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Ballot Measure 84
Oregon Estate Tax Phase-out Initiative

On Tuesday, November 6, 2012, voters will have an opportunity to decide whether or not to phase out the Oregon estate tax. More than enough signatures were obtained by *Common Sense For Oregon, Incorporated*, acting under the assumed business name of *The Coalition to End the Oregon Death Tax*,[1] to qualify Ballot Measure 84[2] ("Measure 84") for the November 2012 ballot.

If Measure 84 passes, Oregon's estate tax (ORS chapter 118) will be phased out over four years. Beginning in 2013, the estate tax will be 75% of the current tax. For a person who dies in 2014, the estate tax will be 50% of the current tax, and in 2015, the estate tax will be 25% of the current tax. Finally, in 2016, the estate tax will be zero. The tax phase-out will result in decreased state revenues in the following amounts: (1) fiscal year 2013-2014 - $17 million; (2) fiscal year 2014-2015 - $43 million; (3) fiscal year 2015-2016 - $72 million; and (4) fiscal year 2016-2017 - $120 million.[3] Thereafter, the revenue loss is likely to continue at the $120 million rate or more for each fiscal year. Although that may seem like a great deal of money, the projected loss in revenue represents less than 1.5% of Oregon's general fund.

Currently, Hawaii, Oregon, and Washington are the only states in the western 13 states that impose a state estate tax. According to a recent *Wall Street Journal* article, 31 states have eliminated or are phasing out their estate taxes. Recently, Tennessee implemented a plan to phase out its estate tax over several years, and Ohio's estate tax will be eliminated in January 2013.[4]

Because Measure 84 is a statutory addition and not a constitutional amendment, the legislature can make changes to the measure. If the measure is passed, the legislature will be faced with several questions to consider and perhaps resolve. Those questions include:

(1) Does Measure 84 also phase out certain income tax transactions?

(2) Will the Oregon income tax cost basis be adjusted to fair market value as of the date of death, or will it remain unchanged? and

(3) Will Measure 84 invalidate or reduce the probate court filing fees for probate petitions?

Possible Income Tax Phase-Out

In addition to the estate tax phase out, Measure 84 may also phase out the capital gains income tax for certain transactions between family members. Section 4(d) of Measure 84 provides that

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1 The coalition's website is http://endoregondeathtax.com/home.

2 A copy of the text of Ballot Measure 84 can be found at http://oregonvotes.org/irr/2012/015text.pdf.

3 A copy of the Estimate of Financial Impact can be found at page 25 of the Ballot Measure Statement at http://oregonvotes.org/doc/history/nov62012/g12_certified_ballot_statement.pdf.

4 *Oregon Death Tax Defiers*, Wall Street Journal, Sept. 14, 2012.

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"a Death tax is . . . (a)ny tax imposed on the transfer of property[5], or any interest therein, from one family member to another family member, where the family relationship between the transferor and the transferee is within the third degree of consanguinity."

Generally, under existing Oregon law, gifts to another family member do not trigger any kind of tax at the state level, because gifts are not taxable in Oregon. However, if a family member engages in a taxable transaction (such as the sale of property) with another family member, the family member making the sale or otherwise profiting from the transaction would be subject to Oregon income tax based on the amount of gain on that sale or transaction.

Under Measure 84, however, it may be possible to avoid the Oregon income tax on a sale with the following strategy. If an individual who owns property has found a third party purchaser who offers $1 million for that property, the seller could avoid Oregon income tax by selling the property to another eligible family member for $1 million. The purchasing family member could then sell the property to the third party for $1 million. Assuming that Oregon will follow the federal income tax cost basis rules, the eligible family member who purchased the property would have a cost basis of $1 million for the purchase. With a $1 million sales price there would be no taxable gain.

The selling family member would pay federal income taxes but no Oregon income taxes. Thus, the selling family member can avoid the Oregon income tax that would have otherwise been incurred with the sale to the third party.

