Trust and Estate Hot Topics and Current Developments

"I'm So Dizzy My Head is Spinning"

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Introduction

This summary of trust and estate hot topics and current developments includes various current developments as well as summaries of discussions from the 45th Annual University of Miami Philip E. Heckerling Institute on Estate Planning regarding planning considerations in light of the passage of the "Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010" (which I have generally shortened in this summary to the Tax Relief Act of 2010, or TRA 2010). Many speakers discussed the effect of TRA 2010 on their particular topic, some noting that the Act is a "sea change" for estate planning.

1. Brief Overview of TRA 2010

The "Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010" was enacted December 17, 2010. It is referred to as "TRA 2010."

a. *Relief Other Than Transfer Tax Provisions*.

(1) *Income Tax Rates*. Taxpayers at every income level would have the lower rates enacted in EGTRRA continued for two years. The top rate, on taxable income above $379,150, will stay at 35% instead of increasing to 39.6%. (Two-year cost: $186.8 billion)

(2) *Itemized Deductions*. The personal exemption phase-out and itemized deduction limitation were both repealed for one year under EGTRRA. The repeal of both of these provisions is extended for an additional two years. This is important, for example, with respect to deductions available for large charitable contributions. Prior to the phase-out of the limitations on itemized deductions, the allowable total amount of itemized deductions was reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeded a threshold amount that was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80%. For high income taxpayers, reducing the otherwise allowable charitable deductions (as well as other itemized deductions) by as much as 80% is a substantial tax detriment. (Cost: $20.7 billion)

(3) *Capital Gains and Dividends Rates*. Lower capital gains and dividend rates are extended for two years. The lower rates are: taxpayers below 25% bracket - 0%, taxpayers above 25% bracket - 15%. If those rates expire, the rates would become 10% and 20%, respectively, and dividends would be taxed as ordinary income. (Cost: $53.2 billion)

(4) *Social Security Tax Cut of 2%*. All taxpayers, including self-employed individuals, have a one year reduction in the "social security payroll tax" of 2 percentage points in 2011. For individuals, the employee rate is reduced from 6.2% to 4.2% (the old age, survivors, and disability insurance tax on the taxable wage base ($106,800 in 2010)). The employer tax rate remains at 6.2%. For self-employed individuals, the rate is reduced from 12.4% to 10.4% for taxable years of individuals that begin in 2011. (Cost: $112 billion)

(5) *Alternative Minimum Tax*. The AMT exemption amounts are increased to $47,450 ($72,450 for joint returns) for 2010 and to $48,450 ($74,450 for joint returns) for 2011. (Over 20 million households are spared from tax increases averaging $3,900 as a result of this change.) (Cost: $136.7 billion)

(6) *IRA Charitable Rollover*. Among the tax extenders are the IRA Charitable Rollover provisions, which technically expired at the end of 2009. The IRA Charitable Rollover is extended for two years, through 2011, which allows individuals who are at least 70 ½ to transfer up to $100,000 per year directly from an IRA to a qualified public charity (not a donor advised fund or supporting organization) without being treated as a taxable withdrawal from the IRA. The transfer can be counted toward the required minimum distribution. The measure applies to all charitable distributions throughout 2010, and distributions made any time during 2010 or in January of 2011 can be counted toward the $100,000 limit for 2010. Individuals who have already taken their 2010 required minimum distributions cannot "undo" those distributions and instead make a charitable distribution to satisfy their 2010 required minimum distributions. (Cost: $979 million)

(7) *Estate, Gift and GST Tax Cost*. Like the other provisions of TRA 2010, the estate, gift and GST provisions apply for only two years. (Cost: $68.1 billion)

b. *Two-Year Tax Relief*. TRA 2010 generally provides various transfer tax provisions that apply for just two years. This is accomplished first by extending the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") generally for two years. (TRA 2010 § 304 says that section 901 EGTRRA applies "to the amendments made by this title," which refers to all of the transfer tax provisions in title III of TRA 2010. The Senate amendment as originally proposed referred to "amendments made by this section," which was nonsensical. If that had not been changed, the transfer tax changes in TRA 2010 would have been permanent under a literal application of the substantive statutory language (although the heading for § 304 did correctly refer to "this title"). However, the word "section" was changed to "title" before the Senate and House vote. Interestingly, getting congressional approval for this important technical change was quite difficult.

c. *Estate, Gift and GST Tax Exemptions and Rates*. TRA 2010 generally sets the estate, gift and GST exemption at $5.0 million, indexed from 2010 beginning in 2012, [TRA 2010 § 302(a)(1)] and sets the maximum rate at 35%. [TRA 2010 § 302(a)(2)]. The $5 million exemptions generally apply beginning in 2010 [TRA § 302(f)], except that the gift exemption remains at $1.0 million for 2010 [TRA § 302(b)(1)(B)].

d. *Estate Tax in 2010 — Default Rule, Estate Tax Applies; Election For Carryover Basis To Apply Instead*. The estate tax applies to estates of decedents dying in 2010, with an estate tax exemption of $5.0 million and a rate of 35%. TRA 2010 § 301(a). Executors (within the meaning of I.R.C. § 2203) of estates of decedents who die in 2010 may elect to have the modified basis rules of § 1022 apply. TRA 2010 § 301(c). The statute does not specify when or how this election is made. Section 301(c) says the election is to be made "at such time and in such manner" as prescribed by the Secretary of the Treasury or his delegate (interestingly, not requiring regulations).

IRS Releases on February 16, 2011 and on March 2, 2011 (discussed below) state that the election to have the carryover basis regime apply "*should not* be made on the decedent's final income tax return." (emphasis in original) The March 2 Release states that the carryover basis election under TRA 2010 § 301(c) "is made by filing Form 8939."

Making the election will not change that the decedent is still treated as a "transferor" for purpose of the GST tax system. TRA 2010 § 301(c)(last sentence).

e. *Extension of Time to File and Pay Estate Tax and GST Tax and to Make Disclaimers; Guidance Regarding Form 8939.*

(1) *Estate Tax Extension; No Statutory Extension for Filing Form 8939.* The estate tax return and payment date of estate tax is extended to no earlier than nine months after the date of enactment. The extension applies to estates of decedents dying from January 1, 2010 through December 16, 2010. After the nine-month extension, is it also possible to get another six-month extension under § 6018? We don't know, but that may be covered in guidance from the IRS about issues for 2010 estates. The estate of the decedent who dies on December 17 can get an automatic 6-month extension beyond September 19. It would seem that automatic extension should also be available for the decedent died before December 17.

The due date for the carryover basis report is not extended. TRA 2010 § 2301(d)(1)(A) (extension applies to any return under § 6018 "as such section is in effect after the date of this enactment of this Act *without regard to any election under subsection (c)*.") The IRS issued a draft of Form 8939 for comments on December 16, 2010. The draft form does not include instructions.

An IRS Release on February 16, 2011, available at http://www.irs.gov/pub/irs-pdf/f8939.pdf gave the first official preliminary guidance regarding procedures and filing dates for the Form 8939. An announcement on March 2, 2011, available at http://www.irs.gov/formspubs/article/0,,id=236791,00.html, described similar information regarding Publication 4895. These Releases give the following guidance:

- The IRS will issue, in order, (1) Form 8939, and shortly thereafter (2) instructions for Form 8939, followed by (3) Publication 4895, Treatment of Property Acquired From a Decedent Dying in 2010.
- The final Form 8939 will be posted at least 90 days before it is required to be filed.
- The Form 8939 *should not* be filed with the decedent's final income tax return (emphasis in original). ." (OBSERVATION: This is despite the literal wording of § 6075(a) providing that "[t]he return required by section 6018 with respect to a decedent shall be filed *with* the return of tax imposed by chapter 1 for the decedent's last taxable year" [(i.e., the decedent's final income tax return] (emphasis added).
- The carryover basis election under § 301(c) of TRA 2010 *should not* be made on the decedent's final income tax return (emphasis in original).
- Instructions on how to make the carryover basis elections under § 301(c) will be described on the Form 8939, in the instructions to Form 8939, and in Publication 4895. The March 2, 2011 Release says that "[t]he election is made by filing Form 8939."
- The March 2, 2011 Release says that Publication 4895 is only relevant for estates that file the Form 8939.
- The latest information on these issues can be found at www.irs.gov/form8939.

A summary of a conversation between Robert Chapman, of the IRS Tax Forms & Publications Desk, and Carol Cantrell on February 3, 2011 (in response to comments filed by the American Bar Association Tax and Real Property, Trust and

Estates Law Sections on January 31, 2011) was published by Leimberg Information Services on Feb 8, 2011. Mr. Chapman's comments included the following:

- The Form 8939, Instructions to the Form 8939 and the Publication 4895 are expected to be released by May 2011.
- The IRS will issue guidance regarding whether appraisals are required and whether group and de minimis rules will be allowed.
- There is no place to report the surviving spouse's one-half of community property on the Form 8939 and the IRS will give guidance; he was asked to clarify that the surviving spouse's one-half would be eligible for the step-up and as well as a step-down in basis and he hinted that it is, by noting that the question of whether both halves of community property is adjusted is the same for both § 1014 and § 1022.
- The estate would be shown as the recipient of property not yet transferred by the time the Form 8939 is filed.
- An amendment would not be required to report subsequent transfers or distributions by the estate.
- Property that is sold by the estate cannot qualify for the $3.0 million spousal basis adjustment, even if the sale proceeds are distributed to the surviving spouse.
- The IRS may add Schedule R from Form 706 (for reporting generation-skipping transfers and exemption allocations) to the Form 8939 so that executors who need to report generation-skipping transfers or exemption allocations will not have to file both the Form 8939 and Form 706.
- The IRS prefers to make the mere act of filing the Form 8939 as the affirmative election under § 301(c) of the Tax Relief . . . Act of 2010 out of the estate tax regime and into carryover basis, rather than providing a box to check. He agrees that the Form 8939 should contain a statement to the effect that filing the form constitutes the election.
- The IRS is likely disinclined to allow a "protective election" out of the estate tax regime in the event an IRS audit adjustment makes the election more advantageous.

On March 1, 2011, the IRS filed another request for comments regarding the Form 8939, stating that comments should be received by May 6, 2011 to be assured of consideration (suggesting that the Form 8939 will not be released before that date).

(2) *Disclaimer Extension*. The time for making any disclaimer under I.R.C. § 2518(b) for property passing by reason of the death of a decedent who dies between January 1 and December 16, 2010 is extended to nine months after the date of enactment. [TRA § 301(d)(1)(C).] Concerns with being able to take advantage of this additional time include (1) that beneficiaries may have already accepted benefits, not realizing that the disclaimer period would be extended, and (2) state law requirements for disclaimers sometimes refer to nine months after the transfer, so disclaimers during the extended time period may not satisfy the state law requirements. Section 2518(c)(3) may provide a way for getting around a continuing state law 9-month limitation on disclaimers.

Section 2518(c)(3) provides that a transfer that does not qualify as a disclaimer under local law may still constitute a qualified disclaimer under federal law, as long as the disclaimer operates as a valid transfer under local law to the persons who would have received the property had it been a qualified disclaimer under local law.

The legislative history to § 2518(c)(3), passed in 1981, says that mere acts of receiving property to be able to make a transfer complying with the statute are not treated as acceptance that would preclude a disclaimer. "[T]he individual's direction of the transferor to the individual who would have taken under local law pursuant to an effective disclaimer will not be construed as acceptance of the property." H. Rept. 97-201, 1981-2 C.B. 352, 392. The Tax Court has made clear that §2518(c)(3) applies to a transfer made by the original beneficiary, not by the executor.

> "The transferor (i.e., the beneficiary) referred to in section 2518(c)(3) is not the same transferor of section 2518(b)(i.e., the estate or executor). Section 2518(c)(3) assumes that a transfer to the beneficiary has already occurred under local law because a disqualified disclaimer did not avoid the transfer. That beneficiary can still avoid the effects of the disqualified disclaimer by making a written transfer to the person who would have received the property (e.g., a surviving spouse) had the beneficiary made an effective disclaimer."

There must be a "written transfer" for § 2518(c)(3) to apply. Case law has held that a purported "disclaimer" that has no effect under state law does not satisfy the transfer requirement. *Bennett v. Commissioner*, 100 T.C. 42 (1993). In *Bennett*, purported disclaimers did not satisfy state law (among other things, they were not timely). The estate argued that the disclaimers satisfied §2518(c)(3), but the court disagreed because the beneficiaries did not make "actual written transfers of their interests in the Memorial Trust to the person who otherwise would have received those interests had the disclaimers been valid under local law." The court stated that §2518(c)(3) "should not be viewed as a catch-all provision to save defective or disqualified disclaimers" but that it applies when a "would be disclaimant makes an actual written transfer to the person who otherwise would have received the property had the disclaimer been valid under local law." The court quoted some of the legislative history:

> "In order to provide uniform treatment among States, the committee believes that where an individual timely transfers the property to the person who would have received the property had the transfer made an effective disclaimer under local law will be treated as an effective disclaimer for Federal estate and gift tax purposes provided the transferor has not accepted the interest or any of its benefits." H. Rept. 97-201, 1981-2 C.B. at 392.

Section 2518(c)(3) requires a written transfer of the person's "entire" interest in the property disclaimed. There is no law as to what that means (and no regulations have been issued regarding § 2518(c)(3)). The legislative history is scant as to the meaning of this requirement:

> "A transferor will not be considered a transfer of the entire interest in the property if, by reason of the transfer, some or all of the beneficial enjoyment in the property returns to the transferor or the transferor has any period after the

transfer to control the beneficial enjoyment from the property." H. Rept. 97-201, 1981-2 C.B. at 392.

It is not clear whether that means that the person's entire interest in a particular "severable" interest (such as the income interest) must be disclaimed or whether literally the entire interest in the property must be disclaimed. Alternatively, is it sufficient for a person to disclaim her entire interest in an undivided one-half interest in Blackacre, or must her entire interest in Blackacre be transferred?

If the disclaimant lives in one of the few states that has a state gift tax, an issue with making transfers that qualify as disclaimers under § 2518(c)(3) is that a state gift tax will apply to the transfer, if it is not a transfer that constitutes a disclaimer under state law.

Practical Planning Pointer: A deed or assignment should be used, reflecting the intent that it constitute a qualified disclaimer under § 2518(c)(3) and that the assets pass to the same persons who would receive the assets if there had been a valid disclaimer under state law.

(3) *Reporting Generation-Skipping Transfers*. The due date for filing a report of any generation-skipping transfer made in 2010 is also extended to nine months after the date of enactment. TRA 2010 § 301(d)(2). This applies to all generation-skipping transfers made in 2010, not just those from decedents dying before the date of enactment. (There is no extension of time for filing a return to make timely allocations of GST exemption (or elect out of automatic allocations) for "indirect skip" transfers to trusts that are not direct skips.)

(4) *Extended Due Date — September 19, 2011*. The due date is extended to no earlier than nine months after the date of enactment (or September 17, 2011, which is a Saturday, so the extended due date would be no earlier than September 19, 2011).

f. *Portability*. The executor of a deceased spouse's estate may transfer any unused estate exemption to the surviving spouse. TRA 2010 § 303. The portability concept is accomplished by amending I.R.C. § 2010(c) to provide that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" ($5.0 million, indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount." I.R.C. § 2010(c)(2), as amended by TRA § 302(a).

(1) *"DESUEA."* The "deceased spousal unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in new § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under I.R.C. § 2001(b)(1)"). The second item is the last deceased spouse's remaining unused exemption amount. Observe that it is strictly defined as the predeceased spouse's basic exclusion amount less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a strict "privity" requirement (discussed below).

(2) *Statute of Limitations on Review of Predeceased Spouse's Estate to Determine Unused Exclusion Amount*. Notwithstanding the statute of limitations on assessing estate or gift taxes for the predeceased spouse, the IRS may examine the return of a predeceased spouse at any time for purposes of determining the deceased spousal

unused exclusion amount available for use by the surviving spouse. I.R.C. § 2010(c)(5)(B), as amended by TRA 2010 § 303(a).

(3) *Must be Timely Filed Estate Tax Return and Election for Predeceased Spouse's Estate*. The Act continues the position of prior portability bills that the executor of the first spouse's estate must file an estate tax return on a timely basis and make an election to permit the surviving spouse to utilize the unused exemption. (Therefore, even small estates of married persons must consider whether to file an estate tax return for the first deceased spouse's estate.)

It is possible that the IRS will develop a "Form 706-EZ" if the estate is filing only for the purpose of making the portability election.

(4) *Only Last Deceased Spouse's Unused Exclusion Amount Applies*. Only the most recent deceased spouse's unused exemption may be used by the surviving spouse (this is different from prior portability legislative proposals). I.R.C. § 2010(c)(5)(B)(i), as amended. An explanation of TRA 2010 by the Joint Committee on Taxation reiterates that this requirement applies even if the *last* deceased spouse has no unused exclusion and even if the *last* deceased spouse does not make a timely election. Joint Committee on Taxation Technical Explanation 52 n.57.

(5) *Privity Requirement*. A spouse may not use his or her spouse's "deceased spousal unused exclusion amount." This is sometimes referred to as the "privity" requirement. For example, assume H1 dies and W has his deceased spousal unused exclusion amount, and assume W remarries H2. If W dies before H2, H2 may then use the deceased spousal unused exclusion amount from W's unused basic exclusion amount, but may not utilize any of H1's unused exclusion amount. The definition of the "deceased spousal unused exclusion amount" has no element at all that might include a deceased person's unused exclusion from a prior spouse in determining how much unused exclusion can be used by a surviving spouse. However, Example 3 of the Joint Committee on Taxation Technical Explanation appears inconsistent with this conclusion. While inconsistent with the statutory language, the Joint Committee on Taxation Technical Explanation appears to adopt a concept that the surviving spouse's estate would first use any deceased spousal unused exclusion at the death of a surviving spouse, leaving more of the surviving spouse's own exclusion that could be used by his or her surviving spouse in the event of remarriage.

(6) *Applies for Gift Tax Purposes*. Portability applies for the gift exemption as well as the estate exemption. TRA 2010 § 303(b)(1) amends I.R.C. § 2505(a)(1), which describes the "applicable credit amount" for gift tax purposes, by referring to the applicable credit amount under § 2010(c) "which would apply if the donor died as of the end of the calendar year…" (Under § 2505(a)(2), the credit amount is further reduced by the amounts of credit allowable in preceding years.) The applicable credit amount under § 2010(c) includes the deceased spousal unused exclusion amount, so that amount is also included in the gift exemption amount.

- A surviving spouse may consider using the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries) so that she does not lose it if a new spouse predeceases or if the basic exclusion amount is decreased.

- There is no way under the statutory language that a surviving spouse can make a gift to utilize her deceased spousal unused exclusion amount without using her own basic exclusion amount. However, Example 3 of the Joint Committee on Taxation Technical Explanation apparently disagrees.
- The recapture/clawback issue discussed below can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exclusion" for making gifts. If the spouse later remarries and the subsequent spouse dies, with less unused exclusion, the spouse will not have as much deceased spousal unused exclusion for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes will be less than for gift tax purposes when the gifts were made. This issue is different than the general recapture/clawback issue discussed below because it potentially applies under current law even if Congress does not later reduce the exemption amount. Also, the statute indicates that the unused exclusion amount can be decreased if the basic exemption amount is decreased by the time of the surviving spouse's death, perhaps suggesting legislative intent to apply the recapture tax in the somewhat analogous situation of lifetime gifts exceeding the total exclusion amount available at the surviving spouse's death. *See* Evans, *Problems With Portability, Part 2*, LEIMBERG INFOR. SERVICES EST. PL. NEWSLETTER 1777 (Feb. 16, 2011). This may result in additional estate taxes being due at the donor's death. The clawback issue in this context may be resolved differently than in the context of making gifts under a larger gift exemption than the estate exemption that exists at the donor's death.
- If an individual makes lifetime gifts in excess of the gift exclusion amount, the excess reduces the DESUEA for that individual's surviving spouse, even though the individual had to pay gift tax on that excess gift amount. (This is because the DESUEA is (i) the basic exclusion amount, minus (ii) the sum of the individual's taxable estate and adjusted taxable gifts. There is no distinction for adjusted taxable gfits that were subject to actual payment of gift tax.) *See* Evans, *Problems With Portability, Part 2*, LEIMBERG INFOR. SERVICES EST. PL. NEWSLETTER 1777 (Feb. 16, 2011).

(7) *Does Not Apply for GST Tax Purposes*. Portability does not apply to the GST exemption.

(8) *Effective Date — Decedents Dying After 2010*. The provision applies to the estates of decedents dying and gifts made after 2010. TRA § 303(c)(1).

