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OCTOBER 2012 NEWSLETTER

TRANSFER TAX (ESTATE, GIFT, GENERATION SKIPPING TAX - GST) EXEMPTIONS ARE SCHEDULED FOR RADICAL REDUCTION AS OF JANUARY 1, 2013; INCOME TAXES ARE SCHEDULED FOR SUBSTANTIAL INCREASES AS OF JANUARY 1, 2013.

If Congress does nothing before the end of 2012, Transfer Tax Exemptions will decrease and transfer tax rates will increase very substantially,

	2012 Exemption	Tax Rate	Scheduled 2013 Exemption	Tax Rate
Gift tax	\$5,120,000	35%	\$1,000,000	55%
Estate tax	\$5,120,000	35%	\$1,000,000	55%
GST Tax	\$5,120,000	35%	\$1,400,000*	55%

*(Approximate; this figure is adjusted for inflation.)

Obviously this would be a radical change/tax increase. Having provided this warning, it is only fair to observe that what President Obama has proposed (see below), and Congressional Democrats support, is the following:

	<u>2013</u>	<u>Tax Rate</u>
Lifetime Exemptions for Gift Tax & GST Tax	\$1,000,000*	45%
Death Exemptions for Estate Tax & GST Tax	\$3,500,000	45%

* (The proposal is unclear; some believe he would retain the unified estate and gift tax exemptions at \$3,500,000)

On the one hand, one can say that the shrinkage of the estate tax exemption to \$1 million and the expansion of the transfer tax rate to 55%, as the law is automatically scheduled to adjust, seems very unlikely, because there are no elected politicians who support that. President Obama's proposal, to put it into context, is a return to the transfer tax system of 2008-2009, which President Bush and the Republican Congress put in place.

On the other hand, preventing these onerous scheduled changes will require cooperation between Democrats and Republicans in Congress, something that has been in short supply for four years. Broadly speaking, we can probably reasonably anticipate that to the extent that Republicans prevail in November's election as to the Presidency, House and Senate, the present generous exemptions and low tax rate are more likely to be retained. In fact, Governor Romney has promised to completely repeal the transfer tax system. To the extent that Democrats prevail, the Obama proposal of more moderate cutbacks in the exemption and tax rate increases are likely to prevail. If the White House and Senate remain Democratic and the House stays Republican, a tax deal may be reached in the "lame duck" Congressional session after the election, before January 1. If the election produces material changes in the current political status quo, a resolution of tax uncertainty will have to await 2013.

Bottom Line: There is a good chance that the current \$5,120,000 lifetime gift tax exemption will be substantially curtailed.

Planning Point: High net worth clients with children/grandchildren should seriously consider gifts to descendants between \$1 million and \$5.12 million before the end of 2012.

INCOME TAX INCREASES COMING IN 2013?

Now that the Supreme Court has upheld the Affordable Care Act, we have more clarity as to what income tax rates are presently scheduled for 2013. Below is a summary of the rate changes scheduled from 2012 to 2013 if Congress permits the "Bush tax cuts" from 2001 and 2003 to expire at the end of 2012. We have separately discussed below the new Medicare Contribution Tax under the Affordable Care Act which is a new additional tax on higher income individuals and those with significant investment income. Combined with the automatic transfer tax changes discussed above, this is the so-called "Fiscal Cliff" the press and news media have discussed so thoroughly. The Republicans would prefer to extend the Bush tax cuts another year and tackle radical reform/simplification of the income tax laws in 2013. Of course they would also like to repeal the Affordable Care Act.

Individual Income Tax Rates

In 2009, the last year for which statistics are available, average tax rates were at historic lows. That is apparently about to change. If Congress allows the Bush tax cuts to expire on

December 31, 2012, ordinary income tax rates will increase for most individual taxpayers. The following table sets forth the scheduled rate increases on ordinary income, using 2012 dollar amounts, which will be adjusted for inflation for 2013.

Tax Brackets (2012 Dollar Amounts)				Marginal	
Single Filers		Married Joint Filers		Rate	
Over	But Not Over	Over	But Not Over	2012	2013
\$0	\$8,700	\$0	\$17,400	10%	15%
8,700	35,350	17,400	70,700	15%	15%
35,350	85,650	70,700	142,700	25%	28%
85,650	178,650	142,700	217,450	28%	31%
178,650	388,350	217,450	388,350	33%	36%
388,350	...	388,350	...	35%	39.60%

Long-Term Capital Gain Rates

The maximum rate on long-term capital gain is scheduled to automatically increase from 15 to 20 percent in 2013. Individual taxpayers in the 10 and 15 percent ordinary income tax brackets currently pay no tax on long-term capital gain, but are scheduled to be subject to a 10 percent long-term capital gain rate in 2013. Please note, an 18 percent maximum rate will apply to capital assets purchased after 2000 and held for more than five years. Additionally, the 3.8 percent Medicare contribution tax discussed below will increase the effective rate of tax on long-term capital gains for certain higher-income taxpayers to as high as 23.8 percent. The following table sets forth the scheduled rate increases.

