Thinking About the IMPOSSIBLE for 2010

No Estate Tax and Carryover Basis

By Jonathan G. Blattmachr and Michael L. Graham

Under current law, the federal estate tax will be eliminated for the year 2010. The income tax "step-up" in basis rule for most property included in a decedent's estate also is eliminated for that year. Rather, the decedent's basis "carries over" to those who succeed to the property subject to special rules. Although many, if not most, estate planners thought the chance of zero estate tax with carryover basis for one year was extremely unlikely—perhaps, even less likely than permanent repeal and carryover basis—it may be that 2010 will be known as the one year without estate tax.

It seems appropriate to think about that possibility in planning now. Perhaps certain clients (such as those who own property with liabilities in excess of income tax basis or what is called "negative basis" property) should be warned about the prospects of carryover basis. It also seems sensible to consider the carryover basis issues for many married clients who just might die in that year with a surviving spouse. This article will focus on how certain estate planning documents (wills and revocable trusts, for example) might be structured in light of the possibility of a year without estate tax.

How Big Is the Formula Marital Deduction If There Is No Marital Deduction?

Usually, the estate plan for a married person who wants to maximize the use of his or her unified credit (or federal estate tax exemption) provides for his or her estate to be divided into two broad shares: one equal to the amount of the federal estate tax exemption and the balance in a form qualifying for the estate tax marital deduction. Generally, there are three broad ways to effect this division: (1) make the amount of the federal exemption a fixed sum of money, (2) make the amount of the marital deduction a fixed sum of money, or (3) make each a fractional share. In each case, a word formula is used to define at least one of them. Sometimes, it defines the federal exemption—and although there are several variants, all essentially say to determine the maximum taxable estate the married person could have at death without paying federal estate tax on account of the unified credit (and, perhaps, other credits). Other times, it defines the amount of the marital deduction. Again, there are several ways to phrase it, but essentially it says to determine the minimum amount necessary as the federal estate tax marital deduction in order to reduce the federal estate tax to zero. Experience teaches that defining either the federal exemption or the marital deduction that way works "just fine" for estate tax purposes.

But just what does either word formula produce if no federal estate tax is in effect when someone dies? If there is no federal estate tax, what is the maximum *taxable* estate one can have without increasing his or her federal estate tax? The concept makes no sense because there will no longer be a taxable estate. Alternatively, what is the minimum marital deduction necessary to reduce the federal estate tax to zero when there is no marital deduction or federal estate tax? Again, the concept makes no sense if there is no marital deduction. One can imagine, in a case in which the spouse of a second marriage succeeds to the marital deduction amount and the children from a prior marriage of the decedent succeed to the exemption amount, that the widow(er) and the children would take diametrically different positions over what each receives.

Even if there is no dispute among the surviving family members (they all agree everything passes under the disposition of the exemption share, for example), the IRS may not agree. And it will have an interest in the outcome in at least two ways. First, it is likely that the exemption share will pass into a trust, and the income earned thereon will not necessarily be taxed to the surviving spouse or to other fam-

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ily members. If the property passes to the surviving spouse (or to a marital deduction trust), the income will be taxed to the surviving spouse (except trust income allocated to corpus and not distributed). Second, the IRS will have a keen interest in the surviving spouse receiving more because the survivor likely will die in a later year when there is an estate tax. Certainly, some practitioners will contend that whatever the result, it can be resolved post-death by a disclaimer. For example, they will contend that the whole estate can pass under the federal exemption disposition by having the widow(er) disclaim any marital deduction disposition under section 2518 of the Internal Revenue Code of 1986 as amended ("Code"). But if the proper construction is that there is no such disposition (that is, everything passes into the marital deduction share if the decedent's spouse survives and nothing passes as part of the federal exemption disposition), the disclaimer will not produce the desired result. In any case, experience indicates that many a surviving spouse is reluctant to disclaim.

Perhaps the judges who will decide this issue will be consistent. But most would agree that a better choice is to let the clients decide. There seem to be two broad choices. One choice is to provide that, in the event there is no federal estate tax in effect when the first spouse dies, the entire estate passes under the marital deduction disposition and rely on the surviving spouse disclaiming that disposition if it "makes sense" to do so. But, as indicated above, and as Prof. Jeffrey Pennell has observed, "[A]mong the world's greatest lies are: (1) 'The check is in the mail'; (2) 'I'm from the government and I want to help you'; and (3) 'Of course I'll disclaim if it will save taxes.'" Tax Mgt. Portfolio No. 843-2d: Estate Tax Marital Deduction, at II.E.3, n.55.

