Federal Estate Tax Update and Planning Considerations for 2010

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I. Introduction

On January 1, 2010, the unthinkable became reality: the federal estate and generation-skipping transfer ("GST") tax regimes lapsed for the year. There continues to be considerable uncertainty regarding possible congressional action in 2010, including the issue of whether any action taken will be retroactive.

And so, here we are: well into the second half of 2010 with no clarity in sight. Where do we stand?

II. Federal Recap

1. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"): Where Do We Stand?

As a result of changes adopted in EGTRRA in 2001, the federal estate tax and generation skipping transfer ("GST") exemption amounts increased, and tax rates decreased through 2009. In 2010, the estate and GST taxes are eliminated altogether, and then reinstated in 2011 to their pre-2001 rates and exemption levels:

Calendar Year	Gift Tax Federal Exemption	Estate Tax and GST Federal Exemption	Highest Federal Marginal Rate (All Taxes)
2002	$1,000,000	$1,000,000	50%
2003	$1,000,000	$1,000,000	49%
2004	$1,000,000	$1,500,000	48%
2005	$1,000,000	$1,500,000	47%
2006	$1,000,000	$2,000,000	46%
2007	$1,000,000	$2,000,000	45%
2008	$1,000,000	$2,000,000	45%
2009	$1,000,000	$3,500,000	45%
2010	$1,000,000	N/A (No estate or GST taxes)	Gift: 35%
2011	$1,000,000	$1,000,000*	Estate: 55% Gift: 55% GST: 55%

*GST tax exemption indexed for inflation

We are indeed facing a most extraordinary year, perhaps best summed up in words of Senate Finance Committee Chairman Max Baucus:

"At this point there is all this massive confusion, this chaos…"

Is that not a perfect description of the state of affairs in 2010?

Ironically, as recently as mid-May, a deal on the estate-tax front was reported to be close. On May 11, Senate Finance Committee member Jon Kyl told reporters that he and Senator Blanche Lincoln were working with Senate Finance Committee Chair Max Baucus and Ranking Minority Member Chuck Grassley on an agreement to move forward on estate tax legislation. Kyl said the details on the estate tax were "pretty well resolved" and that he hoped the bill would pass as soon as possible.

On May 18 it was reported that Kyl had reached an agreement with Baucus on some of the details of a proposal for estate tax reform. Kyl said that they had agreed to a top rate of 35% percent and an exemption level of $5 million, indexed for inflation. However, later that very day it was reported that the tentative agreement on estate tax legislation had fallen apart…

On May 19, Baucus was reported as saying that Democrats and Republicans had yet to reach a compromise on the future of the estate tax. Baucus was quoted as saying:

"There's no agreement on the estate tax on either the substance or process. None whatsoever."

A potential deal to extend the estate tax at a 35% top rate and a $5 million exemption level, indexed for inflation, apparently met resistance from rank-and-file Democrats. The sentiment behind that resistance is perhaps best epitomized in the words of Senator Robert Casey, who told reporters:

"The idea that we're going to give an incredible economic advantage to less than 1 percent of our taxpaying population is really offensive to me."

On June 2, Grassley, in a conference call with reporters, blamed Senate Majority Leader Harry Reid for uncertainty regarding the future of the estate tax. Grassley said that the Senate Finance Committee would like to consider a 35% top estate tax rate, $5 million exemption and a stepped-up basis, but that its members "aren't assured by the majority leader that the bill passed out of committee would be taken up on the floor."

Kyl was again reported in mid-June of saying that he is "pretty close" to gathering the 60 votes needed for the 35% estate tax rate and $5 million exemption. However, on June 29, Lincoln said she and Kyl were still working on their proposal, and had not yet decided when they would bring it to the Senate floor.

Then, late on July 13, Kyl and Lincoln did file a proposal to amend the small business bill (the "Small Business Jobs and Credit Act of 2010," H.R. 5729) to include the estate tax fix. Their proposal would have included a 35% tax rate, phased in over 10 years, a $5 million exemption amount, phased in over 10 years and indexed for inflation, a step-up in basis for inherited assts and, for decedents dying in 2010, an election about whether to pay estate tax or receive a carryover basis.

Asked if the estate tax language would be brought to the Senate floor, Reid said "We'll see".

However, since then, it has been reported that estate tax changes will not be pursued as part of the small business bill.

Lawmakers are also reportedly considering whether to let taxpayers have the option of pre-paying their estate taxes while still alive, with the carrot of a lower rate. In essence, this provides the same sort of incentive as a Roth IRA conversion.

Meanwhile, on June 24, Senator Bernard Sanders introduced the "Responsible Estate Tax Act" (S.B. 3533) to the Senate. The Act includes a proposed $3.5 million per person estate tax exemption, coupled with a progressive rate structure as follows:

- estates over $3.5 million but less than $10 million - 45%
- estates over $10 million but less than $50 million - 50%
- estates over $50 million - 55%

The bill also includes a 10% surtax on the value of an estate above $500 million.

