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What the American Tax Relief Act of 2012 Means for Your Clients
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Major References: The American Taxpayer Relief Act of 2012 (H.R. 8)
Related Reports: 12-50, 12-37, 12-31

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MARKET TREND: New tax legislation implements higher taxes that will significantly impact not only high net worth individuals but also upper middle-class individuals (e.g., annual income of $200,000) who previously benefited from low overall tax rates on wages and investment income, as well as personal exemptions and itemized deductions. SYNOPSIS: As reviewed in more detail below, with the new tax legislation, 2013 will bring higher taxes on all aspects of individual income, including wages, capital gains and qualified dividends, other passive investment income, and estates and lifetime gifts. These changes will generate significant tax hikes in the top marginal tax rates when compared to 2012, particularly when accounting for implementation of the new health care taxes (i.e., the Hospital Insurance Tax on wages and the Medicare Tax on net investment income). The 2013 reinstatement of the 6.2% FICA payroll tax (compared to 4.2% in 2012), the personal exemption phase-out, and the itemized deduction limitation will make the effective tax rates even higher. TAKE AWAYS: • With higher overall tax rates and a permanent $5 million estate tax exemption, there will be a shift in focus to the income tax benefits of life insurance planning, potentially generating more interest in annuities, cash value life insurance, and private placement products as clients seek to increase their exposure to tax-deferred investments. The higher gift tax exemption should continue to assist with product acquisition, due to the simplicity of funding insurance premiums with large gifts. • Client trust planning also must carefully consider the potential tax impact. With grantor trusts, the client will report and pay the trust's tax liability, which may become overly burdensome given the higher tax rates. Non-grantor trusts, however, are more quickly impacted by both the higher income tax rates and the Medicare Tax, as the threshold for application of both is only $11,950. Again, tax-deferred investment options will likely be highly sought after. • For estate tax purposes, life insurance planning should address the potential state estate tax exposure in decoupled states. The traditional uses of life insurance will continue to provide value (e.g., business succession, family protection, inheritance equalization, estate liquidity, etc.), particularly for individuals at middle to high income levels. Since most states do not impose separate gift taxes, individuals above the taxable estate thresholds should consider making lifetime gifts, in order to minimize the combined hit of federal and state estate taxes at death. • The Act did not address many of President Obama's tax proposals, including the estate taxation of grantor trusts, 10-year minimum term GRATs, or valuation discounts. Clients should review their tax liabilities under the new laws and evaluate where life insurance planning can help manage their exposure in order to take advantage of techniques that may disappear as Congress contemplates further budget legislation.

On January 3, 2013, President Obama signed into legislation H.R. 8, the "American Taxpayer Relief Act of 2012" (the "**Act**"). Generally effective as of tax year 2013, the Act makes permanent some of the 2001 and 2003 tax cuts enacted during President George W. Bush's administration, and temporarily extends other tax incentives from 2009.

In general, the Act (1) increases the highest federal income bracket for U.S. individual taxpayers with incomes over $400,000 to 39.6%, (2) increases the tax rate for long-term capital gains and qualified dividends to 20% for individuals with income over $400,000, (3) increases the maximum federal estate, gift and GST tax rates to 40% (up from 35%), and (4) extends a variety of tax incentives that either had already expired or were set to expire on December 31, 2012 through 2013. This Bulletin summarizes key provisions of the Act for individuals, the potential economic impact of these changes on your clients, and corresponding planning alternatives.

Overview of Key Tax Changes

With passage of the Act, the following tax law changes will apply in determining individual income and transfer tax liabilities after 2012:

· Top 39.6% Income Tax Rate. The Act permanently reinstates the top 39.6% tax bracket that existed before 2001. This bracket applies to individual taxpayers with "taxable income" in 2013 over $400,000, or $450,000 for joint returns and to estate and non-grantor trusts over $11,950 (the "**39.6% thresholds**"). Generally, "taxable income" is adjusted gross income ("**AGI**") reduced by allowances for personal exemptions and itemized deductions. These and lower income bracket thresholds are subject to annual inflation adjustments after 2013.

o The Act essentially eliminates the 35% tax bracket for single filers, as that bracket only applies to income beginning at $398,351 and up to $400,000 (a range of $1,649).

