

February 2, 2010

Presidential Fiscal Year 2011 Revenue Proposals

President Releases Fiscal Year 2011 Individual, Estate and Gift Taxation Proposals

SUMMARY

On February 1, 2010, the Obama Administration (the "Administration") released the General Explanations of the Administration's Fiscal Year 2011 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 2011 budget proposals. This memorandum discusses key aspects of the Green Book that relate to individual, estate and gift taxation, most of which are identical to the Administration's Fiscal Year 2010 Revenue Proposals. We are concurrently distributing separate memoranda addressing Green Book proposals affecting (1) corporate and partnership taxation and (2) international taxation that we anticipate may be of interest to our clients, and which may be obtained by following the instructions at the end of this memorandum.

The proposals, if enacted in their current form, would make several changes to the U.S. federal income taxation of individuals. Specifically, effective for taxable years beginning in 2011, the proposals would:

- increase the highest individual income tax rate from 35% to 39.6%, and the second-highest rate from 33% to 36%;
- increase the tax rate on long-term capital gains and qualified dividends from 15% to 20% for taxpayers with income above \$250,000 (for married couples filing jointly) or \$200,000 (for individual filers) less certain deductions and exemptions;
- limit the extent to which itemized deductions reduce tax liability by (1) reducing itemized deductions by 3% of the amount by which adjusted gross income exceeds \$250,000 (for married couples filing jointly) or \$200,000 (for individual filers), but not by more than 80%, and (2) limiting the amount of tax liability that is reduced by itemized deductions to 28% of the

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value of the itemized deductions, even where the taxpayer has income that is subject to a tax rate that is higher than 28%; and

- reduce the personal exemption by 2% of the exemption amount for each \$2,500 or fraction thereof by which adjusted gross income exceeds \$250,000 (for married couples filing jointly) or \$200,000 (for individual filers).

While reinstating the estate tax is not described as a “proposal,” the Green Book assumes that the estate tax would apply in 2010 and thereafter with a maximum rate of 45% and an exemption for the first \$3,500,000 of the value of an estate. In addition, the Green Book assumes that the maximum gift tax rate will continue at the 2009 rate of 45%. The Green Book also makes proposals which, if enacted in their current form, would make several changes to the U.S. federal taxation of estates and gifts. Specifically, effective upon the date of enactment, the proposals would:

- 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;
- 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 member of a family to another; and
- require that the basis of property received upon death or by gift be no greater than the 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 the information necessary to calculate the basis of the transferred property.

DISCUSSION

A. TAXATION OF INDIVIDUALS

1. Tax Rates on Individual Income

Prior to the Bush Administration’s Economic Growth and Tax Relief Reconciliation Act of 2001 (the “Bush Reforms”), the two highest rates of individual income tax were 39.6% and 36%, respectively. The Bush Reforms phased in reductions of these two rates. Under current law, the highest individual income tax rate for 2010 is 35%,¹ applicable to taxable income above \$373,650. The second-highest rate is 33%,² applicable to taxable income above \$209,520 (for married couples filing jointly) or \$171,750 (for individual filers). These two rates are set to expire after 2010.³

¹ See Section 1(i)(2). Unless otherwise indicated, all references to “Section” in this memorandum are to the Internal Revenue Code of 1986, as amended.

² See *id.*

³ See P.L. 108-27 Sec. 303.

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The Green Book proposes to extend permanently, beginning in 2011, the two highest tax rates of 39.6% and 36%, which were applicable prior to the Bush Reforms. The 36% and 39.6% rates would apply to taxable income above specific thresholds, depending on the taxpayer's filing status.

2. Special Tax Rates on Capital Gains and Qualified Dividends

Under current law, gains from the sale of property held as a capital asset 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 special rate.⁴ Under the Bush Reforms, the rate of taxation applicable to long-term capital gains and qualified dividends is generally 15%. This rate is set to expire at the end of 2010.⁵

The Green Book proposes a 20% tax rate on long-term capital gains and qualified dividends beginning in 2011 for income above a specific threshold, depending on the taxpayer's filing status.

