Estate Planning in the Shadow of the One-Year "Repeal" of Estate and GST Tax in 2010

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I. WILL THE ESTATE AND GST TAX BE REENACTED IN 2010; WILL IT BE RETROACTIVE TO JANUARY 1?

A. Legislation During 2010? The House of Representatives passed H.R. 4154 to permanently extend the 2009 system ($3.5 million exemption, 45% rate) on December 3, 2009. The permanent extension passed the House without a single Republican vote — the Republicans are holding out for a larger exemption and lower rates; one proposal is for a $5 million exemption and a 35% rate.

The Senate failed to act before the end of the year. A number of senators oppose the permanent extension, hoping to get more favorable provisions (such as a $5 million exemption with a 35% top rate). When it became apparent that the Senate would not approve the permanent extension of the 2009 system, Finance Committee Chairman Baucus asked for unanimous consent to vote on extending the 2009 law for two months (by passing H.R. 4154 with the two month extension amendment). Senator Mitch McConnell (R-Ky), in turn, requested that the Senate be able to consider an amendment for a $5 million exemption, 35% rate system with portability. Therefore, there was no action.

Congressional staff members of the House Ways and Means and Senate Finance Committees confirmed on December 31, 2009 that a joint letter stating how the Committee members intend to address the estate tax in 2010 (such an agreed joint letter of intent is sometimes released when tax provisions expire at the end of a year) will not be issued because of the absence of any agreement on what approach to take.

At this point, there is "all this massive confusion, this chaos," in the words of Senate Finance Committee Chairman, Max Baucus. Some Republicans and conservative Democrats view the one-year repeal as creating leverage to insist on larger exemptions and lower rates (such as the $5 million exemption, 35% rate proposal). If the estate and generation-skipping transfer ("GST") taxes are repealed for a full year, their view is that returning to a $1 million exemption, 55% rate system would be viewed as a massive increase of the unpopular estate tax that would be politically unfathomable for all. However, some Democrats will view the situation as giving them leverage since 60 votes in the Senate will be required to avoid returning to a $1 million exemption, 55% rate system (unless the estate and gift tax package is adopted as part of a Budget Reconciliation Act in which event only 51 votes in the Senate are needed). Key lawmakers expect the fight over the estate tax to intensify this year when the tax is gone, particularly since this is an election year (and in light of the Massachusetts election electing a Republican senator). Furthermore, the carryover basis system will be extremely complex to administer and will be unpopular as well.

The wide differences in opinion as to the structure of future estate and gift tax legislation are reflected in some of the bills that have been introduced in 2009. These include:

H.R. 3905 – Proposal for $5.0 million exemption (indexed after 2019) and 35% rate. The exemption increase and rate decrease is phased in over 10 years through 2019. The state death tax deduction is phased out over the same period. The bill has bipartisan support.

"Lincoln-Kyl Amendment" to 2009 Budget – Room in the budget for $5 million estate tax exemption, indexed for inflation, and 35% rate, with unification of the gift tax and portability of the estate exemption between spouses. This amendment passed the Senate 51-48, but it applied only if the "legislation would not increase the deficit" over a five or ten year period.

S. 2784 - $3.5 million indexed estate and GST exemption; unification of the gift and estate tax exemptions; 45% rate; and portability of the estate and gift exemptions. (Introduced November 17, 2009; almost identical to the transfer tax provisions of S. 722 introduced in March 2009 by Senators Baucus, Rockefeller and Schumer.)

Many believe that at some point, Congress will act on the estate and GST tax in 2010, but there is certainly the significant possibility that 60 Senators will never be able to agree on a single approach, and that 2010 will pass without further legislation. (As noted above, only 51 votes would be required to pass the legislation if it is included as part of a Budget Reconciliation Act. However, the "Byrd rule" could be invoked if it impacted the budget beyond a ten-year window, in which 60 votes would be required; therefore "permanent" adoption of a transfer tax system that would have decreased revenues as compared to the pre-2001 system may require 60 votes even in a Reconciliation Act.)

The PAYGO legislative adjustments adopted this year by Congress (H.J. Res. 45) includes a two-year exception (through 2011) for extending the 2009 estate and gift tax system. The House version had included an exception for *permanent* extension of the 2009 system.

One of the interesting effects of the current situation is that there may be many mid-wealth estates that are worse off in 2010 than in 2009. Estates under $3.5 million were covered by the estate tax exemption, but there may be many estates under $3.5 million that have more than $1.3 million of appreciation in the estate that will be subject to carryover basis for the appreciation in excess of $1.3 million (but for married individuals, there is also a separate $3.0 million spousal basis adjustment). Some have estimated that the estate tax would impact 6,000 estates, but carryover basis could affect 60,000-70,000 decedents in 2010.

Furthermore, bear in mind that the Administration's Budget Proposal includes various legislative proposals, including restrictions on valuation discounts (by revisions to §2704) and a required minimum 10-year term for GRATs. The 10-year minimum terms for GRATs proposal has found its way into H.R. 4849, "Small Business and Infrastructure Jobs Tax Act of 2010", passed by the House on March 24, 2010; the last section deals with GRATs and imposes a ten-year minimum term, stipulates that frontloading is not permitted (the annuity payments cannot decrease during the first ten years) and requiring that the remainder value must have a value greater than zero, with an effective date being for transfers made after the date of enactment. Footnote 173 of the House Report gives this explanation for the "greater than zero" provision and the prohibition on frontloading the annuity payments: "The proposal also requires that the remainder interest of a GRAT have a term greater than zero and prohibits a reduction in the annuity during the GRAT term. These requirements are designed to prohibit circumvention of the ten-year minimum term requirement of the proposal."

Other estate tax reform proposals have been suggested during the last several years, including the possibility of portability of the estate and gift tax exemptions between spouses and the possibility of unification of the gift tax exemption with the estate and GST tax exemptions. It is conceivable that legislative discussions may include some of those reform measures as well, but it is likely that those other measures would be considered as part of a broader tax measure later during the year. (It is likely that Congress will want to deal with the "Bush tax cuts" (in the 2001 Tax Act) after the mid-term elections in November, and Congress may wait to address the estate tax until then.)

B. Legislation Retroactive to January 1, 2010? There have been varying indications as to whether legislation would be retroactive to January 1, 2010. Retroactivity could be viewed as very unfair to people who have died in the interim (and even more unfair for people who make gifts thinking they are subject to a 35% gift tax rather than a 45% or even higher gift tax) and could be politically difficult to get through Congress in an election year. The longer it takes to pass legislation, the more likely it is that the legislation will not be retroactive.

John Buckley, Chief Tax Counsel to the House Ways and Means Committee, has expressed his opinion that reinstituting the estate and GST taxes retroactive to January 1, 2010 would be unconstitutional. While there have been a handful of cases (including U.S. Supreme Court cases) that have upheld the constitutionality of retroactive changes to the transfer tax system, those cases have generally involved retroactive tax rate increases. Supreme Court cases have upheld the validity of retroactive tax legislation, but none has involved a specific rule that has been in the law a long time (such as GRATs, the definition of fair market value, etc.). U.S. v. Hemme, S. Ct. 2071 (1985) upheld the retroactive application of what is now § 2010(b). In addition, U.S. v. Carlton, 512 U.S. 26 (1994) upheld the validity of retroactive legislation regarding an estate tax deduction that was allowed at one time under one of the various provisions of § 2057 for the sale of stock to ESOPs (adding that the stock had to be owned by the decedent at the date of death). Some experts believe that it will be more difficult to uphold the constitutionality of instituting an estate tax and GST tax system retroactively when no system exists, as opposed to just increasing rates retroactively. However, that is far from clear, and many experts think that a retroactive reenactment of the estate and GST tax effective January 1 would be constitutional. By analogy, the Supreme Court refused to uphold the retroactive effect of the gift tax, when it was instituted in 1924. Untermyer v. Anderson, 276 U.S. 440 (1928). The Supreme Court in U.S. v. Hemme summarized the Untermyer analysis:

> "In Untermyer, this Court construed the Revenue Act of 1924, which was signed on June 2 of that year and imposed a gift tax on gifts made during the entire calendar year 1924. The Court concluded that, 'so far as applicable to bona fide gifts not made in anticipation of death and fully consummated prior to June 2, 1924, those provisions are arbitrary and invalid under the due process clause of the Fifth Amendment.' Id., at 445. The principal objection to the statute was the absence of notice; the Court endorsed the conclusion, ibid., reached in Blodgett v. Holden, 275 U.S. 142, 147 (1927), where a plurality had found it 'wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing.'… Moreover, Untermyer involved the levy of the first gift tax; its authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws, rather than the creation of a wholly new tax."

Later, in U.S. v. Carlton, the Supreme Court emphasized the very strict scrutiny that is applied to any constitutional review of retroactive tax legislation:

> "In holding the 1987 amendment unconstitutional, the Court of Appeals relied on this Court's decisions in Nichols v. Coolidge, 274 U.S. 531 (1927), Blodgett v. Holden, 275 U.S. 142 (1927), and Untermyer v. Anderson, 276 U.S. 440 (1928). Those cases were decided during an era characterized by exacting review of economic legislation under an approach that "has long since been discarded."

> Ferguson v. Skrupa, 372 U.S. 726, 730 (1963). To the extent that their authority survives, they do not control here. Blodgett and Untermyer, which involved the Nation's first gift tax, essentially have been limited to situations involving "the creation of a wholly new tax," and their "authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws." United States v. Hemme, 476 U.S., at 568. Nichols involved a novel development in the estate tax which embraced a transfer that occurred 12 years earlier. The amendment at issue here certainly is not properly characterized as a "wholly new tax," and its period of retroactive effect is limited."

The gift tax was a brand new concept in the 1920's not only in the U.S. but also in Europe. Prior to that, only gifts in contemplation of death were taxed. So when the Court referred to a "new tax" in those opinions, it really meant a "new tax." The estate tax and GST tax may not be viewed as a "new tax" if reenacted. (If the GST tax were "new," how could it apply to trusts that were established between Sept. 1985 and Dec 2009, without it being considered retroactive?) Furthermore, tax legislation is not infrequently made effective as of the date that legislative proposal came out of the House Ways and Means Committee. Keep in mind that the House of Representatives passed a provision for a permanent extension of the 2009 estate, gift and GST tax system, and a reference to a January 1, 2010 date would seem to be consistent with that approach in light of the House activity.

Another possible issue is whether a retroactive increase in the gift tax from 35% to 45% (or even higher) is constitutional. Relying on <u>Carlton</u>, courts have upheld the constitutionality of retroactive gift and estate tax rate increases. <u>Quarty v. United States</u>, 83 AFTR2d ¶ 99-597 (9th Cir. 1999)(increase in gift and estate tax rates from 50% to 53% and 55% in OBRA, signed on August 10, 1993, retroactive to January 1, 1993, was constitutional where the decedent died on January 12, 1993 having made taxable gifts earlier in that year).

Another possibility is that the estate and GST tax system will not be reenacted retroactively, but carryover basis would be eliminated retroactively. If the estate and GST taxes are reenacted retroactively to January 1, no doubt there will be numerous lawsuits over the constitutionality of the provision, which probably will ultimately be resolved by the U.S. Supreme Court after years of litigation in the lower courts. (The <u>Carlton</u> case took seven years to get a Supreme Court resolution of the retroactive issue in that case.)

Whether retroactive legislation would ultimately be held constitutional is not the point. The real point is that it would take six, seven or eight years of uncertainty before we have an answer. That's the political cost of retroactivity.

There would seem to be very little risk of retroactive legislation in 2011 that would be retroactive back into 2010. (Republicans will likely be even more powerful next year. They will not say "we delivered on repealing the estate tax, but now we are reinstating it retroactively.")

An approach that has been discussed in formal discussions with some legislatives staffers is to continue the 2009 system retroactively, right to elect which regime (estate tax or modified carryover basis) would apply. A similar election would likely not be extended to persons who make gifts before the legislation is passed.

II. OVERVIEW OF LAW IN 2010 IN LIGHT OF ONE-YEAR "REPEAL" OF ESTATE AND GST TAX.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") included provisions for increasing the estate and GST "exemptions" in steps to $3.5 million in 2009, and then provides a one year repeal of the estate and generation-skipping transfer tax with carryover basis.

A. Estate and GST Tax. There is commonplace discussion of the estate and GST taxes being "repealed" in 2010. However, § 2210 (added by the 2001 Tax Act) of the Internal Revenue Code says that chapter 11 (the estate tax) "shall not apply to the estates of decedents dying after December 31, 2009" except as provided otherwise in § 2210 (b) regarding qualified domestic trusts (discussed below). Section 2664 (also added by the 2001 Tax Act) similarly provides that chapter 13 (the GST tax) "shall not apply to generation-skipping transfers after December 31, 2009." Accordingly, all of chapters 12 and 13 remain in the Code, but are not applicable to transfers after December 31, 2009.

B. Gift Tax. The gift tax will continue in 2010, but at a 35% top rate rather than the current 45% top rate. (Section 511(d) of the 2001 Tax Act is entitled "Maximum Gift Tax Rate Reduced to Maximum Individual Rate After 2009," but the body of the statutory provision just refers to a 35% top bracket.) The 35% rate applies to gifts over $500,000, effectively meaning that there is a flat 35% tax once the aggregate gifts exceed the gift tax applicable exclusion amount of $1.0 million. Reasons quoted for keeping the gift tax system intact are (1) to provide a backstop against income tax abuse through transfers to relatives with lower income tax brackets, and (2) to provide a barrier to wholesale transfers in 2010 before the re-emergence of the estate and GST tax system in 2011 under the sunset provision. One significant change to the gift tax in 2010 is to add § 2511(c), discussed immediately below.

C. Section 2511(c) Regarding Transfers to Non-Grantor Trusts. Section 2511(c) applies to gifts after December 31, 2009. It provides that except as provided in regulations, a transfer in trust is treated as a transfer by gift unless the trust is a wholly owned grantor trust as to the donor or the donor's spouse. This is a rather strange provision. Apparently, the purpose is to prevent an individual from making an "incomplete gift" to a non-grantor trust that avoids gift taxes but still takes advantage of the trust's lower income tax brackets. However, some planners have wondered whether that section could conceivably be interpreted to mean that transfers to the donor's wholly grantor trust will not be treated as gifts even though they otherwise would be treated as gifts under traditional principles. Could the transfer avoid gift taxation as well as avoid estate inclusion if none of the estate tax inclusion sections are triggered? Obviously, this section will need a great deal of clarification by regulations (hopefully, sooner rather than later). (This provision is discussed in Section IV of this outline, below.)

D. Carryover Basis. For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2). (Observe, that while no step-UP in basis is allowed, the basis of property can be stepped-DOWN.) The Conference Report refers to this as the "modified carryover basis regime." Determining the decedent's carryover basis may be a formidable task for many assets. There are two exceptions from the carryover basis provisions: (1) The executor can allocate up to $1.3 million (increased by certain unused losses and loss carryovers) to increase the basis of assets; and (2) the executor can also allocate up to $3.0 million to increase the basis of assets passing to a surviving spouse, either outright or in a QTIP trust. This is an increased basis of $1.3 and $3.0 million, not assets having a value of $1.3 or $3.0 million, so the allocation process may get complicated. There may be many estates impacted by the carryover basis provisions that did not have to file estate tax returns with a $3.5 million estate tax exemption. (House officials have estimated that an extension of the estate tax [with a $3.5 million exemption, 45% rate] would have impacted 6,000 estates, but the new carryover basis provisions will affect more than 70,000.) As an example, for highly appreciated estates where there is not a surviving spouse to take advantage of the $3.0 million basis increase, an estate valued at well below the $3.5 million 2009 estate tax exemption level may be subject to carryover basis on some of the estate assets if unrealized appreciation in the estate assets exceeds $1.3 million.

E. Continuing Effects for Certain QDOT and Recapture Provisions. Persons who are subject to various "recapture" provisions are not off the hook in 2010. For example, the QDOT tax (with respect to a qualified domestic trust created to obtain a marital deduction for amounts passing to a noncitizen spouse) on distributions continues for 10 years after the estate tax is repealed, but the QDOT tax that applies at the surviving spouse's subsequent death does not apply if the surviving spouse dies after 2009. Also, the recapture provisions for special use valuation, QFOBI deductions, § 6166 installments, and qualified conservation easements continue to apply in 2010. (These provisions are discussed in more detail in Section VIII of this outline, below.)

III. OVERVIEW OF CHANGES IN 2011 IN LIGHT OF 2011 SUNSET PROVISION.

Under the Senate version of the 2001 Tax Act (and eventually the 2001 Tax Act), all of the provisions of the 2001 Tax Act sunset effective January 1, 2011. Section 901 of the 2001 Tax Act provides as follows:

Section 901 Sunset of Provisions of Act.

a. IN GENERAL. All provisions of, and amendments made by, this Act shall not apply — (1) To taxable, plan or limitation years beginning after December 31, 2010, or (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

b. APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986… shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted."

Therefore, for decedents dying, gifts made, or generation skipping transfers after 2010, "[t]he Internal Revenue Code of 1986… shall be applied and administered … as if the provisions and amendments [of the Act] had never been enacted." The Senate version included Section 901(a) but not 901(b). There is no discussion in the Conference Report of the reasons for adding the "had never been enacted" provision in Section 901(b).

The "bottom line" is that all of the provisions in the 2001 Tax Act sunset on January 1, 2011. Steve Leimberg aptly summarizes this result by observing that the military would simply say "AS YOU WERE." In 2001, planners assumed (incorrectly) that the sunset provision assured that there would be future tax legislation in the upcoming years that would, among other things, address the estate tax provisions.

A. Purpose of Sunset Provisions. The purpose of including the sunset provision was to avoid a 60% Senate vote requirement in the Senate. The 2001 Tax Act was part of a "budget reconciliation" authorized by the Congressional Budget Act of 1974, which provides that a budget reconciliation process may occur only once a year, and that legislation under a budget reconciliation procedure is not subject to filibuster in the Senate (which may be broken only by a vote of 60 Senators.) The Congressional Budget Act of 1974 was amended in 1990 to provide what is now called the Byrd Rule (named after the amendment's author, Senator Byrd of West Virginia). The Byrd Rule makes out of order inclusion of any items that are "extraneous" to budget resolution. This would include increases in deficits beyond the fiscal years covered by the reconciliation and decreases in revenue beyond the scope of the budget resolution. Because the budget reconciliation covers up to ten years, it is "extraneous," and out of order, to reduce taxes beyond the ten-year budget window. The Byrd rule can be waived only by a majority vote of 60 Senators. See generally Aucutt, Still Debating the Prospects for Estate Tax Repeal, 28 EST. PLAN. 383 (August 2001). Senate leaders believed that the Act would not be supported by 60 Senators. Based on the history of Senators voting on estate tax repeal in the prior legislative session, it appeared that 60 Senators would not vote for total estate tax repeal. Eventually 62 Senators voted for the 2001 Tax Act — with the sunset provision included.

B. Estate, Gift and GST Tax Impact. Following sunset, all rates in effect in 2001, including the 5% surtax, will apply. The applicable exclusion amount will be $1 million (as scheduled beginning in 2006 under the pre-2001 Tax Act law) for both estate and gift taxes. The GST exemption will be $1 million indexed for inflation since 1997.

C. Carryover Basis Impact. The carryover basis provisions would expire and there would be a step-up in basis at death. Applying the sunset provisions literally as to the carryover basis provisions means that the carryover basis rules are just a concern for recipients of persons who die in 2010 and perhaps only for those recipients who dispose of the received property in 2010. However, the carryover basis rules probably will continue to apply even after 2010 to property received from decedents who die in 2010. See Blattmachr, Gans, Zaritsky & Zeydel, The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010, 112 J. TAX'N (February 2010)("Section 1022 should, under this reading, remain applicable even if the asset is sold in 2011"). (The carryover basis provisions are discussed in more detail in Sections V-VII of this outline, and carryover basis planning strategies are discussed in Section XVII of this outline, below.)

D. Elimination of Other Changes in 2001 Tax Act. Various other changes made in the 2001 Tax Act would also be eliminated when the estate tax returns in 2011. These include changing the deduction for state death taxes back to a credit, eliminating the conservation easement exclusion under § 2031(c), restoring the QFOBI deduction under § 2057, eliminating the changes to § 6166 regarding installment payments of estate taxes with respect to closely held businesses (for example, the owner requirement to be "closely held" would revert to 15 instead of 45), and eliminating the very helpful provisions regarding the qualified severance rules for GST tax purposes. (Some of these provisions are discussed below.)

E. Uncertain Effect of "Had Never Been Enacted" Provision. Read literally, Section 901(b) of the 2001 Tax Act raises a host of surprising results. The uncertainty revolves around two possible ways of interpreting that provision. (1) Does the phrase mean that after 2010, we assume that the 2001 Tax Act provisions were never in effect in 2001-2010? (2) Alternatively, does it mean that going forward from January 1, 2011, we apply the Code to future transactions as if everything added in the 2001 Tax Act were not there. (No one believes that it would applied to mean that events that happened in 2001-2010 would retroactively be treated as taxable events; for example, a person dying in 2010 would not, as of January 1, 2011, have to pay an estate tax even if the estate tax return for his or her estate would have been due in 2011 if the estate tax had applied in 2010, or a person who made a gift in 2010 that was a direct skip for GST purposes would not have to pay a GST tax on that direct skip in 2011.)

Emphasis on the Byrd rule as the reason for Section 901(b) would suggest applying the first approach. However, there are also strong reasons for applying the second approach.

"It may be reasonable to construe section 901(b) [the "had never been enacted provision"] as simply reinforcing the meaning of section 901(a)." See Blattmachr, Gans, Zaritsky & Zeydel, The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010, 112 J. TAX'N (February 2010).