In response to this additional tax phase-out issue, Kevin Mannix, the chief proponent of Measure 84, stated:

"The whole point was to encourage family-owned businesses to remain family owned, . . . this to me is a ghost issue. . . . They're manufacturing a terrible monster out there, a goblin that does not exist."[6]

On the other hand, the "Estimate of Financial Impact" issued as part of the Ballot Measure Statement by the Secretary of State's office states:

"This measure also prohibits all taxes on transfers of property between family members, and phases out existing taxes on those transfers. The current amount of those transfers, and the changes that might occur given elimination of taxes on those transfers are unknown, therefore the impact of this part of the measure is indeterminate."[7]

One can anticipate that the Oregon Department of Revenue will interpret Measure 84 as narrowly as possible, taking the position that Section 4(d) does not apply to income taxes because income taxes are not the same as transfer taxes which are calculated differently. Transfer taxes are based on the net equity value[8] of the property being transferred. In contrast, income taxes are based on the amount of profit or gain rather than net asset value.

Taxpayers are likely to take the position that the words "any tax" in Section 4(d) includes income tax. The Estimate of Financial Impact statement quoted above supports the taxpayers' position; however, taxpayers may have to litigate this issue with the Oregon Department of Revenue.

What Are the Other 49 States Doing?

For a summary of estate/inheritance taxes imposed in various states, see the chart maintained by the Virginia law firm McGuireWoods LLP posted at: http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf. This chart is updated frequently.

Section 4(d) may create an opportunity to game the income tax system. If Measure 84 passes and the term "any taxes" is interpreted to include income taxes, then living family members will be able to transfer any kind of property to fellow family members within the third degree of consanguinity in order to avoid state income taxes.[9] Contrary to Mr. Mannix's assertion, this is not a "ghost issue." Section 4(d) could also mean that salaries, rent, dividends, and interest paid to family members will not be subject to state income taxes. If Measure 84 passes and it applies to income taxes, then Oregon income taxes from intra-family transfers may be phased out over the same four year period.

Income Tax Cost Basis For Oregon Purposes

Measure 84 does not address how the Oregon income tax cost basis should be determined. Generally, Oregon follows the federal income tax cost basis rules. For example, when a person inherits certain types of property from an estate, the income tax cost basis for the property is adjusted to equal the value as of the date of death or the alternate valuation date six months later.

5 Section 5 of Measure 84 provides: "For purposes of this Act, "property" includes, but is not limited to, real property, personal property, and intangible property."

6 *See* Jeff Mapes, *Oregon initiative to abolish estate tax could also provide another tax break*, The Oregonian, Aug. 1, 2012.

7 A copy of the Estimate of Financial Impact can be found at page 25 of the Ballot Measure Statement at http://oregonvotes.org/doc/history/nov62012/g12_certified_ballot_statement.pdf.

8 Net equity equals asset value minus liabilities.

9 Note: federal income taxes would continue to apply.

On the other hand in 2010, when there was no federal estate tax, the federal law provided that the federal income tax cost basis was *not* increased to the fair market value as of the date of death; rather, it carried over either the decedent's cost basis or the fair market value of the property, whichever was lower. If Oregon's tax policy would follow federal law as it existed in 2010 when there was no federal estate tax, then the Oregon cost basis adjustment would be limited to the lower of the decedent's basis or the fair market value of the property.

If Measure 84 passes, the Legislature could act to eliminate the Oregon cost basis increase. However, that remedy could prove problematic if the elimination were determined to be a tax increase, because all tax increase measures require a three/fifths approval by both the Oregon House and the Senate.

Challenge to Probate Filing Fees

Section 8 of Measure 84 provides another challenge. It states "(t)his Act does not prohibit the imposition of fees as to transactions which may occur following the death of a person, such as fees . . . for probate proceedings, *provided that the fees do not exceed the cost of the goods or services provided as a result of the death of the person*." (Emphasis added). The court filing fees to file a probate petition are based on the value of the probate estate and are not based on the "cost of the goods or services." The Legislature may have to address this issue as well.

The coalition's website lists a number of businesses, county farm bureaus, chambers of commerce and the *Associated Oregon Industries* ("AOI") among its supporters who have endorsed the measure. Measure 84 is opposed by *Tax Fairness Oregon*, an Oregon nonprofit corporation. Opposition from organized labor is also likely to emerge. Measure 84 will reduce state revenues, however, the AOI in its endorsement stated that "(s)tudies have indicated a net job gain of 30,000 to 40,000 by passing this measure."[10] Notably, the studies cited do not identify these job gains with any specificity.

