



# **Federal Tax**

  

# **Individual Update**

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## About the Author

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Mr. O'Brien is also a renowned lecturer. He is the owner and principal lecturer of M+O=CPE, Inc., a company that provides its annual year-end tax update each December and January for CPAs and other tax professionals. This annual update has become the definitive way to prepare for tax season for practitioners. These practitioners rely on Mr. O'Brien's custom-written textbook throughout the year to manage the increasingly complex rules of taxation and compliance. As a practicing CPA, Mr. O'Brien provides practical and useful insights into how to apply tax rules in the real world.

Mr. O'Brien is the author of numerous CPE books, and is a regular contributor to *CCH Federal Tax Weekly* and other CCH publications. He has taught CPA review and has taught Advanced Accounting at Hofstra University. Mr. O'Brien graduated as Valedictorian of Hofstra University, and was awarded the prestigious Elijah Watt Sells Award for scoring one of the highest grades in the nation on the CPA Exam. He was also a Senior Accountant at KPMG Peat Marwick.

Mr. O'Brien is available for consultations; for fees and scheduling, call 516-594-9273.

Mr. O'Brien will be the seminar leader for M+O=CPE, Inc.'s Individual Tax Year-End Workshop, which will be presented on December 6, 2012 and repeated on December 13, 2012, January 10, 2013, and January 17, 2013. These seminars are held at the Chateau Briand, located at 440 Old Country Road in Carle Place, New York, 11514. For more information, visit [www.mocpe.com](http://www.mocpe.com).

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## **IMPORTANT NOTICE**

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# Expired and Expiring Provisions

## *Provisions that Expired After 2011*

- There were several provisions that expired after 2011. Renewal would require the enactment of new federal tax legislation.
- Major provisions include the following.
  - Alternative Minimum Tax (“AMT”) Patch
    1. The most recent temporary “patch” legislation affecting the AMT expired after December 31, 2011.
    2. Therefore, under currently-enacted law, the AMT exemption for the 2012 tax year will be lower, and taxpayers will not be permitted to reduce AMT tax liabilities for certain nonrefundable personal credits.
      - a) The AMT exemption amounts scheduled for the 2012 tax year appear below, along with a comparison to the 2011 amounts.

	<u>2012</u>	<u>2011</u>
Married-Joint	45,000	74,450
Unmarried	33,750	48,450

- b) In addition, for the 2012 tax year, taxpayers will not be permitted to reduce AMT liabilities for the dependent care credit, the education credits, and the credit for the elderly and disabled<sup>1</sup>.
  3. Unless Congress enacts new legislation that retroactively reinstates the AMT patch, approximately 34 million taxpayers are expected to face a higher tax liability due to the AMT during the 2012 tax year.
- Other Provisions
    1. Election to deduct state and local sales tax, instead of state and local income taxes, on Schedule A, *Itemized Deductions*
    2. Up to \$4,000 above-the-line deduction for higher education tuition and fees

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<sup>1</sup> These credits would still be permitted to reduce the regular tax liability for a taxpayer; however, since they would not be permitted to reduce the AMT liability, the taxpayer would be required to pay the AMT, if his or her regular tax were reduced below the level of the AMT liability.

3. Up to \$250 above-the-line deduction for classroom-related expenses for educators
4. For taxpayers who are 70½ or older, exclusion from income of up to \$100,000 of IRA distributions made directly to charities<sup>2</sup>
5. Deduction for some mortgage insurance premiums as part of the mortgage interest deduction on Schedule A<sup>3</sup>
6. The \$500 residential energy property credit<sup>4</sup>
7. 100% bonus depreciation (replaced with 50% bonus depreciation in 2012)
8. \$179 dollar limit of \$500,000 (replaced with a \$139,000 dollar limit and a lower phaseout threshold in 2012); qualified realty improvements are no longer deductible after 2011
9. 15-year recovery period for qualified leasehold improvements, qualified restaurant improvements and qualified retail improvements (replaced with a 39-year recovery period)

### ***Provisions Scheduled to Expire After 2012***

- The provisions in this section are available for 2012 tax returns, but they are scheduled to expire after December 31, 2012, unless new legislation is enacted.
- Practitioners should consider the effects of these provisions when projecting 2013 tax liabilities for clients and planning 2013 withholding and/or estimated tax payments.

