

Taxes—Whither Transfer Taxes

Big changes are on the horizon for the transfer tax in 2010. The problem is no one knows exactly what will happen. Here's a rundown of what we do know along with an overview of the various proposals.

2010 Estate and GST Tax Repeal

Under current law, as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Congress increased transfer tax exemptions and dropped rates. Currently, estate tax rates “max out” at 45 percent and the exemption is up to \$3.5 million per person, meaning that together a husband and wife can transfer as much as \$7 million to heirs free of estate and generation-skipping transfer (GST) taxes. Furthermore, both the estate and GST tax are set to expire in 2010, only to return in 2011. At that time, under current law, the estate and GST tax exemptions will return to their pre-2001 amount of only \$1 million and the maximum rate for both taxes will increase to 55 percent.

When EGTRRA was enacted back in 2001, 2010 seemed a long way off and many advisors joked that the best advice anyone could offer a client was to die in 2010. But that no-so-funny joke has completely lost its humor with 2010 just around the corner and federal deficits running at an all-time high. No one really expects Congress to allow the estate and GST taxes to expire.

The Obama Administration's Plan

On May 11 the Treasury Department released its “2009 Green Book” General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals. The proposed changes to transfer taxes, the most significant of which are discussed below, would dramatically affect estate planning.

Rates and Exemptions

The Administration proposes the following:

- Eliminating the 2010 hiatus for estate and GST taxes and imposing 2009 rates and exemptions on decedents dying in and transfers occurring in 2010; and
- Continuing the 2009 rates and exemptions in 2011 and beyond, rather than returning to pre-2001 rates and exemption amounts.

Valuation Discounts

In addition, the Administration proposes certain “reforms” to the transfer tax system.

One of these relates to discounts used in connection with the valuation of family limited partnerships and other similar interests. A common planning technique is to impose significant transfer and withdrawal restrictions on these interests. Currently, appraisers take such restrictions into account, often resulting in valuation discounts for lack of marketability and control of 40 percent or more. Consequently, when such interests are transferred by gift or bequest, the transfer tax value is much less than it would have been without the discount. The Obama Administration’s proposal creates a new category of “disregarded restrictions” that appraisers are not allowed to consider in valuing family limited partnership and other similar interests transferred to family members. Disregarded restrictions would include:

To minimize the risk of estate inclusion, planners sometimes create “rolling GRATs” of relatively short durations (for example, two years). These GRATs are designed so that they result in zero or very low gift tax values for the remainder interest. As distributions are received by the grantor from one GRAT, additional short-term GRATs are created, assuming the grantor’s health and life expectancy warrant it.

- Limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard identified in regulations; and
- Any limitation on a transferee’s ability to be admitted as a full partner or holder of an equity interest in the entity.

In situations where family limited partnership and other interests include liquidation and transfer restriction like those described above, valuation would be based on assumptions provided by the IRS in future regulations. No one expects those regulations to result in valuation discounts anywhere near as large as those currently available.

GRATs

Another Administration proposal would require minimum terms for grantor retained annuity trusts (GRATs). GRATs are irrevocable trusts in which the grantor retains an annuity interest for a term of years. The value of the remainder interest for gift tax purposes is the value of the property transferred less the value of the retained interest as measured with reference to applicable federal regulations. If the annuity payout to the grantor is high enough, the valuation of the remainder interest can be reduced to zero or near zero, allowing the transferred property and post-gift appreciation to pass to the remaindermen gift tax free, or nearly so.

One drawback to GRATs is that if the grantor dies during the term of the retained interest, the transferred property is included in his or her estate for estate tax purposes. To minimize the risk of estate inclusion, planners sometimes create “rolling GRATs” of relatively short durations (for example, two years). These GRATs are designed so that they result in zero or very low gift tax

values for the remainder interest. As distributions are received by the grantor from one GRAT, additional short-term GRATs are created, assuming the grantor's health and life expectancy warrant it.

The Administration's proposal requires that GRATs last at least ten years. While this proposal, if enacted, will not eliminate the tax benefits associated with GRATs, it will force planners to consider other strategies for managing the mortality risk. One approach is to purchase annually renewable term insurance on the grantor's life for the duration of the retained term.

Other Proposals

In addition to the Administration's proposed changes to the transfer tax, other proposals have emerged. One proposal would extend the 2009 rates and exemptions for estate and GST taxes into 2010. Rates for gift, estate, and GST taxes would freeze at 45 percent, and the exemption amounts for gift, estate, and GST taxes would be unified at \$3.5 million and indexed for inflation beginning in 2011.

Another proposal would increase the estate tax exemption to \$5,000,000 and reduce the maximum estate tax rate to 35 percent, beginning in 2010. Another proposal makes the maximum estate tax rate equal to the capital gains tax rate (currently 20 percent). Yet other proposals would keep the maximum rate at the current 45 percent (generally for estates over \$1.5 million), but would create surcharges of five or ten percent for larger estates.

