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Give Gifts, Transfer Assets Before Obama Tax Changes

By Michelle Chapin

The Obama Administration recently released its 2013 Revenue Proposals (the “Green Book”), a number of which are designed to limit certain gift and estate planning opportunities that are currently available. Here is a brief overview of some of the relevant proposals:

Restoring the Gift, Estate and GST Tax limits to 2009 levels:
Under current federal estate tax law, an individual can make lifetime gifts or leave at death $5 million without paying any estate, gift or generation-skipping transfer (GST) tax, while amounts in excess of $5 million are taxed at 35%. The Green Book proposes reducing the exclusion amounts to $3.5 million for estate and GST taxes, and $1 million for gift taxes, with a top tax rate of 45% for the estates of decedents dying, and for transfers made, after December 31, 2012. If this proposal is not enacted, and if Congress fails to act on or before the end of the year, the exemption amount will automatically revert to $1 million (indexed for inflation), with a top tax rate of 55%. To fully utilize your $5 million exemption(s), large gifts should be made on or before December 31, 2012.

Modifying the Valuation Discount Rules to Limit Discounts:
Many transfer tax plans involve transferring assets to one or more separate entities to achieve asset/liability protection and often to isolate control in a small ownership interest. These entities are often created as part of a plan which attempts to freeze or at least limit the growth in value of the transferred assets in the transferor’s estate. Valuation discounts (i.e., for lack of marketability and/or non-voting considerations) for partial ownership interests in these entities are often available and can be utilized to increase the effectiveness of this planning. Under present law, appraisers must disregard restrictions on transfers that would otherwise support discounts, pursuant to Internal Revenue Code § 2704(b). Proposals recommended in the Green Book would broaden the categories of restrictions which the appraiser would have to ignore when valuing transfers to family members of family-controlled entities.

Eliminating Zeroed Out GRATs and Requiring a Minimum GRAT Term:
A Grantor Retained Annuity Trust (GRAT) is a trust which allows its creator (i.e., the Grantor) to make a transfer to that trust but to remain entitled to an annual annuity payment for a term of years. The gift resulting from the funding of a GRAT is the difference between the value of the asset transferred and the retained entitlement. At the end of the term, what remains in the GRAT – usually the earnings and appreciation, if any, of the asset in excess of the interest required on the annuity payments – is distributed to the ultimate beneficiary free of gift tax. If the Grantor dies during the GRAT term, the gift still passes to the beneficiary, but the assets remaining in the GRAT are included in the Grantor’s estate for estate tax purposes. A zeroed out GRAT occurs when the value of the asset transferred into the GRAT is equal to the grantor’s retained interest (i.e., the annuity paid to the Grantor). The Green Book proposes a minimum 10-year term for GRATs so that taxpayers can no longer minimize their risk of the Grantor’s death during the term by utilizing short terms GRATs. The proposal also requires the remainder interest be valued at greater than zero when the interest is created. If you wish to take advantage of the benefits of zeroed-out GRATs or short-term GRATs (i.e., ones with less than a 10-year term), you should do so immediately.

New Defective Grantor Trust Rules:
A grantor trust is a trust with the same tax identity as its grantor. Under current law, there are differences between the grantor trust rules for income tax and those for transfer tax purposes, and these differences are often utilized to the taxpayer’s benefit in sophisticated tax planning. The most common technique is to create an intentionally defective grantor trust which is a grantor trust for income tax purposes, but not for transfer tax purposes, permitting the transfer of certain assets out of a taxpayer’s taxable estate without the imposition of current income tax. Conceptually, a grantor is therefore able to remove from the Grantor’s taxable estate certain assets expected to appreciate in value and replace them with assets less likely to do so. Proposals contained in the Green Book would (a) include the assets of the grantor trust in the gross estate of the Grantor for estate tax purposes, and (b) impose conforming gift tax rules so that any distribution from a grantor trust made during the Grantor’s lifetime incurs a gift tax. While this proposal

is intended to be prospective in effect, it could appear to also affect many existing trusts into which contributions continue to be made. This category of affected trusts would include substantially all existing insurance trusts.

If you are considering making substantial gifts, but have been waiting for the right time to make them, you should consider acting now in order to take advantage of the laws as they currently exist. Similarly, if any of your planning is based upon or designed to take advantage of the laws prior to the proposed changes described above taking effect, you should consult with us to review your assets and discuss your planning options.

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