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Primary Concerns: Canvassing Transfer Tax Proposals

The year 2012 promises to be another cliffhanger for estate planners. With provisions regarding the estate, gift, and generation-skipping transfer (GST) taxes poised to expire on 12/31/2012, our thoughts turn to potential tax legislation. Candidates' positions in the primary elections give an early clue of what is to come. In this column, we will look at those positions, what they are likely to mean for any legislation in this area, and the suspense and intrigue we can expect for the end of the year.

At the writing of this column, the Republican field of presidential candidates has narrowed to four contenders: Mitt Romney, Rick Santorum, Newt Gingrich, and Ron Paul. Each has gone on record as opposing the existence of the estate tax. In general, the Republican presidential candidates are in favor of repealing the estate tax, while President Obama proposes to modify it.

The Republican primary

Taking the candidates in alphabetical order, we will start with Newt Gingrich. Gingrich advocates for a permanent repeal of the estate tax. In stump speeches, he objects to the estate tax as an "immoral,

destructive, anti-cultural tax."¹ While his position on the gift tax and GST is not clear, he supports a general extension of 2012 tax laws.² If Gingrich wishes to continue the gift tax, it would most likely be imposed at a 35% rate, but we do not know what the exemption amount would be. Likewise, we have not been able to find his position on the repeal of the GST tax.

Unlike the other candidates, Ron Paul has an explicit position on the gift tax as well as the estate tax: He supports repeal of both taxes (and presumably the GST, since it would make little sense without the estate and gift taxes).³ Of course, Paul would like to eliminate the income tax and the IRS as well.⁴

Candidate Mitt Romney also supports the repeal of the federal estate tax.⁵ According to Romney, "Government should not tax the same income over and over again." He says the estate tax "also creates a series of perverse incentives that encourages the most complicated and convoluted tax-avoidance schemes at tremendous cost to all

involved. Finally, it can have catastrophic effects when a small family-owned business, in the course of passing to the next generation, creates tax liabilities that the family cannot meet without breaking up the business itself."⁶ Romney's campaign literature does not take a position on the gift tax and the GST tax, but other sources refer to a repeal like that of 2010, which also eliminated the GST tax but left the gift tax in place at a 35% rate.⁷

At the risk of sounding like a broken record, Rick Santorum also supports the repeal of the estate tax, as well as the extension of the Bush tax cuts.⁸ Santorum has supported repeal of the gift and GST tax as well in the past,⁹ but his current platform is silent on those issues. He would also repeal the alternative minimum tax.¹⁰

While the estate tax had one defender in the 2008 Republican primary—John McCain stood alone among the Republican candidates to advocate for a larger estate tax exemption and no repeal—the entire slate of Republican candidates this year supports repeal. McCain's platform in 2008 called for increasing the exemption level to \$5 million per person (\$10 million per couple) and reducing the rate to 15%. While he won

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the Republican nomination, his position on the estate tax was probably not a significant factor in his victory. Interestingly, the compromise enacted at the end of 2010 to create a \$5 million exemption (albeit with a 35% tax rate) closely mirrored McCain's proposal, even though he had lost the 2008 presidential election.

Obama's budget proposals

While the Republican candidates all support repeal, President Obama's budget proposals¹¹ stand in contrast, taking the view that the estate, gift, and GST taxes should remain in effect in 2012 and beyond, with 2009 rates and exemptions in effect. In other words, the President's budget proposal would provide a \$3.5 million exemption for estate and GST tax purposes, a \$1 million exemption for gift tax purposes, and a 45% maximum rate for all three taxes. The proposal would also make portability of the exemption between spouses permanent.

Interestingly, the budget proposal for the 2013 fiscal year takes as its baseline 2012 law (\$5 million indexed exemption and a 45% rate) and measures the proposal to return to 2009 law against that, showing an increase in revenue of \$150 million in fiscal year 2013 and \$118 billion over ten years. This sleight of hand is accomplished by assuming that 2012 law is permanent, whereas in fact, without legislation, the law will revert to 2001 law in 2013. It is beyond obvious that a \$3.5 million exemption and 45% rate will lose revenue as compared to 2001 law, which had only a \$1 million exemption and a 55% top marginal rate.

Obama's budget includes six other proposals in the estate and gift tax area.

Require consistency in value for transfer and income tax purposes.

This proposal would require a duty of consistency with respect to estate tax value and basis of the property in the hands of the heirs. If property gets a new basis under Section 1014, the estate tax value must be used as the basis. Similarly, the basis of property passed by gift must equal the donor's basis under Section 1015 (adjusted for any gift tax paid). If the basis is to be determined under the modified carry-over basis provisions of Section 1022, it must be consistent with basis as reported on the Form 8939. A reporting requirement would be imposed on the donor of a gift and on the executor of an estate to inform the recipient of the property of the basis.

