
General Explanations
of the
Administration's Fiscal Year 2013
Revenue Proposals



Department of the Treasury
February 2012

MODIFY ESTATE AND GIFT TAX PROVISIONS

RESTORE THE ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PARAMETERS IN EFFECT IN 2009

Current Law

Until the end of 2012, the current estate, generation-skipping transfer, and gift tax rate is 35 percent, and each individual has a lifetime exclusion for all three types of taxes of \$5 million (indexed after 2011 for inflation from 2010). 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 other words, the exclusion is "portable"). However, after 2012, the tax rate and tax brackets, the amount of the exclusion, and the law governing these three types of taxes will revert to the law in effect in 2001, as if the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) had never been enacted. Portability of the exemption between spouses for both gift and estate tax purposes, enacted as part of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRUIRJCA), also will no longer apply.

Prior to the enactment of EGTRRA in 2001, the maximum tax rate was 55 percent, plus a 5-percent surcharge on the amount of the taxable estate between approximately \$10 million and \$17.2 million (designed to recapture the benefit of the lower rate brackets). The exclusion for estate and gift tax purposes was \$675,000 and was scheduled to increase to \$1 million by 2006. Under EGTRRA, beginning in 2002, the top tax rate for all three types of taxes was reduced incrementally until it was 45 percent in 2007. In 2004, the exemption for estate taxes (but not for gift taxes) began to increase incrementally until it was \$3.5 million in 2009, and the generation-skipping transfer (GST) tax exemption and rate became unified with the estate tax exemption and rate. During this post-EGTRRA period through 2009, the gift tax exemption remained \$1 million. Under EGTRRA, for 2010, the estate tax was replaced with carryover basis treatment of bequests, the GST tax was not applicable, and the gift tax remained in effect with a \$1 million exclusion and a 35-percent tax rate. The EGTRRA provisions were scheduled to expire at the end of 2010, meaning that the estate tax and GST tax would be inapplicable for only one year.

In 2010, TRUIRJCA retroactively changed applicable law for 2010 by providing a top estate tax rate of 35 percent for taxpayers electing estate tax rather than carryover-basis treatment. It also retroactively reinstated the GST tax and unified the exemption for estate, GST, and gift taxes beginning in 2011 with a \$5 million total lifetime exclusion for all three taxes (indexed after 2011 for inflation from 2010). The Administration's FY 2013 baseline assumes that the estate tax provisions in effect in 2012 are permanent.

Reasons for Change

TRUIRJCA provided a substantial tax cut to the most affluent taxpayers that we cannot afford to continue. We need a permanent estate tax law that provides certainty to taxpayers, is fair, and raises an appropriate amount of revenue.

Proposal

The proposal would make permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate would be 45 percent and the exclusion amount would be \$3.5 million for estate and GST taxes, and \$1 million for gift taxes. As reflected in the Administration's adjusted baseline projection, the portability of unused estate and gift tax exclusion between spouses would be made permanent.

The proposal would be effective for the estates of decedents dying, and for transfers 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 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 fair market value of the property on the decedent's date of death or the decedent's adjusted basis in that property as increased by the additional basis (if any) allocated to that property by the executor under section 1022.

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. The basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. Consistency requires 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 accurately 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 basis of that property, including any additional basis allocated by the executor, as reported on the Form 8939 that the executor filed. 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 and basis 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 for transfers on or after 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 other 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 transferor’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 and a maximum term of the life expectancy of the annuitant plus ten years. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created 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 that the grantor fails to outlive 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.

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 prevent the avoidance of estate and gift 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 lifetime GST tax exemption (\$5,120,000 in 2012) that can be allocated to transfers made, whether directly or in trust, by that person to a grandchild or other "skip person." 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 (all but about three) states included the common law Rule Against Perpetuities (RAP) or some statutory 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 now either have 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 sited 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 (the exemption at the time of enactment) and a maximum duration limited by the RAP, to trusts funded with \$5,120,000 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).

COORDINATE CERTAIN INCOME AND TRANSFER TAX RULES APPLICABLE TO GRANTOR TRUSTS

Current Law

A grantor trust is a trust, whether revocable or irrevocable, of which an individual is treated as the owner for income tax purposes. For income tax purposes, a grantor trust is taxed as if the grantor or another person owns the trust assets directly, and the deemed owner and the trust are treated as the same person. Thus, transactions between the trust and the deemed owner are ignored. For transfer tax purposes, however, the trust and the deemed owner are separate persons, and under certain circumstances the trust is not included in the deemed owner's gross estate for estate tax purposes at the death of the deemed owner.

Reasons for Change

The lack of coordination between the income and transfer tax rules applicable to a grantor trust creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences.

Proposal

To the extent that the income tax rules treat a grantor of a trust as an owner of the trust, the proposal would (1) include the assets of that trust in the gross estate of that grantor for estate tax purposes, (2) subject to gift tax any distribution from the trust to one or more beneficiaries during the grantor's life, and (3) subject to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the trust for income tax purposes. In addition, the proposal would apply to any non-grantor who is deemed to be an owner of the trust and who engages in a sale, exchange, or comparable transaction with the trust that would have been subject to capital gains tax if the person had not been a deemed owner of the trust. In such a case, the proposal would subject to transfer tax the portion of the trust attributable to the property received by the trust in that transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction. The proposal would reduce the amount subject to transfer tax by the value of any taxable gift made to the trust by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts (GRITs); grantor retained annuity trusts (GRATs); personal residence trusts (PRTs); and qualified personal residence trusts (QPRTs).

The proposal would be effective with regard to trusts created on or after the date of enactment and with regard to any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment. Regulatory authority would be granted, including the ability to create transition relief for certain types of automatic, periodic contributions to existing grantor trusts.

EXTEND THE LIEN ON ESTATE TAX DEFERRALS PROVIDED UNDER SECTION 6166 OF THE INTERNAL REVENUE CODE

Current Law

Section 6166 of the Internal Revenue Code allows the deferral of estate tax on certain closely held business interests for up to fourteen years from the (unextended) due date of the estate tax payment (up to fifteen years and three months from date of death). This provision was enacted to reduce the possibility that the payment of the estate tax liability could force the sale or failure of the business. Section 6324(a)(1) imposes a lien on estate assets generally for the ten-year period immediately following the decedent's death to secure the full payment of the estate tax. Thus, the estate tax lien under section 6324(a)(1) expires approximately five years before the due date of the final payment of the deferred estate tax under section 6166.

Reasons for Change

In many cases, the IRS has had difficulty collecting the deferred estate tax, often because of business failures during that tax deferral period. The IRS sometimes requires either an additional lien or some form of security, but these security interests generally are prohibitively expensive and damaging to the day-to-day conduct and financing of the business. In addition, unless these other security measures are put in place toward the beginning of the deferral period, there is a risk that other creditors could have a higher priority interest than the Government.

Proposal

This proposal would extend the estate tax lien under section 6324(a)(1) throughout the section 6166 deferral period.

The proposal would be effective for the estates of all decedents dying on or after the effective date, as well as for all estates of decedents dying before the date of enactment as to which the section 6324(a)(1) lien has not expired on the effective date.