(9) *Only Available Two Years*. Like the rest of the estate and gift tax provisions in TRA 2010, the portability provision expires after 2012. The apparent anticipation is that Congress will extend this benefit following 2012, but there are no guarantees. In light of this, few planners may be willing to rely on portability and forego using bypass trust planning in the first deceased spouse's will. The Fiscal Year 2012 Revenue Proposals (released February 14, 2011), include a provision that would permanently extend the provisions in the Tax Relief … Act of 2010

regarding the portability of unused exemption between spouses. (Estimated 10-year cost: $3.681 billion.)

(10) *Reasons for Using Trusts Even With Portability*. There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including, (a) there is no assurance that portability will apply after 2012, (b) the deceased spousal unused exclusion amount is not indexed, (c) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse, (d) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (e) there is no portability of the GST exemption, and (f) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse. On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death.

(11) *Not Available For Non-Resident Aliens*. If a non-resident alien ("NRA") spouse dies first survived by a citizen spouse, there is no DESUEA because the NRA is merely entitled to a unified credit of $13,000 under § 2102 and does not have a "basic exclusion amount" that could be partly unused. If the citizen spouse dies first, the surviving NRA is not entitled to an exclusion under § 2101(c)(2) that includes the DESUEA, but is merely entitled to a unified credit of $13,000 under § 2102.

(12) *Priority for Treasury Guidance*. Portability is not on the Treasury priority guidance plan. However, there are informal indications that the Treasury will issue guidance on portability and that it will be a priority, right behind providing guidance for 2010 decedents' estates.

g. *Gift Exemption and Change in Method for Calculating Gift Tax*. The gift exemption remains at $1,000,000 in 2010. TRA § 302(b)(1)(B). Beginning in 2011, the gift exemption amount is the same as the estate tax exclusion amount, or $5.0 million. The gift exemption (as well as the estate and GST exemptions) is indexed from 2010 beginning in 2012. Following amendments in TRA 2010 §§ 301(b) & 302(b)(1), § 2505(a)(1) provides that the unified gift tax credit is:

> "(1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year …"

(The last phrase, beginning with "which would apply if the donor died as of the end of the calendar year" is the clause that provides portability of the gift exclusion.)

For gift tax purposes, the gift tax calculation includes subtracting a unified credit, and the amount of unified credit available for a particular year is determined after subtracting the amount of credit already used from prior gifts. In calculating the amount of credit used on prior gifts, use the gift tax rate for the year of the current gift to determine the tentative tax on the applicable exclusion amount that was applicable for offsetting the gift tax on prior gifts. [TRA § 302(d)(2), amending I.R.C. § 2505(a).]

The effect of this change is to "correct" an anomaly that existed under prior law. If an individual had made gifts before 2010 over $500,000, the gifts used more credit (calculated at 37% and 39% rates) than gifts would use at a 35% rate. The result was that donors who had made prior taxable gifts over $500,000 could not make additional gifts in 2010 (at a 35% rate) equal to the difference between $1 million and the prior gifts. (For example, a donor who had made taxable gifts before 2010 of $961,538.46 would not be able to make additional gifts in 2010 [calculating the credit at a 35% rate] without paying gift tax.)

The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts without having to pay gift tax. If a donor has made gifts in prior years in excess of the gift exemption amount for those respective years, the donor can make additional gifts in 2011 equal to the difference between $5 million and the gift exemption used in prior years without paying current gift tax.

h. *Change in Estate Tax Calculation Method Regarding Effects of Prior Gifts.* Generally speaking, the estate tax calculation method of § 2001(b) is designed (1) to tax the estate at the highest estate tax rate brackets, taking into consideration prior gifts (by determining the tax on the combined taxable estate plus adjusted taxable gifts and subtracting the taxes on just the adjusted taxable gifts), and (2) to reflect that the individual has already utilized unified credit that would otherwise be available at death for any taxable gifts made previously (this is done by reducing the amount of tax that is subtracted attributable to just the adjusted taxable gifts by the amount of unified credits attributable to those adjusted taxable gifts.)

The estate tax calculation method is changed to reflect the effects of changing gift tax rates. The calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. § 2001(b)(1).
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The Form 706 instructions for the "Line 7 Worksheet" clarify that the gift unified credit attributable to the applicable credit amount available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year.)
- Step 3: Subtract the applicable credit amount.

TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The gift unified credit equals –

(1) the estate tax applicable credit amount for the year of the gift (§ 2505(a)(1)), less

(2) the aggregate gift unified credits for preceding years (§ 2505(a)(2)), and as discussed above regarding the calculation of the gift tax, TRA 2010 amends § 2505(a) to provide that in calculating the aggregate gift unified credits used in prior years under § 2505(a)(2), rates in effect for the year of each current gift are used in lieu of the actual rates of tax in effect during the preceding years.

i. *Controversial Calculation Issue: "Recapture" vs. "Clawback" If Estate Exemption Is Reduced in the Future ("Line 7 Issue").* If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift exemption amount, it is not clear how Step 2 of the estate tax calculation described above will be interpreted. Following the Form 706 instructions, the hypothetical "chapter 12" offset amount (reported on Line 7 of the Form 706) is calculated using the applicable credit amount "in effect for the year the gift was made," (see the last two lines of the Form 706 Instructions, Line 7 Worksheet) which would be the credit amount for an applicable exclusion amount of $5 million. (Similarly, Letter Ruling 9250004 says that "the unified credit that would have been allowed to the decedent *in the year of the gift* is taken into account as a reduction in arriving at the gift tax payable" for purposes of the estate tax calculation.) The change under § 2001(g) says to use the date of death estate tax *rates* in calculating the gift credit amount for this hypothetical gift tax. This seems to connote that the approach in the Form 706 instructions and in Letter Ruling 9250004 would be applied by using the exclusion amount that was used in the year of the gift and determining a hypothetical gift credit amount using the date of death rate. That means that the gift unified credit amount would fully cover the gift and no gift tax calculated under chapter 12 would be reduced in calculating the tentative estate tax. In effect, the tentative tax (before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously.

That situation, of the estate tax unified credit amount being lower than the gift unified credit amount for prior years, has never happened. It is not clear whether the Form 706 instructions would apply literally in that circumstance or not. On the other hand, if the amount of the chapter 12 tax on just the adjusted taxable gifts, to be subtracted from the tentative tax in Step 2 and reported on Line 7 of the Form 706, is calculated assuming the *gift* unified credit amount were determined on just the lower estate tax applicable exclusion amount, there would be chapter 12 tax that would be subtracted in Step 2, thus giving the estate the benefit of having removed the "excess" exclusion amount from the estate without gift or estate tax.

Here is a different way of stating the issue: One of the purposes of the estate tax calculation procedure is to reflect that using gift exemption also uses the estate exemption. Does that mean that it uses the estate exemption only to the extent of the estate exemption at death, or does it require a "recapture" to the extent that the gift exemption utilized exceeds the estate exemption?

There are indications from Congressional staffers that the "clawback" effect if the exclusion amount is reduced in future years was not intended.

A number of respected planners believe that there will be no clawback. In any event, the result is uncertain. One attorney has summarized it well: "One person's glitch is another's tax logic."

j. *Tax Apportionment.* Tax apportionment of the "clawback" estate tax, if it applies, would be important. However, unless a state apportionment statute specifically allows apportioning estate taxes to donees of lifetime gifts, there would seem to be no ability to do so in the will. Of course, if the donees of lifetime gifts are also recipients under the will, estate taxes attributable to the lifetime gifts could be apportioned to the donees and treated as an advance against their share of the estate passing under the will.

One possible approach may be to have a type of net gift agreement with the donees of the gifts, so that they would agree to pay the estate tax attributable to the adjusted taxable gift inclusion in the event the exclusion amount is reduced in later years. Whether there would be any offset in determining the amount of net gift attributable to such agreement is not clear, because of the speculative nature of whether and by how much the estate exclusion might be reduced in future years. *See McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g*, 120 T.C. 358 (2003). In *McCord*, the donees assumed all gift, GST and estate tax liability attributable to the transfer, specifically including potential estate tax liability under the gift tax gross-up rule of § 2035(b) if the donor were to die within three years. The Tax Court viewed that potential liability as too speculative to consider as an offset to the gift value. The Fifth Circuit reversed, viewing it as even less speculative than the "built-in gains tax" discount that has been allowed in recent years. However, if a reduction in the exclusion amount did occur such that the donees had to reimburse the estate for the additional estate tax, that reimbursement right would likely be an estate asset subject to inclusion in the gross estate.

Another concern with such a net gift-type agreement is that the value of the contractual obligation to pay the additional estate tax may be consideration received that could result in gain recognition under *Dietrich* (unless the donee is a grantor trust). Such gain recognition may result even if the value of the contractual obligation to pay the additional estate tax is not certain enough to be recognized as an offset in determining the value of the gift for gift tax purposes. Letter Ruling 200210018.

What if the taxable gifts are so large that the remaining assets in the gross estate are not sufficient to pay all of the added estate tax? The entire probate estate would be applied to estate taxes (or other expenses that have priority over estate taxes), but there does not appear to be any way for the IRS to collect the remaining tax deficiency from the gift recipients if the gifts were made at least three years before death. I.R.C. § 2035(c)(1)(C)(for purposes of chapter 64 subchapter C relating to the liens for taxes, property transferred within three years of death is treated as being included in the gross estate). (If there is a state law apportionment statute that apportions estate taxes to donees of gifts or if there is an agreement of donees to reimburse the estate for added estate taxes, as addressed above, that obligation presumably would be an estate asset that the IRS could pursue for payment.)

k. *Overview of Considerations of Using and Estate Tax Effects of Using $5 Million Gift Exclusion.*

(1) *How Much Can the Donor Afford to or Want to Give*? While substantial additional gifts can be made without having to pay gift taxes, the initial question is how much can the donor afford to or want to give? See Item 4.b below for further discussion of this initial critical issue.

(2) *"Rainy Day Fund" Considerations*. The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. One possible approach would be to make gifts to a lifetime credit shelter trust for the donor's spouse (or even trusts created by each of the spouses for each other with enough differences so they are not treated as "reciprocal" trusts for tax purposes). Alternatively, self-settled trusts may be

considered in jurisdictions that allow discretionary distributions to the settlor without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). These issues are explored further in Item 4.d-g below.

(3) *Can Make Gifts of Full Additional Gift Exemption Amount*. The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts that were covered by the gift exemption amount at the time of the gifts without having to pay gift tax, even if the donor has previously made gifts exceeding the then available gift exemption amount.

(4) *Gift Does Not Remove Gift Assets From Base For Calculating Estate Tax But Does Not Result in Increasing Aggregate Taxes*. Gifts in effect are just an "advance" on distributions from the estate (without gift tax as long as the gifts do not exceed the exclusion amount), but the gifts are included in the transfer tax base. The amount of the additional estate tax attributable to the taxable gifts is the amount of the taxable gifts times the estate tax rate. Because of this effect, it is still preferable, to the extent possible, to shift value that would otherwise be in the taxable estate without making taxable gifts (e.g.., using strategies such as GRATs, sales to grantor trusts, fractionalization discounts, paying income taxes on grantor trusts, etc.).

Making gifts never increases the total aggregate transfer taxes as opposed to just retaining the assets and paying estate tax on the full amount (unless the gift assets were to depreciate, in which event it would have been better not to have made the gift).

(5) *Utilization of GST Exemption*. Making current gifts and allocating GST exemption to the gifts means that future increases in value of the trust will also be GST exempt without having to allocate additional GST exemption. Even if there is a "clawback" for estate tax purposes if the estate tax exemption is later reduced below $5 million, there would be no clawback of the use of the $5 million GST exemption.

(6) *Use Exemptions Now in Case They Are Later Reduced*. TRA 2010 affords what may eventually be a window of opportunity to make gifts of $5 million without paying current gift tax and to allocate $5 million of GST exemption. Those exemption amounts could be reduced in the future.

(7) *Gift Advantages and Disadvantages*. Even though the overall transfer tax is generally the same whether or not gifts are made, other factors can make gifts advantageous, including removal of appreciation/income for gift assets from gross estate (generally resulting in an eventual tax savings equal to the appreciation/income removed times the estate tax rate), utilizing fractionalization discounts, and paying income taxes on income from grantor trusts that receive gifts. If GST exemption is allocated to the gift, these advantages also apply to increase the amount in the GST exempt trust compared to funding the GST exempt trust at the individual's death. Being able to make larger gifts without paying gift taxes increases these advantages.

In addition, if gift taxes are paid and the donor lives more than three years after making the gift, the gift tax amount is removed from the gross estate. Also, if the estate tax rate is later increased, there will be tax savings generally equal to the amount of the gift subject to payment of gift taxes times the amount of the percentage rate increase.

Gifts can be disadvantageous from an overall tax cost perspective if a) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or b) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

(8) *Potential Clawback of Tax Attributable to Excess Exemption If Estate Tax Exemption Is Later Reduced.* If the Form 706 instructions are followed, and the Line 7 gift tax offset amount is calculated using the applicable exclusion amount for the year of the gift, the estate will pay estate tax on all of the taxable gifts, including the excess of the exclusion utilized by gifts over the estate tax exclusion amount.

The issue, stated briefly, is this: If gifts are made under a gift exclusion amount that exceeds the estate exclusion amount, does the excess amount pass free of gift or estate taxes? For example, if the estate tax rate increases to 45% and if the exemption decreases to $3.5 million, the tax exposure hinging on this issue is $675,000 (i.e., $1.5 million x 45%).

If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax cost at the first spouse's death. For example, if there is a $5 million gift in 2011 and the donor dies in a year in which § 2001(g) remains in effect but the estate tax exemption has been reduced to $3.5 million and the rate has been increased to 45% and if the donor's will leave the entire estate to a surviving spouse or charity, the estate tax will be $1,227,272.73 if the Line 7 gift offset is determined under the Form 706 instructions approach. (Check: [$1,500,000 + $1,227,272.73] x 45% = $1,227,272.73.)

Carlyn McCaffrey points out that an approach to avoid this estate tax at the first spouse's death if clawback applies is to include provisions in the trust agreement of the trust that receives the gift (1) that give an independent party the right to grant the settlor a testamentary limited power of appointment over the trust (which would cause estate inclusion under § 2038, see Item 4.o for a more detailed discussion of this strategy), and (2) that cause any trust property included in the settlor's gross estate to pass to a QTIPable trust if there is a surviving spouse at the settlor's death.

Even if the "clawback" applies, the estate will not pay more estate taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death.

(9) *Effects of Paying Gift Tax If Rates Stay the Same or the Rates Later Increase.* If gifts are made requiring the payment of gift tax, if the donor dies within three years of the gift (so that the gift tax is brought back into the estate), and if the

estate tax rate is the same as the gift tax rate, there is no reduction in the combined gift and estate tax. The gift tax merely "prepays" the transfer tax, but the advantages of making gifts above would apply. By using the rates in effect at the date of death to calculate the gift tax that would have been payable on the adjusted taxable gifts, the system grants an advantage to making gifts at a lower rate than the ultimate estate tax rate. The amount of savings is generally equal to the amount of gifts in excess of the gift exclusion amount times a percentage equal to the difference between the marginal estate tax rate and the marginal gift tax rate.

l. *GST Tax — Overview of Changes*. The general GST effects of the amendments in TRA 2010 are summarized below. A more detailed discussion of changes and planning implications is in Item 5 below.

(1) *GST Applicable Rate in 2010 is Zero*. For all of 2010, the GST tax "applicable rate determined under section 2641(a)... is zero" for all generation-skipping transfers made in 2010. [TRA 2010 § 302(c).] This change in nomenclature (rather than the provision of prior law that all of chapter 13 does not apply to generation-skipping transfers after 2009) makes clear that generation-skipping transfers may be made in further trust.

(2) *GST Tax Applies After 2010*. TRA § 301(a) in effect repeals § 2664 added by EGTRRA, which section provided that Chapter 13 would not apply to generation-skipping transfers after 2009. This change is made effective for transfers made after 2009. However, as discussed immediately above, TRA § 302(c) provides the special rule resulting in a zero GST tax rate for generation-skipping transfers in 2010.

(3) *GST Exemption of $5.0 Million for 2010*. The GST exemption equals the estate tax "applicable exclusion amount under section 2010(c) for such calendar year." I.R.C. § 2631(c). Because the estate tax applicable exclusion amount is changed to $5.0 million for 2010, TRA § 302(a)(1), the GST exemption is $5.0 million for 2010. This is important, because it clarifies that there is up to $5.0 million of GST exemption that can be allocated on a timely basis to transfers to trusts in 2010, and that the donor of direct skip gifts in trust in 2010 should generally opt out of automatic allocation of the GST exemption to those 2010 direct skip gifts.

(4) *GST Exemption in Future Years*. The GST exemption for 2011 will also be $5.0 million. The $5.0 million amount is indexed from 2010, beginning in 2012. (The GST exemption amount is the same as the estate tax applicable exclusion amount, and the estate tax exclusion amount is indexed from 2010 beginning in 2012. TRA 2010 § 302(a)(1).) If the GST exemption amount is not changed by future legislation, after the TRA sunsets following 2012, the GST exemption will be $1.0 million, indexed from 1997.

(5) *GST Tax Rate After 2010*. The "applicable rate" for determining the GST tax is the maximum estate tax rate times the inclusion ratio of the trust. I.R.C. § 2641(a). Because the maximum estate tax rate is 35%, the GST rate is also 35% (except that the rate is zero for generation-skipping transfers in 2010).

m. *Section 2511(c) Deleted*. Section 2511(c), added by EGTRRA, provides that transfers to non-grantor trusts are treated as gifts. That section, which has raised considerable confusion, is fortunately deleted.

n. *Sunset Provision of EGTRRA*. Section 901 of EGTRRA says that the Code will be interpreted as if the provisions of EGTRRA had never been enacted with respect to estates of decedents dying after, gift made after, and generation-skipping transfers after 2010. However, there are many taxpayer favorable provisions in EGTRRA that might conceivably expire under EGTRRA § 901.

Most of these uncertainties are resolved for 2011 and 2012. TRA 2010 § 301(a) says that each Code provision amended by subtitles A or E of title V of EGTRRA "is amended to read as such provision would read if such subtitle had never been enacted." These subtitles only address the estate and GST tax repeal following 2009 and carryover basis.

All of the other provisions of EGTRRA would be given effect for 2011 and 2012, including the reduction of estate and gift tax rates (subtitle B), increase of unified credit exemption equivalent and GST exemption and setting the gift exemption at $1.0 million (subtitle C) (but TRA 2010 also increases the gift exemption beginning in 2011), replacing the state death tax credit with a state tax deduction (subtitle D), expansion of conservation easement rules for estate tax purposes (subtitle F), modifications of GST provisions, including automatic exemption allocations, retroactive allocations, qualified severances, modification of certain valuation rules, and the GST "9100 relief provisions"(subtitle G), and the relaxation of the requirements for deferred estate tax payments under I.R.C. § 6166 (subtitle H). This eliminates the concern about the effect of the sunset rule in EGTRRA on all of those other provisions for 2011 and 2012.

However, TRA 2010 provides for temporary tax relief (generally for just two years), and TRA 2010 § 101(a) states that Section 901 of EGTRRA is applied by replacing "December 31, 2010" with "December 31, 2012." This means that the sunset rule of EGTRRA is now delayed for two years, until following 2012. All of the uncertainties that we have had previously about the EGTRRA sunset provision remain, but are "punted forward" for two years to 2013.

2. Legislative Proposals Not Included in TRA 2010

A bill introduced by Senator Baucus on December 2, 2010 included various provisions that were not included in TRA 2010. The following provisions in the Baucus bill and several other proposals that have received some attention over the last several years were not included.

a. *Farmland*. Estate taxes on farmland could be deferred under the Baucus bill until the farmland is sold or transferred outside the family or ceases to be used for farming, subject to a never-ending complex estate tax recapture provision when the farmland was later sold, transferred outside the family, or ceased to be used as farmland.

b. *Special Use Valuation*. The Baucus bill would have increased the special use valuation adjustment amount from $750,000 (indexed to $1.0 million in 2010) under current law to $3.5 million (indexed from 2009 beginning in 2011).

c. *GRAT 10-Year Minimum Term*. The Baucus bill included the proposal in the President's Budget Proposal for the last two years of a GRAT 10-year minimum term. Under the proposal, grantor retained annuity trusts must have a 10-year minimum term, the annuity amount cannot decrease in any year, and the remainder interest must have a value greater than zero determined at the time of the transfer to the trust. At this point, there has been no indication whether the deletion of this provision reflects Congressional policy not to impose a 10-year minimum term on GRATs, or whether the Congressional writers are just saving this revenue raising provision for subsequent legislation.

d. *Consistency of Basis*. The Baucus bill also included the consistency of basis proposal in the President's Budget Proposal for the last two years. The basis of property in the hands of heirs would be the same as its value as finally determined for estate tax purposes, and the basis of property in the hands of donees for purposes of determining loss would be limited by the fair market value (under I.R.C. § 1015) as finally determined for gift tax purposes. (This provision in the Baucus bill was retroactive, applying to "transfers for which returns are filed after the date of enactment.")