Identical legislation was introduced in the House on July 15 (H.R. 5764).

But wait: there's more…On July 19, Senator Jim DeMint unveiled an amendment to the small business bill that would permanently repeal the estate tax. DeMint said in a news release: "The death tax is an unfair, immoral double tax on property and assets that folks have already paid taxes on throughout their lives."

In a floor speech, Senator Sanders (who introduced the Responsible Estate Tax Act) said the major beneficiaries of the DeMint plan would not be middle-class workers, single parents, or senior citizens but rather billionaires, such as the Walton family who founded Wal-Mart. Their estate, Sanders said, is worth $86.8 billion, and if the estate tax were repealed, the family "obviously of desperate need, obviously struggling hard to keep their family above water economically, struggling hard to stay off of welfare, they would receive an estimated $32.7 billion in tax breaks…"

On July 21, the Senate defeated DeMint's attempt to permanently repeal the estate tax.

On July 27, Baucus was reported as saying that he expects final estate tax language to be settled as a part of broader legislation to extend certain tax cuts slated to expire at the end of 2009. The Senate's August recess is scheduled to begin August 9, and it is unclear whether a draft of that bill will be released prior to the recess.

Part of the complexity in resolving the estate tax situation is the necessity to comply with the pay-as-you-go (or PAYGO) rules. Under the PAYGO rules, increases in direct spending or revenue decreases are to be offset by other spending decreases or revenue increases. In other words, new proposals must either be budget neutral or be offset with other savings. Since the estate, gift and GST taxes are slated to rise in 2011 to top rates of 55%, with $1 million exemption amounts (indexed for inflation with respect to the GST tax exemption), any lower rate/exemption structure would represent a revenue decrease.

And that, as we head into congressional summer recess, is the chaotic state of the federal estate tax system.

2. Modified Carryover Basis Regime

With the sunset of the estate and GST tax regimes in 2010 came the sunrise of a modified carryover basis regime. Instead of inheriting assets with a basis equal to the fair market value of the assets on the date of death, in 2010 beneficiaries inherit assets with a basis equal to the lower of decedent's original cost basis or fair market value on date of death [new Internal Revenue Code (”IRC”) Section 1022(e)].

There are modifications to carryover basis. First, there is a special basis adjustment. The basis of a decedent's appreciated property may be increased by $1.3 million, but not in excess of fair market value on the date of death. Additionally, basis may be further increased by the amount of a decedent's unused capital loss carryovers and net operating loss carryovers.

There is also a modification for a spousal basis adjustment, pursuant to which the basis of property passing to a surviving spouse can be increased by $3 million, but not in excess of fair market value on date of death. To be eligible for the spousal basis adjustment, property must pass to the surviving spouse either outright or in the form of a "qualified terminable interest property" (or "QTIP") trust (a trust established for the exclusive benefit of the surviving spouse, from which the spouse must receive all income).

3. New Reporting Requirements: New Code §6018

Even though there are no federal estate tax returns to be filed 2010, there are still filing requirements. New returns are required to be filed to provide information for the administration of the new basis rules.

Filing requirements are triggered (1) with respect to the transfer at death of non-cash assets in excess of $1.3 million and (2) generally with respect to appreciated property received by a decedent within three years of death which was required to be reported on a gift tax return.

Under new Code §6018, the executor of the will (or trustee of a revocable trust) must report to the IRS:

- Information regarding the recipient of property;
- Accurate descriptions of the property;
- Decedent's adjusted basis in property and fair market value on date of death;
- Decedent's holding period;
- Whether gain on the sale would be treated as ordinary income; and
- Amount of basis increase allocated to property

The return, which as of the time of this writing has not yet been developed, must be filed with decedent's final income tax return. That does not leave much time to file a return if a decedent dies late in 2010, especially if missing or incomplete files regarding basis have to be reconstituted. Penalties are imposed for failure to file. The statute also requires the executor to provide the same information to the recipients of decedent's property

III. Congressional Options for 2010

There appear to be three congressional options for 2010:

1. <u>Retroactive reinstatement of the estate and GST tax regimes, either with 2009 rates and exemptions, or with different rates and exemptions</u>

The burning question with respect to this option is, of course, the constitutionality of retroactively imposing the tax liability. Suffice it to say that, even if the constitutionality of retroactive legislation is ultimately upheld, the imposition of a retroactive tax regime is likely to engender fierce constitutional challenges that will probably take years to resolve. This is particularly so since several billionaires have already died in 2010, giving their estates significant motivation for a contest.

