Budget Proposal Presents Opportunities, Speed Bumps

New tax legislation could have significant impact on your clients' estates

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In the waning days of 2010, Congress passed legislation that ended the uncertainty about the federal estate, gift and generation-skipping transfer (GST) taxes. However, that new certainty lasts only until the end of 2012. The new law created major estate planning opportunities, however, the administration's budget proposals may also put a crimp into these tax saving prospects.

While this is not a detailed summary of the current law, it does highlight some of the advantages that are available under the new legislation and what will remain, or be lost if the president's budget proposals are enacted.

Basic Transfer Taxes

There are three types of transfer taxes: the estate tax, in which taxes are transferred at death; the gift tax, where taxes are transferred during life; and the GST tax (which is an additional tax imposed on gifts or bequests that skip a generation or more, such as gifts to your grandchildren).

As of Jan. 1, 2011, the top tax rate on all these taxes is 35%. Assets transferred at death are subject to a step-up in basis, which eliminates built-in capital gain.

Each individual has a lifetime exemption for gift and estate taxes of $5 million, which will be indexed for inflation after 2011. The gift tax exemption reduces the estate tax exemption. After 2012, the exemption is scheduled to revert to $1 million per person and the top tax rates are to be increased to 55%.

The president's budget proposal will create a permanent $3.5 million exemption and a 45% top rate of tax. Thus, the exemption would be reduced from the current $5 million by $1.5 million per person. Individuals may wish to take advantage of the current $5 million per person to transfer additional wealth at this time without incurring a gift tax.

The Portability Provision

Prior to the Jan. 1 Act, assets had to be divided between spouses so that each spouse had sufficient assets in his or her sole name to take advantage of each spouse's estate tax exemption. At the death of the first spouse, the deceased's assets could not pass outright to the surviving spouse, as this would cause the surviving spouse's estate to increase and the deceased spouse's exemption to be lost. Therefore a trust (sometimes called a "credit shelter trust") would be established, which would benefit the surviving spouse and not cause the assets to be included in his or her estate.

The new tax law provides that the surviving spouse of a person who dies after 2010 and before 2012 may be eligible to increase the surviving spouse's exemption by the unused portion of the deceased spouse's exemption. This provision is known as "portability."

For example if a husband dies, having made no taxable gifts and owns a house and a portfolio jointly with his wife both valued at $2 million, the wife will receive these assets outright and her estate will be worth $4 million. The husband's estate doesn't have to use any of his $5 million exemption because all assets bequeathed to a spouse pass free of estate tax.

But, with portability, the widow will also inherit her husband's $5 million exemption, as none of it was used by his estate. Unless the widow's assets exceed $10 million, there will be no federal tax due at the time of the her death. Without portability, a federal tax would be due if the widow's assets exceeded $5 million.

The president's proposals make portability permanent. This would reduce complexity in planning and the need to create a trust for the benefit of the surviving spouse.

For many married couples, portability may be helpful. Assets owned outright by a surviving spouse will receive a step-up in basis for income tax purposes at the surviving spouse's death. Assets held in a trust for the benefit of the surviving spouse will not.

While portability may make sense in some circumstances, in others it may not. A trust is often beneficial in the event the surviving spouse's assets appreciate in value. If the assets are held in trust, this appreciation in value will escape taxation. Further, a trust would be necessary for married couples residing in states, such as New York and New Jersey, which have their own estate taxes with substantially lower state exemptions, in order to take advantage of both spouse's state exemption amounts.

Portability, however, does not apply to the GST tax. Thus, if married couples wish to engage in multi-generational planning, portability will not be useful.

Donors who are planning to create long term dynasty trusts should take advantage of the current law.

Dynasty Trust Exemption

The GST tax is imposed on transfers to beneficiaries more than one generation below the generation of the person making the gift or bequest. In 2011 and 2012, each person has a $5 million exemption against the GST tax. Individuals often take advantage of this GST exemption by creating long-term "dynasty trusts" and allocating GST exemption to the trust. The dynasty trust becomes permanently exempt from the GST tax.

Many states, including New Jersey, Delaware, South Dakota and Alaska, have changed their state trusts and estates laws to eliminate the so-called rule against perpetuities—a law that was used to limit the duration of a trust. Donors in these states can establish trusts, which can last forever. If the donor's GST exemption is allocated to these perpetual trusts, then assets in the trust will escape gift or estate taxes at every subsequent generation level.

The president's proposal provides that the GST exempt status of the trusts will expire 90 years after the creation of the trust. Thus, donors who are considering planning to create long term dynasty trusts should take advantage of the current law.

Grantor Retained Annuity Trust

In a grantor retained annuity trust ("GRAT"), the creator of the trust retains the right—for a set term ("initial term")—to receive a yearly payout from the trust ("annuity"). At the end of the initial term, the assets of the trust pass to the donor's beneficiaries free of transfer tax. The annuity is often structured so that its present value is equal to the fair market value of the assets gifted to the GRAT. There is no gift tax consequence of the gift to the trust.

The annuity can be structured either as set amount, or one that increases or decreases over time, and can be paid in cash or in kind. However, in order to be successful, the donor must survive the initial term or else most or all of the GRAT would be included in the donor's estate.

GRATs are currently being used when donors believe that property will increase substantially in value or over a short term (such as two to three years) since the appreciation in the value of the GRAT assets escapes taxation. For marketable assets, a short term GRAT will capture a large upswing in the market. Donors will often establish a series of rolling GRATs, using the annuity from one GRAT to establish another GRAT on a year-by-year basis.

The current proposals include a provision to require an initial term of at least 10 years. While this will not eliminate the use of the GRAT, it does increase the mortality risk, and, in the case of GRATs with marketable securities, it reduces the ability to capture a large upswing in the market. For donors with health concerns, the mortality factor may be important.

The minimum 10-year GRAT proposal, combined with the elimination of certain valuation discounts for closely held businesses, will severely reduce the benefits of estate planning for business owners. You should think about engaging in this planning now to take advantage of the current status of GRATs and discounting.

In light of the limited duration of the new tax laws and the president's proposals, you should work with your clients to take advantage of these opportunities soon. **OWS**

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