As with GRATs, the deletion of this provision may just mean that it is being saved for future legislation when revenue offsets will be needed because this is a revenue raising provision.

e. *Section 2704*. TRA 2010 (as well as the Baucus bill) does not contain any provisions addressing I.R.C. § 2704 (as requested in the President's Budget Proposal the last two years). (This provision has not been included in *any* statutory proposal.)

f. *State Death Tax Deduction*. The extension of the estate tax provisions of EGTRRA means that the state death tax credit did not get reinstituted in January 2011 (which would have caused the re-emergence of state death taxes in many states that just have a "federal credit pick-up system" and that therefore have no state estate taxes if there is not a federal death tax credit). Furthermore, some have speculated that as a revenue raiser, Congress may at some point delete the deduction for state death taxes that now exists under I.R.C. § 2058. That was not done in TRA 2010.

3. General Estate Planning Approaches In Light of TRA 2010

a. *Instability and Unpredictability*. We are now looking at a very unstable system. Over the last 10 years, exemptions and rates changed in a stable progressive way. Exemptions have exploded from $2 to $3.5 to $5 million in the last several years. How can we advise clients going forward? It is extremely difficult to predict what will happen in 2013. At some point, will Congress began worrying how to pay for tax relief? Will China stop buying US bonds, so that Congress becomes worried about deficits and deadlock occurs with nothing happening in 2012 and the estate tax returning to a $1 million exemption 55% rate system in 2013? It is hard to handicap whether there will be small exemptions, large exemptions, or estate tax repeal following 2012. The probabilities really don't matter to an individual client. "When you are dealing with a sample of one, probabilities don't matter."

"We have been taught a lesson. We don't know what Congress will do from moment to moment, let alone in two years. This time, at least we know to warn clients that there is a tremendous amount of uncertainty, and we can't predict exactly what will happen." - Carol Harrington

b. *Predictions*. Predictions as to what will happen in 2012 vary significantly.

Beth Kaufman. There are at least four possible outcomes: (a) The 2011-2012 system becomes permanent; (b) the transfer tax system becomes a biannual tax extender; (c) there is complete political gridlock like in December 2009, and the system reverts back to a $1 million exemption 55% rate system temporarily until Congress can reach agreement; or (d) estate tax repeal gets passed.

Political considerations also enter into the uncertainty. The two-year extension through 2012 happens to throw the debate into the 2012 presidential election. Politicians are increasingly campaigning on problems that the other guys created, and political games could lead to gridlock.

The push for estate tax repeal could come from experience in 2011-2012 with estimates of only 5,000-6,000 taxable estates per year with revenue estimates of about $15 billion, down from $50 billion annually in 2001. The argument would be that the lower revenue does not justify all of the bureaucracy and private sector planning and that there should be other tax collection mechanisms.

Sam Donaldson. A rebuttal to the de minimis revenue argument is that the revenue is still substantial. A Congressional Budget Office estimate, based upon the $3.5 million exemption/45% rate system estimated a ten-year revenue of $168.1 billion, representing 1.2% of all federal revenues. However, that would completely fund the entire Department of the Interior and many other federal government agencies. Sam Donaldson quips, "if the exemption is increased to $5 million, maybe the estate tax could fund fish but not wildlife." Michael Graetz points out that the estate tax pays ¾ of the cost of Homeland Security.

Dennis Belcher. We all have a tendency to think tomorrow will look like today. That's why people buy high and sell low. However, tomorrow will not necessarily look like today. The debate over the estate tax in December 2010 included political trading with no associated "price tag." If the price tag does not matter again in 2012, we could very well end up with repeal. However, if the price tag does matter in the future, there could be a very different result. The revenue loss may be only $15 billion annually now, but it could be increasing significantly. The sad reality is that the estate tax system could become a part of the annual debate over tax extenders.

Carol Harrington. The odds of now passing legislation with sound tax policy because Congress has seen the errors of its ways seems rather silly. Having negotiated for 10 years, it's hard to see that congressman will compromise on this. When this comes up in the next lame duck session in 2012, President Obama will not be worried about getting reelected (he will either have been defeated for a second term, or will be in a second term without possible reelection). The economy, the makeup of Congress, etc. will be very different. "After they finish torturing us-- something they enjoy doing-- they'll eventually straighten it out."

Michael Graetz. The $5 million exemption and portability are here to stay. However, the rate structure is more vulnerable to changes. Whatever is done may be on temporary basis. It is a mistake to believe the repeal proponents have given up.

Lou Mezzullo. In light of the low number of the estates that will file estate tax returns and pay tax, generating a very small percentage of the federal revenue, is likely that the estate tax eventually will be repealed.

c. *Impact on Planners' Practices.* Planners will be very busy the next two years. Some planners say they have received more *client initiated* requests for estate planning reviews over several weeks than over the last five years. Look at what you enjoy doing. If your clientele is an "under $5 million" practice, there is already effective tax repeal. Much the same situation exists for $10 million couples if we end up with a $5 million exemption with portability. But there are still many things for planners to do. Some say that estate planners are social workers for the wealthy. Clients are really looking for planning for long-term management and preservation of their assets and distribution planning. State estate taxes and income taxes will become more important in planning practices. Planners will need to persuade their clients of the value of addressing the wide variety of non-tax issues in planning estates.

d. *Increased Focus on Client's Individual Goals and Customized Drafting To Meet Those Goals In light of Inherent Uncertainty.* Previously, planners could ask clients about their goals, and then structure those goals into a fairly standardized credit shelter trust /marital share planning approach. In the future, it will be imperative to focus on client goals in light of very unpredictable tax changes, rather than just tweaking the standard tax planning structure around the client's goals. Bruce Stone: "Clients tell us where they want their estates to go, not Congress, tax lawyers, or estate planners. Neither do state legislatures when they draft statutes to say what formulas mean."

Formula Driven Approach Based on Exemption Amounts. Planners for their entire careers have used instruments driven by standard formula clauses. The academic debate has been over issues such as whether to use pecuniary versus fractional formulas, or pre-residuary versus residuary bequests of the credit shelter or marital bequests. Standardized formula clauses could be used in the past because of stability in the estate tax system. That is no longer the case. Why are you still drafting documents to leave a formula amount, which will be based upon what a small group of people in Washington decide? What client in his or her right mind will want a document with that kind of uncertainty? Drafters must stop drafting wills where *nobody* can know what the formulas will mean.

The standard formula driven approach can still work in a truly harmonious family situation. The maximum exemption amount can pass to the credit shelter trust and the balance to the surviving spouse, without concern for what Congress does to the formulas. Even then, what if Congress repeals the estate tax — what will the formulas mean then?

For really wealthy clients, standard formula drafting will be sufficient. The exemption amount is just a nuisance anyway for them. In addition, for "Ward Cleaver" clients, the standard formula approaches will work fine. For other clients, documents will have to be customized to meet the detailed goals. The document does not necessarily have to address what happens if the exemption is $1 million, $2 million, $3.5 million, $5 million, or $10 million, but the core principles of the distribution plan must be identified to customize the plan in light of uncertain tax laws.

Planners should keep detailed notes of the client's goals in light of a variety of possible future tax law situations.

Customization Example With Formulas Including Flexibility to Defer or Accelerate Estate Taxes at First Spouse's Death. Consider the following as an example of the type of customization using "floors and ceilings" that will be needed in the new paradigm of uncertainty. A client with a $6 million estate has a spouse and two children by a prior marriage. The client wants to leave at least $3 million for supporting the spouse, but wants the overall estate divided so that it ultimately passes one-third to the spouse and two-thirds to the two children. Leaving $3 million outright to the spouse would leave $1 million short of the desired amount to pass eventually to the two children. The plan would be drafted to shift some of the spousal bequest to a QTIPable trust so that at least $4 million would eventually pass to the two children. The remaining $3 million would pass to the children, but not in excess of the federal estate exemption amount.

If the federal exemption is less than $3 million, the difference would pass to a QTIPable trust. If there is a state estate tax with a state-only QTIP election, there could be further limits on the bequest to the children to utilize a separate QTIP trust to avoid state estate taxes at the client's death. It will no longer be possible to just explain a standard credit shelter trust and sell a document based on that model.

As another example, assume wife has a $15 million estate that she wants to leave one-third to her husband and two-thirds to children by prior marriage. If she leaves $10 million directly to the children, that would cost approximately $2.4 million in federal and state estate taxes (assuming she lives in New York), but if the children receive $5 million currently, and receive the second $5 million when the husband subsequently died, the taxes payable at her death would drop to about $400,000 (the state estate taxes on the $5 million bequest to the children).

In this situation, the will might make a formula bequest to the children equal to the lesser of the estate tax exemption amount or two-thirds of the estate, and provide that if two-thirds of the estate exceeds the estate tax exemption amount, the difference passes to a QTIPable trust that would eventually pass to the two children. The other one-third of the estate would pass directly to the surviving spouse or to a QTIP trust for the spouse.

Carlyn McCaffrey has suggested ways to provide flexibility as to whether estate taxes would be paid at the first spouse's death or deferred until the surviving husband's death. One possibility is that the clause could give the surviving husband the right to disclaim his interest in the QTIP trust, (and provide in the trust that any disclaimed assets would pass directly to the children or to trusts for them). The surviving husband might disclaim, for example, if the transfer tax rates were expected to increase in subsequent years.

Another alternative would be to leave the flexibility of whether to defer estate tax until the surviving husband's death in the hands of the children. For example, there might be a formula bequest to a trust for each of the children equal to one-half of an amount equal to the difference between two-thirds of the residuary estate and the applicable exclusion amount. The terms of each trust would give the child the right to receive income from the trust for the surviving spouse's lifetime, with remainder to a discretionary trust for the child and his or her descendents. If the child thought that deferring estate taxes would be preferable, the child could disclaim the income interest, and the trust would provide that if the income interest is disclaimed by the child, it would pass to the surviving husband in a QTIPable format. (The disclaimer of the income interest by the children should be a qualified disclaimer, because the income interest was a severable interest created in the original document.)

Yet another alternative is to give an independent advisor or trustee the flexibility to make the choice of whether to defer estate tax until the surviving husband's death. Under this approach, there would be a formula bequest to a trust for the benefit of the surviving husband and children that would convert into a QTIP trust just for the surviving husband if the independent party (who would be the executor) made a QTIP election (the so-called Clayton election). If the QTIP election were not made, the trust would be a discretionary trust for the benefit of the surviving husband and children, but estate taxes would be due at the wife's death. The independent advisor and the family could make that decision at the time of the wife's death, with greater knowledge of the estate tax exemption amount at the time of the wife's death, and perhaps with better knowledge of what the law might look like when the husband subsequently dies than the parties know at the time the document is drafted.

Statements of Intent. Draft statements of intent regarding the core goals, making them sound as much like the client as possible. They will help if the court needs assistance in interpreting the document, rather than just having the sterile words of a formula. That sort of planning brings value to the client.

e. *Testamentary Drafting Patterns for Building Flexibility.* In this world of tremendous uncertainty regarding future tax systems, there is tension among (i) planning for federal estate tax savings, both at the first spouse's and second spouse's deaths, (ii) planning for state estate tax savings, and (ii) planning for basis step up if there are no estate tax concerns.

(1) *General Planning Strategy.*

(a) First, make sure the federal marital deduction is available at the first spouse's death whether by an outright bequest, QTIP trust, or general power of appointment trust (state estate tax planning flexibility is increased by using "QTIPable" trusts; state estate tax planning may be further simplified by deathbed gifts to utilize the federal gift and estate exemptions because gifts are generally not included in the state estate tax base);

(b) Second, make sure the surviving spouse has the flexibility to shelter the assets from estate tax at his or her subsequent death. For example, an outright bequest to the spouse with credit shelter trust provisions in the event of a disclaimer can work in a homogeneous family situation, but a QTIP trust may be needed for other situations (the portion for which no QTIP election is made is not includable in the surviving spouse's estate under §2044); and

(c) Third, following the first spouse's death, leave the flexibility for causing assets to be included in the surviving spouse's estate to obtain a basis step up at his or her death if there are no estate tax concerns (generally by permitting distributions to the spouse under a very broad "best interests" standard or by granting someone the power to cause the spouse to have a general power of appointment).

(2) *Disclaimer Approach.* The simplest approach is to leave the entire estate to the surviving spouse, but provide that any disclaimed assets would pass into a trust having the spouse and/or other family members as beneficiaries. The disclaimer approach has the advantage of simplicity in a homogeneous family situation. It may become the preferred approach for "low net worth clients." If there are state estate tax concerns, the disclaimed assets should pass into a QTIPable trust if the state recognizes a state-only QTIP election. If there are no state estate tax concerns or if the state does not recognize a QTIP election, the disclaimed assets will likely pass to a trust similar to standard credit shelter trusts.

Is a disclaimer by a surviving spouse invalidated by subsequent grant of a general power of appointment to the spouse? A possible analogy is that the IRS has approved "reverse QPRTs" where the children later decide to give the parent the right to live in the house for a period of time, if the children's decision was an independent action that was not pre-planned. However, it would raise the question of whether the disclaimer satisfies the "pass without direction of the disclaimant" requirement.

(3) *QTIP Trust Approach*. An alternative approach is to leave the entire estate into a trust for which a QTIP election could be made. Marital deduction qualification at the first spouse's death is available by making the QTIP election. To the extent the election is not made, assets would not be included in the surviving spouse's gross estate under § 2044. State estate tax planning is flexible with QTIPable trusts, particularly if the state recognizes a "state-only" QTIP election. (See Item 7 for further discussion of state estate tax planning issues.) "Clayton QTIP" provisions could be included to provide that the assets would pass to a different type of trust to the extent that the federal QTIP election is not made.

While either of the disclaimer or QTIP approaches can be used to afford flexibility in addressing federal and state estate tax planning issues at the deaths of either of the spouses, further planning is needed to afford the flexibility of basis step-up planning at the surviving spouse's subsequent death.

(4) *Basis Step-Up Flexibility; Broad Distribution Powers*. One method of causing estate inclusion if the surviving spouse has no estate tax concerns is to give the independent trustee broad authority to make distributions to the surviving spouse, in the absolute discretion of the trustee. (Even a "best interests" standard for a particular beneficiary might limit distributions for the purpose of allowing the beneficiary to make gifts.) An advantage of this approach is its simplicity, but possible disadvantages are discussed below.

(5) *Basis Step-Up Flexibility; Independent Party With Power to Grant General Power of Appointment.* The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the surviving spouse's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the surviving spouse's creditors. Howard Zaritsky points out that he prefers this approach to the broad distribution powers approach. Making physical distributions to the spouse may be mechanically cumbersome, particularly in a deathbed situation. The mechanics may be much easier by merely having the independent party sign a one-page document granting the spouse a general power of appointment. The surviving spouse may be elderly and have management issues with respect to outright ownership of the assets, or may be susceptible to pressure to make transfer to related family members or caregivers.

(6) *Basis Step-Up Flexibility; Formula General Power of Appointment.* The general consensus is to discourage the use of formula general powers of appointment, granted to the extent that the power would not result in the payment of estate taxes. There is concern that the beneficiary could have indirect control over all of the trust assets as a result of the formula grant of the power, meaning that the beneficiary would have a general power over all of the trust assets for tax purposes. If the formula operates without regard to the availability of a marital or charitable deduction, the formula no longer accurately grants a general power to cause basis step-up even though there would be no estate tax.

(7) *Basis Step-Up Flexibility; Delaware Tax Trap.* Another alternative to leave the flexibility to cause inclusion in the beneficiary's estate is to use the "Delaware tax trap." Delaware law at one time (perhaps still) provided that if someone exercises

a power of appointment to grant a presently exercisable power of appointment to another person, even a *limited* power of appointment, that grant of the new power is treated as a vesting of property for purposes of the rule against perpetuities. The original power could be exercised to appoint the assets in further trust, with a new perpetuities period running from the date of exercise, which means that the trust could be extended indefinitely without having the assets subjected to estate tax. Sections 2041(a)(3) and 2514(d) were enacted to prevent avoiding the estate tax indefinitely by successive exercises of limited powers of appointment and creating new powers in other persons of new presently exercisable limited powers of appointment. Section 2041(a)(3) provides that property subject to a nongeneral power of appointment (which would generally not cause inclusion under § 2041) will cause estate inclusion under that section if the power holder exercises the power of appointment "by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."

Under the law of most states, exercising a power of appointment by creating a new presently exercisable *general* power of appointment in another person is treating as vesting the property in the new power holder because he or she could exercise the power to appoint the property immediately to him or herself. If the new powerholder were to appoint the property in further trust, the perpetuities period on the new trust would run from the time of the exercise creating the new trust. Therefore, at the time the original power holder granted a new presently exercisable general power of appointment, § 2041(a)(3) would be triggered because the new power could be exercised in a way that the vesting of the property in anyone else could be postponed for a period longer than the perpetuities period that applied originally (i.e., "for a period ascertainable without regard to the date of the creation of the first power."). For an excellent discussion of the Delaware tax trap and ways of using the concept to cause estate inclusion in a trust beneficiary (in order to avoid the GST tax), see Jonathan Blattmachr and Jeffrey Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242 (April 1988).

Accordingly, using the Delaware tax trap is one way to cause inclusion in the surviving spouse's (or any other beneficiary's) gross estate, if the beneficiary would not owe estate tax in any event because of the estate tax exemption and the beneficiary would like to obtain a step-up in basis on the trust assets at his or her death. All that must be done to leave open the flexibility of using the Delaware tax trap is for the trust to give the beneficiary a limited power of appointment that includes the power to grant new presently exercisable powers of appointment. (The power to appointment in further trust would generally include this authority.) The decision of whether to trigger estate inclusion in the beneficiary's gross estate is then totally up to the beneficiary. If the beneficiary wants to trigger estate inclusion, the beneficiary would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the original powerholder's gross estate under § 2041(a)(3).

Under that approach, a negative aspect of causing estate inclusion in that manner is that the assets would also have to be included in the successor powerholder's gross estate as well (because the second powerholder would hold a general power of appointment).

Being able to use the Delaware tax trap in statues that have abolished their rule against perpetuities is more complicated. In that situation, a possible strategy suggested by some planners is to provide that the original trust lasts for 1,000 years, but that the power can be exercised to create a trust that could last for 1,000 years after the power is exercised. In this manner, the vesting of the property could be postponed for a period "ascertainable without regard to the date of the creation of the first power." As an example, Steve Gorin, an attorney in St. Louis, Missouri, suggests using the following clause in a state that has abolished its rule against perpetuities:

> "Notwithstanding the foregoing, if a power of to Appoint that is not a general power of appointment (within the meaning of Code section 20141) is exercised by creating another power of appointment which under the applicable local law could be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, then any trust created by such exercise shall terminate no later than one thousand (1,000) years after this Agreement becomes irrevocable; provided however, that the limitations of this sentence shall not apply if the exercise specifically states an intent to create a general power of appointment or specifically refers to Code section 2041(a)(3) in a manner which demonstrates such an intent."

To exercise the Delaware tax trap under that clause, the surviving spouse would "create another power of appointment that postpones the vesting of any estate or interest in such property, or suspends the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the first spouse's death (or creation of an inter vivos irrevocable trust) that also happens to be more than 1,000 years after the first spouse's death" (quoting Steve Gorin). Steve cautions that the use of this approach would depend on particular state law, and there may be limitations if a state has a 360- or 1,000-year rule against perpetuities.

(8) *Basis Step-Up Flexibility; Triggering "String" Provision.* To build in flexibility for achieving a basis step-up at the death of a transferor, consider purchasing appreciated assets from a grantor trust prior to the transferor's death or taking steps to trigger the "string" provisions of §§ 2036-2038. Planning flexibilities in the analogous gift situation regard for achieving estate inclusion in the original donor's estate are discussed below in Item 4.p below.

4. Planning Approaches To Utilize Increased $5 Million Gift Exemption

a. *Overview of Tax Effects.* The tax effects of gifts are summarized in Item 1.k above. The following is a brief summary.

- A donor can make gifts of the full additional gift exemption amount without paying gift tax.

- Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.
- Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:
  - removal of appreciation/income of gift assets from the gross estate;
  - utilizing fractionalization discounts;
  - paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
  - if the donor lives three years, gift taxes paid are removed from the gross estate; and
  - the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well.
- The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.
- Gifts can be disadvantageous from an overall tax cost perspective if a) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or b) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.
- Clawback — if the estate tax exemption amount is reduced below the current gift exemption amount, there is a possible "clawback" effect of having to pay estate tax on the excess gift exemption amount. For example, if the estate tax rate increases to 45% and if the exemption decreases to $3.5 million, the tax exposure hinging on this issue is $675,000 (i.e., $1.5 million x 45%). If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax cost. For example if there is a $5 million gift in 2011 and the donor dies in a year in which the estate tax exemption is reduced to $3.5 million and the rate is increased to 45% and if the donor's will leave the entire estate to a surviving spouse or charity, the estate tax will be $1,227,272.73. (See Item 1.k.(8) for a strategy to avoid this added estate tax at the first spouse's death if clawback were to apply.) Even if the "clawback" applies, the estate will not pay more taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death.
- There is a general belief that the estate tax "clawback" will not occur. Congressional staffers have indicated that it is not intended, and IRS guidance or further congressional technical corrections could make that clear.
- If a clawback of estate tax on the excess exemption amount should occur, the additional estate taxes probably cannot be apportioned against the donees, except in a state where the state apportionment statute allows apportionment against gift donees. If the donor dies within three years of making the gift, the IRS liens can reach the gift property. I.R.C. § 2035(c)(1). The donees could contractually agree to pay the additional estate tax under an arrangement similar to a net gift agreement, but that

contractual obligation would likely allow the IRS to pursue the estate's claim against the donees to collect the estate tax.

- If the donor pays gift taxes, the gift taxes are included in the gross estate if the donor dies within three years. Even in that situation, the gift tax merely "prepays" the transfer tax. If the estate tax rate is later increased above the gift tax rate that applied at the time of the gift, there will be savings equal to the amount of the gifts in excess of the gift exclusion amount times a percentage equal to the difference between the marginal estate tax rate and the marginal gift tax rate. If the donor lives at least three years after making a gift, any gift taxes paid on the gift will be removed from the gross estate for estate tax purposes.

b. *How Much Can the Donor Afford to or Want to Give*? While substantial additional gifts can be made without having to pay gift taxes, the initial question is how much can the donor afford to or want to give? The increased estate exemption may mean that the donor is not as concerned about estate taxes as in the past. However, TRA 2010 only lasts for two years and the estate exemption could be decreased in future years; alternatively, the estate exemption could be increased or the estate tax could be repealed in future years in which event the donor may preferred to have retained the gift assets.

Spouses collectively could give up to $10 million without having to pay gift taxes. Few couples can afford to give $10 million without potentially impacting their lifestyle in later years. A primary concern will be "will I have enough left to live on?" How do you define what are "discretionary" assets? That is not for the planner to define. "It's not the actual ability to make a gift that matters — it's the *perceived* ability to make a gift and maintain one's standard of living into the foreseeable future that matters." As a result, donors interested in making large additional gifts may want to consider the possibility of ways to preserve direct or indirect access to gift assets in the event of a "rainy day" financial reversal (strategies are discussed below).

c. *Gift Splitting*. If one spouse has most of the marital wealth, the couple can still take advantage of both spouses' $5 million gift exemptions by making the split gift election. § 2513. This can achieve the advantages of gifts with respect to $10 million worth of gifts instead of just $5 million.

A consenting spouse should be aware of possible effects of consenting to the election. Indeed, it may be appropriate to compensate the spouse for consenting to split gift treatment or it might be appropriate to amend a premarital agreement. For example, in return for agreeing to the split gift treatment, the donor spouse may agree that the consenting spouse can have the residence and leave it to anyone he or she wishes.

Fortunately, the election is just effective for gift and GST purposes (*see* § 2652(a)(2)), not for the purpose of treating the consenting spouse as the transferor for applying the estate tax "string" statutes (*see, e.g.*, Rev. Rul. 82-198, 1982-2 C.B. 206; Rev. Rul. 74-556, 1074-2 C.B. 300). However, possible bad effects may result for the consenting spouse. (1) At the consenting spouse's death, one-half of the gift assets will be added to the estate as adjusted taxable gifts, and the estate tax calculation operates in a manner that the consenting spouse's gift exclusion utilized in the split gift will effectively use up the consenting spouse's estate tax exclusion amount as well. (As discussed in Item 1.i above, if the estate tax exclusion amount has decreased by the time the consenting spouse dies, this could result in additional estate taxes being payable by the consenting spouse's estate even if all of the estate is passing to a surviving spouse.) (2) If the gift is included in the donor-spouse's gross estate under some section other than § 2035 (for example, a QPRT may be included under § 2036), both halves would be included in the donor-spouse's estate because the donor is treated as the transferor of both halves for estate tax purposes, but the consenting spouse's unified credit is not restored. (If the assets are included in the donor spouse's gross estate under § 2035, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation, but that only applies if the asset is included in the estate under § 2035.) I.R.C. § 2001(e). (3) If the gift is included in the donor's gross estate under § 2035, as mentioned immediately above, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation, but the consenting spouse's gift tax unified credit is not restored for purposes of later gifts by the consenting spouse. If there is any risk that the gift assets may be included in the donor spouse's estate under any of the string statutes, the spouse should be especially cautious about whether to consent to split-gift treatment. *See generally* Zeydel, *Gift-Splitting — A Bondage of a Bad Idea? A Comprehensive Look at the Rules*, J. TAX'N (June 2007).

In light of these potential adverse affects for the consenting spouse, consider whether the consenting spouse should have separate counsel in considering whether to consent to split gift treatment.

d. *"Rainy Day Fund" Considerations*; *Lifetime Credit Shelter Trust for Donor's Spouse*. The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse. The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. In some ways, this is the ideal kind of trust for the spouse because the spouse is a discretionary beneficiary, can be the trustee, can have a limited power of appointment (exercisable at death or in life), and the trust may be protected against claims of both the donor's and spouse's creditors. The power of appointment could be broad enough to appoint the assets back to the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under § 2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor's spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction, as discussed in paragraph f below. Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust, as discussed in paragraph d below.) If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment. The trust could define the "spouse" to be the person to whom the grantor is married to at the time without causing estate inclusion in the donor's estate (*see Estate of Tully Jr. v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§ 2036(a)(2) or 2038), so that the trust could also be available for the benefit of a new spouse. With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the spouse under § 677 (unless the consent of an adverse party were required for distributions to the spouse).

e. *"Rainy Day Fund" Considerations*; *Lifetime Credit Shelter "Non-Reciprocal" Trusts*. Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In Grace, the trust terms were identical, the trusts were created at the same time, and the trusts were of equal value. The Court said that the primary factor in determining whether trusts are sufficiently interrelated is "whether the trusts created by the settlors placed each other in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary." Id. If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Comm'r*, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries). Another possible distinction would be for one trust to include the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary. For an extended discussion of the reciprocal trust doctrine in the context of spouses creating lifetime QTIP trusts for each other, see Gans, Blattmachr & Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, 57-60 (July/August 2007).

The *Grace* case involved reciprocal interests rather than powers. Subsequent cases have differed as to whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under section 2036(a)(2) or 2038. *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to section 2036(a)(2) and 2038 powers); *Exchange Bank & Trust Co. of Florida v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1984); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see Estate of Green v. Comm'r*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. *Estate of Cole v. Comm'r*, 140 F.2d 636 (8th Cir. 1944).

f. *"Rainy Day Fund" Considerations*; *Discretionary Trusts in Self-Settled Trust States*. Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering § 2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Twelve states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help alleviate concerns that § 2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential § 2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under § 2036 is tested at the moment of death, and § 2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as there is no prearrangement). *See* Tech. Adv. Memo. 199935003 (§ 2035 will apply if pre-planned arrangement).

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot revest beneficial title or change the beneficiaries. (Various cases have held that there is no completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.) The ruling also discussed § 2036. The "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." While this is only a private letter ruling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7 holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under § 2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

The ruling does not address the result if the grantor is not a resident of Alaska. Many commentators view the analysis as applying even if the grantor does not reside in the state in which the trust is created. *See* Letter Rulings 9332006 (U.S. grantors created self settled spendthrift trusts under the laws of a foreign country and IRS held no estate inclusion) & 8037116; *Estate of German v. United States*, 7 Ct. Cl. 341 (1985) (Maryland trust created by Florida grantor). However several bankruptcy cases have denied a discharge to grantors of a foreign situs self-settled spendthrift apparently because the law of the grantor's domicile did not permit such trusts.

The position that the self-settled trust will not be included in the gross estate of the grantor may be the strongest for self-settled trusts created in Alaska and Nevada. In all of the other self-settled trusts states, some creditors can reach the trust assets (for example, for certain family obligations such as for alimony or child support), and that may jeopardize the "no inclusion" argument. *See* Rothschild, Blattmachr, Gans & Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be In Grantor's Estate*, 37 EST. PL. 3, 11-12 (Jan. 2010).

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under § 2036 in part based on whether trust assets can be reached by any of the grantor's creditors. *Estate of Uhl v. Comm'r*, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under § 2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); *Estate of Paxton v. Comm'r*, 86 T.C. 785, 818 (1986)(self-settled trust assets included under § 2036 because grantor's creditors could reach income and corpus); *Outwin v. Comm'r*, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); *Estate of German v. U.S.*, 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on § 2036(a)(1), because grantor's creditors could not reach trust assets where trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries). Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

g. "*Rainy Day Fund" Considerations; Sale for Note or Annuity*. A sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift to a grantor trust, but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. "Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze."

If a client has long ago made transfers to a grantor trust, the client might consider selling substantial assets to the trust in return for a lifetime annuity. An "old and cold" trust should be used to build the best arguing position that the transfer is made for full consideration so that § 2036 should not apply. The trust would have to contain sufficient assets to satisfy the "exhaustion" test described in Reg. §§ 25.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 1.7520-3(b)(2)(i), which assumes that the measuring life will live to age 110. If the trust does not have sufficient assets to cover all of the exhaustion test, it may be possible for individuals to guarantee the annuity to avoid the impact of the exhaustion test.

h. *"Rainy Day Fund" Considerations*; *Preferred Partnership*. Mil Hatcher has used preferred partnerships in his planning for many years. A preferred partnership can assist in leaving the donor with access to funds to maintain the donor's lifestyle. He uses this example. Assume client has $20 million of investable assets, producing $800,000 per year (at a 4% withdrawal rate) for living expenses. If the client gives $5 million, the 4% withdrawal amount would be reduced to $600,000. The $600,000 is sufficient currently, but what if the client were to need $800,000 in a year? To assist with the client's comfort level, the client would give $5 million to children (or a grantor trust for them), would keep $5 million (generating $200,000 per year) and would contribute $10 million to a preferred partnership. The client would receive a preferred partnership interest yielding 8% for $5 million of the contribution, or $400,000 per year. The other $5 million would be contributed for a common interest owned by the client. The client would have annual cash flow of $400,000 from the preferred partnership interest and $200,000 from the retained $5 million of investments. In addition, the client would own a $5 million common interest in the partnership, hopefully generated growth of more than 4% per year, and distributions might be made with respect to the common interest if the client needed additional funds at some point in the future.

i. *Taking Advantage of $5 Million GST Exemption*. There are no assurances that the GST exemption will remain at $5 million. Making a $5 million gift and allocating the $5 million of GST exemption that is currently available is one way of assuring that the full $5 million GST exemption can be used. The safest way of utilizing the $5 million GST exemption would be to make direct skip gifts, to as low a generation as is practicable. Even if the TRA 2010 provisions sunset at the end of 2012, and the Code is interpreted as to future generation-skipping transfers as if the provisions of TRA 2010 (or EGTRRA) "had never been enacted," there would be no ability to impose a GST tax retroactively on the direct skip that occurred in 2011 or 2012 when the direct skip gift was made to the trust. On the other hand, if a gift is made to a dynasty trust and $5 million of GST exemption is allocated to the trust and if TRA 2010 sunsets, it is not clear that for purposes of determining the inclusion ratio of the trust as to a generation-skipping transfer that occurs after the sunset date whether the full $5 million of GST exemption could be considered.

j. *Views of Panelists Regarding General Approach Toward Utilizing $5 Million Gift Exemption*.

- If you think the exemptions are going down in the future, take advantage of the gift exemption (and GST exemption, if appropriate) currently.
- Reciprocal trusts for the spouses with different provisions are a possible planning strategy but will not be readily accepted by most clients.
- Most clients do not want to make a $5 million gift unless there is a real reason to do so. The "tax tail has wagged the dog but it won't in the future. That's why this $5 million exemption is a sea-change."
- As to the "clawback" possibility, most panelists were of the "use it or lose it" mindset. If the client is in a position to do so, go ahead and make gifts utilizing the $5 million exemption in 2011 or 2012. We don't know what Congress will do in the future, and most planners are not losing sleep over the clawback possibility. "The exemption has

never gone down, and being young and naïve, I think it will not go down. This may drag into 2013 and may take a new Congress or president, but I think this will work out." Another panelist: "You are young and naïve." Another panelist: "She's young, naïve, and right."

k. *Forgiveness of Outstanding Loans to Children*. Many clients will be interested in forgiving existing loans to children as an easy way of utilizing the $5 million gift exemption. A possible concern exists if there has been a repeated pattern of forgiving loan payments. If the IRS can establish intent from the outset that the entire loan would be forgiven eventually, the IRS may treat the gift as occurring all in the year of the initial advance. *E.g.*, Letter Ruling 200603002; Field Service Advice 1999-837. Utilizing the newly granted increased gift exemption may help rebut the "original intent" implication. Typically, the forgiveness will not result in discharge of indebtedness income. Rev. Rul. 2004-37, 2004-1 C.B. 583 ("debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules").

l. *Gifts to Grantor Trusts*. Making transfers to grantor trusts, where the donor continues to pay income taxes on the trust income, has a huge impact on the amounts that can be transferred over time. The trust assets compound free of income tax, and the payment of income taxes by the donor further depletes his or her estate (substantially over time). Simple $5 million (or $10 million for couples) gifts to grantor trusts can move huge amounts of value out of the donor(s)' gross estates over time.

m. *Gifts to Grantor Trusts Leveraged With Loans*. A very simple additional strategy would be to make a $5 million (or $10 million for couples) gift to a grantor trust and then loan up to nine times that with a very low interest AFR note to the trust, substantially leveraging the amount of future income and appreciation that could be shifted to the trust.

n. *Gifts and Sales to Grantor Trusts*. Sales to grantor trust transactions traditionally are often complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The $5 million gift exemption ($10 million for couples) relieves many of those difficulties. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Huge estate tax savings could result over time from freezing future appreciation from coming into the estate and from "burning" the estate by making the income tax payments. The grantor trust status could be left intact until the grantor had depleted the estate as much as he or she was willing to deplete it.

If prior sale to grantor trust transactions have been structured using guarantees to provide "seed" equity to justify the sale, the clients might make additional gifts to the trust and terminate the guarantee agreements.

The sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). Similarly a sale to an "old and cold" grantor trust for a lifetime annuity may leave the donor in a more comfortable position than making a large gift. See the discussion in Item 4.g.'

o. *Highly Volatile Assets; GRATs or Gift/Sales Transactions With Minimal "Seed" Gift*. For highly volatile assets, a preferable approach may be to use GRATs rather than gift/sale transactions to avoid the possibility of wasting the client's gift exemption if the volatile asset becomes worthless. Mil Hatcher observes that for highly volatile assets, the gift element in the gift/sale transaction should be minimized. This minimizes the risk of the highly volatile asset declining in value substantially, which may eliminate the value of the trust, and result in having wasted the client's gift exemption. For example, if a couple might be interested in selling $30 million of assets to a grantor trust, do not fund that trust with a $10 million gift, but only fund it with a gift of $3,333,000. Using a 9 to 1 ratio, that would still justify a sale of assets for $30 million. If the couple wants to utilize the full $10 million gift exemptions, give the remaining $6,667,000 to another trust. This approach does not expose the other $6,667,000 to the sale transaction in case the assets decline in value. (Alternatively, one grantor trust could be used, but the $3,333,000 amount needed to support the sale would be contributed to an LLC, the member interests in the LLC would be given to the trust, and the sale would be made to the LLC, thus not putting at risk the other $6,667,000 assets given to the trust.) Mil Hatcher observes: "A problem in the past was not coming up with enough seed money. In the future, the problem may be having too much seed money."

p. *Basis Step-Up Flexibility; Repurchase of Assets by Grantor, Triggering "String" Provision*. Consider steps to build in flexibility for achieving a basis step-up at the death of a transferor. Key to this flexibility will be making the gift to a trust rather than an outright gift.

One traditionally used method to achieve a basis step-up is for the grantor to repurchase appreciated assets from a grantor trust recipient.

Another approach is to draft the trust to give an independent trustee or other independent party the power to grant a testamentary limited power of appointment to the grantor. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from beneficiary to another. If so granted, this would cause inclusion in the grantor's estate under § 2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.

The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 35% of the excess of the date of death value over the date of gift value is less than amount equal to 15% of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an ETIP, which would preclude immediate allocation of GST exemption to the trust.

Another possible approach would be to take steps to trigger the "string" provisions of §§ 2036-2038. For example, the parent may continue living in the house in a QPRT without paying rent to trigger § 2036(a)(1). However, the IRS conceivably may not take the position in that type of circumstance that the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under § 2036(a)(1).

A further extension of this planning would be to leave the flexibility of causing the trust assets to be included in the donee-'s estate for estate tax purposes if there are no estate tax concerns for the donee and if a basis step-up at his or her death would be desirable. These are the same strategies that could be used in creating trusts for a spouse in the testamentary context. See Item 3.e.(4-7) for a discussion of specific strategies.

q. *GRATs*. GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption.* Everything else being equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

Furthermore, for transferring hard to value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT. (However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

The $5 million gift exemption opens up the possibility of another strategy that would minimize the valuation risks in making annuity payments. For example, a client might give some of the $5 million gift exemption amount to the grantor trust that will be the remainder beneficiary of a GRAT. When the annuity payment is due, the grantor trust might loan funds to the GRAT which it could use to make the annuity payment, without having to make an in-kind distribution. There would be no gift valuation risk with respect to annuity payments that could be funded with such loan proceeds.

The 10-year minimum term provision is not included in TRA 2010. Does that mean that rolling two-year GRATs can be created within the next two years before TRA 20120 sunsets? We cannot be sure. Congressmen may have simply wanted to save the GRAT 10-year minimum term revenue raising provision for some subsequent bill in 2011 that needs a revenue raiser to offset the cost of some new bill.

r. *Life Insurance Transfers*. A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having $5 million ($10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life insurance coverage that can pass free of transfer tax to younger generations. For example, a $2 million premium can often purchase $20 million of second-to-die life insurance coverage.

Split dollar agreements have often been used in the past to help finance the payment of large premiums by an irrevocable life insurance trust where the insured could not make gifts to the trust large enough to cover the premiums without having to pay current gift taxes. If split dollar arrangements have been used in the past, large gifts (within the $5 million gift exclusion amount) could be made to the trust to roll out of the split dollar arrangement and simplify the planning.

Consider making a large gift to the trust currently (while the $5 million gift exclusion still exists), rather than just making increased gifts as premiums become due. Lock in the ability to make a $5 million transfer to pay future premiums without having to pay a current gift tax. There is always the possibility that the gift exclusion returns to $1 million after 2012.

Some clients may be inclined to drop coverage, under the theory that they have no estate tax concerns with a $5 million ($10 million for a couple) exclusion from the estate tax. Those clients should understand that they may not qualify for insurance if they subsequently find they have a need for it. Furthermore, the estate tax system is in a state of flux, and anything could happen in 2013 (including going back to a $1 million exemption/55% system).

s. *Deemed §2519 Gifts from QTIP Trusts*. One way to make use of the $5 million gift exemption is triggering § 2519 with QTIP trusts. A gift of the income interest will result in a deemed gift of the remainder interest of the QTIP under § 2519. This may be a way for a surviving spouse who is a beneficiary of a QTIP trust to make use of the $5 million gift exemption if the QTIP trust is no longer needed. A gift of a small portion of the income interest in a QTIP trust can also result in a gift of the entire remainder interest under § 2519. However, it is likely that § 2036(a)(1) would cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. Miami Heckerling on Est. Plan. ch. 12 ¶ 1202.3 (2010).