### **Recently-Enacted Provisions**

- The reduced employee share of the Social Security tax rate (4.2% in 2011 and 2012) is scheduled to return to 6.2% after 2012.
- 50% bonus depreciation expires after 2012.
- The higher amount available for the Hope education credit (temporarily called the American Opportunity credit) and the availability of the credit for the first four years of undergraduate studies is scheduled to expire after 2012.

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<sup>2</sup> In 2011, such distributions were excluded from the taxpayer's gross income, but they counted toward the annual required minimum distributions that taxpayers are required to take from traditional IRAs when they reach age 70½. Since the distribution was excluded from gross income, there was no deduction allowed elsewhere for the charitable contribution.

<sup>3</sup> This deduction was limited to mortgage insurance contracts issued after 2006. It was subject to a phaseout that began when adjusted gross income exceeded \$100,000.

<sup>4</sup> This credit is separate from the one that applies to solar equipment. The solar equipment credit expires after 2016.

- The exclusion of income on the discharge of up to \$2 million of home acquisition indebtedness secured by a principal residence (in effect as of January 1, 2007) is scheduled to expire after December 31, 2012<sup>5</sup>.

### **Provisions Related to the 2001 Tax Act**

- The *Economic Growth and Tax Relief Reconciliation Act of 2001* contained a “sunset provision,” which provided that all of its provisions will expire after December 31, 2010, unless extended by subsequent legislation. This same expiration date also applies to certain legislation enacted after 2001.
- The *Pension Protection Act of 2006* made permanent four areas of provisions that were contained in the 2001 Tax<sup>6</sup>.
- The *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010*, enacted on December 17, 2010, extended this sunset provision for two years until December 31, 2012. After that date, most of the provisions from the 2001 Tax Act (with the exception of the four areas that were made permanent by the *Pension Protection Act of 2006*) are scheduled to expire, unless additional legislation is enacted. These provisions include the following.
  - Ordinary income tax rates are scheduled to increase. The 10% bracket is scheduled to be eliminated entirely, and each of the brackets (other than the 15% bracket) is scheduled to increase, as follows.
    1. The 25% bracket is scheduled to revert to 28%.
    2. The 28% bracket is scheduled to revert to 31%.
    3. The 33% bracket is scheduled to revert to 36%.
    4. The 35% bracket is scheduled to revert to 39.6%.
  - The maximum rate on long-term capital gains is scheduled to increase to 20%<sup>7</sup>.

<sup>5</sup> This provision is contained in Internal Revenue Code §108(h). Taxpayers are generally required to recognize income from the discharge of indebtedness, unless the debt was discharged in bankruptcy or the taxpayer was not in bankruptcy but was insolvent immediately before the discharge occurred. Under the special provision, during 2007 through 2012, discharges of up to \$2 million of indebtedness secured by a principal residence will be excluded from gross income, even if the taxpayer is solvent at the time of the discharge. For married taxpayers filing separately, up to \$1 million of indebtedness can be excluded by each spouse. This provision is not available for debt that was used for purposes other than purchasing, building or improving the principal residence or for a reduction of debt due to services provided by the debtor for the lender. The amount excluded from income reduces the adjusted basis of the home.

<sup>6</sup> The first area is the changes to the rules for defined contribution pension plans. Examples include the higher dollar limit for elective deferrals, catch-up contributions for individuals age 50 and older, and higher percentage limits for employer contributions. The second area is the rules for rollovers related to both employer-sponsored retirement plans and IRAs, which includes the ability to roll over balances between different types of plans (e.g., among 401(k), 403(b) and/or 457 plans), the ability to roll over amounts from traditional IRAs into employer-sponsored plans, and the authority of the IRS to waive the 60-day time limit that applies to IRA rollovers, in the case of hardship. The third area is changes to IRA accounts, which includes higher dollar limits for IRA contributions and catch-up contributions for individuals age 50 and older. The fourth area is the tax-free treatment of qualified distributions from §529 plans.

