

February 22, 2011

President Obama's Fiscal Year 2012 Revenue Proposals

Proposals Relating to Individuals and Estate and Gift Taxation

SUMMARY

On February 14, 2011, the Obama Administration (the "Administration") released the General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals (commonly known as the "Green Book"). Although the Green Book does not include proposed statutory language, the Green Book contains significant detail about the fiscal year 2012 revenue proposals. This memorandum discusses key aspects of the Green Book relating to individual, estate and gift taxation that we anticipate may be of interest to our clients. Many of the proposals are similar to the Administration's Fiscal Year 2011 Revenue Proposals (the "2011 Green Book").¹ We are distributing separate memoranda addressing Green Book proposals relating to (1) corporate and partnership taxation, and (2) international taxation, both of which may be obtained by following the instructions at the end of this memorandum.

The Administration prepared and scored (i.e., estimated the impact on revenues of) the Green Book proposals by assuming that (i) the highest individual income tax rate will be 35% through 2012, after which it will rise to 39.6%, (ii) the current zero and 15% tax rates for qualified dividends and net long-term capital gains will be permanently extended for middle-class taxpayers, (iii) for upper-income taxpayers after 2012, the net long-term capital gains rate will rise to 20% and the rates for qualified dividends will return to ordinary income tax rates, and (iv) after 2012, a taxpayer's itemized deductions will again be reduced by 3% of adjusted gross income. The Green Book proposals affecting the U.S. Federal income taxation of individuals include:

- a 20% tax rate for qualified dividend income for upper-income taxpayers beginning in 2013 (in place of the 36% or 39.6% rates that would otherwise apply);

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- limiting the extent to which itemized deductions reduce tax liability by limiting the amount of tax liability that is reduced by itemized deductions to 28% of the value of the itemized deductions, even if the taxpayer has income that is subject to a tax rate higher than 28%;
- making permanent the exclusion of 100% of capital gains from small business stock; and
- providing an exclusion from cancellation of indebtedness income for certain student loan forgiveness.

The Administration also assumed in preparing and scoring the Green Book proposals that the estate tax would apply after 2012 at a rate of 45%, with a \$3.5 million exemption amount (not indexed for inflation). The Green Book proposals, if enacted in their current form, would make the following changes to the U.S. Federal taxation of estates and gifts (effective upon the date of enactment):

- require a minimum term of 10 years for a grantor retained annuity trust (“GRAT”), require that the initial value of the remainder interest in a GRAT be greater than zero, and prohibit any decrease in the stated annuity amount payable during the GRAT term;
- make permanent the portability of a predeceased spouse’s unused gift and estate tax exemption;
- limit the duration of the generation-skipping transfer (“GST”) tax exemption allocated to a particular trust to 90 years;
- limit valuation discounts for estate and gift tax purposes by disregarding certain restrictions in valuing an interest in a family-controlled entity that is transferred from one family member to another; and
- require that the recipient’s basis in property received upon death or by gift be no greater than the then-current value of the property as determined for purposes of the estate tax or gift tax, respectively, and require estates and lifetime donors to report to the recipient of such property and to the Internal Revenue Service information necessary to calculate the basis of the transferred property.

DISCUSSION

A. INCOME AND CAPITAL GAINS TAXATION

1. Special Tax Rates on Capital Gains and Qualified Dividends

Under current law, both gains from the sale of a capital asset held for more than one year (i.e., long-term capital gains) and dividends paid to individual shareholders by domestic and certain foreign corporations (i.e., qualified dividends) are generally taxed at a maximum 15% rate (and for some middle-class taxpayers, zero percent).² The zero and 15% rates are scheduled to expire for taxable years beginning after 2012. Without any change in law, in 2013 the maximum income tax rate on capital gains would generally increase to 20% (18% for assets purchased after December 31, 2000 and held longer than five years) and all dividends would be taxed at ordinary income tax rates.