Maximum Rates	2012	2013	2013 (Including Medicare contribution tax)
Long-Term Capital Gain	15%	20%	23.8%
Qualified 5-Year Capital Gain	15%	18%	21.8%

Dividend Income Rates

The Bush tax cuts created the concept of “qualified dividend income,” which currently allows dividends received from domestic corporations and certain foreign corporations to be taxed at the taxpayer’s long-term capital gain rate. Prior to this, all dividend income was taxed as ordinary income. If Congress fails to extend these provisions, the qualified dividend income provisions will expire, and all dividends will once again be taxed as ordinary income. Most notably, taxpayers in the highest marginal income tax bracket who currently enjoy the 15 percent rate on qualified dividend income will be taxed at 39.6 percent for dividends received from the same issuer in 2013. Further, the 3.8 percent Medicare contribution tax discussed below will increase the effective rate of tax on dividend income for certain higher-income taxpayers to as high as 43.40 percent. The following table sets forth the scheduled rate increases.

Maximum Rates	2012	2013	2013 (including Medicare contribution tax)
Qualified Dividend Income	15%	39.6%	43.4%
Ordinary Dividend Income	35%	39.6%	43.4%

New Medicare Contribution Tax

The Supreme Court has upheld “Obamacare.” In the majority opinion chief Justice Robert wrote “The federal government does have the power to impose a tax on those without health insurance.”

A new 3.8 percent Medicare contribution tax on certain unearned income of individuals, trusts, and estates is scheduled to take effect in 2013. This provision, which was enacted as part of the Affordable Care Act, is scheduled to take effect regardless of whether Congress extends the tax cuts. For individuals, the 3.8 percent tax will be imposed on the lesser of the individual’s net investment income or the amount by which the individual’s modified adjusted gross income (AGI) exceeds certain thresholds (\$250,000 for married individuals filing jointly or \$200,000 for unmarried individuals). For purpose of this tax, investment income includes interest, dividends, income from trades or businesses that are passive activities or that trade in financial instruments and commodities, and net gains from the disposition of property held in a trade or business that is a passive activity or that trades in financial instruments and commodities. Investment income excludes distributions from qualified retirement plans and excludes any items that are taken into account for self-employment tax purposes.

Reduction in Itemized Deductions

Currently itemized deductions are not subject to any overall limitation. If the tax cuts expire, an overall limitation on itemized deductions for higher-income taxpayers will once again apply. Most itemized deductions, except deductions for medical and dental expenses, investment interest, and casualty and theft losses, will be reduced by the lesser of 3 percent of AGI above an inflation-adjusted threshold or 80 percent of the amount of itemized deductions otherwise allowable. The inflation-adjusted threshold is projected to be approximately \$174,450 in 2013 for all taxpayers except those married filing separately.

Other Changes

- The employee portion of the hospital insurance payroll tax (Medicare) will increase by 0.9 percent (from 1.45 percent to 2.35 percent) on wages over \$250,000 for married taxpayers filing jointly and \$200,000 for other taxpayers. The employer's portion of this tax remains 1.45 percent for all wages. This provision, which was enacted as part of the Affordable Care Act, is scheduled to take effect in 2013.
- A higher-income taxpayer's personal exemptions (currently \$3,800 per exemption) will be phased out when AGI exceeds an inflation-indexed threshold. The inflation-adjusted threshold is projected to be \$261,650 for married taxpayers filing jointly and \$174,450 for unmarried taxpayers.
- Also part of the Affordable Care Act, the threshold for claiming the itemized medical and dental expense deduction is scheduled to increase from 7.5 to 10 percent of AGI. The 7.5 percent threshold will continue to apply through 2016 for taxpayers (or spouses) who are 65 and older.
- The standard deduction for married taxpayers filing jointly will decrease to 167% (rather than the current 200%) of the standard deduction for unmarried taxpayers (currently \$5,950). In 2012 dollars, this would lower the standard deduction for joint filers from \$11,900 to \$9,900.