<sup>7</sup> However, the *Taxpayer Relief Act of 1997* added an 18% tax bracket that was scheduled to apply to property held for more than five years, if the property was acquired after December 31, 2000. (Taxpayers were given the ability to make a one-time election to treat previously-held property as being sold and repurchased to qualify for the 18%

- Qualified dividends are scheduled to be taxed as ordinary income<sup>8</sup>.
- The child credit is scheduled to decline to \$500 per child and will no longer be permitted to reduce the alternative minimum tax liability of a taxpayer.
- The dependent care credit is scheduled to consider expenses of only \$2,400 for one child and \$4,800 for two or more children (instead of the current \$3,000 and \$6,000, respectively) and to be computed at a lower percentage for certain taxpayers.
- The marriage penalty relief provisions are scheduled to expire. These provisions increased the standard deduction for married couples to be double the level for unmarried taxpayers, and increased the end point of the 15% ordinary income tax bracket so that it was double the end point of the 15% bracket for unmarried individuals.
- The exclusion from income of certain employer-provided education expenses of up to \$5,250 is scheduled to expire.
- The deduction for student loan interest is scheduled to be allowed only during the first 60 months of repayments of such loans, and the phaseout thresholds for the deduction are scheduled to decline.
- The limit on contributions to education savings accounts is scheduled to decline to \$500 per child, from the present level of \$2,000 per child. In addition, certain technology expenses are scheduled to no longer be qualified expenses for the purpose of withdrawals from such accounts.
- The phaseout of itemized deductions and exemptions, which was eliminated after December 31, 2009, is scheduled to return beginning in 2013, and the calculation is scheduled to be the same as it was in 2005 (adjusted for inflation).
- Internal Revenue Code §1202 allows a portion of the gain from the qualified sale of small business stock to be excluded from income for regular tax purposes. The portion of the excluded gain that must be added back to income for purpose of the alternative minimum tax will increase from 7% to 28% for eligible stock acquired after December 31, 2000 and to 42% for eligible stock acquired on or before December 31, 2000<sup>9</sup>. (However, for qualified small business stock that is purchased after September 27, 2010 and before January 1, 2012 and is held for more than five years, none of the excluded gain on such stock is added back to income for the purpose of the alternative minimum tax.)
- The adoption credit limit is scheduled to revert to a general limit of \$5,000 with lower phaseout thresholds.

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rate.) The 18% bracket and five-year holding period rules were repealed by the *Jobs and Growth Tax Relief Reconciliation Act of 2003*, and this repeal was extended by the December 2010 Tax Act through December 31, 2012. Unless new legislation is enacted, the 18% rate and rules for the five-year holding period will be reinstated.

<sup>8</sup> The lower tax rate for qualified dividends was set forth by the *Jobs and Growth Tax Relief Reconciliation Act of 2003*.

<sup>9</sup> The 7% portion added back for alternative minimum tax purposes was set forth by the *Jobs and Growth Tax Relief Reconciliation Act of 2003*. It originally was set to expire after December 31, 2008; however, the *Tax Increase Prevention and Reconciliation Act of 2005* extended the sunset date to be the same as for the 2001 Tax Act.

- The earned income credit computation rules will result in a reduction of the earned income credit for many eligible taxpayers.
- The \$179 dollar limit (\$139,000 applicable to the 2012 tax year) is scheduled to be replaced with a \$25,000 dollar limit, a lower phaseout threshold, and other restrictions on its use after 2012.

## **New Provisions Effective in 2013 and 2014**

### ***Background***

- *The Patient Protection and Affordable Care Act of 2010*, enacted on March 23, 2010, and the *Health Care and Education Reconciliation Act of 2010*, enacted on March 30, 2010 (these two laws are collectively referred to as “the healthcare legislation”) contain several provisions with delayed effective dates<sup>10</sup>.
- This section summarizes provisions that are effective in 2013 and later years.

### ***Changes Effective in 2013***

#### **Increase in Rate and Scope of Medicare Tax**

- Prior to 2013, the Medicare tax has had two portions: the employee portion and the employer portion. The current rate for each portion is 1.45%, and the tax applies to all wages and/or self-employment earnings, without any dollar limit.
- The healthcare legislation raises the rate of the Medicare tax, and makes it applicable to a wider scope of income.
- Effective for tax years beginning after December 31, 2012, the employee portion of the Medicare tax is increased by 0.9% for individual taxpayers with income in excess of certain thresholds<sup>11</sup>.
  - As a result, for some taxpayers, the total employee portion of the Medicare tax will be 2.35% (1.45% + 0.9%). Since the employer portion will remain at 1.45%, the total

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<sup>10</sup> The United States Supreme Court upheld the constitutionality of this legislation in a decision announced on June 28, 2012. See *National Federation of Independent Business, et al. v. Sebelius, Secretary of Health and Human Services, et al.*

<sup>11</sup> The employer portion of the Medicare tax remains at 1.45% for such taxpayers, and both the employer and employee portions of the Social Security tax remain unchanged for wages up to the level of the Social Security wage base for a given year.