If Measure 84 passes, it will be effective January 1, 2013. At that point, the legislature will be forced to answer the many questions raised by Measure 84.

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10 *See* AOI's endorsement (Aug. 21, 2012), http://endoregondeathtax.com.

Calling All Authors

This is *not* an article announcing that Estate Planning and Administration (E/P) section Newsletter authors will each receive a new iPhone 5. However, it *is* an article about our need for more authors to keep the E/P section Newsletter alive and well. We are experiencing some difficulty identifying authors for our section's Newsletter. The goal of the E/P section Newsletter is to provide a forum for educational articles and Oregon relevant updates on cases and legislation for the members of the E/P section of the Oregon State Bar.

We believe there are several factors contributing to this author shortage. First, we may have taken advantage of our frequent contributors causing them to become shy and introverted or to stop taking our calls and emails entirely. Frankly we don't blame them. Next, in the recent economic reality, many newer attorneys are not practicing in the larger, traditional firms. They are in small firms, going solo, or working as contract attorneys. These attorneys are not experiencing the pressure from firm partners to prove their knowledge and skill through publication that is familiar to many of us. Finally, in the age of social media, including our very own listserv, there are lots of avenues to share an opinion, a kernel of knowledge, or some case experience with the E/P section without investing the time, rigor, citations, and grammar required of a slightly more formal publication. The result of these and likely other factors is that this Newsletter is experiencing a severe shortage of authors and therefore content.

The editorial board decided to initiate a discussion with our readers to encourage participation. Elsewhere in this issue is a note about our reader survey and a link to that survey. We encourage you to take that short, 10-question survey to help us improve the E/P section Newsletter.

There is likely a broad range of barriers to volunteering to write an article, so we address six of the more popular ones below.

1. What would I write about? Just about any Oregon-focused topic that you have to research for your practice is a good article topic. Watch the listserv for topics that generate a lot of discussion and that interest you. Imagine a hypothetical client's circumstances and write about an issue raised by them. (The crazy lady with 99 cats wants to make sure the cats are taken care of. The estate of the car buff who left his tools to his mechanic, who has already died.) At the end of this article is a list of 17 topic ideas just waiting for an author to take an interest and get started.

2. I am not an expert on that topic. There is no better way to become the expert on an area than to write an article on it. By getting into the statutes,

cases, or regulations on a new area, you will quickly know much more than everyone else. By teaching the rest of us about that topic through an article, possibly covering the issue's background, giving some factual examples, and identifying areas to watch for, you will fully understand that new topic when you are finished. Alternatively, volunteer to do one or two case summaries, or a legislative update.

3. I am not a good writer. Without asking how you got through law school if you are not at least a good writer, we want you to remember that writing is the best way to improve your writing. We have a six-member editorial board who are all accomplished writers. Their function is to work with authors to ensure an article is accurate, authoritative and well-written prior to publication. They were all young attorneys once too, and are gentle with authors who are seeking to improve.

4. I am afraid I will say something incorrect. The E/P section is full of experienced estate planners. If you have a topic you would like to write about, we can find one of those experienced attorneys to work with you to ensure your article contains an accurate and thorough analysis of your topic. We can help you locate an "article mentor," or you can seek out someone with a post on the listserv.

5. I don't have time to write an article. The average article is 2,000 words long. According to About.com, the average email is 80 words long. It only takes 25 of those average emails to total 2,000 words. Many of us draft more than 25 emails every day. This article is already 800 words long. We all can find time in a two-month period to write an article on a topic we find interesting. Better yet, if you run into a schedule conflict and let us know, provided we have enough other content, we can move your article to a future issue.

6. If I write one article, they will bug me to write more. Consider that the E/P section has 1,329 members. The E/P section Newsletter averages five authors per issue. If each of us writes just one article, it will be 66.5 years before it is your turn again. Right now, because we have an author shortage, you see the same names in three out of four issues. If you feel guilty right now, sign up for an article. If you feel really guilty, send a frequent author a bouquet of roses.

If you can identify another barrier to writing an article, then we invite you to write an article about it for the newsletter. Be sure to include all of the necessary information so that we can all utilize this new barrier and also avoid writing articles.

