Farrell Fritz

# CLIENT ADVISORY

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## Obama's 2014 Budget Estate and Gift Tax Proposals: How Might They Impact Your Estate Plan?

As we reached the end of 2012 and the expiration (or so we thought) of the $5 million gift/estate tax exemption, many taxpayers scrambled to make gifts to, or for the benefit of, their family members. With these gifts, they sought to remove assets, and their appreciation, from the reach of the estate tax.

Other taxpayers took a "wait and see" approach. As it turned out, the $5 million exemption became "permanent", allowing these taxpayers to plan their gifting at a more leisurely pace – or so we thought.

The Obama Administration released its 2014 budget on April 10, 2013. Although the budget included a number of proposals aimed at increasing the income tax burden on wealthy taxpayers – for example, by implementing the so-called "Buffett Rule" and limiting the value of certain deductions and other tax benefits – the budget also proposes significant changes to the estate and gift tax regimes. These are described below. Some of the provisions appeared in earlier budgets (as far back as the Clinton administration); others are new. Taxpayers and their advisers should familiarize themselves with these proposals and consider whether to take action.

Transfer Tax Rates, Exemptions

- The American Taxpayer Relief Act of 2012 permanently raised the top tax rate for estate, generation skipping transfer (GST), and gift taxes from 35 percent to 40 percent. It also made permanent the substantive estate, GST and gift tax provisions in effect during 2012, fixing the exclusion amount at $5 million, indexed for inflation.
- The budget proposal would undo the foregoing so-called "permanent" changes. It would make permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate

would be 45 percent. The exclusion amount would be $3.5 million for estate and GST taxes and $1 million for gift taxes. There would be no indexing for inflation.

Fortunately, the proposal confirms that, in computing gift and estate tax liabilities, estate or gift tax will not be incurred for a prior gift that was excluded from tax at the time of transfer. Portability of unused estate and gift tax exclusions between spouses is allowed.

The proposal would be effective for the estates of decedents dying, and for transfers made, after December 31, 2017.

Basis Consistency

- The budget proposal imposes both a consistency and a reporting requirement. The basis of property received by reason of death must equal the fair market value of that property for estate tax purposes. The basis of property received by gift during the donor's life must equal the donor's basis. No rule explicitly requires the recipient of the property to use the estate/gift tax value for purposes of the property's income basis. The proposal requires that the basis of the recipient's property be no greater than the property value determined for estate or gift tax purposes.

  A reporting requirement would be imposed on the decedent's estate and on the donor (as to lifetime gift) to provide valuation and basis information to the recipient and to the IRS. The proposal would be effective for transfers on or after the enactment date

GRATs

- The proposal requires that a Grantor Retained Annuity Trust ("GRAT") have a minimum term of ten years and a maximum term of the actuarial life expectancy of the annuitant plus ten years. The minimum term proposal increases the risk that the grantor will not outlive the GRAT term, thereby losing any anticipated transfer tax benefit. The proposal also includes a requirement that the

remainder interest have a value greater than zero at the time the interest is created. It prohibits any decrease in the annuity amount during the GRAT term. The proposal would apply to trusts created after the enactment date.

Duration of GST Exemption

- The proposal provides that, on the 90th anniversary of a trust's creation, the GST exemption allocated to the trust terminates. This would be achieved by increasing the trust's inclusion ratio to one, thereby rendering the entire trust subject to GST tax. The proposal would apply to trusts created, and to additions made to a pre-existing trust, after the enactment date.

Grantor Trusts

- When a person, who is the deemed owner of a trust for income tax purposes, engages in a sale or exchange with the trust, the transaction is disregarded for income tax purposes. Upon the deemed owner's death, the portion of that trust attributable to the property received in that transaction (including all of its retained income and appreciation) would be subject to estate tax as part of the gross estate of the deemed owner.

  In addition, such portion would be subject to gift tax during the deemed owner's life when his treatment as the deemed owner of the trust is terminated. Any distribution from the trust to another person will also be treated as a gift by the deemed owner. The transfer tax would be payable from the trust. The proposal affects trusts that engage in a described transaction on or after the enactment date.

What's Next?

It remains to be seen whether any of these proposals will be enacted into law. Some certainly stand a better chance than others. Given the fact that the proposals have been made, coupled with the likelihood that we are entering a period during which "tax reform" will be a legislative priority,

especially as regards wealthy taxpayers, it behooves taxpayers to consider their estate planning options. With respect to the 2014 budget proposals, a taxpayer may wish to consider: (1) utilizing the taxpayer's remaining gift tax exemption; (2) creating shorter-term or zeroed-out GRATs (for which the low interest rate environment is favorable); (3) creating GST-exempt dynasty trusts; and/or (4) completing sales to intentionally defective grantor trusts.

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