

Estate Planning in 2012

Looking for opportunity in a year of uncertainty



Current estate tax rules are scheduled to expire at the end of 2012. As a result, there is a strong possibility that estate taxes will change in 2013 – but no one knows how. This is an election year, and the political parties are sharply divided. Compromise, while always possible, seems unlikely. What does this mean for your estate plan?

In this report, we will:

- Review the tax rules in effect today
- Look at possible future outcomes (realizing that it's impossible to predict what will happen)
- Consider how individuals at different net worth levels might approach estate planning during 2012

2012 estate, gift and generation-skipping tax rules

At a time of uncertainty, it makes sense to begin by focusing on what we do know. Under current law, exclusions are high, rates are historically low and opportunities for wealth transfer are unprecedented. But current law also provides that estate taxes will return to pre-2001 levels in 2013.

Estate taxes today and tomorrow

	Effective during 2012	Effective in 2013 (if Congress does not modify)
Applicable exclusion at death	\$5,120,000	\$1,000,000
Estate and gift tax rates	Flat 35%	Graduated 41% - 55%
Surtax on estates above \$10 million	Not applicable	5% (phases out benefit of exclusion and lower rates)
Lifetime gift exclusion	\$5,120,000	\$1,000,000
Generation-skipping tax (GST) exemption	\$5,120,000	Approximately \$1,400,000 (inflation-adjusted)
GST rate	35%	55%
"Portability" of unused exclusion to spouse	Available if both spouses die during 2011-2012	Repealed
Effect of state death taxes	State death taxes, where applicable, are a <i>deduction</i> from the federal taxable estate.	State death taxes, where applicable, are offset by a <i>credit</i> against federal estate tax.

It's also helpful to be aware of what the current administration has proposed.

Estate tax provisions in the administration's 2012 budget proposal

Applicable exclusion at death	\$3,500,000
Estate tax rate	Flat 45%
Lifetime gift exclusion	\$1,000,000
GST exemption	\$3,500,000
GST rate	45%
"Portability"	Retain and make permanent
State death taxes	Deductible
Valuation discounts	Restrict use of valuation discounts for family limited partnerships, limited liability companies (LLCs) and similar intra-family entities
Grantor retained annuity trusts (GRATs)	Require minimum 10-year term
GST-exempt trusts	Limit GST exemption to 90 years

Source: Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" (Feb. 14, 2011).

In addition to federal estate taxes, 16 states have their own estate taxes. In many of these states, the exclusions are quite a bit lower than the federal exclusion. Some of these states also impose a gift tax while others do not.

Applicable thresholds for states that impose an estate tax¹

Connecticut	\$2,000,000	Maryland	\$1,000,000	Ohio	\$338,333
Delaware	\$5,120,000	Massachusetts	\$1,000,000	Oregon	\$1,000,000
Washington, D.C.	\$1,000,000	Minnesota	\$1,000,000	Rhode Island	\$892,865
Hawaii	\$3,500,000	New Jersey	\$675,000	Vermont	\$2,750,000
Illinois	\$3,500,000	New York	\$1,000,000	Washington	\$2,000,000
Maine	\$1,000,000	North Carolina	\$5,120,000		

Inheritance taxes can be a factor in eight states. Inheritance taxes are imposed on a beneficiary rather than on the estate itself. Typically, the impact of an inheritance tax varies based on whether the beneficiary is a spouse, child, relative or unrelated individual.

States that have an inheritance tax¹

Indiana	Maryland	Pennsylvania
Iowa	Nebraska (at county level)	Tennessee
Kentucky	New Jersey	

State taxes vary widely and change frequently. A complete description is beyond the scope of this report. It's very important to check with a qualified attorney or tax advisor in your state to determine what rules apply in your particular situation.

¹As of January 2012

Possible outcomes beyond 2012

The political landscape today is fractured, unstable and filled with obstacles. Divergent views, combined with the charged atmosphere of an election year, make it difficult for Congress to reach a compromise and even harder for observers to predict what a compromise might look like. Many different outcomes are possible:

Possible outcome	How it could happen
\$1 million federal exclusion; 55% top rate	<ul style="list-style-type: none">• This is what tax law already provides. It's the "default" result if Congress does not act.• Both parties may be unable or unwilling to compromise during an election year.• A "lame duck" Congress could act after the election but may not have the political will or incentive to do so.• If this occurs, it could be short-lived. A new Congress could act in 2013 to "fix" estate tax rules, and changes could be made retroactive to Jan. 1, 2013.
\$3.5 million exclusion; 45% flat rate	<ul style="list-style-type: none">• This is what the current administration advocated in its 2012 budget proposal (along with some additional revenue-raisers).• This would result in a return to the "high water mark" reached under the 2001 Bush era tax cuts.
\$5.12 million (inflation-adjusted) exclusion; 35% flat rate	<ul style="list-style-type: none">• This is the status quo.• It worked as a compromise in 2010 with support from both parties.
Estate taxes repealed	<ul style="list-style-type: none">• This is the position taken by Republican presidential candidates.• Enacting repeal would require a shift in Congress, particularly in the Senate.
None of the above	<ul style="list-style-type: none">• So far, a majority has not coalesced around any of the alternatives above – so maybe something different would be needed to reach a compromise.

Planning considerations

Regardless of your net worth ...

Update your estate plan to reflect changes in your family and personal situation. Do you have an estate plan? If you do, when did you last update it? More than five years ago? More than 10 years ago? Since that time, has your financial situation changed? Have you retired? Moved to a different state? Have any of your beneficiaries gotten married or divorced or experienced financial reversals? If your existing documents are "out of sync" with current family and personal needs, update them now. Don't leave yourself or your family at risk while waiting for Congress to make a decision on taxes.