George Steinbrenner, who died on July 13 with a net worth estimated by Forbes to be in excess of $1 billion, was quoted by the New York Times in 1998 as saying "I hate to lose. Hate, hate, hate to lose". If his advisors share any of that sentiment, it certainly sets the stage for a nasty battle over the constitutionality of a retroactive tax liability. And if any estate has the motivation to fight, consider the estate of Dan Duncan. Mr. Duncan, a gas-pipeline tycoon who was listed by Forbes as the 74th richest man in the world, died in March with an estimated $9 billion net worth.

On July 27, Senator Charles Grassley, ranking member of the Finance Committee, was reported as saying that he believes there would be constitutional issues with enacting a retroactive estate tax - especially considering Congress has already waited for most of the year - but that the final decision rests with Democratic leaders. On the other hand, House Ways and Means Committee

Chairman Sander Levin left open the possibility of a retroactive estate tax. On July 28, he was reported as saying that he remains undecided about whether the estate tax should be made retroactive to the beginning of 2010.

"We're talking about a few very fortunate people here," Levin said. "This is something that people have known about and knew was possible, but at this point no decision has been made."

2. Enact estate and GST tax legislation, effective from the date of enactment, either with 2009 rates and exemptions, or with different rates and exemptions

3. No congressional action in 2010, with the reemergence of the estate and gift taxes in 2011 at top 55% rates, and $1 million exemptions

As each day in 2010 passes without congressional action, the third option appears to become more likely.

IV. Planning Considerations For 2010

While uncertainty persists at the federal level and many state issues are unresolved as a result of federal inaction, there are valuable planning opportunities to consider. A comprehensive analysis of planning considerations for 2010 is beyond the scope of this paper, however, the following thoughts may be helpful:

1. Gifting Opportunities in 2010

Gifts exceeding $1,000,000 will be subject to gift tax (the gift tax exemption continues to be $1,000,000), but in 2010, the top gift tax rate is 35% compared to the top 2009 rate of 45%, and slated top 2011 rate of 55%. Note, that there remains the possibility (which appears less likely the later we get in the year without congressional action) that Congress might enact legislation to retroactively increase the gift tax rates. However, there may be ways to gift formulaically which may limit the risk of a retroactive rate increase. And if clients are intending to make taxable gifts in any event, this appears to be an opportune year to consider doing so to potentially take advantage of the low 35% rate. If the intent is to use valuation discounts as part of a gifting plan, that may increase the attractiveness of considering current action since indications are that valuation discounts in the family context may be significantly curtailed in the future.

Since the GST tax has also lapsed in 2010, consideration of gifting to grandchildren and more remote descendants also has much appeal. Due the lapse of the GST tax regime this year and the consequent apparent inability to allocate GST exemption to trusts in 2010, it is unclear how distributions in later years from trusts created in 2010 would be characterized (that is, would later distributions be subject to GST tax when made?). Accordingly, the simplest method to take advantage of the hiatus in the GST tax regime is to make outright gifts in 2010 (but gifts over $1 million will be subject to the gift tax). Again, there remains the possibility that Congress might retroactively impose the GST tax regime, so the outright gifting technique is not risk-free, although there may be ways to gift formulaically for this scenario as well. Outright gifts to grandchildren (or other more remote descendants) up to $1 million would appear to be relatively safe, because many practitioners believe that, even if the GST tax regime is retroactively imposed, it is likely that an exemption of at least $1 million will be permitted.

2. Planning with QTIP Trusts

In terms of planning for married persons in 2010, QTIP trusts appear to provide maximum flexibility. Consider that, if property was given outright to a U.S. citizen surviving spouse, that property would qualify for the unlimited marital deduction at the first death, but would be includible in surviving spouse's estate. There is an argument that, if the QTIP mechanism is utilized, the property in the QTIP trust escapes federal estate taxation at the second death, even if that death occurs after 2010. Pursuant to IRC § 2044, assets in a QTIP trust are includible in the estate of the surviving spouse if an estate tax marital deduction was allowed at the death of the first spouse to die. However, in 2010, there is no federal marital deduction, because there is no federal estate tax. Accordingly, some practitioners believe that the QTIP trust property can pass without the imposition of federal estate tax at the time of the second death.

Another advantage of the QTIP trust is that it extends time for determination of whether to qualify property for the marital deduction. Since the estate tax return is due 9 months after the date of death, with an automatic 6-month extension, a 15-month window is effectively available to see what action is most advisable.

3. Utilizing Grantor Retained Annuity Trusts ("GRATs") Before Attractive GRAT Features are Potentially Curtailed

A GRAT is a trust into which the trust's creator transfers assets and retains the right to receive an annual annuity for the trust term.

