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ESTATE AND TAX PLANNING:

Administration's Budget Proposals Include Important Changes for Estate Planning Clients

In the last several months, President Obama introduced his Fiscal Year 2013 Budget Proposals, including several key provisions that would be of significance to estate planning clients. Some of the most important of these proposals are as follows:

Restoration of the Less Favorable 2009 Exemptions and Rates

The Budget Proposals call for a 45% maximum estate, gift and generation-skipping transfer (GST) tax rate, an exemption of \$3.5 Million for estate and GST taxes, and a \$1 Million exemption for lifetime gifts. These changes would be applicable to estates of decedents dying, and transfers made, after December 31, 2012. A concern for clients is that a \$1 Million gift tax exemption is significantly lower compared to the current \$5 Million exemption (which is actually \$5,120,000 as adjusted for inflation). If these Proposals become law for 2013, the impending \$1 Million exemption may incentivize taxpayers to consider making larger gifts in 2012 before the current exemption of \$5 Million disappears. In addition, absent Congressional action in 2012, it is possible that the exemptions for gift, estate and GST tax will return to the pre-2002 low of \$1 Million with a significantly higher top rate of 55%.

Portability of a Deceased Spouse's Unused Exemption Would be Permanent

The Proposals would also make a deceased spouse's unused estate tax exemption portable so that the decedent's surviving spouse could use that additional "unused" amount and shield his or her own assets from estate tax. This "portability" feature is currently in effect if both spouses die before 2013. The Proposals, however, would make "portability" permanent after 2012, rendering the benefit that if one spouse fails to make full use of his or her estate tax exemption (currently \$5 Million) by creating in his/her Will either a special "Credit Shelter Trust" or bequests equal to the \$5 Million to a non-spouse/non-charity, the surviving spouse can essentially inherit the predeceased spouse's unused exemption to

reduce estate taxes at their subsequent death. In sum, the couple could have the benefit of a \$10 Million exemption without having to make special provisions in their Wills. *Caveat: Portability is a great feature for married couples. Still, clients should not rely solely on portability because a Will that does not create a trust to hold assets equal to the exemption amount (i.e., a "Bypass Trust" or "Credit Shelter Trust") could preclude other important estate planning leveraging techniques.*

Minimum Term for GRATs

The Proposals would also require that a grantor of a Grantor Retained Annuity Trust ("GRAT") retain a minimum 10-year term, and that the actuarial value of the assets passing at the end of the GRAT to the Grantor's beneficiaries be greater than zero. These requirements could make the creation of a GRAT a bit less compelling for some clients. First, if interest rates rise from their historical low, the IRS will set a higher hypothetical "default" interest rate applicable to GRATs. A higher default interest rate set by the IRS (the "hurdle rate") will in turn require that a larger annuity be paid back to the Grantor, thereby returning trust assets back to his estate. The greater required annuity amount (which is a function of the IRS hurdle rate) causes an accelerated exhaustion of the trust principal, since more of the trust assets will be needed to satisfy the annuity due the Grantor. Second, the mandate under the Proposals of a 10-year retained term by the Grantor could make it less likely that an elderly Grantor would survive the retained term. A requirement of a successful GRAT is that the Grantor survive the retained term of the GRAT. Please keep in mind, however, that the creation of a GRAT could, under the right circumstances, be an exceedingly useful estate planning tool, regardless of the Proposals. Specifically, if the Grantor is the right age and in good health, and appreciation on assets placed in a GRAT will far exceed the IRS default hurdle rate, and the GRAT is likely to be a huge success.

Create Estate Tax Inclusion for Grantor Trusts

The current law allows ways for a taxpayer to create a trust for other beneficiaries, make a completed gift of assets to the trust, and still be treated as the "owner" of the trust for income tax purposes. If structured properly, this permits the Grantor to treat the trust as the

APRIL 2012

Grantor's alter ego for income taxes and pay the annual income taxes, allowing the trust property to grow without the diminution of income tax payments. Structuring a trust as a "grantor trust" does not necessarily cause the trust property to be included in the Grantor's estate at death. Furthermore, the Grantor's paying the income tax on behalf of the trust is an additional non-taxable transfer to the trust. Unfortunately, this would be changed by the Proposals, which aim to treat any trust classified as a "grantor trust" as one that is includible in the estate of the grantor who is treated as the "owner" of the trust for income tax purposes.

Basis Consistency and Reporting Requirement for Donated and Inherited Property

The basis of property in the hands of the recipient can be no greater than the value of that property as determined for estate or gift tax purposes (subject to later adjustments). Under the Proposals, a reporting requirement would be imposed on executors of estates and donors to provide the necessary valuation and basis information to both the recipient and the IRS. These rules would apply for transfers on or after the enactment date. A concern with this Proposals is that an estate or donor that would not otherwise have to file either an estate or gift tax return will now have the administrative burden and legal obligation of doing so.

As always, we recommend that clients review their estate plans periodically and/or whenever a significant life event occurs (e.g., birth of a child, death of a spouse, purchase of new home, change of state of residence, etc.). Individuals with substantial amounts of wealth or with closely-held businesses may consider whether to take further advantage of the current \$5 Million gift tax exemption, which will expire absent further Congressional action at the end of 2012. The uncertain legislative environment is still an ideal time to consider lifetime gifts because some property values are depressed, interest rates are at an historic low and valuation discounts may not be available in the future.

Reid Glynn, LLP aims to keep you abreast of the ever-changing tax laws. Please do not hesitate to contact us with any questions that you might have or if you would like to discuss your estate plan in light of this Report.

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