Your estate plan should be designed to provide protection during your lifetime, not just at death. Anyone can experience a period of illness or incapacity. As we age, it becomes increasingly important to include robust "lifetime planning" provisions in durable powers of attorney, health care directives and living trusts.

Check beneficiary designations. The transfer of certain assets, such as life insurance, annuities, IRAs, retirement accounts and other employee benefits, is typically governed by beneficiary designations, not according to your will or trust. Out-of-date or incomplete beneficiary designations are one of the most common estate planning mistakes, so be sure to review these regularly.

For taxable estates under \$1 million ...

Focus on nontax issues. Individuals and couples in this category would not have a federally taxable estate, even if the federal exclusion returns to \$1 million, so you can focus on personal and family issues without undue concern about federal estate taxes.

Pay attention to state death taxes. At present, Rhode Island, New Jersey and Ohio impose a state estate tax with an exclusion that's less than \$1 million. If you live in one of these states, or in one of the states that imposes an inheritance tax, check with a local tax advisor to learn how state taxes might impact your estate.

For “on the bubble” estates ...

Individuals with a taxable estate worth between \$1 million – \$5,120,000 and married couples with a taxable estate between \$1 million – \$10,240,000 may or may not be subject to federal estate taxes in the future, depending on what Congress decides.

If you don't have an estate plan, or if your existing documents are outdated (for example, you moved to a new state, married or divorced but have not updated documents to reflect this), don't delay. It is better to put at least a basic plan in place, even if you need to change it later.

If you already have an estate plan:

Make the best use of the exclusions you have. If you are married, it's important to make the best possible use of both spouses' estate tax exclusions. Most married couples should be using “credit shelter trust” planning. Remember, the effectiveness of your plan depends not only on the language in your will or trust but also on how asset ownership is divided between spouses and your beneficiary designations.

Your estate planning documents may contain formula clauses that automatically adjust to changes in the federal estate tax exclusion – but asset titling and beneficiary designations will not adjust automatically. Married couples may find that if one spouse owns “too much” or “not enough,” their documents will not work as intended. Talk with your tax advisor and learn where you stand. If changes are called for, your attorney and CPA can make appropriate suggestions for your specific situation.

Watch out for state estate taxes. Many states begin imposing estate taxes at a threshold considerably lower than the \$5,120,000 federal exclusion. State laws vary widely and change frequently. It is very important that you talk with a qualified tax advisor in your state to learn how your state's laws apply in your particular situation.

Carefully weigh the pros and cons of gifting. Should you make gifts if you don't have a federal taxable estate today but are concerned that you might be subject to estate taxes in the future? There is no clear answer. Gifts could turn out to be beneficial (if you are subject to estate tax in the future) or unnecessary (if your estate does not exceed whatever the future exclusion amount turns out to be). Individuals in this “middle” net worth category should encourage a vigorous discussion of pros and cons involving your attorney, CPA and Financial Advisor before making a final decision about large gifts.

In this net worth range, it can still make sense to implement advanced estate planning strategies during 2012 if they fit your personal, family and charitable objectives. However, these strategies should be able to “stand on their own” - they must make sense independently from hoped-for tax benefits that may or may not be realized.

For estates currently subject to tax ...

Individuals with a taxable estate above \$5,120,000 and married couples with a taxable estate above \$10,240,000 should take a long, hard look at implementing advanced wealth-transfer strategies during 2012. Individuals at this wealth level would still be subject to federal estate taxes, regardless as to whether the exclusion ends up at \$1 million, \$5,120,000 or something in between. Of course, it is possible that estate taxes could be repealed, or the exclusion could be set at an even higher level. But a number of factors suggest that 2012 could be a year of extraordinary opportunity for family wealth transfer:

- The lifetime gift exclusion is at a historic high - \$5,120,000 for individuals and double that for married couples.
- Periods of low asset values can be favorable for gifting.
- With proper implementation, valuation discounts can be recognized when transferring interests in closely held businesses, limited partnerships and limited liability companies.
- While they last, low interest rates are favorable for intra-family sales, loans, grantor retained annuity trusts (GRATs) and charitable lead trusts (CLTs).
- With a \$5,120,000 generation-skipping tax exemption, the opportunity to shift wealth to future generations is unprecedented.
- Generation-skipping trusts can be established in perpetuity, if desired.

If you believe that estate taxes are likely to remain or even increase, it would logically follow that you should take advantage of available opportunities during 2012. Even if a legislative compromise keeps estate tax exclusions at a fairly high level, this could be paired with “revenue raisers” that would effectively eliminate some of the techniques permitted today.

You should also talk frankly with your advisors about possible downsides of any strategy you consider and think realistically about worst-case scenarios. In particular, you should consider whether you will still be happy you made an irrevocable gift if estate taxes end up being repealed and you don't save a dime in tax.

In conclusion

It's easy to be frustrated by the uncertainty about future estate tax rules. But on the positive side, 2012 may actually present a great opportunity to refocus on the personal and family implications of your estate plan.

Your attorney and CPA can help you understand how different estate planning techniques can help:

- Facilitate ongoing investment management
- Support successful transitions for family businesses
- Guard against family disharmony
- Guide spending by heirs
- Provide some degree of asset protection
- Promote charitable goals
- Perpetuate your legacy and values

Talking with your Financial Advisor and estate planning attorney can help you explore possibilities and choose trusts and other wealth transfer strategies that are the best “fit” for your personal, family, financial and tax situation.

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