Vol P. 2411-2413 FRIDAY, MAY 3, 2013 THE LEGAL INTELLIGENCER

TRUSTS AND ESTATES

Enjoy 'Permanence' in the Gift and Estate Tax Regime While It Lasts

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Special to the Legal

May 3, 2013

On April 10, President Obama released his fiscal year 2014 budget proposal. The proposal includes numerous changes to the law that would create greater exposure to estate, gift and generation-skipping transfer (GST) taxes. In this article, we address the following proposed changes: (1) restoring the estate, gift and GST tax parameters in effect in 2009; (2) limiting the duration of the GST tax exemption; (3) eliminating the beneficial GST tax treatment of HEETs (health and education exclusion trusts); (4) adding limitations on GRATs (grantor retained annuity trusts); and (5) coordinating certain income and transfer tax rules applicable to grantor trusts. Except as otherwise noted below, the proposals would generally apply for tax years beginning after December 31.

RESTORATION OF THE ESTATE, GIFT AND GST TAX PARAMETERS

After years of change and much uncertainty, many Americans thought that the estate and gift tax laws had finally reached a state of normalcy when the president signed into law the American Taxpayer Relief Act of 2012 (ATRA) on January 2. The ATRA enacted a so-called "permanent" $5 million (indexed for inflation after 2011) exemption amount for the estate, gift and GST taxes (equal to $5.25 million in 2013, as adjusted for inflation), with a top tax rate of 40 percent. Although these laws are "permanent" by their specific terms (unlike the prior set of laws that had a built-in expiration date), the president's 2014 budget proposal now seeks a return to the 2009 transfer tax laws, beginning in 2018. This means that the estate and GST tax exemptions would be reset at $3.5 million, and the gift tax exemption would be decreased to only $1 million, without adjustment for inflation, in any case. The top tax rate would be increased to 45 percent (which remains better than the 55 percent rate under prior law).

On a positive note, the proposal would retain the new estate and gift tax portability of exemptions between spouses, which allows the surviving spouse to "inherit" any unused exemption of his or her deceased spouse. Also, there does not appear to be a proposal to "claw back" benefits of prior transfers by imposing additional tax liabilities by reason of the reduction in the exemption amounts, a relief to those who have planned ahead to take advantage of the larger exemptions before they will have expired.

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

LIMITATION ON THE DURATION OF GST TAX EXEMPTION

The GST tax is imposed on gifts and bequests to individuals who are two or more generations younger than the transferor, such as grandchildren and more remote descendants (called "skip persons"). The GST tax rate is equal to the highest estate tax rate applicable in any given year. This year, each taxpayer has a GST tax exemption equal to $5.25 million that can be allocated to transfers made to skip persons or to trusts that will benefit skip persons (either now or in the future). To the extent that GST exemption is allocated to a trust, all of the appreciation in the trust after the initial gift will be forever exempt from the GST tax, the gift tax and the estate tax. This creates an opportunity for taxpayers to establish dynasty trusts that will last in perpetuity for grandchildren and more remote descendants. There are some existing limitations on the duration of dynasty trusts in states that have retained the Rule Against Perpetuities (RAP); however, many states (including Pennsylvania and New Jersey) have either repealed or limited the application of the RAP.

The proposal would limit the duration of the GST tax exemption by providing that it would expire on the 90th anniversary of the creation of the trust. This limitation would be effective for trusts created after the enactment date (and to the portion of a pre-existing trust attributable to additions to such a trust made after that date). Accordingly, it may be extremely beneficial for families to fully fund dynasty trusts in the short term before a change in the law is implemented.

ELIMINATION OF GST TAX TREATMENT OF HEETS

The Internal Revenue Code provides that payments made by a donor directly to a medical provider or directly to a school for tuition for the benefit of other individuals are exempt from the gift tax under Section 2503(e) and, correspondingly, exempt from the GST tax pursuant to Section 2611(b)(1). To take advantage of these sections of the code, many donors have created trusts known as HEETs, which allow the trustees to make distributions for the medical expenses and tuition of multiple generations of descendants.

The budget proposal would limit the exclusion from the GST tax under Code Sec. 2611(b)(1) to a payment by a donor directly to the provider of medical care or to the school in payment of tuition. As a result, it would no longer apply to trust distributions, even if the trust distributions are made directly to medical providers and/or schools. The proposal would apply to trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts. This may present another opportunity to lock in an existing tax savings opportunity that soon may no longer be available.