In 2014

Everyone must have health insurance or pay a tax - \$95 or 1% of income, whichever is higher.

Businesses with more than 50 full time employees must provide health insurance coverage to all employees. The rules here are very intricate.

State-sponsored health insurance exchanges become available. Adults with pre-existing conditions cannot be denied coverage or have their insurance canceled because of pre-existing conditions.

In 2015

If you do not have health insurance, the tax rises to the greater of \$325 or 2% of income.

OBAMA ADMINISTRATION'S 2012 PROPOSALS TO CHANGE ESTATE AND GIFT TAX

The Obama Administration's February 2012 proposed budget contained the following proposals for calendar year 2013:

1. Return the estate and generation-skipping transfer ("GST") tax exemptions to \$3.5 million, the level of those exemptions in 2009.
2. Return the gift tax exemption to \$1 million, again the 2009 amount. (Some commentators do not read the proposal this way and believe the proposal would retain the unification of gift and estate tax exemptions at \$3.5 million.)
3. Return the tax rate on estates, gifts and generation-skipping transfers to 45%, the 2009 rate.
4. Make permanent the "portability" of any unused estate tax or gift tax exemption of a predeceased spouse to the surviving spouse.
5. Curbing the use of minority valuation discounts (for lack of control, lack of marketability), for instance on transfers of family LLC and Partnership interests. (Discounts of 30% or more are common today.) The change is proposed to be retroactive if the statute of limitations has not closed.
6. Requiring a minimum GRAT term of 10 years (2 year term is typical today).
7. Imposing a maximum period of 90 years on GST trusts, thereby restricting the permanent transfer tax exemption available today in perpetual "dynasty" trusts.
8. Including in the estate of a grantor all trusts established by the grantor which are "defective" grantor trusts for income tax purposes. The proposal would subject to gift tax any distributions from a grantor trust to other persons during the grantor's lifetime, and subject to gift tax all remaining assets in a trust that ceases to be a grantor trust during the grantor's life.

There is no way to predict which if any of these proposals may become law in 2013 or thereafter, but the incentives to take advantage of present law in 2012 are clear.

ESTATE TAX PLANNING OPPORTUNITIES IN 2012 BEFORE THE TAX LAW CHANGES

Gifts: The Basics:

The gift tax exemption in 2012 is \$5,120,000. In 2013 it may be reduced to \$1 million or \$3.5 million. So very wealthy clients should consider gifts of \$1 million up to \$5,120,000 before the end of 2012. While no one knows exactly what will happen if the exemptions are reduced in 2013 to a number smaller than what has been given away through 2012, there is a broad

consensus that the worst case scenario is that the surplus gifts may, in effect, be added back to the estate of the donor at death. This essentially means that there is no material downside to 2012 gifts up to a cumulative lifetime total of \$5.12 million, and many observers expect a congressional or Treasury "fix" so that there would not even be a claw-back at death. And even with a claw-back at death, and this is the key planning reason to make large gifts, post-gift appreciation of the donated assets would be excluded from the donor's taxable estate.

Special Types of Gifts:

Lifetime Credit Shelter (Spousal Lifetime Access Trust – SLAT)

A Husband and/or Wife may make in 2012 a gift up to the \$5.12 million limit in trust for the spouse for life, then passing tax-free to children at the spouse's death, or in trust for the spouse and the children and grandchildren for the spouse's life, then passing tax-free to the children at the spouse's death. In either case the trust would probably be discretionary (to protect it from creditors and spouses of beneficiaries) with the spouse as co-trustee with the power to fire and replace an "independent" co-trustee. An obvious advantage is that the \$5.12 million in the trust is still available to the couple for the life of the beneficiary spouse, but at the death of the beneficiary spouse it will not be subject to estate tax. So if no principal is eroded during the beneficiary spouse's life, at least \$5.12 million will go to the children tax-free, even if the estate tax exemption in the year of that spouse's death is only \$1 million or \$3.5 million.

Both spouses may set up such trusts for each other, and get the full \$10,240,000 out of their combined estates in 2012, while having all assets of both trusts available to them for so long as both are alive, and 50% or \$5,120,000 available to the surviving spouse for life. For technical tax reasons such trusts may not be completely identical and reciprocal, but minor variations will satisfy the tax requirements. A large life insurance policy may be purchased for use with this technique to leverage the opportunity. The value of the gift is the single premium paid on the policy.

