Current Developments Musings

April 2011

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(A number of other summaries prepared by Steve Akers and other resource information for professional advisors is available at www.bessemer.com/advisor.)

1. Procedures for Making Carryover Basis Election to Avoid Estate Tax Regime for 2010 Decedents

a. *Estate Tax Regime Is Default System.* The default rule is that the estate tax applies to estates of decedents dying in 2010. An election is available for estates that prefer not to be subject to estate tax but to be subject to carryover basis instead. By far, most of the decedents dying in 2010 had estates well under $5 million and have no estate tax concerns in any event. Those estates do not have to file anything in order to be able to take advantage of the pre-2010 traditional basis step-up rules.

b. *Procedures for Making Carryover Basis Election to Avoid Estate Tax Regime.* 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). 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).

c. *Process for Determining Whether to Make Carryover Basis Election.* For many estates, the decision will be easy whether to be subject to the estate tax or carryover basis (if the taxable estate is either well under $5 million or well over $5 million). However, the executor should carefully document and retain the analysis of the rationale for what ever decision is made regarding the carryover basis 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. *Who Makes Carryover Basis Election?* The IRS has indicated informally that it will give guidance regarding who makes the election if multiple persons are in possession of property where there is no court appointed executor.

e. *No Spousal Basis Adjustment for Assets Sold During Administration.* The IRS indicates that the $3 million spousal basis adjustment cannot be allocated to any assets sold during this administration, because they do not pass to the surviving spouse. If the IRS does not change that position, there will be a lot of "constructive receipts" by spouses before sales took place.

f. *Attach or Keep Documentation Basis and Values Listed on Form 8939.* There is no statute of limitations as to values described on the Form 8939. Attach documentation or at least keep documentation of basis and values listed on the form.

g. *Extended Time for Filing Estate Tax Return.* The act extends the time for filing estate tax returns of decedents dying before the date of enactment to nine months after that date (i.e., to September 19, 2011). Is a further extension available beyond that? We are not sure. 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.

2. 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).

The first three items below are repeats from the prior two years. The items after that are new.

b. *Require Consistency in Value for Transfer and Income Tax Purposes.* This continues the approach from prior Budget Proposals 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 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)

c. *Modify Rules on Valuation Discounts*. This continues the proposal from prior years 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. 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).

d. *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)

e. *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)

f. *Limit Duration of GST Exemption*. The proposal would limit the GST exemption to 90 years after a trust is created. At least 25 states have extended their perpetuities provisions far beyond the traditional lives in being plus 21 years. 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)

Planning. This year is a doubly good year to create long term trusts: (1) $5 million of GST exemption is available this year (and next); and (2) Trusts created before the effective date of this legislation (if it is enacted) would not be subject to the 90-year limitation.

Rationale. Four highly respected academics and attorneys have sent letters to the Treasury Department in late 2010 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. 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."

Several years ago the Staff of the Joint Committee on Taxation proposed a rule that would prohibit 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 was no discussion of how existing trusts would be treated.) 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 Administration's 2012 Fiscal Year Budget uses another approach, which merely causes the exemption to expire at the end of the prescribed period.

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). If the Administration's proposal of limiting the exemption's effectiveness to 90 years passes, query whether the American Law Institute will change its approach to be consistent?

Professor Lawrence 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.

3. 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.

4. 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." *May 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…*
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> *. . .*
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> 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…
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> Under *Chevron*, in contrast, deference to an agency's interpretation of an ambiguous statute does not turn on such considerations…
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> 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.
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> . . .
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> The principles underlying our 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]
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> 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 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 that 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.

5. 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 in 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.)

6. Continued Use of Residence Following End of QPRT Term Where Decedent Intended to Pay Rent But Died Suddenly Before Fair Market Rental Was Determined and Before Payments Were Made Did Not Result in §2036 Inclusion; Estate of Riese v. Comm'r, T.C. Memo. 2011-60

In *Estate of Riese v. Comm'r,* 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.

The court allowed a debt deduction for the amount of rent determined up to the date of death, but refused to allow and administrative expense deduction for the post-death rent, reasoning that the estate "did not require a roof over its head" and had no need to rent the house following the decedent's death.

7. Transfers With § 2036 Retained Interests, *Adler* and *Van* Cases. Aggregation of Various Undivided Interests Included in Estate Under § 2036; Adler v. Comm'r, T.C. Memo. 2011-28

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*

In *Adler v. Comm'r*, T.C. Memo. 2011-28, the 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.

8. Failure to Pay Penalty Applied Despite Reliance on CPA; Baccei v. U.S. (9th Cir. 2011)

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)...
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> 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.

9. 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)(per curiam)

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, 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.") However, attorneys involved in the case indicate that there was testimony that the property was not zoned for commercial development at the date of death, and a number of sales fell through before the eventual purchaser was able to obtain a zoning change several years after the date of death, but those facts were not mentioned in the Fifth Circuit's opinion.

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.

Section 2036: The court ruled against the IRS with respect to §2036, finding that there was a legitimate non-tax purpose of the partnership. The court did not allow the §2036 issue to go to the jury, but the jury heard all of the evidence related to §2036 (presumably including testimony suggesting that the partnership was created primarily to generate discounts).

10. Collection Action Against Transferees Under Transferee Liability Allowed 17 Years After Date of Death, U.S. v. Kulhanek; No Necessity for Assessment Against 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 (10th 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.

11. 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 judgment 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.

respect to the accuracy or completeness of such information. Views expressed herein are current opinions only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

The Ultimate Irony: Part II

States Begin to Tackle Construction Issue Dilemmas in Their Own Formulaic Construction Statutes

April 7, 2011

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States React to Unintended Estate Plan Distortions Caused by Lapse of Federal Estate Tax Regime

When the federal estate and generation-skipping transfer ("GST") tax regimes initially lapsed on January 1, 2010, that had a significant trickle-down effect at the state level. Estate planning documents frequently contain dispositive provisions tied to formulas that are linked to federal tax concepts – like the federal estate tax or GST tax exemption amounts. The lapse of the federal estate and GST tax regimes caused much uncertainty in the construction of formulaic dispositive provisions when the tax concepts to which they were tied simply disappeared.

