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Transfer Tax Certainty Is Finally Here! What Now?

Author: BETH SHAPIRO KAUFMAN

BETH SHAPIRO KAUFMAN, of the District of Columbia and Maryland Bars, is a partner in the Washington, D.C., office of the law firm of Caplin & Drysdale, Chartered. She is also a Fellow of the American College of Trust and Estate Counsel, and has written and lectured extensively on estate planning.

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For the first time in more than a decade, we have an estate and gift tax law without an expiration date. Since 2001, we have had only temporary provisions of the Code dealing with the estate, gift, and generation-skipping transfer (GST) tax exemptions, the applicable rates, and certain taxpayer-friendly GST provisions, among other things. The previous expiration date, 12/31/2010, brought a last-minute two-year extension. Portability of the exemption amount was added for 2011 and 2012, but, again, with an expiration date.

At the end of 2012, we faced reversion to 2001 law once again. This time the legislation was more than last minute. The American Taxpayer Relief Act (ATRA) passed the Senate early on the morning of 1/1/2013. The House accepted the Senate provisions late on the same day and ATRA was signed by the President on 1/2/2013.

The new bill gave us a permanent, indexed, unified exemption from gift and estate tax at $5 million, along with a same-sized exemption from GST. A new maximum tax rate of 40% was enacted. The state death tax credit is permanently gone, and the GST relief provisions and portability are permanently in the Code. All concerns about the potential clawback of gift tax exemption used in 2011 and 2012 are moot.

So now what? While ATRA resolved the immediate issue of expiring tax provisions, it did not address other economic and budgetary issues. Our country still faces problems with an unbalanced budget, sequestration, and an escalating national debt. There are continued calls for broad-based tax reform. There could be more tax legislation on the way. In short, permanent means only until Congress acts again.

Rates and exemptions

In my view, the big picture items-rates and exemptions-are unlikely to change again soon. Congress and the President just had their opportunity to negotiate these provisions and they reached an agreement at a $5 million indexed exemption and a 40% maximum rate. There is no reason to believe that they would reach a different agreement now, only months later.

Nevertheless, there are conditions that could lead to change in the future. On the one hand, we still have record-high debt as a nation and it is easy to believe that higher taxes of some sort are in our future. If tax revenues must increase, estate and gift taxes would seem to be a ready candidate, especially if there is a belief that new taxes must fall disproportionately on the rich. It is hard to get more progressive than a tax that hits only the top one-half percent by wealth.

On the other hand, the calls for repeal of the estate tax have not ended. Even after ATRA, repeal bills have been introduced in Congress. In some ways, the argument for repeal has been improved by the increased threshold for estate and gift taxes. By increasing the exemption and reducing the tax rate, the expected revenue from the estate and gift taxes has dropped from an anticipated $57 to $60 billion **1** to under $15 billion for fiscal year 2012. **2** Opponents of the estate and gift taxes argue that the costs of administering and enforcing the taxes, plus the costs incurred by taxpayers planning to avoid imposition of the taxes, grossly exceed the revenue the taxes raise. This is probably the strongest argument against the estate and gift taxes.

On balance, though, I do not think that either side has the

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support it would need to cause Congress to revisit the rates or exemption in effect now. Since our current law provides for indexing of the exemption, even the periodic revisions we have seen over the history of the estate tax should not be needed. Thus, present law on rates and exemptions likely will remain in effect through the next cycle of tax reform.

Just because I do not foresee rates and exemptions changing does not mean that there will be no legislation in this area. In the context of "tighteners" or general tax reform, several areas could see action. The most likely targets are planning techniques that the government thinks provide too great a tax benefit.

Grantor retained annuity trusts (GRATs)

I often describe the outcome of a zeroed-out GRAT to clients as "heads you win, tails you don't lose." The zeroed-out GRAT is a technique with only upside potential. If the investment return exceeds the hurdle rate, the technique succeeds. If the return falls short of the hurdle rate, the grantor gets his or her property back and is out only the transaction costs. Proposals to alter the requirements for a GRAT attempt to create some downside for the taxpayer.

The Administration has repeatedly proposed to impose a minimum ten-year term for GRATs. [3] A longer term would increase the risk that the grantor of a GRAT might die during the GRAT term, and smooth out the potential for out-of-proportion gains in short-term GRATs. A ten-year minimum term would make GRATs far less attractive to older clients.