As an example of the differences between these two possible approaches, consider the creation and funding of a trust in 2008 to which GST exemption was automatically allocated under the automatic allocation rules in the 2001 Tax Act. Will the trust be treated in 2011 as if there had been no GST exemption allocation to the trust (under the first interpretation, where we assume the 2001 Tax Act provisions were never in effect in 2001-2010, so there could be no automatic allocation)? Or does the "had never been enacted" provision mean only that the GST exemption automatic allocation rules will not apply to *future* transfers to the trust (under the second interpretation)? Other examples of uncertainties created by the "had never been enacted" provision include:

- If a decedent dies in 2010, while the carryover basis rules of §1022 apply, and if a beneficiary sells an appreciated asset received from the decedent in 2012, is the beneficiary's basis stepped up basis to the date of death value in 2010 (i.e., do the carryover basis rules apply only if the decedent dies and the recipient sells the asset in 2010)? If the 2001 Tax Act had never been enacted, the beneficiary's basis would have been a stepped up basis under §1014.
- If a $3.5 million gift was made to a trust in 2009 and $3.5 million worth of GST exemption was allocated to the trust, and if there is a taxable distribution in 2011, is the inclusion ratio no longer zero, because the available GST exemption in 2009 as if the 2001 Tax Act "had never been enacted" would only be $1.0 million indexed after 1997?
- If a trust was created in 1990, but GST exemption was not allocated until 2008 under a "9100 relief" ruling (as allowed in the 2001 Tax Act), is that allocation of GST exemption (based on the date of gift value) still effective?
- If trusts were severed in 2008 under the qualified severance rules, when a taxable distribution occurs in 2011 from the "GST-exempt" severed trust, will the distribution be treated as having been made from the combined trust, which is only partially GST exempt? Or does the "had never been enacted" provision merely mean that there could be no further qualified severances after 2010?

IV. TRANSFERS TO TRUSTS BEGINNING IN 2010 ARE GIFTS EXCEPT FOR TRANSFERS TO GRANTOR TRUSTS

A. General Rule. Section 2511(c) treats transfers in trust after December 31, 2009 as taxable gifts unless the trust is treated as wholly owned by the donor or the donor's spouse under §§ 671-679 of the Code. The purpose of this change is to prevent transfers from shifting the income tax brackets applicable to investment income from the donor's bracket to the bracket of the trust or trust beneficiaries without subjecting the transferred property to gift tax. Prior to 2010, this apparently could be accomplished by transferring property to a non-grantor trust with the donor retaining sufficient control to make the gift incomplete for gift tax purposes but not for purposes of the grantor trust rules. Perhaps the primary (though not intended) impact of this provision is to suspend use of the planning strategy of creating "Defective Intentional Non-Grantor Trusts" (or "DING Trusts") that may avoid state income taxes on trust income or permit a stepped up basis for assets purchased from a donor. [1] Transfers to such trusts will be treated as taxable gifts for federal gift tax purposes if made in 2010.

B. Converse; Are Gifts to Grantor Trusts Automatically Incomplete Gifts? The statute says that gifts to non-grantor trusts are treated as completed gifts; it does not say that gifts to grantor trusts are treated as incomplete gifts, and that certainly does not seem to be the intent of the statute. The issue is of theoretical concern; some planners have raised the question of whether donor's gifts to grantor trusts in 2010 will be treated as completed gifts. The issue has been brought to the attention of the IRS. IRS representatives have said that the IRS will attempt to give guidance as soon as possible. Section 2511(c) itself says that it applies "except as provided in regulations," and it seems clear that the IRS will not want to take the position that gifts to grantor trusts are incomplete gifts. This would leave open the possibility that the assets would not be subject to gift tax at the time of the transfer and would not be subject to estate inclusion at the donor's death if none of the "string statutes" apply or at a later time during the donor's life when the trust became a non-grantor trust. (The client's death should not result in the completion of the gift for gift tax purposes. See Estate of DiMarco v. Comm'r, 87 T.C. 653 (1986) ("transfers of property do not become complete for gift tax purposes by reason of the death of the donor"); Treas. Reg. § 25.2511-2(f).)

C. Legislative Intent. The little legislative history that exists for this provision indicates that the purpose is to prevent taxpayers from using multiple non-grantor trusts to shift income for income tax purposes without having to make taxable gifts. The Official Explanation to the 2002 Technical Corrections Act provides as follows:

> *"Transfers in trust. — The provision clarifies that the effect of section 511(e) of the Act (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. sec. 25.2511-2(c)."*

D. IRS Guidance. On February 2, 2010, the IRS issued Notice 2010-19 indicating that the IRS intends to issue guidance regarding §2511(c). The Notice clarifies that gifts to wholly grantor trusts will be governed by the normal gift tax rules under chapter 12:

> "The provisions of Chapter 12 as in effect on December 31, 2009, continue to apply (both before and during 2010) to all transfers made to any [wholly grantor trust] to determine whether the transfer is subject to gift tax."

E. Application to Charitable Remainder Trusts. A charitable remainder trust cannot be a grantor trust, so §2511(c) literally appears to apply to charitable remainder trusts. Section 2511(c) literally may be interpreted to require that the full amount contributed to a charitable remainder trust, except for the value of the charity's remainder interest, would be treated as a taxable gift, including (i) the donor's retained annuity or unitrust interest

[1] [insert citation to NYSBA report]

and (ii) the interest of any successor noncharitable annuity or unitrust beneficiary (even though the donor has reserved the right to revoke the successor beneficiary's interest). Caution should be exercised in creating any charitable remainder trust in 2010 until this issue is clarified by the IRS.

F. <u>Cannot Just Use Testamentary Power of Appointment to Make Gift Incomplete, Because May Not be a Wholly Grantor Trust</u>. Query, how can a transfer be made to a trust, with a retained power in the grantor to avoid having a complete gift, without making the trust a grantor trust as to the grantor in its entirety? One way is to create an irrevocable trust for beneficiaries other than the grantor, but have the grantor retain a <u>testamentary</u> power of appointment to change the trust terms. Section 674(b)(3) provides an exception from the grantor trust rules for <u>testamentary</u> powers of appointment. However, that exception does not apply to the extent that the power can be exercised over income that is accumulated without the consent of an adverse party. Even in that situation, however, the grantor is treated as the owner of only the income of the trust. Therefore, the trust would not be treated as <u>wholly</u> owned by the grantor under the grantor trust rules, so § 2511(c) would treat the transfer to the trust as a completed gift.

G. <u>Availability of Annual Exclusions for Trust Transfers</u>. Literally, this statue might be construed to remove gift tax exclusions available under § 2503 (such as the annual exclusion) for gifts to non-grantor trusts. Apparently, this was not intended, and IRS guidance or regulations will likely clarify this result. This possible uncertainty makes even more important drafting a Crummey trust to give a donor the right to direct that any particular gift is not subject to withdrawal rights. In the unlikely event that the legislation eventually is interpreted to disallow annual exclusions, a donor could direct that gifts in 2010 and afterward would not be subject to withdrawal rights, to avoid the risk that a beneficiary would exercise the withdrawal right if the withdrawal right does not allow an annual exclusion. (This flexibility for Crummey trusts is helpful in any event.)

V. CARRYOVER BASIS

A. <u>General Rule — No Stepped Up Basis</u>. Under the law prior to 2010, assets received from a decedent generally received a basis equal to the fair market value of the property at the date of death of the decedent. I.R.C. § 1014. The general purpose of the stepped-basis rule is to avoid double taxation, subjecting the same property to both estate taxation and income taxation when the asset is sold after the decedent's death. The stepped-up basis rule avoids the capital gains tax on the sale, up to the gain in the asset at the date of death. With the "repeal" of the estate tax, there is no need for the stepped-up basis to avoid the double taxation. (As a more practical matter, coupling carryover basis with the repeal of the estate tax is necessary for fiscal reasons, to offset some of the revenue loss due to the estate tax repeal.) For decedents dying after December 31, 2009, § 1014 will not apply, and the stepped-up basis under § 1014 is no longer allowed. I.R.C. § 1014(f). For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the <u>lesser</u> of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2). (Observe, that while no step-UP in basis is allowed, the basis of property can be stepped-DOWN.) The Conference Report refers to this as the "modified carryover basis regime."

B. <u>"Property Acquired from the Decedent"</u>. The carryover basis regime applies to "property acquired from the decedent." In addition, the permitted basis adjustments described below apply to "property acquired from a decedent" that was "owned by the decedent" at the time of death. Also, the information return required under new § 6018 applies to "property acquired from a decedent." "Property acquired from the decedent" includes the following: (1) Property acquired by bequest, devise or inheritance; (2) property acquired by the decedent's estate from the decedent; (3) property transferred by the decedent during his lifetime to a qualified revocable trust defined in § 645(b)(1); (4) property transferred during lifetime to another trust over which the decedent reserved the right to alter, amend, or terminate the trust in a way that would change the enjoyment of the trust (i.e., trusts included in the decedent's estate under §§2036(a)(2) or 2038; observe that trusts included in the estate under §2036(a)(1) will not be treated as "acquired from the decedent" even if though the trust is in the decedent's gross estate); and (5) any other property passing from the decedent by reason of death to the extent that it passes without consideration (for example, property held as joint tenants with right of survivorship or as tenants by the entireties). I.R.C. § 1022(e).

C. $1.3 Million Basis Adjustment. Under the pre-2010 estate tax and stepped-up basis rules, a certain amount of property can pass without either estate tax or capital gains tax on pre-death appreciation. To keep this same concept, the 2001 Tax Act provides two amounts that can be used to provide a stepped-up basis for property acquired from a decedent. The first is a $1.3 million basis adjustment. I.R.C. § 1022(b). (This is a basis increase of $1.3 million, not a stepped-up basis on assets having a date of death value of $1.3 million.)

1. Increased by Unused Losses and Loss Carryovers. The $1.3 million amount is increased by any capital loss carryover under § 1212(b), the amount of any net operating loss carryover under section 172 which would (but for the decedent's death) be carried over from the decedent's last taxable year to a later year, plus the total amount of losses that would have been allowable under § 165 if the property had been sold at fair market value immediately before the decedent's death. I.R.C. § 1022(b)(2)(C). (Under § 165(f), losses from sales or exchanges of capital assets are allowed only to the extent allowed in §§ 1211 and 1212. Under § 1211, the deduction for capital losses that are not offset by capital gains is limited to $3,000 per year. Therefore, apparently there is the possibility that a substantial amount of built-in losses at death will not be added to the $1.3 million amount. The Senate Report to the 2001 Tax Act does not address this apparent limitation. It merely says that "[t]he $1.3 million is increased by the amount of unused capital losses, net operating losses, and *certain* 'built-in' losses of the decedent." (emphasis added).)

   While there can be a step DOWN in basis at death, the aggregate amount by which estate assets (other than personal use assets) receive a decrease in basis (except as limited by the $3,000 limit if there are not enough gains in the year of death to offset the losses) is added to the $1.3 million amount to result in additional increased basis for other assets that are appreciated at the time of death (assuming the estate has appreciation in appreciated estate assets exceeding the $1.3 million [and $3.0 million, if applicable] basis adjustments that would be allowed in any event).

2. Non-Resident Aliens. Decedents who are non-residents and non-citizens of the United States are eligible for only a $60,000, rather than a $1.3 million basis increase. Furthermore, they do not receive the benefit of increasing the basis adjustment by built-in losses and loss carryovers. I.R.C. § 1022(b)(3).

3. Anomaly for Many Decedents Dying in 2006-2009 vs. 2010. The disparity between the estate exemption ($2.0 million in 2006-08, and $3.5 million in 2009) and the $1.3 million basis adjustment after 2009 creates the anomaly that some

people will actually be better off (for tax purposes, at least) dying in 2006-2009 rather than in 2010 after the estate tax is repealed and carryover basis is instituted. If the client has an estate that is covered by the exemption (up to $2.0 million in 2006-08 and $3.5 million in 2009), there will be no estate` tax, but the basis adjustment could be as little as $1.3 million. This adjustment might not be sufficient to provide a full basis step-up if the estate has a great deal of appreciation.

D. <u>$3.0 Million Basis Adjustment For Property Passing to a Surviving Spouse</u>. The basis of property transferred to a surviving spouse ("qualified spousal property") can be increased by an additional $3.0 million. (Thus, the basis of property transferred to surviving spouses can be increased by a total of $4.3 million (plus the amount of built-in losses and loss carryovers).) "Qualified spousal property" includes property passing outright to a spouse or passing as qualified terminable interest property.

1. <u>Outright Transfer Property</u>. Property passing outright to the surviving spouse includes any property acquired from the decedent by his or her surviving spouse, unless on the lapse of time or the occurrence of an event or contingency, the interest passing to the spouse will fail and (1) the property will pass to another person for less than an adequate and full consideration in money or money's worth, or (2) the property "is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust." For purposes of the second exception, an interest is not considered to terminate or fail merely because it is the ownership of a bond, note or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term. I.R.C. § 1022(c)(4)(B). In addition, an interest that is conditioned on survival for six months after the decedent's death will not be excluded from the definition of outright transfer property if the spouse does not in fact die within such six month period. I.R.C. § 1022(c)(4)(C). Observe that such a survivorship requirement should not be used for decedents dying after 12-31-2009, because if the surviving spouse in fact dies within such six month period, the $3.0 million basis adjustment available for property passing to a surviving spouse would not be available.

2. <u>Qualified Terminable Interest Property</u>. This is defined to mean property that passes from the decedent from which the spouse is entitled to all the income for life payable annually or at more frequent intervals. In addition, no person can have a power to appoint any part of the property to anyone other than the surviving spouse during the spouse's lifetime. I.R.C. § 1022(c)(5). In addition, regulations may provide for an annuity to be treated in a manner similar to an income interest in property. <u>Id.</u>

   Generally speaking, this provision describes property that would qualify for a QTIP election under pre-2010 law. One possible difference from the QTIP trust rules is that income must be "payable annually or at more frequent intervals" under § 1022. There is identical language in § 2056(b)(5) (for life estate with general power of appointment marital trusts) and § 2056(b)(7) (for QTIP trusts). Rulings and regulations under § 2056 treat trusts that merely allow the spouse the right to withdraw income even if the income is not required to be distributed annually as qualifying for the marital deduction. Rev. Rul. 2000-2, 2000-1 C.B. 305; Treas. Reg. § 20.2056(b)-5(f)(8). It is not yet known whether regulations or rulings under § 1022 will be as expansive as the rulings under § 2056 (even though the statutory requirement is identical). To be conservative, trusts intended to qualify for the $3.0 million spousal basis adjustment should mandate that income be paid at least annually until regulations or rulings make clear that a "right to withdraw" approach is sufficient. There would be no necessity of having anyone make a QTIP election (indeed, no estate tax return would be filed if the estate tax is not applicable.)

Another possible difference is that the QTIP election provided in § 2056(b)(7)(B)(i)(III) is omitted from § 1022(c)(5)(A). As a result, a so-called "Clayton QTIP trust" (see Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992); Reg. § 20.2056(b)-7(d)(3)), in which the spouse's income interest is conditioned on the executor's QTIP election, will not be considered qualified spousal property.

Observe that property in a marital deduction "estate trust" would not qualify for the $3.0 million basis adjustment because the income would not be payable at least annually.

3. Non-Citizen Spouse. Observe that there is no "qualified domestic trust" requirement. Assets left outright to a non-citizen spouse can qualify for the $3.0 million basis adjustment even though such a bequest would not qualify for the estate tax marital deduction.

4. Coordination with $1.3 Million Basis Adjustment. The $3.0 million basis adjustment can be made ONLY with respect to property passing outright to a surviving spouse or to a QTIP trust. The $1.3 million basis adjustment is available for property that passes either to a surviving spouse or to others. Thus, the executor could elect for property passing to the spouse to receive a full $4.3 million increase in basis, or could choose to increase the basis of property passing to the surviving spouse by $3.0 million and to increase the basis of property passing to others by $1.3 million.

E. Requirements Common to Both Basis Adjustments.

1. Allocated on Asset-By-Asset Basis. The Conference Report makes clear that the basis increase is allocable on an asset-by-asset basis. For example, the basis increase can be allocated to a share of stock or a block of stock. If the estate owns an interest in an entity, it is not possible to make the allocation to specific assets in the entity.

2. No Asset Can Have Basis Adjusted Above Fair Market Value. In no case can the basis of an individual asset be adjusted above its fair market value. I.R.C. § 1022(d)(2).

3. Allocation Made By Executor. The executor is to allocate the two basis adjustments to specific assets on "the return required by section 6018." I.R.C. § 1022(d)(3)(A). (Section 6018 describes the information return required for transfers at death of non-cash assets over $1.3 million and for appreciated properties received by a decedent within three years of death that do not qualify for the basis adjustments under § 1022(d)(1)(C). See Section VI.B of this outline.)

What if there is a revocable trust? Section 1022(d)(3)(A) says the "executor" shall allocate the basis adjustments on the return required by § 6018. Section 6018 (a) says the "executor" shall file the information return, and § 6018(b)(4), entitled "*Returns by trustees or beneficiaries*," provides that if the executor cannot make a complete information return for any property, the executor is to file a description of such property and the name of every person holding a legal or beneficial interest in the property. Section 6018 does not discuss revocable trusts. However, the Senate and Conference Report to § 6018 says that the information report is to be filed by "the executor of the estate (or the trustee of a revocable trust)."

Presumably, regulations will eventually detail the procedures for the trustee of a revocable trust to file the information report, and to make the basis adjustments on the return due under § 6018. The regulations also, hopefully, will make clear how the allocation responsibility will be divided between an executor under a pour-over will and the trustee of a revocable trust. For example, what if there is a will that pours over to a revocable trust, and an executor is appointed under the will? Would that executor be entitled to make all basis allocation decisions even if there are very few assets in the probate estate and very large assets in the revocable trust?

4. <u>Allocation Can Be Changed Only With IRS Consent</u>. Once the executor makes the basis adjustment allocation, it can be changed only as provided in regulations. I.R.C. § 1022(d)(3)(B).

5. <u>Inflation Adjustment</u>. The $1.3 and $3.0 million amounts (and the $60,000 amount for a non-resident alien) are indexed for inflation occurring after December 31, 2009. I.R.C. § 1022(d)(4). The adjustments will be made in increments of $100,000 for the $1.3 million amount, $250,000 for the $3.0 million amount, and $5,000 for the $60,000 amount. I.R.C. § 1022(d)(4)(B).

6. <u>Property Acquired From a Decedent</u>. The carryover basis regime applies only to "property acquired from a decedent." Only such property may have its basis adjustment under either of the two adjustments. See Section V.B. of this outline.

7. <u>Ownership</u>. In addition to being "acquired from a decedent," property must be "owned by the decedent at the time of death." I.R.C. § 1022(d)(1)(A). Ownership is defined more narrowly than "property acquired from a decedent." A very important example of this distinction is that property in a QTIP trust at the surviving spouse's death is not treated as being "owned" by the surviving spouse, and therefore cannot qualify for the basis adjustments at the surviving spouse's subsequent death (unless the trustee distributed the property to the surviving spouse outright prior to his or her death.) [A possible argument suggested by some planners is that if the QTIP is taxed to the spouse under §678 he or she would be treated "as the owner of the trust" under §678. It is likely that the IRS would not agree with that interpretation.] Similarly, assets that had been transferred by a spouse (the donor-spouse) during his or her lifetime to a QTIP trust for the other spouse would not qualify for the $3.0 million spousal basis adjustment at the donor-spouse's death. The following ownership rules apply.

    a. <u>Joint Tenancy With Surviving Spouse</u>. Property held as joints tenants or tenants by the entireties with the surviving spouse is deemed to be owned one-half by the decedent (and therefore, one-half is eligible for the basis increase.) I.R.C. § 1022(d)(1)(B)(i)(I).

    b. <u>Joint Tenancy With Others Than Spouse</u>. Property held as joints tenants with right of survivorship with anyone other than the surviving spouse is deemed to be owned by the decedent to the extent the property is attributable to consideration furnished by the decedent. I.R.C. § 1022(d)(1)(B)(i)(II).

c. Joint Tenants Acquired Interests by Gift, Devise or Inheritance. If multiple joint tenants acquired their interests by gift, devise or inheritance, and if their interests are not otherwise specified or fixed by law, the decedent joint tenant will be treated as the owner to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants. I.R.C. § 1022(d)(1)(B)(i)(III).

d. Qualified Revocable Trust. Property transferred by the decedent during his lifetime to a qualified revocable trust (under § 645(b)(1)) is considered to be owned by the decedent (and thus eligible for the basis increase). I.R.C. § 1022(d)(1)(B)(ii).

e. Powers of Appointment. The decedent shall NOT be treated as owning any property solely be reason of holding a power of appointment with respect to such property. I.R.C. § 1022(d)(1)(B)(iii). (Accordingly, property in a general power of appointment marital trust appears not to qualify for the $1.3 million basis adjustment at the surviving spouse's subsequent death, unless the spouse exercises the power of appointment to leave the assets to his or her estate.)

f. Community Property. The decedent is treated as owning the surviving spouse's one-half share of community property "if at least one-half of the whole of the community interest in such property is treated as owned by, and acquired from, the decedent without regard to this clause." I.R.C. § 1022(d)(1)(B)(iv). The language is very strange, and it is unclear exactly what requirements the statute is referring to. The entirety of the Senate Committee Report to the Tax Act of 2001 about this issue is as follows:

> "Property acquired from the decedent is … (6) the surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property.
>
> …
>
> The decedent also is treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase) if at least one-half of the property was owned by, and acquired from, the decedent.[44]
>
> [44] Thus, similar to the present law rule in sec. 1014(b)(6), both the decedent's and the surviving spouse's share of community property could be eligible for a basis increase."

Despite the strange language, it appears generally that the decedent's one-half interest in the community property and the surviving spouse's interest in the community property are both eligible for the $1.3 and $3.0 million basis adjustments.

As a result of this rule for community property, in community property states it is easier to plan to be able to fully utilize the $3.0 million spousal basis adjustment. The surviving spouse's one-half of community property assets may have sufficient built-in gain to fully utilize the $3.0 million adjustment. Mickey Davis, Houston, Texas, suggests a triage system. If the total appreciation is less than $2.6 million there are no planning concerns (because the $1.3 million basis adjustment will provide a full adjustment to fair market value of decedent's one-half of the community property). If the total appreciation in community property assets is more than \$6.0 million, there are no planning concerns (because the surviving spouse's one-half of the community can fully utilize the \$3.0 million spousal basis adjustment). It is only for community estates with appreciation between \$2.6 million and \$6.0 million that special planning is needed to assure full utilization of the basis adjustments.

8. Ineligible Property. The following types of property are not eligible for the basis adjustments.

   a. Gifts to Decedent Within Three Years Other Than Spousal Gifts. Property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the three year period ending on the decedent's death generally does not qualify for the basis adjustments. I.R.C. § 1022(d)(1)(C)(i). However, property given to the decedent within three years of death by the decedent's spouse does qualify for the basis adjustments, unless the spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration. I.R.C. § 1022(d)(1)(C)(ii). Query what happens if the property is acquired within the proscribed three year period for partial consideration. Is the entire property ineligible for the basis adjustment, or only a portion of the property attributable to the gift element of the transfer?