On the federal front, it was not until the waning weeks of 2010 that Congress enacted the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act"). In the interim, in order to prevent unintended distortion to estate plans during a period of federal estate tax lapse, 20 jurisdictions enacted legislation in 2010 regarding formulaic dispositions in dispositive instruments of decedents dying in 2010.

Eighteen[1] of those jurisdictions generally provide for the construction of formula clauses with reference to the law as it existed on December 31, 2009 (when the federal estate and GST exemption amounts were $3,500,000 million). In the other two jurisdictions[2], a court is authorized to construe a dispositive instrument in order to determine a decedent's intent.

A detailed discussion of the formulaic construction issues, and the reaction of the various jurisdictions, is included in Part I of this article, annexed below.

Election to Opt Out of Estate Tax Treatment Causes State Construction Dilemmas

The 2010 Act, signed into law on December 17, includes a retroactive imposition of the federal estate tax regime for 2010, with a $5,000,000 federal estate tax exemption amount and 35% estate tax rate. The 2010 Act also includes an election to opt out of estate tax treatment and be subject instead to a modified carry-over basis regime.

When formula construction statutes were enacted as a response to the uncertainty created by the initial lapse of the federal estate and GST tax regimes, a possible retroactive enactment of those regimes was apparently anticipated. Accordingly, most

[1] Delaware, Georgia, Idaho, Indiana, Maryland, Michigan, Minnesota, Nebraska, New York, North Carolina, Pennsylvania, South Dakota, Tennessee, Utah, Virginia, Washington State, Washington D.C., and Wisconsin

[2] Florida and South Carolina

states provide that their formulaic construction provisions will not apply if the federal estate tax "becomes applicable" or "becomes effective" before January 1, 2011.

Presumably, if an estate is subject to estate tax under the 2010 Act, the statutory rules of construction should not apply, and formulaic provisions will be tied to the $5,000,000 exemption amount.

But what if an estate elects to opt out of the estate tax regime? Does the estate tax have to "become applicable" or "become effective" for the particular case at hand, or is it sufficient that the estate tax regime is potentially applicable or effective in 2010 (even though a carry-over basis election is made)?

If the estate tax has to be applicable to the case at hand in order for the statutory construction rules not to apply, there may be an anomalous result if carry-over basis treatment is elected: in the estate tax default treatment scenario, a $5,000,000 exemption would presumably apply in the interpretation of formula clauses. However, if carry-over basis treatment is chosen and the statutory construction rules are applicable, formulaic clauses may be interpreted with a $3,500,000 exemption (because state statutory construction rules typically refer to the law as of December 31, 2009). This potentially creates a very difficult dilemma for a fiduciary, typically subject to duties of impartiality, if the fiduciary's election might determine the size of a funding amount.

While formulaic legislation generally seems to have been drafted to anticipate a possible retroactive estate tax, an election about whether to have the estate tax apply does not seem to have been anticipated.

And Time May be Running Out to Bring a Construction Proceeding

Add to this uncertainty that fact that time may be running out to bring a judicial proceeding to construe a formula clause.

In all the state formula clause construction legislation that passed in 2010, there is some provision to enable certain interested parties to bring a judicial proceeding to construe a formula disposition.

Generally, the time frame for commencing a judicial proceeding is within 12 months of death...so time may be running out, or may indeed have run.

Virginia: First State to Introduce Clarifying Legislation on January 20, 2011, Law Enacted March 26, 2011

In an attempt to remedy these issues, clarifying legislation was enacted in Virginia on March 26. The legislation provides that a formula clause in an instrument of a decedent dying in 2010 is deemed to refer to federal laws applicable to decedents dying in 2010, regardless of any election to opt out of estate tax treatment. Accordingly, formula clauses should be construed to refer to a $5,000,000 exemption amount, irrespective of whether an estate is subject to an estate tax regime or a modified carry-over basis regime.

The time for bringing a construction proceeding is extended until December 31, 2011. Extrinsic evidence that contradicts the plain meaning of an instrument is admissible in such a proceeding to determine whether the decedent intended that the instrument be construed otherwise than as provided in the statute; and the burden of proof, by clear and convincing evidence, is on the person seeking to establish that result. The court is authorized to modify a document to conform to the decedent's intention or achieve the decedent's tax objectives.

There is also provision for interested persons to enter into a binding agreement regarding the decedent's intent, without court approval.

South Dakota: Legislation Introduced on February 14, 2011, Law Enacted March 11, 2011

Like the Virginia approach, the South Dakota legislation clarifies that a formula clause in an instrument of a decedent dying in 2010 is deemed to refer to federal laws applicable to decedents dying in 2010, regardless of any election to opt out of estate tax treatment. Accordingly, formula clauses should be construed to refer to a $5,000,000 exemption amount, irrespective of whether an estate is subject to an estate tax regime or a modified carry-over basis regime.

The time for bringing a construction proceeding is extended until December 31, 2011. Extrinsic evidence that contradicts the plain meaning of an instrument is admissible in such a proceeding to determine whether the decedent intended that the instrument be construed otherwise than as provided in the statute; and the burden of proof, by clear and convincing evidence, is on the person seeking to establish that result. The court is authorized to modify a document to conform to the decedent's intention or achieve the decedent's tax objectives.

There is also provision for interested persons to enter into a binding agreement regarding the decedent's intent, without court approval.

Mississippi: Legislation Introduced February 1, 2011, But Dies in Committee

Interestingly, Mississippi had not enacted construction legislation to aid in the interpretation of formula clauses when the federal estate and GST taxes regimes initially lapsed in 2010.

For decedents dying in 2010, the Mississippi bill provided for the construction of formula clauses with reference to federal laws as they applied to estates of decedents dying on December 31, 2010. The statutory construction rule did not apply if a personal representative elected out of estate tax treatment and into the carry-over basis regime.

Accordingly, instead of formula clauses being interpreted consistently (whether an estate is subject to an estate tax or a modified carry-over basis regime), it appears that the statutory construction rule in Mississippi would have applied only to those estates subject to the estate tax regime.

A construction proceeding could have been commenced within 24 months of death.

The Mississippi bill died in committee on February 10, 2011.