This article is a bit tongue-in-cheek in an effort to highlight the E/P section's author shortage in a lighthearted manner. We hope you will give some consideration to contributing to the E/P section Newsletter.

Article Ideas

1. Article – The issues surrounding the "claw back" of lifetime gifts if the federal exemption is reduced from $5M to a lower figure.

2. Article – Oregon's special marital property election: is it a gift? Oregon-only QTIP? Do we need both? Possibly in fall 2012, once Oregon DOR has done some work on its rules for the recently amended inheritance tax laws.

3. Article – Identify probate code and trust code disconnects.

4. Article – Estates eligible for a small estate affidavit - retrieving assets from banks/brokerages.

5. Article – Trust investing and exculpatory clauses (or) tax-deferred annuities as trust investments.

6. Article – The impact of estate taxes on taxpayer migration.

7. Article – Proposed updates/revisions to the OUTC.

8. Article – Dynasty trust - compare Oregon vs. Delaware vs. Alaska vs. Washington.

9. Article – When specific devises have to be liquidated, what happens to the devise?

10. Article – Apportionment clauses, the default rule in Oregon, important considerations.

11. Article – Traps to avoid when planning for clients who are veterans.

12. Article – When is there a duty for lawyers to report abuse of vulnerable citizens (elderly, disabled, children) and when is it OK with respect to confidentiality?

13. Article – Update on trust protectors.

14. Article – Factors to consider when choosing the situs of RLTs (community property, inheritance taxes).

15. Article – Permissible trustees for irrevocable trusts.

16. Article – Estate tax and other estate planning issues for same-sex couples.

17. Article – Your great idea here.

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Transfers of Mortgaged Property to Revocable Trusts:

Limits on When Federal Law Protects Your Client From Triggering a Due-on-Sale Mortgage Clause

In estate planning, we frequently rely on revocable trusts as a tool to assist clients in consolidating their assets into one entity that can be managed without interruption in the event of death or incapacity. Once a client executes a revocable trust, we advise and assist the client in the process of transferring the client's assets to the trust. These assets usually include real estate, which may or may not be subject to a mortgage. If the real estate is subject to a mortgage, it is important for the estate planning attorney to advise the client of any risks of triggering a "due-on-sale" clause that may be part of the client's agreement with his financial institution. Most estate planners are aware that the Garn-St. Germain Depository Institutions Act of 1982, Pub L No. 97-320 (the "Act"), provides some protection from triggering a due-on-sale clause when real estate is transferred to a lifetime trust for the client's own benefit; however, the protection offered by the Act is limited.[1] In addition, the regulations that interpret the Act are more restrictive than the Act itself. Therefore, it is important to understand the specific terms of the Act and regulations in order to effectively advise clients in the process of transferring encumbered real estate to a trust.

The Act was an initiative of the Reagan administration that, among other things, deregulated savings and loan associations and allowed banks to provide adjustable rate mortgages. For purposes of this discussion, the relevant part of the Act is that it provides federal preemption of any state-law limitations imposed on a due-on-sale clause that is part of a home mortgage. A due-on-sale clause is a contractual provision in a mortgage that authorizes the lender, at its option, to declare immediately due and payable any amount secured by real property upon the sale or transfer of the real property without the lender's consent.[2] Pursuant to the Act, lenders may enforce a due-on-sale clause in a contract unless one of the nine specific exceptions articulated in the Act applies.[3] The exception articulated in the Act that we frequently rely on is that a lender cannot exercise the option to enforce a due-on-sale clause if residential real property is transferred to an "inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property."[4]

The Act is supplemented by regulations that were issued by the Department of the Treasury, Office of Thrift Supervision, on November 30, 1989 (12 CFR § 591.1, *et seq.*) (the "Regulation").[5] Tracking the Act, the Regulation sets out the general rule that federal law preempts any state law prohibitions on the exercise of due-on-sale clauses by most lenders, and that under federal law, the terms of the contract between the lender and the borrower will control.[6] The Regulation goes on to explain the circumstances in which a lender is specifically prohibited from exercising a due-on-sale clause. Similar to the Act, these circumstances include transfers to an inter vivos trust "in which the borrower is and remains the beneficiary and occupant of the property."[7] Notably, the inter vivos trust exception as interpreted by the Regulation is more restrictive than the terms of the Act.

