After the relative calm following the enactment of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRA 2010), we are beginning to see signs of turbulence in the estate tax arena. (Note: See my Guide to the New Estate Tax Law for an overview of TRA 2010.)

PRESIDENT OBAMA'S 2012 BUDGET

When President Obama reached a compromise with top-ranking Republicans in 2010 to raise the Federal estate tax exemption to $5 million with rates of 35 percent, he warned that this "generous treatment" would only be temporary. The President's 2012 budget seeks to follow through on that warning.

ESTATE AND GIFT TAX EXEMPTIONS AND RATES

President Obama's 2012 budget, which was released in mid-February, would return the Federal estate exemption to its 2009 level of $3.5 million. The gift and generation-skipping transfer (GST) tax exemption would be set at $1 million. A 45 percent tax rate would apply for all transfer taxes.

PORTABILITY OF DECEASED SPOUSE'S UNUSED EXEMPTION

Portability allows a surviving spouse to take advantage of the unused exemption of a predeceased spouse. Under TRA 2010, spouses of individuals who die after December 31, 2010, but before January 1, 2013, can increase their exclusion amount by the amount of the exemption that was unused by their predeceased spouse. President Obama's budget would make portability permanent (it is currently set to expire at the end of 2012).

RESTRICTIONS ON THE USE OF GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

The President's 2012 budget would curb the use of GRATs to arbitrage the applicable Federal interest rate. In a low-interest rate environment, GRATs are used to transfer wealth between family members at a reduced gift tax cost if the grantor survives the term of the GRAT (for a more detailed explanation of GRATs, see my article on Making Good Use of GRATs in 2010). This has resulted in the widespread use of short-term, "zeroed out" GRATs as a tax planning technique. The President's budget would curb this technique by requiring a 10-year minimum term and a remainder value that is greater than zero.

RESTRICTIONS ON VALUATION DISCOUNTS

Valuation discounts are often used in estates that are worth more than the Federal estate tax exemption. These discounts are especially appropriate in family-owned businesses, where the value of the business is likely to be impaired by lack of marketability to the general public. It is not uncommon for valuation discounts to reach 30 to 40 percent, resulting in a substantial tax savings.

The IRS is aware of these techniques and has litigated a string of family limited partnership cases, with mixed success in the courts. President Obama's budget creates a new class of tax restrictions that would prevent the use of valuation discounts in some family-controlled companies.

Curbing the Use of Dynasty Trusts

Dynasty trusts are funded with assets that pass free of the GST tax exemption. These trusts are typically created in a jurisdiction that does not follow the common law rule against perpetuities, allowing the trusts to continue indefinitely. This allows the trust assets to be sheltered from transfer taxes throughout the term of the trust over many generations. The Obama administration would curb this benefit by placing a 90-year maximum term on new dynasty trusts or money added to existing dynasty trusts.

Discussions Beginning in Congress

In early June, the New York Post reported that Senate Republicans are retreating from their push for an all-out repeal of the estate tax.

According to the Post, both sides of the aisle are comfortable with a $5 million exemption amount. But there is disagreement about the tax rates that should apply. Democrats are pushing for a 45 percent tax rate; Republicans prefer the current 35 percent rate.

A Few Concluding Thoughts

This isn't the first time we've seen what President Obama is proposing. A similar bill (H.R. 4154, Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009) was passed by the House of Representatives in 2009. No Republicans voted for the bill, and it died in the Senate.

Based on previous legislative attempts, it is not clear that a return to 2009 levels is a viable option. It seems more likely that President Obama's budget is intended to appease those in his party who were critical of the concessions at the end of 2010 while leaving himself room to compromise in return for concessions from top-ranking Republicans.

I see these recent developments as more of a starting point for discussions, preliminary volleys before the real fight begins. With any luck, we won't need to wait until December 2012 to see how it ends.