Idaho: Legislation Introduced February 17, 2011

The Idaho proposal is substantially similar to the Virginia approach.

The Idaho bill has passed both the Idaho House and Senate, and was sent to the Governor for signature on April 6, 2011.

Washington State: Legislation Introduced February 22, 2011

Washington State was not among those states that provided that its formulaic construction provisions will not apply if the federal estate tax "becomes applicable" or "becomes effective" before January 1, 2011. The Washington State formula clause legislation enacted in 2010 provides that the statutory rules of construction will be presumed not to apply if the federal estate tax becomes applicable before January 1, 2011 "*and* such tax has been permanently repealed and not merely temporarily repealed for calendar year 2010" (emphasis added). There is no proposal to change that language.

With regard to the ability to bring a construction proceeding, the proposed amendments include the ability to introduce extrinsic evidence, and extend the time for commencing a proceeding to within 2 years of death.

The Washington bill passed the Washington Senate on March 4, 2011, passed the Washington House on April 6, 2011, and is awaiting presentation to the Governor.

Status of State Formulaic Clause Construction Legislation as of April 7, 2011

Jurisdictions That Enacted Laws in 2010 Regarding Construction of Formula Bequests		States That Enacted Clarifying Legislation in Light of 2010 Act (as of April 7, 2011)	States with Pending Clarifying Legislation In Light of 2010 Act (as of April 7, 2011)
Delaware ***12 Del. C. § 3335***	New York ***NY EPTL § 2-1.13***	South Dakota *Amends Chapter* ***10-40A of the S.D. Codified Laws***	Idaho ***2011 ID S.B. 1120***
District of Columbia ***D.C. Code § 20-1108***	North Carolina ***N.C. Gen. Stat. § 31-46.1***	Virginia *Amends* ***§ 64.1-62.4 of the Virginia Code***	Washington State ***2011 WA S.B. 5849***
Florida ***Fla. Stat. § 736.04114; Fla. Stat. § 733.1051***	Pennsylvania ***20 Pa.C.S. § 2801 to § 2803***		
Georgia ***O.C.G.A. § 53-4-75***	South Carolina ***S.C. Code Ann. § 62-2-612***		
Idaho ***Idaho Code § 15-1-501***	South Dakota ***S.D. Codified Laws § 10-40A-11, 10-40A-12, 10-40A-13***		
Indiana ***Burns Ind. Code Ann. § 29-1-6-1(n)-(r)***	Tennessee ***Tenn. Code Ann. § 32-3-113***		
Maryland ***Md. ESTATES AND TRUSTS Code Ann. § 11-110***	Utah ***Utah Code Ann. § 75-3-917***		
Michigan ***MCLS § 700.2723***	Virginia ***Va. Code Ann. § 64.1-62.4***		
Minnesota ***Minn. Stat. § 524.2-712***	Washington State ***ARCW § 11.108.080 to § 11.108.090***		
Nebraska ***R.R.S. Neb. § 30-2342.02***	Wisconsin ***Wis. Stat. § 854.30***		

20 Jurisdictions Enacted Formulaic Construction Legislation in 2010 - How Will the Other 16 React?

The reaction of the other 16 jurisdictions that enacted legislation in 2010 regarding formulaic dispositive provisions (Florida, Delaware, Georgia, Indiana, Maryland, Michigan, Minnesota, Nebraska, New York, North Carolina, Pennsylvania, South Carolina, Tennessee, Utah, Washington D.C., and Wisconsin) remains to be seen. Some states have proposals circulating that have not yet been formally introduced as legislation.

Certainly, these issues are ripe for legislative change, both to effect consistency in the interpretation of formula clauses (whether an estate is subject to an estate tax or a modified carry-over basis regime), and to extend deadlines (which may have already run) to commence a construction proceeding.

The Ultimate Irony: In Light of the Passage of President Obama's Tax Proposal, State Formulaic Construction Statutes May Face Their Own Construction Issues

…And Time For a Construction Proceeding May Be Running Out

December 16, 2010

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Problems with Distorted Formulaic Dispositions May Continue to Persist

When the federal estate and generation-skipping transfer ("GST") tax regimes lapsed on January 1, 2010, that had a significant trickle-down effect at the state level. When state taxation regimes are entwined with federal tax concepts, what happens when those federal tax concepts disappear?

President Obama's proposal, passed on December 15 by the Senate and December 16 by the House, includes a $5,000,000 estate tax exemption amount and 35% estate tax rate for 2010, with an option to elect out of estate tax treatment and be subject to a carry-over basis regime. Accordingly, the effect of an election to be subject to an estate tax or carry-over basis regime should also be factored into the analysis of formulaic provisions (discussed further below).

A federal estate and GST tax lapse can cause particularly acute problems regarding the construction of formula provisions in dispositive instruments. Many dispositive instruments contain formulaic terminology tied to federal tax concepts, like the federal estate tax exemption amount or GST tax exemption amount. Formula provisions can become distorted if their conceptual underpinnings have been removed from the law.

Before 2010, a disposition in a will of the "federal estate tax exemption amount" or a disposition of the "largest amount that can pass free of federal estate taxes" would have accomplished the same result - a disposition of the largest amount that could pass without the imposition of federal tax. In 2009, that amount would have been $3,500,000 million.

However, if an estate is not subject to estate tax in 2010, a disposition of the "federal estate tax exemption amount" could be interpreted to mean no disposition at all: if there is no federal estate tax, there can be no federal estate tax exemption amount. On the other hand, a disposition of the "largest amount that can pass free of federal estate taxes" could be interpreted to mean a disposition of the whole estate: if there is no federal estate tax, the whole estate is the largest amount that can pass free of federal taxes.

How ironic that a disposition of the same amount was intended in both scenarios. Yet, depending on terminology used, the whole estate or nothing could be construed to pass - and neither of those results was intended.

