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# Proposals Shape Estate Planning for 2013

*GRATs, RMDs and Clawbacks are in Play*

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***"A learned blockhead is a greater blockhead than an ignorant one."***

*—Benjamin Franklin*

***We met at nine, we met at eight***
***I was on time, no you were late***
***Ah yes, I remember it well***

*—Lyric from Gigi by Alan Jay Lerner and Frederick Loewe, performed by Maurice Chevalier and Hermione Gingold*

The Obama Administration recently proposed a $3.8 trillion budget for 2013 that includes a number of specific changes affecting estate taxes and financial planning.

For our purposes, a small but highly relevant portion of that plan involves rolling the estate tax back to the rates and exemptions that applied in 2009. Other proposals would affect gift taxes, GRATs, generation-skipping transfers, retirement plans, capital gains, and income taxes.

Was 2009 a sufficiently good vintage of tax conditions to consider a return visit? Let's consider how that year measures up and review the other key proposals for 2013.

## The Wine Cellar

Shall we revisit the estate tax approach of 2009? It was not that far in the past—only 26 months in real time—but it was three tax systems ago and a lot of brain cells had to be directed to new information since then.

The top estate tax exclusion of 2009 was relatively high at $3.5 million compared to the $2 million level that preceded it…or was it low compared to the repeal of the tax that followed? Ah yes, we remember it well.

The top estate tax rate of 2009 was high at 45% compared with the top gift tax rate of 35% and the top income tax rate of 35%…or was that top estate tax rate low compared to the high 55% or 60% estate tax approach of 2001 that was going to return by default in 2011 and once again is waiting in the wings for 2013? Ah yes, we remember it well.

The Administration's approach would be to retain the $3.5 million exclusion for estate and generation-skipping transfer tax and the $1 million gift tax exclusion. There would be a top rate of 45% for all transfer taxes. Portability of unused estate and gift exclusions between spouses would also be retained and would become permanent. The net effect is estimated to reduce the Federal deficit by $118.8 billion over the next decade.

If the lifetime gift tax exclusion were to drop from $5 million in 2012 to $1 million in 2013, a lot of donors would consider making large gifts during 2012 while they still can. On the other hand, this would limit the available estate tax exclusion in the future. "Clawback" or recapture of gift tax is also a potential hazard (see below).

There is also no guarantee that the exclusion will drop in this manner. One reason Congress may resist this proposal is that it decouples the estate and gift tax system again, so soon after they were reunited. Memo to Congress: The transfer tax system works better when all the transfer taxes are coordinated.

## Other Vintage Years

Perhaps another vintage would be appealing as long as we are rummaging about our wine cellar?

The Andre Cold Duck of 2010: Here's a vintage that is too new to gather any dust on our shelves. Observers may recall that the 2010 version of estate tax repeal had tremendous effervescence—much like a bottle of Champagne that had been shaken for 10 years while we waited for the estate tax repeal to arrive.

Unfortunately, this was the same brew that was served with a moldy carry over basis idea from the '70s. We awoke in 2011 with a vague recollection of a wild party, a feeling of remorse over some regrettable decisions and a massive migraine that is best experienced at 35-year intervals. Let's party like this again in 2045.

The 2008 Chardonnay: Going back an extra year, there was the estate tax of 2008. This might be a safe choice. It was a modest and unmemorable vintage that was best served with Wheat Thins and Jarlsberg cheese. The 2008 estate tax featured an exclusion of $2 million for the third consecutive year and the same top tax rate of 45% as proposed for 2013.

What a curious anomaly to have transfer tax rules that stayed the same for more than one year. Even now that $2-million amount would likely exclude 99% of all decedents from the Federal estate tax. So the laborious debate over the difference between a $3.5-million exclusion, a $5-million exclusion, and even portability of unused exclusions between spouses is focused on a very small percentage of estates.

Of course, if you are one of those persons affected, it matters a lot! However, if the Federal estate tax were to be established in a semi-permanent manner with some amount as the known exclusion amount, then those persons affected would be able to plan their estates accordingly and implement appropriate gifts, trusts, and expenditures with advance planning.