   This section clearly allows pre-mortem interspousal transfers to transfer low basis assets to a dying spouse in order to be able to fully utilize the spouse's \$1.3 and \$3.0 million basis adjustments. Observe that a one year restriction applies in similar situations under pre-2010 law to achieve a step-up in basis. Section 1014(e) provides that if a decedent had acquired appreciated property within one year of his death and such property passes from the decedent to the donor of such property (or the spouse of such donor), no step-up in basis is allowed for such property at the decedent's death. All of § 1014 (including § 1014(e)) no longer applies to decedents dying after 12-31-2009. Consider revising powers of attorney to permit interspousal gifts for this purpose.

   This provision is not as important in community property states as in common law states, because both halves of community property qualify for the basis adjustments, without the necessity of transferring assets to the dying spouse.

   A spouse may want to consider deathbed gifts to a dying spouse as well for purposes of being able to pass the assets through an estate to descendants when there is no estate tax. Perhaps the assets could even pass back into a credit shelter trust with the donor-spouse as a discretionary beneficiary, but the IRS might raise an implied agreement of retained enjoyment issue under §2036(a)(1). Assets left in a QTIP for a dying spouse may pass back into a trust for the original donor-spouse without risk of having the assets included in the surviving spouse's estate under §2036(a)(1) because of a specific provision in the QTIP regulations. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, assets in a QTIP trust for the benefit of the decedent spouse will not be treated as passing from the decedent for carryover basis purposes, so cannot take advantage of the basis adjustments.

b. Income In Respect of a Decedent. Property that constitutes a right to receive income in respect of a decedent under § 691 does not qualify for a basis adjustment. I.R.C. § 1022(f).

c. Stock of Certain Entities. Stock in the following entities does not qualify for the basis adjustments: (1) foreign personal company; (2) domestic international sales corporation (of a former DISC); (3) foreign investment company; and (4) passive foreign investment company unless the decedent shareholder had made a qualified electing fund election. I.R.C. § 1022(d)(1)(D).

VI. REPORTING REQUIREMENTS AFTER 2009

The 2001 Tax Act requires certain new returns to be filed to provide information for administration of the new basis rules.

A. Lifetime Gifts. Within 30 days of filing a gift tax return, each recipient of a gift must receive a copy of the information included in the return with respect to the gift. I.R.C. § 6019(b). This section presumably applies to gifts made after December 31, 2009. The effective date provision in the legislation is not totally clear, because the effective date for the section of the Act in which this change is included is for "estates of decedents dying after December 31, 2009." 2001 Tax Act § 542(f)(1). Presumably, this will be interpreted to apply to gifts after 2009.

B. Transfers at Death. For decedents dying after December 31, 2009, two types of transfers at death of "property acquired from the decedent" (with the same meaning as is afforded to that term under § 1022(e)) must be reported on returns to the IRS under new § 6018. The two types of property that must be reported are: (1) transfers at death of non-cash assets in excess of $1.3 million; and (2) appreciated property received by a decedent within three years of death that does not qualify for the basis adjustments by reason of § 1022(d)(1)(C) and which was required to be reported on a gift tax return. The return is to be filed by the executor. I.R.C. § 6018 (a). If the executor is unable to make a complete return with all the information described below, the executor is still required to file a return under § 6018 giving a description of the property and the name of every person holding an interest in the property. The IRS may contact those persons in turn to file an information return. I.R.C. § 6018(b)(4).

The information required to be furnished to the IRS with the return under § 6018 is as follows:

(1) the name and TIN of the recipient of the property,

(2) an accurate description of the property,

(3) the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,

(4) the decedent's holding period in the property,

(5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,

(6) the amount of basis increase allocated to the property under the $1.3 million and $3.0 million basis adjustments, and

(7) any other information that regulations may prescribe. I.R.C. § 6018(c). The return to the IRS is required to be filed with the decedent's final income tax return or such later date specified in regulations. I.R.C. § 6075(a). Observe that this could be a short period of time for decedents who die late in the calendar year (unless the decedent's final income tax return is extended.)

In addition to the return required to be filed with the IRS, the person required to file that return must also furnish to each recipient of property described in the return a written statement giving similar information with respect to the property passing from the decedent to such person. I.R.C. § 6018(e).

There is no statute of limitations operating against the IRS with respect to values reported on the § 6018 report. The IRS could question those values years later when beneficiaries sell the assets. (This is probably the same as under current law. Values listed on an estate tax return, even after the period for assessment of additional estate taxes has run, probably are not binding on the IRS or the recipient of the property for income tax purposes [i.e., determining the amount of the basis step-up].)

C. Penalties for Failure to File Required Information.

1. Failure to Report to Beneficiaries or Donees. Any person required to report to beneficiaries or donees under § 6018(e) or § 6019 shall pay a penalty of $50 for each failure to report such required information. I.R.C. § 6716(b).

2. Failure to Report to IRS. Any person required to report to the IRS under § 6018 (for transfers of non-cash assets over $1.3 million or for certain transfers within three years of death) who fails to do so in a timely filed return shall pay a penalty of $10,000 for each such failure (except that the penalty is limited to $500 in the case of a failure to furnish information required under § 6018(b)(2) — which requires reporting certain gifts within three years of death.) I.R.C. § 6716(a).

3. Reasonable Cause Exception. No penalty is imposed with respect to any failure that is due to reasonable cause. I.R.C. § 6716(c).

4. Intentional Disregard. If any failure to report to the IRS or a beneficiary is due to intentional disregard of the rules, the penalty is 5 percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a lifetime gift.) I.R.C. § 6716(d).

VII. SPECIAL GAIN PROVISIONS

Many of the special gain provisions are included to coordinate with the modified carryover basis rules that would apply for decedents dying after December 31, 2009.

A. Transfer of Property Subject to a Liability. Gain is not recognized at the time of death when the estate or any beneficiary (other than a tax-exempt beneficiary) acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, no gain is recognized by the estate on the distribution of such property to a beneficiary of the estate (other than to a tax-exempt beneficiary) by reason of the liability. I.R.C. § 1022(g). The term "tax-exempt beneficiary" is defined to include specified governmental entities, an organization exempt from income tax, and a foreign person or entity, and to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance. I.R.C. § 1022(g)(2).

If a beneficiary is bequeathed property with liabilities in excess of the basis of the property, the beneficiary may realize substantial gain on the disposition of the property. For example, if a beneficiary receives property with a gross value of $120,000, basis of $10,000, and subject to a $110,000 liability, the bequest would have a net value of $120k minus $110k or $10,000. However, a sale of the property would generate a taxable gain of $120k minus $10k, or $110,000, which would generate a capital gains tax (at 20%) of $22,000. The income tax liability would exceed the net value of the bequest. The beneficiary would want to disclaim the bequest, although it is not totally clear that the disclaimer would be recognized for income tax purposes, because § 2518 generally applies for gift, estate and GST tax purposes, but not for income tax purposes. <u>See</u> Blattmachr, Gans, Zaritsky & Zeydel, <u>The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010</u>, 112 J. TAX'N (February 2010). Indeed, there would be a rush by all beneficiaries to disclaim the bequest. How will a particular beneficiary know that the asset is going to be distributed to him or her, in order to know to disclaim the bequest before the 9-month disclaimer period runs? Perhaps all beneficiaries would want to sign a general disclaimer as to any asset for which the net value of the property is less than its basis. (However, that may, depending on the document, result in the asset passing to the disclaimant's descendants, leaving them with the problem.) Pity the second (or third or fourth) cousin who fails to get notice of the problem (or cannot be located) and fails to disclaim the property. The statute prevents the family from being able to avoid the income tax liability by having the property escheat to the state or affirmatively leaving the property to a government or other tax-exempt entity. (Indeed, the purpose of this provision is to prevent taxpayers from borrowing against their property, leaving the cash to beneficiaries [obviously with a full basis], and leaving the encumbered property to charity. Blattmachr & Detzel, <u>Estate Planning Changes in the 2001 Tax Act — More Than You Can Count</u>, 95 J. TAX'N 74, 81 (Aug. 2001).)

To be fair to the unsuspecting beneficiary who would get stuck with the tax liability, the estate should sell or allow the foreclosure of the property so that the inherent income tax liability would be borne by the estate generally. (In fact, query whether the executor-beneficiary of the estate who disclaims and does not dispose of the property at the estate level, but "sticks" the income tax liability on other remote family members, would have liability for the deceitful action.)

It is unclear what the consequences would be under §1022 if property with a debt in excess of basis is held at the time of the decedent's death by a revocable trust that lacks sufficient assets to pay the income tax on a subsequent disposition of the property.

B. <u>Exclusion for Gain on the Sale of a Principal Residence</u>. The income tax exclusion of up to $250,000 on the sale of a principal residence is extended to estates and beneficiaries and trusts which, immediately before the decedent's death, met the definition of a qualified revocable trust as defined in § 645(b)(1). I.R.C. § 121(d)(11). The Conference Report indicates that if the decedent's estate or an heir sells the decedent's principal residence, $250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of ownership and occupancy of the property as a principal residence can be added to the heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence.

There does not appear to be any time limit on when the estate or beneficiary can avail itself of the decedent's $250,000 exclusion under § 121. Observe that a testamentary trust does not qualify for the exclusion under § 121. Therefore, if all of the estate passes to testamentary trusts, the estate should sell the residence and then distribute the sale proceeds to the testamentary trust.

C. No Automatic Long Term Holding Period for Estates; Transfer of Property in Satisfaction of a Pecuniary Bequest. The automatic long-term capital gains holding period under § 1223(11) will not apply in 2010, because § 1041(a) does not apply. The decedent's holding period may be tacked to the estate or beneficiary's holding period if the basis is determined "in whole or in part" from the decedent's basis. If the decedent's basis is higher than the fair market value at the time of death, the decedent's basis would play no factor in determining the basis, so tacking would not be available. (That would be a reason for selling loss assets before the decedent's death.) Otherwise, tacking apparently would be available, even if the basis has been adjusted to the date of death value by basis adjustment allocations, because the basis is the decedent's basis plus the amount of allocated basis adjustment.

Distributions of property in kind from trusts or estates that are in satisfaction of pecuniary bequests or pecuniary amounts are treated as taxable sales or exchanges, and gains or losses may result. See Reg. § 1.661(a)-2(f)(1); Kenan v. Comm'r, 114 F.2d 217 (2nd Cir. 1940); Rev. Rul. 60-87, 1960-1C.B. 286 (funding pecuniary marital deduction bequest); Rev. Rul. 74-178, 1974-1 C.B. 196 (distribution in satisfaction of a debt). This could produce enormous gain under a carryover basis regime. Fortunately, the 2001 Tax Act provides that gain is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis). I.R.C. § 1040(a). A similar rule will apply to certain trusts (to be described in future regulations.) I.R.C. § 1040(b). (Before such regulations are issued, a § 645 election should be made for "qualified revocable trusts," to treat them as an estate, if they will make in-kind distributions to satisfy pecuniary bequests.)

Under the literal wording of the statute, it appears that the inherent pre-death gain in income in respect of a decedent assets would not be triggered by using the asset to fund a pecuniary bequest.

Losses generally cannot be recognized for transactions between various categories of related parties, including transactions between an estate and a beneficiary of the estate. However, The Taxpayer Relief Act of 1997 made clear that the loss disallowance rules for estates do not extend to a sale or exchange that is in satisfaction of a pecuniary bequest. I.R.C. § 267(b)(13). How will losses on funding pecuniary bequests be treated under the 2001 Tax Act? The Act itself does not address losses. However, the Senate Report, which was accepted in the Conference Agreement, states that gain "or loss" will be recognized only to the extent that the fair market value at the time of transfer exceeds the fair market value at the date of death. (However, that statement does not make sense with respect to losses.)

The basis of property acquired in satisfaction of pecuniary bequests is the basis of the property immediately before the exchange increased by the amount of the gain recognized to the estate or trust on the exchange (i.e., the amount of the post death appreciation). I.R.C. § 1040(c).

D. Transfers to Foreign Trusts, Estates and Nonresident Aliens. The pre-2010 rule, providing that a transfer by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange, is expanded. The new law treats transfers by a U.S. person to a nonresident who is not a U.S. citizen as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor. I.R.C. § 684(a). Exceptions from the gain recognition rule include transfers to grantor trusts, and lifetime transfers to non-resident aliens. I.R.C. § 684(b).

E. Effective Date. The changes described in this Section VII are all in connection with the adoption of the carryover basis system and apply to decedents dying after or transfers after December 31, 2009.

VIII. ESTATE TAX PROVISIONS THAT EXTEND BEYOND DATE OF ESTATE TAX "REPEAL."

A. QDOTs. If the first spouse died before January 1, 2010, the QDOT tax (which applies generally when distributions of principal are made from the QDOT to the spouse or at the surviving spouse's subsequent death) applies to distributions to the surviving spouse before his or her death if the distributions are made on or before December 31, 2020. I.R.C. § 2210(b)(1). Thus for distributions to the surviving spouse, the QDOT tax on distributions continues to apply for eleven years after the estate tax is repealed. (This seems to be an unduly harsh penalty on noncitizen surviving spouses that does not apply to citizen spouses.) The QDOT tax that applies at the surviving spouse's subsequent death, however, does not apply after December 31, 2009. I.R.C. § 2210(b)(2).

B. Recapture Provisions. Except for QDOTs, the 2001 Tax Act does not specifically mention recapture rules for estates of decedents who die before the estate tax is repealed. However, those recapture rules are necessarily preserved under the language of § 2210(a), which makes the estate tax provisions of chapter 11 inapplicable only to "the estates of decedents dying after December 31, 2009" – that is, not to the estates of decedents dying on or before that date. In addition, the Senate Report addresses this issue directly:

> "Prior to repeal of the estate tax, many estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax or other estate tax. Because repeal of the estate tax is effective for decedents dying after December 31, 2010 [which was the effective date of the repeal provision in the Senate bill], these estate tax recapture provisions generally will continue to apply to estates of decedents dying before January 2, 2011."

The various recapture and other provisions that continue to apply are summarized below.

1. Special Use Valuation. The recapture tax imposed under § 2032A(c) continues to apply for estates of decedents who die before December 31, 2009. The recapture tax applies if certain disqualifying events occur within 10 years of the decedent's death.
2. QFOBI Deduction. The QFOBI recapture provisions, which apply, for example, if an heir ceases to use the property in a qualified manner within 10 years of the decedent's death, would continue to apply for estates of decedents who die before December 31, 2009.
3. Section 6166 Installments. Estates of decedents who die before December 31, 2009 that qualify for extended payments of estate tax under § 6166 would continue to make installment payments after 12-31-09. The acceleration rules would continue to apply (for example if more than 50% of the value of the business is distributed, sold or otherwise disposed).
4. Qualified Conservation Easements. A donor may retain a development right in the conveyance of a conservation easement. However, the advantage of an estate tax

deduction for the easement is disallowed if there is not an agreement to extinguish the development rights within two years after the decedent's death, or the date of the sale of the land subject to the easement. This liability for additional tax is continued after 12-31-09 for the estates of decedents who die on or before that date.

IX. ESTATE TAX INSTALLMENT PAYMENTS

The following provisions regarding § 6166 payouts were included in the 2001 Tax Act. These provisions would no longer apply under the 2011 sunset, as discussed in Section III of this outline.

A. Permissible Number of Shareholders or Partners Expanded to Meet "Closely-Held" Test. Section 6166(b)(9)(B)(iii)(l) was revised to expand from 15 to 45 the number of shareholders or partners that are permitted in order for the business to meet the "closely-held" test. The alternative 20% test (i.e., 20% or more capital interest in a partnership or 20% or more voting stock in a corporation) was not changed. The provision applies to decedents dying after 12-31-01.

B. Qualified Lending and Financing Business. An interest in a qualifying lending and financing business (as defined in § 6166(b)(1)(B)) were treated as stock in an active trade or business and qualifies for the installment payment provisions. For this business interest, the installment payments must be made over 5 years. § 6166(b)(10)(A)(ii-iii). The Conference Report says that no inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under present law. The provision applies to decedents dying after 12-31-01.

C. Holding Companies; Stock of Operating Subsidiaries Do Not Have to be Non-Readily Tradable. The installment payment provisions were expanded to include holding companies where the holding company stock is not readily tradable, but the stock of operating subsidiaries is readily tradable. For this type of holding company stock, the estate tax must be paid over five years. § 6166(b)(8)(ii). (The holding company rules have previously provided that the five year deferral of principal provision does not apply. For this special type of holding company, the entire tax must be paid over the first five years.) The provision applies to decedents dying after 12-31-01.

X. QUALIFIED CONSERVATION EASEMENT

A. Background. An executor could elect to exclude from the taxable estate 40% of any land subject to a qualified conservation easement, up to a maximum exclusion of $400,000 in 2001 and $500,000 thereafter. The 40% amount was reduced by 2 percentage points for each percentage point by which the value of the qualified conservation easement was less than 30 percent of the value of the land. Such percentage amount, as so reduced, is the "applicable percentage" that may be excluded from the taxable estate.

B. Eliminate Distance Requirement. The 2001 Tax Act expanded the availability of the qualified conservation easement exclusion by eliminating the requirement that the land by located within 25 miles of a metropolitan area, national park or wilderness area or within 10 miles of an Urban National Forest. The land could be located anywhere in the United States or its possessions. I.R.C. § 2031(c)(8)(A)(i).

C. Clarification of Valuation Date. For purposes of determining the "applicable percentage," values to be used were the values as of the date of the contribution. I.R.C. § 2031(c)(2).

D. Effective Date. The qualified conservation easement amendments were effective for decedents dying after December 31, 2000. 2001 Tax Act § 551(c). However, they would be removed after 2010 under the 2011 sunset provision.

XI. GENERATION-SKIPPING TRANSFER TAX REVISIONS

A. GST Exemption for 2010 Transfers. The GST exemption in any particular year is the same as the estate tax applicable exclusion amount under §2010(c) in such year. In 2009 that amount was $3.5 million. In 2010, there is no estate tax applicable exclusion amount under §2010(c). As a result, transferors will not be able to allocate any GST exemption to the transfers they make in 2010. Transferors who want to allocate GST exemption to 2010 transfers will have to wait until 2011. The value of the property transferred in 2010 will be determined as of the time of making the allocation because it will not be possible to make a timely GST exemption allocation to a 2010 transfer.

In 2011, however, under the sunset rule, there may be at least $1,340,000 of GST exemption (discussed in Section XI.C below of this outline. It is not totally clear that the indexed GST exemption amount in 2011 can be allocated to gifts made in 2010, but hopefully it can.

B. Repeal. In 2010, the generation-skipping transfer tax (the "GST tax") does not apply to generation-skipping transfers. There is commonplace discussion of the GST tax being "repealed" in 2010. However, § 2664 (added by the 2001 Tax Act) says that chapter 13 (the chapter that imposes the GST tax) "shall not apply to generation-skipping transfers after December 31, 2009." Accordingly, all of chapter 13 remains in the Code, but does not apply to transfers after December 31, 2009.

C. Sunset — Generally. The sunset provision in Section 901(a) of the 2001 Tax Act includes provisions of and amendments to the Act affecting generation-skipping transfers that will be made after December 31, 2010. Section 901(b) provides that "[t]he Internal Revenue Code of 1986... shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted." Thus, after December 31, 2010, the Internal Revenue Code of 1986 "springs back" and is to be applied as if the provisions and amendments made by the 2001 Act had never been enacted. Presumably the GST exemption will be the 2003 amount of the GST exemption, indexed for inflation from 1997 to 2011. The indexed amount in 2010 would be $1,340,000, so presumably the indexed amount in 2011 will be at least that much. (A Revenue Procedure is issued each year providing indexing amounts. The $1 million GST exemption indexed amount happens to be the same as the indexed amount for the "2% interest rate portion" of §6166 installment payouts under §6601(j). For 2010, the indexed amount is $1,340,000.)

D. Application of the Sunset Provision to Pre-2001 Act Provisions of Chapter 13. The "had never been enacted" sunset provision creates a variety of uncertainties regarding the application of the provisions of chapter 13 that were in existence prior to the 2001 Act. Carlyn McCaffrey points out the following possible uncertainties:

1. The 2001 Act is unclear as to whether a trust to which GST exemption of $3.5 million had been allocated before 2010 will lose its exemption in 2011 to the extent the exemption exceeds $1 million with an inflation adjustment.

2. The 2001 Act is unclear as to whether decedents who die in 2010 creating trusts under their wills that could have future GSTs will be treated as the transferors of those trusts for GST purposes. The transfer to the trusts in 2010 will not be subject

to estate tax. As a result, such decedents would not come within the definition of "transferor" under §2652(a). A trust without a transferor produces strange results under chapter 13 because all of its beneficiaries will be non-skip persons. This is so because the term "non-skip person" is defined as any person who is not a skip-person. None of the trust's beneficiaries can be skip persons because (1) a skip person is a person assigned to two or more generations below the transferor and (2) this trust has no transferor. This means that no distribution from such a trust would be a taxable distribution and that no termination of an interest would be a taxable termination because every person holding an interest after a termination will be a non-skip person. As a result, when the GST tax "springs back" in 2011,the GST tax may not apply to such a trust. Plaine & Wilkenfeld, <u>Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001</u>, 27 ACTEC J. 119, 120-21 (2001). Alternatively, if the "had never been enacted" provision were literally applied, the IRS could conclude that 2010 decedents should be treated as transferors because the estate tax would have been applied to the transfer in 2010 if the 2001 Act had never been enacted.

3. The 2001 Act is unclear as to whether a 2010 decedent who is a beneficiary of a pre-2010 QTIP will become the transferor of any continuing trusts that could have future GSTs. Arguably he or she will not because the trust property will not be subject to estate tax in his or her estate, Application of the "had never been enacted" could result in such decedent being treated as the transferor.