An alternative is to direct that the entire estate passes under the disposition of the exemption amount. In such a case, it no doubt makes sense to ensure that the surviving spouse is a beneficiary of that trust, either entitled to income or eligible to receive income and corpus. The widow(er) might be given the right to demand property from that trust for his or her health, education, maintenance, and support (although in some states this may subject the trust assets to the claims of creditors of the surviving spouse; see *In re Flood*, 219 N.Y.L.J. No. 4, at 32, col. 3, Mar. 1998, aff'd, 691 N.Y.S.2d 354 (N.Y. App. Div. 1999)). In addition, the survivor could be granted the right to direct where the trust is to pass on his or her death, and the trustee may be authorized to consider the needs of the

surviving spouse as more important than those of other beneficiaries, including remainder beneficiaries.

One more complication: the decedent's estate may still be subject to state estate tax even if there is no federal tax. Hence, the practitioner must decide if the "traditional" division between an exemption share and a marital deduction share should be used to take advantage of the state exemption and to avoid state death tax (by also using the state estate tax marital deduction). Some practitioners likely will decide that it is preferable to pay a relatively small state estate tax (by having the entire estate of the spouse dying in 2010 passing into an estate tax exemption or credit shelter trust) than potentially increasing the estate of the surviving spouse who is likely to die after the federal estate tax has come back into effect.

In any case, when the married client decides that his or her entire estate (except for specific or dollar bequests, perhaps) should pass as would the federal exemption (into a so-called credit shelter or bypass trust, for example), the following fractional share language might be considered (if using a pecuniary formula, similar changes should be made). Also, the bracketed language in italics would be added if reference should be made to state estate tax if there is no federal estate tax in effect:

> A. If my spouse survives me, I give a fractional share of my estate as determined after payment of transfer taxes, expenses and any other pre-residuary gift, the numerator of which shall be equal to my Estate Tax Exemption and the denominator of which shall be equal to the value, as finally determined for Federal estate tax purposes, [(*or, if there is no Federal estate tax in effect at the time of my death, as finally determined for death tax purposes under the law of the state of my domicile*)] of my estate as so determined to the Trustee of the Credit Shelter Trust under this Will, to be disposed of under the terms of that trust.

In the following definition of "Estate Tax Exemption," the first bracketed phrase in italics should be included if you wish to take state death taxes into account in a "decoupled" state, but this may result in a relatively small state death tax savings at the death of the first spouse, as compared to a substantially overall higher federal estate tax at the death of the surviving spouse. The second and third bracketed phrases in italics should be included if reference should be made to state estate tax if there is no federal estate tax in effect:

> B. My "Estate Tax Exemption" means the largest amount that can pass to the Credit Shelter Trust without increasing the Federal estate tax [*and without increasing the state death tax*] due by reason of my death, [*or, if I*

die when there is no Federal estate tax, without increasing my state of domicile's death tax if my state of domicile's death tax law permits an unlimited exemption or deduction for transfers to a surviving spouse and an exemption or credit against the state death tax regardless of the person to whom property passes,] and shall mean my entire estate, to the extent not effectively disposed of by the provisions of this Will preceding this gift, if there is no Federal estate tax [*and, under the law of the state of my domicile, if there is no state death tax*] in effect at the time of my death.

Carryover Basis Matters

For persons dying in 2010 (whether or not married), some consideration ought to be given to the carryover basis rules. Those rules are found in Code § 1022, which is to become effective if the currently enacted estate tax repeal rule is not changed before 2010.

Under Code § 1022, the basis of assets acquired from a decedent will not equal their estate tax values for any year that no federal estate tax is in effect. During that time, the decedent's basis will "carry over" to those who succeed to the property on the decedent's death (although in no event can the basis exceed its fair market value at death).

There are exceptions and special rules. Under one of these, the executor/personal representative may allocate up to $1.3 million to increase the basis of assets up to their fair market value. (The $1.3 million amount is increased by certain pre-death losses of the decedent. Different thresholds apply for a noncitizen, nondomiciliary of the United States.) For example, assume a decedent owns a piece of real estate worth $5 million on her death for which her basis is $800,000. Under Code § 1022, the decedent's $800,000 basis would remain the basis in the real estate when she dies. The executor/personal representative may increase the basis of the land to $2.2 million by allocating the entire $1.3 million basis increase to that asset.