States React

To prevent unintended distortion to estate plans, many states introduced legislation in 2010 regarding formulaic dispositions:

Jurisdictions with Bills Pending (As of December 15, 2010)
New Jersey
Ohio

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)
Delaware - 12 Del. C. § 3335 (2010)
District of Columbia - D.C. Code § 20-1108 (2010)
Florida - Fla. Stat. § 736.04114 (2010), Fla. Stat. § 733.1051 (2010)
Georgia - O.C.G.A. § 53-4-75 (2010)
Idaho - Idaho Code § 15-1-501 (2010)
Indiana - Burns Ind. Code Ann. § 29-1-6-1(n)-(r) (2010)
Maryland - Md. ESTATES AND TRUSTS Code Ann. § 11-110 (2010)
Minnesota - Minn. Stat. § 524.2-712 (2010)
Michigan – To be inserted into Chapter 700, Article I of the Michigan Compiled Laws
Nebraska - R.R.S. Neb. § 30-2342.02 (2010)
New York - NY EPTL § 2-1.13 (2010)
North Carolina - N.C. Gen. Stat. § 31-46.1 (2010)
Pennsylvania – To be inserted into Title 20 of the Consolidated Statutes of Pennsylvania
South Carolina – To be inserted into Title 12, Chapter 16 of the South Carolina Code of Laws
South Dakota - S.D. Codified Laws § 10-40A-11, 10-40A-12, 10-40A-13 (2010)
Tennessee - Tenn. Code Ann. § 32-3-113 (2010)

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)
Utah - Utah Code Ann. § 75-3-917 (2010)
Virginia - Va. Code Ann. § 64.1-62.4 (2010)
Washington State – To be inserted into chapter 11.108 of the Revised Code of Washington
Wisconsin - Wis. Stat. § 854.30 (2010)

Most States Provide Statutory Construction Rules

States have generally[1] taken the approach of construing formula clauses during a period of federal estate tax lapse with reference to the law as it existed on December 31, 2009 (when the federal estate tax exemption amount was $3.5 million). Accordingly, in the absence of an applicable federal estate tax in 2010, a disposition of the "federal estate tax exemption amount" or the "largest amount that can pass free of federal estate taxes" would both be interpreted to mean a $3,500,000 million disposition. These rules of construction apply not only to formulaic dispositions of the federal estate tax exemption amount, but also to formulaic dispositions of the GST tax exemption amount ($3,500,000 million in 2009).

Judicial Construction Alternative

In Florida and South Carolina, a court is authorized to construe a trust or will that contains a formula disposition in order to determine the decedent's intent. Accordingly, in the absence of a statutory rule of construction, a court proceeding is required.

How Does An Election To Opt Out Of Estate Tax Treatment Effect Statutory Construction Legislation?

Most states provide that their statutory rules of construction will not apply if the federal estate tax or GST tax "becomes applicable" or "becomes effective" before January 1, 2011. Presumably, if an estate is subject to estate tax under the bill that is poised to be signed by the president, the statutory rules of construction will not apply, and formulaic provisions will be keyed to the $5,000,000 exemption amount.

But will the statutory construction rules also fall away if an estate tax/modified carry-over basis election exists and the estate tax option is not chosen? In other words, does the estate tax have to "become applicable" or "become effective" for the particular case at hand, or is it sufficient that the estate tax regime is potentially applicable or effective in 2010 (even though a carry-over basis election is made)?

If the estate tax has to be applicable to the case at hand in order for the statutory construction rules not to apply, there may be an anomalous result if carry-over basis treatment is elected: In the estate tax default treatment scenario, a $5,000,000 exemption would presumably apply in the interpretation of formula clauses. However, if carry-over basis treatment is chosen and the statutory construction rules are applicable, formulaic clauses may be interpreted with a $3,500,000 exemption (because state statutory construction rules typically refer to the law as of December 31, 2009). This election option could present a very difficult dilemma for a fiduciary, typically subject to duties of impartiality, if the fiduciary's election might determine a funding amount.

While formulaic legislation generally seems to have been drafted to anticipate a possible retroactive estate/GST tax, an election about whether to have the estate tax apply does not seem to have been anticipated.

And if State Statutory Construction Rules Do Apply, Do They Always Produce the Best Result?

In many acrimonious situations, if the statutory rules of construction apply, they might prevent an unintended disinheritance. However, query whether those rules of statutory construction always produce the most tax-efficient result.

Take, for example, a will which provides for the largest amount that can pass free of federal estate taxes to fund a trust for the benefit of a surviving spouse and children. If there were no construction rules and that disposition was interpreted in 2010 to mean that the whole estate passed to that trust (a so-called "credit shelter trust"), no federal estate taxes would be due at the death of the surviving spouse. If, however, such a clause was interpreted with reference to the law as of December 31, 2009, the amount passing to the trust would be limited to $3,500,000 million. If the remainder of the estate passed outright to the surviving spouse, that entire balance would be subject to federal estate tax at the death of the surviving spouse (after 2010).

In a harmonious family situation, it may have been a much more efficient tax result for the entire estate to pass to a trust which would not be subject to federal taxation on the death of the surviving spouse.[2]

Time May be Running Out to Bring a Judicial Proceeding

In all the state formula clause "fix" legislation that has passed so far, there is some provision to enable certain interested parties to bring a judicial proceeding to construe a formula disposition.

Typically, states permit either a general construction proceeding, or a proceeding to determine if a formulaic disposition should be construed without reference to a state's statutory rules of construction.

In Florida, the ability to bring a judicial proceeding is tied to whether a disposition occurred within a defined period. Generally, however, the time frame for commencing a judicial proceeding is within 12 months of death, but can be shorter (in Indiana, for example, the proceeding must be commenced within 9 months of death). Accordingly, if a decedent died early in 2010, time is running out to bring a proceeding (or, in Indiana, may have already run out).

