Roberts & Holland LLP

NEW YORK
(212) 903-8700

WASHINGTON D.C.
(202) 293-3400

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ESTATE & GIFT TAX PLANNING NEWSLETTER

Estate and Gift Planning in 2014 and Beyond

By: Quincy Cotton, Stuart J. Gross and Mark David Rozen

2014 Federal Exemptions and Rates

While Federal estate and gift tax rates have decreased in recent years, they continue to be a significant burden. Under current law, the top marginal rate for the Federal estate and gift tax is 40% (although, because of how the taxes are calculated, the effective estate tax rate is generally significantly higher than the effective gift tax rate). The generation-skipping transfer tax, an extra layer of tax that is imposed, in addition to the estate or gift tax, on transfers that "skip" a generation (e.g. from grandparent to grandchild), is imposed at a flat rate of 40%. However, the amounts that taxpayers are permitted to transfer before these taxes apply - the cumulative exemptions and the annual exclusions - have been increasing.

The unified gift and estate tax exemption and the generation-skipping transfer tax exemption are increased annually by a cost of living adjustment. The annual gift tax exclusion is adjusted as well, but only when the adjustment is $1,000 or more. The exemptions and exclusion amounts for 2014 are as follows:

- Unified estate and gift tax exemption of $5,340,000
- Generation-skipping transfer tax exemption of $5,340,000
- Annual gift tax exclusion of $14,000
- Annual gift tax exclusion to non-citizen spouse of $145,000

If you have used your gift and estate tax exemption in prior years, you may want to "top up" your gifts on an ongoing basis.

New York State Estate and Gift Tax

New York State imposes an estate tax of its own, with a top marginal rate of 16% and an exemption of $1,000,000. The New York estate tax can be claimed as a deduction from the Federal taxable estate, and the top effective combined Federal and New York rate is 49.6%. New York does not impose a gift tax.

Over the years there have been discussions about the impact of the New York estate tax regime -- in particular, its role in driving wealthy New Yorkers to leave New York for states that do not impose an estate tax (such as Florida). The New York State Tax Reform and Fairness Commission established by Governor Cuomo in December 2012 published a report in November 2013 that recommends an increase in the exemption from $1,000,000 to $3,000,000, in light of increases in the value of real property and other assets and changing ideas of what is considered to be substantial wealth. Governor Cuomo's budget bill of January 2014 surpasses that recommendation by proposing to increase the estate tax exemption essentially to conform to the Federal exemption by 2019, although there would be no New York exemption once the taxable estate exceeds 105% of the New York exemption. In addition to increasing the New York exemption amount, the budget bill proposes to decrease the top New York estate tax rate from 16% to 10% by April 2017.

The budget bill also contains a proposed new "add-back" of taxable gifts for New York estate tax purposes. Federal estate tax law requires lifetime gifts (including gifts that were sheltered by the donor's gift tax exclusion amount, currently $5,340,000) to be "added back" to the tax base, which may bump the estate into a higher rate bracket -- in effect the rate that would have applied if the decedent had not made the lifetime gifts. Under current law, the Federal add-back rule does not have much impact, because the lower rate brackets are subsumed by the Federal exclusion amount; a flat 40% rate applies to a taxable estate above the Federal exclusion amount.

Current New York estate tax law does not have an add-back rule. Governor Cuomo's budget bill includes a New York add-back rule, for lifetime gifts made on or after April 1, 2014. If lifetime gifts are added back to the tax base for New York estate tax purposes, one result is that the estate tax rate is higher than without the add-back, because of the bump into a higher bracket. Under the language of the budget bill, a second potentially more material result is that New York estate tax may be imposed on the decedent's lifetime gifts, even though New York does not have a gift tax. The Memorandum in Support of the budget bill expresses the purpose of the add-back rule as closing a "loophole by preventing deathbed gifts from escaping the [New York] estate tax." As drafted, the budget bill has a significantly greater reach, however, effectively imposing a deferred gift tax. We do not think this was intended and we certainly hope that the language will be corrected before the bill becomes law. In any event, gifts prior to April 1, 2014 are *not* added back under the budget proposal, so wealthy New Yorkers who have not previously gifted the maximum amount sheltered by the Federal exclusion amount and who are comfortable making gifts may wish to do so prior to April 1, 2014.

Proposed Changes to New York State Income Taxation of Trusts

Another proposal in Governor Cuomo's budget bill affects the income taxation of certain trusts (sometimes called "INGs") created by New York State residents. These trusts are created largely to avoid state income taxes, without making a completed gift for Federal gift tax purposes. One taxpayer who had created such a trust obtained a Federal private letter ruling in 2013 granting the desired Federal tax consequences (private letter rulings apply only to the taxpayer requesting the ruling, although they indicate the IRS position on issues and are therefore often looked upon as guidance to others seeking the same outcome). For Federal purposes, an income tax is still being paid (by the trust rather than by the trust grantor) and the assets will still be included in the grantor's estate at his death, so the Federal government is not losing those revenue sources. New York State, however, is negatively impacted by such a trust, because New York State income tax is not being paid on the earnings of the trust assets.