Medicare tax will be 3.8% (2.35% for the employee portion plus 1.45% for the employer portion).

- The additional tax will apply to the excess of wages (and/or self-employment earnings) over \$200,000 for unmarried taxpayers, \$250,000 for married taxpayers filing joint returns<sup>12</sup>, and \$125,000 for married taxpayers filing separate returns. These thresholds are not subject to indexing for inflation.
- Employers are required to withhold the additional portion of the Medicare tax only when an employee's compensation for the year exceeds \$200,000, regardless of the filing status of the employee<sup>13</sup>.
- In addition, effective for tax years beginning after December 31, 2012, the entire Medicare tax (i.e., 3.8%) will apply to the unearned income of individual taxpayers with income in excess of certain thresholds<sup>14</sup>.
  - The threshold at which the tax applies is \$200,000 for unmarried taxpayers, \$250,000 for married taxpayers filing joint returns, and \$125,000 for married taxpayers filing separate returns<sup>15</sup>. These thresholds are not subject to indexing for inflation.
  - For this purpose, unearned income includes the following.
    1. Income from interest, dividends, annuities, royalties and rents<sup>16</sup>
    2. Income from a trade or business that is passive for the taxpayer
    3. Net gain attributable to the disposition of property<sup>17</sup>

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<sup>12</sup> For the purpose of the threshold, the combined wages and self-employment income of both spouses are compared to the \$250,000 threshold. The threshold applies once per joint return, NOT per spouse.

<sup>13</sup> The IRS website has guidance for employers regarding these new withholding rules. See <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax>.

<sup>14</sup> This marks a fundamental change in the applicability of the Medicare tax from solely a payroll/self-employment tax to a broader tax.

<sup>15</sup> Unearned income that is received by estates and trusts will also be subject to the Medicare tax on unearned income. Therefore, this new tax will be computed on Forms 1041, *U.S. Income Tax Return for Estates and Trusts*, as well as on Form 1040 for individuals. Estates and trusts will be subject to the new tax on the lesser of their undistributed net investment income or the excess of their adjusted gross income over the highest income tax bracket for estates and trusts for the tax year. (While the tax does not apply to the 2012 tax year, for the purposes of discussion, the highest income tax bracket begins at \$11,650.)

<sup>16</sup> However, interest, dividends, annuities, royalties and rents derived from an active trade or business (i.e., from a nonpassive activity) are excluded from the Medicare tax on unearned income.

<sup>17</sup> For the purpose of disposition of property, if the property is held in a trade or business that is passive for the taxpayer, or one that consists of trading financial instruments or commodities, then the gain will be subject to the Medicare tax on unearned income. If property is held in an active trade or business (i.e., nonpassive activity) conducted as a sole proprietorship, S corporation, partnership or limited liability company that is taxed as a partnership, the gain will be excluded from the Medicare tax on unearned income. If a taxpayer sells his or her ownership interest in an S corporation, partnership or limited liability company that is taxed as a partnership, gain is subject to the Medicare tax on unearned income only if the activity conducted by the entity is passive for the taxpayer. If the entity conducts an activity that is nonpassive for the taxpayer, then any gain on a sale of the ownership interest in that entity is not subject to the Medicare tax on unearned income.

4. Income from a trade or business that consists of trading financial instruments or commodities
  5. All of these sources of income are reduced by expenses directly related to the production of the income, and the tax is applied to the NET investment income.
- Items Excluded from the Definition of Unearned Income
1. Unearned income excludes items that would be excluded from gross income, such as tax-exempt interest and excluded gain from the sale of a principal residence.
  2. Unearned income also excludes distributions from qualified retirement plans.
- Computing the Tax
1. Subtract the threshold discussed above from the taxpayer's modified adjusted gross income<sup>18</sup>. The result is "Excess MAGI." If the Excess MAGI is zero or less, the taxpayer is not subject to the Medicare tax on unearned income.
  2. Compare the Excess MAGI to the taxpayer's net investment income, and choose the lesser amount. The result is the amount subject to tax.
  3. Multiply the amount subject to tax by 3.8%.