LIMITATIONS ON GRANTOR RETAINED ANNUITY TRUSTS

GRATs have been a popular and effective estate planning technique, enabling taxpayers to minimize or eliminate the gift tax cost of wealth transfers. GRATs are funded with assets that a donor expects will appreciate over the term of the trust. The donor (or "grantor") of a GRAT retains a series of annuity payments from the GRAT for a certain term of years, and, following that term, any remaining funds would pass, outright or in trust, to specified beneficiaries selected by the donor. The greater the appreciation of the assets in the GRAT during its term, the greater the transfer tax benefit achieved. In order for a GRAT to be successful, the grantor must outlive the term of the GRAT and the assets must grow at a rate that is greater than the federal 7520 rate (in May, the 7520 rate is at a low 1.2 percent, making GRATs particularly attractive). In recent years it has become common for taxpayers to create GRATs with minimal terms (i.e., two-year periods), often creating a series of short-term GRATs. These short-term GRATs reduce the risk of the grantor's death during the term and can benefit from volatile investment returns by capturing the benefit of high returns as they arise while also allowing a renewed opportunity to capture high returns after a short-term market downturn by creating a new GRAT with reduced value assets.

Most GRATs are structured to be worth zero, or close to zero, for gift tax purposes. This is possible by requiring that the present value of the annuity payments to be made to the grantor (computed using the applicable 7520 rate) will be equal, or nearly equal, to the value of the assets transferred to the GRAT. As noted above, if the actual investment return on the assets exceeds such rate, it's likely that some wealth will be transferred to the grantor's intended beneficiaries without the imposition of any gift or estate tax.

Effective upon enactment, the budget proposal would require a GRAT to have a minimum term of 10 years and a maximum term equal to the life of the annuitant plus 10 years. The proposal would prohibit any reduction in the annual annuity payable during the term of the GRAT and require that the remainder interest have a value greater than zero, thereby eliminating the ability to completely "zero-out" the gift made upon the GRAT's creation for gift tax purposes, resulting in a greater gift tax cost to the taxpayer.

COORDINATION OF INCOME AND TRANSFER TAX RULES

There is a popular estate planning technique that takes advantage of the fact that the grantor trust rules are different for income tax purposes and federal transfer tax purposes. Based on these rules, it is possible for an individual to create a trust that is not included in his or her estate for estate tax purposes (and is a completed gift for gift tax purposes), but which remains a grantor trust for income tax purposes, so that all of the income tax attributes of the trust remain with the grantor of the trust. These types of trusts are called intentionally defective grantor trusts, or IDGTs.

A sale to an IDGT is an estate planning technique that can provide substantial benefits to those individuals seeking to transfer assets, while minimizing income, estate and gift tax liabilities. The sale strategy is effective, in part, for the following reasons: (1) the sale will not trigger any capital gains taxes since, for federal income tax purposes (but not Pennsylvania income tax purposes), the grantor of the trust is both the seller (in his or her individual capacity) and the buyer (since the trust is a "grantor trust"); (2) there are typically opportunities to discount the value set for the purchase price; (3) the sale may be financed by a promissory note payable by the trust to the grantor, and such note may carry a low interest rate (in May, the interest rate on a midterm note can be as low as 1 percent); (4) all of the appreciation on the assets sold to the trust inure for the benefit of the trust beneficiaries and grow, estate- and gift-tax free; and (5) the grantor can pay the federal income tax on the income attributes of the trust despite that the income remains in the trust (thus, in effect, making a gift-tax free gift of such income tax).

The budget proposal would target, for estate tax inclusion, those IDGTs involving sales, exchanges, or comparable transactions. Thus, in a case where a taxpayer sold property to an IDGT, the portion of the trust attributable to the property sold to the trust (plus all retained income and appreciation on such property), less the consideration received by the taxpayer, would be: (1) included in the taxpayer's estate for estate tax purposes; (2) treated as a gift by the taxpayer in the event that the trust ceases to be a grantor trust during the taxpayer's lifetime; or (3) treated as a gift by the taxpayer to the extent of any trust distributions to others during the taxpayer's lifetime. These changes to the grantor trust rules would be effective upon enactment.

We have learned from the 13th-hour passage of the most recent tax act that it is impossible to predict the timing or content of the next budget or tax act. Such an act might include some, all, or none of the above provisions. However, we believe it is worthwhile to be mindful of what changes are being proposed so that, where appropriate, opportunities can be seized while they continue to be available. •

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