· Top 20% Tax Rate on Capital Gains and Qualified Dividends: For taxpayers with taxable income over the 39.6% tax thresholds, the tax rate on capital gains and qualified dividend income[i] increases from 15% to 20%.

· Health Care Taxes: The Patient Protection and Affordable Care Act implemented the following additional taxes on net investment income and wages as of 2013.

o *3.8% Medicare Tax*. A 3.8% tax applies to the lesser of (1) net investment income ("**NII**," *e.g.*, dividends, interest, rents, capital gains, passive activity income) or (2) the excess of modified AGI over applicable thresholds ($200,000 single filers; $250,000 joint filers).

o *0.9% Increase in Hospital Insurance Tax ("**HI Tax**")*. A 0.9% increase (from 1.45% to 2.35%) will apply on the employee's portion of the HI Tax on total wages in excess of set thresholds ($200,000 single filers; $250,000 joint filers).

· Itemized Deduction Limitations: The so-called "Pease limitation" on itemized deductions is reinstated for taxpayers with AGI in excess of specified thresholds ($250,000 for single filers; $300,000 for joint filers). The limitation is the lesser of (i) 3% of excess AGI over the specified threshold or (ii) 80% of "unprotected" itemized deductions (*e.g.*, mortgage interest, charitable contributions, state and local taxes, etc.). The itemized deduction thresholds are subject to annual inflation adjustments after 2013.

· Personal Exemption Phase-out ("**PEP**"): The Act phases out personal and dependency exemptions ($3,900 each in 2013) at 2% for each $2,500 of AGI in excess of the itemized deduction thresholds.

· Expiration of Payroll FICA Tax Cut. The employee portion of the FICA payroll tax reverts to 6.2% from 4.2% on wages up to the Social Security Tax threshold ($113,700 for 2013).

· Estate, Gift & Generation Skipping Transfer ("**GST**") Taxes.

o *Top 40% Rate*: The maximum marginal estate and gift tax rates (and the flat GST tax rate) increase from 35% to 40%.

o *$5 Million Estate, Gift & GST Tax Exemption, Inflation Adjusted*. The estate, gift, and GST tax exemptions are set at $5 million, subject to annual inflation adjustments (*e.g*., $5.25 million in 2013).

o *Permanent Unification and Portability of Estate & Gift Tax Exemptions*. The estate and gift tax exemptions remain unified at $5 million (inflation-adjusted), with the continued ability to elect portability of these exemptions between spouses.

o *Deduction for State Estate Taxes*. The Act allows continued deductions for state estate taxes in calculating the federal taxable estate.

· Tax-Free IRA Distributions for Charities. The Act extends, until December 31, 2013, the ability of individuals who have attained age 70½ to transfer up to $100,000 per year directly from an IRA to certain public charities without including this amount in their gross income.

o IRA distributions made in January 2013 also may be treated as having been made in 2012 for these purposes, and taxpayers who received distributions in December 2012 may treat the portion of that distribution transferred in cash to a public charity before February 1, 2013 as if it had been transferred directly from the IRA to the charity.

· Roth Conversion Options for Certain Retirement Plans. Effective after December 31, 2012, the Act permits 401(k) and other qualified plans, §403(b) plans and §457(b) plans that permit Roth contributions to allow participants to elect to have the plan transfer to Roth accounts under the plan amounts that otherwise would not be distributable under the plan (for example, because of the limitations generally applicable to 401(k) or other elective deferrals). Participants would be subject to immediate tax on the amounts transferred.

· Permanent AMT Patch. To prevent an expansion of the number of households subject to the alternative minimum tax ("**AMT**"), the Act increases the AMT exemption amount from $33,750 to $50,600 (and from $45,000 to $78,750 for joint returns) in 2012 and will index the AMT exemption amount, exemption phase-out threshold, and income bracket beginning in 2013.[ii] As a result, fewer households will be subject to the AMT.

Impact and Planning Options

It is difficult to appreciate the significant tax consequences of these changes without understanding their effect in actual dollars. Accordingly, the following examples illustrate the potential, real-dollar impact that the new laws ("**current law**") will have on the tax liabilities of clients in 2013, compared to their liability if all the prior tax laws had been extended and the Medicare and HI Taxes did not apply ("**prior law**"). Possible planning options for dealing with the increased tax exposure also are reviewed. In all examples, H and W are a married couple who file joint income tax returns.[iii]

Wage Income. Earned income (*i.e*., wages) will be subject to both the 39.6% income tax rate and the increased HI Tax, assuming the individual taxpayer exceeds the specified thresholds. In addition, all wage earners will pay an additional 2% FICA payroll tax (total 6.2%) on wages up to the Social Security Tax

Threshold ($113,700 in 2013).

Example 1: H and W earn $500,000 of wages and, have no NII.

Taxes on Wages	Prior Law	The Act
Federal Income Tax on Wages	$143,342	$145,646
HI Tax on Wages	$7,250	$9,500
Payroll Taxes on Wages (up to $113,700)	$4,775	$7,050
Total Taxes	**$155,367**	**$162,196**
Difference	**--**	**+$6,829**
Total Taxes as Percentage of Income	**31%**	**32.4%**

Note that the marriage penalty is significant under the Act: If H and W were not married and each earned $250,000 of wages, their combined tax bills would be $141,410 ($133,260 in federal income tax and $8,150 in HI Tax). After getting married, however, they are paying total taxes of $155,146 ($145,646 in federal income tax and $9,500 in HI Tax), ***an increase of $13,736***.[iv]

Planning Option - Deferred Compensation. The increase in the HI Tax and the highest marginal tax rate to 39.6% will undoubtedly result in increased demand for qualified and non-qualified deferred compensation arrangements. Those high wage earners who believe tax rates will decrease in the future may benefit by deferring income until the rates change. Even if income tax rates remain the same, deferring income until retirement, when employees may be in lower tax brackets, may be beneficial. In that regard, under the new rate structure, those currently subject to the 39.6% marginal tax rate would save 6.6% (in addition to the benefit derived from the deferral itself) if their taxable income in the year of withdrawal (including the amount withdrawn) did not exceed $398,350 (regardless of whether single or filing a joint return).

Long-Term Capital Gains and Qualified Dividends. With the increase in the top long-term capital gain and qualified dividend rate to 20% and the application of the 3.8% Medicare Tax to capital gains and dividends, individuals with long-term capital gains and/or qualified dividends and income above the specified thresholds will experience even higher increases in their overall tax liabilities.[v]

Example 2: H and W have $500,000 of wages and $400,000 of long-term capital gain from the sale of a capital asset, which qualifies as NII for Medicare Tax purposes.

Taxes on Wages & Capital Gain	Prior Law	Current Law
Wages:		
Federal Income Tax	$143,342	$145,646

HI Tax	$7,250	$9,500
Payroll Taxes on Wages (up to $113,700)	$4,775	$7,050
Capital Gain:		
Federal Capital Gains Tax	$60,000	$80,000
Medicare Tax on NII	N/A	$15,200
Total Taxes	**$215,367**	**$257,396**
Difference	**--**	**+$42,029**
Total Taxes as Percentage of Income	**23.9%**	**28.5%**

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Note that the higher taxation of H and W's capital gain, through application of the Medicare Tax and the higher capital gains rate, generates most of the tax increase under current law ($60,000 under prior law versus $95,200 under current law).

Planning Option - Charitable Donation of Appreciated Securities. Clients may consider donating appreciated securities, rather than cash, to a charity in order to obtain a charitable income tax deduction based on the fair market value of the securities and to avoid capital gains tax on the appreciation. The deduction will be subject to the various deductibility limitations on charitable deductions specifically, and now, the additional overall limitation on itemized deductions. The client, however, could use the retained cash to purchase replacement securities, or, alternatively, to fund the purchase of a life insurance contract, which can offer tax-free growth for investments within the policy. The charitable deduction could still help to offset the cost of purchasing the policy.

Planning Option - Contribution of Appreciated Property to a CRT. With a charitable remainder trust ("**CRT**"), the trust pays either an annuity or unitrust interest to the donor or other non-charitable beneficiary for a specified period, with the trust remainder passing to a charity. The remainder interest must have a present value of least 10% of the value of the property transferred to the trust, but the client receives a charitable income tax deduction for the value of the charitable remainder interest (again, subject to the various charitable deduction limitations and the itemized deduction limitation). CRTs, however, are exempted from the Medicare Tax because they are tax-exempt. Thus, a client could contribute property with built-in capital gain to a CRT, which could sell the property without exposing the trust or the donor to the Medicare Tax on the gain. While the client must include the CRT payments in modified AGI, these will be spread out over the CRT term.

<u>Example</u>: Client contributes $1 million of appreciated stock with $500,000 of built-in-gain to a 10-year charitable remainder annuity trust ("**CRAT**"). Based on a 1.2% 7520 rate and a 9.5% annual annuity, the CRAT generates a $110,000 charitable income tax deduction (subject to the Pease limitation). The CRAT's later sale of the stock could avoid up to ***$119,000 in tax*** (based on current law effective tax rates). The client receives a fixed annuity stream of $95,000 per year, which can fund annual premiums on a life insurance policy designed for wealth replacement or retirement planning if it contains a cash value component.

<u>Other Passive Income</u>. Passive investment income other than from long-term capital gains and qualified dividends (*e.g.*, rents, interest, royalties, and non-qualified dividends) may receive the greatest tax hit from the changes under current law. Not only is this income subject to tax at the 39.6% ordinary income rate, but it also generally qualifies as NII for Medicare Tax purposes.

Example 3: H and W have $500,000 of wages, $400,000 of long-term capital gain, and $500,000 of passive income from interest and rents.

Taxes on Wages, Capital Gain & Passive Income	**Prior Law**	**Current Law**
Federal Income Tax on Wages & Passive Income	$318,342	$343,646
Federal Capital Gains Tax on Gain	$60,000	$80,000
HI Tax on Wages	$7,250	$9,500
Payroll Taxes on Wages (up to $113,700)	$4,775	$7,050
Medicare Tax on NII (Capital Gain & Passive Income)	N/A	$34,200
Total Taxes	**$390,367**	**$477,396**
Difference	**--**	**+$87,029**
Total Taxes as Percentage of Income	**27.8%**	**34.1%**

Planning Option - Tax-Deferral Planning. With higher income taxes, tax-deferred and tax-free investment opportunities will have significant appeal. In this regard, the tax-deferred investment growth and income stream provided by annuities will become increasingly attractive. Through the acquisition of deferred annuities, a client can also control the timing of the income recognition. Thus, if a client expects to have lower income and NII in the future, a deferred annuity can delay receipt and recognition of the income until later year when the client may have income levels farther from the applicable income tax or Medicare Tax thresholds.

Cash value life insurance products provide much of the same tax-deferral benefits as an annuity, plus the advantage of the income tax-free payment of death benefits. Investment in a life insurance policy will grow, free of exposure to income tax or Medicare Tax. Assuming the policy is not a modified endowment contract, a client can make withdrawals of cash value, up to his or her investment in the contract, without incurring either income tax or Medicare tax.

Planning Option - Private Placement Products. Private placement annuities and life insurance may particularly appeal to high-net-worth clients with substantial exposure to tax-inefficient investments, such as private equity funds, hedge funds, commodity funds, or high-yield taxable bonds. These investments are often taxed at the highest income tax rates, yet may not currently distribute income to offset the tax liability. Further, income from these investments typically will qualify as NII under the Medicare Tax. Holding these or similar investments through the investment account of a properly structured private placement product, however, can defer income recognition for both income tax and Medicare Tax purposes.

