

Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms

MAKE PERMANENT THE PORTABILITY OF UNUSED EXEMPTION BETWEEN SPOUSES

Current Law

Each individual has a lifetime exclusion for purposes of estate and gift taxes. That exclusion is \$5 million in 2011 and will be indexed for inflation after 2011. However, after 2012, the amount of this exclusion is scheduled to revert to the amount that would have been in effect had the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) never been enacted (thus, \$1 million). For the first time, current law now provides that the surviving spouse of a person who dies after December 31, 2010, may be eligible to increase the surviving spouse's exclusion amount by the portion of the predeceased spouse's exclusion that remained unused at the predeceased spouse's death. In no event, however, may the surviving spouse's exclusion amount be increased by more than the amount of exclusion available to a person in that calendar year. This provision allowing the portability of the predeceased spouse's unused exemption applies through December 31, 2012. If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the unused exclusion of the last such deceased spouse to die. The surviving spouse may use his or her exclusion, augmented by such predeceased spouse's unused exclusion, for taxable transfers made during life or at death.

The surviving spouse may use the unused exclusion of such predeceased spouse only if the executor of that predeceased spouse makes an election on a timely filed estate tax return (including extensions) for the estate of that predeceased spouse on which such unused exemption amount is computed, regardless of whether the estate of that predeceased spouse otherwise is required to file an estate tax return. Notwithstanding the statute of limitations for assessing estate or gift tax with respect to that predeceased spouse, the return of that predeceased spouse may be examined and adjusted for purposes of determining the deceased spouse's unused exclusion amount available for use by the surviving spouse.

Reasons for Change

Without this portability provision, spouses are often required to retitle assets into each spouse's separate name and create complex trusts in order to allow the first spouse to die to take full advantage of his or her exclusion. Depending upon the nature of the couple's assets, such a division may not be possible. Such a division also has significant consequences under property law and often is not consistent with the way in which the married couple would prefer to handle their financial affairs. Portability would obviate the need for such burdensome planning.

Proposal

This proposal would extend portability permanently, thus making the use of the last predeceased spouse's unused exemption available to all estates of decedents dying and gifts made after December 31, 2012.

REQUIRE CONSISTENCY IN VALUE FOR TRANSFER AND INCOME TAX PURPOSES

Current Law

Section 1014 provides that the basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. Similarly, property included in the decedent's gross estate for estate tax purposes generally must be valued at its fair market value on the date of death. Although the same valuation standard applies to both provisions, current law does not explicitly require that the recipient's basis in that property be the same as the value at which that property was reported for estate tax purposes.

Section 1015 provides that the donee's basis in property received by gift during the life of the donor generally is the donor's adjusted basis in the property, increased by gift tax paid on the transfer. If, however, the donor's basis exceeds the fair market value of the property on the date of the gift, the donee's basis is limited to that fair market value for purposes of determining any subsequent loss.

Section 1022, applicable to the estates of decedents dying during 2010 if a timely election to that effect is made, provides that the basis of property acquired from such a decedent is the lesser of the decedent's adjusted basis in that property or the fair market value of the property on the decedent's date of death.

Section 6034A imposes a consistency requirement – specifically, that the recipient of a distribution of income from a trust or estate must report on the recipient's own income tax return the exact information included on the Schedule K-1 of the trust's or estate's income tax return – but this provision applies only for income tax purposes, and the Schedule K-1 does not include basis information.

Reasons for Change

Taxpayers should be required to take consistent positions in dealing with the Internal Revenue Service, whether or not principles of privity apply. If the logic underlying the determination of the new basis in property acquired on the death of the owner is that the new basis is the amount used to determine the decedent's estate tax liability, then the law should require that the same value be used by the recipient, unless that value is in excess of the accurate value. In the case of property transferred on death or by gift during life, often the executor of the estate or the donor, respectively, will be in the best position to ensure that the recipient receives the information that will be necessary to determine the recipient's basis in the transferred property.

Proposal

This proposal would impose both a consistency and a reporting requirement. The basis of property received by reason of death under section 1014 must equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor must equal the donor's basis determined under section 1015. The basis of property acquired from a decedent to whose estate section 1022 is applicable is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. This proposal would require

that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments).

A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary valuation information to both the recipient and the Internal Revenue Service.

A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

The proposal would be effective as of the date of enactment.