The Governor's budget bill, which follows suggestions made by the New York State Tax Reform and Fairness Commission, would cause the income of such a trust to be included in the current income of the grantor for New York State income tax purposes.[1] This change is proposed to be effective immediately and to be applicable to tax years beginning on or after January 1, 2014 (with an exclusion for income earned by trusts that are liquidated on or before June 1, 2014).

[1] In the case of trusts created by non-residents of New York, or trusts created by residents of New York that are otherwise not taxable in New York, Governor Cuomo's budget bill adds a "throwback rule," so that if distributions are made to New York residents in years after those in which the income was earned but not subject to New York income tax, the beneficiary will be taxed on that "accumulated" income. This tax will not apply to income accumulated by the trust (i) prior to the birth of the beneficiary or prior to the beneficiary attaining the age of twenty-one, (ii) prior to tax year 2011, or (iii) prior to the beneficiary first becoming a resident of New York.

Grantor Retained Annuity Trusts

Grantor retained annuity trusts (GRATs) have been in the news recently. You may have read about certain billionaires transferring hundreds of millions (or even billions) of dollars to younger generations while paying little or no gift tax, and wondered, if they can do that, can I? Fortunately, GRATs remain a virtually gift tax-free method of potentially passing on wealth. A GRAT is a trust to which the grantor transfers assets and in which the grantor retains the right to receive an annuity for an initial period of years (with a minimum of two years). The annuity amount may be structured so that the stream of annuity payments has a present value, based on the applicable IRS interest rate (published monthly), approximately equal to the value of the property transferred to the GRAT. The result is a so-called "zeroed-out" GRAT; since the value of the annuity payments equals the value of the property transferred to the GRAT, the value of the remainder interest in the trust (representing the gift) is deemed to have a value of close to zero. If the assets in the GRAT out-perform the applicable IRS rate, however, there will be value remaining after the annuity payments have been made, and no gift tax is imposed when this value passes to the next generation (or a continuing trust for their benefit) after the annuity period ends. The "hurdle" rate for GRATs has been extremely low in recent years – 2.4% for February 2014 -- making GRATs very attractive.

To increase the likelihood of capturing above-market returns without such returns being offset by below-market returns, it often is advantageous to use a two-year GRAT; it is more likely that assets can out-perform the IRS-promulgated rate for two years than for a longer period. Also, as annuity payments are made to the grantor, she can transfer those amounts to a new GRAT. This approach minimizes the adverse estate tax consequences of the donor's death during the annuity period (in addition to taking advantage of shorter-term market swings). For example, if a grantor transfers $10,000,000-worth of stock to a GRAT with a two-year term at a time when the market is low and the relevant interest rate is 2.4%, and the stock appreciates 5% in year 1 and 10% in year 2, there will be approximately $670,000 of value remaining to pass to the next generation gift tax-free. If the GRAT continued for a third year and the market went down 5% in year 3, there would be less than $510,000 remaining at the end of the term. By using the shorter term, an extra $160,000 can pass free of gift tax.

In his last few budget proposals, President Obama has included changes to the rules for GRATs to require a minimum ten-year annuity term and a minimum gift amount. In other words, the grantor's annuity must continue for at least ten years and there must be some amount of value (and therefore some amount of gift, although just how much has not been specified) for the remainder interest, computed at the time the GRAT is created. The longer annuity period puts more pressure on the grantor's life expectancy, since a GRAT's assets are largely included in the grantor's estate if he dies during the annuity period. The longer period also makes it somewhat less likely that the assets of the GRAT will significantly out-perform the IRS rate. The minimum value for the remainder interest increases the transaction cost involved. To date, the proposed rule changes have not gained traction. Thus, the short-term GRAT remains viable, and market volatility together with low IRS rates combine to make this an effective technique for the tax-efficient transfer of wealth to the next generation.

If you would like more information on estate planning generally or any of the specific items discussed herein, please contact any member of our Estate Tax Planning Practice Team.

Our Estate Tax Planning Practice Team

Stuart J. Gross	(212) 903-8723
Mark David Rozen	(212) 903-8743
Quincy Cotton	(212) 903-8739
Lionel Etra	(212) 903-8721
Debra G. Kosakoff	(212) 903-8735
Jessica. G. Weinberg	(212) 903-8750
Sanford H. Goldberg	(212) 903-8745