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OBAMA ADMINISTRATION BUDGET PROPOSES INCOME AND ESTATE TAX INCREASES

The White House has released its 2013 budget, along with the Treasury Department "Green Book," which explains the administration's revenue proposals. The administration again proposes increasing the estate tax by returning to the rates and exemptions applicable in 2009 and limiting or eliminating several estate tax reduction mechanisms now in common use. These proposals serve as a sharp reminder that the opportunity to do certain types of estate planning on a large, efficient scale may disappear at the end of this year.

The budget also includes income tax increases that would apply to high-income taxpayers. Making gifts to family members or beneficiaries who pay tax at lower rates may therefore lower overall tax burdens.

Background

For years, individuals planning their estates have been standing on shifting sands. The estate tax exemption has increased 20 times since 1976, and the estate tax was repealed altogether for 2010. The top estate tax rates have fallen since 1976 from a high of 77% to the current 35% rate.

Under current law, an individual may give away $5 million (adjusted to $5,120,000 now for inflation) during lifetime or at death free from gift and estate taxes. If a deceased spouse's estate does not take full advantage of that $5 million exemption, the surviving spouse's estate may use the unused portion. If an individual transfers more than $5 million or a married couple transfers more than $10 million, the excess is taxed at 35%. However, this structure – a $5 million exemption, 35% tax rate and "portability" of exemption between spouses – applies only in 2011 and 2012. At the end of this year, if Congress fails to act, the federal estate tax law will revert to 1997 law. The estate and gift tax exemption will be $1 million, a top tax rate of 55% will apply, and portability will be repealed.

Budget Proposal – Estate Tax Regime

The proposed 2013 budget maintains the portability of unused estate and gift tax exemptions between spouses. However, the estate tax exemption would fall to $3.5 million and the estate tax rate would be increased to 45%. The gift tax exemption would no longer be the same as the estate tax exemption and would fall to $1 million.

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Planning Considerations

The proposed reduction of the gift tax exemption to $1 million would significantly limit lifetime gifts, which can move growth on the gifted property out of a donor's estate. Some people are choosing to take advantage of the $5 million gift tax exemption in the window of opportunity that exists now. An individual may make large gifts of property this year, ensuring that if the value of the property grows, that appreciation will not be taxed as part of the individual's estate. This type of planning can also reduce state estate taxes at death.

Call to Action: Now is the time to review your estate plan before the sands shift again and the current advantageous tax planning environment disappears, or as described below, becomes even more challenging.

Other Budget Proposals

The administration proposals would increase income taxes for high-income individuals and couples and would limit or eliminate several planning techniques frequently used to reduce or avoid estate and gift taxes. Some of these techniques have been in use for decades, and others are refinements of long-standing estate planning mechanisms. The budget includes the following proposals:

- *Elimination of the "Intentional Grantor Trust."* A grantor trust is typically a trust that is treated for income tax purposes as the property of the grantor – the person who established the trust. The grantor, and not the trust or the beneficiaries, is therefore taxed on the trust income. The trust property can grow free from the burden of income tax. Further, a grantor trust may be structured so that it is not part of the grantor's estate for estate tax purposes. In fact, the grantor's payment of income taxes on behalf of the grantor trust reduces the property exposed to tax in the grantor's estate.

  The administration proposal would prevent this by including in the grantor's taxable estate any trust treated as owned by the grantor for income tax purposes. Even an irrevocable life insurance trust – a fundamental part of estate tax planning for many people – would be rendered ineffective by this provision. While the insurance industry is certain to fight it vigorously, this proposal remains a very significant concern for taxpayers.

- *Elimination of Perpetual Trusts.* Illinois law, and the law of many other states, now allows a trust to last forever (a "dynasty trust"). These trusts may be made exempt from the generation-skipping transfer tax (or "GST"), a tax on transfers to

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grandchildren and younger generations. Property in a GST-exempt, dynasty trust can grow and be held for the benefit of future generations – theoretically for hundreds of years – without exposure to estate tax or GST. The administration proposal would limit the tax-sheltered period of trusts to 90 years. After that time, distributions would be subject to GST.

- *Continued Attack on GRATS.* Grantor retained annuity trusts or "GRATs" are designed to shift the appreciation on trust property from the grantor's estate to his or her beneficiaries at a low or no gift tax cost. The administration's proposal would not eliminate these trusts, but would make them riskier and less efficient by requiring that they generate a taxable gift and last for at least ten years. This rather arbitrary rule would make the use of a GRAT riskier for elderly taxpayers and introduce an additional element of uncertainty for younger taxpayers as well.

- *Limits on Valuation Discounts*. The administration continues to object to the practice of valuing interests in family business entities at a discount, which may reflect the fact that the owners may have a limited ability to sell their interests or control the underlying property. Under the administration's proposal, certain rights and restrictions of the family owners would be disregarded when valuing the family-controlled interests for estate and gift tax purposes.

Planning Considerations

It is easy to take a wait-and-see attitude about these proposals because some of them are perennial – often proposed and ultimately deleted before legislation is enacted. But some of these proposals, like the elimination of the tax benefits of dynasty trusts, are recent, and this is the first year in which the administration has proposed that all grantor trusts should be subject to estate tax. Congress is likely to focus on the estate tax after the elections this fall, as the "sunset" of the current tax law approaches. Some of these other proposals may receive attention at the same time. If enacted later this year, the administration's proposals should not apply to gifts and transactions that have already occurred.

Call to Action: These techniques are targeted, in part, because they work. The administration's explanation of GRATs, for example, calls them "a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers." Therefore, this may be an optimal time to take advantage of some of these targeted estate planning techniques. The current $5 million gift tax exemption provides clients with a rare opportunity to do efficient estate planning on a large scale. **The current financial environment with extraordinarily low interest rate environment and depressed real estate values also offer unique opportunities for effective wealth transfers now.**

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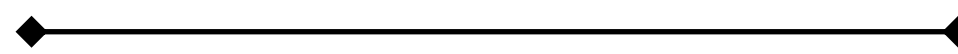
Income Tax Issues

The estate tax is not the only tax increase on the table. The administration proposes a number of measures that would increase income taxes for individuals with more than $200,000 in adjusted gross income and married couples with more than $250,000 of "AGI." This includes restoration of the 36% and 39.6% marginal tax rates, reinstatement of the limitations on itemized deductions, and restored phase-out of the personal exemption for upper-income taxpayers. In addition, the administration proposes raising the top capital gains rate from 15% to 20% for this group. High-income taxpayers would also pay tax on dividends at ordinary income rates (topping out at 39.6%), rather than as capital gains (now 15% and possibly increasing to 20%).

Planning Consideration

Increases in the effective tax rates that apply to upper-income individuals and families may make gift-giving even more logical for some individuals. An individual paying federal income tax at a 39.6% top rate (with fewer deductions and exemptions and with dividends taxed as ordinary income) may wish to make gifts to adult family members and other beneficiaries who will not be taxed at the same high rate. This is one more reason to plan as Congress nears action.



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