MODIFY RULES ON VALUATION DISCOUNTS

Current Law

The fair market value of property transferred, whether on the death or during the life of the transferor, generally is subject to estate or gift tax at the time of the transfer. Sections 2701 through 2704 of the Internal Revenue Code were enacted to prevent the reduction of taxes through the use of “estate freezes” and other techniques designed to reduce the value of the transferor’s taxable estate and discount the value of the taxable transfer to the beneficiaries of the transferor without reducing the economic benefit to the beneficiaries. Generally, section 2704(b) provides that certain “applicable restrictions” (that would normally justify discounts in the value of the interests transferred) are to be ignored in valuing interests in family-controlled entities if those interests are transferred (either by gift or on death) to or for the benefit of other family members. The application of these special rules results in an increase in the transfer tax value of those interests above the price that a hypothetical willing buyer would pay a willing seller, because section 2704(b) generally directs an appraiser to ignore the rights and restrictions that otherwise would support significant discounts for lack of marketability and control.

Reasons for Change

Judicial decisions and the enactment of new statutes in most states, in effect, have made section 2704(b) inapplicable in many situations by recharacterizing restrictions such that they no longer fall within the definition of an “applicable restriction”. In addition, the Internal Revenue Service has identified additional arrangements designed to circumvent the application of section 2704.

Proposal

This proposal would create an additional category of restrictions (“disregarded restrictions”) that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transfer’s family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard to be identified in regulations. A disregarded restriction also would include any limitation on a transferee’s ability to be admitted as a full partner or to hold an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

REQUIRE A MINIMUM TERM FOR GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

Current Law

Section 2702 provides that, if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is valued at zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a “qualified interest.” A fixed annuity, such as the annuity interest retained by the grantor of a GRAT, is one form of qualified interest, so the gift of the remainder interest in the GRAT is determined by deducting the present value of the retained annuity during the GRAT term from the fair market value of the property contributed to the trust.

Generally, a GRAT is an irrevocable trust funded with assets expected to appreciate in value, in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries, who generally are descendants of the grantor. If the grantor dies during the GRAT term, however, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor’s gross estate for estate tax purposes. To this extent, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax-free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized.

Reasons for Change

GRATs have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, providing that the grantor survives the GRAT term and the trust assets do not depreciate in value. The greater the appreciation, the greater the transfer tax benefit achieved. Taxpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor’s death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.

Proposal

This proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of ten years.⁹ The proposal would also include a requirement that the remainder interest have a value greater than zero and would prohibit any decrease in the annuity during the GRAT term. Although a minimum term would not prevent “zeroing-out” the gift tax value of the remainder interest, it would increase the risk of the grantor’s death during the GRAT term and the resulting loss of any anticipated transfer tax benefit.

This proposal would apply to trusts created after the date of enactment.

⁹ Cf. section 673 as applicable to a so-called *Clifford* trust created before or on March 1, 1986, with a ten-year minimum term.

LIMIT DURATION OF GENERATION-SKIPPING TRANSFER (GST) TAX EXEMPTION

Current Law

Generation-skipping transfer tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor. The GST tax was enacted to “backstop” the estate and gift tax system by preventing the avoidance of those taxes through the use of a trust that gives successive life interests to multiple generations of beneficiaries. In such a trust, no estate tax would be incurred as beneficiaries died because their respective life interests would die with them and thus would cause no inclusion of the trust assets in the deceased beneficiary’s gross estate. The GST tax is a flat tax on the value of the transfer at the highest estate tax bracket applicable in that year. Each person has a GST tax exemption (originally \$1 million, \$3.5 million in 2009, and \$5 million in 2010 and 2011), that can be allocated to transfers made by that person, whether made directly to a grandchild or other “skip person” or in trust. The allocation of GST exemption to a transfer or to a trust excludes from the GST tax not only the amount of the transfer or trust assets equal to the amount of GST exemption allocated, but also all appreciation and income on that amount during the existence of the trust.

At the time of the enactment of the GST provisions, the law of most (generally, all but about three) states included the common law Rule against Perpetuities (RAP) or some statutory enactment or version of it. The RAP generally requires that every trust terminate no later than 21 years after the death of a person who was alive (a life in being) at the time of the creation of the trust.

Reasons for Change

Many states have now either repealed or limited the application of their RAP statutes, with the effect that trusts created subject to the law of those jurisdictions may continue in perpetuity. (A trust may be situated anywhere; a grantor is not limited to the jurisdiction of the grantor’s domicile for this purpose.) As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with \$1 million and a maximum duration limited by the RAP, to trusts funded with \$5 million and continuing (and growing) in perpetuity.

Proposal

This proposal would provide that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from a different grantor are deemed to be held in a separate trust under section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts will be deemed to have the same date of creation as the initial trust, with one exception, as follows. If, prior to the 90th anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as

described in section 2642(c)(2), the inclusion ratio of the distributee trust will not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on the beneficiary's death will be included in the beneficiary's gross estate for Federal estate tax purposes. The other rules of section 2653 also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision.

This proposal would apply to trusts created after enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).