4. The 2001 Act is unclear as to whether the generation move down rule of §2653(a) will apply to generation-skipping transfers that take place in 2010. A gift in 2010 to a trust that is a skip person (i.e., generally a trust in which only skip persons have present interests) will be a direct skip within the meaning of §2612(b), but will not be subject to the GST tax because the GST tax does not apply to any 2010 transfers. Whether a distribution to a skip person from such a trust after 2010 would be treated as a taxable distribution depends on how the sunset provisions are applied. Ordinarily, after the occurrence of a direct skip, the generation-assignment of the transferor moves down to the generation immediately above the generation assignment of the highest generation of any person who has an interest in the trust immediately after the direct skip. But, if Chapter 13 is inapplicable to generation-skipping transfers that take place in 2010, arguably §2653(a) does not apply to the 2010 direct skip. On the other hand, a literal application of the "if it had never been enacted rule" would cause §2653(a) to apply to a 2010 direct skip (because in 2011, if §2664 "had never been enacted," chapter 13 would have applied to the transfer, so §2653(a) would have applied). A similar issue arises in connection with 2010 taxable terminations.

5. The 2001 Act is unclear as to whether the basis adjustment rule of §2654(a)(2) will apply to taxable terminations that occur in 2010 at the same time as and as a result of the death of an individual. Section 2654(a)(2) provides that the basis of property that is the subject of such a taxable termination shall be adjusted in a manner similar to the manner provided under §1014. But, if Chapter 13 is inapplicable to generation-skipping transfers that take place in 2010, arguably §2654(a)(2) does not apply to a 2010 taxable termination. On the other hand, a literal application of the "if it had never been enacted rule" would cause §2654(a)(2) to apply to a 2010 taxable termination.

6. The 2001 Act is unclear as to whether §2642(c)'s zero inclusion rule for direct skips which are nontaxable gifts will apply to gifts made in 2010. Section 2664 says that chapter 13 will not apply to a 2010 GST. A direct skip is a form of GST. Therefore, section 2664 seems to prevent the application of the zero inclusion to a 2010 direct skip. On the other hand, a literal application of the "if it had never been enacted rule" would cause §2642(c) to apply to a 2010 direct skip that is a nontaxable gift.

7. It is unclear what happens to trusts subject to an estate tax inclusion period (ETIP) under § 2642(f). Section 2642(f) prohibits allocating GST exemption to an inter vivos transfer of property that would be includible in the gross estate of the transferor (other than under § 2035) if the transferor were to die immediately after the transfer. The ETIP extends until when the property involved in the transfer is not longer "includible in the gross estate of the transferor under chapter 11." Therefore, the ETIP should end in 2010. Unfortunately, there is no GST exemption in 2010 to allocate to the trust. However, some trusts may have allocated GST exemption to a trust with an ETIP, to have a delayed effectiveness until the end of the ETIP. In that situation, the GST exemption has "kicked in" in 2010. What is the effect in 2011? Will the ETIP be treated as continuing throughout the entire period under the "had never been enacted" provision? Will a new ETIP start? . To add to the uncertainty, the "had never been enacted" sunset rule conceivably could change the result in 2011 (so that the ETIP is treated as if it did not end in 2010), under the reasoning that §2664 (which caused the estate tax not to apply if the transferor died in 2010) would be deemed never to have occurred.

E. <u>Application of the Sunset Provision to Provisions of Chapter 13 That Were Added by the 2001 Act</u>. The particular GST provisions enacted in the 2001 Tax Act, which would all sunset in 2011 without further legislation, are discussed below.

1. <u>Additional Automatic Allocations Under 2001 Tax Act</u>. The automatic GST exemption allocation provisions of §2632(c) added by the 2001 Tax Act would be removed as part of the 2011 sunset. . Direct automatic allocations or "opt-in" automatic allocations for transfers to trusts under §2632(c), which was a part of EGTRRA, might conceivably be invalidated under the sunset rule in 2011. The IRS could issue a regulation to treat any "opt-in" or automatic allocation as if it had been an affirmative allocation.

2. <u>Retroactive Allocation of GST Exemption Under 2001 Tax Act</u>.

a. <u>Rationale</u>. If a taxable termination occurs from a trust because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and GST exemption had not been allocated to the trust (because the transferor anticipated that the assets would pass to the child), the GST tax would be due even if the transferor had unused GST exemption. "The Committee believes it is appropriate to provide that when there is an unnatural order of death (e.g., when the second generation dies before the first generation transferor), the transferor can allocate generation-skipping transfer tax exemption retroactively to the date of the respective transfer to the trust." (House Report to the 2001 Tax Act, p. 37)

b. General Rule Allowing Retroactive Allocation of GST Exemption. If a lineal descendant of a grandparent of the transferor of a trust is a beneficiary of the trust and predeceases the transferor, the transferor can retroactively allocate any unused GST tax exemption to any previous transfer (or transfers on a chronological basis) to the trust. The retroactive allocation can be made if: (a) A non-skip person (i.e., a person assigned to the transferor's children's generation or to a higher generation) has an interest or a future interest in a trust to which any transfer has been made, (b) such person is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) such person is in a generation younger than the generation of the transferor, and (d) such person dies before the transferor. I.R.C. § 2632(d)(1).

c. 2011 Sunset. The 2011 sunset will remove this retroactive allocation possibility.

3. Valuation of GST Exemption Allocations to Transfers Effective at Death. The general rule before 2010 was that the value for GST exemption purposes of property includible in the decedent's gross estate is the same as its value for estate tax purposes. Treas. Reg. § 26.2642-2(b)(1). If alternate valuation is used for estate tax purposes, that value will apply for GST purposes also. Property valued under the special use valuation provisions of Section 2032A will use the special use value for GST purposes (but only if the recapture agreement provides for the recapture of GST tax.) Id. The 2001 Tax Act codifies that the finally determined estate tax value controls for transfers as a result of the transferor's death. I.R.C. § 2642(b)(2)(A). However, if the regulatory requirements (as described in Reg. § 26.2642(b)) regarding post-death changes are not met, the value of property shall be determined as of the time of the distribution concerned. Id.

4. Relief From Late Elections Under 2001 Tax Act.

a. IRS Has Discretion to Recognize Late Elections As If Timely Made. The Treasury Secretary is directed to adopt regulations (which are now close to being finalized) describing the circumstances and procedures for granting extensions of time to make the election to allocate GST exemption and to grant exceptions to the time requirement. If such relief is granted, the gift or estate tax value of the transfer to trust would be used for determining the GST exemption allocation. I.R.C. § 2642(g)(1)(A). Shortly after the enactment of the 2001 Tax Act, Notice 2001-50, 2001-2 C.B. 189, acknowledged § 2642(g)(1) and stated that taxpayers may seek extensions of time to take those actions under Reg. § 301.9100-3. The Service has received and granted hundreds of requests for such relief over the years since the publication of Notice 2001-50. In addition, Rev. Proc. 2004-46, 2004-2 C.B. 142, provided a simplified method of dealing with pre-2001 gifts that meet the requirements of the annual gift tax exclusion under § 2503(b) but not the special "tax-vesting" requirements applicable for GST tax purposes to gifts in trust under § 2642(c)(2). These developments have created very helpful flexibilities.

b. 2011 Sunset. This helpful provision would be removed in the 2011 sunset, and the continued validity of Notice 2001-50 and Rev. Proc. 2004-46 would be in doubt. Also in doubt would be the continued validity of any late GST exemption allocations that have been permitted by the IRS since the enactment of the 2001 Tax Act under the authority of §2642(g).

5. Severances Under 2001 Tax Act. If a trust is severed in a "qualified severance," the resulting trusts are treated as separate trusts for GST purposes. I.R.C. § 2642(a)(3)(A).

   a. Significance. The significance of this severance authorization in the 2001 Tax Act cannot be underestimated. It can be extremely useful in the administration of trusts that have inclusion ratios of other than 1 or zero (a "partially exempt trust"). For example, for partially exempt trusts, every year that a distribution is made to a skip person (i.e., a person assigned to the generation of the transferor's grandchildren or to a lower generation), a tax return must be filed (a 706GS-D) and some GST tax must be paid.

   Under prior law, the IRS took the position that there was no possibility of dividing a partially exempt trust into two trusts — one of which was fully exempt and one of which was fully non-exempt. In addition, there was no authority under the prior severance regulations to sever an inter vivos trust that is not included in the grantor's estate for GST purposes — so that the trust could be severed before GST exemption is allocated to the newly created trusts (again, to create fully exempt and fully non-exempt trusts).

   b. 2011 Sunset. This incredibly helpful provision would be removed in the 2011 sunset (without further legislation). If the "as if it had never been enacted rule is applied," doubt would be cast on the validity of all prior severances that were effected under the authority of §2642(a)(3). Because the "qualified severance" legislation was largely a reaction to an administrative position on severances that was thought to be unduly harsh – Reg. § 26.2654-1(b), as applied before the addition of Reg. § 26.2654-1(c) and Reg. § 26.2642-6 in 2007 in response to the enactment of I.R.C. § 2642(a)(3) – it is possible that similar relief could be confirmed administratively even after the sunset. Qualified severances were allowed under EGTRRA, as a result of the IRS's strict interpretation of not allowing "downstream splits." The IRS could by regulations recognize downstream splits that previously occurred and continue to recognize them, or could adopt its own downstream split rule if it were so inclined.

XII. PLANNING — REVIEW EXISTING DOCUMENTS

A. Meaning of Documents. Formula provisions in documents may be nonsensical if there is no estate tax. The formula provisions may be tied to concepts that are meaningless. For example, what does a bequest of property qualifying for a marital deduction up to a certain amount mean, when there is no marital deduction because the estate tax law does not apply to the estate of a decedent who dies in 2010? What does a bequest of the maximum amount of taxable estate without causing or increasing the federal estate tax mean when there is no federal estate tax and no "taxable estate?" What does a bequest of the remaining GST exemption amount mean in a year in which there is no GST exemption? Or a direction in a trust to divide the trust into exempt and non-exempt trusts at some triggering date, based on the trustor's remaining GST exemption? What is the meaning of a formula bequest setting the term or payout rate for a charitable lead annuity trust so that the estate is not subject to estate tax?

The same type of bequest may have very different result, depending on the wording used in the formula. For example, a bequest to the credit shelter trust of "the applicable exclusion amount under 2010(c)" may mean zero, since there is no applicable exclusion amount in 2010. However, a bequest to the credit shelter trust of "the largest taxable estate I can have without any estate tax" may be the entire estate. More pointedly, a bequest of "the largest amount that can pass free of federal estate tax" is likely to be the entire estate, while adding the words "by reason of the unified credit" could change it to zero, and neither might be what the testator would have wanted.

1. Will Construction Suits. There may be a number of will construction suits over the coming years to resolve these ambiguities. Even in some situations where there seems to be no ambiguity, surviving family members may be able to convince the state court that the testator would not have intended extreme results produced by the formulas (as illustrated in Section XII.B, below). (Even if Congress acts to reinstitute the estate and GST tax retroactively to January 1, 2010, there may be lawsuits as to the state law meaning of the instruments at time of the testator's death.)

2. State Construction Statutes. Some states are considering statutes to provide presumptive interpretations of wills. For example, statutes in Washington and Virginia provide that if the federal estate tax does not apply, the will is to be interpreted as if the person died on 12/31/09 unless a contrary intent is disclosed in the will. A Florida statutory proposal provides that a judicial construction is permissible and the court can consider extrinsic evidence as to the testator's intent.

3. State Estate Tax Ambiguities. Similarly, ambiguities may exist in light of state estate taxes. For example, a state marital deduction may be allowed for QTIP bequests only if the estate makes the federal QTIP election (and there would be no way of doing so in 2010 if no federal estate tax return is required.)

4. Other Documents. These uncertainties can impact other trusts and other documents as well. For example, GRATs may grant a power of appointment to the grantor over the portion of the GRAT included in the grantor's gross estate (so that the grantor could exercise the power of appointment to leave those assets in a manner that qualifies for the marital deduction). Even if there is no federal estate tax, being able to exercise that power of appointment may be important to qualify for the marital deduction for *state* estate tax purposes. What does that term mean if there is no federal estate tax and no federal gross estate? Premarital agreement and property settlement agreement sometime refer to "gross estate" definitions.

5. Potential Marital Deduction Concerns. A further concern is whether amounts passing to the surviving spouse or QTIP trust under formulas as a result of retroactive reinstatement of the estate tax months after the decedent's death will qualify for the marital deduction. See Blattmachr, Gans, Zaritsky & Zeydel, The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010, 112 J. TAX'N (February 2010)("No one can predict the answer. It may seem obvious to some what the 'fair' answer would be, but as we all know life under the tax law is not always fair."). Hopefully, any retroactive estate tax legislation will make clear that the marital deduction will be available in that situation.

B. Results Inconsistent With Testator's Intent. Even if the literal meaning of a formula clause is clear, the change in the estate and GST tax laws may be applied under the formula that is dramatically inconsistent with the testator's intent. A typical estate plan for married individuals is to leave as much as possible to trusts or individuals other than the surviving spouse without generating any federal estate tax (in order to avoid having those assets be subjected to estate tax at the surviving spouse's subsequent death). Those types of plans may be impacted dramatically by this law change. For example, if a client's plan is to leave as much as possible to a credit shelter trust for the decedent's children without generating federal estate taxes at the first spouse's death, with the balance of the estate passing to the surviving spouse, that plan may be construed to leave the entire estate to the trust for the children if there is no federal estate tax system in place (depending on the specific wording of the formula bequests). That might cut out the surviving spouse from receiving anything under the first decedent-spouse's will, and may not at all be what the client intended. In those situations, there may be expensive court fights over the construction of the document in light of the client's intent, but the laws of most states are that the client's intent is irrelevant if the document is not ambiguous. Particularly for married individuals with these kinds of formula driven clauses, it will be important for clients to have their estate plans reviewed.

C. <u>Does the Document Address What Happens If No Estate Tax</u>? Some documents created after 2001 have addressed the possible scenarios of how the estate is disposed under various circumstances, including whether there is or is not an estate tax. For example, the approach of one firm has generally been to provide in documents that if the federal estate tax does not apply to the estate, the bequest to the credit shelter trust is limited to the amount of the state estate tax exemption, but if there is a federal estate tax, the full federal estate tax exemption amount passes to the credit shelter trust. Those types of documents may need no further revisions. Even with those documents, it makes sense to review the bequests that will pass under the documents in light of the current values and assets in the client's estate, because clients probably did not seriously focus on what they really wanted to happen in the event there is no estate tax. However, many planners (and clients) operated under the belief that Congress would extend the federal estate tax after 2009 and did not address the contingency of having no estate tax when the client dies. Furthermore, documents signed before the 2001 Tax Act no doubt will not address this contingency.

D. <u>Codicil "Fix."</u> Is it possible to have a fairly short and simple codicil to "fix" these potential problems, depending on the client's intentions? For example, the codicil might provide generally that if the client dies at a time when the estate and GST tax do not apply to the client's estate and if the taxes are not retroactively reinstated to apply to the client's estate, notwithstanding any contrary provisions in the Will, for purposes of all computations that are required to be made under the relevant sections, it shall be presumed that Chapters 11 and 13 of the Code as in effect on December 31, 2009 are applicable at the time of the client's death and that all elections under those Chapters shall be deemed to be available for purposes of the computations. That type of clause is one way to address the mechanical/computational ambiguities that may arise, but the clause would have to be tailored to fit the client's intentions. (For example, the client may prefer that the credit shelter trust be funded with the entire estate rather than just having it funded with the exemption amount available on December 31.)

XIII. TESTAMENTARY PLANNING FOR MARRIED CLIENTS IN 2010 IN LIGHT OF UNCERTAINTY

During 2001-2009, planners had to deal with the effect of increasing exemptions and the possibility of estate tax repeal on plans. The same uncertainties still exist. There is uncertainty as to whether and when the estate and GST tax will be reinstituted and there is uncertainty over the possible increase (or decrease) in the estate tax and GST tax exemptions from the 2009 $3.5

million level. The planning is particularly complicated for married individuals who are concerned with how much to leave to a credit shelter trust, QTIP or outright to a spouse, as well as complications because of the possibility of taking advantage of a $3.0 million basis adjustment for assets passing to a QTIP-type trust.

A. Scenarios of Problem Situations.

1. All to Credit Shelter Trust/Marital Trust Plan. Some clients may wish to leave their entire estates to trusts for their spouses and descendants (either a credit shelter trust or a QTIP trust) for non-tax reasons, including giving their surviving spouses the ability to control where assets will pass at the second death and to provide asset protection for the surviving spouses. These reasons should continue to apply even if there is no estate tax. Those clients may not be concerned with the possibility of increasing exemptions. If the estate tax is not in effect and no marital deduction is needed, the formula clause may leave the entire estate to the credit shelter trust for the spouse and descendants. This approach may be preferable because it allows providing for the possibility of making discretionary distributions to descendants, which would not be possible from the QTIP trust. However, assets passing to the credit shelter trust would not qualify for the $3.0 million spousal basis adjustment.

2. Exemption Formula Bequest to Credit Shelter Trust/Balance Outright to Surviving Spouse. This is the classic problem situation in planning for exemption increases. The client wants to leave the exemption to a credit shelter trust to save estate taxes at the surviving spouse's death, but wants to leave the balance of the estate outright to the surviving spouse. The client may be thinking that a substantial part of the estate will pass outright to the surviving spouse. Continued estate tax repeal or future exemption increases may result in the entire estate passing to the bypass trust, leaving nothing to pass outright to the surviving spouse. This may be contrary to the client's (and the spouse's) wishes.

3. All to Credit Shelter Trust/Marital Trust; Desire for More Flexibility in Marital Trust If No Marital Deduction Needed. Even if the client wants to leave the entire estate to a credit shelter trust or to a marital trust, there may still be a desire to revise the terms of the trusts if there is no need to qualify for the marital deduction at the first spouse's death or if there is no estate tax.

   a. Revision to Marital Trust Terms if Marital Deduction Not Needed. If the applicable exclusion amount is large enough so that no estate taxes are due at the first spouse's death even if there is no marital deduction, there may be a desire to revise the terms of the marital trust, to delete some of the terms that are necessary to qualify the trust for the marital deduction. These include (i) deletion of the mandatory income requirement, (ii) permitting the trustee to make distributions to beneficiaries other than the surviving spouse, and (iii) giving the surviving spouse a lifetime power of appointment to appoint the assets to persons other than the surviving spouse. Under the "Clayton trust" regulation, the terms of the marital trust may be revised under the trust document (for example, to include these additional provisions) if the executor does not make a QTIP election for the marital trust. See the discussion of using Clayton trust provisions in Section XIII.B.2 of this outline, below.

   b. Revisions to Credit Shelter Trust Terms if No Estate Tax Concerns. If there is no estate tax, or if the applicable exclusion amount is large enough to cover the surviving spouse's estate even if the assets of the credit shelter trust are included in the surviving spouse's estate, the client might wish to give the surviving spouse increased flexibility over the credit shelter trust, including serving as trustee without an ascertainable standard on distributions or having a power to withdraw whatever he or she wants from the trust, although this will still be subject to state law limitations on fiduciaries' exercises of discretion in their own favor. (In addition, including broad withdrawal powers for the surviving spouse will impact the degree of asset protection available for the surviving spouse.)

c. Bequest to Trust For Children. If the will or revocable trust leaves a formula bequest of as much as possible without causing estate taxes to be paid (typically, the applicable exclusion amount) to a trust for the client's children, there may be a desire to change the will or revocable trust if there is continued repeal or if the applicable exclusion amount increases. The formula clause could otherwise end up leaving the client's entire estate to the trust for children, with nothing passing to or for the benefit of the surviving spouse.

d. Outright Formula Bequest to Children. The client may be even less inclined to leave substantially increased amounts under a formula bequest that passes outright to children. Furthermore, as the applicable exclusion amount increases (or if there is no continuing estate tax), the client may wish a significant part of the bequest to pass to a trust for the children to provide management assistance and asset protection.

e. Bequest to Children of Prior Marriage. The situation is particularly sensitive if the client leaves a formula bequest to children by a prior marriage. For example, if husband has two children by a prior marriage and two children of his current marriage and if the marital estate is predominantly community property, the husband's current plan may be to leave all of his applicable exclusion amount to his children by his prior marriage, anticipating that his wife will leave her one-half of the community estate to the children by the current marriage. However, if the husband dies first, he may not wish to leave *all* of his one-half of the community estate to his children by a prior marriage, in order to make sure that his wife has sufficient assets to provide for her support.

B. Alternative Planning Approaches.

1. Retain "Standard" Credit Shelter Trust/Marital Trust Plan. Depending on the wording of the formula clause, the entire estate often will be left to the credit shelter trust if there is no estate tax applicable at the testator's death (for example, if there is a formula bequest to the credit shelter trust of the largest amount that can pass without incurring federal estate tax or if there is a bequest to the spouse or QTIP trust of the smallest amount without causing the imposition of a federal estate tax). As discussed in Section XIII.A.1. above, many clients will be happy to leave the entire estate to the credit shelter trust if there is no estate tax. The client may want to sign a simple codicil clarifying that the intent is indeed to leave the maximum amount possible to the credit shelter trust, even if that is the entire estate. Alternatively, the client may be willing to risk that any possible ambiguity will be resolved in favor of leaving all of the estate to the credit shelter trust. Be

aware, however, that this may not leave enough to the spouse or a QTIP trust to utilize fully the $3.0 million spousal basis adjustment.

In light of the fact that the $3.0 million spousal basis adjustment only applies if the decedent dies in 2010, the client may opt in favor of the simplicity of making no major changes to the plan and may be willing to take that risk of not being able to utilize all of the $3.0 million spousal basis adjustment. Furthermore, the client may determine that the $1.3 million basis adjustment will likely cover all or a large part of the appreciation in the estate assets, remembering that retirement plans and other income in respect of decedent assets do not qualify for the basis adjustments in any event and that the residence is entitled to the $250,000 gain exclusion. See Section XVII.A, below. Furthermore, residents of community property states may be able to take full advantage of the $3.0 million spousal basis adjustment by applying the adjustment to the surviving spouse's one-half of the community property.

2. Simple Codicil Fix. To the extent that there is ambiguity in the interpretation of the formula clauses, a simple codicil might be used to clarify the ambiguity. For example, the codicil could provide that the formulas will be applied in accordance with the law as it existed on December 31, 2009 if the client wants to limit the amount passing to the credit shelter trust to $3.5 million, or the codicil could provide that. See Section XII.D. The codicil could provide that clarify that the formulas will be applied to leave the maximum amount possible to the credit shelter trust, even if that is all of the estate. Again, this simple approach may not operate to leave enough assets to the spouse or QTIP trust to take full advantage of the of the $3.0 million spousal basis adjustment.