What Banks Say About Transfers of Mortgaged Property to RLTs

An informal phone survey of national and regional banks revealed that there is virtually no understanding among home mortgage specialists regarding the details of the Garn-St. Germain Act.

One national bank responded that it does not mind if a borrower retitles the real estate to a revocable trust. However, the trust can only become the responsible party on a mortgage if the mortgage is refinanced.

A regional bank representative countered that it does not allow a revocable trust to be the responsible party on a mortgage, only an individual. That bank discourages changing the title to the real property subject to the mortgage.

A summary of the key points of the Act and the Regulation follows. A reference to the "exception" means the prohibition on a lender from exercising its option under a due-on-sale clause when real property is transferred to an inter vivos trust.

1. The Borrower Must Be the Beneficiary of the Trust. The Act and the Regulation are consistent in providing that the exception only applies to transfers of real estate to an inter vivos trust of which the borrower "is and remains the beneficiary."[8]

1 12 USC § 1701j-3(d)(8).
2 12 CFR § 591.2(b)
3 12 USC § 1701j-3(b).
4 12 USC § 1701j-3(d)(8).

5 The Office of Thrift Supervision ("OTS") ceased to exist when it was merged with the Office of the Comptroller of the Currency ("OCC") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub L No. 111-203, § 312). On its website, the OCC states: "The OCC is reviewing regulations developed by the former [OTS]; updates will be published as they are developed and approved." OCC, Laws & Regulations (Sept. 5, 2012), http://www.occ.treas.gov/topics/laws-regulations/index-laws-regulations.html.
6 12 CFR §§ 591.3 (loans originated by federal savings associations), 591.4 (loans originated by other lenders). State law may apply to real property loans originated in a state by lenders other than national banks, federal savings associations, and federal banks. 12 CFR § 591.4(c)(1)(i).
7 12 CFR § 591.5(b)(1)(vi).
8 12 USC § 1701j-3(d)(8); 12 CFR § 591.5(b)(1)(vi).

2. The Borrower Must Occupy the Property. The Act and the Regulation are consistent in stating that the exception only applies if the transfer of real estate to an inter vivos trust does not relate to a change in the occupancy of the property.[9] While the Act does not specifically require that the borrower must be the occupant of the property, the Regulation states that the exception only applies to "any loan on the security of a home occupied or to be occupied by the borrower"[10] and where the borrower "is and remains…the…occupant of the property."[11]

3. The Exception Applies Only So Long as Circumstances Do Not Change. The Regulation makes clear that any exception to the general rule that a due-on-sale clause is enforceable, including this exception for transfers to an inter vivos trust, only exists so long as the borrower satisfies the stated requirements.[12] For example, if a borrower transfers real estate to her revocable trust, the inter vivos trust exception will not apply after the borrower's death when the borrower is no longer the beneficiary of the trust or the occupant of the property.

4. The Regulation Requires Advance Approval from the Lender. Finally, and significantly, the Regulation (but not the Act) requires that, prior to any transfer to an inter vivos trust, the borrower must determine whether the lender requires any "reasonable means acceptable to the lender by which the lender will be assured of timely notice of any subsequent transfer of the beneficial interest or change in occupancy." The extremely awkward language of the Regulation provides that the exception applies when property is transferred to an inter vivos trust "unless as a condition precedent" to such a transfer the borrower "refuses to provide" the lender with reasonable means of timely notice of a subsequent transfer. Since the "condition precedent" is the borrower's "refusal to provide" information, the implication is that the borrower must determine whether there is anything required from the borrower by the financial institution prior to transferring any real estate to the trust. The takeaway from this is that a borrower may not be protected from the lender's ability to enforce a due-on-sale clause under the Regulation if the borrower transfers encumbered property to an inter vivos trust without contacting the lender prior to the transfer to determine what the lender requires in order to be assured of timely notice of a subsequent transfer.

When advising clients with mortgaged property, it is important to keep the technicalities of the Act and the Regulation in mind to avoid any conflict between the client and the client's financial institution. Briefly, be mindful that the protection offered by the Act, as interpreted by the Regulation, is guaranteed only when, and so long as:

- The client owns and occupies the property.
- The client is the only beneficiary of the trust.
- The client contacts the financial institution in advance of transferring property to a revocable trust to determine what, if any, guarantees the client must provide the financial institution so that it is advised of any subsequent transfer of the beneficial interest or changes in occupancy.