Authorize Executor/PR to Allocate to Nonprobate Assets

Because the executor is a fiduciary under the decedent's will and has no direct authority or responsibility for nonprobate assets, it may be that a beneficiary under the will would contend that the executor must allocate, to the extent possible, the $1.3 million basis increase to probate assets. In that event, the beneficiary would also undoubtedly contend that an executor who allocates basis to property outside the probate estate, without specific authorization, would be subject to removal, surcharge, or loss of commissions. Hence, it may be best to provide expressly in the client's will that the executor/personal representative may allocate part or all of the $1.3 million basis increase allowed under Code § 1022 to any asset or assets in the decedent's gross estate including those passing outside of the will. Of course, this provision must be contained in the will as it is the executor who makes the allocation (and not, for example, the trustee of any revocable trust created by the property owner, even if such a trust is the principal estate planning document used to transmit wealth when the property owner dies). The following is a sample provision that might be inserted in a will so the executor/personal representative is expressly authorized to allocate any basis increase (including the $3 million spousal basis increase discussed below) to nonprobate property.

For persons dying in 2010, some consideration ought to be given to the carryover basis rules.

Adjustments to Basis. I authorize my Executor/Personal Representative, in the exercise of sole and absolute discretion, to make any adjustment to basis authorized by law, including but not limited to increasing the basis of any property included in my gross estate, whether or not passing under my will, by allocating any amount by which the basis of assets may be increased. My Executor/Personal Representative shall be under no duty and shall not be required to allocate basis increase exclusively, primarily or at all to assets passing under this instrument as opposed to other property included in my gross estate. I waive any such duty that otherwise would exist. Any such allocation shall not cause my Executor/Personal Representative to be liable to any person or to be subject to removal or forfeiture of commissions or other compensation.

Authorize Executor/PR to Allocate to Own Assets

Whether or not the executor/personal representative is authorized to allocate the $1.3 million basis increase allowed under Code § 1022 to any asset or assets in the decedent's gross estate including those passing outside of the will, the question arises about whether the executor/personal representative may allocate basis to property the fiduciary is "inheriting" individually or as a trustee, as opposed to being required to allocate all or a pro rata portion of the basis step-up to property others receive. Hence, it may be appropriate for the property owner's will to provide expressly that the executor/personal representative may or may not allocate that basis increase to assets that the executor/personal representative is receiving. A sample provision permitting that might be written as follows:

> My Executor may elect, in the exercise of sole and absolute discretion and without permission of any court or other authority, to allocate basis increase to one or more of all assets that any Executor receives or in which the Executor has a personal

interest to the partial or total exclusion of other assets with respect to which the election could be made. Any such allocation shall not cause my Executor to be liable to any person or to be subject to removal or forfeiture of commissions or other compensation.

An ancillary issue is that if, under the will or governing law, the executor has the discretion to allocate the basis increase to assets he or she is receiving, the fiduciary who does not do so might be treated as making a taxable gift, bestowing a tax benefit away from himself or herself to another. Of course, that issue arises for other tax options and elections as well. See generally J. Blattmachr, M. Gans & S. Heilborn, *Gifts by Fiduciaries by Tax Options and Elections*, Prob. & Prop., Nov./Dec. 2004, at 39. A sample provision that might be inserted in an instrument to attempt to avoid having a fiduciary be deemed to have made a gift by the manner in which a tax election or option is exercised (or not exercised) might read something like the following:

> No individual fiduciary hereunder shall participate in any decision with respect to any tax election or option, under Federal, state or local law that could enlarge, diminish or shift his or her beneficial interest hereunder from or to the beneficial interest hereunder of another person. Any such tax election or option shall be made only by a fiduciary or fiduciaries that do not have a beneficial interest hereunder or whose beneficial interest could not be enlarged, diminished or shifted by the election or option. If the only fiduciary or fiduciaries who otherwise could exercise such tax election or option hold beneficial interests hereunder that could be so enlarged, diminished or shifted, another individual or a bank or trust company (but not an individual, bank or trust company that is related or subordinate within the meaning of Code Sec. 672(c) to any acting fiduciary hereunder) shall be appointed by the fiduciary or fiduciaries by an acknowledged instrument delivered to the person so appointed and the fiduciary so appointed shall alone exercise any such election or option.

Make Bequest to Use Spousal Basis Increase

In addition to the $1.3 million basis increase the executor/personal representative may allocate to assets, that fiduciary is authorized to allocate up to $3 million to increase the basis of assets that are received by the property owner's surviving spouse or a QTIP (qualified terminable interest property) trust. For example, assume that the decedent bequeaths a piece of real estate worth $5 million to her husband.

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Also assume that her basis in the property was $800,000. Under Code § 1022, the decedent's $800,000 basis would remain the basis in the real estate when she dies, and is inherited by her husband. The executor/personal representative, however, may increase the basis of the land to $3.8 million, by allocating the entire $3 million spousal property basis increase to that asset.