The Administration assumed in preparing the Green Book that the zero and 15% rates for qualified dividends and net long-term capital gains will be permanently extended for “middle-class taxpayers,” and that, beginning in 2013, long-term capital gains for “upper-income taxpayers” will be taxed at a 20% rate

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(with a reduced 18% rate for gains from assets held over five years).³ The Green Book proposes, beginning in 2013, a 20% rate on qualified dividends received by upper-income taxpayers (i.e., qualified dividends that would otherwise be taxed at a 36% or 39.6% ordinary income tax rate) and a complete repeal of the special 18% rate.

The following chart summarizes this.

Type of Income & Taxpayer	Current Law 2011 and 2012	Green Book's Assumed Baseline After 2012	Green Book Proposals After 2012
Ordinary income maximum rate	35%	39.6%	no change
Capital gain maximum rate	15%	20% (18% for gains from assets held for over 5 years)	20% (no 18% rate)
Qualified dividends maximum rate	15%	39.6%	20%
Middle-class taxpayer capital gains rate	0% or 15%	0% or 15%	no change

2. Itemized Deductions

Taxpayers may claim a standard deduction or instead may elect to claim certain itemized deductions. Itemized deductions include state and local income (or, alternatively, sales) taxes, state and local property taxes, charitable donations, qualified mortgage interest and investment interest expense, among others. Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Bush Reforms"), the amount of itemized deductions available to offset taxable income (other than medical expenses, investment interest expense, theft and casualty losses and gambling losses) was reduced by 3% of the amount by which adjusted gross income exceeded a certain statutory floor that was indexed annually for inflation, but not by more than 80% of the total amount of itemized deductions.⁴ The Bush Reforms phased out this 3% reduction so that by 2010 itemized deductions were available without any reduction,⁵ the 3% reduction was scheduled to become effective again in 2011, but the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("the 2010 Tax Act") extended the non-applicability of this reduction through 2012. The Administration assumed in preparing and scoring the Green Book proposals that the 3% reduction will become effective again after December 31, 2012.

The Green Book proposes that, beginning in 2012, in addition to the reinstated 3% reduction, the amount of tax that may be offset by itemized deductions be capped at 28% of the value of the itemized deductions, even for taxpayers with income subject to tax at a higher rate. For example, for a taxpayer with income subject to the 39.6% rate and \$1,000 of itemized deductions (after applying the 3% reduction), these itemized deductions would reduce total tax liability by \$280 (28% of \$1,000) as opposed

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to the full \$396 (39.6% of \$1,000) reduction that would occur absent this proposal. The 2011 Green Book contained a similar proposal that would have applied for taxable years beginning after December 31, 2010. In addition to reducing the value of itemized deductions generally, this proposal could result in substantially increased taxes for individuals with substantial investment interest expense, as investment income (other than long-term capital gains and qualified dividend income) may be taxed at a 39.6% rate while the related interest expense would be deductible at a maximum 28% rate. The proposal could also reduce the financial incentive for individuals to make charitable contributions.

This provision would be effective for taxable years beginning after December 31, 2011.

3. Elimination of Capital Gains Taxation on Investments in Small Business Stock

The Creating Small Business Jobs Act of 2010⁶ provided that taxpayers other than corporations may exclude 100% of the gain from the sale of qualified small business stock acquired after September 27, 2010 and before January 1, 2011 (subsequently extended to January 1, 2012)⁷ where the stock is held for at least five years and certain other requirements are met.⁸ The Green Book would make the 100% small business stock exclusion permanent for individuals and other non-corporate taxpayers and eliminate the alternative minimum tax preference item for gains excluded under this provision. For this purpose, a “small business” generally means any domestic C corporation if, when the stock is issued, such corporation does not have gross assets exceeding \$50 million (including the proceeds of the newly issued stock). Unlike the 2011 Green Book, the current Green Book specifies that taxpayers would be required to report qualified sales on their tax returns. This proposal would be effective for qualified small business stock acquired after December 31, 2011.

