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Estate Tax

Tax Professionals Back Portability Provisions In Obama Estate Plan; Permanence a Priority

Language in President Obama's recent budget proposal making permanent a law allowing a spouse to transfer his or her estate tax exemption to a surviving spouse will simplify planning, but what taxpayers really need is underlying estate tax permanence, attorneys said in recent interviews.

Obama's fiscal year 2012 budget recommended making permanent the 2009 estate tax law that saw a 45 percent top rate of taxation paired with a $3.5 million exemption level. But it also recommended making portability permanent, requiring consistency in value for transfer and income tax purposes, modifying the rules on valuation discounts, requiring a minimum 10-year term for Grantor Retained Annuity Trusts (GRATs), and limiting the duration of the generation-skipping transfer tax exemption (31 DTR GG-1, 2/15/11).

''For certain estates, portability can be very important. If they're interested in simplicity and they don't want to be bothered with a lot of trusts, it makes it possible for the surviving spouse to have two exemptions,'' said Carlyn McCaffrey, chair of the Estate Planning practice group at Weil, Gotshal & Manges in New York. ''That's a big simplification.''

The $800 billion package of tax cuts that Obama signed into law (Pub. L. No. 111-312) in December 2010 set the estate tax for 2011 and 2012 at a reduced 35 percent tax, coupled with an increased $5 million exemption level per person. But without further action, the tax rate in 2013 will revert to its pre-2001 level of 55 percent and an exemption level set to drop to $1 million per person (242 DTR GG-3, 12/20/10).

Portability Seen as Favorable Simplification Tool. The 2010 law also, for the first time, included portability language allowing a surviving spouse to use any unused estate tax exemption amounts that his or her spouse left at death. For the next two years, that change would allow a surviving spouse to have a $10 million exemption if the decedent did not use his or her exemption.

Obama's budget, if enacted, would make exemption portability permanent, a change that would cost the federal government about $3.7 billion over 10 years according to the Treasury Department. Estate-planning attorneys said the benefits it brings to taxpayers make it well worth the cost.

''It is going to be a tremendous field-leveler for people with modest estates, but still not so modest that they can ignore the estate tax all together,'' said Ronald Aucutt with McGuireWoods LLP in McLean, Va.

Aucutt said a pyramid can reflect the general distribution of upper-income wealth, where there are fewer taxpayers subjected to the estate tax in the band closest to the bottom.

Those people, he told BNA, should not be ''expected to turn cartwheels'' and engage in the level of planning that the uber-rich do. ''It's not fair that they pay a penalty for not doing all kinds of fancy planning—not the most aggressive kind of planning, but the ordinary kind of planning that would create complicated and sometimes oppressive-sounding trusts to achieve the same results that portability now does.''

Treasury agreed, saying in its ''Green Book'' explanation of revenue proposals in the budget that ''portability would obviate the need for such burdensome planning.''

Portability ''tends, to some extent, to put my profession out of business. I think the fear and nervousness that has been expressed about that has been exaggerated, but I understand that at the margin it could have that effect,'' Aucutt said. ''There's still a lot of estate planning things that people of that sort should be doing.''

Permanent Portability Needs A Tweak. Both the 2010 law and the Obama budget proposal include language limiting the portability of the $5 million lifetime exclusion for estate and gift taxes to the ''last'' deceased spouse to die.

Shirley Kovar, a partner with Henderson, Caverly, Pum & Charney LLP in Rancho Santa Fe, Calif., called the ''last'' deceased spouse language a ''glitch'' and said lawmakers working on estate tax permanency need to contemplate what happens to a surviving spouse with two decedent spouses.

In 2006, then-Ways and Means Committee Chairman William Thomas (R-Calif.) introduced legislation that included portability, but without any ''last spouse'' rules. Aucutt said Congress should keep the portability provision simple and cap the surviving spouse's exemption at ''no more than double'' the exemption allowed by law.

The current restriction, he said, is ''troublesome'' because it will create a distortion as far as estate and gift planning is concerned. ''It will encourage a surviving spouse to use his or her pre-deceased spouse's carried over exemption by lifetime gifts, especially if they remarry or are thinking of remarrying in order to not lose it if it should turn out that they do remarry and are widowed again,'' Aucutt said. ''To influence that kind of behavior and force people to do things that they wouldn't naturally do, is not a good result.''

Beth Kaufman, a partner at Caplin & Drysdale in Washington, D.C., echoed that sentiment, saying the current portability language still raises practical problems for couples who may actually be dissuaded from marrying.

''Usually we don't like policies that discourage marriage or create incentives to marry terminally ill paupers to create a tax exemption,'' Kaufman said.

Change to GRATs Could Deter Use. Obama's budget also included a change to tax law that would raise about $3 billion over 10 years by requiring a minimum term of 10-year term for GRATs. Obama has previously proposed this change and congressional Democrats have long viewed that change as a potential offset for other tax matters, but have never succeeded on getting it enacted.

In its description of the provision, Treasury noted that GRATs are a ''popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers,'' as long as the grantor survives the term of the GRAT and the trust assets do not depreciate.