There is a "tie in" here between the estate tax repeal and the carryover basis that ought to be considered for several married persons who might die in 2010. As indicated above, it may well be that a will or revocable trust that provides for an "optimum" marital deduction (that is, the part of the estate equal to the federal estate tax exemption passes one way and the balance qualifies for the marital deduction) will be construed as having all the property pass as part of the federal exemption share such as to a "credit shelter trust." Unless that trust just happens to be in the form of a QTIP trust, there may well be insufficient assets in the decedent's estate to be able fully to use the special $3 million spousal property basis increase. And it is unlikely that a disclaimer even by all the beneficiaries of the credit shelter trust will save the day—the disclaimed assets may not pass to the marital deduction disposition because that disposition never could come into effect based on the construction of the instrument. (Maybe, just maybe, if the disclaimed property passes into intestacy and the surviving spouse is the only heir-at-law or all other heirs disclaim—a complicated matter to say the least—it will pass to that spouse and there will be property to which the $3 million spousal property basis increase may be allocated.)

One simple way to ensure there is enough property to which the special $3 million spousal basis increase can be allocated is to bequeath all assets to the surviving spouse. As indicated above, however, a married property owner may not want to have his or her entire estate pass to the surviving spouse for several reasons. One reason is that if the estate tax is reenacted by the time the surviving spouse dies, assets the survivor has inherited outright presumably would be included in the survivor's gross estate for federal estate tax purposes. Hence, the married property owner may want his or her entire estate to pass into a trust that will not be included in the gross estate but from which the surviving spouse may benefit. For several reasons (including creditor protection for the surviving spouse and to permit maximum income shifting among surviving family members), the married property owner may want the assets placed in a trust from which the trustee may distribute property to the surviving spouse or to the property owner's descendants. But such a trust is not the type to which any portion of the special spouse $3 million spousal property basis increase may be allocated. Hence, an

outright bequest either to the spouse or to a QTIP trust (from which all income must be paid to the spouse for life) must be created to be able to make that allocation.

Outright or QTIP Trust?

An initial question is whether, in making such a disposition to ensure use of the $3 million spousal basis increase, the disposition should pass outright to the surviving spouse or to a QTIP trust. It is at least arguable that a QTIP trust is preferable. One reason relates to estate tax inclusion when the surviving spouse dies. Certainly, anything he or she inherits will be in his or her estate when he or she later dies (and the estate tax is likely back in effect). But the QTIP trust may not be so included. At least under current law, that QTIP trust created by a married person while no federal estate tax is in effect would not be included in the estate of the surviving spouse. Although a QTIP trust is included under Code § 2044 in the estate of the spouse for whom it was created, that section applies only if the spouse who created it got the benefit of an estate or gift tax marital deduction. Because there would have been no estate tax in effect when it was created, it should not be included in the estate of the surviving spouse. Therefore, using a QTIP may be the better choice to take advantage of the $3 million spousal property basis increase.

How Much Must Pass to Use the $3 Million Spousal Basis Increase?

The disposition to or for the spouse to which the executor/personal representative is to allocate the $3 million spousal property basis increase may be structured in several ways. It is important to realize that it is a $3 million *increase in basis* and *not* just an allocation to $3 million *worth of assets* to which the allocation applies. An example may help to illustrate this principle. Assume a married woman dies in 2010 when there is no federal estate tax. She bequeathed her husband stock worth $3 million in which her basis was $1.4 million, a piece of land worth $2 million in which her basis was $100,000, and a painting worth $4 million of which her basis was $1 million. The inherent gain in the assets are (1) $1.6 million in the stock, (2) $1.9 million in the land, and (3) $3 million in the painting. Suppose the executor wants to increase the basis in the stock to its $3 million fair market value. The executor would not allocate the entire $3 million basis increase to the stock even though it is worth $3 million, but would allocate only $1.6 million. The carryover basis of $1.4 million plus the allocation of an additional $1.6 million of basis to the stock will increase its basis to $3 million, its fair market value when the property owner died. (Note again that the executor cannot allocate more to an asset than will increase its basis to its fair market value at the decedent's death). The executor will allocate the balance of the $3 million spousal basis increase (such balance being $1.4 million) to the other assets. For example, the executor might allocate this balance to the painting, bringing its basis up from $1 million to $2.4 million. Alternatively, the executor might allocate the entire $3 million basis increase to the painting, bringing its basis up from $1 million to its full fair market value of $4 million.

