

Gifts with (Government) Strings Attached?

Assessing the Wealth-Transfer Tax Proposals

“With a new presidential administration in place, estate-planning circles are buzzing about possible changes to the estate and gift tax laws,” says Mitch Drossman, national director of wealth planning strategies for U.S. Trust. Indeed, a variety of proposals are being discussed in legislative circles these days.

“Some of these would increase the tax burden on individuals, and some would decrease it,” Drossman notes. “While it’s difficult to handicap the likelihood of success for each proposal — some are unlikely to even become bills let alone see passage — I think it’s important for individuals and their planning professionals to be aware of them, to track their legislative progress, and in certain circumstances, to plan accordingly.”

WHERE DO WE STAND?

The federal estate tax is scheduled to be repealed in 2010 and then return with a vengeance (for taxpayers) in 2011 — that is, with a \$1 million exemption rather than the current \$3.5 million, and a top estate and gift tax rate of 55% rather than the current 45%. State rates may add to this burden. The gift tax exemption would remain at \$1 million. The Obama administration would prefer to leave the current \$3.5 million estate tax exemption, \$1 million gift tax exemption, and 45% estate and gift tax rates intact.

Beyond these broad strokes, Drossman adds, are several proposals — the sub-

ject of various Congressional hearings, reports by the staff of the Joint Committee on Taxation, and others that could impact individual tax burdens if enacted.

REUNIFICATION OF ESTATE AND GIFT TAX EXEMPTIONS

“Right now, estate and gift tax exemptions are not unified — that is, they are not the same amounts,” explains Steven Lavner, a member of the national wealth planning strategies group at U.S. Trust. Of the total estate tax exemption of \$3.5 million, only \$1 million can be used during an individual’s lifetime. This mismatch tends to discourage substantial lifetime giving. “Say I wanted to give my child a \$2 million gift now. I would face taxes on \$1 million. If I waited until after my death, my estate would pay no taxes.” This works to the government’s benefit from a revenue perspective.

However, a number of legislative proposals calling for reunification of estate and gift tax exemptions have emerged in recent years, including a bill introduced in April 2009. This isn’t likely given the President’s proposals, the current economic climate and the government’s need for revenue.

PORTABILITY OF THE ESTATE TAX EXEMPTION

“Portability means that my estate tax exemption, or any remaining portion of it that I don’t utilize, can be transferred to my spouse upon my death,” says Drossman. “In certain cases, it could minimize the need for retitling of assets and the utilization of a variety of sophisticated planning options. That said, even if something like this does pass, planning would still be recommended, particularly for families with more than \$7 million in assets. Until portability provisions are enacted, we’ll need to pay careful attention to asset titling and take appropriate actions when necessary to utilize both spouses’ estate tax exemptions.”

LIMITING GENERATION-SKIPPING TAX EXEMPTION FOR DYNASTY TRUSTS

Estate, gift and generation-skipping tax laws are designed to impose a transfer tax on every generation, Drossman explains. “However, there is a provision that allows you to skip multiple generations without that tax being imposed. Say I have my money put into a trust for my children, but the trust doesn’t terminate; it keeps going from generation to generation. States tend to want assets to be productive and so they have usually placed limits on trusts’ duration. But the tide has turned, and many states now allow trusts to go on with no required end point — and so their assets continue to grow. Maybe the trust makes distributions from time to time, and pays taxes on its earnings, but there is no requirement that the trust distribute its principal, so it’s never taxed.”

Current proposals, however, would limit the ability to exempt these so-called dynasty trusts. “This would make certain types of planning more difficult,” he says. But just how likely is enactment of such proposals? “It’s hard to say. For those interested in creating such a trust, it would probably be prudent to avoid delays.”

LIMITING VALUATION DISCOUNTS

“Valuation discounts have been a significant element in estate planning for some time,” Lavner says, “particularly the minority-interest and lack-of-marketability discounts. The first acknowledges that a

minority interest in an asset — say a small stake in a family business — does not confer a controlling interest, and therefore it's not as valuable as it might be. The same goes for the lack-of-marketability discount. When you purchase an illiquid asset it's not always possible to sell your stake right away — not without offering a discount to potential buyers. Establishing and utilizing these discounts is a big part of estate planning.”

Unfortunately, these discounts have attracted government scrutiny and resulted in a number of proposals to limit their availability. The Obama Administration's 2010 Revenue Proposals would disregard certain restrictions for purposes of valuing an interest in a family-controlled entity, if the restriction will lapse or may be removed by the transferor and/or the transferor's family. Although many other proposals have been around for years, the current political environment, combined with a need to raise revenue, may suggest a greater likelihood of enactment, in Lavner's view. “For anyone contemplating gifts involving valuation discounts, it would probably be prudent to act sooner rather than later.”

LIMITING CRUMMEY POWERS

One of the most widely used estate planning techniques is the annual gift tax exclusion, which currently allows for gifts of

up to \$13,000 per individual each year. The only limitation is that they must be gifts of “present interests” to qualify for the exclusion — that is, the beneficiary must have the right to enjoy the property immediately.

“This means outright gifts qualify, but gifts in trusts may not unless special provisions are utilized,” says Drossman. “One way to do this is by giving the beneficiary the temporary right to withdraw the gift from the trust — known as a ‘Crummey power’ (the name is derived from a famous court case). Recognizing the benefit of qualifying gifts for as many annual exclusions as possible, some planners have granted Crummey powers in trusts to individuals who have no other beneficial interest in the trust — extending the present-interest requirement far beyond original Congressional intent, with a corresponding decrease in tax revenue.”

A number of potential changes are on the horizon, each of which would restrict the use of Crummey powers. “If any of these options are adopted, they could significantly alter the drafting of many trust instruments,” says Drossman.

LIMITING GRATs

Another widely used estate planning technique is the Grantor Retained Annuity Trust (GRAT). “It allows an

individual to make a tax-free transfer of appreciation on property in excess of the interest rate prescribed by the IRS,” notes Drossman. “GRATs have been so successful that they have drawn government scrutiny.” GRATs are typically created for a short term, commonly two years. However, to require some downside risk to this technique, the Administration's 2010 Revenue Proposals would require that a GRAT have a minimum term of 10 years.







KEEP YOUR EYES OPEN, PLAN AHEAD WHEN NECESSARY

“No one knows which, if any, of the above proposals may ultimately be enacted or the exact form they might take,” Drossman notes. “Given the need to raise revenue, the proposals for reunification and portability may be less likely than the others. While there is a small chance that some of these changes could be made retroactive, for anyone contemplating actions in areas that could be impacted, it probably still makes good sense to consult with advisors and take action now.” ■

By Sean Gillia, U.S. Trust

Potential Reforms

Below are five possible legislative proposals and their potential impact on taxpayers.

Reform					
Reunification of Estate & Gift Tax Exemptions	Portability of Estate Tax Exemption	Limit Generation-Skipping Tax Exemption	Limit on Valuation Discounts	Limit Crummey Powers	Limit GRATs
Description					
Current mismatch discourages lifetime giving.	Allowing surviving spouses to utilize unused exemptions of deceased spouses would simplify certain aspects of estate planning.	Limiting the ability to exempt dynasty trusts would make certain types of planning more challenging.	Valuation discounts are central to estate planning today; limiting or eliminating them would pose planning challenges.	A number of potential changes could restrict the use of the annual gift tax exclusion in trusts.	Requiring a 10-year minimum term would curtail the use of GRATs in estate planning.
Potential Impact on Taxpayers					
Positive 	Positive 	Negative 	Negative 	Negative 	Negative 

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