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The author thanks Alayna Nicholes for her research contributions to this article.

9 *Id.*
10 12 CFR § 591.5(b).
11 12 CFR § 591.5(b)(1)(vi).
12 12 CFR § 591.5(b)(5).

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The Estate Planning section CLE Committee changed the date for the November CLE. Update your calendars now so you arrive on the right day.

Advising Oregon Estates

Date: Friday, November 16, 2012 (New Date)

Time: 9:00 am – 4:30 pm

Location: Oregon Convention Center, Portland

To participate as a presenter or suggest a topic for future CLEs, contact CLE committee chair Holly Mitchell at (503) 226-1371 or hmitchell@duffykekel.com.

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Estate Planning Newsletter Reader Survey

The purpose of this survey is to better serve our readers with articles and updates that are relevant and useful. The goal of the newsletter is to provide an educational forum for Oregon-relevant articles and updates for members of the E/P section. We are experiencing some difficulty finding authors and feel a reader survey may provide information that would help us improve the newsletter and generate more interest in supporting it by authoring articles, practice tips, case summaries, etc. Currently, the newsletter is published electronically each quarter (January, April, July, and October).

The short online survey (only ten questions!) will run during the month of October. To take the survey, click here: http://www.surveymonkey.com/s/R7P3M3V.

The New 3.8% Medicare Surtax

Unless Congress changes or repeals the "Patient Protection and Affordable Care Act" ("Health Care Act") P.L. 111-152, a new, 3.8% surtax will begin on January 1, 2013. Section §1411 of the Internal Revenue Code ("§1411 Surtax"), passed as part of the Health Care Act, imposes a tax on individuals, trusts and estates who have certain types of passive investment income, provided that they also have a modified adjusted gross income above a threshold amount. This article is a short summary of the §1411 Surtax provisions.

The 3.8% §1411 Surtax is imposed on "the lesser of" the taxpayer's (a) net investment income ("NII") for the taxable year, or (b) modified adjusted gross income ("MAGI") above a "threshold amount."[1] That threshold amount is $250,000 for married couples, $125,000 for married couples filing separately, and $200,000 for single taxpayers. For trusts and estates, the threshold amount is the beginning of the top income tax bracket ($11,650 in 2012). If a taxpayer's MAGI is less than the threshold amount, no §1411 Surtax is due. If a taxpayer's MAGI is greater than the threshold amount a 3.8% §1411 Surtax is due calculated on the lesser of NII or the amount of the MAGI over the threshold amount. A taxpayer with no investment income will not be subject to the §1411 Surax, even if his income is above the threshold amount.

"Net investment income" or NII (that is, income subject to the §1411 Surtax) includes interest, dividends, annuities, rents, royalties, income derived from a passive activity, and net capital gain derived from the disposition of property (other than property held in an active trade or business) reduced by deductions properly allocable to such income. "Net investment income" does <u>not</u> include income from the following (that is, the following are not subject to the §1411 Surtax): income derived from an active trade or business; distributions from IRAs or qualified plans; self-employment income; trusts for charity (except Charitable Lead Trusts); gain on the sale of an active interest in a partnership or S corporation (but note that a C corporation would be subject to the §1411Surtax); or items which are otherwise excluded or exempt from income under income tax law, such as interest from tax-exempt bonds, capital gain excluded under IRC §121 (sale of the principal residence exception), and veteran's benefits.

Note that the §1411 Surtax liability calculation for MAGI purposes is determined before any tax deductions are considered. Thus, even though tax deductions could place a taxpayer in the lowest income tax bracket, the taxpayer could still have NII subject to the §1411 Surtax.

Because the NII threshold amount for trusts is so low ($11,650 in 2012), taking effective tax planning measures this year could be very important. It is believed that the §1411 Surtax will not apply to grantor trusts and simple trusts. With a grantor trust, the grantor is treated as the owner and all items of trust income are reported on the grantor's individual income tax return. Therefore, the passive investment income from the trust would be added to the grantor's passive investment income. Any surtax would be calculated based on the grantor's NII and MAGI.