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)	Time for Bringing Judicial Proceeding
Delaware	Within the later of 6 months of (1) death or (2) July 12, 2010 (the effective date of the Delaware legislation) Note, statutory presumption will not apply if a disinterested fiduciary elects to opt out of its application, and no beneficiary objects within 30 days of receipt of written notice of the election
District of Columbia	Within 12 months of death
Florida	Proceeding can be brought if disposition occurred in "applicable period" (Beginning January 1, 2010 until the earlier of (1) December 31, 2010 or (2) the day before the date on which federal estate and GST tax sunset is repealed or modified)
Georgia	Within 1 year of death
Idaho	Within 12 months of death

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)	Time for Bringing Judicial Proceeding
Indiana	Within 9 months of death
Maryland	Within 1 year of death
Michigan	Within the earlier of (a) two years after the decedent's death, or (b) six months after the fiduciary sends notice to the beneficiary
Minnesota	By December 31, 2011
Nebraska	Within 12 months of death
New York	Within 12 months of death
North Carolina	Within 12 months of death
Pennsylvania	Within 12 months of death
South Carolina	Within 12 months of death
South Dakota	Within 12 months of death
Tennessee	Within 12 months of death Note, general rule of construction will not apply if a personal representative elects to opt out of its application with beneficiary consent within 9 months of death
Utah	Within 12 months of death
Virginia	Within 12 months of death
Washington State	Within 12 months of death
Wisconsin	Within 1 year of death

Time Generally Runs From the Commencement of a Proceeding

As practitioners apparently still continue to grapple with uncertainty, the clock is ticking on the ability to bring such a proceeding, which generally must be *commenced* within the applicable time frame.

Accordingly, practitioners may wish to consider at least commencing a proceeding in order to keep their options open.

[1] Florida and South Carolina have taken a different approach (discussed separately). Other states provide for additional exceptions from the statutory construction rules.

[2] Note that state-level taxes may have to be factored into the analysis, and potentially the loss of a spousal basis adjustment for capital gains tax purposes.

"Transfer Tax and Life Insurance Planning in 2011 – 2012"

By

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In addition to staving off the reversion to pre-2001 rates and exemptions, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010") made several enhancements to our transfer tax system. Part I of this article is a discussion to build a common understanding on what TRA 2010 does and does not address. Part II contains a more comprehensive examination of some of the many planning opportunities that exists, with a focus on planning with new or existing life insurance.

PART I
What TRA 2010 Does, and Doesn't, Address

I. Observations about Portability

A. A New Concept. Portability, or the ability for the first estate to transfer unused estate and gift tax exemptions to a surviving spouse, was introduced. We have not seen it before in our transfer tax system, and it has received a lot of publicity (who by now hasn't heard of DSUEA – deceased spousal unused exemption amount?). As may not be surprising, this first effort contains some bugs, yet portability could have major significance due to the increase in the gift and estate tax exemption to $5 million.

B. Limited Applicability; Limited Duration. Portability is available for estate and gift tax exemptions, but not the GST exemption. Also, like all of the transfer tax provisions of TRA 2010, portability expires after 2012. Interestingly, the Administration's 2012 Budget seeks to make portability permanent, but without further law, it evaporates at the end of 2012. Thus, many drafting attorneys are unwilling to rely on portability as the cornerstone feature in planning documents. There has been debate over the future of credit shelter trusts, but for the most part, practitioners are being cautious before eliminating them for most clients.

C. Must be Timely Filed Estate Tax Return and Election Made by Executor of Predeceased Spouse's Estate. The executor of the first spouse's estate must file an estate tax return on a timely basis and make an election on that return to permit the surviving spouse to receive the first-to-die's DSUEA. This is true even if there is no other cause to file a 706. In such cases, a determination will need to be made by the executor whether as a fiduciary to expend the effort and resources (that might otherwise flow to someone other than the surviving spouse) to prepare and file the return.

D. Only the Last Deceased Spouse's Unused Exemption Amounts Applies. Only the most recent deceased spouse's unused exemption can be used by the surviving spouse. Thus, remarriage introduces complications. For example, if H1's DSUEA passes to W, and W remarries and survives H2, H1's DSUEA is wasted - a good reason for W to consider making gifts during the second marriage to use H1's DSUEA.

E. Use or Lose Concept (To Eliminate Risks of a Subsequent Remarriage or Future Reduction in Gift/Estate Tax Exemption Amounts). As just noted, a surviving spouse of a decedent dying in 2011 or 2012 should consider using the deceased spouse's unused exemption with gifts, especially if the surviving spouse remarries or in case the surviving spouse passes in a year in which the exemptions are lower. Clawback is addressed below.

F. New Estate Plans May Increasingly Rely on Disclaimer Trusts. Due to the uncertainty of future estate tax laws, some lawyers are also employing disclaimer planning to maximize the tax savings in first marriage situations.

G. QTIP Trusts in Combination with Disclaimer (Family or Bypass) Trusts. If the surviving spouse is a beneficiary of the Family or Bypass Trust, consider a double disclaimer by the surviving spouse first from the QTIP Trust (of which the surviving spouse is the sole beneficiary) to the Family or Bypass Trust and a second disclaimer of the surviving spouse's interest in the Family or Bypass Trust, to take advantage of the enlarged exemption amounts.

H. Other Issues. There are other issues, including some inconsistencies between the statutory language and the Joint Committee Explanation of the act (especially, example 3), including privity. The issue here is easily framed by an example. H1's exemption to W, W remarries H2 and W passes, H2 cannot receive any of H1's DSUEA. The sub-issue is if W made gifts, could she use H1's exemption before her own? Apparently she could not, according to the Committee explanation.

I. Non-Tax Reasons Continue for the Use of Trusts. Removing future appreciation, asset protection, special needs planning, disability planning, planning for the investment management of assets, charitable planning and estate equalization among heirs are several non-tax reasons that even mass affluent clients will continue to rely on the use of trusts in their planning.

II. Reunification of the Gift and Estate Tax Exemption for Two Years Creates Many Immediate Planning Opportunities, Especially for Very Wealthy Clients

A. Clients May Be Very Interested in Sophisticated Estate Planning. Clients, especially those with very significant net worths, have an enormous (possibly temporary) opportunity to do transfer planning taking advantage of the $5 million gift and GST tax exemptions.

i. There is no assurance Congress will extend the $5 million exemptions beyond 2012.

ii. Future growth in value of assets will be removed from the donor's estate.

iii. TRA 2010 did not prohibit the traditional planning strategies currently in use, such as direct gifts, short term GRATs, sales to grantor trusts, or general valuation discount planning. NOTE: Just because TRA 2010 did not prohibit them, this doesn't mean Congress cannot pass tax legislation to do so. In fact, the Administration's 2012 Budget mentioned above also seeks to have imposed a minimum 10 year term on GRATs and prohibit valuation discounts on intra-family transfers.

iv. What may be possible to give, may be more than prudent. Even wealthier clients may feel more uncomfortable in making gifts fully using their exemptions.

