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So What Does It Mean To Have a "Permanent" Estate and Gift Tax System Anyway? -- Estate Planning in 2013 and Beyond

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The American Taxpayer Relief Act of 2012 ("ATRA") was signed into law by President Obama on January 2, 2013 to avert the tax side of the "fiscal cliff." For the first time since 2001, ATRA has instilled some degree of stability into the estate, gift and generation-skipping transfer (GST) tax systems by eliminating the application of expiration dates to favorable exclusion amounts and tax rates. The new tax system features a unified $5,000,000 exclusion amount subject to indexing (the indexed amount is $5,250,000 for 2013) for each of the estate, gift and GST tax regimes, with a 40% tax rate for taxable transfers that exceed the applicable exclusion amount. In addition, this exclusion is now permanently "portable" for estate and gift tax purposes (but not for GST tax purposes) between spouses following the first spouse's death.[1]

But when it comes to taxes, nothing is truly "permanent," because Congress possesses the ability at moment's notice to revamp the system yet again the next time it needs a revenue raiser. This is of particular concern to wealthy individuals and their advisors for two primary reasons:

- ATRA only temporarily postponed for two months the spending side of the fiscal cliff (known as "sequestration"), which would impose across-the-board spending cuts; and
- The Obama Administration's Greenbook proposals lurk in the background and, if adopted, would effect fundamental changes to the availability and effectiveness of commonly-employed estate planning strategies, including the use of grantor trusts, grantor retained annuity trusts (GRATs), and marketability discounts for interests in family-controlled entities with passive assets.

Accordingly, ATRA's "permanence" in this realm is perhaps better regarded as merely introducing a new "status quo" until the next shoe drops possibly later this year.

Where We Were on December 31, 2012 and What We Have Today

Until December 31, 2012, estate planning professionals and their clients were dealing with an extremely favorable "two-year patch" that was scheduled to expire when the clock struck midnight on January 1, 2013. On December 17, 2010, President Obama signed into law "The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" ("TRA 2010"). TRA 2010 ushered in sweeping

changes to the Federal estate, gift and GST tax systems. Among other things, TRA 2010 unified the estate, gift and GST lifetime exemption amounts at $5 million for the years 2011 and 2012, with this amount to be indexed in 2012 – the 2012 indexed amount was $5,120,000. TRA 2010 also established a maximum tax rate of 35%. It moreover ushered in the portability of lifetime exemption amounts between spouses for estate and gift tax (but not GST tax) purposes for the years 2011 and 2012.

TRA 2010 was a "two-year patch" that expired on December 31, 2012, meaning that come January 1, 2013, the tax laws that existed back in *2001* – including the $1 million Federal estate, gift and GST tax exemptions,[2] and the 55% top estate, gift and GST tax rates – were scheduled to come roaring back into effect. Because it was impossible to predict when Congress would act and what form such legislation might take, the unanimous consensus of estate planning professionals was that the year 2012 posed a unique opportunity for estate planning that could be lost forever once the clock struck January 1, 2013.

Giving new meaning to the phrase "better late than never," Congress passed ATRA on New Year's Day 2013 to effectively make TRA 2010's transfer tax provisions permanent, with the primary modification that the top estate, gift and GST tax rates increased from 35% to 40%. The 2013 indexed exclusion amount for the estate, gift and GST taxes is $5,250,000. In addition, the portability of the applicable exclusion amounts between spouses for estate and gift tax (but not GST tax) purposes were made permanent.[3] So in 2013 we now find ourselves in a favorable environment for estate planning for high net worth individuals – at least until Congress next acts to change the rules of the game.

What *Could* Happen in 2013?

There is substantial concern that the next shoe could soon drop and eliminate several commonly employed estate planning techniques within the contours of the now "permanent" estate, gift and GST tax system.

As earlier noted, ATRA only temporarily postponed for two months the spending side of the "fiscal cliff" (known as "sequestration"), which imposed across-the-board spending cuts after 2012. Thus, Congress will once again have to deal with spending cuts almost immediately, and such consideration can be expected to go hand-in-hand with considering revenue raisers to offset them.