Other than the provision concerning Form 8939, which is applicable with respect to only 2010 decedents, this proposal is identical to proposals that have been included in the administration's budget proposals since the Clinton administration. This proposal is estimated to raise \$2 billion over ten years.

Modify rules on valuation discounts.

This proposal would create a new category under Section 2704, "disregarded restrictions." These, along with "applicable restrictions," would be ignored in valuing an interest in a family-controlled entity transferred to a mem-

ber of the family if, after the transfer, the restriction will lapse or may be removed by agreement. The proposal would also give the IRS regulatory authority to create safe harbors such that certain language in the governing documents will avoid application of Section 2704.

This proposal has been in the last few budget proposals and represents the administration's attempt to broaden the impact of Section 2704 and to bring within Section 2704's reach techniques that were not in use when Section 2704 was originally enacted. This proposal is estimated to raise \$18 billion over ten years.

Require a minimum term for grantor retained annuity trusts.

This proposal would require GRATs to have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. It would also require that the remainder interest have a value greater than zero at the time the interest is created. Finally, the proposal would prohibit any decrease in the annuity during the GRAT term.

The primary goal of the proposal is to increase the risk in using a GRAT. A ten-year term increases the likelihood of death within the retained period, making it less likely that an elderly grantor will create a GRAT. A ten-year term will also tend to moderate the annual rate of return.

¹ See "Newt Gingrich: End the Death Tax Now," <http://www.youtube.com/watch?v=OFv2U13sSlY> (video uploaded 4/8/2011).

² "The Gingrich Jobs and Growth Plan," available at <http://www.newt.org/solutions/jobs-economy/>.

³ Ron Paul, "Plan to Restore America," available at <http://c3244172.r72.cf0.rackcdn.com/wp-content/uploads/2011/10/RestoreAmericaPlan.pdf>.

⁴ See <http://www.ronpaul.com/on-the-issues/taxes/>.

⁵ "Believe in America: Mitt Romney's Plan for Jobs and Economic Growth," available at <http://www.mittromney.com/sites/default/files/shared/TaxPolicy.pdf>.

⁶ *Id.*

⁷ "The Romney Plan (Updated)," *Tax Topics*, Tax Policy Center, Urban Institute and Brookings Institution, available at <http://taxpolicycenter.org/taxtopics/romney-plan.cfm>.

⁸ "Rick Santorum's Made in America Plan," available at http://www.ricksantorum.com/sites/default/files/Santorum_MIA_Plan.pdf.

⁹ See, e.g., S. 2894, 106th Cong., 2d Sess. (introduced on 7/19/2000).

¹⁰ "Rick Santorum's Made in America Plan," *supra* at 8.

¹¹ *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

The newest addition to this proposal—putting in a maximum term as well as a minimum term—appears responsive to specific recent planning techniques that have been described on the lecture circuit. The effective date of this proposal is tied to the date of enactment. It is estimated to produce revenues of \$3 billion over ten years.

Limit duration of GST tax exemption. This proposal responds to the modern phenomenon of states repealing their rules against perpetuities by, in essence, imposing a federal rule against perpetuities for GST purposes. A proposal to address this issue has previously been proposed by the Joint Committee on Taxation.¹² Under the budget proposal, on the 90th anniversary of the creation of a trust, the GST exemption allocated to the trust would expire, and the inclusion ratio would reset to 1. There would be an exception for an incapacitated beneficiary.

The proposal would apply to trusts created after the date of enactment and to new contributions to existing trusts after the date of enactment. Because this proposal imposes a tax only long in the future, it is listed as having “negligible revenue effect” in the ten-year budget window. The real impact of this proposal is that it would cause people to create trusts that terminate just shy of 90 years, effectively imposing a federal rule against perpetuities.

Coordinate certain income and transfer tax rules applicable to grantor trusts. This proposal is the newcomer to the package, and it has created quite a stir. It address-

es the lack of coordination between the grantor trust (income tax) rules and the estate tax inclusion rules. It presumably reflects the government’s dissatisfaction with the fact that taxpayers are taking advantage of the differences between these two rules with popular estate planning techniques, such as the sale to an intentionally defective grantor trust.

In an effort to stop taxpayers from using these techniques, the proposal would include the assets of a grantor trust in the gross estate of the grantor for estate tax purposes. In addition, any distribution from the trust to a beneficiary during the grantor’s lifetime would be subject to gift tax, and any amounts remaining in the trust at the time the grantor’s grantor trust powers terminate would be subject to gift tax. Finally, if property is sold to a grantor trust by the trust’s owner (under the grantor trust rules), a gift tax would apply. GRATs, GRITs, QPRTs, and personal residence trusts are specifically exempted from this proposal.

The proposal would apply to new trusts created after the date of enactment, as well as to additions to existing trusts made after the date of enactment. The proposal is estimated to raise \$900 million over ten years.