For example, if the spouse makes a gift of 0.1% of the income interest, retaining the other 99.9%, it is likely that 99.9% of the trust assets would be included in the spouse's estate under § 2036(a)(1). A possible planning approach would be for the spouse to sell the income interest, rather than making a gift of it, to avoid § 2036(a)(1) inclusion. The spouse would continue to receive payments on that note (rather than a fluctuating income entitlement). That could result in freezing the value of the QTIP trust assets for transfer tax purposes. This was the fact situation in Letter Ruling 201024008, but a ruling on the § 2036(a)(1) issue was not requested or given. (A sale of the income interest may result in the spouse having a zero basis in the income interest under § 1001(e)(1) for purposes of determining how much gain is recognized on the sale transaction. Section 1001(e)(1) should not be triggered by a gift of some or all of the income interest.)

t. *QPRTs*. One of the disadvantages of a qualified personal residence trust (QPRT) is that there is a significant (though highly discounted) gift element. The $5 million ($10 million for a couple) gift exemption may permit the transfer of even very valuable residences to a QPRT while still allowing the gift element to be covered by the gift exclusion to avoid having to pay gift taxes when the QPRT is created. (Of course, QPRTs are not as favorable in the current very low AFR environment as they are with a higher AFR.)

u. *Same-Sex Couples*. Planning for same-sex couples is difficult because of the lack of a gift or estate tax marital deduction. The increased $5 million gift tax exclusion opens up significant possibilities for transferring assets between the partners without current gift tax consequences.

v. *Equalizing Gifts to Children or Grandchildren*. A frequently recurring request is to make gifts to equalize gifts to all of the children or grandchildren. The extra $4 million of gift exclusion may permit some donors to equalize gifts when they have not had enough gift exclusion to do so in the past.

w. *Gifts to Save State Estate Taxes*. Only several states have state gift taxes. At least one state, Maine, requires that gifts made within one year of death be added to the gross estate for state estate tax purposes. In other states, gifts within the $5 million gift exemption would be free of federal and state gift taxes. However, the gift assets would no longer be subject to state estate taxes (as long as there were no retained interests in or powers over the gift assets that would cause estate inclusion for state estate tax purposes). Even deathbed gifts could result in substantial state estate tax savings. (See Item 7.) A disadvantage is that the gift assets will not be eligible for a step-up in basis at the donor's death, but that would not be a disadvantage for a gift of high basis assets.

x. *Gifts May Impact § 6166 Qualification*. Closely held business interests often represent highly appreciating-high income producing assets that can be the perfect vehicle for gifts. Making $5 million ($10 million per couple) of gifts in a closely held business may take the business interest in the estate below the 35% of adjusted gross estate level needed to qualify for § 6166 estate tax deferral.

5. Generation-Skipping Planning Issues Under TRA 2010

a. *GST Exemption Allocations; Opting Out of Automatic Allocations; Allocating GST Exemptions to "Indirect Transfers" to Trusts*. There is now 2010 GST exemption ($5 million) that can be allocated on a timely basis to transfers that were made in trust during 2010.

It is VERY important to remember to "opt out" of automatic allocations to direct skip gifts in 2010 that are intended to pass to the current beneficiary rather than future generations. Because the GST tax rate is zero on direct skip gifts in 2010, allocating GST exemption to the transfer would waste the exemption (unless a direct skip trust will remain in existence for the life of the current beneficiary and then pass to younger generations). Dennis Belcher warns: "That will catch a lot of people. You can't say it enough times."

Be sure to calendar the date for opting out of automatic GST exemption allocations for any direct skips (unless the trust is intended eventually to pass to beneficiaries in younger generations than the current beneficiaries of the trust). (The due date is no earlier than September 19, 2011. If the direct skip was a lifetime gift, and if the individual's income tax return is extended to October 17, that also extends the gift tax return's due date to October 17, 2011.)

One planning pointer in light of the uncertainty about sunsetting of the various favorable provisions in EGTRRA (including the automatic GST exemption allocation rules in EGTRRA), as discussed in Item 2.n, is that planners should not rely on automatic GST exemption allocations under the automatic allocation provisions added in EGTRRA, but instead should file returns making affirmative exemption allocations until the sunset uncertainties of the EGTRRA provisions are resolved.

While TRA 2010 provides an extended due date (to no earlier than September 19, 2011) for reporting direct skip transfers, there is no extension of time or allocating GST exemption or opting out of automatic allocation for "indirect skip" transfers to trusts (i.e., transfers to trusts that are not direct skips). If an individual has made both direct skip gifts as well as indirect skip gifts, as a practical matter both should be reported, making GST exemption allocations or opting out of automatic allocations, on the same tax return under the normal filing cycle (April 18, 2011 or October 17, 2011 if the return is extended).

b. *Disclaimers in 2011 Can Result in 2010 Direct Skips*. Disclaimers in 2011 may result in direct skips having been made in 2010 with a zero GST tax rate. For testamentary transfers, the general thinking is that direct bequests under the will are deemed to have occurred at the time of death for GST purposes. (Otherwise there would be too much possibility for manipulation of the GST tax system by indefinitely delaying the funding of bequests.) A corollary is that disclaimers also operate as of the date of death for testamentary transfers. Under this reasoning, disclaimers made in 2011 (and keep in mind the extended period for disclaimers up to September 17, 2011 for estates of decedents who died before December 17, 2010, but the extended period does not apply to disclaimers of gifts) may result in transfers for younger generation beneficiaries that are treated as 2010 direct skips, thus qualifying for the zero GST tax rate.

If there is any question about whether acceptance may have already occurred, precluding the effectiveness of a disclaimer, consider filing a Form 709 to report the disclaimer as a nongift transaction, in order to start the statute of limitations on a gift allegation by the IRS.

c. *Reporting 2010 Direct Skip, Taxable Distribution or Taxable Termination Transfers*. Should returns be filed to report 2010 generation-skipping transfers? Even though there is a zero GST rate, a return is still technically required. However, the issue of generation-skipping transfers with a zero rate has been around for 25 years; trusts with a zero inclusion ratio are not *exempt* from the GST tax — they just have a zero tax rate. However, "nobody filed tax returns for zero inclusion ratio trusts," unless they were worried about what the inclusion ratio was. For direct skip gifts (or other generation-skipping transfers) in 2010, there is no uncertainty. The only purpose for filing a return would be to get the statute of limitations running, but with a zero tax rate, that does not matter. There are no penalties where no GST tax is due, because there are no information reporting penalties for GST tax returns. Carol Harrington's advice: "File if you want to, but I am not planning to file GST tax returns to report 2010 generation-skipping transfers."

d. *Mechanics of Allocating GST Exemption for 2010 Decedents if the Carryover Basis Election is Made*. For 2010 decedents, the $5 million GST exemption should be allocated on a Form 706 like always. If the estate makes the carryover basis election to opt out of the estate tax regime, the estate will not be filing a Form 706, and we do not yet know how the GST exemption allocations will be made. There have been indications from the IRS that it may add Schedule R of the Form 706 to the Form 8939, as discussed in Item 1.e.(1).

e. *Addition at a Later Time of Upper Generation Beneficiaries to Direct Skip Trusts*. Some planners suggest that some independent party (an independent trust, a trust protector, or anyone other than the donor) could add upper level generations as discretionary beneficiaries to a skip person trust sometime after the trust is created without causing the trust to lose its status as a skip person trust (resulting in application of the move-down rule under § 2653 when the direct skip transfer was made to the trust). The older generation beneficiaries could only be added at a later time — long enough to provide comfort that such persons could not be viewed as having an interest in the trust currently. If non-skip persons (beneficiaries at the children level) could be added at a later time, in effect, the trust could benefit children and grandchildren without any GST tax being due when the trust is created in 2010 (because of the zero GST rate in 2010) or when distributions are made to grandchildren during the trust term or upon termination. There is some concern, however, that a court might ultimately find that to be an abusive "end-run" around taking advantage of the zero tax rate on direct skips in 2010.

A trust will be a skip person (and therefore, result in application of the move-down rule under § 2653) if a second generation below the transferor or more remote beneficiary has a right to receive current distributions or is a permissible current recipient of distributions and if there are no interests held by non-skip persons. § 2613(a)(2) (definition of skip person trust) and § 2652(c)(definition of "interest"). If that is the case, it does not matter that non-skip persons may be contingent remaindermen or future beneficiaries. (The possibility that non-skip persons may receive benefits in the future applies under the statute and regulations only if there are no persons that hold interests in the trust when it is created (for example if no distributions can be made to anyone for a period of years).)

Some respected planners suggest waiting five years before upper generation beneficiaries are added. This would help to counter any argument that the non-skip person should be treated as an intended current beneficiary by implication or under some kind of application of a step transaction theory.

Another possible IRS argument is that nominally named beneficiaries can be ignored under § 2652(c)(2) if the interest is used primarily to postpone or avoid any GST tax. If the grandchild's interest in the trust at the outset is ignored, the trust would have no beneficiaries with current interests, and § 2613(a)(2) says that future contingent beneficiaries are then considered in determining whether the trust is a skip person (but the interest of any person to whom the likelihood of a distribution is so remote as to be negligible [applying actuarial standards showing there is less than a 5% probability] is disregarded, Reg. § 26.2612-1(d)(2)). The IRS may view the children as have contingent future interests, thus causing the trust not to be a skip person at the outset, which would mean that the move-down rule would not apply, so subsequent distributions to grandchildren or more remote beneficiaries would be subject to the GST tax. There is not much guidance on how the nominal interest test is applied. In Letter Ruling 9109032 the IRS applied the statute to disregard temporary absence of an interest (for one year).

Some planners even suggest that the trust agreement could provide that older generation beneficiaries would automatically become discretionary beneficiaries after a stated period of time — such as five years, because then only lower level generation beneficiaries would hold current interests, thus literally making the trust a skip person.) However, other planners prefer a more conservative approach of not adding upper level beneficiaries at a later time.

Conclusion: There is concern if the plan all along is for the children to be added back as beneficiaries. Have some considerable delay before adding children as beneficiaries and they should only have discretionary interests.

f. *Retroactive Exemption Allocation if Untimely Order of Deaths, What GST Exemption is Available?* Under § 2632(d) (added by EGTRRA), if a child (or certain other "G2" members) predeceases the transferor, the transferor may allocate unused GST exemption to any previous transfers to the trust on a chronological basis. How much GST exemption is available is not clear. Proposed regulations say only the GST exemption available at the time of the original transfer can be applied retroactively, but the statutory language of § 2632(d) suggests that the amount of GST exemption available immediately before the untimely death can be allocated. Accordingly, if the untimely death occurs in 2010 or later, GST exemption of $5 million (indexed) should be available under the statutory language.

g. *ETIPs Did Not End on January 1, 1010.* GST exemption cannot be allocated during an "estate tax inclusion period" (i.e., during any time that the trust assets would be included in the transferor's estate if he or she died during that period). Under EGTRRA, Chapter 11 did not apply after 2009, raising the questions of whether ETIPs ended on January 1, 2010. Because the reinstatement of the estate tax to January 1, 2010 is retroactive, planners uniformly believe that ETIPs did not end at the beginning in 2010. This is the likely result regardless of whether the carryover basis election is made for a 2010 decedent, because the Joint Committee on Taxation Technical Explanation says that the carryover basis election is not intended to affect generation-skipping transfer tax rules. This issue regarding the effect of the carryover basis regime election obviously applies only to 2010 decedents, and for those decedents, the ETIP ends as of the date of death in any event. However, because TRA 2010 only applies for two years, we will have the uncertainty regarding ETIPs again on January 1, 2013 absent further legislation.

h. *Basis Adjustment for Taxable Terminations at Death.* If a taxable termination occurs at the death of an individual, there is a basis adjustment under § 2654(a)(2) similar to the basis adjustment under § 1014. Does making the carryover basis election for 2010 decedents change that basis adjustment that applies to taxable terminations at death? Probably not, in light of the comment by the Joint Committee that making the carryover basis election does not impact generation-skipping transfer tax issues.

i. *65-Day Rule Cannot Be Used to Treat Taxable Distributions as Occurring in 2010.* The "65 day rule" under § 663(b) is an income tax rule and has no relevance for GST tax purposes.

6. Planning Considerations For Untimely 2010 Gifts

A donor who made gifts in 2010 and would pay a 35% gift tax may prefer to "undo" the 2010 transfer and instead make the transfer effective in 2011 when there is a $5 million gift exemption. (If the client can afford to make gifts with other assets in 2011 to utilize the $5 million gift exemption amount, there is no real problem with having made gifts and paying gift tax in 2010. If the donor lives at least three years, there is the advantage of taxing the transfer on a tax exclusive basis.)

a. *Decision Tree.* Plan of attack: (1) Consider disclaimers, and if that is not available; (2) Consider rescission. Do not give up easily on "self-help" to undo the 2010 gift.

b. *Disclaimer.*

(1) Is a disclaimer possible? (The extended time period for making disclaimers only applies to estates of decedents who died before December 17, 2010. It does not apply to disclaimers of gifts.)

(2) Has the donee accepted the property so that a disclaimer is no longer available? The IRS may be more generous than in the past in determining what constitutes acceptance, in light of the totally unforeseen legislative change extending the time for the disclaimer. "Merely taking delivery of an instrument of title, without more, does not constitute acceptance." Treas. Reg. § 25.2518-2(d)(4). Perhaps depositing a check in one's account may be allowed, but receiving interest or dividends or selling the asset or spending the proceeds would not be. If the donee reverses the transfer, perhaps any purported acceptance would be negated. Look carefully at state law. File a Form 709 to report the disclaimer as a non-gift transaction. That starts the statute of limitations as to whether the transfer has gift consequences for that year. (One accountant reports that she always files Form 709s for disclaimers to report them as non-gift transactions.)

(3) Determine where the disclaimed property will pass under local law. There may be a different result in different states. Look at all relevant states to see if there are differences of whether property would pass. If the assets do not pass back to the donor as a result of the disclaimer, a disclaimer will not "undo" the 2010 gift. Gifts to trusts are particularly suspect; the disclaimed assets may not return to the settlor but to other trust beneficiaries. *See generally* Handler & Chen, *Formula Disclaimers: Procter-Proofing Gifts Against Revaluations by Service,* 96 J. TAX'N 231 (April 2002).

(4) Apply relevant conflict of laws principles to determine which state's law applies. (For testamentary transfers, it may be more likely that the law of the transferor's domicile would apply than for inter vivos transfers. For gifts, the law of the donee's domicile may apply.)

c. *Rescission.* If a disclaimer will not work, consider rescission of the 2010 gift. If a gift is made under a mistake of a material fact, rescission may be possible under state law if the donees have not substantially changed their position in a way that would make the rescission unconscionable. The question is whether a business judgment of what legislation may or may not pass in the future is a mistake of fact or just an error of judgment. The most recent rescission case, *Breakiron v. Guidonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010), allowed rescission of a disclaimer from a QPRT on the basis of a mistake of law as to the effect of the untimely disclaimer. In *Stone v. Stone*, (a 1947 income tax case) a rescission was permitted of gifts to children that were made under the mistaken assumption that the income tax from the gift assets would be shifted to the donees. In *Neal v. United States*, 187 F.3d 626 (3rd Cir. 1999), the donor relinquished a retained power to avoid triggering the old § 2036(c), which was later repealed retroactively. *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).

Rescissions have generally relied on a retroactive change in law or bad advice; no case has been located based on a wrong guess of what the law would be in the following year. Perhaps the mistake in *Neal* of not knowing that § 2036(c) would be repealed retroactively is analogous to not knowing that the gift exemption would be increased substantially for the following year.

The notion that rescissions are respected only if they occur in the same taxable year is an income tax concept. *See* Rev. Rul. 80-58, 1980-1 C.B. 181 (rescission occurring in same year as taxable event is respected if parties are returned to their original positions). Completing a rescission in 2011 of a 2010 transaction may still be recognized for transfer tax purposes.

7. State Estate Tax Planning in Light of $5 Million Federal Exemption Under TRA 2010

While state estate taxes are considerably lower than federal estate taxes, they are still significant. Planning for domicile of the client will still be important. Formula clauses should be reviewed in light of the increased federal exclusion amount. Some clients may have opted previously to fully fund a bypass trust even though doing so would generate some state estate tax at the first spouse's death. The client may have been willing to do that with a $3.5 million federal exclusion but may not be willing to do that with a $5 million federal exclusion. For example, if the state has a $1 million exemption (which is the case for most of the states that have state estate taxes), paying state estate tax on the excess $4 million would incur $391,600 of state estate taxes in some states if the state tax is charged against the bypass trust (leaving a net funding of $4,608,400) and would incur $444,091 of state tax if the state tax is not paid out of the bypass trust. A possible strategy to avoid paying this state tax is to fund the bypass trust with only the state exemption amount and rely on portability to take advantage of the balance of the first deceased spouse's federal exemption amount. However, as discussed in Item 1.f, there are a variety of uncertainties in relying on portability (not the least of which is that the portability provisions expire in two years unless renewed by Congress).

In states that allow a state-only QTIP election, planning to accommodate the increased federal exemption amount is more flexible. For example, in states with a $1 million state exemption, the bypass trust could be funded with the state exemption amount ($1 million), and a "QTIPable" trust could be funded with the remainder of the federal exemption amount (the remaining $4 million). A state-only QTIP election would be made for the $4 million trust. In this manner, the full $5 million federal exemption is utilized without incurring state estate taxes at the first spouse's death.

Gift planning may also save significant state estate taxes, because gifts are not included in the state gross estate base. The ability to make a $5 million gift without federal gift tax means that very substantial state estate taxes may be saved via gift planning. This is particularly important for deathbed planning. Query whether states that have state estate taxes will move toward enacting state gift taxes as a backstop to the state estate tax.

8. "Best Practices" Summaries of General Planning Ideas in Light of TRA 2010

a. *Bruce Stone Ideas.*

(1) Send a letter to clients soon about portability. Why? Business generation. Tell clients that portability is an option, but don't recommend in the letter that the client use portability. Information about the portability concept will spread in the public press, and clients will appreciate hearing it from you. (Bruce agrees that it is better to use credit shelter trust planning rather than relying on portability.)

(2) If a credit shelter trust is used, leave flexibility to obtain a basis step up if the surviving spouse has no estate tax concerns. Bruce prefers the simple drafting

technique of giving an independent trustee the authority to make distributions to the spouse based on best interests. In Florida that also allows decanting to a trust with a power of appointment. He prefers avoiding the complexity of granting or removing general powers of appointment.

(3) If a client made taxable gifts in 2010, don't give up on rescission. Don't cross ethical boundaries, but do not give up on rescission.

(4) If a beneficiary is willing to make a disclaimer from a 2010 estate to result in a direct skip, don't give up if it appears that there may have been acceptance. See if it is possible to restore the status quo and then make the gift. Maybe couple the disclaimer with a rescission. (Dummies will do these things and not report them. Good planners should at least explore alternatives if there is a reasonable shot of being authorized by applicable law.)

(5) Do not forget to elect out of the automatic allocation rules for 2010 direct skips.

(6) If there are doubts about whether to make the carryover basis election, get ready to go to court now. It is possible that no extension will be possible on the time frame for making the election (when it is announced). There are innumerable potential conflicts of interest. Get ready now to go to court to get court approval of the decision.

(7) Look at what makes you happy in your practice and how clients fit into that.

(8) Use arbitration clauses in estate planning documents to get out of the court system and get into arbitration.

b. *Carol Harrington Ideas.*

(1) It is now possible to use the full GST exemption (or any amount desired of the available GST exemption) without paying gift tax.

(2) Leveraging opportunities also work for GST exempt trusts.

(3) Estate planners will have a very busy couple of years.

(4) Where is the transfer tax going? The political situation is very unstable. Even if the estate tax is repealed it may not stay repealed. We could go back and forth in future years on how extensively the transfer tax applies. Change creates a lot of work for attorneys.

(5) Life will be different for estate planners. We will not have "cookie cutter" plans like in the past.

(6) Clients with estates in the \$5-\$10 million range will be the hardest estate to plan. \$100 million clients will be easy.

(7) We may have a constant recycling of transfer tax laws in annual extender packages.

(8) Will clients pay for all of this back and forth? If not, the courts will have to resolve ambiguities that are created.

(9) There will be plenty to do — everybody stay calm.

(10) Prediction — there will be much increasing unpredictability.

c. *Mil Hatcher Key Idea.*

(1) Don't be paralyzed. This may be the opportunity of a lifetime. Mil doesn't think we will have estate tax repeal, and the estate tax bite in the future could be worse. There could even be a clawback of the excess gift exemption — but that just means there is a window of opportunity now to make transfers without current transfer taxation.

9. Undoing Prior Transactions In Light of Increased Exemptions

If the estate and gift exemption remains at $5 million or higher on a long-term basis, many clients will have no perceived estate tax concerns. Indeed, clients may be interested in "undoing" some previous estate planning transactions. Some possibilities include the following.

(1) *ILITs*. If there are no estate tax concerns, the client may be reluctant to continue feeding premiums to a life insurance policy in an ILIT. Should trustees notify the settler and beneficiaries of the increased $5 million exemption? Keep in mind that trustees have fiduciary duties to the beneficiaries and disappointed beneficiaries may raise concerns. "Tread carefully and communicate with trust customers. Make individual choices and not wholesale decisions."

(2) *QPRTs*. Parents may want to stop paying rent to their children or to a trust that owns the residence. "Reverse QPRTs" (discussed further in Item 17.b) may become more popular.

(3) *FLPs and LLCs*. Transfer tax reasons for implementing FLPs and LLCs may be eliminated. The client will have to weigh the non-tax advantages of these entities against the disadvantage of having discounts that will minimize basis step up.