3. One-Year Term Insurance to Keep Simple Approach. The loss of the $3.0 million spousal basis adjustment may eventually cost the family $3.0 million times approximate 20% capital gains rate (not knowing how the rate will increase after 2010 when it is 15%), or $600,000. In order to avoid complicated changes to the estate plan to take advantage of the $3.0 million spousal basis adjustment, the client may prefer the simplicity of buying a one-year term life insurance policy on the spouses' lives to benefit the family by at least that amount.

4. Overview of More Sophisticated Approaches to Leave Desired Amount to Credit Shelter Trust AND Take Advantage of $3.0 Million Spousal Basis Adjustment. There are two main approaches to coordinate with leaving the desired amount to the credit shelter trust and taking full advantage of the $3.0 million spousal basis adjustment. (1) Leave all of the estate to a QTIP trust, and rely on QTIP elections, and basis adjustments to cause the QTIP trust either to avoid estate inclusion in the surviving spouse's estate or to qualify for the marital deduction if the estate tax is reinstated, and to rely on disclaimers to cause assets that do not need to remain in the QTIP trust for tax purposes (such as qualifying for the $3.0 million spousal basis adjustment) to pass to a trust with more flexible terms for the spouse and the family. This approach is simpler from a drafting perspective than using complicated formula clauses, but relying on disclaimers has several significant disadvantages including the inability of the disclaiming spouse to keep a testamentary limited power of appointment and the danger of an inadvertent acceptance precluding a disclaimer. (2) Use formulas (or described specific amounts) to leave the desired amounts to the credit shelter trust and the QTIP trust (or to the spouse outright). These formulas may leave assets that could utilize the

$3.0 million basis adjustment and may address whether the maximum or minimum current value would be included in that bequest (i.e., whether assets with the most appreciation or least appreciation would be chosen in funding a bequest to utilize the basis adjustment).

5. Use QTIP Trust Bequest. A key to maximizing planning flexibility during this time of uncertainty is to use a QTIP bequest for the spousal bequest (rather than an estate-type trust or outright bequest to the surviving spouse). This is true for two major reasons.

First, assets in a QTIP trust for which an estate tax marital deduction is not allowed at the first spouse's death are not includible in the surviving spouse's estate under § 2044. I.R.C. § 2044(b); Treas. Reg. § 20.2044-1(a). Therefore, if there is no estate tax in 2010 when the first spouse dies, and all of the estate is left to a QTIP trust, and if the estate tax is reinstituted before the surviving spouse dies, there should be no inclusion of the QTIP assets in the surviving spouse's estate. If the estate had been left outright to the surviving spouse at a time when there is no estate tax but the estate tax is reinstituted before the surviving spouse's subsequent death, the assets would be subject to estate tax at that time. In effect, the QTIP would act as a credit shelter trust.

Second, there is considerable complexity introduced into the planning process to assure that the estate qualifies for the $3.0 million spousal adjustment. Leaving all of the estate to a QTIP trust means that the assets would qualify for the $3.0 million spousal basis adjustment (in the event that carryover basis is not repealed retroactive to January 1, 2010).

Some commentators have suggested leaving the entire estate to the QTIP trust, including even tangible assets and the residence. A possible effect of leaving the residence to the QTIP trust is that a subsequent sale by the QTIP trust may not qualify for the $250,000 gain exclusion on the sale of a principal residence under § 121(d)(11). Following the death of an individual, it allows the estate, an individual beneficiary ("who acquired such property from the decedent (within the meaning of section 1022)") or a revocable trust to take advantage of the $250,000 exclusion. A sale by the QTIP trust would not literally meet any of those requirements. If the QTIP trust later makes a distribution to an individual who sells the asset, perhaps the asset would be treated as having been received from the decedent, but that result is doubtful.

A disadvantage of leaving all of the estate to a QTIP trust is that it is rather inflexible and does not permit distributions directly to descendants. If the spouse wanted to transfer assets from the trust to the children, the spouse would have to receive a distribution and make a gift to the children. An alternate method for transferring value to the children on a gift tax free basis while the spouse is alive is to arrange for the spouse to purchase a portion of the children's remainder interest. When §2519 applies to a QTIP, the IRS takes the position that the purchase by the spouse of a remainder interest is a taxable gift. (See Rev. Rul. 98-8, 1998-1 CB 541.) Section 2519 will not apply to a testamentary QTIP created by a 2010 decedent because no marital deduction would be permitted for property transferred to it. As a result, the spouse should not be treated as having made a taxable gift of the purchase price. Additional ways of achieving flexibility are discussed below.

6. <u>QTIP Trust With Clayton Provision or Authority to Add Beneficiaries If Marital Deduction Not Needed — Does Not Work to Qualify Trust for $3.0 Million Spousal Basis Adjustment</u>. Under the "Clayton trust" regulation, the terms of the marital trust may be disregarded under the trust document (for example, to include descendants as discretionary beneficiaries, to delete the mandatory income distribution to the spouse requirement, and to give the spouse a lifetime special power of appointment) if the executor does not make a QTIP election for the marital trust. Reg. § 20.2056(b)-7(d)(3). A typical "Clayton trust" clause provides that the provisions of the QTIP trust would be revised to the extent that the executor does not make the QTIP election for the trust. Implementing that type of clause could be problematic for decedents dying in 2010 when there is no estate tax and no estate tax return will be filed.

   More specifically, the regulation provides the converse."[A] qualifying income interest for life that is contingent upon the executor's election under § 2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse." Presumably, the clause could be drafted to provide that if no estate tax return is filed on which the executor makes the QTIP election within a specified period, the terms of the trust would revert to the credit shelter trust terms. The problem with that approach is that the definition of a "qualifying income interest for life" that qualifies for the $3.0 million spousal adjustment under § 1022(c)(5) does not include the concept of an election. If there is any concern that there may be more than $1.3 million of appreciation in the client's estate, for which the additional $3.0 million spousal adjustment would be important, Clayton provisions for the QTIP trust cannot comfortably be used, without employing a complicated formula approach directing that if carryover basis applies, the terms of the QTIP would be relaxed only for the amount in excess of a defined formula amount of assets to qualify for the $3.0 million spousal basis adjustment. (That kind of formula can be quite complicated, because the value of the assets to which the provision would apply could vary dramatically, depending on how much inherent appreciation there is in the assets and other factors such as the amount of the decedent's unrealized losses at death and his or her unused realized capital losses and net operating loss carryovers.)

   Another approach may be to give an independent party the authority to add potential beneficiaries to the QTIP trust to the extent that the existence of the power will not jeopardize the federal estate tax marital deduction. If there is no federal estate tax applicable to the decedent's estate, that authority would permit the flexibility to broaden the base of beneficiaries. However, such a provision would likely disqualify the trust for any available state marital deduction (if the state recognizes QTIP marital deductions). Furthermore, such a provision may also endanger qualification for the $3.0 million spousal basis adjustment.

7. <u>QTIP Trust With Disclaimer</u>. The will or revocable trust could leave all of the decedent's estate to a QTIP trust, and provide that any assets disclaimed by the spouse would pass to a bypass trust having the spouse as a potential beneficiary (or the will could provide that disclaimed assets would pass to the decedent's children or trusts for children.) The spouse could then disclaim any assets in excess of the amount needed for the $3.0 million spousal basis adjustment. If desired, the spouse could also disclaim as to any assets for which a marital deduction is not needed at

the first spouse's death (which might be all of the remaining assets in the trust for which the $3.0 million spousal adjustment is not important) if there is no estate tax that applies to the decedent's estate.

In light of the fact that a permanent repeal of the estate tax, with a continued carryover basis system, seems highly unlikely at this point, all of the carryover basis rules (and the attendant complexity on the planning) will apply only to estates of persons who die in 2010. This is another reason that it might not make sense to include complex formula funding provisions, based on the amount of assets needed to fully utilize the spousal adjustment, but instead to rely on the simplicity of the "all to QTIP trust/disclaimer" approach.

To utilize this type of planning, it will be very important to include a clause providing where the disclaimed assets will pass, and that assets disclaimed from the QTIP will pass to the credit shelter trust, perhaps to a special portion of the credit shelter trust with special provisions applying to that portion (i.e., the spouse would have no limited power of appointment over that portion). Under the disclaimer regulations, the spouse could disclaim using a formula amount, to provide a "savings clause" against disclaiming "too much" and generating an estate tax at the first spouse's death if there is an estate tax that applies to the first spouse's estate. Reg. § 25.2518-3(d), Ex. 20. It may be possible to fashion a formula disclaimer regarding the $3.0 million spousal adjustment provision as well, but that could be very complicated because the amount of assets to fully utilize the basis adjustment depends on which assets are selected for that purpose and the amount of appreciation in those assets.

The spouse could disclaim as to specific assets, as long as the disclaimed assets actually "leave" the trust and pass to someone other than the disclaimant. Reg. § 25.2518(a)(2). (A removal of the disclaimed property to another trust under the same instrument is sufficient. Ltr. Rul. 8951041.) Various letter rulings have approved disclaimers of percentage undivided interests, even though the executor could use his discretion in selecting which assets would fund the disclaimed portion, e.g., Ltr. Rul. 8652016, but that discretionary authority is implicit in many rulings that have approved formula disclaimers. E.g., Ltr. Rul. 200420007 (approved disclaimer of fractional share of residuary estate by child, with disclaimed assets passing to foundation; numerator of fraction is $X and denominator is value of residue determined on the basis of values, deductions, and other information reported on the federal estate tax return). The spouse could disclaim a pecuniary amount, or a "reverse pecuniary amount" (i.e., everything in excess of $X.) Reg. § 25.2518-3(c). The disclaimed assets can pass into a trust having the spouse as a beneficiary. I.R.C. § 2518(b)(4)(A). The surviving spouse can serve as a fiduciary over the disclaimed assets as long as he or she does not retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Reg. § 25.2518-2(d)(2). The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Reg. § 25.2518-2(e)(1)(i), § 25.2518-2(e)(2), & § 25.2518-2(e)(5)(Ex. 12). In effect, the spouse has a great deal of flexibility in making disclaimers.

Disadvantages. There are several disadvantages of relying on the disclaimer approach. (1) The most important is that the spouse may refuse to disclaim assets, even though a disclaimer would be appropriate based on the tax situation.

However, that is much more of a concern when property passes outright to a spouse, and when the spouse may not want to give up full ownership of the asset. (2) Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a limited power of appointment over disclaimed assets. Reg. § 25.2518-2(e)(2) & § 25.2518-2(e)(5)(Ex. 5). To some, that is a significant disadvantage because the "power to disappoint" can give the surviving spouse considerable influence over the remainder beneficiaries. However, a family member other than the surviving spouse-disclaimant (such as the spouse's brother or sister) could have a power of appointment that could be exercised at the spouse's death (or earlier if that is desired). (3) In addition, there is the risk that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible, or that the spouse dies before signing a written disclaimer. Estate of Chamberlain, 87 A.F.T.R.2d 2001-2386 (9th Cir. 2001), *aff'g by unpub'd order*, T.C. Memo 1999-181. See Zaritsky, Disclaimer-Based Estate Planning — A Question of Suitability, 28 EST. PL. 400 (Aug. 2001).

8. Formula Based Approaches — Overview and Complexity of Coordination With $3.0 Million Spousal Basis Adjustment. Formula based approaches could be used, taking into consideration at least two factors: (1) Leaving the desired amount to the credit shelter trust based on whether there is or is not an estate tax (which could be all of the estate or some described lesser amount to assure that the spouse receives a certain amount of assets directly or in his or her own trust); and (2) leaving the amount "needed" to qualify for the $3.0 million spousal basis adjustment to the surviving spouse or to a QTIP trust which might operate only with respect to estate assets for which the appreciation cannot be "covered" by the $1.3 million basis adjustment or by the surviving spouse's one-half of community property.

   Using formulas to define the amounts passing to various recipients, including the QTIP trust of a sufficient amount to fully utilize the $3.0 million spousal basis adjustment (at least to the extent needed to fully adjust the basis of the estate property) can be quite complex. The complexity derives from the fact that the amount of assets that must be left to the trust to fully utilize the $3.0 million basis adjustment varies dramatically based on which assets are chosen for that purpose and how much appreciation there is in those assets. A direction to fund the QTIP with as much or as little value as possible to fully utilize the $3.0 million basis adjustment in effect directs exactly which assets to use to fund the bequest (and presumably takes away the ability of the executor to choose to sell those assets to raise cash for paying administration expenses.) Furthermore, if that approach is used and the planner models what assets will likely pass to the QTIP to satisfy the formula clause, it is possible that the results may change dramatically over just several years based on investment performance of the assets.

   Some planners have a great deal of concern about using formulas based on basis adjustments. The entire value could be left in a QTIP trust if there is not a great deal of appreciation. Is the basis step-up issue worth running the risk of not being able to avoid estate inclusion at the surviving spouse's death of a potentially very large part of the estate?

   Furthermore, such formulas could lead to difficult administration issues. It is hard enough to fund bequests based on their market values, let alone based on basis determinations which may be significantly more uncertain.

Detailed planning considerations regarding carryover basis issues are discussed in Section XVII of this outline, below.

9. Maximizing Credit Shelter Trust. Many clients would probably prefer first to fund as much value into the credit shelter trust, in order to shield the assets from estate inclusion at the surviving spouse's subsequent death and to maximize planning flexibility (such as being able to include descendants as discretionary beneficiaries and not having to give the spouse a mandatory income interest). An approach to accomplish this would be to use a series of three bequests: (1) First, a bequest to the credit shelter trust of the maximum value that would utilize the $1.3 million basis adjustment (i.e., using the assets that have the least appreciation and all of the income in respect of decedent assets); (2) Next, a bequest to the QTIP trust of the minimum amount of assets that would fully utilize the $3.0 million spousal basis adjustment (i.e., using the portion of the remaining assets with the most appreciation); and (3) The balance to the credit shelter trust. Observe that if all of the estate passes to the credit shelter trust under the first step, that means that all of the appreciation in the estate can be covered by the $1.3 million basis adjustment and the $3.0 million spousal basis adjustment is not needed.

   Giving the surviving spouse considerable powers over and interests in the credit shelter trust will facilitate making the client comfortable with this approach. These would include (1) naming the spouse as a co-trustee or as a sole trustee (with appropriate restrictions on distributions so that the spouse does not have a general power of appointment under section 2041 over the credit shelter trust if the estate tax applies at the time of the spouse's subsequent death); (2) giving the spouse a testamentary limited power of appointment over the credit shelter trust; (3) giving the spouse an inter vivos limited power of appointment over the credit shelter trust; (4) naming the spouse as the sole or at least the preferred beneficiary of the credit shelter trust; (5) including specific precatory directions to the trustee (other than the spouse) to be extremely generous in making distributions to the spouse if the assets passing to the credit shelter trusts exceed X% of the estate; (6) giving a trustee other than the spouse, or a "trust protector" the authority to make distributions of as much or all of the trust outright to the spouse as the trustee or trust protector deems to be in the best interest of the spouse, and (7) providing that the surviving spouse would no longer be a beneficiary if the spouse remarried.

   A multiple credit shelter trust approach may be helpful. The will could specify that if more than X% of the estate is passing to the credit shelter trust, a defined portion (percentage or amount) of the credit shelter trust would be segregated into a separate trust. One trust would be the classic credit shelter trust for the benefit of the surviving spouse and descendants (or perhaps primarily for the benefit of the descendants). The second trust would be for the exclusive (or primary) benefit of the spouse, and the spouse would be given some of the "maximum control" features described in the preceding paragraph.

10. QTIP Formula Bequests. Sample QTIP formula bequests for your consideration if a client does not want to rely on the simplicity of an All to QTIP/Disclaimer approach, to make use of the $3.0 million spousal adjustment, are provided below (based on forms graciously provided by Mickey Davis, Houston Texas). (Observe that if the client wishes to maximize the amount passing to the credit shelter trust as described in the preceding paragraph, these clauses could be adjusted to apply

after the initial bequest to the credit shelter of the largest amount, to which basis adjustment can be applied.)

A. *<u>Simplest Approach</u>: If I die at a time when the federal estate tax is not applicable to my estate but Section 1022 of the Code is applicable, [I give to the Trustee of the QTIP Trust] all of my interest in any assets passing under this Will the adjusted basis of which is less than their fair market value at the date of my death, if any.*

B. *<u>Approach Using QTIP Trust For Assets Selected by Executor to Qualify for $3.0 Million Spousal Basis Adjustment</u>: If I die at a time when the federal estate tax is not applicable to my estate but Section 1022 of the Code is applicable, and the unrealized appreciation of the assets in my estate for which a basis adjustment could be permitted under Section 1022 of the Code exceeds the amount otherwise allowed by Section 1022(b)(2) of the Code, [I give to the Trustee of the QTIP Trust] all of my interest in those assets passing under this Will selected by my Executor the adjusted basis of which is less than their fair market value at the date of my death, that would not otherwise be eligible for a basis adjustment but for Section 1022(c), if any.*

C. *<u>Approach Directing Minimum Amount to QTIP Trust to Fully Utilize $3.0 Million Basis Adjustment (the underlined phrases address the minimum bequest matter; Realize that using this approach mandates the assets that would pass to the QTIP Trust and what assets could not be sold to pay administration expenses)</u>: If I die at a time when the federal estate tax is not applicable to my estate but Section 1022 of the Code is applicable, and the unrealized appreciation of the assets in my estate for which a basis adjustment could be permitted under Section 1022 of the Code exceeds the amount otherwise allowed by Section 1022(b)(2) of the Code, [I give to the Trustee of the QTIP Trust] all of my interest in those assets passing under this Will having the lowest combined value as of the date of my death as finally determined for federal tax purposes, that have sufficient unrealized appreciation to fully utilize the basis adjustment permitted under Section 1022(c), if any. The purpose of this gift is to take maximum advantage of the basis increase allowed under Code Sec. 1022(c) if I die when the carryover basis rules are in effect, but to minimize the amount of property passing to the Marital Deduction Trust, and I direct that this provision be construed to achieve that result.*

<u>Considerations for Alternative B</u>. Query whether there may be any marital deduction qualification issues with a clause that provides this much discretion to the executor? The executor might have the flexibility of funding this bequest with $100 million (if there are $100 million worth of assets in the estate having a basis of $97 million) or $3.0 million (if there are $3.0 million of assets in the estate with a basis of zero.

Consideration should also be given to selecting an executor to exercise this power who does not have an economic interest in estate assets that would be affected by the manner in which he or she exercises the election power. If a person with such an interest exercises the power in a manner adverse to his or her own interests, there may be gift tax implications.

Exoneration provisions are appropriate for the executor if the executor has extremely wide discretion in selecting assets to receive the basis adjustment. This type of provision would be especially important for a clause similar to Approach B, in which the total value of assets passing to the QTIP Trust depends on the assets selected by the executor and whether they have a high or low amount of appreciation.

Exoneration. *I authorize my Executor in the Executor's sole and absolute discretion to make any election or allocation to adjust the federal income tax cost basis of assets passing as a result of my death to the extent authorized by law, whether or not those assets pass under my will, by allocating any amount by which the basis of assets may be increased. My Executor shall be under no duty to allocate basis increase exclusively, primarily or at all to assets passing under this will as opposed to other property passing as a result of my death, or to allocate basis equally or pro rata among various recipients of those assets. Neither any such allocation nor any failure to make such an allocation shall cause my Executor to be liable to any person.*

Considerations for Alternative C. Observe that further guidance may be needed for estates with community property, because the $3.0 million spousal adjustment generally can be allocated to the surviving spouse's one-half of community property. See Section V.E.7.f of this outline. The client with community property may not need to leave anything to the QTIP Trust to be able to fully utilize the $3.0 million spousal adjustment (if there is $3.0 million of appreciation in the surviving spouse's one-half of community property).

11. Further Formula Limitations. Further limits could be added to the formulas described above. For example, the bequest could put a "cap" on the amount of the estate that would pass to the credit shelter trust (so that the entire estate would not pass to the credit shelter trust under a "maximum amount that can pass without estate tax" clause as the exemptions increase or if the estate tax remains repealed.) Alternatives would include (1) a dollar cap, (2) a percentage cap, (3) a cap based on the greater of a dollar amount or a specified percentage, or (4) a cap based on the lesser of a dollar amount or a specified percentage, or (5) other creative formulations.

For example, a formula credit shelter pecuniary bequest (or the numerator in a formula credit shelter fractional bequest) could include the following after the existing formula language: "*provided that the determined amount shall not exceed one million five hundred thousand dollars ($1,500,000).*" Howard Zaritsky suggests adding language to clarify the testator's intent: "*I recognize that leaving only one million five hundred thousand dollars ($1,500,000) as the Estate Tax Exemption Share may, in some cases, increase the estate taxes due at my spouse's death, but I choose to impose this limitation on the Estate Tax Exemption Share in order to assure that my spouse receives an amount that I believe to be sufficient.*"

12. Consider State Death Taxes in Credit Shelter Trust Bequest Formula. Planning in light of state estate taxes will be determined on a state by state basis. Depending on the precise wording of state estate tax laws, some states may not have a state estate tax when there is no federal estate tax (although one might anticipate that the state legislatures may change the wording of those provisions so as not to lose the revenue).

One issue is whether a state marital deduction will be allowed for assets passing to a QTIP trust, even though there is no way to make a QTIP election for federal tax purposes for decedent dying in 2010. Hopefully the states will allow a marital deduction for assets passing to a QTIP trust in 2010. For example, New York allows an estate to use the alternate valuation rules even if the estate is not required to file a Form 706 and therefore could not satisfy the requirements of § 2032, and this may suggest that New York would permit the alternate valuation (and marital deduction) for state purposes during 2010. <u>See</u> Blattmachr, Gans, Zaritsky & Zeydel, <u>The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010</u>, 112 J. TAX'N n. 39 (February 2010). However, this result is not totally clear.

> "It would be improper for a state that bases its estate tax on the federal estate tax law to disallow a marital deduction allowed by the 'old' federal estate tax regime that it is following. Nevertheless, there is a risk that a decedent who dies in 2010 will not be allowed a QTIP election for state death tax purposes." Blattmachr, Gans, Zaritsky & Zeydel, <u>The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010</u>, 112 J. TAX'N (February 2010).

Indeed, New York has released guidance (TSB-M-10(1)M) explaining how an estate may elect to take a marital deduction for "qualified terminal interest property" for New York State purposes when no federal estate tax return is filed.