A minimum term is not the only potential legislative change being discussed for GRATs. Another way to even the playing field would be to impose a minimum remainder value for GRATs. In charitable remainder trusts, for example, the statute requires a minimum 10% remainder value to pass to charity, ensuring that taxpayers gaining the advantages of having a tax-exempt trust must pay at least a 10% "tip" to charity. Although the Administration seems to prefer the minimum term to the minimum remainder strategy, the President's proposal has provided that the GRAT remainder must have a value greater than zero at the time of its creation. Apparently "greater than zero," though, means literally greater than zero, and the remainders of a few dollars or just pennies typically seen in "zeroed-out" GRATs would be sufficient to satisfy this requirement.

Some proposals have also included a maximum term of not more than ten years more than the life expectancy of the annuitant. This proposal is directed at a technique that uses a long-term GRAT with a low annual payout. Even though the grantor is expected to die during the GRAT annuity term, Reg. 20.2036-1(c)(2)(i) limits the amount includable in the deceased annuitant's estate to the amount that would be required to produce the required annuity based on the Section 7520 rate in effect at the date of death, and the amount so included is often considerably less than the amount remaining in the GRAT. The proposed term limitation would eliminate that kind of planning with a GRAT.

A final possibility would be a rule that causes transfers to GRATs to be incomplete gifts until the annuity term ends. That change would most likely signal the end of the GRAT as a tax-saving technique, and it is not a proposal that has gained much traction at this time.

While a number of changes to the GRAT rules have been floated, there is little concern that existing GRATs will be affected, as all of the proposals we have seen apply only prospectively to GRATs created after the date of enactment. In the future, though, the ability to fund short-term zeroed-out GRATs may be limited.

Sales to grantor trusts

The Administration's fiscal year 2013 revenue proposals included a new proposal to "coordinate certain income tax and transfer tax rules applicable to grantor trusts." The proposal cited a need for change based on the fact that the current lack of coordination between the two sets of laws "creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences." The solution outlined by the Administration would include grantor trust assets in the gross estate of the grantor for estate tax purposes, subject distributions from a grantor trust to a beneficiary (other than the grantor) during the grantor's life to gift tax, and if the grantor ceases to be the owner under the grantor trust rules at any time during life, trigger a gift tax on the remaining trust assets. **4** In other words, the gift tax consequences would flow from the grantor trust status of a trust.

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The fiscal year 2014 proposal is narrower in scope than the fiscal year 2013 proposal, but still determines the gift and estate tax consequences based on the existence of a grantor trust power. The revised proposal excludes:

- Certain trusts (GRATs, GRUTs, and QPRTs) in which a grantor retains an interest.
- Certain trusts used in connection with retirement plans (such as "rabbi trusts").
- Life insurance trusts.

Otherwise, if a grantor engages in a sale or exchange with a grantor trust, the grantor would be treated as a deemed owner of the trust assets for gift and estate tax purposes. The assets, along with any income or appreciation thereon, would be subject to estate tax in the grantor's estate, or subject to gift tax if actually distributed to a beneficiary other than the grantor, or when the grantor trust power terminates prior to the grantor's death. The amount subject to tax would be reduced for any gift tax paid on the initial transfer, and the tax would be paid from the assets of the trust.

Most practitioners would admit that the "lack of coordination" between the grantor trust rules and the transfer tax rules creates many tax planning opportunities, the most popular of which is the sale to an intentionally defective grantor trust. That transaction, under current IRS rules, allows the grantor to make a completed gift of property to a trust over which the grantor retains certain grantor trust powers, but leaves the grantor responsible for the income tax on the earnings of the trust. By paying the trust's income tax bill for life, the grantor can effectively leverage the value of his or her gift tax exemption. These transactions have been particularly attractive to clients in the current low-interest-rate environment.

The fiscal year 2014 proposal is much more narrowly crafted to address the transaction with which the Administration takes umbrage. Nevertheless, it embeds the illogical grantor trust rules into the transfer tax system, creating coordination but also complexity. Furthermore, the Administration proposes to make the law applicable to any transactions with a trust on or after the date of enactment, potentially subjecting existing trusts to the reach of these new provisions. It remains to be seen whether this proposal is attractive to anyone in Congress. This is a proposal to watch.