3. Itemized Deductions

Taxpayers may take a standard deduction or may elect instead to itemize their deductions.⁶ Itemized deductions include state and local income or sales tax, state and local property tax, charitable donations and investment interest expense, among others. Before 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.⁷ The amount of such itemized deductions, after applying this reduction, was then available to offset taxable income, beginning with income taxed at the highest tax rate applicable to the taxpayer. The Bush Reforms gradually phased out this deduction limitation, and for 2010 itemized deductions are available in full without any reduction.⁸ Absent a change in law, the rate at which itemized deductions are reduced is set to return for 2011 to the rate applicable prior to the Bush Reforms.

The Green Book proposes two changes to the rules governing itemized deductions. First, the Green Book proposes, beginning in 2011, to apply permanently the 3% rate of reduction to itemized deductions (other than medical expenses, investment interest expense, theft and casualty losses and gambling losses). Under the proposal, such itemized deductions would be reduced by 3% of the amount by which adjusted gross income exceeds a relevant threshold, but not by more than 80%.

⁴ See Section 1(h).

⁵ See P.L. 108-27 Sec. 303.

⁶ See Section 63(e).

⁷ See Section 68.

⁸ See Section 68(g).

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Second, the Green Book proposes that itemized deductions be available to offset income at a rate of only 28%, even for taxpayers with income subject to tax at a rate higher than 28%. For example, a taxpayer with income subject to the proposed 39.6% rate who has \$1,000 of itemized deductions would apply his or her itemized deductions to reduce his or her total tax liability by only \$280 (28% of \$1,000), as opposed to a reduction of \$396 (39.6% of \$1,000) absent this rule change. 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 only a 28% rate. In addition, the proposal may reduce the incentive for individuals to make charitable contributions.

4. Personal Exemptions

Individual taxpayers are generally allowed an exemption for the taxpayer and for each dependent of the taxpayer.⁹ For 2010, the amount deductible per exemption is \$3,650. Before the Bush Reforms, the amount deductible for personal exemptions was reduced by 2% for each \$2,500 (\$1,250 for married couples filing separately) or fraction thereof by which the taxpayer's adjusted gross income exceeded the relevant threshold.¹⁰ The Bush Reforms gradually phased out the reduction in the personal exemption, and for 2010 the personal exemption is available in full.¹¹ After 2010, the reduction is scheduled to return to a rate of 2% for each \$2,500 (\$1,250 for married couples filing separately) or fraction thereof by which the taxpayer's adjusted gross income exceeds the relevant threshold amount, which was the applicable rate prior to the Bush Reforms.¹²

The Green Book proposes to extend permanently, beginning in 2011, the rate applicable prior to the Bush Reforms. Under the proposal, the amount deductible for personal exemptions would be reduced by 2% for each \$2,500 (\$1,250 for married couples filing separately) or fraction thereof by which the taxpayer's adjusted gross income exceeds \$250,000 for married couples filing jointly, or \$200,000 for individual filers. After 2011, the relevant thresholds would be indexed annually for inflation.

⁹ See Section 151.

¹⁰ See Section 151(d)(3).

¹¹ See Section 151(d)(3)(F).

¹² See Section 151(d)(3); P.L. 107-16 Sec. 901.

B. TAXATION OF ESTATES AND GIFTS

1. Estate Tax Continuation

In 2009, the estate tax applied at a maximum rate of 45% on the assets of an estate in excess of \$3,500,000.¹³ The estate tax was repealed entirely effective January 1, 2010 and the gift tax rate for 2010 is 35%. Without Congressional action, however, the estate tax would return in 2011 at a maximum rate of 55% with an exemption for the first \$1,000,000. The gift tax rate also would be 55%.¹⁴ The Green Book does not make a formal proposal regarding the rate of estate tax or the exemption amount. However, the Green Book states that it is “assumed” that the 2009 maximum rate (45%) and exemption amount (\$3,500,000) will be extended.¹⁵

2. GRATs

A 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 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).¹⁶

¹³ See Sections 2001(c)(2) & 2010(c). On February 2, 2010, the Internal Revenue Service issued Notice 2010-19 addressing an ambiguity in the statute that implemented the temporary repeal of the estate tax. Specifically, the Notice clarified that donative transfers to grantor trusts (including GRATs) will continue to be treated as completed gifts if they would have been so treated prior to the temporary repeal of the estate tax on January 1, 2010.