To make sure that a marital deduction is allowed for state purposes, one alternative would be to leave the assets outright to the spouse or into a general power of appointment trust. The disadvantage of doing so is that those assets would be subject to federal estate tax at the surviving spouse's subsequent death, whereas they may not have been subject to federal estate tax at the spouse's subsequent death under § 2044 if they had passed into a QTIP-style trust in 2010 when the estate tax does not apply. The commentators cited above concluded that "[i]n all, potential payment of state estate tax may be a small price to pay to obtain federal estate tax exclusion." <u>Id</u>.

If the state allows a state-only QTIP election, the planning is considerably easier (assuming the state-only QTIP election is recognized during 2010 when the federal estate tax and its QTIP election do not apply). (Eleven states currently allow state-only QTIP elections: Connecticut, Indiana, Kentucky, Maine, Maryland, Massachusetts, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, and Washington.) The excess value over the state exemption amount can be left to a QTIP trust for which the state-only QTIP election is made, to avoid state estate tax, while the amount in such trust will not be included in the surviving spouse's estate for federal estate tax purposes at his or her subsequent death. Indeed, the entire estate could be left to the QTIP trust because if the federal estate does not apply in 2010, there should be no estate inclusion for federal estate tax purposes under §2044 at the surviving spouse's subsequent death.

If the state does not recognize state-only QTIP elections, the client will have to decide whether to leave assets to the credit shelter trust in excess of the state exemption to save federal estate taxes at the surviving spouse's subsequent death, even though doing so will generate a state estate tax at the first decedent-spouse's death. The client may decide to leave assets to a credit shelter trust only up to the amount of the state exemption amount, to the extent that the state does not have a complete marital deduction, to avoid state estate taxes at the first spouse's death. An example of such a clause is as follows:

> *"My 'Estate Tax Exemption' means the largest amount that can pass to the Family Trust as a Formula Gift without increasing my federal estate tax, or if I die when there is no federal estate tax, without increasing my state death tax if my state's death tax law permits an unlimited exemption or deduction for transfers to a surviving spouse and an exemption or credit against the state death tax regardless of the person to whom property passes, and shall mean my entire estate, to the extent not effectively disposed of by the foregoing provisions of this document, if there is no federal estate tax or state death tax in effect at the time of my death."* Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act — More Than You Can Count, 95 J. TAX'N 74, 86-87 (Aug. 2001)

Alternatively, the client may want to leave assets to the credit shelter trust even in excess of the state exemption amount, in order to save estate taxes at the surviving spouse's subsequent death, in light of the fact that the federal tax is substantially greater than the state tax. However, if the client has made the decision in the past to leave the entire federal exemption to the credit shelter trust even though that may mean paying state estate tax, the effects of that decision should be revisited in light of the fact that the entire estate may now pass to the credit shelter trout, depending on the wording of the formula bequest. For example, New York has a $1,000,000 state exclusion amount, and the state tax on leaving $3.5 million to a credit shelter trust is $229,200. The client may be very willing to pay $229,200 of tax to be able to get a full $3.5 million in the bypass trust (representing a 6.5% rate of tax on the $3.5 million). However, if the client has a $25 million estate that would pass entirely to a credit shelter trust, the state tax would increase to $3,446,800 (representing a 13.9% tax on the $25 million). The client may decide to leave some, but not all, of the excess of the estate over the $3.5 million amount if the client dies in 2010 when the federal estate tax does not apply.

XIV. TRANSFER PLANNING OPPORTUNITIES

A. General Gift Tax Effects. Of course, gifts in excess of the donor's $1 million exemption and $13,000 annual exclusions will be subject to gift tax, but clients who plan to make large gifts anyway should consider doing it early in 2010, when there is a chance that they may pay a 35% gift tax rather than the 45% top rate that might be reinstated and the 55% top rate that will apply beginning in 2011.

There is a concern that the Congress may retroactively impose a 45% rate after a gift is made. One strategy to reduce the impact of such a change is to make net gifts, so that the additional tax would itself reduce the gift amount. Another approach is to make a gift by formula, limited to amounts for which a 35% gift tax rate is applicable. (See Section XV.H below regarding formula clauses for transfers with GST tax impacts.)

If the 45% gift tax rate is retroactively reinstated, and if under applicable state law, Carlyn McCaffrey points out that the gift is rescindable because the donor made the gift with the mistaken belief that the gift tax rate was only 35%, the donor may be able to rescind the gift and receive a gift tax refund. See Neal v. United States, 187 F.3d 626 (3rd Cir. 1999) in which the Third Circuit permitted a gift tax refund for gift taxes paid on a rescinded release of a contingent reversionary interest in a trust, a rescission that became unnecessary with the retroactive repeal of §2036(b). See also Berger v. United States, 487 F. Supp 49 (Pa. 1980) (rescinded gift not taxed); cf. Rev. Rul. 80-58, 1980-1 C.B. 181; Ltr. Ruls. 200613027, 200701019, 200911004 (income rulings relying on rescissions to undo transactions).

Keep in mind that the Administration proposes to dramatically change the rules regarding valuation discounts. If there is an estate and gift tax reform package adopted this year, it could include that provision. If there is no legislation, there is the possibility that the IRS will issue regulations under § 2704 that would place significant restrictions on valuation discounts on entities that are valued on the basis of their liquidation value (such as family limited partnerships holding marketable securities or other assets other than operating businesses.) However, that project has been on the IRS "business plan" for seven years and some commentators believe the IRS may believe that the regulations go further than authorized by the current statute, and that the regulations will not be issued until there is further §2704 legislation To be sure of being able to take advantage take advantage of the lower 35% rates in 2010 and to avoid possible future restrictions on valuation discounts, clients should consider make desired gifts and sales as early in the year as possible.

While we think of having a gift "exemption" of $1.0 million, we actually have a gift tax credit of an amount that covers $1.0 million of gifts. Having a credit rather than an exemption system has an interesting impact this year when the gift tax rate has lowered to 35%. An individual who has made taxable gifts before 2010 of more than $500,000 will not be able to make gifts in 2010 of the difference between $1.0 million and the prior taxable gifts. This is because the prior taxable gifts over $500,000 utilized the gift tax credit at greater than the 35% rate that applies in 2010. For example a donor who has made taxable gifts before 2010 of $961,000 will not be able to make additional gifts in 2010 without paying gift tax.

This same concept works in reverse. A donor who has made no taxable gifts in prior years and makes a $1.0 million gift in 2010 can make an additional $36,000 of gifts after 2010.

B. Inter Vivos QTIP Trusts.

1. Goal. Using an inter vivos QTIP trust may allow a person to make a transfer and postpone the time of deciding whether to treat the transfer as a completed gift (for example, to take advantage of the 35% gift tax rate if the gift tax rate is not increased retroactively, especially if the assets appreciate substantially in value after the time of the transfer). The ability to defer making the decision during this time of uncertainty, coupled with the significant rate differential makes this strategy even more appealing than in the past. (A 35% gift tax rate translates to 25.9% tax inclusive equivalent. For example, if a person died owning $100.00 and paid an "equivalent" estate tax of $25.90 and left $74.10 to children, that would be the same amount as if the person made a gift of $74.10, and paid a gift tax of 35%, or $25.90.) The disparity between a 45% (or even higher) estate tax rate and a 25.9% rate is quite significant.

The decision of whether to treat the transfer as a taxable gift (or whether it qualifies for the marital deduction) could be delayed until the due date of the gift tax return, or October 15 of the following year if the gift tax return is extended. (Observe that the QTIP election *must* be made on a timely filed gift tax return, and there is no possibility of getting 9100 relief to make a late election.)

Furthermore, the donee-spouse could trigger a taxable gift by disclaiming the gift within the 9-month disclaimer period if the spouse had not received any distributions from the trust. That might allow more flexibility to dictate where the disclaimed assets will pass, with more flexible provisions than can be included in a QTIP trust.

2. Description. An original donor-spouse [say, for example, the husband] would make a gift to an inter vivos QTIP trust for the spouse (in this example, the wife). Several important tax elections and special tax rules apply to this transfer. (1) The trustee could make a QTIP election (including a formula election) to elect that enough assets qualify for the marital deduction so that no gift taxes are paid on the transfer. (2) Section 2652(c) provides that a trust for which the QTIP election is made may be treated as having been transferred by the original donor-spouse [the husband in this example] for GST purposes by making the "reverse" QTIP election. The ETIP rule does not apply to a QTIP trust if the "reverse" QTIP election has been made. Treas. Reg. § 26.2632-1(c)(2)(ii)(C). (This would be important if the GST tax is restored retroactively in a manner that applies to this trust; otherwise there would seem to be no way to make the reverse QTIP election at a time when there is no GST tax.) (3) The original donor spouse [the husband] can be a contingent remainderman if the donee-spouse [the wife] predeceases the donor-spouse [the husband] without invoking the ETIP rule for GST purposes and without requiring inclusion in the donor's [the husband's] estate if the donor [the husband] should predecease the donee-spouse [the wife]. See Treas. Reg. § 26.2523(f)-1(f), Ex. 11. (4) The Clayton regulations provide that the portion of the assets for which the QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse that would not be in the spouse's estate for estate tax purposes. However, it is not clear that regulation applies for gift tax purposes to an inter vivos QTIP trust, as discussed below.

3. Formula QTIP Election. Furthermore, this strategy may allow limiting the amount of the taxable gift if the donor wishes to put a cap on the amount of gift tax owed as a result of the transfer. Various examples in the regulations reiterate that formula QTIP elections may be used. See Treas. Reg. §§ 20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h) Exs. (7-8). For a discussion of the mechanics of making a formula election, see Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to the least amount possible …"). By using a formula QTIP election, the planner can provide that the QTIP election is made over a sufficient portion of the transferred property so that only a maximum set amount gift tax is payable on the transfer. In this manner, making a formula QTIP election operates much like using a defined value clause — except that the formula QTIP election approach is clearly sanctioned in the regulations and existing rulings.

4. Clayton Uncertainty. The non-elected portion of an inter vivos QTIP should continue to give the spouse a mandatory income interest and permit distributions to no one other than the spouse during his or her lifetime. The Clayton regulation, Treas. Reg. § 20.2056(b)-7(d)(3), is only in an estate tax regulation and not in the the similar gift tax regulation, Reg. § 25.2523(f)-1(b). The gift tax regulation is not a model of clarity, and there would seem to be some uncertainty about this result. Section 25.2523(f)-1(a)(1) of the gift tax regulations states as follows:

"(c) *Qualifying income interest for life* — (1) *In general*. For purposes of this section, the term *qualifying income interest for life* is defined as provided in section 2056(b)(7)(B)(ii) and § 20.2056(b)-7(d)(1)."

On the one hand, this statement would seem to incorporate the "Clayton regulation," because this statement provides that for gift tax purposes, the term "qualifying income interest for life" is defined as provided in section 2056(b)(7)B)(ii) of the Internal Revenue Code. The Clayton regulation is in the section of the regulations describing a "qualifying income interest for life." Therefore, the interpretation of that estate tax statutory term, as including an income interest that is contingent of the existence of a QTIP election, would seem to control for gift tax purposes also. More importantly, the gift tax QTIP statute itself provides that "rules similar to the rules of clauses (ii)… of section 2056(b)(7)(B) shall apply." Section 2056(b)(7)(B)(ii) defines the term "qualifying income interest for life." If the gift tax statute simply makes reference to the statutory definition of "qualifying income interest for life," an interpretation of that statute to include an income interest that is contingent on the existence of a QTIP election would seem to controlling for gift tax purposes also.

On the other hand, the general statement in the gift tax regulation, quoted above, refers not only to section 2056(b)(7)(B)(ii) of the statute, it also refers specifically to § 20.2056(b)-7(d)(**1**) of the regulations. However, the "Clayton regulation" is in § 20.2056(b)-7(d)(**3**). Furthermore, the gift tax regulation specifically restates (as a very similar mirror provision) what is in § 20.2056(b)-7(d)(**2**), (**4**), (**5**), and (**6**), thus suggesting that the omission of 7(d)(**3**) has particular significance, raising the question of whether an income interest that is contingent on whether a QTIP election is made would qualify for the gift tax marital deduction.

C. Marital Trust Transfers. If a client is a beneficiary of a marital trust that will be taxed at his or her death (if the estate tax is reinstituted), another planning possibility is to have the trustee make a significant distribution to the client, and have the client make gifts to children or grandchildren, again planning to take advantage of the possibility of the lower 35% gift tax rate and the ability to make such gifts in long-term trusts that may escape GST tax. This planning technique, however, should be considered only for clients who fully understand the very real possibility that they will owe significant additional taxes (gift and GST tax) if the 2009 tax regime is reenacted retroactively.

D. Charitable Planning Considerations. Carlyn McCaffrey points out the following charitable planning considerations.

1. Make Lifetime Rather Than Testamentary Gifts. The "repeal" of the estate tax highlights the benefits even under pre-1010 law of making charitable gifts during lifetime rather than at death. Lifetime gifts can generate an income tax deduction for the decedent.

2 Gifts to Children To Permit Them To Make Charitable Gifts. Giving to charity at death wastes the opportunity of giving to children and allowing them to make charitable contributions and getting a big income tax deduction. (Of course, there would be no legal obligation on the child to make the charitable gift.)

3. Testamentary Charitable Remainder Trusts. Charitable remainder trusts are tax exempt entities. Treas. Reg. § 1.664-1(a)(1)(i). The regulations to section 664 require that a deduction is allowed under §§ 170, 2055, 2106 or 2522 as a requirement to be a CRT. The only possible section that would apply to

testamentary charitable remainder trusts is § 2055 — but it is not applicable in 2010. Hopefully, the IRS will revise this regulation to permit the creation of testamentary CRTs in 2010. (For clients who want a testamentary charitable remainder unitrust, the client could create a lifetime CRUT, qualifying for an income tax deduction, and make a testamentary addition to it to avoid this issue. This works for CRUTs because they can receive additional contributions.)

4. Testamentary Charitable Lead Trusts. Testamentary charitable lead annuity trusts are often structured so that there is a 100% estate tax charitable deduction for amounts passing to the trust, and amounts may remain to pass without estate taxes to family members at the end of the trust term if the trust has combined income and appreciation in excess of the § 7520 rate. (The IRS and Treasury currently are working on a project to provide sample formula provisions for creation of such CLATs.) Some clients may want to revise instruments with large CLATs if they should die at a time when the estate tax does not apply.

5. Political Action Committees. Transfers to organizations described in § 501(c)(4), including political action committees, are not deductible for estate or gift tax purposes under §§ 2055 or 2522. Prior to this year, special transfer planning considerations were required for making bequests to those organizations in light of the absence of an estate tax charitable deduction. That is not a concern as long as the estate tax does not apply.

XV. GST PLANNING OPPORTUNITIES IN 2010

These comments regarding GST planning opportunities are offered by Carlyn McCaffrey, New York. Carlyn indicates that the major transfer planning opportunities that she is considering during the "gap period" of having no estate or GST taxes relate to GST planning opportunities.

A. Direct Skip Gifts. Consider making gifts to grandchildren or more remote descendants that would be subject to the GST tax as direct skips if the GST tax were imposed on direct skips in 2010. If the GST tax is not reenacted retroactively to January 1, 2010, there would never be any GST tax costs imposed on that transfer. The obvious downside is that there can be no certainty at the time of making such a gift that Congress will not subsequently reinstitute the GST tax retroactively.

If the trust is a skip person trust (only for second generation or more remote beneficiaries), the automatic allocation rule that applied for direct skips before the 2001 Act may apply to cause automatic allocation to have occurred in 2010 under the sunset rule after 2010. IF the planner does not automatic allocation to apply, a return should be filed electing out of automatic allocation.

B. Gifts to Long-Term Trusts That Are Not Skip Persons. Consider transfers to long-term trusts for descendants that are not skip person trusts because one or more non-skip persons have current interests in them. Such transfers would not be subject to the GST tax whether or not the GST tax is retroactively imposed. Because such trusts would be created at a time when the GST tax is not imposed, if the GST tax is reinstituted, they could be grandfathered from the reinstituted tax. Although this is a possibility, if the GST tax is reenacted, whether or not it is reenacted retroactively, it seems unlikely that trusts created during the window of time from January 1 until the legislation is passed would be protected from the tax. No GST tax would be incurred when a contribution is made to such a trust, but a GST tax may apply whenever a distribution is made from the trust to a skip person or when a taxable termination occurs if the GST tax is reinstituted. That may be the result, even if the GST tax is not reinstituted retroactively to January 1, 2010. A downside to making gifts to long-term trusts this year is that there is no GST exemption available in 2010, but there *may* be the possibility of timely allocating GST exemption to the trust in 2011 GST exemption amount under pre-2001 law ($1.0 million, indexed after 1997, $1,340,000 in 2010). See Section XI.C of this outline.

For irrevocable life insurance trusts, The concern is that no GST exemption allocation can be made in 2010. If the plan is to make late allocations, that should not be a problem. (Observe that no late allocations can be made in 2010 for transfers to ILITs in prior years.) If the client has used less than $1,340,000 of GST exemption previously, and it is a GST trust, the "as if had never been enacted rule" may allow allocation of GST exemption up to that amount (or whatever the indexed GST exemption amount is for 2011). The safest approach is not to waste the ability to use annual exclusion amounts, but to make the gifts in a way so that when the uncertainty over, the gifts can be added to the insurance trout. Step 1. Create a new ILIT, the beneficiary of which is the old ILIT. Step 2. To pay the premiums, client lends money to the original ILIT trust to make the payments. Step 3. Once the legislative uncertainty is over, if there is available GST exemption, the trustee of the new trust can contribute the assets to old trust, and it can then repay the debt.

If loans are made to an irrevocable life insurance trust in 2010 so that the trust can pay premium payments, be aware that split dollar principles may apply if the loan is to be repaid from the policy (or there is a presumption to that effect). In that case, be aware that (1) payment ordering rules apply so that loans must be repaid in the order in which the loans were made, and (2) if the loan is nonrecourse, a statement must be filed with the income tax returns of the lender and borrower, signed by both parties, representing that a reasonable person would expect that all payments under the loan will be made, Reg. §1.7872-15(d).

If an additional contribution is made to a trust in 2010 without any GST exemption allocation, does the inclusion ratio change? Yes., Section 2664 merely says that chapter 13 does not apply to GST transfers. The contribution of assets to a trust is not a GST transfer (unless the trust is a skip person trust), so chapter 13 applies to the contribution to the trust, thus requiring a change to the inclusion ratio (unless a timely allocation can somehow be made in 2011).

C. <u>Gifts to Skip Person Trusts.</u> Another planning alternative is to make a gift to a trust for grandchildren, or more remote beneficiaries. The transfer in 2010 will not be subject to a GST tax on a direct skip tax unless the GST tax is reenacted retroactively. However, when distributions are made to grandchildren in a later year in which the GST tax applies to GSTs, there is the possibility that the distribution would be treated as a taxable distribution. Ordinarily, a distribution to a grandchild from a trust that has been funded with gifts that are direct skips are protected from GST tax by the generation "move-down" rule of §2653(a). The "move-down rule" generally provides that if "there is a generation-skipping transfer" — such as a direct skip transfer to a trust for grandchildren and more remote descendants — and the property remains in trust, the trust will be treated for purposes of applying the GST tax to future transfers as if its transferor were assigned to the first generation above the generation of those beneficiaries who have present interests in the trust who are assigned to the highest generation. I.R.C. § 2653(a). Therefore, future distributions to a grandchild would not be taxable distributions, but distributions to a great-grandchild would be.

The possible problem with this planning technique is that the move-down rule may not apply because §2664 provides that chapter 13 does not apply to any GST that occurs after

December 31, 2009. Because the gift to the grandchildren's trust was a direct skip that occurred after December 31, 2009 and because §2653(a) is part of chapter 13, it is possible that §2653(a) does not apply to the gift. The contrary argument is that the sunset provision says that all the provisions of the Code shall be applied to GSTs as if the 2001 Tax Act "had never been enacted." If the 2001 Tax Act had never been enacted, the transfer to the trust in 2010 would have caused the generation assignment of the transferor to move down to his or her children's generation for purposes of determining whether future distributions are taxable distributions.

See Section XI.D.6 of this outline regarding the application of the zero inclusion ratio rule of §2642(c) for certain direct skip nontaxable gifts.

D. <u>Planning Opportunities for Existing Trusts That Are Not GST-Exempt</u>. No GST tax will be imposed on a trust that is subject to the GST tax if the interest in the trust of a beneficiary terminates this year in a taxable termination. Similarly, no GST tax will be imposed on a skip person who receives a distribution this year from such a trust. However, there is a significant risk that the GST tax will later be enacted retroactive to January 1, and the GST tax would apply to GST transfers that took place before the enactment unless the courts hold that the retroactive application of the tax is unconstitutional. In light of the uncertainty, trustees may be wary of making large transfers from non-exempt trusts unless a GST tax is otherwise expected in the relatively near future. Defined value clauses may protect against that uncertainty.

E. <u>Planning Opportunities for Existing Trusts That Are GST-Exempt</u>. Existing trusts that are GST exempt on account of the allocation by their transferors of GST exemption in excess of, the maximum amount of GST exemption that would have been allowed under the tax law as it existed prior to the 2001 Act may lose such excess GST exemption beginning in 2011. For example, suppose T had allocated $3.5 million of her GST exemption to a trust with a value of $3.5 million in 2009. In 2010, this trust has an inclusion ratio of zero. In 2011, if Congress does not act to change chapter 13, this trust may have an inclusion ratio of 62% because the amount of GST exemption that could have been allocated to the trust in 2009 if the 2001 Act had never been enacted is only $1,330,000 (i.e., $1.0 million indexed after 1997).

To protect against this possibility, trustees may want to consider making taxable distributions from these trusts now. Such transfers should not be subject to the GST tax even if the law is changed to apply chapter 13 retroactively to 2010 GSTs because, in that event, the amount of GST exemption previously allocated to the trust is unlikely to change. Such distributions should be made outright to skip persons rather than to skip person trusts because of the uncertainty, discussed above, that the move-down rule will apply to 2010 generation-skipping transfers.