Much concern has been expressed over this proposal because it would take a set of peculiar rules (i.e., the grantor trust rules) and apply them for estate and gift tax purposes, in lieu of the existing rules that arguably make a lot more sense. While that would be an unfortunate result, the more likely outcome is that this proposal will spur discussion about how best to resolve the existing disparity between the grantor trust rules and the transfer tax rules, and a better solution will be crafted. Expect to see more discussion of these issues this year and beyond as practitioners and professional groups weigh in to improve this proposal.

Extend the lien on estate tax deferrals provided under Section 6166.

Section 6166 allows for the payment of tax attributable to closely held business interests over up to 14 years. However, the estate tax lien under Section 6324(a)(1) continues for only ten years after death. Thus, if an estate elects to take advantage of the payment plan under Section 6166, the government is unprotected by lien for the last five years of the payment plan.

This proposal would extend the period of the lien under Section 6324(a)(1) to coincide with the 6166 deferral period. The change

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¹² *Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform*, Joint Committee on Taxation (JCX-23-08), 4/2/2008, pages 33-36; *Options to Improve Tax Compliance and Tax Reform Expenditures*, Joint Committee on Taxation (JCS-02-05), 1/27/2005, pages 392-395.

would apply to all estates of decedents dying after the date of enactment, but it would also apply to extend any existing liens in effect at the date of enactment, even though the decedents died before enactment. The proposal is estimated to raise \$160 million over ten years.

What happens to budget proposals? Over the last decade or so, no budget proposals in the estate and gift tax area have been enacted. There is no reason to believe that the fiscal year 2013 budget proposals will fare any better. Particularly in an election year, Congress is unlikely even to consider, let alone adopt, any of these proposals. In this election year, these proposals are more important for the light they shed on President Obama's platform and agenda. They provide a stark comparison to the position of the Republican candidates. Where Obama seeks to close loopholes and back off from the generous exemption level of 2012, his opponents would prefer to repeal the estate tax altogether. Neither side is likely to make significant headway on these issues before the November election.

What to watch in 2012

There are really two major questions for 2012: What is going to happen, and when is it going to happen. Starting with the question of "when," the situation in 2012 is very similar to that in 2010. We have tax provisions expiring at the end of the year, with the threat of reversion to a less-taxpayer-favorable law if Congress does not act. In an ideal world, Congress would resolve these issues prior to the November election; however, given the political realities, this is very unlikely to happen.

The next time segment that could see action would be the lame duck period between the election day and the seating of the new Congress and inauguration of the president. If the elections produce a change in majority party either in the White House or in Congress, lame duck legislation would seem unlikely. If there are no significant changes in power from the election, we could see a repeat of 2010 with legislation enacted between the election and Congress' winter recess. Barring that, the most likely time for legislation would be post-inauguration, meaning that the law will have reverted to 2001 law and would need to be changed retroactively. While retroactive tax law changes have been challenged in the past, the anticipated changes would be all taxpayer favorable and thus unlikely to draw a challenge.

The options in terms of substance remain very similar to those considered in 2010, except without the complication of an intervening repeal year. Congress could do nothing and allow the law to revert to 2001 law, with a \$1 million exemption for estate and gift tax purposes and a slightly higher (indexed) exemption for GST purposes. A reversion to 2001 law would bring a 55% maximum rate, a return of the state death tax credit, a return of the 5% surtax on large estates, and loss of all of the GST relief provisions.

Alternatively, Congress could adopt a middle ground position, fixing the estate and GST exemption level at something like \$3.5 million (the Obama budget proposal). The Obama proposal calls for only a \$1 million gift tax exemption, which could be part of this proposal. Likewise, the rate under this middle-ground position could be as low as 35% (2011 and 2012

rate) or as high as 55% (2001 law), or could settle in between, perhaps at 45% (the Obama proposal).

Another possibility would be an extension of 2012 law. Ideally this would be a permanent extension, providing certainty in an area that has seen none in over a decade. But the possibility also exists that budgetary considerations will push Congress to enact only a temporary extension, perhaps another two years, and leave us to look forward to "déjà vu all over again" in 2014!

The last possibility would be repeal. Endorsed by every Republican presidential candidate, repeal is not off the table. President George W. Bush, however, had repeal in his budget proposal every year he was in office, and yet it was never enacted. Thus, election of a Republican president clearly would not consign the estate tax to doom. Budgetary realities really should prohibit consideration of repeal of the estate tax, but Congress does not always do what it should.

While these options look very similar to those available in 2010, there is one important difference. The one-year repeal in 2010 posed many difficult technical problems both with the estate tax and with the GST. In 2012, both of those taxes are in place. Instead the debate is focused on what the tax rate and the exemption level should be. Without the technical challenges of 2010, the legislative solution can be simpler and the risk of creating new issues (like the claw-back issue) is reduced.

Election years occupy a special place in the hearts of estate planners. Like a good movie, they provide us with intrigue, excitement, suspense, and terror. This election year should be an award winner. ■