care insurance. But for those who don't have that option, there are other options that must be addressed early on.

Planning is especially important for women. The statistics show that women are more likely to become caregivers for a parent or spouse and, therefore, women are more likely to realize the drains on energy, work, finances, and time. What is worse, a woman is more likely not to have a spouse to take care of her when she needs it.

Whatever your circumstances, you need these documents at a minimum: Will, Financial Power of Attorney, Health Care Power of Attorney and a HIPAA Release. You may need others, such as a revocable living trust, life insurance trust, caregiver agreements, promissory notes, deeds and so on. But the value is not in the documents so much as in the strategy: the plan. The documents allow the strategy to be implemented. If you go to the internet and download "forms", you may have documents but you don't have a plan, or more accurately you have someone else's plan. This is intensely personal planning, and for the present at least, is much better done by a knowledgeable and experienced human who sits across the table from you than by a computer program.

Our clients are less than thrilled with the dreaded "legalese" and the sheer volume of their documents. We wish we could simplify them. We would all be happier. But simpler is not always better. The best we can hope for is that your planning turns out to be more than you need. It is a very good thing if you don't need to trigger the planning you've done for nursing home confinement or dementia. Do you consider your hazard insurance a waste of money if your house doesn't burn down? If you do need it, this planning can preserve your life savings, your family's harmony and your house as well. Ask someone who has gone through a health care crisis with elderly parents after having done this type of planning and ask them how valuable it can be. Life requires planning…

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couples), your estate planning documents may be unnecessarily complex in light of the revisions to the estate tax and the permanent adoption of the portability provisions. You should consider revisiting your estate planning documents and simplifying them, as appropriate.

If you have specific questions regarding your current estate plan, or if you believe, based upon the above, that a change to your estate plan may be appropriate, please call our office to schedule an appointment to discuss the same.

Does your group need a guest speaker?

We are available to speak to your professional, civic, religious or special interest group on various topics (Estate Planning, Elder Law, IRA Planning, Special Needs Trusts, Disability Planning.) Give our office a call at **(856) 489-8388** to arrange a date and time or visit our website at www.fendrickmorganlaw.com.

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Staffordshire Professional Center
1307 White Horse Rd. • Bldg. B • Suite 200 • Voorhees, NJ 08043
ph: (856) 489-8388 • fax: (856) 489-8424
www.fendrickmorganlaw.com