F. <u>Planning Opportunities for Existing Trusts That Have Benefited From Provisions in the 2001 Act</u>. Trusts that have benefited from the deemed GST exemption allocation rule of §2632(c) or from the retroactive GST exemption allocation rule of §2632(d), and trusts that have received late GST exemption allocations under §2643(g) may lose the benefit of those allocations starting in 2011 because, if the 2001 Act had not been enacted, these GST exemption allocations would not have occurred. Similarly, trusts that have been the subject of qualified severances under §2642(a)(3), may be reconnected with their severed counterparts starting in 2011 for all purposes of the GST tax. If that occurs, the benefit of a zero inclusion ratio that one of the severed trusts might have enjoyed will be lost if the trust with which it is reconnected did not have a zero inclusion ratio.

To protect against this possibility, trustees may want to consider making taxable distributions from these trusts now. Such transfers should not be subject to the GST tax even if the law is changed to apply chapter 13 retroactively if the trusts from which the distributions are made have zero inclusion ratios. For the reasons discussed above, such distributions should be made outright to skip persons rather than to trusts that are skip persons.

G. Planning for Outright Transfers to Skip Persons. In many cases outright transfers to skip persons will present non-tax practical problems. In some cases, the skip persons will be minors who lack the capacity to make decisions with respect to investment property. Outright transfers to minors could ultimately require the appointment of a guardian to manage the transferred property. Gifts to accounts under a uniform gifts or transfers to minors act are not a solution because such accounts are treated as trusts for GST purposes under §2652(b). See Treas. Reg. §26.2652-1(b)(2) Example 1. In other cases, the skip person, although adults, lack the sophistication necessary to manage substantial funds or have creditor or marital problems.

One solution that can minimize these kinds of problems is to transfer the trust assets intended to be distributed to a skip person to a limited liability company (an "LLC") managed by a trustee or another reliable person. The trustees would then distribute an LLC interest to the skip person. The manager would make the investment decisions and the LLC shell could provide some protection against the skip person's creditors.

Another solution to the investment management issue and some creditor protection issues that will be available in the case of some transfers to adult skip persons is the use of a self-settled trust. The skip person could transfer the distributed property to a trust for his or her benefit. This would give him or her the benefit of the investment skills of the trustee. In addition, some states will protect the assets of self-settled trusts against the claims of the settlor's creditors.

H. Using Formula Clauses to Protect Against Retroactive Reinstatement. Individuals who would like to take advantage of the possibility that the GST tax will not apply to direct skips made in 2010 but want to hedge against the possibility that Congress will enact a law that applies the GST tax retroactively to 2010 transfers should consider the use of a formula transfer designed to limit the amount of the transfer to the maximum amount that can be transferred free of the GST tax. For example, suppose T would like to transfer $5 million to her grandchild G in 2010 and is willing to pay a gift tax but does not want to pay a GST tax. She might first transfer $5 million worth of investment assets to an LLC managed by another person, such as G's parent C. T could then execute a form of assignment assigning a fraction of her interest in the LLC to G. The form would define the fraction as a fraction with a numerator equal to the lesser of 5 million or the maximum amount that can be transferred as of the date of the transfer free of GST tax (taking retroactive changes in the law into account) and a denominator equal to 5 million. If the GST tax is retroactively reinstated, this fraction should result in a transfer of nothing.

Trustees who would like to make taxable distributions in 2010 but want to hedge against the possibility of a retroactive application of the GST to taxable distributions could use a similar approach.

These types of clauses should not be subject to a public policy attack under Procter. The formula clause is based on the behavior of Congress, not the IRS. There should be no concern that the clause is merely intended to reduce the IRS's incentive to audit returns.

"[I]n the circumstance where formulas are necessitated by the uncertain state of the tax law, the use of a formula would not appear to constitute 'trifling with the judicial process' as proscribed by *Procter.*" See Blattmachr, Gans, Zaritsky & Zeydel, The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010, 112 J. TAX'N (February 2010).

Another approach is to use a "formula allocation" type of transfer, similar to the defined value clause addressed in Petter v. Comm'r, T.C. Memo 2009-280 (2009). As an example, a distribution from a non-GST exempt trust might be allocated to a grandchild to the extent that the distribution would not be subject to any GST tax, but would be allocated to another person (for example, a child or a trust having a child has a potential beneficiary) if any GST tax liability would otherwise be incurred. By its nature, such a clause would take into account any retroactive legislation (even if it did not specifically reference retroactive legislation.) Another example use of such a clause would be for an individual who wants to make a large gift to grandchildren, but wants to hedge against the possibility of retroactive legislation that would subject the transfer to the GST tax. See Hatcher & Koren, Formula Clauses: Hedging Value and Legislative Risks, TAX NOTES (March 15, 2010). Their thesis is that such a formula allocation clause provides the strongest argument against a Procter argument, which the Petter case summarized as a clause that results in the transferor receiving some property back.

Another more complicated, but perhaps safer approach that is available in both cases is the double formula transfer. The double formula transfer is accomplished by a formula transfer to a trust that is not a skip person trust followed by a formula transfer from that trust to an individual skip person. Suppose, for example, that TT, the trustee of a trust with an inclusion ratio of 1, would like to make a distribution to a skip person, G, in 2010 of a 5% interest in an LLC from a trust that permits current distributions to G and to G's parent C. TT would not want to make the distribution if it would attract a GST tax. TT could, if the terms of the trust agreement or local law permit, make a distribution, by an assignment form, to a new trust for the benefit of C and G of a fraction of a 5% interest in LLC. The assignment form would define the numerator of the fraction as the lesser of the maximum amount that can be transferred as of the date of the transfer free of GST tax (taking retroactive changes in the law into account) and the denominator of the fraction as X. This transfer would not be subject to the GST tax even if the GST tax is retroactively imposed on taxable distributions that occur in 2010 and even if the IRS successfully attacked the use of formula clauses of this sort because the new trust would not be a skip person trust. Shortly after this assignment is made the trustee of the new trust makes a transfer of all of its interest in the LLC to G. The second transfer should not be a taxable distribution even if the GST tax is retroactively imposed on taxable distributions that occur in 2010 and even if the IRS successfully attacked the use of formula clauses of this sort because the trustees of the new trust could not transfer any more than it had received from TT.

I. Testamentary Transfers. It is possible that testamentary transfers to trusts in 2010 will not be subject to GST tax in the future, because the "transferor" is the person subject to a transfer tax, and decedents who die in 2010 are not subject to estate tax. The definitions of skip persons and non-skip persons are tied to the definition of transferors. Non-skip persons are everyone other than skip persons, and if skip persons cannot be identified because of the lack of a transferor, perhaps the whole world constitutes non-skip persons, If so, future transfers from the trust would not be subject to GST tax. Inter vivos gifts are not subject to this same possible interpretation because donors are subject to gift taxes in 2010.

XVI. MISCELLANEOUS DRAFTING ISSUES AND PRE-MORTEM/POST-MORTEM PLANNING ISSUES

A. Definition of "Repeal". The estate and GST tax provisions are not actually "repealed" in 2010. Section 2210 simply says that chapter 11 "shall not apply" to the estates of decedents who die after 2009; §2664 says that chapter 13 shall not apply to GSTs after 2009.. Rather than referring to "repeal," a preferable approach would be to draft "if I die when the federal estate tax is not applicable… " Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 129 (2001).

In addition, such clauses should refer to federal, and not state death taxes, because it is likely that many states will continue to have state death tax systems even if the federal estate tax remains inapplicable.

B. Reference to Estate and GST Tax Code Sections That No Longer Apply. Lloyd Leva Plaine has suggested the following definition:

> *"(a) "Code" refers to the Internal Revenue Code of 1986, as amended, and reference to any provision or section of that Code shall be deemed to refer to the provision or section of the federal tax laws, in effect on the date of my death, that corresponds to the provision or section referred to that was in effect at the time of the execution of this instrument. Notwithstanding the provisions of the previous sentence, if there is no provision or section of the federal tax law at the date of my death that corresponds to such provision or section, and if the federal estate tax is not applicable (as defined in Paragraph (b) of this Item) at my death, then [for purposes of determining the amount of property that passes under a provision of this instrument and/or for any other purpose(s), even if not for all purposes or references to a provision or section of the federal tax law, a reference to a provision or section of the federal tax law shall nevertheless be deemed to refer to the provision or section that was in effect at the time of the execution of this instrument or the provision that was in effect immediately before the tax law became inapplicable, if the independent executor or nonbeneficiary trustee, in his sole discretion, determines that such result or results is more consistent with my intention.] [ALTERNATIVE FOR BRACKETED CLAUSE: such provision or term shall be interpreted by the independent executor or nonbeneficiary trustee in such manner as such independent executor or nonbeneficiary trustee considers advisable keeping in mind the general scheme of distribution of this instrument and the purposes for which any trusts created herein are being established.] The provisions of the previous sentence shall not apply if their inclusion in this instrument would cause any property passing under this instrument that would otherwise qualify for the federal estate tax, marital deduction, charitable deduction, special use valuation or Qualified Family Owned Business deduction, to fail to qualify. The independent executor or nonbeneficiary trustee shall not bear any liability for any decision made by such person in good faith pursuant to the power granted to him under the terms of the second sentence of this Subparagraph.*

(b) For purposes of this instrument, the federal estate tax shall be "applicable" at a person's death if the federal estate tax of Subtitle B, Chapter 11 of the Code (Sections, 2001, et. seq.) is then applicable and a federal estate, federal inheritance, or other federal transfer tax is imposed on such person's assets on account of his or her death and shall not be applicable if the federal estate tax of Subtitle B. Chapter 11 of the Code (Sections 2001, et. seq.) is not then applicable and no federal estate, federal inheritance, or other federal transfer tax is imposed on such person's assets on account of his or her death."

Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 135-36 (2001).

C. Marital Deduction "Unidentified Asset" Clause. Formula marital deduction clauses often provide that any assets that would not qualify for the marital deduction must pass to the bypass trust. The "unidentified asset" clause is included because of Regulation § 20.2056(b)-2, which provides that the marital deduction is reduced to the extent that it could be funded with assets that do not qualify for the marital deduction. If there is no estate tax, and therefore no marital deduction, no asset could qualify for the marital deduction, so this clause might be interpreted to leave the entire estate to the bypass trust. Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 133 (2001). The unidentified asset clause is of limited utility, following 1981 when it became possible to make a QTIP election for many types of previously nondeductible terminable interests. The clause should probably be eliminated in many plans, but in any event, give careful consideration of whether to leave this clause in wills and revocable trusts in 2010 as to decedents dying when the estate tax does not apply (and perhaps even afterward).

D. Interpretation of GST Formula Bequest After GST Repeal. When there is no GST exemption, a formula GST bequest (equal to the amount of the testator's remaining GST exemption) is ambiguous. This formula may be interpreted as being a bequest of zero. The instrument should clarify the testator's intent. For example: *"My 'Available GST Exemption' shall mean my entire estate [or other desired amount], to the extent not effectively disposed of by the foregoing provisions of this document, if there is no federal generation-skipping tax in effect at the time of my death."* Blattmachr & Detzel, Estate Planning Changes In the 2001 Tax Act — More Than You Can Count, 95 J. TAX'N 74, 88 (Aug. 2001).

E. General Fiduciary and Interpretation Provisions. Bruce Stone, of Miami, Florida, offers the following clause (in his unique incredible "easy to read" drafting style):

As of the date of execution of this trust agreement [this amendment to my trust agreement], the estate and generation skipping transfer taxes have been repealed, and new rules providing for carryover basis of assets for federal income tax purposes are in effect. Nevertheless, I understand that the estate and generation skipping taxes are scheduled to become effective once again on January 1, 2011. I also understand that those taxes might be reinstated and made effective before January 1, 2011, and perhaps on a retroactive basis. Therefore this trust agreement contains references to provisions of the Internal Revenue Code that may or may not be effective upon by death or upon dates after my death on which distributions are to be made under this trust agreement, references to those provisions are to be *given effect only to the extent that they (or successor provisions) are validly in effect with respect to transfers under this trust agreement.*

If I die when the federal estate and generation-skipping transfer taxes are not in effect, because of the possibility that those taxes might be reinstated after my death and made effective retroactively (and thus perhaps apply to transfers under this trust agreement), I authorize the Trustee to delay or refrain from making distributions under any one or more provisions of this trust agreement until the Trustee in its judgment determines whether those taxes will validly apply to those distributions. The Trustee may set aside or withhold portions of amounts or assets otherwise required to be distributed under this trust agreement in order to pay fees and costs to determine its duties and obligations (including compliance with provisions of existing and anticipated future federal tax laws, and fees to determine or contest the validity of any retroactively reinstated taxes). The Trustee may establish and maintain reserves for the payment of those fees, costs and taxes (including amounts estimated for taxes that may be reinstated retroactively). I understand that the Trustee may determine it to be prudent to sell assets after my death as necessary to establish those reserves, and thereby realize gains that would not be necessary if the estate and generation skipping transfer taxes are not retroactively reinstated and incur income taxes if the carryover basis rules are not repealed retroactively.

Because of the highly complex and uncertain nature of these matters, I intentionally relive the Trustee and its agents from all liability for actions or failure to act in determining how to comply with their duties under state and federal tax law while protecting the beneficial interests of the beneficiaries, even if a court finds the Trustee to have been negligent in its actions or failures to act or in breach of a fiduciary duty, unless the court specifically finds by clear and convincing evidence that the Trustee acted (or failed to act) in bad faith or with reckless indifference to the purposes of the trust or the beneficial interests of the beneficiaries.

I recognize that these uncertainties the Trustee may encounter will significantly increase the effort require for the Trustee to comply with its obligations under state and federal tax law while complying with its fiduciary duties to the beneficiaries, and could increase the exposure of the Trustee to potential liability in complying with those duties. If applicable, I recognize that those factors constitute circumstances that require extraordinary services by the Trustee and its advisers, and I direct that those factors be taken into account in determining reasonable compensation for the Trustee and its advisors.

F. Pre-Mortem and Post-Mortem Planning Considerations Overview.

1. Pre-Mortem Harvesting Losses. Depreciation that would be recognized as deductible under §165 if the asset had been sold before death is added to the $1.3 million basis adjustment. However, if there are not enough gains to offset losses, capital losses are only deductible to the extent of $3,000 per year. Furthermore, there is no tacking allowed (under §1223(11)) for depreciated assets where the basis is the date of death value and is not determined by reference to the decedent's basis. Also, there is the possibility of retroactive reenactment of pre-2010 law, and under prior law it always made sense to harvest losses before death to avoid the step down in basis.

2. <u>Pre-Mortem Transfer From Spouse to Dying Spouse to Use Basis Adjustments</u>. Assets received from a spouse can qualify for the basis adjustments, regardless when made. (There is a three-rule requirement for assets received from anyone other than the spouse.)

3. <u>Set Expectations Regarding Distributions</u>. Beneficiaries of an estate have two questions: What do I get and when do I get it? Set expectations that distributions will be minimized in 2010. There is substantial uncertainty in light of the possibility of retroactive legislation. Current distributions could lock in planning flexibilities. (An exception to that may be in funding pecuniary legacies. As under current law, post-death appreciation will be treated as gain recognition on funding.) Also, retroactive legislation may change the persons entitled to formula bequests. Furthermore, executors will not know for some time whether carryover basis will continue to apply to 2010 decedents, and whether the executor should take the relative bases of assets into account in funding distributions. There should be no distributions under wills with formula bequests until we know "the rest of the story." (That is another reason why it will harder to impose the estate tax retroactively if Congress waits until late in the year to react.)

4. <u>Delay Sales</u>. Consider delaying sales until 2011, because there is the possibility (probably remote) that carryover basis only applies if the assets from the 2010 estate is actually sold in 2010. If the estate tax is reinstituted retroactively, presumably the IRS will be lenient in allowing estate tax payment extensions.

5. <u>Retain Reserve or Use Refunding Agreements In Case of Law Change</u>. If distributions are made currently, retain a reserve or require refunding agreements to satisfy estate taxes in case the estates tax is enacted retroactively. However, it appears that the executor cannot have liability to the IRS for making distributions at a time that the estate tax does not apply, even if the estate tax is imposed retroactively.

6. <u>Fiduciary Investment Concerns</u>. Executors will have the tension of fiduciary concerns with holding on to concentrated positions vs. paying income taxes when selling appreciated assets under a carryover basis system. Hedging strategies may be a possibility for some marketable securities.

7. <u>Compliance</u>. No estate tax returns will be due for 2010 decedents and the carryover basis report under § 6018 will not be due until the due date of the decedent's final income tax return (which could be extended to October 15, 2011). Defer reporting until we have a better idea of how all of this will work out.

8. <u>Disclaimers</u>. Disclaimers may be a way to "undo" some unintended bequests under formula clauses in 2010. The most common reason disclaimers fail is from inadvertent acceptance. Counsel clients "early and often" not to accept benefits.

9. <u>Elective Share</u>. If the bulk of the estate passes to a non-marital trust, leaving the surviving spouse with few assets, the elective share may be very important as a way of getting assets to the surviving spouse. Counsel should advise the spouse to learn about the elective share. That may also be a way of getting assets to the surviving spouse to qualify for the $3.0 million spousal basis adjustment.

10. <u>Carefully Plan Regarding State Estate Taxes</u>. The best strategy, if available, is to make a state permitted QTIP election. Otherwise make calculations of the amount of state estate tax for funding various possible amounts into the credit shelter trust so the client can make the decision of how much to fund to the credit shelter trust

(assuming there are strategies to get the remaining assets to pass to the surviving spouse by disclaimers, construction suits, elective share, etc.)

XVII. CARROVER BASIS PLANNING STRATEGIES

A. Run the Numbers — Is There Even an Issue? The basis adjustment allowed to every estate will be \$1.3 million. Typically, an estate would have to be considerably larger than \$1.3 million to have unrealized appreciation (not counting income in respect of a decedent — or IRD — items) in excess of \$1.3 million. If a client's estate in 2010 will likely have appreciation of well under \$1.3 million, there are no issues at all. All of the assets (except IRD items) can be stepped up to fair market value and all of the carryover basis complexities can be ignored for that client. (This will be the case for many clients.) Furthermore, the \$1.3 million amount will be growing; the \$1.3 million basis adjustment is indexed for inflation using 2009 as the base year. I.R.C. § 1022(d)(4)(A)(ii).

In light of the fact that a permanent repeal of the estate tax, with a continued carryover basis system, seems highly unlikely at this point, all of the carryover basis rules (and the attendant complexity on the planning) applies only to estates of persons who die in 2010.

B. Basis Adjustment Allocation Issue Closely Tied to Distribution Issues.

1. Discretionary Distributions of Low Basis and High Basis Property. Under a carryover basis system, deciding how to divide low basis vs. high basis assets among beneficiaries makes a huge difference in the potential tax costs to the various beneficiaries. This issue is every bit as important, if not more so, than deciding how to allocate basis adjustment among beneficiaries. Executors have dealt with this issue for years, but it has been critical only with respect to deciding how to allocate income in respect of a decedent items or assets that have substantial post-death appreciation. (However, the basis adjustment issue seems to be getting all the attention, perhaps because it is a new issue that planners have not had to consider previously.)

2. Distributions to Spouse. Under the carryover basis regime, assets will have to be distributed to the spouse that have at least \$3.0 million of appreciation to be able to utilize fully the \$3.0 million basis adjustment of assets passing to a surviving spouse or QTIP.

3. Formula Bequest Tied to Basis. One possible planning approach is to use tax driven formula clauses tied to basis issues in determining the amount of various bequests under the will. For example, the testator may want to assure being able to take full advantage of the \$3.0 million spousal basis adjustment, but may want to leave substantial assets for children. A formula clause could leave at least enough to the spouse to take advantage of the \$3.0 million basis adjustment. Many complexities arise in drafting such a formula. For example, does the client want to leave as much value as possible to the spouse under that clause (by funding the bequest with assets that have relatively little appreciation), or does the client want to leave as little as possible to the spouse under this bequest (by funding the bequest with assets that have almost 100% appreciation)?

C. Allocation Issues and Alternatives.

1. Executor Can Allocate Basis Adjustment. The executor can choose which assets will receive the \$1.3 million basis adjustment (for any bequests) and the \$3.0 million basis adjustment (for bequests to a spouse or QTIP). Apparently, the basis may be allocated to any asset included in the decedent's estate, not just assets

passing under the will. See Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 88 (August 2001). For a discussion of the coordination with the trustee of a revocable trust in making this basis adjustment allocation, see Section V.E.3. of this outline.

2. Big Dollar Issue. This decision can mean many hundreds of thousands (or millions) of dollars to the beneficiaries. (The first spouse's $1.3 + $3.0 million adjustment, plus the surviving spouse's $1.3 million adjustment, is a total of $5.6 million of basis adjustment for the couple. At a 20% capital gains tax [the 15% rate applies only through 2010], this would mean $1.12 million of tax savings for the recipients who receive the assets with the stepped-up basis.)

3. Fiduciary Issue. The executor owes fiduciary duties to the beneficiaries and this would extend to the allocation of the basis adjustments. There may be concern with how the adjustment is allocated among beneficiaries under the will (or if any of the adjustment is allocated to assets passing outside the will). See Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 88 (August 2001).

4. Potential Conflicts of Interest. If a beneficiary is the executor, substantial conflicts of interest can arise. Exercise of the discretion in a manner that unduly benefits the executor will be scrutinized. Having an independent or corporate executor will be desirable in many situations to make the basis adjustment allocations and avoid the significant conflicts of interest that would arise if a beneficiary makes those decisions.

5. Exoneration From Liability. In light of the wide discretion and the potential for huge shifts of economic value by the basis adjustment decision, many fiduciaries are maintaining that it is only fair to exonerate the executor from liability for the basis adjustment allocation decision. Some planners have suggested that standard exculpation clauses for tax elections made by the executor should cover these elections also.

6. Beneficiary Consents; Probate Court Approval. Similar to the manner in which executors now seek consents from beneficiaries as to discretionary distribution decisions, the preferred approach will be to work with the beneficiaries in dividing the estate assets and in making basis adjustment allocations in a manner that is agreeable to all estate beneficiaries. Executors will seek consents to the basis adjustment decisions.

   In some states, where an executor can seek court approval for actions by the executor, executors may wish to seek court approval of basis adjustment decisions where the beneficiaries do not unanimously consent to the executor's decisions.