Simple trusts require all income to be distributed currently, so undistributed net investment income would generally be zero. If the beneficiaries would not be subject to the §1411 Surtax on distributions, then tax savings can be realized by distributing enough of the trust's net income to reduce the undistributed trust or estate NII below the threshold amount. Additionally, if a trust or estate can choose a tax year beginning in late 2012 rather than early 2013 significant tax savings could be realized.

Although the §1411 Surtax is not imposed directly on retirement accounts such as IRAs, such accounts may affect income in a way that could trigger this surtax. For example, a married individual with $250,000 of investment income would not be subject to the §1411 Surtax, but if that individual is required to start taking required minimum distributions from a retirement account (such as an IRA), those required minimum distributions would increase his MAGI above the $250,000 threshold amount, and any amount over the threshold amount will, as mentioned above, be subject to the 3.8% §1411 Surtax.

That outcome could be avoided or reduced with careful tax planning. For example, the individual might consider converting his regular IRA to a Roth IRA in 2012. By doing so, he could delay the minimum distributions until a time when the distributions from the Roth IRA are non-taxable and not subject to the 3.8% §1411 Surtax. In order to totally avoid the §1411 Surtax, however, Roth conversions should be implemented before 2013, as a conversion made after 2013 will increase MAGI and probably trigger the §1411 Surtax.

Similarly, it may be advisable to delay distributions from an annuity until after retirement. Income deferred within the annuity will not be subject to the §1411 Surtax. Then, after retirement, assuming that the taxpayer's MAGI will be lower, it is less likely that withdrawals from an annuity will raise MAGI above the threshold amount.

The reduction of "net investment income" can be accomplished through a variety of means, including the shifting of assets to tax exempt bonds, IRAs and qualified plans, tax deferred annuities, life insurance trusts, leveraged real estate, and oil and gas investments.

Another means of effective tax planning is to reduce MAGI. This can be accomplished through a variety

1 "Modified Adjusted Gross Income" includes income earned overseas, subject to certain deductions. *See* IRC §911(a) and (d)(6).

of ways, including Roth conversions, non-grantor charitable lead trusts (a trust that files a form 1041), charitable remainder trusts, installment sales, charitable contributions, and above the line deductions such as contributions to qualified plans and traditional IRAs. As described above, required minimum distributions increase MAGI, so planning to reduce the §1411 Surtax will be a challenge.

In summary, the best way to plan for the 2013 §1411 Surtax is to maximize payments to qualified retirement plans, such as IRAs and 401(k)s. It is also advisable to implement Roth IRA conversions in 2012, because the §1411 Surtax does not apply to the future nontaxable distributions from a Roth IRA. Furthermore, a conversion made before 2013 can lower future MAGI, thereby reducing exposure to the §1411 Surtax. Because annuities are subject to taxation upon distribution, taxpayers should invest money in tax-exempt and tax-deferred vehicles, such as municipal bonds, tax deferred non-qualified annuities, life insurance, and non-qualified deferred compensation.

The good news is that there are some steps that can be taken this year to avoid or reduce the amount of §1411 Surtax beginning in 2013. Also, 2012 is an exceptional year for estate planning in general. The federal estate tax exemption is $5.12 million, which allows a married couple to transfer as much as $10.24 million from their estate with no estate tax. Under current law, this exemption is scheduled to shrink to $1 million in 2013. Other Bush tax cuts, including income and capital gain taxes, are set to expire at the end of 2012. With the new 3.8% §1411 Surtax becoming effective in January, the year 2013 is on track to have the highest tax rates seen in years.

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Caution - Estate and Gift Taxes When Planning for Same-Sex Couples

State-recognized marriages of same-sex couples are not recognized by the Federal Defense of Marriage Act ("DOMA"). However, a number of states, such as Oregon, do recognize and/or have adopted provisions for same-sex couples to be married or to have their unions legally sanctioned. DOMA has been held unconstitutional in federal courts around the country, but the U.S. Supreme Court has yet to rule on this question. As a result, all same-sex married couples are treated as legal strangers for federal gift and estate tax purposes. Thus, transfers of property between same-sex couples, adding a same-sex spouse to the title of real property, accounts, or other assets, paying a mortgage on jointly held property, or setting up and funding joint revocable trusts may have unanticipated federal transfer tax consequences.

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