**Moonshine:** Here's one that tastes like Hallelujah in a bottle! The year 1916 witnessed an inside the park homerun for Honus Wagner, the first $1-million contract for silent movie star Mary Pickford, the arrival of Albert Einstein's general theory of relativity, and the enactment of the first Federal estate tax. The estate tax rates ranged from 1% to 10% with an exemption of $50,000. By 1919 the top rate was increased to 25% for estates over $10 million to help finance World War I.

Perhaps a return to our roots with lower tax rates for estate tax would relieve pressure on the establishment of sizable exclusions or their portability or other elaborate mechanisms for transfer tax minimization.

**Uvaggio:** This being a Presidential election year, one may anticipate politicians uncorking some potent bottles of vintage tax concepts. As opposed to a Grand Vin that has a lineage of grapes with a noble pedigree, we may soon be sampling an Uvaggio, i.e., a blend of several left over ideas designed to curry favor with as many constituencies as possible. It is an election year, after all, which means consensus on tax reforms might not occur until after the November election.

## Administration Proposals

President Obama's Budget Message explained his position on transfer taxation as well as income taxation:

In the Budget, I reiterate my opposition to permanently extending the Bush tax cuts for families making more than $250,000 a year and my opposition to a more generous estate tax than we had in 2009 benefiting only the very largest estates. These policies were unfair and unaffordable when they were passed, and they remain so today. I will push for their expiration in the coming year. I also propose to eliminate special tax breaks for oil and gas companies; preferred treatment for the purchase of corporate jets; tax rules that give a larger percentage deduction to the wealthiest two percent than to middle-class families for itemized deductions; and a loophole that allows some of the wealthiest money managers in the country to pay only 15 percent tax on the millions of dollars they earn. And I support tax reform that observes the "Buffett Rule" that no household making more than $1 million annually should pay a smaller share of its income taxes than middle-class families pay.

The Administration's proposed budget for 2013 goes beyond the reform of the estate tax and actually has a significant number of substantive changes. The suggestions and means of implementing them are not completely articulated, however

• Consistent reporting of stepped up basis for inherited assets that have appreciated in basis with the reporting of gains when those properties are subsequently sold is already part of basic tax practice but to accomplish more enforcement in this area, more reporting requirements would apply. Analysis: Does this mean that non-taxable estates would have to get formal appraisals and file information returns or schedules? Or will estate administration best practices require documentation of date of death valuations or capital assets using other acceptable valuation means?

• Valuation discounts for family-controlled entities would be limited. Section 2704 would be amended to disregard limits on an owner's right to liquidate interests, to be admitted as a full partner, or to hold an equity interest. Analysis: Were such amendments enacted the key questions would be whether the changes would apply

retroactively to pre-existing entities (yes, most likely) and which safe harbor discount valuation harbors might remain. Knowing that this is an area targeted by the Treasury, the art and science of securing valuation discounts will need to incorporate alternate and redundant reasons.

• Three new limits on GRATs have been proposed. Zeroed out remainder interests would not be permitted. The annuity would have to remain consistent throughout the term. And GRATs would have a minimum 10-year term and a maximum term of the annuitant's life expectancy plus ten years.

**Analysis:** Taxpayers would be well advised to remember that the IRS is a sore loser. Limiting GRATs that appear to be too good to be true has been on the IRS agenda for a long time. For example, the Treasury adopted regulations to prevent the use of GRATs that were "zeroed out" for gift tax purposes. The Tax Court ruled them invalid a decade ago. The IRS has never gotten over it. The moral of the story: Judicial setbacks for the IRS may eventually be corrected legislatively.

The critical change to watch here, however, is the 10-year minimum term. This change is estimated to reduce the deficit by $3.3 billion over 10 years. A potential flaw in this is the assumption that grantors will not adapt to such changes. The bottom line for the grantor's estate is to survive the term of the GRAT. Long mandatory durations for GRATs will make them riskier for many grantors.

• A trust that has been in existence for 90 years would no longer be entitled to exemptions from generation-skipping transfer tax. **Analysis:** This is a proposal that indicates Treasury interest in addressing dynasty trusts by enacting a Federal version of the rule against perpetuities. The choice of 90 years as a limit appears to approximate a lifetime plus 21 years which was the traditional perpetuity measure.