7. Various Issues for Direction or Guidance. Some of the possible factors that the executor might consider in the allocation process, and issues that the clients could address in the will or revocable trust, include the following factors.

   a. General Desire for Equality or Approach for Allocating Among Beneficiaries. Absent contrary directions or guidance in a decedent's will, the executor would have a fiduciary duty to treat the beneficiaries impartially. The will should give the executor guidance. For example, is the general goal to treat all beneficiaries of the residuary estate fairly, or does the client want the executor to favor some beneficiaries over others? If the executor is the surviving spouse, the client might want to give the spouse complete discretion, and explicitly provide that the spouse, as executor, would not be required to treat all beneficiaries fairly.

b. Favor Particular Specific Bequests; Preference to Residuary or Particular Residuary Bequests? The will or revocable trust might want to favor particular specific bequests. For example, if the client contemplates that a highly appreciated closely held business would be sold relatively soon after the client's death, the client might want to specifically express that the basis adjustment should be allocated among the beneficiaries of that interest.

To the extent that the value of the decedent's residence does not exceed $250,000, there should be no need to allocate basis adjustment to the residence, because of the availability of the $250,000 exclusion under § 121.

If there are not particularly sensitive or valuable specific bequests, the client may wish to prefer allocating the basis adjustment among some or all of the beneficiaries of the residuary estate.

c. Allocate to Children of First Marriage? If there are children of a prior marriage and of the current marriage, the client may wish to allocate his or her $1.3 million adjustment among his or her children (or trusts for them). The client may feel that the surviving spouse (or more precisely, children of the surviving spouse who he or she may designate as the executor) will likely allocate the surviving spouse's $1.3 million basis adjustment among the surviving spouse's children. Also the surviving spouse or a QTIP trust may receive assets to which the first decedent-spouse's $3.0 million basis adjustment may be made, which may subsequently be distributed to the second spouse's children. (However, using a QTIP trust rather than an outright bequest can help to assure that assets remaining in the QTIP trust at the surviving spouse's subsequent death will be allocated among all of the decedent's children as he or she deems to be appropriate.)

d. Allocate to Easy to Value Assets? If the executor allocates the basis adjustment to difficult-to-value assets, the IRS may subsequently contest the date of death value ascribed to the assets by the executor. If the IRS succeeds in arguing that the executor overvalued the date of death value of the asset, the basis adjustment allocation would end up not having allocated the full possible basis adjustment. That complexity could be avoided by allocating the basis adjustment to easy-to-value assets (such as a stock and bond portfolio.)

e. Assets Most Likely to Be Sold in Near Future. The client may want the executor to prefer allocating the basis adjustment to assets that will likely be sold soon after the decedent's date of death.

f. Tax Brackets of Beneficiaries. The client may want the executor to favor allocating the adjustments to assets passing to high bracket beneficiaries, especially if the income tax brackets of the beneficiaries are dramatically different. The client might even make some additional bequest to low tax bracket beneficiaries to account for this difference.

D. Planning and Drafting Strategies.

1. Begin Maintaining Good Basis Records. Reviewing old records to determine the basis of assets can be cumbersome and expensive. At least going forward, maintain

good basis information records, and update them on an annual basis. In this respect, the 2001 Tax Act version of carryover basis is more difficult to administer than the 1976 version — which provided a fresh start adjustment to 1976. (The 2001 version is also more difficult to administer because of all the basis adjustment allocation decisions — none of which were allowed under the 1976 version.) Guidance for the type of information to be collected and preserved is found in the list of information required to be furnished to the IRS and beneficiaries under I.R.C. § 6018, set forth in Section VI of this outline, above.

2. Determine If There is a Potential Problem, Based on Anticipated Appreciation of the Estate Assets. Be aware that all of the monetary amounts described below will be indexed for inflation, beginning with a base year of 2009.

   a. Under $1.3 Million of Appreciation. If the anticipated total appreciation of the client's or a married couple's (for married clients) estate in 2010 will be well under $1.3 million, there is no need for any action. The basis adjustment will provide a full step-up in basis regardless which spouse dies first and regardless where the assets pass at each spouse's death.

   b. Over $1.3 Million of Appreciation. If it is anticipated that the total appreciation of a married couple's assets in 2010 will exceed $1.3 million, it is important to plan (in 2010) so that (1) the first spouse to die has sufficient assets to take advantage of the $1.3 and $3.0 million basis adjustments, and (2) sufficient assets pass to the surviving spouse to utilize the $3.0 million spousal basis adjustment.

   c. Over $1.3 Million But Under $5.6 Million of Appreciation. If the $1.3 million and $3.0 million basis adjustment allowed at the first spouse's death plus the $1.3 million basis adjustment allowed at the second spouse's death (assuming he or she has that much appreciated assets other than assets in a QTIP trust), or a total anticipated appreciation of $5.6 million, is well more than the anticipated amount of appreciation at the second spouse's death, there is no need to be concerned with the difficulties of how to allocate the basis adjustment among beneficiaries. All beneficiaries could get a full stepped basis (except beneficiaries receiving income in respect of a decedent assets). However, it will be important to plan so to assure that the full $1.3 million plus $3.0 million basis adjustment can be utilized at the first spouse's death.

3. Classic Disclaimer Plan or All to QTIP Plan Accommodates Carryover Basis Planning. Planning for flexibility to accommodate increases in the exemptions and possible continued repeal often will utilize one of several approaches: (1) All to a QTIP trust, and depend upon partial QTIP elections (if there is an estate tax) to utilize the first decedent-spouse's exemption amount (or so much of it as seems appropriate based on the client's wishes as to minimum amounts that should pass exclusively for the surviving spouse) and to have assets shifted to a trust with more flexibility to the extent the marital deduction is not needed; (2) All to a QTIP trust, with provisions that disclaimed assets pass to a trust with more flexibility (so that assets not needed to qualify for the marital deduction or the $3.0 million spousal adjustment can be in a more flexible trust); or (3) All outright to spouse, and rely on disclaimers by the spouse to utilize the first spouse's exemption amount. Any of these approaches will also flexibly accommodate full use of the $1.3 adjustment and the $3.0 million spousal basis adjustment because assets in the QTIP trust or

assets passing to the spouse outright that are not disclaimed would qualify for the \$3.0 million spousal basis adjustment.

The only possible complicating factor is that if the will uses a "Clayton QTIP" approach, and provides that with a first spousal death beginning in 2010, some of the QTIP restrictions would no longer apply. In that case, the \$3.0 million spousal basis adjustment would likely no longer be available for assets passing to that QTIP trust.

4. <u>Consider Authorizing Outright Distributions to Spouse From QTIP</u>. Assets in a QTIP trust at the second spouse's death will not qualify for the \$1.3 million basis adjustment available to the surviving spouse. Property must be "owned" by a decedent prior to death to qualify for either of the basis adjustments, and property in a QTIP does not meet that test.

   Consider with the client whether to give an independent trustee or a trust protector (in particular, someone other than the surviving spouse) the authority to make unrestricted distributions of QTIP trust assets outright to the surviving spouse, not subject to an ascertainable standard. Without such an explicit provision in the instrument, the fiduciary would only be permitted to make principal distributions to the surviving spouse in accordance with any standards listed in the agreement. If the first spouse dies in the near future, leaving most of the estate to a QTIP trust, there may be no ability years later when the surviving spouse dies to take advantage of the surviving spouse's \$1.3 million basis adjustment (if there is a carryover basis system in place at his or her subsequent death) if the spouse does not own (outright) assets with at least \$1.3 million of appreciation at that time.

   For the client who is using a QTIP trust to assure who will receive the remaining assets at the spouse's subsequent death, this may present a troublesome decision. The client in that situation might want to require the approval of more than one independent person. The client might to require the approval of persons who would be "affiliated" with remainder beneficiaries of the QTIP trust (for example, perhaps aunts or uncles of those beneficiaries, who are not related to the surviving spouse's anticipated beneficiaries.) The client also might want to condition the existence of the power on there being a carryover basis system in effect or on there being significant tax advantages from the exercise of the power, other than tax benefits that might result from subsequent gifts of the distributed assets by the surviving spouse (to avoid a potential argument that the power indirectly gives someone the right to make distributions to a person other than the surviving spouse).

5. <u>Provide Allocation Guidance</u>. The client may want to give guidance to the executor in making the allocation decision.

   a. <u>General Fairness Statement</u>. There could be a very general statement that the client would want the executor to treat all beneficiaries of the estate in a fair manner.

   b. <u>Particular Beneficiaries (or Class)</u>. The guidance could indicate that the basis adjustment generally should be allocated to particular beneficiaries (for example, children and children of deceased children of the client).

   c. <u>Pro Rata Guidance</u>. The guidance could suggest that the allocation generally would allocated on a pro rata basis (based on the ratio that the percentage of unrealized appreciation in each asset acquired from the decedent bears to the unrealized appreciation in all assets acquired from the decedent).

d. Non-Probate Assets. The executor has the discretion to allocate the basis adjustment among all assets "owned" by the decedent, which would include non-probate assets. The guidance could specifically address whether the executor has the authority to allocate the basis adjustment to recipients of non-probate assets. (Without such a specific direction, beneficiaries under the will might complain that the executor is violating its duty of loyalty to the will beneficiaries.)

6. Consider Whether to Provide Broad Exoneration to Executor. The basis allocation decision may shift substantial value among estate beneficiaries. In light of the potential disputes that might arise, it would be appropriate to provide the executor with broad exculpatory provisions with respect to the basis allocation decisions.

7. Special Difficulties in Qualifying for $3.0 Million Spousal Basis Adjustment. Many of the really difficult drafting issues will evolve around qualifying for the $3.0 million spousal basis adjustment.

a. Substantial Tax Advantage; Typically Want to Qualify. The advantage of an additional $3.0 million of basis step-up can yield substantial tax savings to the family (i.e., $3.0 million times 20% capital gains rate, or $600,000.) Typically, the client will want his or her family to be able to take advantage of $600,000 of tax savings, even in a split family situation.

b. If Concern About Spouse's Disposition, Use QTIP. In a split family situation, the client would probably want to use a QTIP trust, to be able to control where the assets would pass following the second spouse's death.

c. Do Not Use Survivorship Requirement. An interest that is conditioned on survival for 6 months after the decedent's death will not be excluded from the definition of outright transfer property if the spouse does not in fact die within such six month period. I.R.C. § 1022(c)(4)(C). Nevertheless, such a survivorship requirement should not be used for decedents dying after 12-31-2009, because if the surviving spouse in fact dies within such six month period, the $3.0 million basis adjustment available for property passing to a surviving spouse would not be available.

d. Paradigm Shift — Bequests Based on Combination of Value and Basis. Drafting formula bequests to leave enough to the spouse (or QTIP trust) to take advantage of the $3.0 million spousal basis adjustment will be a significant paradigm shift from planning with traditional formula clauses based just on values. The primary focus of the bequest will be to on the difference between fair market value and the adjusted basis of assets (i.e. the "appreciation"), in order to leave assets with appreciation of at least $3.0 million to the spouse or QTIP trust. That creates a huge additional complication. To pass assets with a specified amount of appreciation can leave a substantial variance in the value passing under the bequest. If the bequest passes property that has a basis of zero, the bequest would be valued at $3.0 million. However, it conceivably could also be interpreted as a bequest of assets worth $100 million, having a basis of $97 million.

e. Tax-Driven Formula Bequest. Formula bequests may be utilized to assure the availability of the $3.0 million spousal basis adjustment, but drafting such a formula bequest is a huge challenge.

(1) Must Give Direction of Which Assets to Select. In light of the huge discrepancy of values that could pass to beneficiaries if the clause just left "assets having appreciation of $3.0 million" to the surviving spouse, the clause must give guidance to the executor as to how to select assets in satisfaction of this bequest. A mere general direction to treat beneficiaries fairly is not sufficient. That really gives the executor no guidance at all as to the testator's thinking of what would be fair. This is not just a matter of allocating basis adjustment among the amounts received by the estate beneficiaries. Funding this bequest determines the amounts to be received by the various beneficiaries.

(2) Smallest or Largest Amount Alternative. One alternative would be to give the executor general guidance to fund the bequest with assets having as small appreciation as possible (which would have the effect of leaving more value to the spouse under this formula bequest) or to leave assets with as large appreciation as possible (which would minimize the value of this bequest to the spouse.) The executor at least needs guidance.

(3) Likelihood of Sale. Just funding the bequest based on the amounts of appreciation (smallest or highest) in the assets does not take into consideration other important factors, such as when the assets will likely be sold. It would be more advantageous to get the basis adjustment on the assets most likely to be sold first. If the clause is just tied to distributing assets in satisfaction of this formula bequest that have as much appreciation as possible, the executor may not have the flexibility to consider those other important factors.

(4) Minimum Amount to Children. Another alternative would be to leave the executor wide discretion in choosing which assets to use for funding, but specify that a minimum amount of value must be left to the non-spousal bequest.

(5) Mechanical Valuation Difficulties. The executor will be faced with difficult valuation complexities in funding the bequest. The values passing under this bequest to the spouse will be highly dependent on the adjusted basis and date of death values of the selected assets. If either of those are incorrect (and both could be difficult to determine with accuracy), the amount funded in satisfaction of the bequest will be incorrect. Filing the report under § 6018 does not start the statute of limitations on the determination of the basis of the assets, and the IRS could contest the values years later as assets are sold and income tax returns are filed.

(6) Disclaimer to Spouse May Not Work. A client who strongly wishes to leave a certain amount of property to children or to trusts for descendants may want to rely on disclaimers to leave sufficient assets to the surviving spouse to qualify for the full $3.0 million spousal adjustment. However, it is not totally clear that disclaimed

property, which passes to the surviving spouse as a result of the disclaimer, would qualify for the $3.0 million spousal adjustment. Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 89 (August 2001). Section 1022(c)(4)(A) defines outright transfer property in terms of property "acquired from the decedent." Section 1022(c)(5)(A)(i) defines qualified terminable interest property in terms of property "which passes from the decedent." Would these include interests passing by way of disclaimers?

The marital deduction rules provide an analogy. Section 2056(a) allows the marital deduction for property which "passes or has passed" from the decedent to the surviving spouse. Section 2518(a) provides that if a person makes a qualified disclaimer, "this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person." Regulation § 20.2056(d)-2(b) makes clear that if a beneficiary other than a surviving spouse makes a qualified disclaimer, which causes the property to pass to a surviving spouse, the disclaimed interest is treated as "passing directly from the decedent to the surviving spouse."

The uncertainty arises in that (i) there is no specific regulation addressing this issue as there is for the marital deduction, and we do not yet know if regulations to § 1022 will adopt the same approach, and (ii) in 2010, § 2518 continues in effect (the repeal provision provides that "chapter 11 of subtitle B" (the estate tax provisions) will not apply, and § 2518 is in chapter 12 of subtitle B), but § 2518 applies only "for purposes of this subtitle," i.e. subtitle B dealing with estate, gift and GST taxes. Section 1022 is in subtitle A, dealing with income taxes, so the disclaimer statute would not apply to § 1022.

(7) Sample Clause. Do you want to be the first to draft this nightmare of a formula clause with funding directions? Fortunately, Ellen Harrison has given planners who want to address this issue from a detailed formula based approach an excellent starting point to draft such a clause for their particular client situations. (An alternate approach that many planners will likely follow is just to use a QTIP/disclaimer approach without detailed formula clauses. See Sections XIII.B.5 - XIII.B.7 of this outline.) Observe that this clause addresses most of the various factors addressed in this section regarding tax-driven formula bequests:

> "*Alternative Disposition if Federal Estate Tax is not in Effect* *If the federal estate tax is not in effect at my death, then: (1) If my Spouse and any Descendant survives me. If my wife/husband and any descendant of mine survives me, I devise and bequeath to my said Trustee, to hold in trust pursuant to the provisions of the Marital Trust described in FOURTH hereof the smallest amount, if any, that would be necessary to maximize the additional adjustments to basis allowed by section 1022(c)(2)(B) after taking into account basis adjustments allowed under section 1022(b) and basis*

adjustments allowable for qualified spousal property that is specifically bequeathed to my husband/wife or that passes to him/her outside of the provisions of my Will; provided, however, that the amount of unrealized gain that would be excludable under Section 121 (hereinafter 'section 121 gain') shall not be considered an allowable adjustment. For purposes of this SIXTH (A) it shall be assumed, regardless of what in fact occurs, that my executor will allocate the adjustments allowed by section 1022(b) to assets that are eligible for a basis adjustment (other than section 121 gain) in the following order: first to assets passing outside of this Will to anyone other than my husband/wife or charity; second to property specifically bequeathed to anyone other than my husband/wife or charity; finally to those other assets passing under this Will that have the highest basis in order to maximize the value of the bequest to the Family/ Residuary Trust. I intend that the income interest of my wife/husband in the Marital Trust under FOURTH be a 'qualifying income interest for life' within the meaning of section 1022(c)(5) and any provision of this Will which would be inconsistent with my intent shall be void. My executor shall use date of death fair market value and basis to determine the amount of this bequest and to fund this bequest provided that the aggregate fair market value of assets used to fund this bequest on the date it is paid shall not be less than the amount of this bequest. The foregoing formula shall not be construed to require that my executor allocate basis to assets used to fund this or any other bequest or to assets passing outside of this Will. My executor is not required to make any specific allocation, and no equitable adjustments shall be required as a result of my executor's allocation of basis adjustments to any assets, whether or not passing under this Will." Berall & Harrison, <u>Should We Anticipate 2010 and the Arrival of Carryover Basis? Is There Planning That Can Be/Should Be/Must Be Done Now? What About a "Head-In-The-Sand" Prayer That It Never Becomes a Reality (Or "I'll Be Retired By Then")</u>, ANNUAL NOTRE DAME TAX & ESTATE PL. INST. at 23-38 to 23-39 (2001).

8. <u>"Reverse Discount Planning"</u>. If carryover basis becomes applicable, there will be a major paradigm shift between the IRS and taxpayers on valuation issues. The IRS will argue for low values and for large discounts for date of death values, and taxpayers will argue for high values and for low discounts (because basis can be stepped down if the fair market value at the date of death is lower than the decedent's basis in an asset). The planner can consider this in planning current transfers to take advantage of fractionalization discounts.

   a. <u>Some Assets Cannot Be "Unfractionalized"</u>. Some types of assets will be difficult to "unfractionalize." For example, if a parent transfers sliver interests in a vacation home over the years, and owns only an undivided 75% interest in the vacation home before his death, that cannot be unfractionalized (unless he's willing to buy back the 25% interest that had been transferred over the years.) Without such a purchase, the interest will be valued as an undivided 75% interest in a vacation home at the parent's death.

b. Partnership Interests. On the other hand, some types of interests can be "unfractionalized" if all of the parties agree. For example, if various family members own interests in a partnership, all of the partners could collectively agree to amend the partnership agreement if the estate tax is repealed, to provide that any limited partner would have the right at any time to withdraw and receive a pro rata portion of the total value of the partnership assets. Alternatively, the partners could agree to have only one general partner, who would have the unilateral authority under state law at any time to withdraw and force the liquidation of the partnership. In that case, to the extent that the partnership holds in-kind assets (such as real estate), there may still be a fractionalization discount as to those specific assets. However, to the extent that the partnership owns liquid stocks and bonds, those assets would not be subject to a fractionalization discount.

c. Leave Flexibility for Pre-Mortem Repurchases to Convert Minority to Majority Interest. The parties may leave the flexibility for the client to repurchase sufficient interests to convert a minority interest into a majority interest, thus removing minority interest discounts. There is a three year look back window for purposes of the basis adjustment, but that applies to only property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the three years prior to death. I.R.C. § 1022(d)(1)(C)(i). It would not apply to a repurchase for full consideration of an interest in the property. Of course, the IRS could still attempt to make a "sham transaction" argument, see Estate of Murphy, T.C. Memo 1990-472, but they would be battling uphill against the specific wording [and very apparent exception for full consideration transfers] in the statute. Indeed, another paragraph of § 1022 [§ 1022(g)(2)(D)] adopts a "principal purpose of tax avoidance" exception, but § 1022(d)(1)(C) does not. Planning fractionalized transfer transactions with grantor trusts during the phase-in years will be very helpful in leaving open this flexibility. If a grantor trust owns the asset, it could be repurchased by the grantor in a pre-mortem transaction without having the seller recognize taxable income on the sale.

9. Maintain Community Property Status of Assets. The carryover basis rules maintain the basis step-up advantage given to spouses who own community property. Both the decedent's one-half and the surviving spouse's one-half of community property would be entitled to a basis step-up at death using the decedent spouse's $1.3 and $3.0 million basis adjustments. However, for clients with very large estates (who have unrealized appreciation well in excess of $4.3 million), there is not as strong of a basis step-up advantage for maintaining property as community property as there was in the past. (The unrealized appreciation in excess of $4.3 million at the first spouse's death would not receive a step-up in basis.)

10. Interspousal Transfers. The clients should consider whether to make interspousal transfers so that each spouse will own sufficient assets to take advantage of the full

$1.3 plus $3.0 million of basis adjustment, regardless of which spouse dies first. (We're talking about pretty large estates here — where each spouse would own assets with assets having $4.3 million of unrealized appreciation.)

For spouses having widely disparate estate values, QTIP trusts are often used to equalize the estates for estate tax purposes. That will not be effective for the basis adjustment rules, because assets in a QTIP trust for the benefit of the decedent-spouse will not be treated as "owned" by that spouse for purposes of the basis adjustment rules.

To take advantage of the basis adjustment for each spouse, in the event of a sudden unanticipated death, the "propertied" spouse would have to be willing to transfer outright ownership of assets to the other spouse. (The only other alternative, which may give at least the appearance of more control to the propertied spouse, would be to acquire assets in the names of both spouses as joint tenants with right of survivorship. Each spouse would be treated as owning one-half of joint tenancy property for purposes of the basis adjustments. I.R.C. § 1022(d)(1)(B)(i). However, the "propertied" spouse would then run the risk of dying first, and having the spouse acquire all of the joint tenancy property under the survivorship provision.)

11. Pre-Mortem Gifts to Spouse. The interspousal transfers can be delayed until it is apparent that the non-propertied spouse will likely die first. The new carryover basis rules clearly permit pre-mortem interspousal transfers to transfer low basis assets to a dying spouse in order to be able to fully utilize the spouse's $1.3 and $3.0 million basis adjustment. There is no three-year waiting period for transfers to spouses, unless the "donor spouse" acquired the property in whole or in part by gift or inter vivos transfer for less than adequate and full consideration during within three years prior to the transferee-spouse's death. I.R.C. § 1022(d)(1)(C)(ii). See Section V.E.8.a. for a discussion of how this compares to the current one-year rule that does apply to spouses in order to receive a step-up in basis at death if the property is left back to the original owner-spouse.