### **Threshold for Deduction of Medical Expenses**

- Currently, medical expenses are deductible for regular income tax purposes only to the extent that they exceed 7.5% of a taxpayer's adjusted gross income.
- However, for alternative minimum tax purposes, the deduction is available only to the extent that such expenses exceed 10% of a taxpayer's adjusted gross income.
- The healthcare legislation makes the following changes.
  - Generally, effective after December 31, 2012, the threshold for regular tax purposes will be raised to 10% of a taxpayer's adjusted gross income. The threshold for alternative minimum tax purposes will remain at 10%.
  - However, a special rule applies to taxpayers who are age 65 or older.
    1. For calendar-year taxpayers in 2013 through 2016, the change in the rule for regular tax purposes will be deferred.

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<sup>18</sup> For the purpose of the Medicare tax, modified adjusted gross income is adjusted gross income plus any foreign earned income excluded from gross income under Internal Revenue Code §911(a)(1). (Reduce the excluded amount of foreign earned income by any deductions and exclusions disallowed with respect to the foreign income. (Such deductions and exclusions would have been disallowed for the purpose of determining taxable income, since the foreign earned income to which they relate was excluded from gross income.))

2. During any of these tax years, if a taxpayer (or such taxpayer's spouse) has attained the age of 65 before the close of such tax year, the taxpayer is permitted to continue to use the 7.5% threshold for regular tax purposes for that tax year.
- If a taxpayer is subject to the alternative minimum tax, this provision should not affect their federal tax liability. However, their itemized deductions for state income tax purposes may be reduced, if they had deductible medical expenses in excess of 7.5% of their adjusted gross income that were previously deducted on the state income tax return as a state itemized deduction.
  - The higher threshold may be an incentive to batch payments for medical expenses into one tax year, if otherwise feasible and desirable.

### **New Restrictions on Contributions to Flexible Spending Accounts**

- For flexible spending accounts that are established to pay medical expenses, there is presently no limit established under §125 of the Internal Revenue Code on the amount of contributions made to the accounts by employees<sup>19</sup>.
- Effective for tax years beginning after December 31, 2012, the healthcare legislation limits such contributions to \$2,500 per year<sup>20</sup>.

### ***Changes Effective in 2014***

#### **Penalty on Certain Individuals Who Do Not Have Health Insurance**

- Effective after December 31, 2013, the healthcare legislation penalizes individuals who do not have health insurance coverage for themselves (and for their dependents, if applicable), unless an exception applies.
- The penalty is expected to be computed as part of the individual's Form 1040.

#### **Refundable Credit for Health Insurance Premiums**

- Effective after December 31, 2013, the healthcare legislation provides a refundable income tax credit for individuals who meet certain income levels and who have health insurance coverage for themselves (and for their dependents, if applicable)<sup>21</sup>.

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<sup>19</sup> If the account owner does not use the funds by the end of the year (or within 2½ months of the end of the year, if the plan adopts a grace period), the account owner loses the funds.

<sup>20</sup> The \$2,500 limit will be indexed for inflation in the future. This limit does not apply to accounts established to pay dependent care expenses. The limit on contributions to those accounts remains \$5,000 per year.

<sup>21</sup> A taxpayer's eligibility for the credit will be based on how his or her income compares to the U.S. poverty line. If a taxpayer's income is over four times the poverty line, they will be ineligible for the credit. The lower the income of a taxpayer, the higher the credit will be. The poverty line amount is published by the U.S. Department of Health and Human Services and is available at <http://aspe.hhs.gov/poverty>. For 2012, the poverty line for a family

- This credit is expected to be computed as part of an individual's Form 1040.

