# KATZ BASKIES & WOLF PLLC

Trusts & Estates, Tax & Business Law



**GENERAL NEWS**

**The President's Budget Proposal Includes Major Estate-Tax Related Initiatives**

On February 13, 2012, President Obama released his fiscal year 2013 federal budget. Within the proposal are numerous provisions that, if enacted, would significantly affect estate planning and many of the sophisticated tax-planning techniques we use. Although a budget proposal is by definition nothing more than a proposal, since these provisions are in the budget, there is a chance one or more of the following initiatives will pass, impacting wealth transfer planning for our clients.

Restoration of 2009 transfer tax rules.

The estate, generation-skipping transfer (GST), and gift tax rules would be rolled back to their 2009 levels and would be made "permanent" (as distinguished from the last several years where the rules have changed almost annually). Thus, the estate tax rate would be 45% and the estate tax exclusion amount would be $3.5 million. The GST exemption would also go back to $3.5 million. In addition, the $1 million exemption for gift taxes would be reinstated. Currently the exemption for gift, estate and GST taxes is $5 million.

Estate Tax Portability would be made permanent.

For estates of decedents who died in 2011 and 2012, the law currently provides that a surviving spouse may "inherit" the unused estate tax exclusion of a predeceased spouse. Thus, if a husband dies and leaves his entire estate to his wife, the wife then has a $10 million gift and estate tax exemption (under current law). The proposal would extend the portability of the estate tax exemption (although not at current levels). This is an important provision as portability is currently scheduled to expire after Dec. 31, 2012.

The IRS would toughen the rules for valuation discounts.

Currently, intra-family transfers of interests in certain types of entities (limited partnerships, limited liability companies and corporations) are valued after applying discounts for lack of control and lack of marketability, which can be substantial. These discounts may significantly reduce the value of gifts made and/or assets included in the estate.

Certain additional restrictions ("disregarded restrictions") would be ignored under Code Sec. 2704 in valuing an interest in a family-controlled entity transferred to a member of the same family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. The transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in Treasury Regulations. The precise impact of these rules is still unclear, but obviously, the intent is to curtail discounting in intra-family gift and estate tax planning.

The Proposal would add minimum and maximum terms for grantor retained annuity trusts (GRATs).

A GRAT is a powerful wealth transfer tool where a client transfers assts to an irrevocable trust, retaining an annuity payment (a fixed annual payout) from the trust for a term and then on the expiration of the term, the trust assets may pass tax-free to the family (or trusts for them). If assets appreciate during the term, GRATs can successfully capture and transfer that appreciation tax-free (in many cases) to the heirs.

New proposed rules would require all GRATs to have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. Also, the remainder interest would be required to have a value greater than zero at the time the interest is created. Further, any decrease in the annuity during the GRAT term would be prohibited (thus eliminating the chance to "game the system" by creating 10 year GRATs with very high payouts in the first year and then drastically reduced payments for the rest of the term). These rules (or similar ones) have been proposed several times now, and they seem to be a likely part of any compromise on estate tax. As these rules would apply to trusts created after the enactment date, clients wishing to use GRATs may wish to act soon.

90 year Cap on GST exemption.

The budget proposal provides that clients using GST exemption can only benefit for 90 years (not the applicable rule against perpetuities, which in Florida is 360 years). Instead, if passed, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. This rule might not change current planning a great deal, but it would drastically limit the benefits of some of the multi-generational "dynasty" trusts created for clients.

Restriction on transfer tax benefits of Grantor Trusts.

One of the most surprising and controversial new proposals would seek to coordinate income and transfer tax rules applicable to grantor trusts. The current lack of coordination between the income and transfer tax rules applicable to grantor trusts creates important estate planning opportunities for clients. Currently, clients can structure transactions between themselves and their grantor trusts that can result in the transfer of significant wealth without gift, estate or GST tax consequences. The use of grantor trusts is among the most powerful and popular planning tools available to clients.

The proposed new rules for grantor trusts would limit this popular planning technique by: (1) including the assets of a grantor trust in the grantor's gross estate for estate tax purposes, (2) applying gift tax to any distribution to a third party from a grantor trust during the grantor's life, and (3) applying the gift tax to the assets of the trust, if the trust ceases to be taxed as a grantor trust at any time during the grantor's life. These rules would apply for trusts created on or after the enactment date and with regard to any portion of a pre-enactment trust attributable to a contribution made on or after the enactment date.

**Conclusion**

While budge proposals are far from law, there are some themes expressed in the budget proposal that have applicability to clients now.

First, the time to use the $5 million gift exemption is now. The proposal to "roll back" the estate, gift and GST tax laws to the 2009 levels may be a viable compromise between the present levels ($5 million) and the scheduled 2013 levels ($1 million exemption). Even if the estate/GST exemptions stay at $5 million, it seems a reversion to the $1 million gift tax exemption may be likely. This compromise is worthy of some consideration, and as a result, clients considering making gifts in 2012 to utilize the $5 million gift exemptions should consider speeding up that process.

Second, this is far from the first time we've heard about GRAT reform and Valuation Discount reform in connection with any estate, gift or GST tax extension/compromise. While it seems unlikely the Treasury can point to hard evidence that those changes are significant revenue enhancers, it seems more and more likely that some changes to GRATs and to discount entities may be on the horizon. Again, clients considering GRATs or using discount entities should consider moving ahead with gifting and/or sale transactions soon.

Third, the newest proposal relates to changing the tax treatment of grantor trusts. If passed, this proposal would end a very powerful estate planning tool. This appears to be the first time such a proposal made it into the budget, and while it is still far from law, the potential change is very significant. It bears watching and attention.


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