Valuation discounts

Another area in which legislation has long been threatened is valuation discounts. Prior to this year, proposals to cut back on the availability of valuation discounts have been included in the Administration's budget proposals for the last 15 years. 5 While the specific provisions of the proposals have varied, the target is the family limited partnership (and its cousin the family limited liability company). In essence, the government is looking for ways to limit the ability of family members to form entities and reduce asset values through discounts.

One way to cut back on valuation discounts is to look through the entity to examine the underlying assets and deny valuation discounts where the underlying assets are cash or marketable securities. This was the approach proposed

by the government during the Clinton administration.

Another possibility is to create safe harbors. This could take the form of standards for the governing document of a family-owned entity, and it could provide for certain fixed discount amounts if the standards are satisfied.

The Administration's fiscal year 2013 proposal would amend Section 2704 to create a category of "disregarded restrictions" that would be ignored in valuing an interest in a family-controlled entity under certain conditions. Specifically, if, after the transfer, the restriction will lapse or can be removed by the transferor or the transferor's family, the restriction would be ignored. Examples of disregarded restrictions include limitations on an owner's right to liquidate his or her interest that are more restrictive than a given standard, and any limitation on a transferee's ability to be admitted as a full partner or to hold an equity interest in the entity. In essence, instead of measuring restrictions against those in the applicable state law, the proposal would measure them against a standard to be articulated in Treasury regulations. 6 By putting the standards in regulations, the IRS would be able to keep up with changes in typical documents through the regulatory process without the need for new legislation.

A valuation discount proposal was conspicuously missing from the most recently released budget proposal. It is hard to know whether the Administration is giving up on reforming this area, or whether it intends to pursue its attack on valuation discounts only in court or by regulation.

Dynastic trusts

When the GST tax was enacted in 1985, nearly all states had rules against perpetuities on their books. Over time, these statutes have been modified or repealed so that now a majority of the states have eliminated the rule against perpetuities with respect to at least some trusts. The decline in popularity of state rules against perpetuities has led the government to propose ways to limit the use of one person's GST exemption in perpetuity.

A few decades ago, the federal law could rely on state laws to terminate trusts, either 21 years after the lives in being or 90 years after the trust's creation. With repeal of these laws, trusts can continue in perpetuity, which also allows the GST exemption to continue in perpetuity. Some people have suggested enactment of a federal rule against perpetuities, but the Administration has not taken that tack. The current legislative proposal is one that would cause GST exemption to expire 90 years after its use, in effect resetting an exempt trust's inclusion ratio to one 90 years after the trust is created. The proposal would apply to only new trusts or new contributions to existing trusts. [7]

An earlier iteration of this proposal suggested limiting GST exemption to skips of one generation. That proposal would be much more restrictive than either a traditional "lives in being" rule against perpetuities, or the more modern 90-year limitation.

While these proposals might appeal to some lawmakers on policy grounds, they produce no revenue for generations. Under the current proposal, only a distribution to a skip person after the 90th anniversary of the trust would actually trigger imposition of a GST tax. A tax proposal's revenue generating potential is evaluated by Congress over a five-year or ten-year period. These GST proposals would not generate any revenue for at least 90 years. For this reason, it is not possible to view a GST proposal as a revenue raiser over any relevant period, and it seems unlikely that these restrictions would be enacted in a legislative season that is motivated by revenue generation and budget considerations.

Conclusion

While rates and exemption amounts seem secure at the moment, "permanent" in the context of tax legislation means only "until Congress acts again." The next effort at tax legislation is likely to focus on revenue increases through loophole closing. A few of planners' favorite transactions could come under fire in such an effort. If so, taxpayers may find that the tax saving available by funding GRATs, creating intentionally defective grantor trusts, taking valuation discounts, and funding dynastic trusts, will be significantly limited in the future. As these potential changes have prospective effective dates, taxpayers contemplating these transactions should take advantage of present law while it is in effect.

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Congressional Research Service, Estate and Gift Tax Revenues: Past and Projected (8/24/2007), available at http://www.policyarchive.org/handle/10207/bitstreams/18765.pdf.

2

Fiscal Year 2012 IRS Data Book, available at http://www.irs.gov/pub/irs-soi/12databk.pdf.

3

General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, at page 142, available on line at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

4

General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, at page 83, available on line at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

5

General Explanations of the Administration's Revenue Proposals (Fiscal Year 1999), at page 129, available on line at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY1999.pdf.

6

General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, at page 79, available on line at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

7

General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, at page 143, available on line at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf .