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**Gift and Estate Taxes in 2012: The “Clock” is Ticking**

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Given that the normal difficulty of predicting the fate of tax legislation is multiplied considerably during a presidential election year, we should conservatively assume that 2013 may well bring changes which may not be likely to benefit the taxpayer.

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“America will never be destroyed from the outside. If we falter and lose our freedoms, it will be because we destroyed ourselves.”

- Abraham Lincoln

NEW RULES FOR TEMPORARY ESTATE, GIFT AND GST TAX CHANGES

For 2012, the top estate tax rate will remain at 35%, and the exemption will be $5.12 million per individual. In addition, the reunification of the exemption amount and the rates for estate, gift and GST taxes continues. Unless extended or changed, the estate, gift and GST tax exemptions and rates revert to 2001 levels in 2013. That is, the top rate would revert to 55% and the exemption to $1 million.

PORTABILITY OF EXEMPTION

In addition, for the balance of 2012, the executor of a deceased spouse’s estate may elect, on an estate tax return filed in a timely manner, to transfer any unused exemption to the surviving spouse. The surviving spouse may then use the predeceased spousal carryover amount, in addition to their own $5.12 million exemption, for taxable transfers made during life or at death. The exemption that is available for use by a surviving spouse, if the surviving spouse is predeceased by more than one spouse, is the lesser of $5.12 million or the unused exemption of the last deceased spouse. Unless extended, this provision expires, along with the other estate tax changes, at the end of this year.

TAXPAYER RESPONSES

People have reacted to uncertainty about the future of the federal estate tax in several ways. For example:

- Some are renewing their focus on estate planning basics by better aligning their estate plans with larger family goals, organizing documents and contacts and confirming that beneficiary designations are accurate.
- Many are considering restructuring their estate planning documents — taking into account the new portability rules — and often are making alternative plans under their wills or revocable living trusts. How those plans will be implemented depends on both the size of the estate and the amount of the exemption at the death of the decedent.
- Others are aggressively taking advantage of the increased gift tax exemption to move assets to beneficiaries during their lifetimes.

Time may be slipping away for use of what has been the largest exemption amount in history. In considering whether to use all or part of the exemption, one should confer with an advisor as to the potential effect of such a large scale gift on the ability to sustain a particular standard of living during one's retirement years.

The $5.12 million gift tax exemption is scheduled to be available through the end of 2012 and could effectively remove assets and appreciation from potential future estate or generation splitting transfer taxes. Estate freeze techniques that take advantage of the current low interest rate environment are also highly effective to facilitate the removal of appreciation from future estate taxes.

FORMULA CLAUSES

One thing tax attorneys may focus on is the use of “formula clauses” under their clients’ current wills or revocable living trusts. Formula clauses divide the assets passing under the will or trust among various beneficiaries. This has most commonly been used to preserve both spouses’ estate tax exemption amounts (e.g., “everything to my spouse except the amount that can pass tax free to my bypass trust under the estate tax exemption”).

In general, formula clauses work well; however, with the large increase in the unified exemption amount, they might not reflect the client’s intent. For example, depending on how the will

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* The estate tax exemption was indexed for inflation in 2012.
or trust is written, it is possible that a surviving spouse could receive nothing at all—that is, everything would remain in trust and nothing would be paid to the survivor outright. Also, most formula clauses have not anticipated a portability option and should be revisited with that in mind.

QUALIFIED DISCLAIMERS
One solution to complications that may arise when using formula clauses involves the use of something called a “qualified disclaimer,” under which a beneficiary gives up an interest that otherwise would have been received under a will or trust. If the result of the formula clause would be to give too much to the surviving spouse, he or she could disclaim the “excess” amount.

A beneficiary who disclaims is treated as never having received the disclaimed portion. Thus, use of the disclaimer can eliminate any adverse tax consequences and, since the disclaimed interest passes as if the beneficiary died before the decedent, these assets would pass to the next person in line under members of the beneficiary’s family. It is important to note that for a qualified disclaimer to work properly, the spouse exercising the disclaimer must do so in writing within nine months and must not receive any monetary benefit from the disclaimed asset prior to disclaiming. An attorney can determine whether amendments to the will may be necessary.