B. "Clawback". If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift tax exemption amount, it is not clear how the estate tax calculation will be interpreted. In other words, if an individual makes a gift of the $5 million gift tax exemption amount, and later dies after the estate tax exemption has been reduced to a lower amount, will estate tax be payable on the "excess" amount? There is no clear answer, but many advisors believe there isn't an issue and if there might be, a technical corrections bill will resolve the situation. Further, staffers on the Joint Committee on Taxation indicate that was not intended, and also suggest that this will be clarified by future legislation.

Advisors should be aware of the possibility of the additional estate tax, but should not overemphasize the fear of it because in general the combined estate/gift tax would not be greater than if no gift were made in the first place.

- 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 or unless gift taxes are actually paid at higher rates than the estate tax rate.
- An issue that may be of concern arises if the gift was made to persons different from the residuary beneficiaries. In that case, the residuary beneficiaries may end up paying the additional estate tax with respect to assets that have passed to the donees.
- If the estate would otherwise pass to a surviving spouse or charity, the additional tax expands because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax hit. Even in that case, while there may be estate taxes payable at the first spouse's death, those same taxes would have been payable if the gift assets had been transferred to the gift donees at the first spouse's death.

The recapture/clawback estate issue discussed above can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exemption amount." If the spouse later remarries and the subsequent spouse dies, with less exclusion, the spouse will not have as much DSUEA 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 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.

III. Other Planning Techniques

A. Carried Interests and Business Buy-Sell Arrangements Under Chapter 14. TRA made no changes to any of the prior provisions in Chapter 14 that impacts carried interest planning and buy-sell agreements among other items.

B. GRATs. Ultimately, Congress made no change in the minimum term required for a new GRAT. While the 7520 rate has inched up in the past few months, short-term and rolling GRAT programs should remain popular.

C. CLATs. Similarly, the relatively low interest rates should be an incentive for charitably-minded donors to establish CLATs.

D. A Possible Twist on Intra-Family Loans. While in the past, many wealthy donors loaned significant amounts of money to heirs or grantor trusts for heirs to take advantage of the low AFR rates and the opportunity to arbitrage the expected investment return on the assets given away.

i. Now, lenders involved in a prior intra-family loan transaction may want to consider forgiving some part or all of the entire loan balance, treating the amount forgiven as a gift and relying on the increased gift / GST tax exemptions.

ii. What about a "net gift" arrangement under which the donee agrees to pay any gift tax from the loan forgiveness if the gift exceeds $5 million? (Reduces the effective gift tax rate to about 25.9%). A gift forgiving the unpaid loan balance should not be debt cancellation income to the donor even if the donee is not a grantor trust as to the lender/forgiver. However, be careful that the net gift agreement won't give the IRS a resource to pay a tax liability for an insolvent estate should "clawback" in fact apply.

E. Sales to Grantor Trusts Compared to GRATs. Sales to grantor trusts have various advantages, especially that GST exemption can be allocated to the grantor trust at the outset so that all appreciation in trust is also forever GST exempt.

i. GST exemption cannot be allocated to a GRAT until the end of the retained annuity term.

ii. The leverage opportunities from a sale transaction have increased, since a $5 million pre-sale gift to a trust should support a $50 million sale (applying the generally accepted 10:1 debt to equity rule of thumb).

iii. The hurdle rate in a sale utilizing a mid-term AFR rate is lower than the 7520 rate required in a GRAT.

iv. Mortality is a consideration in a GRAT as the donor must be alive when the GRAT expires for such strategy to completely succeed, whereas a sale will completely succeed even if the seller dies shortly after the sale is completed (and assuming all the bona fides of the sale are adhered to).

F. Equalize Gifts Among Children and Grandchildren. It is now possible to use the additional gift exemption amount to equalize gifts among children or among grandchildren. For example, perhaps grandparents began annual exclusion trusts for grandchildren, but then more grandchildren are born after one grandparent has passed. The younger grandchildren thus may be receiving half of the gifts the older ones received when they were young. Consider doing a present value computation to determine how much more should be added to hopefully equalize the purchasing power at a future date.

Part II

Planning Opportunities, Especially with Life Insurance

I. Divergence of Planning Opportunities for Next Two Years Depending on Client Net Worth

A. Mass Affluent Couples (Estates Below $10 Million). The $10 million combined estate tax exemption available for 2011 and 2012 to mass affluent couples will most likely cause them to focus their wealth transfer planning on non-tax considerations. From a life insurance perspective, they will focus on situations such as funding a buy-sell agreement, equalizing inheritances among children, providing liquidity at death to a second marriage situation or providing for a special needs child or grandchild.

B. Very Wealthy Couples (Combined Estates Well Above $10 Million). The reunification of the gift and estate tax exemption at $5 million – for at least two years – and the increase of the GST exemption to $5 million creates a potential time-limited window of opportunity to make large simple completed gifts to an irrevocable life insurance trust ("ILIT").

II. New Interim Funding Paradigm for ILITS?

A. Prior Custom Was to Rely on Annual Exclusion Gifts and *Crummey* Notices to Fund Premiums Annually. In the past, most advisors recommended that every year individuals take advantage of the gift tax annual exclusion, to the fullest extent possible, to fund annual premiums due by ILITs. This meant that the ILIT trustee had to send timely annual *Crummey* notices to beneficiaries to grant them time-limited withdrawal rights over trust property. It rarely made sense to pass up annual exclusion gifts to make a significant taxable gift to an ILIT because of the $1 million lifetime gift tax exclusion.

B. Temporary 2-Year Change in Funding Approach for ILITs? There may be a temporary shift in the preferred funding paradigm for ILITs, especially for large ILIT-owned life insurance premiums due on significant trust-owned portfolios. Due to the sunsetting of the TRA 2010 provisions after 2012 – and a possible return to the 2001 gift tax exemption amount of $1 million in 2013 – advisors may want to encourage wealthy clients to explore funding options for large ILIT-owned policies to consider making large front-loaded taxable gifts to their ILITs (assuming they can afford to do so).

