February 11, 2010

The budget proposal that President Obama and his Administration introduced this week has received wide media attention. That budget proposal is based on assumptions that include changes in federal taxes. This letter summarizes the federal tax changes embedded in the proposal that would affect wealth transfer tax planning. The Administration proposal assumes that the law governing estate, gift and generation-skipping taxes in effect during 2009 is extended permanently. Accordingly, references to "Current Law" in this letter reflect applicable law in effect in 2009.

MODIFY RULES ON VALUATION ADJUSTMENTS

Current Law: Federal tax law allows the fair market value of property transferred at death or during the life of the transferor to be adjusted to reflect restrictions on transfer or liquidation. Those restrictions are typically imposed by agreement, for example in an operating agreement for a partnership or LLC. Federal regulations give "applicable restrictions" on liquidation zero weight in valuing interests in family-controlled entities that are transferred to or for the benefit of other family members. Nevertheless, judicial decisions and the enactment of new statutes in most states have systematically eroded the regulatory definition of disallowed "applicable restrictions".

Proposal. The Administration proposal would attack this issue with a new category of "disregarded restrictions" that would be given a zero value when valuing an interest in a family-controlled entity transferred to a family member. If the disregarded restriction has a zero value, the interest would be subject to gift or estate tax at full liquidation value. Disregarded restrictions would include limitations on a right to liquidate that are more restrictive than a regulatory standard, even if allowed under state law. A disregarded restriction would include any limitation on a transferee's ability to be admitted as a full partner or member, rather than being merely an assignee. Any restriction that lapses after the transfer or that may be removed by the transferor or the transfer's family may be disregarded. If enacted, this proposal would require careful review of restrictions on transfer in a partnership or other operating agreement to avoid overvaluation of partnership or LLC interests that do not conform to the new regulatory standards.

CONSISTENT VALUATION FOR TRANSFER AND INCOME TAX PURPOSES

Current Law. Federal income tax law provides two general rules for calculating the income tax basis of property received either by inheritance or by gift. Income tax basis is used to calculate the capital gain realized when an inherited or gifted asset is later sold. First, the basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. Second, a donee's basis in property received by lifetime gift generally is the donor's adjusted basis in the property, increased by any gift tax paid on the transfer. Current law does not explicitly require that the recipient's income tax basis be the same as the reported value for estate or gift tax purposes.

Proposal. The Administration proposal would impose both a consistency and a reporting requirement. 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. The executor of the decedent's estate and the donor of a lifetime gift would be required to report the necessary information to both the recipient and the tax authorities. If enacted, this proposal would require greater co-ordination between estate and gift tax and income tax reporting and the resulting compliance.

MINIMUM TERM FOR GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

Current Law. 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 remaining trust assets are transferred to the grantor's beneficiaries. If the grantor dies during the GRAT term, however, the portion of the trust assets needed to produce the annuity are included in the grantor's gross estate. GRATs can achieve a significant wealth transfer at a reduced gift tax cost, provided that the grantor survives the GRAT term and the trust assets do not depreciate in value. The greater the appreciation in the GRAT property during the term of the annuity interest, the greater the transfer tax benefit achieved.

The taxable gift of the remainder interest in the GRAT is calculated by deducting the present value of the retained annuity from the fair market value of the property contributed. Taxpayers often minimize the term of the GRAT to reduce the risk of the grantor's death, in many cases to two years. They also retain 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. The Administration proposal would require that a GRAT have a minimum term of ten years. The proposal also requires that the remainder interest have a value greater than zero and prohibits 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.

These proposals do not eliminate the tax benefit of accepted estate planning approaches, but may require review and amendment of applicable documentation and reconsideration of projected benefits. Opportunities for transfer tax savings still abound in a time of historically low interest rates, depreciated property values and valuation adjustments allowable under current law. Please feel free to call with any questions you may have on how to take advantage of these planning opportunities.

Very truly yours,

JOHN A. HARTOG, INC.