4. Exclusion from Income for Certain Student Loan Forgiveness

Individuals whose debt is forgiven are generally required to recognize cancellation of indebtedness income in the amount of the debt forgiven. Certain exceptions exist for student loan repayment programs, and students participating in these programs are entitled to exclude loan forgiveness income.

The Green Book proposes allowing additional borrowers to exclude forgiven student loan amounts from gross income. Specifically, the proposal would extend the exclusion of loan forgiveness from income to individuals who, after making income-contingent or income-based loan repayments for 25 years under the Federal Direct Loan Program or the Federal Family Education Loan Program, have their remaining loan balance forgiven. The Green Book explains that “these individuals will have had low incomes relative to their debt burden for many years.”

This provision would be effective for taxable years beginning after December 31, 2011.

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B. GIFT AND ESTATE TAXATION

The Administration assumed in preparing the Green Book an estate and gift tax lifetime exclusion amount of \$3.5 million (not indexed for inflation) and a maximum tax rate of 45% for decedents dying after December 31, 2012.⁹

1. GRATs

A grantor retained annuity trust (“GRAT”) allows a donor to transfer appreciation in the value of property over a fixed interest rate (set monthly by the Internal Revenue Service) at a nominal gift tax cost. A GRAT is an irrevocable trust to which the grantor contributes property while retaining the right to receive an annuity back from the trust in cash or in kind at the end of each year. At the end of the GRAT term, any assets remaining in the trust after payment of the annuities pass to the trust's remainder beneficiaries (typically one or more trusts for the benefit of children). When the GRAT is created, the grantor is deemed to make a gift of the remainder interest to the beneficiary. The annuity payments can be fixed, however, such that the value of the GRAT remainder interest at the time of the initial transfer is zero or very close to zero (i.e., a so-called “zeroed-out” GRAT).¹⁰

Selecting the shortest permissible term for a GRAT (currently two years) is generally advantageous for two reasons. First, if the grantor dies during the term of the GRAT, the portion of the trust assets needed to produce the retained annuity are included in the grantor's estate and are subject to estate tax. A shorter term is therefore preferable as it increases the likelihood that the grantor will survive the term of the GRAT. Second, a GRAT succeeds only if there are assets remaining in the trust after payment of the annuities, which is possible only if the assets appreciate at a rate that is higher than the interest rate fixed by the Internal Revenue Service. A series of shorter-term GRATs is therefore preferable to a single long-term GRAT, because the shorter term decreases the likelihood that periods of appreciation in the value of the trust's assets will be offset by subsequent periods of depreciation.

The Green Book proposes a requirement that a GRAT have a minimum term of 10 years, eliminating the benefits of shorter-term GRATs described above. The Green Book also would include a requirement that the remainder interest have a value greater than zero (although presumably such value could be nominal), and would prohibit any decrease in the stated annuity amount payable during the GRAT term.

The 2011 Green Book contained the same proposal. This provision would be effective as of the date of enactment.

2. Estate Tax Portability of Unused Exemption Between Spouses

The 2010 Tax Act included a provision permitting a surviving spouse to apply a deceased spouse's unused estate and gift tax exclusion amount to transfers made by the surviving spouse.¹¹ This so-called portability of the unused exemption is set to expire after December 31, 2012. The Green Book proposes the permanent extension of portability.

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This provision would become available to all estates of decedents dying and gifts made after December 31, 2012.

3. Duration of Generation-Skipping Transfer (GST) Tax Exemption

The GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor.¹² The GST tax is imposed at the highest estate tax rate applicable in the year of transfer, subject to an exemption amount.¹³ When GST exemption is allocated to a transfer to a trust, all income and appreciation from the transferred property is also exempt, and it is possible to avoid the imposition of GST tax for the remaining term of the trust, even if assets are distributed to beneficiaries at lower generational levels than the original beneficiaries.

