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The Obama Administration's Fiscal Year 2014 Tax Proposals That Pertain to Estate Planning

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The Obama Administration's Fiscal Year 2014 tax ("Greenbook") proposals that pertain to estate planning, which were released in April 2013, have shattered as a mirage any notion of a "permanent" estate and gift tax system little more than three months after Congress's enactment of so-called "permanent" tax relief in this field. In fact, the proposals have actually created a new urgency for wealthy individuals to engage in transactions with their grantor trusts.

The Fiscal Year 2014 Greenbook proposals come on the heels of the recent transformation that had just occurred in the overall estate planning landscape courtesy of the American Taxpayer Relief Act of 2012 ("ATRA"), which 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 purported to establish some degree of stability in the estate, gift and generation-skipping transfer (GST) tax systems through the elimination of sunset provisions to favorable exclusion amounts, tax rates and GST tax rules. This manifested itself as a "permanent" 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 to apply to taxable transfers that exceed the applicable exclusion amount. Moreover, ATRA made this exclusion permanently "portable" for estate and gift tax purposes (but not for GST tax purposes) between spouses following the first spouse's death. 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 through the executor's election on the estate tax return of the first spouse to die.

With the lone exception of maintaining portability, all of this has now been put in jeopardy during the years to come and can be expected to be the subject of intense budget negotiations in Congress. A summary of several of the key provisions of the Fiscal Year 2014 Greenbook proposals is set forth below. Conspicuously absent from this year's Greenbook is the Obama Administration's long-time stalwart proposal to eliminate marketability discounts for interests in family-owned entities that hold passive assets, such as marketable securities.

The Estate, Gift and GST Tax Exclusions and Rates Would Revert Back to 2009 Rules

The Obama Administration proposes to restore the 2009 estate, gift and GST transfer tax exclusions and rates beginning in 2018. Under this proposal, the estate and GST tax exemption amounts would be reduced to \$3,500,000, while the gift tax exemption would be reduced to \$1,000,000. There would no longer be any indexing of these exemption amounts for inflation. The top tax rate would be increased to 45%. Portability would, however, continue in effect.

The Administration's proposal clarifies that there would be no "clawback" for prior transfers by reason of the reduction in the estate, gift and GST tax exemption amounts. Accordingly, if this proposal were enacted into law, it would most likely prompt another rush of gifting for wealthy individuals in late 2017 similar to the recent gifting rush at the end of 2012.

Sales, Exchanges and "Comparable Transactions" with Grantor Trusts

The Obama Administration would attempt to address the "disconnect" between the income tax rules and the estate tax rules that apply to "intentionally defective grantor trusts" ("IDGTs").[1] However, in stark contrast to the previous year's vastly overbroad Greenbook proposal concerning grantor trusts – which would have generally included most grantor trusts in the taxpayer's estate for estate tax purposes -- the Fiscal Year 2014 proposal is much more narrowly drawn and would only be triggered in the case of certain *transactions with grantor trusts* that constitute a "*sale, exchange or comparable transaction* that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust." In the case of such transactions, the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments of such property), net of the amount of the consideration received by the person in that transaction, (i) would be subject to estate tax as part of the gross estate of the deemed owner, (ii) would be subject to gift tax when grantor trust status ceases as to the deemed owner during such person's lifetime, and (iii) would be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to such other person) during the life of the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

Thus, the current proposal would allow IDGTs to be created, but would not allow taxpayers to sell or exchange assets to an IDGT (or engage in a "comparable transaction") without potential adverse tax consequences. An "exchange" presumably could include a grantor's exercise of a power to substitute assets of equivalent value in a nonfiduciary capacity, which is a commonly used trigger for grantor trust status under IRC § 675(4)(C). It is unclear what this proposal means through its reference to "comparable transactions" and whether that would embrace, for example, making loans to the trust, or leasing back real property (such as a vacation home) from the trust.