(4) *Grantor Trusts*. The grantor may wish to stop paying income taxes on the grantor trusts income by "toggling off" the grantor trust status. Even more than in the past, there may be a desire for the grantor to repurchase appreciated assets from grantor trusts in order to achieve a basis step up at the grantor's death.

10. Decision of Electing Carryover Basis Regime Rather Than Estate Tax Regime for 2010 Decedents; Carryover Basis Issues

a. *Have a Process*. The executor should have a checklist and a process for making the decision. Fiduciaries are not guarantors of results, but they must demonstrate that they exercise their discretion. Projections and assumptions in the analysis should be documented and shared with the affected parties. In a Uniform Trust Code state, consent can be obtained from the beneficiaries including by virtual representation. If consents cannot be obtained from the beneficiaries, get court approval. The fiduciary will be in the crosshairs of whoever is disappointed. There is time to accomplish this, but the key is having a process with a checklist approach, documentation in the file of the analysis, and consents or court approval.

b. *In Many Estates The Decision Will Be Easy*. The decision will be easy and straightforward for many estates: (1) The taxable estate may clearly be under $5 million (select estate tax regime); (2) The taxable estate may be well over $5 million and the current estate tax will substantially exceed the ultimate income tax that will be paid on appreciation (select carryover basis regime); (3) The estate may have appreciation that can easily be covered by the $1.3 million and $3.0 million (if applicable) basis adjustments (bearing in mind that retirement benefits and other IRD assets cannot receive a basis step-up in any event) (select carryover basis regime); or (4) The estate may be only nominally above $5 million with a great deal of appreciation that cannot be covered by the basis adjustments (select estate tax regime). However, even in those "easy" cases, the planner must still be very careful to consider tax effects that may not be obvious on the surface. For example, carefully consider the tax effects of a stepped-up basis vs. carryover basis for real estate or other depreciable property, particularly for property with a "negative basis." Also, even in those "easy" situations, the executor must determine whether the election will change the amounts of bequests passing under the will.)

c. *Factors on Decision Making Process*. The executor will have to consider a variety of factors in making the election decision, such as

- whether the election will change the amounts passing under formula bequests (including that the election will result in assets passing under the "alternate non-marital deduction manner" if the will contains a "Clayton marital trust"),
- the amount of estate tax payable currently vs. the gain that would be subject to income tax on a future sale of assets (keeping in mind that income tax rates may *exceed* estate tax rates) (35% estate tax for excess over $5 million vs. 15% rate [but for recapture items the income tax rates could be 25%, 28% or even 35% and the income tax rates may be expected to increase in future years]),
- anticipated future capital gains rates (and ordinary income rates for "ordinary income property"),
- anticipated state income taxes (including determination of domicile of the beneficiaries and their personal income tax situations),
- anticipated dates of sale,
- anticipated cash needs of beneficiaries,
- the character of the gain (for example, the Joint Committee on Taxation Technical Explanation (p.40) says that "real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir"),
- whether depreciation can be used to derive current income tax benefits even without selling an asset,
- ability to allocate basis adjustments up to fair market value at the date of death for assets that will likely be sold in the near future,
- weighing the present value of anticipated income tax costs against the current estate tax amount,
- determination of which beneficiaries bear estate taxes and comparison to persons who bear income tax attributable to lack of basis step-up,
- the election will result in no benefit of a deduction against federal estate taxes for the payment of state death taxes,
- the election will result in no § 691(c) deduction for estate taxes attributable to income in respect of a decedent property,
- the election will result in no ability to use a prior transfer credit under § 2013,
- whether the election will impact the ability to make a QTIP election for only state purposes,
- whether aggressive positions would be taken on the estate tax return or have been taken on prior gift tax returns (and whether there is any question whether disclosures

on gift tax returns satisfied the adequate disclosure regulations) that would be highlighted by filing an estate tax return,

- without the election, *both* halves of community property would receive a full stepped-up basis, and
- whether the expenses of administering the estate will be increased (by making or not making the election).

Consideration of the detailed tax effects of carryover basis is particularly sensitive for real estate or other depreciable property, especially if the property has a "negative basis" due to refinancing or other reasons.

d. *Basis Adjustments*. If the carryover basis system applies, the estate is entitled to the $1.3 million basis adjustment for assets passing to any beneficiary and the $3.0 million basis adjustment for assets passing to a surviving spouse or "QTIP-type" trusts. Sam Donaldson quips, this is "free-basising." Beth Kaufman says "that must be a West coast thing." Sam puts it that the $3.0 million spousal adjustment applies "if you are lucky enough to have a client who died of being nagged to death."

e. *Possible Impact on Amounts Passing Under Will.* If the election is made, chapter 11 does not apply, so there is no "applicable exclusion amount." Even if that changes the literal meaning of formulas, will the local court determine that the election made many months after the date of death changes the construction of the will? If making the carryover basis election changes the amounts passing under the will, this would be a very important factor the executor also has to consider in making the election decision. Some state laws provide that assets passing under a will vest as of the moment of death, subject to the administration of the estate. Does it make a difference if bequests have already been funded? If there is any possibility that the election may impact the amounts of bequests under the will, attempt to get consents of all of the parties. (Equitable adjustments among the parties may be appropriate.)

One Wall Street Journal commentator observed: "There's another word for an executor who gets to choose how much money a beneficiary receives — defendant."

Twenty states (including the District of Columbia) have statutes regarding the construction of formula "tax-free" bequest clauses for 2010. Eighteen of those state statutes refer to estate tax rules on December 31, 2009. Florida and South Carolina have "go-to-court" statutes that do not specifically apply 2009 law. Will formula "tax-free" bequests in those states mean that $3.5 million continues to pass under the clause rather than $5 million that could pass without estate tax under TRA 2010? Most of those state statutes say that the special construction applies only for 2010 decedents, but if the federal estate or generation-skipping transfer tax becomes effective before January 1, 2011, the statute will no longer apply as of the date the tax becomes legally effective. If the carryover basis election is made, does that mean the estate tax was not "legally effective" before the date of death, so the $3.5 million construction continues to apply rather than having the statute sunset? If so, the tax-free formula bequest may be $5 million if the estate tax applies but $3.5 million if carryover basis applies. (A bill was introduced January 20, 2011 in Virginia providing that, among other things, [1] the formula in a will or trust would mean $5 million, whether or not the carryover basis election is made, [2] that extrinsic evidence would be admissible for 2010 decedents to determine the testator's intent in a proceeding commenced any time before January 1, 2012, even if it contradicts the plain meaning of the document, and [3] that interested persons may enter a binding agreement regarding the construction of the instrument and may seek court approval of the agreement.)

f. *Holding Period*. The holding period is not automatically long term under § 1022, but there is tacking of the decedent's holding period if the basis is determined in whole or in part by reference to the decedent's basis. However, the basis is the *lesser* of the decedent's basis or fair market value, and if the asset is depreciated and the basis equals the fair market value at death, there may be no tacking of the decedent's holding period. That has been the position of the IRS in the past in other contexts, but we do not know if the IRS will apply that same argument in the context of the carryover basis regime.

g. *Adjustments to $1.3 Million Basis Adjustment.* The $1.3 million amount is increased by net operating losses and capital loss carryovers. These generally would appear on the decedent's final Form 1040. A complexity is that if there is a joint return, the surviving spouse may have gains that offset some of the losses and there is no guidance on how to determine the decedent's share of the losses.

   In addition, the $1.3 million amount is increased by any losses that would have been allowable under §165 if the decedent's property had been sold at fair market value before the decedent's death. Section 165 allows both business losses and investment losses, excluding only personal losses. The adjustment for depreciated business and investment property can be quite significant, probably a much bigger factor than the adjustment for net operating losses and net operating loss carryovers. It is not clear how this rule will apply to passive losses. They would be deductible under § 165 so they would seem to increase the $1.3 million amount. However, § 469(g)(2) describes how unused passive losses at death are treated, and the §1022 and § 469 treatment is inconsistent. Fortunately, both sections grant full regulatory authority to the IRS, so the IRS will need to provide guidance.

h. *IRS Guidance is Coming*. The Treasury and IRS have indicated that their highest priority in the transfer tax area is providing guidance for 2010 decedent's estates. An IRS Release on February 16, 2011 indicates that the IRS will be issuing the following (in the order listed): (1) Form 8939, (2) instructions to Form 8939, and (3) (Publication 4895, "Tax Treatment of Property Acquired From a Decedent Dying in 2010.") See Item 1.e.(1) regarding information about the Form 8939 and Publication 4895.

i. *Community Property*. Both halves of community property can qualify for receiving basis adjustments and are subject to the modified carryover basis system (i.e., subject to a potential reduction in basis for depreciated assets). If there is substantial appreciation in community property, being able to get both halves of the community property stepped-up may be critically important in the election decision.

11. Administration's Fiscal Year 2012 Revenue Proposals

a. *Overview*. The Treasury on February 14, 2011 released the General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals. The President's Budget Proposal for Fiscal Year 2012 includes three repeated transfer tax related items from the prior two years and two new items dealing with estate and gift taxes. In addition, the proposal modifies the "Pay-As-You-Go (PAYGO)" baseline to assume that the 2009 estate tax system will be made permanent after the expiration of the Tax Relief

… Act of 2010 provisions (at an estimated revenue cost of $270.21 billion from 2012 to 2021).

b. *Repeated Items.*

(1) *Require Consistency in Value for Transfer and Income Tax Purposes.* This continues the approach of requiring that the basis for income tax purposes be the same "as determined for estate or gift tax purposes (subject to subsequent adjustments)." The proposal does *not* adopt the approach suggested in a a Joint Committee on Taxation report to require that the income tax basis be consistent with values as reported on gift or estate tax returns, even if the transfer tax values were subsequently adjusted on audit.) (Estimated 10-year revenue: $2.095 billion)

(2) *Modify Rules on Valuation Discounts.* This continues the proposal to revise § 2704 to add a new category of "disregarded restrictions" that would be ignored for transfer tax valuation purposes in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Disregarded restrictions would include limitations on a holder's right to liquidate that are more restrictive than a standard *to be identified in regulations*, and any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in an entity. For purposes of determining if restrictions can be removed, certain interests (*to be identified in regulations*) held by charities or others who are not family members would be ignored. Regulations could create "safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met." There would be "conforming clarifications" regarding the interaction of the valuation discount restrictions with transfer tax marital and charitable deductions. While this same provision has been in the Budget Proposal the last two years, it has not been included in a single statutory proposal. (Estimated 10-year revenue: $18.166 billion).

A report issued by the Staff of the Joint Committee on Taxation on September 8, 2009 regarding this proposal observed various possible objections to the proposal: (1) It does not specify or adequately describe the liquidation restrictions that will be disregarded, and leaves the key aspects to future regulations; (2) the IRS already has broad statutory authority to issue new regulations and further legislation is premature and unnecessary; (3) it only targets marketability discounts arising from liquidation restrictions, and a broader approach would be preferable, because "taxpayers might seek to take advantage of marketability discounts through structures that did not depend on liquidation restrictions;" and (4) it does not directly address minority discounts and other proposals (e.g., the 2005 Joint Committee Staff proposal and H.R. 436) address "excessive minority discounts more directly through aggregation of certain interests."

(3) *Require Minimum Term for GRATs.* The proposal imposes three additional requirements on GRATs: (a) a 10-year minimum term would be required for GRATs, (b) the remainder interest must have a value greater than zero, and (c) the annuity amount could not decrease in any year during the annuity term. (Estimated 10-year revenue: $2.959 billion)

c. *New Items.*

(1) *Make Portability Permanent.* This proposal would permanently extend the provisions in the Tax Relief … Act of 2010 regarding the portability of unused exemption between spouses. (Estimated 10-year cost: $3.681 billion)

(2) *Limit Duration of GST Exemption.* The proposal would limit the GST exemption to 90 years after a trust is created. This would be accomplished by increasing the inclusion ratio of any trust to one on the 90th anniversary of the creation of the trust. Contributions to a trust by separate grantors are treated as separate trusts for GST purposes. For each such separate trust, the 90-year period would be measured from the date of the first contribution by the grantor of that separate trust. If an existing trust pours over or is decanted into another trust, the 90-year period would be based on the creation date of the initial trust unless the assets pass to a single beneficiary-"vested" trust (this exception permits an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary). The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date. (Estimated 10-year revenue impact: Negligible)

d. *Background Behind GST Proposal.*

(1) *Letters to Treasury Department Urging Two-Generation Limit Rule.* Four highly respected academics and attorneys have recently sent letters to the Treasury Department urging a proposal to limit the GST exemption to trusts for two generations. Letters have been sent by Professors Gregory S. Alexander (Cornell University Law School), John H. Langbein (Yale Law School), and Lawrence W. Waggoner (University of Michigan Law School), and by attorney Raymond H. Young.

(2) *Rationale.* The authors state that there is a growing loophole in the GST tax system, as noted in Professor Langbein's letter:

> "…the loophole arose because the drafters of the original GST exemption presupposed that the long-established state-law rule against perpetuities would limit the revenue loss. Congress had no reason to foresee a few lawyers and financial-services vendors would set off a race among some of the states to repeal the rule against perpetuities for the purpose of attracting trust business. The result has been that the GST exemption has now become a lure for the creation in such states of dynasty trusts, trusts that are designed to shelter wealth from GST taxation for centuries. In May of this year, the American Law Institute voted to urge Congress to plug the loophole, a decision that I think is indicative of the policy consensus on this matter in the bar and in legal academia.
>
> It is a rare occurrence that plugging a tax loophole can have such totally benign consequences: raising revenue within the spirit of the law, while preventing any evasion of the core policy of the estate tax, which is to prevent the untaxed accumulation of dynastic wealth."

(3) *Joint Committee on Taxation Proposal.* Professor Waggoner's letter indicates that several years ago the Staff of the Joint Committee on Taxation foresaw the tax-

revenue leakage and made a similar proposal. The Staff Report states: "Perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation. In addition, perpetual dynasty trusts deny equal treatment of all taxpayers because such trusts can only be established in the States that have repealed the mandatory rule against perpetuities." Their proposal prohibits allocating GST exemption to a "perpetual dynasty trust," which would include trusts permitting distributions to beneficiaries in the generations below the transferor's grandchildren's generation. (There is no discussion of how existing trusts would be treated. At the least, the proposal would seem to prohibit any future allocation to existing trusts that could last longer then two generations, and might require rewriting of trusts that could extend beyond the prescribed limit in order to allocate GST exemption to the trust.)

(4) *Alternate Proposed Approaches*. The approach proposed by the Staff of the Joint Committee on Taxation might be referred to an "invalidation approach" — invalidating the allocation of any GST exemption to trusts that *might* last beyond the prescribed term. The approach adopted in the Budget Proposal for Fiscal Year 2012, which might be referred to as an "expiration approach," would merely cause the exemption to expire at the end of the prescribed period. Professor Waggoner's letter described the alternatives in urging that these provisions be considered in the 2010 estate and gift tax legislation discussions:

> "The 111th Congress now has an opportunity to close the loophole in the GST Exemption. The 2010 tax bill is not yet finalized. Congress should adopt a generation limit that is calibrated to the generations-based policy of the GST Tax. The Staff of the Joint Committee on Taxation wisely proposed a two-generation limit. A trust would not qualify for the exemption if it can continue beyond the death of the youngest beneficiary who is no more than two generations younger than the trust settlor. A softer approach would be to provide that a trust initially qualifies for the exemption but loses its exemption once the youngest beneficiary who is no more than two generations younger than the trust settlor passes away. Either approach would put a halt to the ill-advised perpetual or near-perpetual trust movement and the unwarranted loss of tax revenue that is now occurring."

Instead of using a two-generation approach as suggested by Professor Waggoner, the Budget Proposal uses a fixed 90-year standard.

(5) *American Law Institute Proposal is Consistent and GST Proposal Would Encourage States to Adopt Similar Perpetuities Limits*. The American Law Institute in May 2010 adopted a proposal that a trust would be required to terminate no later than the death of the youngest beneficiary who is no more than two generations younger than the trust settlor. See RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS §§ 27.1-27.3 (Tent. Draft No. 6, Approved 2010). Professor Waggoner believes that adoption of the GST proposal would encourage states to adopt similar perpetuities limits:

> "If Congress were to impose a two-generation limit on the GST Exemption, the GST Exemption and the [American Law Institute] perpetuity rule would be in complete agreement and be mutually supportive. I would then expect the

Uniform Law Commission to act quickly to revise the 1986 Uniform Statutory Rule Against Perpetuities (USRAP) by replacing the now rather dated 90-year limit with a two-generation limit consistent with the ALI proposal.

(6) *Examples of Numbers of Future Beneficiaries*. Professor Waggoner estimates that the following numbers of living beneficiaries could exist after the described number of years: 150 years-450 beneficiaries, 250 years-7,000 beneficiaries, 350 years-114,500 beneficiaries, 450 years-1.8 million beneficiaries. He points out that a trustee cannot hope to fulfill the duty of impartiality to all beneficiaries in administering a trust with 1.8 million beneficiaries.

12. Treasury-IRS Priority Guidance Plan

a. *Little Action in 2010*. Only one item on the 2009-2010 list was acted upon – repealing §2511(c). The IRS was burdened by the same problems as the rest of us; the uncertainty was paralyzing. They tried to get out guidance for 2010 decedents, and then Congress changed all the rules.

b. *Highest Priorities*. IRS and Treasury officials have indicated informally that their number one priority is publishing guidance for 2010 decedents. Their number two priority is now giving guidance regarding portability, even though it is not on the 2010-2011 Priority Guidance Plan.

c. *Carryover Items*. Among the carryover items from the prior year are the following: (1) Charitable lead trust ordering rules and adjustments to charitable lead trust sample forms; (2) effect of substitution powers under §2042 (despite the *Jordahl* case, it is safest to except life insurance from substitution powers until the IRS issues guidance); (3) protective claims for refund guidance; (4) §2053 – effect of guarantees and applying present value concepts; (5) private trust companies guidance; (6) § 67(e) final regulations regarding the 2% "haircut" rule exception for estates and trusts; and (7) § 7477 final regulations regarding declaratory judgment procedures for gift tax valuation issues.

d. *Private Trust Companies*. This has been on the action plan since 2004. Notice 2008-63 issued a proposed Revenue Ruling dealing with two situations. The IRS received many comments, some of which were inconsistent. The IRS now feels that the conflicts between state partnership laws and provisions that they were going to require for the documents are not consistent in all states. They are going back to the drawing board to outline what would be acceptable where there is no state statute governing private trust companies. This guidance is far from being completed.

e. *Section 67(e) — Haircut Rule Application to Investment Management Fees and Trustee Fees*. In *Knight v. Commissioner*, 128 S. Ct. 782 (2008), the Supreme Court rejected Judge Sotomayor's reasoning in the Second Circuit case (*Rudkin)* that "would equals could" and that the §67(e) exception for trusts applies only if a particular expense "could not" be incurred by taxpayers other than trusts or estates. (The Supreme Case was unanimous; query whether it would have been an 8-1 decision or at least had an additional concurring opinion had Justice Sotomayor been on the Court?) In light of the Supreme Court's reasoning, it would seem that the §67(e) proposed regulations will need to be substantially changed. The IRS has not yet issued an extension for 2010 returns relieving trustees from having to separate out trustee fees between unique and non-unique categories. We anticipate that the extension will be issued again for 2010 returns unless the IRS issues its final regulations in the near future.

f. *Declaratory Judgment Procedures for Gift Tax Issues.* We are awaiting final regulations under §7477 (added in 1977), which empowers the Tax Court to issue declaratory judgments regarding the value of gifts (including the use of unified credit) even if no gift tax is owed. This issue is becoming more important with the gift exemption going to $5 million. Before §7477 was adopted, there was no recourse if an IRS audit revalued a gift, thus requiring more use of the gift tax unified credit, if the audit did not result in the imposition of gift tax. (This procedure is only available in the Tax Court, not district courts.)

13. Decanting

a. *No Ruling Position.* Rev. Proc. 2011-3, 2011-1 I.R.B. 111 is the annual "no ruling" revenue procedure. It adds "decanting" rulings to the list of topics under Section 5, dealing with areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise. The specific relevant sections of the Revenue Procedure include § 5.09 (whether decanting distributions qualify for a distributions deduction under § 661 or are included in income of the recipient under § 662), 5.16 (whether decanting is a gift under §2501), and 5.17 (whether a decanting distribution results in the loss of GST exempt status or constitutes a taxable termination or taxable distribution under §2612).

b. *Should Planners Continue Decanting Transactions?* In a private letter ruling pending since the summer of 2010, the IRS is saying that it will not rule because decanting is involved. The Service makes no distinctions whether the decanting is specifically authorized in the trust agreement or not. There is no decanting project on the Priority Guidance Plan, but we will likely see one in the future. Whether to proceed with a decanting transaction at this point depends upon the differences in the trust terms. If mere administrative provisions are being changed, that should not cause a problem, even though it is not possible to get a ruling. If the decanting transaction affects distributions, various adverse tax consequences are possible, and planners should be wary.