### **Penalty on Businesses that Do Not Offer Health Insurance to Employees**

- Effective after December 31, 2013, the healthcare legislation imposes a penalty on certain businesses who either do not offer health insurance to their employees, or who offer it at a cost that makes the employees eligible for the refundable credit for health insurance premiums.
- To be subject to the penalty, the business must generally have employed an average of more than 50 actual or equivalent full-time employees during the preceding calendar year<sup>22</sup>.
- Future regulations will establish the method of reporting and paying this penalty.

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of one person in the 48 contiguous States was \$11,170. For each additional person in the family, add \$3,960 to that amount. Therefore, the poverty line for a two-person family for 2012 was \$15,130 (\$11,170 + \$3,960), for a three-person family was \$19,090 (\$15,130 + \$3,960), etc. Four times the 2012 poverty line for a family of four was \$92,200.

<sup>22</sup> If the business was not in existence in the prior year, use the average number of employees reasonably expected to be employed during the current year. For this purpose, full-time means employees who average at least 30 hours of service per week. The number of hours per month of part-time employees must be totaled and divided by 120 hours to determine the number of full-time equivalent employees represented by the part-time workers. For the purpose of the 50-employee test, count both actual full-time workers and equivalent full-time workers. A business that employs more than 50 seasonal workers for 120 or fewer days during a calendar year is treated as being below the threshold of more than 50 full-time employees.

# **Appendix: Estate and Gift Taxes**

## ***Gifts Made and Decedents Who Die During 2012***

### **Federal Rules**

- *Gifts*
  - The annual gift tax exclusion amount is \$13,000 per donee in 2012 (same as in 2009 through 2011).
  - In 2012, the gift tax applies to cumulative lifetime gifts that exceed \$5,120,000 (up from \$5 million in 2011), and the maximum rate is 35%.
  - The generation-skipping tax also uses the \$5,120,000 lifetime exclusion amount for 2012 (up from \$5 million in 2011), and the maximum rate is also 35%.
- *Estates*
  - The estate tax applies to estates with taxable values in excess of \$5,120,000 (up from \$5 million in 2011).
    1. The maximum estate tax rate is 35%.
    2. The generation-skipping tax also uses the \$5 million lifetime exclusion amount, and the maximum rate is also 35%.
    3. The basis of the property inherited by heirs is the fair value as of date of the decedent's death (or alternative valuation date, if applicable), and the holding period of such property is automatically treated as long-term.
- *Portability Provision*
  - There is a new "portability" feature for the applicable exclusion amount for married individuals if one spouse dies during 2011 or 2012 and the other spouse either makes gifts or dies before the end of 2012.
    1. If a married individual dies in 2011 or 2012, and his or her estate does not use the full lifetime exclusion (\$5 million in 2011 or \$5,120,000 in 2012), the decedent's spouse (or the estate of the decedent's spouse) can use the remaining exclusion 2011 or 2012.
      - a) For Gift Tax:
        - If spouse 1 dies during 2011 or 2012 and spouse 2 makes a gift after the date of death of spouse 1 and before the end of 2012, spouse 2 can use the remaining unused exclusion amount from spouse 1.

- The remaining unused exclusion from spouse 1 is in addition to the separate exclusion already applicable to spouse 2 on his or her own.
- b) For Estate Tax:
- If spouse 1 dies during 2011 or 2012 and spouse 2 also dies during either 2011 or 2012 (before the portability provision is scheduled to expire), the estate of spouse 2 will be able to use the remaining unused exclusion amount from the estate of spouse 1<sup>23</sup>.
  - The remaining unused exclusion from spouse 1 is in addition to the separate exclusion already applicable to spouse 2 on his or her own.
2. The executor of the estate of the first spouse to die must elect the portability provision on a timely-filed Form 706 for the first spouse's estate<sup>24</sup>.
    - a) The 2012 versions of Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, and Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, include new sections that relate to the portability election<sup>25</sup>.
    - b) The election, if made, is irrevocable.
    - c) Even though the estate of the first spouse to die is not be required to file Form 706, since the estate value is below the federal exemption level, the estate must still file a timely Form 706 to make this election.
  3. If one spouse dies and the second spouse remarries, only the unused exclusion amount from the last predeceased spouse can be used.
  4. The portability election applies to the unused portion of the exclusion for the gift and estate taxes, but it does not apply to any unused portion of the exclusion for the generation-skipping tax.
  5. The portability provision is scheduled to expire after 2012. If it is allowed to expire, the election made on the estate tax return of the first spouse to die would be rendered moot.
  6. The IRS has the authority to review the first spouse's gift and estate tax returns solely to determine the validity of the claim for the unused portion of the credit for that

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<sup>23</sup> If spouse 2 made gifts and used any portion of the remaining exclusion from the estate of spouse 1 toward those gifts, then the exclusion available for the estate of spouse 2 will be reduced by the amount of such gifts.