Planning Option - Roth Conversions. The Act expanded the ability of individuals to convert pre-tax balances in certain employer retirement plans into designated Roth accounts. Roth accounts offer income tax planning flexibility, since they do not require mandatory distributions, and any account distributions made are not subject to income tax nor included in modified AGI for purposes of determining application of the Medicare Tax. A Roth conversion, however, will accelerate the tax due on the Roth account to the year of conversion, for both income and Medicare tax purposes. Thus, a thorough tax and financial analysis must be conducted to determine whether a Roth conversion will make sense, specifically considering whether the income tax rate applicable to the conversion will be less than the expected tax rate on future retirement account distributions.

<u>PEP and Limitations on Itemized Deductions</u>. The PEP and itemized deduction limitations have been referred to as the "stealth" tax, since they will effectively raise income tax rates on individuals with AGIs starting at $250,000 ($300,000 married), which are much lower thresholds than the 39.6% thresholds of $400,000/$450,000.

Example 4 - PEP: H and W are eligible for personal exemptions ($3,900 each) and have $500,000 of AGI. Their PEP is calculated as follows:

- $500,000 of AGI exceeds the $300,000 threshold by $200,000.
- Excess AGI in multiples of $2,500 ($200,000 / $2,500) equals 80.
- The phase-out percentage equals 2% as increased by the multiple (2 x 80), or 160%.
- Since the phase-out percentage exceeds 100%, the couple ***cannot*** use any of their personal exemptions.

Without the PEP, H & W's tax liability would have been reduced by approximately $3,600. Note that personal exemptions will completely phase-out for single filers with AGI of $375,000 or more and joint filers with AGI of $425,000 or more.

Example 5 - Itemized Deductions. H and W have combined AGI of $500,000 and $50,000 of itemized deductions ($20,000 of state and local taxes, $10,000 in charitable deductions, and $20,000 in mortgage interest). Their itemized deduction limitation is computed as the lesser of the following (disregarding other limitations (*e.g.*, on medical expenses)):

- Excess AGI over the $300,000 threshold is $200,000. 3% of $200,000 is $6,000.
- 80% of their itemized deductions ($50,000) equals $40,000.

Thus, H's and W's itemized deduction reduction will be $6,000, allowing the couple to use $44,000 of its $50,000 of itemized deductions. ***Without this limitation, the couple's tax liability would have been lower by approximately $2,000***.

Alternatively, assume H and W have $2 million of AGI and $50,000 of itemized deductions:

- Excess AGI over the $300,000 threshold is $1,700,000. 3% of $1,700,000 is $51,000.
- 80% of their itemized deductions ($50,000) equals $40,000.

Thus, the itemized deduction reduction will be $40,000, allowing the couple to use ***only $10,000*** of its $50,000 of itemized deductions. Without the itemized deduction limitation, ***the couple's resulting tax liability would have been lower by approximately $15,000.***

<u>Estate Taxation</u>. The estate, gift and GST tax area had fewer changes than anticipated. Although the top tax rates increased to 40%, the tax hikes are offset by the permanence of the $5 million estate, gift and GST tax exemptions, subject to annual inflation adjustments, as well as the permanent unification and portability of the estate and gift tax exemption. While this removes most individuals from estate exposure, clients in decoupled states should still appreciate the impact of state estate taxes.

Example 6: H and W have a combined taxable estate of $15 million. Both die in the same year as New York residents. They have executed "sweetheart" wills, which leave the estate of the first spouse to die outright to the surviving spouse. Neither H nor W has used any of his or her federal gift tax exemption.