For couples with net worth substantially above \$10 million such an approach merits serious consideration. And the concept may be easily grasped: the clients are just setting up during their lives trusts identical to the trusts they were going to set up at death if each was the first spouse to die. The parents are giving away assets now for gift and estate tax purposes but retaining the use of the assets for their lives.

Such trusts may be set up as Perpetual Dynasty Trusts for the descendants of the parents in trust for generation after generation, potentially forever, always available to the beneficiaries in each generation if and as they need funds, but never subject to transfer taxes again. As President Obama has proposed restrictions on Perpetual Trusts (see article above), 2012 may be the last year in which it is possible to create perpetually transfer tax-exempt trusts.

Leveraged Discounted Gifts to Children Using Family LLCs

We noted above that there is some risk that in 2013 or later discounted valuations may no longer be available on gifts of minority interests in Family LLCs, but in 2012 such discounts are available. So in families with large net worth, various investment assets - - securities, real estate - - may be pooled in a Family LLC, and then minority interests in that LLC may be given to children or grandchildren or to trusts for them. Gift tax valuation discounts may be justified in the 30% range. So, for example, if \$20 million of assets was pooled in an LLC, and a 25% interest in the LLC was to be given to children, the value of 25% would not be \$5 million but rather would be something like 70% of \$5 million, or \$3.5 million. So, in fact, 36% could be given, discounted at 30% that would be about \$5.04 million. But based on underlying assets undiscounted, 36% would represent a value of \$7.2 million.

Create a 2 - Year Grantor Retained Annuity Trust (GRAT)

The Obama Administration's proposal discussed above to require a minimum 10-year term on GRATs may some day be adopted. So proper candidates should consider whether to create a 2- year GRAT while they are permitted. The best sort of asset to put in such a GRAT is an asset with a presently low or depressed value which the donor expects to be materially more valuable at the end of two years.

In a GRAT, a donor contributes property to an irrevocable trust, retaining the right to annuity payments (typically made annually on the anniversary date of the initial contribution) equal to the value of the assets contributed, so that no gift is made upon the creation of the GRAT. At the end of the term (typically two years), if the GRAT assets have outperformed by appreciation in value the expected interest rate (which is fairly easy to do in today's low-interest rate climate), any appreciation in the value of the donated asset passes to younger generation family members, e.g., children, free of income tax and gift tax.

This is a low risk technique: if the donated asset does not appreciate, it all comes back to the donor, and no harm has been done. If the donor likes, he/she can then try again and re-gift the same asset to another 2-year GRAT.

ESTATE TAX PLANNING OPPORTUNITIES BECAUSE OF LOW INTEREST RATES AND DEPRESSED VALUES

The silver lining in the catastrophe of the Great Recession is that it has created a historically and unlikely-to-be-repeated-soon environment for tax-advantageous gift giving. The adage "where there is danger, there is opportunity" applies.

The situation is created by a confluence of events:

- Many asset classes remain at materially depressed values, i.e., low values for gift

tax purposes, so it is an excellent time to give assets away before they appreciate to more “normal” values.

- The current climate of historically low interest rates make this an especially favorable time to employ sophisticated gifting techniques such as GRATs and Charitable Lead Annuity Trusts which are most advantageous when the §7520 rate (an interest rate published each month by the IRS which is used to value annuity and remainder interests, etc.) is low. The §7520 rate for October 2012 is 1.2%. Moreover, it is now possible to make loans to family members at extremely low rates without causing those loans to be treated as gifts because the applicable federal rates (“AFRs”) also published monthly by the IRS are so low. In October 2012, a short-term loan (less than three years) may bear an interest rate as low as 0.23%, a mid-term loan (between three and nine years), 0.93%, and a long-term loan (more than nine years), 2.36%. These low AFRs also make techniques such as installment sales to Intentionally Defective Grantor Trusts especially favorable right now. Interest rates are certain to rise again in the future, so anyone considering intra-family loans or gifting techniques such as GRATS, should act soon to take advantage of today’s low rates.

These techniques are complex and the analysis of whether one might be right for you may be time consuming.

VIRGINIA LAW DEVELOPMENTS

Virginia recently enacted three important new statutes related to trust administration.

The directed trustee statute allows the settlor (creator) of a trust to provide in the trust document that the Trustee must follow the directions of a third person (the “trust director”) with regard to one or more aspects of trust administration. For example, a settlor who transfers an interest in a family business to an irrevocable trust might want a family member involved in the business to make all decisions regarding the business interest while a professional Trustee handles all other trust administration responsibilities such as managing the trust’s liquid assets, maintaining records, and preparing accountings and tax returns. Properly drafted directed trustee provisions should insulate the Trustee from liability for decisions made by the trust director that are within the scope of his authority. The trust director is a fiduciary and must act in the best interests of the beneficiaries in accordance with the terms of the trust agreement. In order for the directed trustee statute to apply, it must be expressly incorporated by reference into the trust agreement.

