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Obama Administration's Fiscal Year 2010 Revenue Proposals Relating to Estate, Gift and Income Taxation of Individuals

President Obama's budget[1] includes several proposals relating to the U.S. federal estate, gift and income tax laws applicable to high net worth individuals. This memorandum summarizes some of the more significant proposals included in the budget.

The President's budget includes three proposals relating to U.S. federal estate and gift taxes that may be of particular interest to our clients. First, the President's budget indicates that the current 2009 estate and gift tax rates and estate and gift tax exemptions would be extended to 2010 and beyond. Second, the President's budget includes a proposal to require a minimum 10-year term for grantor retained annuity trusts (or "GRATs"). Finally, the use of discounts in valuing family entities would be severely limited.

The President's budget also includes proposals to increase the income tax rates applicable to certain individual taxpayers and to reduce itemized deductions for certain individual taxpayers. These changes would take effect in 2011. For the most part, these increases reinstate tax rates in effect during the Clinton administration.

Estate and Gift Tax Exemptions and Rates

Under current law, each individual may transfer at death an amount equal to the U.S. federal estate tax exemption (reduced by certain lifetime gifts) without the imposition of a federal estate tax. Currently, the amount of the federal estate tax exemption is $3.5 million and the top federal estate tax rate is 45%. The federal estate tax is currently scheduled to be repealed in 2010, but then reinstated in 2011 with a federal estate tax exemption of $1 million and a top federal estate tax rate of 55% (with a 5% surcharge for certain large estates).

Under current law, the top federal gift tax rate is 45% and there is a $1 million exemption from the federal gift tax.

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[1] The President's budget is set forth in the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals.

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Although the President's budget does not contain an explicit proposal on estate or gift taxes, it indicates in an Appendix that there is an intention to make the 2009 federal estate exemption of $3.5 million and the 2009 top federal estate and gift tax rates of 45% permanent. It appears that the federal gift tax exemption would remain at $1 million.

GRATs

As discussed in more detail in our memorandum dated November 19, 2008[2], a GRAT is a technique for transferring to children or other beneficiaries the total return on assets in excess of a benchmark interest rate. Under a GRAT, a donor establishes a trust whereby the donor retains a fixed annuity for a term of years that is designed to return to the donor an amount roughly equal to the value of the property transferred to the trust. The annuity is valued by reference to interest rates published by the Internal Revenue Service. The total return on the property held in the trust in excess of the benchmark rate passes to children or other beneficiaries free of gift taxes. If the donor dies before the end of the GRAT term, the trust property (or a portion of the trust property) is includible in the donor's taxable estate, eliminating (or reducing) the potential tax benefits associated with the GRAT.

Many GRATs are set up for a two-year term. Two-year GRATs have two significant benefits. First, in a volatile market, the use of a series of two-year GRATs over a longer time horizon increases the likelihood that a GRAT will successfully transfer appreciation to the trust remaindermen in any two-year period. Second, the use of a two-year GRAT minimizes the mortality risk discussed above.

Under the proposal in the President's budget, a GRAT would be required to have a minimum term of 10 years. The President's budget indicates that the intent of the proposal is to increase the mortality risk associated with GRATs and thereby increase the risk that the anticipated transfer tax savings would not be achieved. The legislation also has the effect of increasing a GRAT's sensitivity to volatile markets: if the investment performance of a 10-year GRAT is poor in one or more years of the GRAT term, it may be difficult for the GRAT ultimately to be successful.

Nonetheless, if this legislation passes, GRATs will still be a viable estate planning technique for individuals for whom a 10-year time horizon is acceptable. A long-term GRAT has the benefit of locking in an interest rate for the full 10-year term, which is a significant benefit in a low interest rate environment. Further, with a long-term GRAT, many grantors will wish to take advantage of a rule permitting a GRAT annuity to start small and increase by up to 20% each year. Such a graduated annuity has the benefit of permitting the GRAT's assets to grow in the early years with relatively small annuity payments.

[2] For a more detailed discussion of GRATs, please refer to our memorandum dated November 19, 2008 at the following link: http://www.cgsh.com/memoranda_regarding_estate_planning_developments_and_opportunities/.

The President's budget indicates that this provision would become effective upon enactment. Thus, prior to enactment, a client can still establish a short-term GRAT.

Valuation discounts

When an individual makes a gift of an interest in an entity, such as a family limited partnership or a family limited liability company, the value of the gift may be discounted for certain factors such as lack of marketability and lack of control.

Under the President's budget, when valuing a "family-controlled entity" for estate and gift tax purposes, certain restrictions that are subject to removal by the donor or other family members would be disregarded ("disregarded restrictions"). Disregarded restrictions would include restrictions on the donee's ability to liquidate his or her interest in the entity and the donee's inability to be admitted as a full partner or member. Interests of certain non-family members would be ignored in determining whether the entity is family-controlled, presumably to prevent circumvention of the new rules.

The President's budget indicates that certain restrictions will still be respected for valuation purposes but leaves much of the detail concerning acceptable restrictions and other aspects of the legislation to future regulations.

The proposal would apply to transfers after the date of enactment with respect to restrictions created after October 8, 1990. However, it is possible that Treasury Regulations might be issued that restrict the use of valuation discounts for family-controlled entities prior to enactment of legislation. Therefore, it is difficult to determine when and to what extent valuation discounts may be curtailed.

Income Tax

The President's budget proposes income tax changes that would take effect beginning in 2011.

The highest individual income tax rate would increase from 35% to 39.6%, and the next highest rate would increase from 33% to 36%.

The rate on long-term capital gains and qualified dividends would increase from 15% to 20% for taxpayers who exceed certain income thresholds ($200,000 for single taxpayers and $250,000 for married couples filing jointly, subject to adjustments for certain deductions and exemptions).

Itemized deductions would be reduced by 3% of the amount by which adjusted gross income exceeds certain income thresholds ($200,000 for single taxpayers and $250,000 for married couples filing jointly, subject to annual adjustments for inflation). Itemized deductions would not be reduced, however, by more than 80%. (These limitations on

itemized deductions were in effect under prior law but were being gradually phased out, with a scheduled repeal in 2010 and reinstatement in 2011.)

Finally, the amount of tax liability that may be offset by itemized deductions would be limited to 28% of the amount of the itemized deductions, even if a taxpayer is subject to a tax rate that is higher than 28% (i.e., the proposed 36% or 39.6% tax brackets). This last proposal has been controversial, particularly with respect to the effect it might have on charitable giving.

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Since the legislative proposals with respect to GRATs and the valuation of family controlled entities, if enacted, could significantly reduce the tax benefits associated with these techniques, clients interested in implementing either of these techniques should contact us.

If you would like to discuss any of these proposals in greater detail, please contact one of the attorneys in our Private Clients and Charitable Organizations Practice Group.

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