	Prior Law	**Current Law**
Tentative Federal Estate Tax on Taxable Estate*	$4,577,420	$5,199,080
Less Surviving Spouse's and Deceased's Spouse's Unused Estate Exclusion Amount**	($3,655,800)	($3,655,800)
Plus New York Estate Taxes	$1,866,800	$1,866,800
Total Federal and State Estate Taxes	**$2,788,420**	**$3,410,080**
Total Taxes as Percentage of Estate	**18.6%**	**22.7%**

*Assumes deduction applicable for state estate taxes.
**Assumes an applicable exclusion amount and a deceased spousal unused exclusion amount of $5,250,000 each and the estate of the predeceasing spouse electing portability for the surviving spouse.

Note the significant impact of the state estate tax. For states decoupled from the federal estate tax, the combined maximum marginal estate tax rate could reach close to 50% (*e.g.*, 49.6% in New York).

Planning Option - Lifetime Gifts. The higher federal estate tax rate increases the incentive for making lifetime gifts, particularly for individuals with estates over the applicable estate tax exemption ($5.25 million for individuals, $10.5 million for married couples). First, most states do not impose a separate state gift tax on lifetime gifts. Second, due to the tax-exclusive nature of the gift tax and the tax-inclusive nature of the estate tax, it costs less to make a gift than a testamentary bequest.

Example: Using flat tax rates, assume H, a New York resident, has $1.4 million in wealth and wants to transfer it to C. If H makes the transfer by bequest, a maximum combined federal and state estate tax of 49.6% applies to the total $1.4 million. H's estate would pay $694,400 in estate taxes ($1,400,000 x .496), and C would receive $705,600. If, however, H makes a gift to C of $1 million, a 40% gift tax rate applies only to the $1 million, and H pays only $400,000 in gift tax. ***H faced an effective tax rate of 49.6% on his wealth when transferred through his estate, but only an effective tax rate of 28.6% when transferred by gift.***

Trust Taxation. With the higher income tax rates, client trust planning must carefully consider the potential income tax impact. With grantor trusts, the client will report and pay the trust's tax liability, which may be particularly burdensome where the top combined tax rate on investment income ranges from 23.8% (long-term capital gains and qualified dividends) to 43.4% (other passive investment income). ***Non-grantor trusts, however, are more quickly impacted by both the higher income tax rates and the Medicare Tax, as the threshold for application of both is only $11,950***.

Example 7:[vi] H and W have $500,000 in wages and must report $500,000 of interest and rents earned by a grantor trust. Their total tax liability under current law would equal approximately ***$362,096***, likely too burdensome for the couple to sustain. Alternatively, if the trust was a non-grantor trust, the couple's taxes would be $162,196, but the non-grantor trust's overall taxes would be roughly $214,658, for a combined tax liability of ***$376,854***.

Planning Option - Life Insurance. As before the Act, using gifts to fund the acquisition of life insurance through a properly structured trust remains both an income and estate tax-efficient planning option. For income tax purposes, investment in a life insurance policy can minimize the income and Medicare tax burdens, whether held by a grantor or non-grantor trust. Also, growth within the policy, and policy loans and withdrawals (up to basis in the contract) should be income and Medicare-tax free. For grantor trusts structured as a spousal lifetime access trust, the client's spouse could still have access to the trust funds, if income is needed during life (alternatively, an independent party could be given the discretionary power to add the spouse as a beneficiary in the future). In addition, for estate tax purposes, the trust will protect the insurance death benefit from estate tax and can maximize estate tax deferral for multiple generations if structured as a GST-exempt trust.

Planning Option - Allow for Tax Reimbursement. Depending on applicable state law, the terms of a grantor trust can authorize (but should not mandate) discretionary trust distributions to the grantor to reimburse him or her for the taxes paid on the trust's income. Care must be taken, however, to avoid the potential risk for estate tax inclusion. A mandatory reimbursement provision would result in estate tax inclusion. Further, even with regard to a discretionary reimbursement clause, any understanding or pre-existing arrangement between a grantor and a trustee regarding the trustee's exercise of this discretion could cause estate tax inclusion. Also, if the reimbursement clause would subject the trust assets to the claims of A's creditors under applicable state law, this would be a basis for estate tax inclusion. In such cases, the client may consider including the grantor's spouse as a trust beneficiary or giving an independent party the discretionary power to add the spouse as a beneficiary in the future.