There is currently no minimum GRAT term in the law, although a common term is two or three years. Jerome Hesch, an attorney with Carlton Fields in Miami, said taxpayers use GRATs to eliminate estate taxes but because they depend on volatility, they likely will no longer be used if a 10-year term becomes mandatory.

Taxpayers anticipate that the property in the GRAT trust will either increase in value or dramatically decrease in value over the two- or three-year period. An increase means the GRAT will be successful, while the reverse is true as well. But a 10-year GRAT could mean the increases and decreases balance out.

''What the two-year rolling GRATS were doing was taking into account the volatility of marketable securities,'' Hesch said. ''Once they have minimum GRATs of ten years, nobody will ever use them again.''

Aucutt disagreed that GRATs would no longer be used, but said the change would definitely reduce their use. He said people really depended on the large upswings that could occur with a shorter period. Extending the term also increases the likelihood that the grantor will die during the term.

''You will see more creative use of GRATs. Right now almost all GRATs look the same in terms of the distribution of scheme,'' Aucutt said. ''I think we're going to see more customized payout schedules that take into account the longer term. There's going to be a lot more attention paid to the subtleties of the GRAT.''

Kaufman said passage of a minimum term for GRATs in Congress has seemed inevitable as a way to pay for other provisions, but since there were no revenue raisers used to offset the tax extenders package in 2010, it will be interesting to see if will be possible under a split Congress by the time the current individual income tax rates expire again in 2012.

''We will see if there is anything left to the art of compromise,'' Kaufman said. ''I think the end of 2012 will probably look a lot like 2010. . . I think the outcome will turn more on politics and the economy than good policy.''

Ninety-Year Limit Proposed on GST Exemption. Kaufman said a new and interesting provision in this year's budget proposal was the addition of a plan to terminate the tax exclusion for trusts set up for grandchildren or individuals who would otherwise be liable for the generation-skipping transfer tax. The exemption for 2011 is $5 million, but would return to $1 million in future years absent congressional action.

Under the president's proposal, the generation-skipping transfer tax exemption would expire 90 years after creation of a trust, preventing beneficiaries from claiming estate tax-free money in the trust in perpetuity.

Moreover, ''because contributions to a trust from a different grantor are deemed to be held in a separate trust under section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust,'' Treasury said.

Treasury said the new limit is necessary because all but three states had laws preventing trusts from existing in perpetuity, but many of those laws have now been repealed.

Kaufman did not balk at the concept behind the proposal, but said there may be minimal legislative interest in the provision because it would not raise any additional revenues under the budget.

''The revenue impact isn't available for 90 years—I don't think that's in anybody's budget window,'' Kaufman said.

Valuation Changes Raise Big-Time Revenue. Aucutt said one of the biggest problems with the estate tax is that it is based on value and value is hard to determine, particularly on a consistent basis.

Because there are so many ways to determine value, there also are many ways to deal with having a value-based system, he said. To respond to changes, aside from the GRATs, Treasury included two other previous recommendations in its budget proposal.

In the wake of judicial decisions and new state laws that Treasury said have made Section 2704(b) ''inapplicable in many situations,'' and in response to the IRS identifying new arrangements designed to circumvent that law, the budget contains language that would raise $18 billion over 10 years.

It would grant Treasury the authority to modify the rules as they relate to valuation discounts and create a new category of ''disregarded restrictions'' that would

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be ignored in valuing property for the purposes of calculating estate and gift taxes.

Additionally, in an effort to bring consistency to certain areas of estate tax law, the budget proposes to require that the basis of property received under Section 1014 be no greater than the value of the property as determined for estate or gift tax purposes. According to Treasury's explanation, a reporting requirement would be imposed on the executor of the estate and on the donor of a lifetime gift to provide the necessary valuation information to both the recipient and the Internal Revenue Service. Treasury has long said this would close a $2 billion ''loophole'' allowing individuals facing estate and gift taxes to undervalue transferred property.

''Certainly the administration sees it as a way to capture money,'' McCaffrey said. ''People in the Service believe that this is an abuse that needs to be cured and practitioners think it's just the logical result of the valuation rules.''

Permanence is Important. Although many estate-planning attorneys cannot agree on all of the details about how the estate tax should be structured, they all seem to agree that whatever Congress does, they need to make it permanent.

The structure for the last few years, where the estate tax changed yearly through 2009 and then expired for 2010 and then was reinstated for 2011 and 2012 with the possibility of it reverting back to 2001 levels unless further action is taken does not work for families trying to plan their estates, the attorneys said.

''I think that some would say that within reason having stability and permanence is even more important than the level that we have that permanence. There are some would find $3.5 million permanent easier to deal with than $5 million with an uncertain future,'' Aucutt said.

McCaffrey agreed that Congress needs to fix the system. ''There are all kinds of questions raised by [their] kind of odd way of legislating tax laws,'' she concluded. The big uncertainty in the estate tax law is ''what will it look like in 2013?''

''Permanence is the more important objective,'' Aucutt said. ''At some point, there's got to be an end and a decision. But I fear that may not happen.''

By Heather M. Rothman and Brett Ferguson