14. Defined Value Clause Updates

Most of the information in this section comes from ideas from a seminar presented by Carlyn McCaffrey and John Porter at the 45th Annual University of Miami Philip E. Heckerling Institute on Estate Planning

a. *Petter on Appeal; Another "McCord"-Type Case Pending in Tax Court. Petter v. Commissioner,* T.C. Memo. 2009-820 upheld classic defined value clauses that allocated blocks of LLC units in gift and sale transactions between grantor trusts for the family and charities. The court held that the clauses did not violate public policy for various reasons. That case is on appeal to the 9th Circuit Court of Appeals. (The 8th Circuit Court of Appeals has previously upheld a formula disclaimer that operated much like a defined value clause. *Estate of Christensen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009).)

There is another McCord-type case by John Porter that is pending in the Tax Court. *Hendrix v. Commissioner*, Cause No. 10501-03. In that case, the parents gave (with a net gift) and sold stock in a C corporation to trusts for their children. As indicated by the cause number, the case was first filed in 2003 (and apparently delayed until the *McCord* result was determined). The IRS argued that the McCord-type defined value clause was invalid because it created a condition subsequent and violated public policy. The taxpayer filed a motion for summary judgment, in light of the ruling of the Fifth Circuit Court of Appeals in *McCord,* but the judge wanted to hear evidence as to whether there was any collusion between the taxpayers and the charity. The case was tried before Judge Paris in December 2008 and the parties are still awaiting decision over two years later. The delay may suggest that this will be a reviewed decision.

b. *Possible Methods of Reducing Gift Risk Due to Valuation of Hard to Value Assets.* Possible approaches include using (1) a GRAT, (2) net gifts, (3) defined value formula clauses (either defining the transfer or defining the consideration received), or (4) an incomplete gift approach combined with a defined value transfer clause.

c. *GRATs.* GRATs avoid valuation risk because of the provision in the regulations recognizing that the annuity amount can be described in terms of a percentage of the initial value transferred to the trust. This protects against unforeseen gift risk on the creation of the GRAT. The GRAT is the only "bullet proof" method. (However, John Porter describes a recent audit in which the business was sold for substantially more than the value when it was contributed to the GRAT. The examining agent, who is very knowledgeable about GRATs, stated that the IRS is considering taking the position that the donor or so undervalued the property when contributed that she violated the spirit of § 2702, so the donor's retained annuity was not a qualified annuity interest under § 2702. The valuation issue was ultimately resolved and the IRS dropped that "spiritual" argument.)

A problem with GRATs is that the cash flow may be insufficient to support the annuity payments without using a very long-term (which increases the actuarial risk of dying during the GRAT term and causing estate inclusion). A shorter term could be used with in-kind distributions, but the valuation of assets used to satisfy the annual annuity payments is not protected by the GRAT "savings clause" feature in the regulations.

The following is a method of protecting against valuation risk and making the annual annuity payments from a GRAT. Make a gift using some of the $5 million gift exemption amount to a second trust (the "remainder trust") that is the pourover recipient of the GRAT at the end of the GRAT term. When an annuity payment is due after one year, the GRAT will borrow cash or other investment assets from the remainder trust and pay the annuity with those assets. After two years the GRAT terminates and passes to the remainder trust subject to the debt, and the debt would be extinguished. In this manner, the hard to value asset is moved to the remainder trust without any gift risk at all. (Disadvantages to that approach: (1) estate inclusion if the donor dies during the GRAT term; (2) GST exemption cannot be allocated until the end of the GRAT term; (3) a key advantage of the GRAT is the ability to shift much of the future appreciation/income of the contributed asset without using any gift exemption and this strategy will require using substantial gift exemption; and (4) the GRAT transaction has a built-in interest factor equal to the §7520 rate which is higher than the intrafamily short and midterm loan rates.

d. *Net Gifts*. If the IRS re-values the gift, the net gift donees will have significantly reduced gift tax and penalties compared to what the donor would have owed without a net gift arrangement.

e. *Defined Value Clauses.* Clauses defining the amount transferred were used in *McCord* and *Petter*. It should also be possible to use a formula clause defining the consideration based on the value of a fixed property interest as finally determined for federal gift tax purposes. (As an example of a defined consideration approach, the parent might give $200,000 cash to a trust and loan an additional $2 million, which the trust would use to acquire a $2.0 million two-year Treasury Note. Parent might subsequently sell Blackacre to the trust in return for a fraction of the Treasury Note; the numerator of the fraction would be the value of Blackacre as finally determined for federal gift tax purposes and the denominator would equal $2.0 million.)

f. *Structuring Defined Value Clauses.*

(1) *Spillover Arrangement Preferred.* If there is any excess value, does the excess go to the transferor or to someone else? The successful reported cases have involved "spillover" type transactions. A properly structured defined value "transfer" clause should work, because property does not really "return" to the transferor but all that is transferred in the first place is a fraction of a larger piece of property. However, the more conservative approach is to use the "spillover" arrangement.

(2) *Who to Use as Spillover Recipient.* The excess value would pass to some person or entity that would not have gift tax consequences. Possibilities are a charity, a GRAT, the donor's spouse, a QTIP trust for the donor's spouse, or an incomplete gift trust. The reported cases so far have used a charity as the spillover entity. John Porter prefers using the charity approach. Several cases have mentioned a public policy favoring charities. In addition, they are independent parties and owe duties to assure that they are receiving proper value under contractual arrangements. John Porter's next preferred spillover is a GRAT. Remainder beneficiaries of the GRAT should be different than the beneficiaries of the grantor trust that is the original donee of the defined value transfer. In addition, use an independent trustee who has a fiduciary duty to assure that the GRAT is receiving its appropriate number of units under the formula transferor. Using the spouse or a QTIP trust is not as favorable because the excess "spillover" value will be included in the spouse's gross estate and there are no independent parties reviewing the appropriate values under the formulas.

(3) *Some Property Should Pass To Spillover Transferee.* Some significant property should pass to the spillover transferee even if the assets are not revalued by the IRS. The spillover transferee will not meaningfully participate in the negotiations regarding the proper number of units passing under the formula transferor unless it thinks that it will receive significant value. This is not essential but it provides a more comfortable arguing position.

(4) *Consider Leaving Some Percentage of "Excess Value" to Spillover Transferee.* For example, the formula could be structured to leave 1% or 2% of any excess value upon a revaluation to the trust resulting in additional taxable gift. This would help counter a "mootness" argument under *Procter*. However, there was no additional taxable gift produced by the operation of the formula in the successful *McCord* or *Petter* cases.

(5) *Method of Valuing Property For Purposes of Applying the Formula.* If the property is valued by an appraiser, that does not eliminate any gift tax risk. One approach would be for the transferees to come to agreement as to the number of units passing under the formula (as in *McCord*). The other approach is to use values as finally determined for federal gift tax purposes. The first approach shifts the gift tax risk to a later time (if a family member agrees upon a value resulting in too few units passing to that person or trust). If a charity and is involved there is

no gift tax risk, but the charity runs into potential problems with the state attorney general or there could be self-dealing problems if it is a private foundation. Using values as finally determined for federal gift tax purposes protects both the transferor and transferee from gift taxes. That was used in *Petter*.

John Porter likes both approaches. The *McCord* approach runs the risk of shifting units away from the family trust based on what the charity does. The *Petter* (as finally determined for federal gift tax purposes) approach runs the risk of shifting additional units away from the family trust based on what the IRS does.

(6) *Buying Out Charity's Interest*. Is it permissible for the trust to purchase the charities interest before the gift tax audit is completed? John Porter would prefer not. However, it should be permissible if the charity approaches the family rather than vice versa about selling its interest for a fixed sum rather than not knowing for sure what it owns until a gift tax audit is completed years later.

(7) *Income Tax Reporting*. If the various transferees are all grantor trusts (for example, if a GRAT is the spillover transferee), income tax reporting is simplified – everything appears on the grantor's income tax return. If the income is reported by separate taxpayers, and one party is later determined to have reported excess income, there may not be the ability to amend a return and get a refund, even if the statute of limitations has not run. The taxpayer appeared to be entitled to the income at the time, and she had an obligation to report income on her return. Perhaps §1341 can help. If an item of income is included in gross income in a prior year because it appeared as if the taxpayer had a right to it but it is determined that she did not, there is a special way to calculate income tax in the subsequent year to provide relief. However, §1341 only applies if in the subsequent year she is entitled to a deduction for the obligation to return the income previously received under the claim of right, and it is not clear what that other section would be in this situation. John Porter said they are facing that issue in *Petter*.

(8) *Qualified Appraisal Important*. It is important to obtain a qualified appraisal. It satisfies the adequate disclosure regulations, and helps rebut an IRS argument that the taxpayer is just trying to win the audit lottery with a defined value clause used in conjunction with a "low ball" appraisal.

g. *Incomplete Gift Trust Approach*. If the sale is made to a grantor trust for the client that is created by the client's spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments. *See Gibbs v. Comm'r*, T.C. Memo 1997-196. A concern with this approach is that the full appreciation in the asset that is "sold/given" to the trust would be included in the grantor's gross estate, less a § 2043 consideration offset for the value of the consideration (i.e., the note amount). A preferable approach would be to use a defined value transfer approach, to transfer a fraction of an asset in the sale transaction. For example, if the asset is believed to be worth $1 million, the formula could transferor a fraction of the asset with a numerator of $1 million and a denominator equal to the finally determined gift tax value the property. The combined defined value clause and incomplete gift trust gives protection against the gift tax and minimizes potential estate inclusion.

15. Deference to Regulations: Mayo Foundation Supreme Court Case

a. *Significance*. Regulations sometime seem suspect as to whether they are authorized by the relevant statutory provisions. However, the courts have given great deference to regulations. The Supreme Court reconfirmed that deference in the recent *Mayo Foundation* case.

b. *Mayo Foundation; Supreme Court Analysis.* The Supreme Court addressed the deference issue in the *Mayo Foundation* case, issued January 11, 2011. *Mayo Foundation for Medical Education & Research v. U.S.*, 131 S. Ct. 704, 107 AFTR 2d 2011-341. In an 8-0 decision (Justice Kagan did not participate in the "consideration or decision of the case"), the Court resolved a challenge to a Treasury regulation defining the term "student" for purposes of the FICA rules. It upheld the regulation. The reasoning eliminated two possible grounds for future challenges of regulations.

Chevron As Exclusive Test; Rejection of National Muffler Factors. First, the Court appears to have adopted the doctrine of the *Chevron* case [467 U.S. 837 (1984)] as the exclusive test for determining the validity of a Treasury regulation. The *Chevron* test involves two steps. First, if there is a statutory ambiguity, has Congress "directly addressed the precise question at issue? Second, if not, is the regulation "arbitrary or capricious, in substance, or manifestly contrary to the statute" or instead, is it a "reasonable interpretation" of the statute? *The Chevron* decision said that the regulation should be upheld if it is based upon "a reasonable construction of what Congress has said." *Mayo Foundation*.

The taxpayers in *Mayo* were relying on an earlier case than *Chevron*, the *National Muffler* case [440 U.S. 472 (1979)], which had suggested a much more elaborate approach in the second step. The *National Muffler* case said there would be heightened scrutiny (1) if Treasury had not been consistent over time in its interpretation of the particular regulation, (2) if the regulation was enacted years after the relevant statute was enacted, or (3) because of the way the regulation evolved, including whether the regulation had been promulgated after an adverse judicial decision (as happened in the *Gerson* case [507 F.3d 435 (6^{th} Cir. 2007)] involving the validity of the GST effective date regulations which were revised after IRS losses in *Simpson* [183 F.3d 812 (8^{th} Cir. 1999) and *Bachler* [281 F.3d 1078 (9^{th} Cir. 2002)]). The Supreme Court appears to totally reject applying the *National Muffler* factors to tax regulations going forward:

> The Government... contends that the *National Muffler* standard has been superseded by *Chevron*…
>
> . . .
>
> Under *National Muffler*, for example, a court may view an agency's interpretation of a statute with heightened skepticism when it has not been consistent over time, when it was promulgated years after the relevant statute was enacted, or because of the way in which the regulation evolved…
>
> Under *Chevron*, in contrast, deference to an agency's interpretation of an ambiguous statute does not turn on such considerations…
>
> Aside from our past citation of *National Muffler,* Mayo has not advanced any justification for applying a less deferential standard of review to Treasury Department regulations than we apply to the rules of any other agency. In the

absence of such justification, we are not inclined to carve out an approach to administrative review good for tax law only.

…

The principles underlying out decision in *Chevron* apply with full force in the tax context…. Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes. [citation omitted] We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.

Rejection of Distinction for Interpretive vs. Legislative Regulations. In addition, the Court also eliminated the theory that regulations are entitled to less deference if they are an interpretation of statutes than if they are regulations that are promulgated pursuant to a specific direction by Congress to enact regulations.

[B]oth the full-time employee rule and the rule at issue in *National Muffler* were promulgated pursuant to the Treasury Department's general authority under 26 U.S.C. §7805(a) to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code…. In two decisions predating *Chevron*, this Court stated the "we owe the [Treasury Department's] interpretation less deference" when it is contained in a rule adopted under that "general authority" than when it is "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." [citing *Rowan Cos.* and *Vogel Fertilizer* cases]

Since *Rowan* and *Vogel* were decided, however, the administrative landscape has changed significantly. We have held that *Chevron* deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority. [citation omitted] Our inquiry in that regard does not turn on whether Congress's delegation of authority was general or specific.

c. *Application to Deference Standard in* Walton. In *Walton v. Comm'r*, 115 T.C. 589 (2000), the infamous "Example 5" regulation [Reg. §25.2702-3(e)(Ex. 5)] provided that if the grantor of a GRAT died before the end of the GRAT term, the value of the contingent right of the grantor's estate to receive the remaining annuity payments could not be treated as part of the retained value of property contributed to the GRAT. The Tax Court did a *Chevron* analysis, and concluded that the regulation was invalid under *Chevron* as well as *National Muffler*. It recognized that § 2702 did not address the permissible term of a qualified annuity, then determined Congressional objectives from the legislative history, and based on an understanding of that objective the court determined that the regulation was an unreasonable interpretation of §2702 and was invalid. *Mayo* does not appear to change the *Walton* result.

16. Tax Patents Invalidated Under Senate Version of Patent Reform Act

The Senate passed the Patent Reform Act, which it renamed the "America Invests Act" by a vote of 95-5 on March 8, 2011. Section 14 of that Act provides that tax strategy patents are not patentable because they are deemed prior art (not novel and non-obvious) since they require the Tax Code in order for the patent to work. The issue of tax strategy patents has been under study for several years, and the approach of this legislation was suggested by the Patent and Trademark Office staff in conjunction with the Senate Finance Committee and Senate Judiciary Committee staff as a way to deal with tax strategy patents that would not set a blanket exemption precedent that might apply to other types of patents.

This provision applies to any patent pending and any patent issued after the date of enactment. Therefore, for example, it would not invalidate the SO-GRAT patent.

A floor statement by Sen. Grassley specifically noted a letter sent from a coalition of 15 groups describing why tax strategy patents are bad for taxpayers.

17. Step Transaction Doctrine; Transfers to LLC and Transfers of Interests in LLC; Ninth Circuit Reversal of Linton v. U.S (9th Cir. 2011)

a. *Background.* When assets are contributed to an FLP or LLC and interests are conveyed the same day or soon thereafter, the IRS argues that the step transaction should be applied to treat the transaction as if there were a transfer of the those actual assets to the donees without any discount. The step transaction doctrine was suggested in the *Shepherd* case, and dictum by the Eighth Circuit in the *Senda* case supported the IRS's argument (the case referred to "integrated steps in a single transaction"). Two Tax Court memorandum cases (*Holman* and *Gross*) addressed the step transaction doctrine in this context, but held that the doctrine did *not* apply where the entity interest transfers were made long enough after the date of funding (6 days and 11 days, respectively) that there was a "real economic risk of a change in value." In two subsequent cases where the funding and transfers of interests in the entity occurred on the same day, a federal district court had applied the step transaction doctrine (*Heckerman* and *Linton*). The district court in *Linton* had granted summary judgment in favor of the IRS as to the step transaction doctrine (as well as another issue).

b. *Ninth Circuit Reversal.* The Ninth Circuit has reversed the *Linton* case. *Linton v. U.S.,* 630 F.3d 1211 (9th Cir. January 21, 2011). The facts in *Linton* were messy (and the court remanded the case for further factual determinations), but the contributions to an LLC and transfers of interests in the LLC may have occurred on the same day. The IRS argued that even if the funding of assets to the LLC clearly occurred before the transfers of interests in the LLC, the gifts should still be characterized as gifts of the assets to the donees (without a discount) under the step transaction doctrine, which collapses "formally distinct steps in an integrated transaction" in order to assess federal tax liability on the basis of a "realistic view of the entire transaction."

The court considered the three alternative tests for the step transaction doctrine (which have been applied mostly in income tax cases). The district court concluded that all three of the alternative tests applied. The Ninth Circuit held that none of them applied.

(1) The *end result test* did not apply because the end result sought was for the trust to end up with the LLC interest (not specific assets).

(2) The *interdependence test* requires that the steps are so interdependent that legal relations created by one transaction would have been fruitless without a completion of the series of transactions. The court concluded that putting assets in LLCs was a reasonable activity that made sense whether or not there was a gift, so the various steps have independence.

(3) The *binding commitment test* requires that there be a binding commitment to enter into the later steps of the transaction. The court concluded that test only applies to transactions spanning several years.

c. *The Dreaded Footnote — Economic Risk of Changed Value Test Still Applies.* The Ninth Circuit concluded specifically that the step transaction doctrine did not apply, and reversed the lower court's grant of summary judgment in favor of the IRS. However, in footnote 9 the court said that there are "timing requirements" between the funding of the LLC and the transfer of interests in the LLC "for the same reason that they apply the step transaction doctrine: to ensure that the two transactions are adequately distinct that the second transaction merits independent, and more favorable tax treatment" (pointing to *Holman* and *Gross* and quoting the "real economic risk" test of those cases). The court suspects that the timing requirements are "in essence a working out of the step transaction doctrine in a particular set of circumstances," and that once the lower court subsequently determines the timing facts and the effects of those facts, "there would be no need to apply the three traditional step transaction doctrine tests."

However, the court reiterates that on remand the court will apply the timing test issues that have been raised by *Holman* and *Gross*:

> To obtain favorable tax treatment, the Lintons needed to transfer assets to the LLC and then wait at least some amount of time before they gifted the LLC interest to their children. The waiting period would subject the gifted assets to some risk of changed valuation before they were transferred, through the LLC, to the children's trusts. That would make the two transactions distinct for tax purposes. (The government has not challenged that the nine days between January 22 and January 31 is a sufficiently long to make the transactions distinct, notwithstanding that some of the value transferred to the LLC was cash.)
>
> uch discretionary powers will be exercised only by another Trustee, if any."

(3) *Use Powers of Appointment and Amendment to Gain Flexibility.*

(4) *Plan for Disclaimers to Provide Alternate Dispositive Schemes.*

(5) *Allow a Beneficiary to Release an Interest and Accelerate Subsequent Interests.*

(6) *Allow Trustee to Terminate Trust if Trustee Considers it Appropriate.*

18. Qualified Personal Residence Trust Issues

a. *Grantor's Paying Rent at End of QPRT Term.* If the grantor continues to live in the residence at the end of the QPRT term, the IRS will likely allege that there was an implied agreement of retained enjoyment under § 2036(a)(1) and include the residence in the grantor's estate. However, if the grantor pays fair market rental value, various letter rulings have indicated that § 2036 will not apply. Natalie Choate quips: "The biggest problem is that parents have to pay rent to the children. Blattmachr's clients love to pay rent to children and love to pay income taxes for their children. But there are some people out there who haven't figured out why that's such a good deal."

The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under § 2036. *E.g.,* Ltr. Ruls. 200825004, 200822011, 199931028. In the QPRT rulings, there is no §2036 inclusion as long as "there is no express or implied understanding that Grantor may retain use or possession of Residence whether or not rent is paid."

In an actual situation, the lawyer sent letters to the donor near the end of the QPRT term about the necessity of signing a lease and paying rent for continued occupancy of the residence. She died one week after the QPRT term ended without negotiating a lease or paying rent. The IRS asserted there was an implied understanding of retained enjoyment triggering estate inclusion under § 2036.