C. Large Gifts to ILIT are Simple. Once the ILIT trustee accepts a large taxable gift made by the insured to the trust, the gift is complete. There is no need to send out *Crummey* notices. Non-professionals might assume the role of ILIT trustee if they could administer an ILIT without the need to annually send out *Crummey* notices. There would be no need for an ILIT trustee to engage in or monitor complicated split-dollar agreements or private premium loans to the ILIT.

III. Continued Use of Trusts

Despite the increased transfer tax exemptions, there are many reasons why trusts will continue to be important to a client's estate plan.

A. Some Tax Reasons to Continue to Use ILITs and Other Trusts.

i. Absent further Congressional action, the benefits of TRA 2010 expire after 2012. Life insurance is a long-term asset that, if owned by an ILIT, can provide virtually certain estate liquidity in an era of tax uncertainty.

ii. Use of a traditional credit shelter or bypass trust provides an opportunity to continue to shelter from estate tax at the surviving spouse's death any estate tax on the appreciation in value of assets after the death of the first spouse.

iii. The state estate tax exemption in states that now have separate state estate tax or inheritance tax laws generally remain significantly lower than the current $5 million federal estate tax exemption. It is unlikely that these states can afford to increase their state exemptions to match the increased federal estate tax exemption. In these states, use of a trust may save considerable state estate taxes at the surviving spouse's death.

B. Some Non-Tax Reasons to Continue to Use ILITs and Other Trusts

i. Trusts can protect assets from claims of beneficiaries (possibly ex-spouses).

ii. Trusts can provide asset and investment management expertise for a spouse and children through professional expertise.

iii. In second marriage situations, trusts can provide for the second spouse while also protecting the inheritance of children of the first marriage.

iv. Trusts can avoid the cost and delay of probate. In the case of life insurance owned by an ILIT, there are no settlement costs or transaction or retitling delays incurred to reduce the asset to cash following the death of the insured.

v. Trusts allow the senior generation to retain indirect influence over their descendant's wealth long after the matriarch or patriarch is gone. Wealth advisors often encourage very affluent individuals to establish fully discretionary trusts, utilizing an independent trustee that will benefit currently unborn descendants. Some donors striving for future flexibility in administering these trusts have inserted beneficiary incentive language into the trust document itself or periodically write non-binding side letters to the trustee to ensure the trust is administered consistent with the donor's intent.

C. Hedging The Gift Tax Laws: Rainy Day Funds?

i. For mass affluent couples unsure of whether they will ever need access to large gift proceeds in the future, there are several techniques available. A donor might consider establishing a "rainy day" fund with a large taxable gift made in 2011 or 2012 and name the non-donor spouse as a permissible beneficiary. If the trust's distribution powers are limited to an "ascertainable standard," the non-donor spouse could be the trustee. Some have suggested that each spouse contribute assets to new trusts that benefit the other spouse initially. These trusts must not be considered to be "reciprocal trusts" (i.e., the terms of each trust must be materially different). Another approach is for a donor to establish a trust in a state that has adopted a self-settled spendthrift statute, naming him or herself as a permissible beneficiary with an independent trustee. So long as creditors of the donor cannot reach the trust assets, the gift to the trust should be considered to be complete for gift tax purposes.

ii. For very wealthy couples, there is presumably less financial need to design a rainy day fund which the non-donor spouse might access during his or her lifetime. Nevertheless, even very wealthy individuals establish a trust that allows a trust protector to add the non-donor spouse as a permissible beneficiary if the family's financial fortunes decline in the future. So long as there is no pre-arranged plan and there is a longstanding durable marriage, the non-donor spouse could be a conduit in indirectly returning trust assets to the donor spouse.

IV. Side Funds

A. Front-loading Gifts to ILITs and Back-loading Premium Payments Due Carriers. An individual can put in place today a large portfolio of permanent ILIT-owned life insurance and hedge whether to continue to fund the program in the future. The insured could make a simple large taxable gift to the ILIT in 2011 or 2012 but backload or optimize premium payments on certain types of products (such as no lapse guaranteed universal life ("NLG UL" policies)). Until significant premiums are due many years after the large gifts are made to the ILIT, the ILIT trustee can conservatively invest the excess gift proceeds for future use by the family. If the insured decides in the future not to continue the life insurance program, or decides to downsize the extent of coverage due to the ultimate success of other well-known estate freeze strategies, the excess gift proceeds and investment income can be redeployed for non-insurance needs.

B. Back-loading of Premiums Produces Superior IRRS and Reduces NPV Costs of Coverage. While carriers prefer receiving more premiums earlier and most insurance products reward agents for maximizing first year premiums, the best interests of most insureds are to back-load beyond life expectancy significant premium outlays. (Note that back-loading, optimizing or stepped increases in premiums can only be used with a universal life or variable universal life type of product, not with a whole life policy). When measured by internal rate of return ("IRR") and net present value ("NPV"), the back-loading of premiums can often lock up the maximum amount of current coverage for the smallest current outlay.

V. Modified Endowment Contracts (MECs)

A. The Dilemma. While insureds should consider accelerating funding of their ILITs in the next couple of years, they must also consider the potential adverse income tax consequences of likewise accelerating premium payments on a new policy.

B. Limits on Lifetime Tax-Free Withdrawal against Policy Basis or Policy Loan Distributions If Policy Is Considered a MEC on Issuance. The federal tax law defines life insurance for tax purposes. This definition limits a policyholder's ability to accelerate funding of the policy. If cumulative premiums paid during the policy's first seven years are too large in relation to the death benefit the policy will be categorized as a MEC. If a policy is labeled a MEC, all lifetime amounts received from a policy loan or withdrawal are first treated as ordinary income to the extent the distribution does not exceed the gain on the policy at the time of such distribution. In effect, a MEC is taxed under the "last in, first out" method. A non-MEC policy continues to be taxed under the "first in, first out" method applicable to a traditional level-funded life insurance policy, with the result that the first dollars distributed during the insured's life will be tax free.