Such a Federal provision would trample on approaches taken by a number of jurisdictions which have eliminated or limited the application of the rule against perpetuities. Nevertheless, there are some problems with this proposed enforcement concept. Dynasty trusts maintain properties for future generations without necessarily distributing funds. Tax planners would also have a 90-year head start to address a new 90-year GST exemption limit. With so few trusts involved in the first place, it is doubtful this approach would be effective. In fact, the Administration offers no estimate for any improvement this would have on the deficit since it won't help until fiscal 2103.

• Grantor trusts would all be included in the grantor's gross estate. Non grantors who have ownership interests in trusts would have certain portions of trusts included in their gross estates based on certain sales transactions. In all likelihood, the practice of creating intentionally defective grantor trusts that enable the grantor to pay income tax on the trust income without inclusion of the trust assets in the grantors estate would run afoul of the new rule.

**Analysis:** This is a very troubling proposal that would create havoc, uncertainty, and inequitable results on many standard trusts in plain vanilla estates that are not the actual sophisticated trust targets of the Treasury. Hopefully this provision, if ever enacted, will be more narrowly focused on more deserving targets.

• Estate tax liens based on Section 6166 deferrals would be extended from 10 years to 15 years and three months.

• The 15% tax rate on long term capital gains would continue to apply to persons with adjusted gross income under $200,000 or $250,000 for joint filers (with COLA indexing), but would increase to 20% for those with more than $200,000 of annual income.

• Qualified dividends would be taxed as ordinary income for upper income taxpayers and not at a 15% tax rate.

• Required minimum distributions (RMDs) would no longer be required of qualified plan participants who own less than 5% of an employer's business or who have, in the aggregate, less than $75,000 in their retirement plans and IRAs.

## Clawback Watch

There is growing concern that gifts made during 2011 and 2012 which utilized the applicable limits of $5 million and $5.12 million, respectively, could end up triggering estate tax for donors who then died during 2013 or thereafter if the applicable estate tax exclusion were then at a lower level.

In other words, the government, having retracted its transfer tax claws during 2011 and 2012 for lifetime gifts but then (potentially) reconsidering its decision in 2013, would re-extend its claws like an amazing super Federal feline and "clawback" the appropriate amount of tax by including the lifetime gift in the donor's taxable estate.

"Pshaw," most experts have declared. The clawback scenario makes too many assumptions they say. It requires the sunset of the current law to arrive and send us back to 2001 with a $1-million estate and gift tax exclusion. In the alternative, if Congress enacts another new estate and gift tax with a lower exclusion for 2013, a clawback would be possible. However, Congress would have to be asleep at the wheel and fail to provide a transitional rule to be fair to those people and estates who were affected.

Congressional action to correct a problem can't be assumed of course and Congress has a horrendous track record when it comes to proactively correcting sunset provisions even when it has a ten-year warning of their arrival. But Congress has provided transitional rules for situations like this and has done so retroactively when needed as well. Thus Congress provided a transitional rule to allow estates of persons dying during 2010 to retroactively elect to have a taxable estate and a stepped up basis instead of no estate tax and a carryover basis.

There are experts, however, who feel a clawback is a serious possibility. This is an area that will need to be kept in mind. Donors who want to take advantage of the $5.12 million lifetime exclusion for gifts while it still applies during 2012 will have to weigh that decision against the anticipated exclusion levels for estates in the future as well as the potential for clawbacks. Unfortunately, the final answers may not be known until the end of 2012 or possibly after the fact in 2013.

## An Ingenious Vintner?

Are we reforming our tax reforms because we have reached a wiser consensus or will we continue to lurch from one set of rules to another? Some candidates favor the elimination of the estate tax but have not specified if they mean the 2010 version or something new.

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Have we learned anything from the past or are we doomed to repeat our mistakes? Will normal citizens finally have some consistent set of rules so that they can at least take comfort in having planned their estates?

The constant tinkering with the transfer tax system over the past dozen years has resulted in repeated doomsday deadlines, complex tax elections, retroactive Band-Aids and legislative malpractice that punishes decedents posthumously.

Learned blockheads may be better than ignorant ones, but those who continue to perpetuate uncertainly on estates should be invited to the wine cellar to sample some Amontillado. It's right over here, in a cask, in this alcove…

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