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Obama's Revenue Proposals Have Far Reaching Estate Planning Consequences

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The Obama Administration's recently released Fiscal Year 2013 Revenue Proposals, if enacted, will have a drastic effect on estate planning.

Summary of Proposals

The proposals can be summarized as follows:

Transfer Tax Rates and Exclusions. The Administration's proposal would restore transfer tax rules which were in effect in 2009. Until the end of 2012, and because of extensions of the Bush-era tax cuts (EGTRRA legislation), the current generation-skipping transfer, estate and gift tax rate is 35% and the individual lifetime exclusion is $5 million. Through the end of 2012, the exclusion is portable (i.e., where a decedent does not use all of the decedent's exclusion, the surviving spouse can elect to utilize the unused exclusion). Unless legislation is enacted, the tax rates and exclusions after 2012 will revert to those in effect in 2001 as if the Bush-era tax cuts had never been enacted. Prior to the 2001 EGTRRA legislation, the maximum tax rate was 55% plus a 5% surcharge on the amount of the taxable estate between $10 million and $17.2 million (which is designed to recapture the benefit of lower rate brackets). The applicable exclusion was $675,000.

The Administration's proposal would make permanent a top tax rate of 45%. The exclusion would be $3.5 million for estate and generation-skipping tax purposes and $1 million for gift tax purposes. The proposal would also indefinitely continue portability of the lifetime exemption. The proposal would be effective for estates of decedents dying, and for transfers made, after December 31, 2012.

Consistency in Value for Transfer and Income Tax Purposes. For estate tax purposes, current law provides that the basis of property acquired from a decedent is the fair market value of the property on the date of death (or six months later if the alternate valuation date is elected). The basis of property acquired by gift is the basis in the hands of the donor, increased by any gift tax paid. If a donor's basis exceeds the value of the gifted property, the donee's basis is limited to the value on the date of the gift.

Apparently, there have been instances of taxpayers taking positions with respect to basis which are inconsistent with what has been done for transfer tax purposes. The Administration's proposal would impose a consistency and a reporting requirement. An executor or donor would be required to provide basis and valuation information to both the recipient and the IRS.

The proposal would be effective for transfers on or after the date of enactment.

Valuation Discounts. For many years the Internal Revenue Code has had a number of provisions designed to reduce a taxpayer's ability to take discounts on the transfer of an interest in family controlled entities. The Internal Revenue Code presently provides that certain restrictions are to be ignored in valuing interests in family controlled entities if the interests in those entities are transferred to family members.

The Administration's proposal would add a new set of restrictions. Limitations on the transferee's ability to be admitted as a full partner, or to hold an equity interest in the family controlled entity, would be disregarded in valuing the interest transferred when the restriction can be removed by other members of the family controlled entity. This new classification of restrictions would be set forth in regulations.

The proposal would be effective for transfers after the date of enactment.

Minimum Term for Grantor Retained Annuity Trusts ("GRAT"). The proposal would require that a "GRAT" have a minimum term of ten years. In addition, the remainder interest must have a value greater than zero. The effect of this proposal would be to eliminate the use of the popular estate tax planning technique known as "Walton GRATs" or "zeroed-out GRATs". Those techniques encourage individuals to create GRATs with terms as short as two years to hedge against the risk of the grantor dying during the term of the GRAT. Further, this technique generally causes zero or negligible gift tax consequences. Requiring a minimum term of ten years and a remainder interest of greater than zero would bring an end to this effective technique.

The proposal would apply to trusts created after the date of enactment.

Generation-Skipping Transfer Tax Limitation. The generation-skipping transfer ("GST") tax generally applies to transfers from a donor to a recipient who is two or more generations below the donor. There is currently, however, an exemption from the GST tax equal to $5 million. In addition to reducing the GST tax exemption to $3.5 million, the Administration's proposals would require that the GST tax exemption allocated to a trust expire or terminate after 90 years. This proposal would thus curb the use of multi-generation trusts.

The proposal would apply to trusts created after the date of enactment, and to additions made to preexisting trusts after the date of enactment.

Coordination of Income and Transfer Tax Rules for Grantor Trusts. "Grantor" trusts are commonly used in estate planning. A grantor trust is one in which all items of income, deduction, etc. are taxed to the grantor as opposed to the trust itself, but with the trust being created in such a way that the taxed assets are not included in the grantor's estate for estate tax purposes. Individuals oftentimes utilize grantor trusts to sell assets to the trust. The sale of an asset to this type of trust from the trust's grantor is not an income tax recognition event. In addition, the grantor's payment of the trust's income tax liability is not deemed to be an additional gift to the trust.

Now, however, the Administration proposes that any trust created as grantor trust would also be included in the gross estate of the grantor for estate tax purposes, and distributions from a grantor trust would constitute taxable gifts. This significant change would effectively remove grantor trusts from an estate planner's arsenal.

This proposal would apply to trusts created after the date of enactment, and to contributions made to preexisting grantor trusts after the date of enactment.

Extension of Lien on Estate Tax Deferrals. Current law imposes a lien on estate assets for ten years following a decedent's death when an estate has made an election to defer estate tax payments under Section 6166 of the Internal Revenue Code. However, the effective deferral period under Section 6166 for payment of tax is fifteen years and three months. To help ensure payment of the tax during the deferral period, the proposal would extend the lien on estate assets for the full fifteen year and three month deferral period.

The proposal would apply to estates of decedents dying after the date of enactment, as well as to estates currently paying estate taxes under a deferral period where the lien has not expired on the date of enactment.

Conclusion

Many of these proposals may have only a slight chance of becoming law. However, even if not passed now, they could (and many probably will) resurface at a later point regardless of which party controls the White House. As a result, taxpayers should be alert to the Administration's agenda. It is better to be prepared through informed discussions with an estate planning attorney in advance of changes. Taxpayers can thus avoid hasty reactive planning when legislative changes are imminent. Should you wish to discuss your estate plan because of these or other issues, please contact any one of the attorneys in the Firm's Tax Department.