Keeping the exemption at \$3.5 million (or even increasing it) would eliminate the need for sophisticated planning for nearly everyone, except high-net worth clients with estates of \$7 million or more. However, trust planning including the use of charitable, marital, and family trusts, to assure proper management and distribution of assets would continue to be important even for the not-so-wealthy.

Several proposals also include a portability provision that allows a surviving spouse with an estate that exceeds the applicable estate tax exemption to apply any unused portion of the deceased spouse's exemption. Under these proposals, however, the deceased spouse's unused exemption would not be indexed for inflation after his or her death. Furthermore, the portability feature would not apply to the GST tax.

Portability would eliminate the current "use-it-or-lose-it" approach to the exemption amount that has led to the typical estate plan whereby at the death of the first spouse to die an amount equal to exemption is left in a by-pass trust with the balance passing to the marital trust. Under the portability proposal, even if everything is left to the surviving spouse (by plan or default), the surviving spouse could take advantage of the deceased spouse's unused exemption.

Several proposals also include a portability provision that allows a surviving spouse with an estate that exceeds the applicable estate tax exemption to apply any unused portion of the deceased spouse's exemption.

Farmers and ranchers would also benefit from at least one proposal, with an increase in the maximum valuation reduction under the special use valuation rules that permit an executor to

With federal deficits running high, Congress may be inclined toward maintaining current levels for rates and exemptions, while imposing carry-over basis. This means that pre-death appreciation in equities, closely-held businesses, and real estate would be taxed to the estate or the beneficiary when the decedent's property is sold.

value business realty in accordance with its actual use value, rather than its fair market value. The maximum valuation reduction would be \$3.5 million, indexed for inflation beginning in 2011.

Many of the proposals would eliminate “step-up (step-down)” basis, whereby the estate’s basis in most of the decedent’s property becomes the fair market value of the property at date of death (or the alternate valuation date). The effect of a basis step-up is to shelter pre-death appreciation from capital gains tax when a decedent’s property is sold post-death.

Under the proposals, beginning in 2010, the estate would take a “carry-over” basis in the decedent’s property instead of receiving a basis step-up (step-down). This means that pre-death appreciation in equities, closely-held businesses, and real estate would be taxed to the estate or the beneficiary when the decedent’s property is sold.

One of the proposals would eliminate marketability discounts even in connection with transfers to unrelated persons. This proposal would also eliminate minority discounts for family-owned interests in passive assets including cash or cash equivalents, stock of a corporation, options, derivatives, foreign currency, REIT interests, annuities, real estate used in a real

estate business, collectibles, etc. The proposed change applies only to estate and gift taxes. It does not apply to generation-skipping transfer taxes.

The Bottom Line

It’s a pretty safe bet that estate and GST taxes will remain in place in 2010. It’s also a pretty safe bet that transfer taxes will be with us in 2011 and beyond. With federal deficits running high, Congress may be inclined toward maintaining current levels for rates and exemptions, while imposing carry-over basis. Carry-over basis at death has been a hard-sell in the past. Arguments against it have included record-keeping challenges, enforcement difficulties, and unfairness (due to pre-death appreciation being subjected to both estate and capital gains taxes). These arguments carry less weight in a computerized world where record-keeping and enforcement is no harder at death than during life. The fairness issue is weakened with exemption levels high enough so that only the very wealthy are affected by estate taxes.

Taxes and similar topics are covered in great detail in many of Cannon’s professional development solutions. To find out more visit: www.cannonfinancial.com.

Copyright ©2009 Cannon Financial Institute - All Rights Reserved

Subscribe to Cannon Insights at <http://www.cannonfinancial.com/newsletter/subscribe>

Disclaimer: The materials and information contained herein are intended for educational purposes, to stimulate thought and discussion so as to provide the reader with useful ideas in the area of wealth management planning. These materials and information do not constitute and should not be considered to be tax, accounting, investment, or legal advice regarding the use of any particular wealth management, estate planning, or other technique, device, or suggestion, nor any of the legal, accounting, tax, or other consequences associated with them.

While the content herein is based upon information believed to be reliable, no representation or warranty is given as to its accuracy or completeness. For this reason, the program of study should not be relied upon as such. Although effort has been made to ensure the accuracy of these materials, you should verify independently all statements made in the materials before applying them to your particular fact pattern with a client. You should also determine independently the legal, investment, accounting, tax, and other consequences of using any particular device, technique, or suggestions, and before using them in your own wealth management planning or with a client or prospect. Information, concepts, and opinions provided herein are subject to change without notice.

The strategies contained within these materials may not be suitable for all clients. For many concepts discussed herein, clients are strongly urged to consult with their own advisors regarding any potential strategy and will need to discuss their particular circumstances with their legal and tax advisors beforehand to determine whether a particular strategy described herein is suitable for their particular circumstances.

Examples, provided throughout these materials, are for illustrative purposes only, and no representation is being made that a client will or is likely to achieve the results shown. The examples shown are purely fictional and are not based upon any particular client's circumstances.