Under the Green Book proposal, the GST exclusion allocated to a trust would terminate on the 90th anniversary of the creation of the trust. Because contributions to a trust from different grantors are deemed to be held in separate trusts, each such separate share would be subject to the 90-year rule, measured from the date of the first contribution by the relevant grantor. For purposes of this rule, pour-over trusts and trusts created by a decanting power generally will be deemed to have the same date of creation as the initial trust. An exception would apply, however, if prior to the 90th anniversary of the trust, trust property is distributed in further trust for a beneficiary of the initial trust, as long as the further trust is held for the sole benefit of that beneficiary and any assets remaining in the further trust on the beneficiary's death will be included in the beneficiary's gross estate for Federal estate tax purposes.¹⁴

The proposal includes a grant of regulatory authority to facilitate the implementation and administration of this provision. This provision would be effective for trusts created after the date of enactment and to the portion of a pre-existing trust attributable to additions to such trust after such date.

4. Valuation Discounts

Under current law, certain "applicable restrictions" on an interest in a corporation or partnership are disregarded for estate or gift tax purposes in determining the fair market value of interests in a family-controlled entity transferred from one member of the family to another.¹⁵ The term "applicable restrictions" includes certain restrictions on liquidation (in whole or in part) of the entity, where the restriction lapses or may be removed by a member of the donor's family.¹⁶

The Green Book proposes 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 members of the transferor's family. The proposal includes in the category of "disregarded restrictions" (1) certain limitations on a holder's right to liquidate his or her interest in the company, and (2) limitations on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. For purposes of determining whether a restriction may be removed by members of the transferor's family after the transfer, certain

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interests held by charities or others would be deemed to be held by the family. The application of the proposed rule would result in an increase in the estate or gift tax value of certain interests in family-controlled entities.

The proposal, if enacted, would grant regulatory authority, including authority to provide safe harbors from treatment of certain limitations as applicable restrictions or disregarded restrictions. The 2011 Green Book contained a similar proposal. This provision would be effective as of the date of enactment to property subject to restrictions created after October 8, 1990.

5. Basis of Received Property

Under current law, the income tax basis of property received from a decedent generally is equal to the fair market value of that property on the date of the decedent's death.¹⁷ In the case of a lifetime gift, the basis of property in the hands of the recipient generally is equal to its adjusted basis in the hands of the donor immediately prior to the transfer (or fair market value, if lower, for the purposes of determining loss), increased by any gift tax paid as a result of the transfer.¹⁸ For estate and gift tax purposes, property also must be valued at its fair market value on the date of the decedent's death or the date of the gift, as the case may be.¹⁹ Although the standard for valuing transferred property is identical for income, estate and gift tax purposes, there is no rule under current law that the values must be consistent.

The Green Book proposes both a consistency and a reporting requirement. Under the Green Book proposal, the basis of the property in the hands of the recipient may not be greater (subject to any subsequent adjustments) than the value assigned to such property for purposes of the estate or gift tax. The proposal would require the executor of a decedent's estate or the donor of a lifetime gift to provide to both the recipient of such property and the Internal Revenue Service information necessary to determine the basis of the transferred property.

The proposal, if enacted, would grant regulatory authority to provide details about the implementation and administration of the consistency and reporting requirements. The 2011 Green Book contained a similar proposal. This provision would be effective as of the date of enactment.

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ENDNOTES

¹ A further discussion of the 2011 Green Book can be found in the Sullivan & Cromwell LLP publication entitled "Presidential Fiscal Year 2011 Revenue Proposals – President Releases Fiscal Year 2011 Individual, Estate and Gift Taxation Proposals" (February 2, 2010), which may be obtained by following the instructions at the end of this publication.

² See Section 1(h) of the Internal Revenue Code of 1986, as amended (the "Code").

