$1.50 VOL. 36 NO. 25 www.ocbj.com JUNE 24-30, 2013

ORANGE COUNTY BUSINESS JOURNAL

The "Permanent" Relief Act

by Timothy J. Kay, Partner, and Steffi G. Hafen, Associate, Snell & Wilmer

Exemptions and Rates

On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 ("ATRA"), setting the unified Federal gift and estate tax exemption at $5 million, indexed for inflation ($5.25 million for 2013, expected to increase by $100,000 or more every year thereafter). ATRA set the generation-skipping transfer tax ("GST tax") exemption at the same inflation-adjusted amount. Estate and gift tax and GST tax are all permanently set at 40% rates. Taxpayers who previously exhausted their lifetime gift exemption may now make additional tax free gifts each year as their lifetime exemption increases, in addition to the annual exclusion amounts of $14,000 per donee.

Portability

ATRA also made "portability" permanent – a great benefit to married couples. If a spouse dies without exhausting his/her lifetime gift and estate tax exemption, so long as the decedent's executor makes the proper election on an estate tax return, the unused exemption amount is credited to the surviving spouse for use during life or at death. Any of the deceased spouse's unused exemption at the second death will be combined with the second to die's estate tax exemption to offset any estate tax liability in the survivor's estate.

This allows a surviving spouse to use the exemption of the deceased spouse to make significant lifetime gifts, either outright or in trust to take advantage of advanced tax planning techniques.

Previous planning relied on the creation of a "bypass" or "credit shelter" trust at the first death to fully utilize the decedent's estate tax exemption. Some couples may now conclude that their estate plan should be simplified into an "all to the survivor" plan, eliminating any irrevocable trust at the first death.

Wealthy couples may still plan to fund an irrevocable trust at the first death in the form of a QTIP trust that will provide for the surviving spouse but ensure that those assets ultimately pass according to the wishes of the first-to-die, rather than the wishes of the survivor. This will be particularly important for couples in a second marriage with children of a first marriage who are to be remainder beneficiaries. (The survivor, of course, will control his/her share of the wealth, often held in a survivor's trust.) The QTIP trust may also receive the benefit of the GST exemption of the first to die, increasing the assets that may eventually benefit grandchildren without additional transfer taxation. Relying on portability alone may not be appropriate for couples with high net worth or specific estate planning goals.

Permanent?

The provisions of the tax code are as "permanent" as the ever-changing priorities of the Congress and the President. In President Obama's 2014 Budget Proposal ("Budget Proposal") published in April of this year, he called for a return of the gift, estate and GST tax regimes in effect in 2009. This would mean a 45% marginal tax rate, a $3.5 million exemption for estate and GST purposes and a $1 million exemption for gift taxes – none of which would be indexed for inflation.

Also on the Administration's chopping block are taxpayer friendly advanced techniques such as defective grantor trusts, zeroed-out GRATs, dynasty planning, and health and education exclusion trusts.

Defective Grantor Trusts

A defective grantor trust ("DGT") is an irrevocable trust treated as owned by the grantor for income tax purposes, but not for gift or estate tax purposes. A grantor can use available gift exemption to transfer assets (typically using valuation discounts) or cash to a DGT and name a child (or anyone) as a beneficiary. The grantor is taxed on all items of the DGT's income, deductions and credits. By paying the income tax for the DGT, the grantor causes the DGT to grow income tax free, effectively creating additional tax free gifts to the DGT. The grantor might also choose to sell additional assets to the DGT for a low interest promissory note, arbitraging the low interest against the future growth and earnings of the DGT assets without triggering a taxable sale.

The Budget Proposal would gut this technique by requiring that all DGT assets be included and taxed in the grantor's estate at death, rendering this technique counterproductive. Changes to the grantor trust rules are expected to be effective as of the date of enactment, meaning the technique is still available at the present. Planners sense that this is a priority proposal for the Treasury Department and remain concerned that the change could be adopted as a small part of some unrelated tax legislation.