Potential revenue raisers could be derived from the Obama Administration's Greenbook proposals that pertain to estate planning. As further discussed below, these proposals would substantially reduce both the availability and the effectiveness of commonly-employed estate planning strategies, including the use of grantor trusts, GRATs, and marketability discounts for family controlled entities with passive assets. Thus, high net worth individuals who wish to avail themselves of these techniques should consult their advisors during the near term.

The Obama Administration's Greenbook proposals affecting estate planning include the following:

- A proposal that would attempt to address the "disconnect" between the income tax rules and the estates tax rules applicable to intentionally defective grantor trusts ("IDGTs"), by among things, (i) including grantor trusts in the grantor's estate for estate tax purposes, (ii) treating distributions from grantor trusts to persons other than the grantor as a taxable gift; and (iii) causing tax consequences to occur upon toggling grantor trust status on and off. By way of background, an IDGT is an irrevocable trust for which one of the "grantor trust" provisions set forth in IRC §§ 671-679 is triggered.[4] Transfers by the grantor to the IDGT will be complete for gift tax (and estate tax) purposes but incomplete for income tax purposes. Therefore, if the trust is drafted properly, the income and gains of the trust will be taxable to the grantor, but the assets transferred to the trust by the grantor will be excluded from the grantor's gross estate upon death. Further, the grantor's payment of income taxes attributable to the trust will not

constitute a gift for Federal gift tax purposes because the grantor is discharging his own legal obligation.[5] In addition, transactions between the grantor and the grantor trust will not be taxable events.[6] These tax benefits of IDGTs under current law are all on top of the wonderful asset protection and property management benefits that trusts can provide.

- A proposal that would extend IRC § 2704(b) to eliminate marketability discounts for interests in family-owned entities that hold passive assets, such as marketable securities.
- A proposal that would significantly reduce the attractiveness of GRATs by, among other things, requiring a minimum term of ten years (thereby eliminating short-term rolling GRATs), preventing the ability to front-load the GRAT annuity, and imposing a minimum taxable gift requirement. By way of background, a GRAT involves a grantor's transfer of property to an irrevocable trust (the GRAT) for a specified number of years, retaining the right to receive an annuity (a fixed amount payable not less frequently than annually). Upon termination of the GRAT, the trust assets are paid to the remaindermen named by the grantor, typically his or her children, or to a trust of which the grantor's spouse and issue are beneficiaries. In essence, the grantor creates a GRAT to transfer its remainder at termination. This transfer is a taxable gift that is deemed to occur upon creation of the GRAT. The remainder is valued for tax purposes by subtracting the interest retained by the grantor—the annuity—from the value of the initial transfer into the GRAT. The Internal Revenue Service ("IRS") requires that the value of the retained annuity be calculated on an actuarial basis using the assumed interest rate published by the IRS under Section 7520 of the Internal Revenue Code that is in effect for the month that the GRAT is funded. For February 2013, the Section 7520 rate is 1.2%.
- A proposal that would impose a consistency requirement for basis purposes between what is reported as fair market value on the decedent's Form 706 Federal Estate and Generation-Skipping Transfer Tax Return as finally determined for Federal estate tax purposes, and what the beneficiary later reports as his or her stepped-up basis upon the decedent's death for income tax purposes; and
- A proposal that would limit the availability of the GST exemption to 90 years.

The message for wealthy individuals is clear. The opportunity to use commonly employed estate planning techniques such as planning with IDGTs, family limited partnerships and family limited liability companies, and short-term GRATs may soon become very limited. Therefore, prudence suggests employing these techniques before this window of opportunity closes and maintaining flexibility in estate planning documents to adjust to changing circumstances.