<sup>24</sup> Timely-filed includes the extended due date for the form, if the extension request was properly filed by the original due date. The IRS has issued guidance on the portability provision in both temporary and proposed regulations. See Treasury Decision 9593 and REG-141832-11. (Earlier guidance related to the 2011 tax year was contained in IRS Notice 2011-82.)

<sup>25</sup> Form 706 also includes a checkbox by which a decedent's estate can elect not to apply the portability provision to any unused exemption from the estate of the decedent. Most likely, very few estates would elect out of the portability provision.

decedent made by the surviving spouse. This is true, even if the statute of limitations has expired for the decedent.

### **New York State Rules**

- New York State has not made any changes related to the estate tax rules for decedents who die in 2011 or 2012.
- The New York State estate tax continues to apply to estates with a taxable value of more than \$1,000,000<sup>26</sup>.
- New York State has not enacted a portability provision for married individuals. Therefore, any portion of the \$1 million exclusion for New York State estate tax purposes that is not used by the first spouse to die is unavailable for the estate of the surviving spouse, even if the estate of the surviving spouse benefits from the federal portability provision discussed earlier.

### ***Scheduled Changes for After 2012***

#### **Federal Rules**

- On January 1, 2013, all provisions relating to estate and gift taxes return to the levels that prevailed in 2001, prior to the enactment of the *Economic Growth and Tax Relief Reconciliation Act of 2001*.
- As a result, the gift tax is scheduled to apply to lifetime transfers in excess of \$1 million, with a maximum rate of 55%.
- In addition, the estate tax is scheduled to apply to estates with a taxable value of \$1 million and with a maximum rate of 55%.
- Finally, the generation-skipping tax is scheduled to apply to lifetime transfers in excess of \$1 million, with a maximum rate of 55%.

**New York State Rules:** New York State has not made any changes related to the estate (or gift) tax rules for after 2012.

#### **“Claw-Back” Issue**

- If the applicable exclusion amount for the federal estate tax returns to \$1 million, there is a question as to how gifts made during 2011 or 2012 will be treated on the estate tax return for

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<sup>26</sup> New York State repealed its gift tax as of January 1, 2000. However, when determining if an estate is required to file Form ET-706, compare the value of the decedent’s assets at the date of death plus the value of lifetime gifts that were made by the decedent to the \$1,000,000 filing threshold. If these combined amounts exceed the threshold, the estate is required to file the return.

such an individual, if the individual dies after 2012.

- The federal estate tax return considers lifetime gifts made by the decedent for the purpose of determining the appropriate graduated tax rate to be levied on the value of the decedent's estate.
- A strict reading of the applicable sections of the Internal Revenue Code indicates that if the gift and estate tax rates are allowed to increase in 2013 and the applicable exclusion amount is allowed to decline in 2013, the rules for computing the estate tax could result in the taxation of gifts made during 2011 or 2012 that were in excess of the applicable exclusion amount in effect at the time of a decedent's death.
  - It is highly unlikely that this was the intention of Congress; yet, there is no current guidance on how the hypothetical gift tax credit would be computed for estate tax purposes in 2013 or beyond (if the \$5,120,000 exclusion amount were allowed to expire).
  - As a result, there is no way to assure how gifts of up to \$5 million made during 2011 (\$5,120,000 in 2012) will be treated on the estate tax return of a decedent, if the decedent dies after 2012<sup>27</sup>.
  - While the higher exclusion amount for gift tax purposes can prove tremendously useful for taxpayers who wish to give such gifts, practitioners should warn their clients about the uncertainty about the future treatment of such gifts.

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<sup>27</sup> If the Treasury Department or the IRS were to assert the claw-back interpretation, Congress could legislate a technical correction to address the issue. Absent such a correction by Congress, it is likely that the effect of the provision would be challenged in court.