C. MEC Status Has No Adverse Income Tax Consequences for Death Benefit. Even if a policy is categorized as a MEC, the death benefit – like a non-MEC – will not be subject to income tax (so long as the "transfer of value" rules were not violated during the insured's lifetime).

D. Product and Client Profile Can Impact MEC Risk Tolerance. In the case of most NLG UL policies, there is very little practical opportunity to receive a lifetime distribution of a policy loan or withdrawal against policy cash value because such action would likely seriously jeopardize the continued viability of the policy. Moreover, very wealthy clients with no need for lifetime access to policy cash value can tolerate MEC status because they will never request a lifetime distribution from the policy cash value.

VI. The Future of Split Dollar Arrangements and Private Loans

A. Split Dollar Arrangements and Private Loan Programs Are Complex Interim Funding Strategies, but Offer Unparalleled Transfer Tax Leverage Opportunities. Previously, large premium policies owned by an ILIT were funded on an interim basis by relying on some combination of a split dollar arrangement and/or private loan program funded by the insured. As noted above, during 2011 and 2012, insureds will be able to fund large premium amounts through large, simple taxable gifts to an ILIT.

B. Reasons to Discontinue Split Dollar and Private Loans.

i. Both techniques require early implementation of an exit strategy because both are “interim” funding approaches, so GRATs and sales to grantor trusts must be undertaken early on by the insured to eventually unwind these large premium advances.

ii. Following the death of the first insured in a second to die survivorship policy, the annual economic benefit cost of reporting for the surviving spouse will rise dramatically.

iii. If a non-guaranteed policy is in an “equity” position (because policy cash value exceeds premiums paid) when a split dollar arrangement is terminated during the insured’s life, under IR Notice 2002-8 the IRS can be expected to assert that there will be current income, gift and possibly GST tax consequences for the policyholder.

iv. Each premium advance is considered a separate loan under the final split dollar loan rules, and a separate written loan agreement should be executed for each premium advance each year.

v. Once low interest rates are in place by relying on historically low AFR rates for the months the loans were made, advisors must constantly monitor the interest rates on these loans prior to their maturity. Advisors will want to consider refinancing such split dollar loans before maturity if interest rates do decline.

C. Large Gift to ILIT to Unwind Spilt Dollar or Large Gift Forgiving Loan Balance. Some donors may decide to capitalize on the current $5 million gift and GST tax exemptions by unwinding their current split dollar or loan programs. In unwinding a loan program, the donor might simply cancel the outstanding loans of the ILIT by applying some portion of his or her $5 million exemption with no out-of-pocket exchange of money. In unwinding a split dollar arrangement, the same result should be obtained.

D. Reasons to Continue Split Dollar Arrangements and Private Loan Programs. The major reason to tolerate the administrative complexity associated with a split dollar arrangement or private loan program is the enormous tax leverage available to a donor-insured. The current measure of the gift for both gift and GST tax reporting purposes is either the annual economic benefit cost, using either the IRS Table 2001 rates or possibly a carrier's slower term rates if available, or the annual interest on all outstanding loans.

i. For survivorship policies where both insureds are alive, the annual economic benefit costs used to measure the gift are initially relatively nominal but these costs do rise as the insureds grow older. At some point, when the insureds are in their 70s and 80s, it may be preferable to convert a loan program to minimize current tax reporting costs. (This is known as "switch dollar").

ii. In dynasty trusts designed to benefit multiple generations, the ability to leverage both gift and GST tax reporting cost of coverage at a fraction of the overall annual premium outlay provides additional incentive to adopt a split dollar arrangement or private loan program.

VII. Dynasty Trusts and Leveraging the Death Benefit.

A. Combining a Large Gift with Maximizing the Death Benefit. A married couple that is committed to taking advantage of the two-year window in the transfer tax laws by making a large gift to an ILIT in 2011 and 2012 may be able to leverage say, $1 million of premium payments into perhaps $5 million of death benefit (assumes co-insureds ages 65/65 in good health). For very healthy insureds who qualify for preferred underwriting, they may be able to obtain even larger amounts of death benefit.

B. Tradeoff is Policy Cash Value. For married couples wishing to maximize the estate liquidity (death benefit) amount they should seriously consider purchasing NLG UL products held by a long-term dynasty trust. In this circumstance, the insureds must forego lifetime access to policy cash value. Another type of product that may be beneficial in maximizing death benefit is current assumption UL with an underlying guarantee to a prescribed age of say 90 or 95. For clients who insist upon having lifetime access to policy cash value during their retirement, the trade-off is a reduced death benefit. A cash accumulation type of universal life policy would be appropriate, but in order to build up cash value in the policy by the 10th policy year, the amount of pure death benefit coverage must be reduced.

VIII. Discounted Assets

A. A Combination of Discounted Assets and Cash Can Be Used to Fund an ILIT. Some very affluent insureds wish to maximize the leverage available from a valuation discounted gift made to an ILIT. For these clients, they might consider combining a gift of cash/marketable securities with a gift of discounted assets to the ILIT. The cash contributed to the ILIT could be earmarked for premiums due in the near-term. So long as the discounted asset participates in a successful interim liquidity event, the ILIT would be able to use such sale proceeds to cover significant long-term premiums.

B. Large Sales to a Grantor Trust in Vogue? In the past when the lifetime gift tax exemption was $1 million, a common concern with a sale to grantor trust transaction was how to get the initial gift into the ILIT without paying gift tax. The rule of thumb among commentators in pre-funding trusts prior to a sale for note transaction has been that the amount sold should be no more than 10 times the amount of the initial gift. The increase in the gift and GST exemptions to $5 million for at least two years should allow for much larger initial gifts and, therefore, much larger sale transactions. A $10 million initial gift by a married couple made in 2011 or 2012 should now support a $100 million sale for note transaction.

C. GRATs May Remain Popular. While the TRA 2010 did not impose a 10-year minimum term for GRATs (as proposed earlier in the year), a GRAT remains a popular and effective “estate freeze” in certain circumstances. Naming an ILIT as remainder beneficiary of a GRAT program involving a series of rolling, 2-year GRATs may squeeze enough appreciation and eventual liquidity from a single volatile publically traded asset to fund future premiums. The remainder trust (ILIT) will generally be a non-exempt trust for GST tax purposes.