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Wealth Strategies

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Foreshadowing Change?

President Obama recently released his 2013 federal budget proposal. This budget proposal recommends substantial changes to wealth transfer tax laws. It also recommends reducing or eliminating the use of successful wealth transfer and family succession planning techniques. The following will summarize the President's proposed changes.

Estate Tax

The current estate tax exemption amount of $5.12 million would be reduced to $3.5 million. The corresponding estate tax rate would increase from 35% to 45%. These changes would return both the estate tax exemption amount and tax rate to levels previously seen during 2009.

Generation-Skipping Transfer ("GST") Tax

As a reminder, the GST tax system was designed to promote collection of wealth transfer taxes at each generation. The current GST tax exemption amount of $5.12 million would be reduced to $3.5 million. The corresponding GST tax rate would increase from 35% to 45%. These changes similarly would return the GST tax exemption amount and tax rate to levels previously seen during 2009.

Gift Tax

The current gift tax exemption amount of $5.12 million would be reduced to $1 million. The corresponding gift tax rate would increase from 35% to 45%. These changes similarly would return the gift tax exemption amount and tax rate to levels previously in seen during 2009.

This change would unwind the unification of estate, GST and gift tax laws that returned during last year and this year. More importantly, it could adversely impact wealth transfer planning by making it more difficult for taxpayers to make large lifetime (non-taxable) gifts to shift wealth within their families.

In addition to lower exemption amounts and increased tax rates, the President has proposed to minimize or eliminate the benefits of using the following planning techniques.

Intentionally Defective Irrevocable Trust ("IDIT")

An IDIT is a type of trust to which transfers are deemed complete for gift and estate tax purposes but incomplete for income tax purposes. This technique has proved successful because it allows a taxpayer to sell assets to the IDIT without triggering any corresponding capital gains tax. This technique also has proved successful because the IRS does not treat the taxpayer's ongoing payment of income taxes as additional gifts to the trust.

> The President's budget proposal may trap wealth at the oldest generation. This may lead to higher transfer tax payments sooner than available under current law.

Why would someone want to give assets away but retain income tax liability related to them? These tax payments foster preservation and growth of IDIT assets. These payments also allow taxpayers to remove assets from their estates that would be subject to future estate taxes.

The President's proposed budget would eliminate the benefits of IDITs by treating all beneficiary distributions as gifts during the taxpayer's lifetime. The President's proposed budget further recommends that all remaining IDIT assets be subject to estate tax at the taxpayer's death.

Grantor Retained Annuity Trust ("GRAT")

A GRAT is a type of gift trust that allows a taxpayer to transfer property while retaining the right to receive an annuity payment for a term of years. Thereafter, the remaining assets of the GRAT will benefit other family members. The value of the family gift for these purposes will equal the difference between the property's value and the taxpayer's retained annuity value.

Family businesses with low values that are expected to appreciate have been used for gifting through a GRAT. The most famous example of this type of GRAT planning involved the transfer of Walmart stock within the family of Sam Walton. Sam Walton created a series of short-term GRATs funded with Walmart stock, and his required annuity payments exactly equaled the value of the stock. This resulted in no initial gift by Mr. Walton to his family and ultimately removed all of the gifted stock from his estate (at no tax cost) as he survived each GRAT term.

The President's proposed budget would mandate that GRATs remain in existence for at least 10 years. This would eliminate the use of successful, short-term GRATs like those created by Sam Walton. It also would increase the likelihood of death during the GRAT term (which would subject the remaining GRAT assets to estate tax).

Valuation Discounts

Currently, taxpayers can transfer interests in family-owned businesses on a discounted basis with appropriate planning. The President's proposed budget would eliminate the ability of families to attain such discounts when transferring family-owned business interests.

Dynasty Trusts

States previously had maintained "rules against perpetuities" to force the distribution of trust assets to beneficiaries within a measurable time period. Many states since have extended their rules against perpetuities allowing trusts to last forever. Estate planners have used these changes to create perpetual "dynasty" trusts that can benefit several generations without becoming subject to transfer taxes over time. The President's proposed budget would restrict the lifespan of dynasty trusts to 90 years and subject their assets to transfer taxes then.

Opportunity Knocks

The President's budget proposal as it relates to wealth trust taxes may not represent the final law. However, the laws currently are written to sunset if Congress does not act by the end of this year. That would result in even lower exemption amounts and even higher tax rates as they existed prior to the Bush tax cut era. Hopefully, Congress will take action before then, but that has proven to be difficult during our current election year. Taxpayers are watching closely and giving second thought to making those larger gifts (including those based on successful planning techniques) as permitted under current law.

ABOUT THE AUTHOR

Terry LaBant leads our Wealth Strategies team. Terry has 20 years of experience consulting with clients in six core areas that influence the creation, preservation and protection of family wealth. They include: tax planning, estate planning, retirement planning and asset protection.

For more information about federal and state taxes, please consult the Internal Revenue Service and the appropriate state-level departments of revenue, respectively.

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