Ways to Structure the Marital Bequest

There seem to be two principal ways to structure the bequest to the spouse or a QTIP trust. One is to minimize the amount that will be transferred to the spouse or the marital trust. The other is to maximize income tax savings. Here is an illustrative comparison. A married man dies with two assets. One is a $4 million vacant parcel of land in which his basis is $1 million. The inherent profit in the land is long-term capital gain. The other asset is a commercial building worth $10 million with a basis of $7 million on which he has taken accelerated depreciation for tax purposes. A portion of the inherent profit in the building will be taxed at higher than the 15% long-term capital gains tax rate. Both assets have inherent untaxed profit of $3 million, but the gain in the vacant land will face a lower tax than will the commercial building. So allocating the $3 million spousal basis increase to the commercial real estate will save more income tax, but it may put more in the spouse's estate (although, as mentioned, any asset given to a QTIP trust while the carryover basis rules are in effect should not be included in the estate of the surviving spouse, at least as the law is now written).

Clients need to decide whether their principal goal is to minimize what the surviving spouse receives (or will be paid to a QTIP trust for the survivor) while still being able to use the entire $3 million spousal property basis increase, or to minimize potential income taxes even if it means the survivor (or the QTIP trust) will receive more. Here is a sample provision that might be considered to minimize what the surviving spouse receives to fully use the basis increase allowed for qualified spousal property:

> *Qualified Spousal Property Gift.* If I die when there is no Federal estate tax in effect, I give to the Trustee of the QTIP trust hereunder the lesser of (i) all carryover basis property passing hereunder and not disposed of by the foregoing provisions of this instrument, or (ii) those assets, not effectively disposed of by the foregoing provisions of this instrument, having the lowest combined value as of my date of death as finally determined for Federal tax purposes to which my Executor may allocate the entire basis increase allowable, after reducing such basis increase allowable, as of my date of death under Code Sec. 1022(c), by the basis increase that could be allocated to any other assets otherwise constituting qualified spousal property and otherwise passing to my Spouse or a qualified terminable interest property trust within the meaning of Code Sec. 1022(c), whether under this instrument or otherwise. The purpose of this gift is to take maximum advantage of the basis increase allowed under Code Sec. 1022(c) if I die when the carryover basis rules are in effect, but minimize the amount of property passing to the qualified terminable interest property trust and I direct that this provision be construed to achieve that result. For purposes of this paragraph, the term "carryover

basis property" means property with respect to which the additional basis increase under Code Sec. 1022(c) could be made if it were acquired by my Spouse.

And here is a sample provision that might be considered to maximize income tax saving through the use of the basis increase allowed for spousal property:

Qualified Spousal Property Gift. If I die when there is no Federal estate tax in effect, I give to the Trustee of the QTIP trust hereunder the lesser of (i) all carryover basis property passing hereunder and not disposed of by the foregoing provisions of this instrument, or (ii) those assets not effectively disposed of by the foregoing provisions of this instrument, having the lowest combined value as of my date of death as finally determined for Federal tax purposes that would produce the greatest income tax (taking into account the nature of the inherent gain) if sold for such value to which my Executor may allocate the entire basis increase allowable, after reducing such basis increase allowable as of my date of death under Code Sec. 1022(c) by the amount that could be allocated to any other assets otherwise constituting qualified spousal property and otherwise passing to my Spouse or a qualified terminable interest property trust within the meaning of Code Sec. 1022(c). The purpose of this gift is to reduce potential income taxes attributable to inherent gain in carryover basis property passing hereunder while attempting to minimize the amount of property passing to the qualified terminable interest property trust and I direct that this provision be construed to achieve that result. For purposes of this paragraph, the term "carryover basis property" means property with respect to which the additional basis increase under Code Sec. 1022(c) could be made if it were acquired by my Spouse.

Summary

Although most would probably place the chances at less than 50% that the year 2010 will bring a repeal of federal estate tax and its companion carryover basis, it is far from impossible. It seems prudent to plan for repeal of federal estate tax and carryover basis now by having a decedent's estate planning documents structured to maximize flexibility and savings. In addition, married clients need to decide how much should pass into a nonmarital deduction trust and how much, if any, should pass to (or in a QTIP trust for) the surviving spouse. Although from an overall perspective it seems appropriate to minimize what the survivor inherits if there is no estate tax, the carryover basis provisions suggest a sizable disposition to the spouse (or, perhaps, better yet, to a QTIP trust) to take advantage of the $3 million spousal increase in basis rule under Code § 1022. Also, executors/personal representatives should be specifically authorized to make such allocations of basis increase as they think best. ■