3 The Green Book, like the 2011 Green Book before it, continues to distinguish between what it refers to as middle-class taxpayers and upper-income taxpayers. The Green Book does not, however, give an income threshold over which a taxpayer will be considered an “upper-income taxpayer.” The 2011 Green Book set this threshold at \$250,000 for joint returns and \$200,000 for single taxpayers.

4 Code Section 68(a).

5 Code Section 68(g).

6 Pub. L. No. 111-240.

7 See The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 108-27.

8 See Code Section 1202(c).

9 This requires an assumption that future legislation will prevent the exclusion amount from reverting to \$1 million, as is currently scheduled when the Bush Reforms, as extended by the 2010 Tax Act, expire. Under the 2010 Tax Act, the estate and gift tax lifetime exclusion amount is set at \$5 million for 2011 and \$5 million indexed for inflation for 2012, with a tax rate of 35%.

10 To illustrate how a successful “zeroed-out” GRAT works, assume a grantor transfers \$100 in value of assets to a two-year GRAT and retains the right, under the trust terms, to receive an annuity each year. Using the interest rate mandated by the IRS for February 2011 of 2.8%, each of the two annuity payments would be approximately 53% of the original \$100. Assume further that the trust assets increase in value at a 10% annual rate of return. By the time the trust ends, the trust will have paid out approximately \$106 in annuity payments to the grantor, which is more than the initial value of the trust. However, the trust still will have approximately \$10 of value remaining at the end of its term to distribute to the remainder beneficiaries free of gift and estate tax. Had the initial \$100 not been funded in the GRAT, the \$10 growth on those assets over the hurdle rate would be subject to estate tax in the grantor’s estate rather than passing tax-free to the grantor’s descendants through the GRAT.

11 Code Section 2010(c)(4). In order for a surviving spouse to apply the deceased spouse’s unused exemption amount, the deceased spouse’s executor must make an election on a timely filed estate tax return.

12 The GST tax is intended to backstop the estate and gift tax by limiting the ability to pass assets down multiple generations with only a single layer of estate or gift tax.

13 Under the 2010 Tax Act, the GST exemption is \$5 million for 2011 and 2012 (indexed for inflation in 2012). At the expiration of the 2010 Tax Act without further legislative action, the GST exemption would revert to \$1 million.

14 The stated purpose of this exception is to permit a distribution for an incapacitated beneficiary to continue in trust without incurring GST tax on distributions to the beneficiary.

15 Code Section 2704(b)(1).

16 Code Section 2704(b)(2).

17 Code Section 1014(a).

18 Code Section 1015.

19 *Id.* See also Code Section 1022 applicable to the estates of certain decedents dying during 2010. If a timely election out of the estate tax regime is made, the basis of property acquired from such a decedent is the lesser of the decedent’s adjusted basis in that property and the fair market value of the property on the decedent’s date of death.

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CONTACTING SULLIVAN & CROMWELL LLP

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CONTACTS

New York

James I. Black III	+1-212-558-3948	blackj@sullcrom.com
Charles T. Dowling	+1-212-558-3845	dowlingc@sullcrom.com
Jeffrey D. Hochberg	+1-212-558-3266	hochbergj@sullcrom.com
Andrew S. Mason	+1-212-558-3759	masona@sullcrom.com
Zena M. Tamler	+1-212-558-1675	tamlerz@sullcrom.com
Diana L. Wollman	+1-212-558-4055	wollmand@sullcrom.com
Basil P. Zirinis, III	+1-212-558-3848	zirinisb@sullcrom.com
Aditi Banerjee	+1-212-558-7242	banerjeea@sullcrom.com
Todd I. Pollock	+1-212-558-4771	pollockt@sullcrom.com
John C. Wildt	+1-212-558-7878	wildtj@sullcrom.com

Washington, D.C.

Donald L. Korb	+1-202-956-7675	korbd@sullcrom.com
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London

S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com
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