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Estate Tax Aspects of the President's Fiscal Year 2013 Budget

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Estate Taxes

Until the end of 2012, the estate tax, the generation–skipping transfer tax (GST), and the gift tax rates are 35%, with each individual having an exclusion of up to $5 million. The lifetime exclusion is portable, meaning the surviving spouse may be able to increase his/her exclusion amount by the amount of the deceased's spouse's unused exclusion at death.

The Obama Administration is concerned about the substantial tax cut that affluent taxpayers received from the provisions of the Tax Relief, Unemployment, Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Tax Act"). The Administration's proposal recommends that the estate, GST, and gift tax parameters that existed in 2009 be reinstated permanently. The top tax rate would be 45% and the exclusion amount would decrease to $3.5 million for estate, gift and GST taxes.

Generation Skipping Transfer ("GST") Tax

Currently, the GST is imposed on gifts and bequests made to transferees who are two or more generations younger than the transferor. The GST was imposed so that people could not avoid estate and gift taxes through a trust that gives successive life interests to multiple generations of beneficiaries. The GST tax is a flat tax on the value of the transfer determined by the highest estate tax bracket in effect for the year in which the transfer is made. Each individual has a lifetime GST tax exemption ($5,120,000 in 2012) that can be allocated to transfers made. At the time that the GST was enacted, most states had the law against perpetuities and all trusts had to terminate no later than 21 years after the death of a life in being at the time of the creation of the trust.

Now that many states (including New Jersey) have repealed their rule against perpetuity statutes, trusts created subject to the law of these states can continue in perpetuity. Now, the transfer tax protection that the GST exemption provided is effectively expanded from trusts funded with $1 million to trusts funded with $5,120,000 and continuing indefinitely. The Obama Administration proposes that on the 90th anniversary of a trust, the GST exclusion shall terminate.

Coordination of Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

Under current law, a grantor trust is a trust where an individual who has created the trust (the "grantor") is treated as the owner of the trust for income tax purposes. A grantor trust is taxed as though the grantor or another person owns the trust assets directly, The owner and the trust are treated as one, so transactions between the trust and the deemed owner are ignored for income tax purposes. For estate tax purposes, the trust and the owner are separate persons and under some circumstances, the trust is not included in the owner's gross estate for estate tax calculations at the time of death.

The perceived current inconsistency allows for individuals to make transactions with the trust that result in significant wealth transfer free of the transfer tax. The Obama Administration's proposal suggests that the owner's trust assets be included in the gross estate of that grantor for estate tax purposes, be subject to gift tax for any distribution to one or more beneficiaries during the grantor's life, and for the remaining trust assets to be subject to gift tax at any time during the grantor's life if the grantor ceases to be the deemed owner at any point in his life. The proposal would also apply to non-grantor owners of the trusts who engage in sale, exchange, or comparable transactions with the trust that would have been subject to capital gains if they were not deemed the owner of the trust. In these cases, the portion of the trust attributable to the property received by the trust in that transaction would be subject to transfer tax.

Potentially Decreased Gift Tax Applicable Exclusion Amount

The 2010 Tax increased the applicable exclusion amount for gift tax purposes to $5 million, or $10 million per married couple. This change has provided an unprecedented opportunity to move substantial amounts of wealth out of individuals' estates.

The Obama Administration's proposal would be to reduce the applicable exclusion for gift tax purposes to $1,000,000.00. Most likely such legislation would be prospective in nature. The proposal must be monitored to see if there would be any "clawback" rules for gifts made before January 1, 2013 in excess of $1,000,000.

New Jersey Death Taxes

Despite the federal estate tax exemption (whether it be $5,000,000 or $3,500,000), New Jersey residents still must plan for the New Jersey Estate Tax and the New Jersey Inheritance Tax. New Jersey exempts only $675,000 or less per estate and carries a top rate of 16%. Also New Jersey imposes an inheritance tax on money left to anyone other than the decedent's spouse or domestic partner, descendants, ancestors, and charities. Any estate tax owed is reduced by the inheritance tax paid.