Following the lead of several other American jurisdictions which have enacted legislation permitting “self-settled spendthrift trusts” over the past several years, Virginia now allows a settlor to create a trust for his own benefit which is not subject to the claims of his own creditors after a period of five years. Such a trust must meet several requirements, among the most important of which are that the trust must be irrevocable, the settlor cannot be the only beneficiary, the settlor’s interest in the trust must be limited to discretionary distributions of income and/or principal, and there must be an “independent qualified trustee” which is not related to or employed by the settlor.

While this is an interesting development, we continue to believe that for now it is better to establish such trusts offshore than in Virginia or other US jurisdictions.

Probably the most useful of the three new Virginia statutes is the “decanting” statute, which allows a Trustee (which must be a “disinterested” Trustee) to effectively change the terms of an existing irrevocable trust by distributing the trust assets to a new trust with different provisions. There are of course numerous limitations on this authority: for example, it cannot be used to add beneficiaries, or to reduce or eliminate a fixed income or annuity interest, or to accelerate a future interest to a present interest. However, it can be used to make all sorts of useful adjustments to a trust, such as changing Trustee succession provisions, granting more flexible investment authority, and limiting distributions to beneficiaries who are irresponsible or have mental health or substance abuse problems. We expect the decanting statute to be widely employed.

NEWS AT THE FIRM

Our 15th Anniversary

We opened the doors of our firm on Old Meadow Road on November 1, 1997, fifteen year ago. We have survived, thrived, and grown because of the hard work, diligence, and thoughtfulness of our staff, the loyalty and trust of our clients, and our network of fellow financial service professionals and attorneys and their referrals of friends and colleagues to us. We are busier now than we have ever been, but our commitment to providing prompt, thorough, sophisticated, reasonably-priced, and conscientious client service has not wavered. Thank you.

New Staff Member

Nivin Joudeh joined Frederick J. Tansill & Associates, LLC in May, 2011 as the firm’s Office Manager and Paralegal. She began her professional career in the Mortgage Lending Industry and Real Estate Settlements industry, and she has worked in the Law Firm marketing and management field for the past 18 years in the Northern Virginia area. She most recently worked as a real estate paralegal at a Tysons firm, where she handled hundreds of residential settlements. She is available for consultation with clients on real estate matters.

As office manager, she is responsible for the firm’s accounting, billing, and collections, and anyone with questions on such matters can contact her. She is in charge of vendor upkeep, assists attorneys with document production and research as needed and coordinates the firm’s client service needs.

Nivin was born in Jordan and immigrated to the United States at a young age. She has dual citizenship with both Jordan and the United States. She is married to Kevin O’Rourke, a former secret service agent, and she has two daughters, Rhonda and Reema. She has a BS degree in Accounting and an MBA in Finance. She is also fluent in Arabic.

Brooke's Accomplishments

We are proud to announce that in February 2012, Brooke Tansill took and passed the Virginia bar exam. She is now a member of the Virginia State Bar, the District of Columbia Bar and the Arizona State Bar. In the past year she has also joined the Northern Virginia Estate Planning Council and the Fairfax Bar Association. In August of this year, Brooke was selected for inclusion in the Emerging Leaders Institute Class of 2013, a 10-month intensive training program by Leadership Fairfax. Congratulations to Brooke!

Cindy's Family

Cindy and her husband Todd Gaziano are adjusting to life as empty-nesters this fall, having recently delivered their daughter Kate to UVA (Cindy's undergraduate alma mater). Although Kate's parents are both lawyers, she intends to follow in the footsteps of her grandfather and uncles (on Todd's side) and pursue a career as a doctor. Cindy and Todd really miss having Kate at home, but they recently enjoyed their first vacation by themselves in many years, and they still have the company of their two canine children, Sam and Frodo. They are also happy to have Kate nearby so that they can visit her, and she can visit them, frequently.

Fred's First Grandchild

Henry Wang Tansill was born June 9, 2012 to Brendan and Jackie in New York City. Hank is a handsome rascal and the new family star. Perhaps he will be the 4th generation lawyer in the family.

Review of Your Situation

If you would like us to review the desirability of any changes or additions to your estate plan in light of the impending tax law changes, please contact us to set up an appointment.

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