Zeroed-out GRATs

In a grantor retained annuity trust ("GRAT"), the grantor transfers property to an irrevocable trust and retains the right to a stream of payments for a term of years. At the end of the term, the property remaining in the GRAT passes to or for the benefit of the remainder beneficiaries named in the trust instrument. The grantor is treated as making a taxable gift of the remainder interest, valued pursuant to actuarial tables at the time the GRAT is funded. Actuarial tables account for the present value of expected payments to the grantor based upon current interest rates and the grantor's life expectancy. The GRAT provides the opportunity to make a tax free gift of any growth in value of the trust assets not accounted for by the actuarial tables.

In a "zeroed-out" GRAT, gift tax can be avoided entirely on the growth of rapidly appreciating assets by selecting an annuity amount equal to the present value of the assets transferred to the GRAT. The grantor will be treated as having made a negligible taxable gift.

Imagine a taxpayer who owns an interest in a business that is likely to be sold in a year or so, but for which no binding agreement for sale has been reached. The contribution to the GRAT will likely consist of a minority interest and will be properly discounted to reflect its lack of marketability and control. The present value of a two year annuity obligation is structured to equal the appraised value of the contributed interest, so there is no significant taxable gift tax. The business interest may be sold by the trustee of the GRAT within the first year at a price much higher than the gift valuation. The annuity is paid to the grantor for two years, equaling the appraised value of the initial contribution, and then the entire remaining balance of the GRAT passes to the children gift-tax free. If the contributed assets are not sold or do not increase in value, the grantor will simply receive 100% of the initial contribution in the form of the required annuity payments, but will not have made a taxable gift of any significance.

The Budget Proposal seeks to impose a minimum term for GRATs (likely 10 years) and a minimum value for the taxable gift – perhaps up to 10% of the value of the contribution. This will increase the gift tax cost of using a GRAT and increase the risk that if the GRAT assets fail to perform as optimistically projected during the planning, the taxable gift may exceed the value actually transferred to the grantor's remainder beneficiaries. Again, changes are expected to be applicable to trusts created after the date of enactment.

Dynasty Planning

Dynasty trusts are irrevocable trusts formed in jurisdictions that allow trusts to exist in perpetuity and to which GST tax exemption is allocated. These trusts can benefit successive generations without being reduced by GST tax at each generation.

California law does not provide for perpetual trusts for families, so California residents often create these trusts in friendlier states, such as Delaware, that allow trusts to exist in perpetuity.

The Budget Proposal would limit the duration of the GST tax exemption and minimize the tax savings of dynasty trusts over multiple generations. Any change will likely be applicable to additions to preexisting trusts and to trusts created after the date of enactment.

Turning Down the HEET?

Gifts to pay tuition or medical expenses are excluded from both gift and GST tax if executed correctly. The health and education exclusion trust ("HEET") takes advantage of this taxpayer-friendly law and is structured to provide for the health and education costs for multiple generations without ever incurring gift or GST tax liabilities. The Budget Proposal seeks to clarify the GST tax treatment of HEETs, likely limiting the permissible duration of the GST tax exemption.

Planning Today

ATRA provides some wonderful estate planning opportunities that are available to taxpayers today while the President's Budget Proposal singles out the techniques that are so good the IRS wants to eliminate them. Early planning with these powerful tools can result in very significant gift tax free transfers to your loved ones over time.

Finally, portability may be touted as allowing simpler estate planning, but for couples with significant wealth, blended families or unique goals, portability alone may not be the answer. A check-up with your estate planner may be advised to ensure that your plan takes appropriate advantage of today's laws and cutting edge techniques.

Timothy J. Kay

Timothy J. Kay is a Certified Specialist in Estate Planning, Trust and Probate Law, California Board of Legal Specialization. His practice is concentrated in tax, trust, and estate matters with emphasis in estate planning, trust and probate administration, and estate and gift taxation. Tim can be reached at 714.427.7400 or tkay@swlaw.com.

Steffi G. Hafen

Steffi G. Hafen is an associate in the Orange County office of Snell & Wilmer. Her practice is concentrated in estate planning and taxation matters. Steffi can be reached at 714.427.7076 or shafen@swlaw.com.