Portability Made Permanent

One of the more notable provisions contained within the 2010 Tax Act is the "portability" provision, which provides in general terms that if one spouse does not fully utilize his/her entire applicable exclusion amount, the unused portion can be used by the surviving spouse's estate. This provision is intended to avoid the need for credit shelter trusts in estate planning documents. Unfortunately, under current law, both spouses must die before 2013 in order to benefit from the portability provision.

The Obama Administration is proposing that the portability of the unused estate and gift tax exclusion would be made permanent. Credit shelter trusts continue to provide significant additional benefits beyond just the use of each spouse's applicable exclusion amounts. These include the following:

- Ensuring that assets contained in the credit shelter trust pass to children of the couple and not to any new spouse of the surviving spouse.
- Ensuring that appreciation on the assets contained within the credit shelter trust, which may exceed the applicable exclusion amount at the surviving spouse's death, are not subject to estate tax at that time.
- Protection of assets in the credit shelter trust from creditors of the surviving spouse, including any marital claims of future spouses.

Even if the portability provision becomes permanent, estate plans should continue to consider the benefits of credit shelter trusts for the reasons stated above.

GRATs

There had been much anticipation that the 2010 Tax Act would limit the estate tax planning opportunities using Grantor Retained Annuity Trusts ("GRATs"). GRATs have aided people in transferring wealth while minimizing the gift tax cost of transfers as long as the grantor survives the GRAT term. Taxpayers have kept the GRAT term short to reduce the mortality risk of the grantor's death during that period and have reduced the gift tax value of their remainder interest to little or nothing.

The Obama Administration proposes that the GRAT term be a minimum of ten years and a maximum term of the life expectancy of the annuitant plus ten years. The proposal also requires that the remainder interest have a value greater than zero when created and prohibits a decrease in the annuity during the GRAT term. A longer minimum period increases the risk of using these devices.

Valuations

Judicial decisions and new statutes in some states have made the enforcement of the valuation discount rules difficult for the IRS. The Obama Administration's proposal will modify the valuation discounts when valuing an interest in a family-controlled entity transferred to a member of the family.

Income Tax Proposals

Below is a brief summary of the Obama Administration's proposal regarding income taxes:

- Extend Bush tax cuts for all but the top two brackets. The only change would be to have the 33% and 35% rates go back to their pre-2001 levels of 36% and 39.6%. Taxpayers in the top two marginal brackets would still benefit from reduced rates on the portion of their income taxed in the lower brackets.

- Raise the long-term capital gains rate to 20% for single taxpayers making more than $200,000 per year, $250,000 for married taxpayers filing jointly and $125,000 for married taxpayers filing separately.

- Tax rate on qualified dividends would revert to ordinary income tax rates (up to 39.6%) for the same taxpayers. For everyone else, the rate would stay at 15% (or 0%)

- Tax "carried interest" as ordinary income.

- Reduce value of itemized deductions for taxpayers in the 33% and 35% brackets to 28% (33% bracket current starts at $178,650 for single taxpayers and $217,450 for married filing jointly.

- Reinstate the personal exemption phase-out for upper income taxpayers

- Extend reduction of social security tax on self-employed from 14.2% to 12.2% for the rest of 2012.

- Enact a permanent AMT Patch.

- Make the HOPE tax credit permanent. The credit is worth up to $2,500 per year.

- Make recent expansions of the low-income tax credit permanent.

Summary

To summarize, the Administration's 2013 Budget makes significant estate and gift tax proposals. The key points discussed above include the following:

- Restore the estate, gift and GST tax to 2009 rates.

- Require a minimum term for GRATs of ten years.

- Limit the duration of GST tax exemption to 90 years.

- Modify the rules on valuation discounts.

- Require consistency in value for transfer and income tax purposes.

Now is the time to do planning. Contact our Business Group if you should have any questions.

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