STATE ESTATE TAX
More than half of the states have enacted laws that impose a state estate tax on the estate of a decedent. Therefore, it is important to make sure that estate planning takes into account state transfer laws. This can be especially complex when real estate is owned in more than one state. State legislators may consider tapping taxes as a means of addressing burgeoning budget deficits.

Time may be slipping away from use of what has been the largest exemption amount in history. In considering whether to use all or part of an exemption, one should confer with an advisor as to the potential effect of such a large scale gift on the ability to sustain a particular standard of living during one’s retirement years.

YET ANOTHER ELEMENT OF UNCERTAINTY
As another testament to the power of uncertainty, recently, two popular wealth transfer strategies have come under attack. The release of the Obama administration fiscal 2013 budget included a provision which ap-

BASIC LEGAL DOCUMENTS

Will: A document, prepared and executed by a person with the formality required by the laws of his or her domicile at the time, which is intended to govern and direct the disposition of that person’s estate and for settlement of legal affairs at the time of death, but which has no legal effect until death.

Revocable Living Trust (“RLT”): A trust created by a person during his or her life and in which the terms can be amended or revoked by him or her. The revocable living trust can be used as a substitute for a will and as a means of avoiding probate.

Power of Attorney: A document that enables a person (the “principal”) to appoint another person to make decisions (other than health care decisions) in the event the principal, during his or her life, can no longer make those decisions for himself or herself. If it contains specific language, it will remain valid even if the principal becomes incompetent or incapacitated. Most states have specific statutes that address powers of attorney for health care decisions.

Living Will: A document, prepared and executed by a person with the formality required by the laws of his or her domicile, in which he or she specifies which life prolonging measures and other medical procedures he or she does and does not want to be taken in the case of terminal illness or if incapacity were to occur.

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to grantor trusts. Often called an “intentionally defective grantor trust,” this wealth transfer vehicle takes its name from the fact that the grantor retains responsibility for any income tax owed by the trust, while the trust nevertheless qualifies for exclusion from the grantor’s estate. The Obama 2013 budget proposal states that, if a taxpayer is considered owner of the trust for income tax purposes, the trust will be includable in the taxpayer’s estate; and, if the trust ever ceases to be a grantor trust during the life of the taxpayer, the grantor will be considered to have made a gift in the amount of the trust. Of course, the budget proposal is not yet a bill, much less a law. But it does signal the intent of the current administration to prevent the use of a very popular technique for shifting larger amounts of assets free of gift or estate tax. In addition, the 2013 budget proposal also stipulates a return to higher rates of estate tax, increasing the top rate to 45% from the current 35% and decreasing the exemption amount to $3,500,000 from the current amount of $5,120,000. This would mark a return to 2009 levels.

There is also currently a bill in the Senate to support highway construction and repair. It contains a proposal which would eliminate the so-called “stretch IRA.” The “stretch IRA” concept involves designating one’s children as beneficiaries and thus allowing them to stretch out payments over their lifetimes. The result is effectively to ensure a lower tax bill annually, rather than a large tax bill up front, since annual payouts would be based on the beneficiaries assumedly longer life expectancy. The Senate bill would end the practice by requiring that all taxes on an inherited IRA held by a nontaxpaying person be paid within five years of the taxpayer’s death. Again, this, too, is but a bill, with no promise of its passage in the Senate, nor, of course, any assurance it would be passed by the House of Representatives. However, this also signals a willingness on the part of Congress to find revenue from wherever it can; and IRAs by definition contain much of the way of future tax revenues which might be actualized sooner rather than later.

Both of these proposals lend further support to the idea that one should “make hay while the sun shines,” as the old saying goes; that is, take advantage of opportunities while they still exist. If one does, and the laws do not change in these or other areas, it only means one has taken action earlier to effectively and legally reduce one’s overall tax liability.

CONCLUSION
Clients should review their estate plans and documents with their tax and legal advisors, making sure that established plans still reflect their current desires and take into account changing laws. The increase in the exemption amount could produce unexpected results. However, the new portability feature may eventually simplify the titling of assets to accomplish family goals. Since these amounts and provisions may not extend beyond 2012, a timely consultation with advisors is essential.

As a result, now is a good time to call your Financial Advisor to discuss how Morgan Stanley Smith Barney and your Financial Advisor can work with your other advisers to assist in this process.

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