¹⁴ See P.L. 107-16 Sec. 901.

¹⁵ It is anticipated that, early in 2010, Congress will consider transfer tax legislation that would supersede the sunset provision. If enacted, such legislation is likely to be made retroactive to January 1, 2010, assuming such retroactive application withstands constitutional challenge.

¹⁶ 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 2010 of 3.4%, 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 term 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

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Selecting the shortest permissible term for a GRAT (currently 2 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 former 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.

3. Valuation Discounts

Under current law, certain "applicable restrictions" are disregarded for estate or gift tax purposes in determining the fair market value of interests in a family-controlled entity that are transferred from one member of the family to another by gift or at death.¹⁷ 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.¹⁸ The Green Book proposes an additional category of restrictions (to be called "disregarded restrictions") that would be disregarded in determining the value of such interests. The application of the proposed rule would result in an increase in estate or gift tax value of certain interests in family-controlled entities.

The proposal would include 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, in each case, if the limitation may lapse or be removed by a member of the family. The proposal, if enacted, would grant regulatory authority to provide a safe harbor pursuant to which taxpayers could draft the governing documents of a family-controlled entity so as to avoid creating interests that are subject to "applicable restrictions" or "disregarded restrictions," if certain standards are met.

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tax in the grantor's estate rather than having passed tax-free to the grantor's descendants through the GRAT.

¹⁷ See Section 2704(b)(1).

¹⁸ See Section 2704(b)(2).

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4. Basis of Received Property

Under current law, the income tax basis of property received from a decedent is generally equal to the fair market value of that property on the date of the decedent's death.¹⁹ Property included in the estate of the decedent generally must be valued for estate tax purposes at its fair market value on the date of the decedent's death.²⁰ The basis of a lifetime gift in the hands of the recipient is generally equal to its adjusted basis in the hands of the donor immediately prior to the transfer (or fair market value, if lower, for purposes of determining loss), increased by any gift tax paid as a result of the transfer.²¹ Although the valuation standard for income, estate and gift tax purposes is identical, there is no rule under current law that the values must be consistent.

The Green Book proposes a consistency requirement. Under the new rule, the basis in the hands of a recipient of property received from a decedent or a donor may not be greater than the value assigned to such property for purposes of the estate or gift tax (subject to subsequent adjustments).²² The proposal would require the executor of a decedent's estate or donor of a lifetime gift to provide to the recipient of such property and to the Internal Revenue Service the information with respect to value that is necessary to determine the basis of the transferred property.

EFFECTIVE DATES

Each of the proposals related to individual income tax described above in Section A would become effective for taxable years beginning on January 1, 2011, if enacted. Each of the proposals related to estate or gift tax described above in Section B would become effective upon enactment. The proposal related to valuation discount described above in Section B.3 would apply to transfers on or after the date of enactment of property subject to restrictions created after October 8, 1990.

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¹⁹ See Section 1014(a).

²⁰ See Section 2031(a).

²¹ See Section 1015.

²² Although not entirely clear, presumably the proposal would apply to property received by gift only if the property is later sold at a loss. If, instead, the property is later sold at a gain, it seems the current rule would still apply and, accordingly, the property's basis would equal its adjusted basis in the hands of the donor immediately prior to the transfer (increased by any gift tax paid as a result of the transfer) even if that amount is greater than the value assigned to such property for purposes of the gift tax.

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