Natalie Choate suggests stating in the original QPRT trust agreement that the donor has the option to lease the residence on a month-to-month basis at the end of the QPRT term, and that if the donor remains in possession of the residence beyond the end of the QPRT term, "such continued occupancy by the Transferor shall be deemed an exercise of the Transferor's option to rent…"

b. *"Upstream QPRTs."* If the parent does not want to pay rent at the end of the QPRT term, one alternative is for the remainder beneficiaries (e.g., children of the donor) to contribute the residence into a series of one-year (or longer term) QPRTs allowing the parent to live in the residence. The gift would be the very small actuarial value of the right to use the residence for the one-year (or other) term. Various rulings have approved these types of "reverse" QPRTs. *E.g.,* Letter Rulings 200935004 & 200920033. The rulings express no opinion concerning whether the transfer to the new QPRT would result in the residence being included in parent's estate under § 2036 (apparently leaving open the possibility of arguing that at the time the parent transferred the residence into the original QPRT there was an express or implied agreement that the children would allow the parent to use the residence at the end of the original QPRT term without paying rent). There are no objective rules for assuring that the "gift-back" to the original donor is a separate and independent act and that there is not an express or implied agreement that would trigger § 2036 to include the residence in the original donor's estate.

Planning Pointer: After a reasonable period of holding the residence or renting it to the original donor, the original beneficiaries could meet with counsel to discuss a gift back to the original donor. They should use their own attorney rather than the original donor's attorney. For a discussion of these rulings, see Handler, Tax Update, Trusts & Estates, August 2009, at 9 and February 2009, at 10.

c. *Continued Use of Residence Following End of QPRT Term Where Decedent Intended to Pay Rent But Died Suddenly Before Rent Was Paid Did Not Result in § 2036 Inclusion, Estate of Riese.* In *Estate of Riese*, T.C. Memo. 2011-60, the decedent remained in a residence following the end of the QPRT term and died unexpectedly before any rent was paid. The IRS argued that § 2036 applied.

When the QPRT was being considered, there had been discussions between the attorney and the decedent and the decedent's daughter (who assisted the decedent with her financial matters) that she would have to pay rent if she remained in the residence following the end of the QPRT term. Following the end of the QPRT term on April 19, 2003, the daughter discussed with the attorney how to determine the fair market rent. The attorney advised that the rent could be determined and paid by the end of that calendar year. The decedent had a stroke and died unexpectedly in October, 2003 before the fair market rent had been determined and before any rent payments had been made.

The IRS argued that there was an implied agreement of retained enjoyment in light of the fact that the decedent continued living in the residence without paying rent. The court disagreed, pointing to various facts suggesting that there was not an implied agreement of retained enjoyment. Some of these facts included that the necessity of paying rent was discussed on multiple occasions with the decedent and her daughter before the QPRT was created, and that the daughter discussed with the attorney how to determine fair market rent following the decedent's death.

> "While counsel's advice to determine rent by the end of the year was not the most prudent course of action, i.e., executing a lease and determining rent before the QPRT terminated would have been the ideal, we accept the parties' good faith testimony that they intended to determine rent by the end of the year... The Secretary had not issued any regulations or guidance as to how and when rent should be paid upon the termination of a QPRT. We believe that doing so by the end of the calendar year in which the QPRT expired would have been reasonable under the circumstances."

The underlying premise of the reasoning is that § 2036 is not triggered if a donor must pay fair market rent for continued use of the property. Interestingly, that underlying premise was never discussed, and it seemed well enough established that the court assumed § 2036 would not apply if the donor intended to pay rent following the end of the QPRT term.

19. Transfers with § 2036 Retained Interests, *Adler* and *Van* Cases

a. *Transfer of Residence With Continued Occupancy by Donor Without Paying Rent Resulted in § 2036 Inclusion; Van v. Comm'r*

In a rather involved (and somewhat comical) fact situation, the court in *Van v. Comm'r*, T.C. Memo. 2011-22, ultimately determined that the decedent had acquired a beneficial interest in a residence and later gave the residence to a trust but continued to live there as the exclusive occupant for the rest of her life without paying rent. The court concluded that § 2036 applied. The court's reasoning seems to focus on the fact that the decedent never paid any rent, and cited two prior cases (*Disbrow* and *Trotter*) that had applied § 2036 where the decedent either paid no rent or made irregular rent payments for less than the amount stated in a lease agreement.

b. *Aggregation of Various Undivided Interests Included in Estate Under § 2036; Adler v. Comm'r*

Decedent had made gifts of undivided one-fifth interests in property to his five children, retaining a life estate. Those transfers were brought back into the estate under § 2036. The court concluded that they should be aggregated for valuation purposes, and no undivided interest discount was allowed. The court distinguished the *Mellinger* case, which did not require aggregating undivided interests included in the estate under § 2044 (QTIP property) and § 2033, because in this case the donor/decedent was able to control the disposition of all of the interests.

20. Failure to Pay Penalty Applied Despite Reliance on CPA; *Baccei v. U.S.*

In *Baccei v. U.S.*, 107 AFTR 2d 2011-898 (9th Cir. February 16, 2011), the Ninth Circuit affirmed the lower court decision applying a failure to file penalty. The CPA filed a Form 4768 extension request for an estate tax return, but forgot to indicate the date for the extended request and also did not check the box for extension of time to pay the tax. There was a cover letter sent with the incomplete form that indicated there was no ability to pay the tax and that was the reason for seeking the extension. The IRS denied the request because those items were left blank. The taxpayer made three arguments: substantial compliance, affirmative misconduct by the IRS, and reasonable cause. The court rejected all three.

As to substantial compliance, the court determined that the regulation was clear that the request for an extension of time to pay estate tax must state the period of the extension requested, and there was no substantial compliance.

Furthermore the court also determined that the IRS's inaction, namely failing to notify the executor that the payment extension request was deficient, was not affirmative misconduct.

Perhaps most important from a legal standpoint, the court noted the rule recognized in a number of cases that reliance on professionals is not "reasonable cause" to excuse the failure to *file* penalty, and the court extended that reasoning to the failure to *pay* penalty:

> "Although we have found no cases evaluating whether a taxpayer's reliance on an accountant to obtain an extension of time to pay taxes owed constitutes 'reasonable cause' under § 6651(a)(2), we draw guidance from *United States v. Boyle, 469 U.S. 241* [which held that reliance on an agent] is not 'reasonable cause' for a late filing under § 6651(a)(1)...
>
> . . .
>
> We extend these determinations of reasonable cause under § 6651(a)(1) [failure to file penalty] to determinations of reasonable cause under § 6651(a)(2) [failure to pay penalty]. There is no reason to distinguish between reasonable cause for a failure to timely *file* an estate tax return and reasonable cause for a failure to timely *pay* an estate tax, and we refuse to do so.

21. No FLP Discount Allowed; Jury Determined Value Based on Sale Price of Partnership Interest About Two Years After Estate Valuation Date; *Levy v. U.S.*, (5th Cir. 2010)

The Fifth Circuit affirmed a jury finding at the district court setting the value of a partnership interest at $25 million without allowing any discount for lack of control and marketability due to partnership ownership. *Levy v. U.S.*, 106 AFTR2d 2010-7205 (5th Cir. 2010)(*per curiam*).

The facts are not well developed in the appellate opinion. The estate owned an interest in a limited partnership that owned undeveloped land near Dallas, Texas, and apparently, the partnership sold the land about two years after the estate valuation date, resulting in the estate receiving $25 million.

The jury determined that the value of the estate's interest was $25 million, without a discount for lack of control and marketability due to partnership ownership. The court rejected the estate's various arguments for setting aside the jury verdict.

The trial court did not abuse its discretion in admitting evidence of the sale two years after the valuation date. ("The estate's expert testified that the Plano real estate market was relatively flat--increasing approximately 3%-- so the sales price would be an accurate comparator.")

As to the jury verdict allowing no discounts, the court concluded that "[t]he jury could have rationally found that no discounts for lack of control or marketability were merited because the estate controlled the general partnership interest, which has nearly unfettered control over the Partnership's assets."

A confusing final footnote stated that while the appellate court "declined to set aside the jury's verdict of zero discount, we note that the actual discount applied in taxing the Estate was thirty percent. Given the valuation found by the jury, it would have had to find a discount of larger than thirty percent for the verdict to have made a difference to the judgment in this case."

Practical Lesson: Actual subsequent sales are highly persuasive absent changed economic conditions. That may be particularly true for jury trials. In this case, the jury refused to allow any discount and set the value at the amount of the actual sale proceeds received by the estate.

22. Collection Action Against Transferees Under Transferee Liability Allowed 17 Years After Date of Death, *U.S. v. Kulhanek*; No Necessity for Assessment Agasint Transferee, *Mangiardi v. Comm'r*

a. *Collection Action Against Transferees 17 Years After Date of Death*; *U.S. v. Kulhanek*, 106 AFTR2d 2010-7263 (W.D. Pa. 2010). In this case, the IRS "came knocking on the door" of the recipients of retirement benefits and life insurance and collected estate taxes from them 17 years after the decedent's death!

Facts. The defendants were recipients of a $300,000 retirement account and a $10,000 life insurance policy. Each of them received distributions shortly after the decedent's death. The estate tax return was filed in 1992, making a § 6166 election. The stock of the business interest was sold in 1999. Over nine years later, the IRS filed an action against the defendants pursuant to § 6324(a)(2), which addresses transferee liability, to collect unpaid estate taxes of about $200,000 plus statutory interest.

Analysis. Under § 6324(a)(1) there is an absolute 10-year limit on the special automatic estate tax lien, without extensions or tolling. However, the court said that the IRS was not proceeding under that section but under the transferee liability provision of §6324(a)(2), which does not contain the absolute 10-year limitation by its terms. Because transferee liability is derivative of the transferor's liability, courts addressing the limitations applicable to § 6324(a)(2) have looked at the generally applicable statutes of limitations created under §§ 6501-6502.

Section 6501 requires that the IRS assess tax within three years after the return was filed. Section 6502 requires that an action to collect tax must be commenced within 10 years after the assessment of the tax, and that period can be suspended or extended. There was a tolling of the statute of limitations in this case under §6503(d) during the § 6166 deferral period. Because the § 6166 election preceded the assessment of tax liability, the assessment did not trigger the running of the statute of limitations until the end of the § 6166 extension period. The collection action was filed almost 9 1/2 years after the §6166 deferral period ended by reason of the sale of the stock — so it was filed within the allowed 10-year period.

Planning Concerns. (1) Transferees are personally liable up to the value they received at the date of the original transfer to them (in this case the date of death), even if they do not have that much value still remaining from those assets at the time of the later collection action. Recipients of gifts and recipients of assets following an individual's death must understand that this potential personal liability exists, and that it could arise well over a decade later without notice.

(2) There is no indication in this case that the IRS ever made an assessment against the defendants personally under the transferee liability provision, despite the fact that § 6901(c) provides that the period of limitations for assessment of transferee liability against an initial transferee is one year after the expiration of the period of limitation for assessment against the transferor. The IRS must assess tax against the estate within three

years of filing the estate tax return (§ 6501(a)), so § 6901(c) requires assessment against the transferee within four years after the return was filed. The case did not discuss whether the IRS made an assessment against the recipients of the retirement accounts and life insurance policy within four years (which would be unusual), and did not address the effect of a failure to make such an assessment. Again, this raises the concern that transferees may conceivably first get notice of an unpaid estate tax liability when a Complaint is filed many years (in this case 17 years) after the date of death. (In this case, presumably the defendants had notice that an estate tax liability was unpaid, because they were the decedent's daughters, although the case did not indicate whether they were also the executors of the estate.) The potential injustice of this possibility, without prior assessment against the transferees, was raised in the recent *Mangiardi* case, discussed immediately below.

b. *No Necessity for Assessment Against Transferee, Estate of Mangiardi v. Comm'r, T.C. Memo. 2001-24*. In this case, the IRS proceeded to collect estate taxes from an IRA beneficiary eight years after the IRA owner's death, without ever having assessed tax against the beneficiary — and the IRS won.

Facts. The decedent's estate consisted almost entirely of nonprobate assets, a revocable trust valued at \$4.6 million and IRAs valued at \$3.4 million. The IRAs passed to the decedent's nine children. The decedent died in April, 2000 and the estate tax return was filed in July, 2001. The IRS granted six extensions for payment of the estate tax under § 6161. The extensions ended in December, 2004. The letter granting the last extension said that it could not be extended past December, 2004, because "we must ensure that the transferee assessments are made prior to the assessment expiration date to make those assessments." (The four-year period for making assessments against transferee would end four years after filing of the estate tax return, or in April, 2004.) However, assessments were never made against the IRA beneficiaries.

About 1 ½ years after the last extension expired (in July 2006), the IRS gave notice of intent to levy to collect tax. Maureen Mangiardi, a co-trustee of the revocable trust and statutory executor (perhaps one of the decedent's children) timely submitted a hearing request, arguing that the IRS was precluded from collecting estate tax liability from the IRA beneficiaries because the time for making a transferee assessment against them under § 6901 had expired. That proceeding was ultimately concluded in January, 2008 when the IRS sent a notice of determination that it could collect the estate tax liabilities either from the executor or from the beneficiaries without a prior assessment against the transferees under § 6901.

Analysis. The issue is whether a § 6901(c) assessment against transferees (which would have been required in this case within four years of filing the estate tax return) is required before the initiation of a collection action under the transferee liability provisions of § 6324(a)(2). The court held that it was not, and allowed the collection action to continue. The court's reasoning was rather terse, acknowledging that "[f]ew courts have considered this issue directly; however the Courts of Appeals for the Third Circuit and Tenth Circuit have held that respondent may collect estate tax from a transferee pursuant to section 6324(a)(2) without a prior assessment against the transferee under section 6901. United States v. Geniviva, 16 F.3d 522, 525 (3d Cir. 1994); United States v. Russell, 461 F.2d 605, 607 (10^{th} Cir., 1972)," and that it found those cases persuasive.

The court also upheld the IRS's denial to accept $700,000 as an offer-in-compromise. The court reiterated that the IRS could proceed against the IRA beneficiaries in the amount of the IRA distributions, and the IRS had determined that the reasonable collection potential "was at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions." The court agreed that the IRS did not abuse its discretion in refusing the offer-in-compromise because the petitioner did not offer an acceptable amount.

Reasoning That § 6901(c) Assessment is Not Required. The *Geniviva* case reasons that § 6901(c) and § 6324(a)(2) are "cumulative and alternative — not exclusive or mandatory" (quoting *Russell*). The *Geniviva* case relies on a Supreme Court case for this result:

> Before 1926, when section 6901 was enacted, the only means by which the Government could impose liability against the transferee was a bill in equity or an action at law brought under the precursor to section 6324 [citation omitted]. Section 6901 did not eliminate or limit such an action; rather, it provided an ADDITIONAL means by which the Government could enforce the collection of taxes. Leighton v. United States, 289 U.S. 506, 507-08 (1933). Thus, in Leighton the Supreme Court held that a failure by the Government to personally assess the shareholders of a defunct corporation did not bar an action to impose transferee liability against them… Leighton has never been overruled, either by the Court or by statute, and is binding upon us.

At least one district court opinion refused to go along with this reasoning. *United States v. Schneider, 92-2 U.S.T.C.* ¶60,119 (D.N.D. 1992). *Geniviva* distinguished that case, but noted the extreme unfairness of not requiring assessment against the transferees:

> [W]e express a certain sorrow that what seems inherently unfair is also quite in accordance with the law, and note a compassion for the equitable position of the appellants. They received their inheritance apparently believing that the affairs of their late mother's estate had been competently represented both professionally and personally, and handled in accordance with the law. Years later they found out that the estate had been poorly advised and represented, and had an unresolved, serious tax problem. Now they find themselves defendants in a lawsuit for the collection of those taxes, and under circumstances amounting to a forfeiture of their entire inheritance.

Planning Concerns. (1) The *Geniviva* court was correct that the result seems "inherently unfair." In a case where there is a § 6166 deferral (like the *Kulhanek* situation), it is conceivable that the IRS could first contact IRA or life insurance beneficiaries up to 24 years (the § 6166 14-year deferral period plus the additional 10 years allowed under § 6324(a)(2), by reference to § 6502) after the decedent's death that there are unpaid estate taxes, and that they are personally liable for the unpaid taxes (plus accrued interest over 24 years!) up to the amount of the benefits they received from the decedent 24 years earlier, without ever having had prior notice from the IRS of an assessment against them. Yes, that seems "inherently unfair."

(2) This concern is exacerbated with respect to IRA beneficiaries or beneficiaries of other retirement accounts. For example, in *Kulhanek* the IRS concluded that a reasonable offer-in-compromise "was at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions." That simple conclusion ignores that the IRA beneficiaries will owe income taxes at ordinary income tax rates on the IRA receipts. For example, using the *Kulhanek* facts assume that beneficiaries of the $3,433,0 IRA were in the 35% income tax

bracket when they received their distributions years earlier. They would have paid income taxes of $1,201,552, leaving them net proceeds of $2,231,454. That does not matter; they are still personally liable under § 6324(a)(2) for the full $3,433,007 that they received from the decedent. Even assuming they still have the $2,231,454 net proceeds many years later, they would still have to cough up the additional $1,201,552 out of their other assets. Yes, there is a § 691(c) deduction against the income tax for estate tax attributable to the IRD asset, but the statute of limitations for getting a refund of those income taxes has long passed. Hello bankruptcy!

(3) I have been under the misimpression for lo these many years that the transferees' concern about liability lasted for four years after the estate return was filed because of the limitations period for assessment under § 6901(c). *That is flat wrong* under the reasoning of these cases, and transferees may have potential liability for estate tax many years beyond that. In many ways, the § 6901(c) time limit is meaningless.

23. Deductibility of Palimony Claim; *Estate of Shapiro v. U.S.* (9th Cir. 2011)

An unmarried couple lived together 22 years in Nevada. "After learning that Shapiro was involved with another woman," the cohabitant brought a palimony claim, which was outstanding when the decedent died. His estate claimed a § 2053 deduction for the value of the palimony claim, and estimated the claim at $8 million. The palimony case settled the next year for $1 million. The IRS denied any deduction. The lower court granted summary judgment disallowing a deduction for the palimony claim, because the woman paid no consideration that was valid to support a contract under Nevada law. In a 2-1 decision, the Ninth Circuit reversed the summary that disallowed the palimony deduction, saying that "twenty-two years of cooking, cleaning and other homemaking services" does in fact constitute consideration that is good enough to support a contract under Nevada law. It noted that the lower court never reached the issue of whether those services constituted "adequate and full consideration in money or money's worth," which is necessary to support a deduction under § 2053. It remanded the case for the lower court to consider that question, and if it determined that it did meet that standard, to determine the value of the claim as of the date of death. *Estate of Shapiro v. Comm'r*, 107 AFTR 2d 2011-942 (9th Cir. February 2, 2011)

The dissent reasoned that § 2053 requires consideration "in money or money's worth," that other regulations and cases define that term to exclude love and affection, and that there were no allegations that the cohabitant had enhanced the value of the estate in money or money's worth. While "she cooked, cleaned and provided emotional support to Shapiro, the Estate presented no evidence that these services have a cash value or what that cash value would be." The dissent would have held that a § 2053 deduction should not be allowed because there were no facts suggesting that the "in money or money's worth" standard was satisfied.

24. Family Limited Partnership Annual Exclusion Gifts

a. *Avoid FLP Interests for Annual Exclusion Gifts*. To the extent possible, avoid questions about annual exclusion qualification by making gifts of cash rather than family limited partnership or LLC interests.

b. *Avoiding the Fisher Price Cases*. *Price v. Commissioner*, T.C. Memo 2010-2 denied the annual exclusion for gifts of limited partnership interests because the donees had neither the right to income nor substantial present enjoyment of the property, primarily because income was not paid each year, and a partner had to obtain the unanimous consent of all of the partners to sell its partnership interest. *Fisher v. U.S.*, 105 AFTR 2d 2010-1347 (S.D. Ind. 2010) denied the annual exclusion where the donees could transfer their interest at any time, merely subject to a right of first refusal. The court did not explain its reasoning, but it was probably correct in reaching the result because the LLC could pay with *non-negotiable* notes. Possible alternatives that may permit the annual exclusion include (1) do not include a prohibition on transfers or the requirement of unanimous consent, (2) "regularize" distributions, (3) specify that the general parent/manager owes fiduciary duties, (4) give donee-partners a Crummey withdrawal power to withdraw the fair market value of the limited partnership interest for a limited period of time after each gift, and (5) give donee-partners a limited period of time to sell the interest to the donor or for its fair market value, determined without regard to the existence of the put right.

c. *Embrace Rationale of Fisher Price Cases*. We should embrace the rationale in the Fisher Price cases rather than fighting them (and use assets other than family limited partnership interests for annual exclusion gifts). The Fisher Price cases emphasize that limited partnership interests have no substantive present economic benefit. These represent judicial cases acknowledging that FLP interests are not very marketable. These cases are ultimately helpful.

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