The New World of Estate Planning Based on Portability

Finally, ATRA established as permanent the portability of the applicable exclusion amounts between spouses where the first spouse to die is either a U.S. citizen or a U.S. resident. Portability, in a nutshell, involves the carryover of the first decedent spouse's unused applicable exclusion amount to the surviving spouse for estate and gift tax purposes (but not for GST tax purposes) and can be accomplished simply through the executor's election on the estate tax return of the first spouse to die. This is a true "game changer," because it effectively means that estate planning advice to married clients who are U.S. citizens or U.S. residents should generally consider the pros and cons of relying on portability of the applicable exclusion amount either in lieu of, or in conjunction with, establishing a traditional "credit shelter trust."

Portability will ensure a step-up in basis of the subject assets at the surviving spouse's death and may appeal to clients as a reason to avoid having to plan their estates. Portability, however, does not dispense with the need to consider using credit shelter or bypass trusts (which could include a trust of which the sole lifetime beneficiary is the surviving spouse) in estate planning in many instances. The following

considerations continue to support the use of credit shelter or bypass trusts, in lieu of relying exclusively on portability:

- There are substantial non-tax benefits to be derived from using trusts, including asset protection, asset management, and restricting transfers of assets by a surviving spouse (particularly if there are children from a prior marriage, or concerns about a subsequent remarriage).
- Portability does not generally apply for *state* estate tax purposes, including for New York State. Thus, a well-drafted estate plan for a New York married couple will still typically involve funding a credit shelter trust with the largest amount capable of passing free of New York State estate tax (currently $1,000,000) to avoid wasting the New York State estate tax exemption upon the death of the first spouse to die.
- A step-up in basis may nevertheless be achieved over assets in a credit shelter trust by giving the surviving spouse a general power of appointment over the property of the credit shelter trust (such as by allowing the surviving spouse to designate by her Will that some portion of the trust property shall be paid over to her estate upon her death) in a formula amount equal to the largest amount capable of passing free of Federal estate tax as finally determined for Federal estate tax purposes. This general power of appointment will cause estate tax inclusion over the property that is subject to it, thereby producing a step-up in basis to such extent.
- The deceased spousal unused exclusion (DSUE) amount is not indexed.
- Depending upon subsequent facts and circumstances, the DSUE amount may be lost if the surviving spouse remarries and survives his or her next spouse.
- With portability, growth in assets is not excluded from the gross estate of the surviving spouse. In contrast, growth in the assets of a credit shelter or bypass trust is excluded from the gross estate of the surviving spouse; and
- There is no portability of the GST exemption. So planning with trusts will still generally be warranted if GST planning for grandchildren and more remote descendants is desired.

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[1] A discussion of ATRA's income tax provisions is beyond the scope of this article. It bears mentioning, however, that as a result of the increase in the maximum Federal income tax rate to 39.6% as augmented by the 3.8% additional tax on net investment income under the Patient Protection and Affordable Care Act (thereby producing an aggregate maximum Federal income tax rate of 43.4%), it will frequently be desirable (all other things being equal) for executors of estates and trustees of nongrantor trusts to consider making distributions to beneficiaries in lower tax brackets. This is so because, in 2013, estates and nongrantor trusts reach the maximum tax bracket at only $11,950 of taxable income.

[2] The GST exemption amount was subject to indexing and would have been $1,430,000 in 2013.

[3] In addition, as a result of ATRA, the state death tax deduction of IRC § 2058 remains permanent while the state death tax credit remains repealed. Moreover, the favorable GST Section 9100 relief, substantial compliance and automatic allocation rules that were enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 were all made permanent.

[4] For example, grantor trust status may be triggered under IRC § 675(4)(C) if the trust agreement provides that any person acting in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity, may exercise the power to reacquire the trust corpus by substituting other property of an equivalent value. The IRS confirmed in Rev. Rul. 2008-22 that the grantor's retention of this substitution power does not constitute a retained interest for estate tax purposes under IRC §§ 2036 and 2038 provided that adequate fiduciary safeguards are in place to ensure the grantor's compliance with the terms of this power. *See also* Rev. Rul. 2011-28 (extending this safe harbor to life insurance for purposes of IRC § 2042).

[5] *See* Rev. Rul. 2004-64.

[6] *See* Rev. Rul. 85-13.

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