Planning Option - Allow for Termination of Grantor Trust Status. Even if the grantor trust cannot include a reimbursement provision, it should allow for the "turning-off" of grantor trust status during the grantor's lifetime, in the event the tax burden becomes economically impractical for the grantor to bear.

Planning Option - Distribute Trust Income. Given the low threshold for application of the Medicare Tax and the 39.6% top marginal income tax rate to non-grantor trusts (*e.g.*, $11,950), the income of most non-grantor trusts will be subject to maximum taxation if not distributed. Thus, trustees will want to review whether to make increased distributions to beneficiaries who will not be subject to the Medicare Tax. Further, given the top tax income tax rate of 39.6% on trust income in excess of $11,950, trustees also will have a greater incentive to distribute trust income to beneficiaries in lower brackets. Finally, there will be additional incentives to adjust trust investment portfolios toward tax-exempt and tax-deferred investments, including insurance products, muni-bonds, etc.

What Was Not Addressed

The Act only addressed the federal tax aspects needed to avoid the so-called “fiscal cliff,” leaving many other issues (such as the spending cuts) for later debate. In addition, the revenue effect of the Act, as it stands right now, is negative. As a result, Congress will have to quickly find measures to offset these “revenue losers” while addressing the growing concern over spending. In its search for revenue, Congress may consider several of the federal transfer tax changes proposed by the Obama administration in its previous federal budget proposals (the so-called “**Green Book**”), including the estate taxation of grantor trust assets, imposition of 10-year minimum terms for GRATs, limits on the duration of the GST tax exemption with regard to dynasty trusts, and additional limits on valuation discounts for transfers of family entity interests. Thus, advisors should remain vigilant regarding future tax and budget debates and advise clients seeking to implement tax-efficient plans that they should take advantage of these planning options sooner rather than later.

Take Aways

· With higher overall tax rates and a permanent $5 million estate tax exemption, there will be a shift in focus to the income tax benefits of life insurance planning, potentially generating more interest in annuities, cash value life insurance, and private placement products as clients seek to increase their exposure to tax-deferred investments. The higher gift tax exemption should continue to assist with product acquisition, due to the simplicity of funding insurance premiums with large gifts.

· Client trust planning also must carefully consider the potential tax impact. With grantor trusts, the client will report and pay the trust’s tax liability, which may become overly burdensome given the higher tax rates. Non-grantor trusts, however, are more quickly impacted by both the higher income tax rates and the Medicare Tax, as the threshold for application of both is only $11,950. Again, tax-deferred investment options will likely be highly sought after.

· For estate tax purposes, life insurance planning should address the potential state estate tax exposure in decoupled states, as well as the more “traditional” reasons for life insurance (*e.g.*, business succession, family protection, inheritance equalization, estate liquidity, etc.), particularly for individuals at middle to high income levels. Since most states do not impose separate gift taxes, individuals above the taxable estate thresholds should consider making lifetime gifts, in order to minimize the combined hit of federal and state estate taxes at death.

· The Act did not address many of President Obama’s tax proposals, including the estate taxation of grantor trusts, 10-year minimum term GRATs, or valuation discounts. Thus, clients should review their tax liabilities under the new laws and evaluate where life insurance planning can help manage their exposure in order to take advantage of planning techniques that may disappear as Congress contemplates further budget legislation.

NOTES

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[i] Qualified dividend income is income from dividends paid by U.S. and certain qualified non-U.S. corporations to non-corporate taxpayers, with respect to stock held for at least 61 days within a 121-day period.

[ii] Note that the AMT Patch applies to 2012 and going forward.

[iii] These examples do not take into account standard or itemized deductions.

[iv] The marriage penalty could have been higher in the absence of some relief provided by the Act.

[v] Note that the Medicare Contribution Tax "kicks in" at lower thresholds than the 39.6% threshold for federal income tax.

[vi] Calculation and taxation of the trust income has been simplified for purposes of illustration.