Significantly, the 2014 Greenbook proposal specifically excludes from its ambit trusts that are grantor trusts solely by reason of IRC § 677(a)(3), which pertains to the application of income to pay life insurance premiums. Thus, such narrowly drawn irrevocable life insurance trusts would not be subject to estate tax inclusion merely because they are grantor trusts, perhaps even if the specified transactions described above were engaged in. In addition, the proposal would not alter the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code (such as grantor retained annuity trusts and qualified personal residence trusts).

This proposal would apply to transactions entered into on or after the date of enactment. Thus, a rush to engage in sales, swaps, loans and leases with grantor trusts can be expected to occur in the near term while the current favorable tax environment for such transactions is still available.

Additional Restrictions on Grantor Retained Annuity Trusts

The Obama Administration would significantly reduce the attractiveness of grantor retained annuity trusts ("GRATs")[2] 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. In addition, to combat the perceived abuse of "99-year GRATs," the Obama Administration would limit the maximum term of a GRAT to the annuitant's life expectancy plus ten years.

Additional Greenbook Proposals That Pertain to Estate Planning

The Administration's 2014 Greenbook contains the following additional proposals that pertain to estate planning:

- A proposal that would change existing law under IRC § 101 by subjecting "buyers of policies" to the "transfer-for-value" exception to the exclusion of life insurance proceeds for income tax purposes. The phrase "buyers of policies" presumably is broad enough to encompass grantor trusts. If enacted, such "buyers of policies" would be taxed on death benefit proceeds in excess of the amount of consideration furnished.
- A proposal that would limit the scope of the current law exclusion under IRC § 2611(b)(1) for GST tax purposes for direct payments of tuition and medical care so that this exclusion would only apply to payments *made by a living donor* directly to the provider of medical care or to the school for tuition. As a result of these restrictions, trust distributions for these same purposes -- including in the case of so-called "Health and Education Exclusion Trusts" ("HEET Trusts") -- would not qualify for this exclusion.
- 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 (presumably, 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.
- A proposal that would limit the availability of the GST exemption to 90 years.
- A proposal that would extend the 10 year estate tax lien under IRC §

6324(a)(1) to cover the entire 14 year and 9 month term subsequent to the decedent's death that is subject to the deferral of estate tax under IRC § 6166.

- A proposal that would restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation.

Related Proposals Pertaining to Qualified Plans and Individual Retirement Accounts

In addition, the Fiscal Year 2014 Greenbook includes the following proposals that pertain to qualified plans and Individual retirement accounts:

- A proposal that would limit the total accrual of retirement benefits by prohibiting additional contributions or the receipt of additional accruals if the taxpayer has accumulated retirement benefits in excess of the amount necessary to provide the maximum annuity permitted under a defined benefit plan (currently $205,000 per year payable as a joint and 100% survivor annuity beginning at age 62). This amount is currently approximately $3,400,000 at age 62.
- A proposal that would generally require non-spouse beneficiaries of qualified retirement plans or IRAs to take distributions over no more than five years. Exceptions would apply for beneficiaries who are disabled, chronically ill, up to 10 years younger than the participant or IRA owner, or a minor child (the minor child's five-year distribution period would commence upon attaining the age of majority).
- A proposal that would extend to non-spouse beneficiaries the ability to make sixty (60) day rollovers of distributions from qualified plans or IRAs to non-spousal inherited IRAs. This proposal would afford non-spouse beneficiaries the same treatment for 60-day rollover purposes that surviving spouses currently enjoy.
- A proposal that would exempt participants and IRA owners with aggregate benefits under $75,000 from having to take required minimum distributions.

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[1] An IDGT is an irrevocable trust for which one of the "grantor trust" provisions set forth in IRC §§ 671-679 is triggered. 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. *See* Rev. Rul. 2004-64. In addition, transactions between the grantor and the grantor trust will not be taxable events. *See* Rev. Rul. 85-13. 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.

[2] 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 <u>remainder</u> 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.

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