Every month, the IRS publishes interest rates (known as the "7520 rates"), which are used to value transfers to trusts. The IRS assumes that a trust created during any particular month will grow, for its entire term, at the interest rate in effect during that month. The IRS does not look at the actual growth of trust assets. Accordingly, growth surpassing the IRS' assumptions can be passed gift and estate tax-free to family members. For August 2010, the 7520 rate is 2.6% (compared to a high of almost 12% in 1989), making strategies that depend for their success on beating the IRS assumptions more compelling.

The key to success in a GRAT is the ability to outperform the IRS interest rate assumptions. For a trust created in August 2010, for example, if the trust portfolio grows at a rate that exceeds 2.6%, the entire excess can pass to family members (or a trust for their benefit) at the end of the trust term free of gift and estate taxes. Right now, not only is the interest rate very low, but there might also be an opportunity to transfer assets with depressed values. Assets with depressed values may be more likely to rebound, further increasing the chances of outperforming the IRS assumptions.

Tax Free Transfer of Assets

A very attractive feature of a GRAT is the ability to structure it without any gift tax consequences. This is known as "zeroing–out" a GRAT. The annuity is typically set so that, assuming growth at the 7520 rate (2.6% for August, 2010), all the assets will be paid back to the trust creator by the end of the trust term. Accordingly, no gift tax is owed on creation of the trust. This means that there is no risk of wasted transfer tax costs associated with creation of an unsuccessful GRAT.

If trust assets actually grow at a rate that exceeds the applicable 7520 rate, all the excess appreciation passes to family members free of gift and estate taxes. If the GRAT assets do not appreciate above that rate, the trust creator simply receives back all of the assets contributed to the trust in the form of the annuity payments. The creator is in no worse position than if he had done nothing. The only lost costs are the GRAT set-up costs (typically, legal and appraisal fees).

Short Term GRATs

If the trust creator dies during the trust term, the assets held in the GRAT will typically be included in the creator's estate and no transfer tax savings will have been effected. Accordingly, in order to minimize the risk of death during the trust term, short-term GRATs of 2 or 3 years have become very popular. The other advantage of a short term GRAT is to capture bursts of appreciation. Over a longer term, positive and negative performance are more likely to offset each other.

Since GRATs carry little or no downside risk, this has led many to create a series of short term GRATs funded with different asset portfolios to increase the odds that at least some of the trusts will outperform the 7520 rate and achieve tax-free transfer of property to family members.

Proposed Changes Mean You Will Have To Have Some Skin in the Game

If the GRAT technique seems too good to be true, apparently Congress is of the same opinion. Provisions curtailing the GRAT technique have been introduced or passed in either the House or Senate seven times since March:

- **H.R. 4849 "Small Business and Infrastructure Jobs Tax Act of 2010"**
  - Passed House - 3/24/2010
- **H.R. 5297 "Small Business Jobs Relief Act of 2010"**
  - Passed House - 6/15/2010 **(But GRAT provisions not included in Small Business Jobs Act, the Senate counterpart to this House bill)**

- **S.B. 3533 "Responsible Estate Tax Act of 2010"**
    - Introduced Senate - 6/24/2010
- **S.B. 3548 "Extend COBRA Premium Assistance Program Act of 2010"**
    - Introduced Senate - 6/29/2010
- **H.R. 4899 "Supplemental Appropriations Act of 2010"**
    - Passed House - 7/1/2010 **(But GRAT provisions not included in final version of bill passed by House and Senate and signed into law by the President on July 29)**
- **H.R. 5764 "Responsible Estate Tax Act "**
    - Introduced House - 7/15/2010
- **H.R. 5982 "Small Business Tax Relief Act of 2010"**
    - Introduced House - 7/30/2010

Clearly, Congress views GRATs as a mechanism taxpayers use to avoid taxation. According to the legislative report that accompanied the first House Bill:

> "The [proposed] provision limits opportunities to inappropriately achieve gift tax-free transfers to family members in situations where gifts of remainder interests in fact have substantial value."

All the proposed legislation includes the following provisions:

- A requirement that a GRAT have a minimum 10 year term

The requirement for a minimum 10-year term substantially increases the mortality risk: if the trust creator dies during the trust term, all or most of the trust assets will be included in the creator's estate. Indeed, the House Ways and Means Committee Report explicitly states that the 10-year minimum term requirement "is designed to introduce additional downside risk to the use of GRATs".

- A requirement that the annuity payment not be reduced from one year to the next during the first 10 years of the GRAT

This requirement effectively eliminates the possibility of front-loading all the GRAT payments to create the economic equivalent of a short-term GRAT.

- A requirement that the remainder interest at the time of the transfer have "a value greater than zero".

This requirement would eliminate the zeroing-out technique to avoid gift taxes. It would force some portion of the assets transferred to the GRAT to be subject to gift tax at the time of the GRAT's creation. The specific value that would be subject to gift tax is not specified in the proposed legislation, but when this proposal was originally suggested, some planners thought it would be 10% of the value of the property transferred to the GRAT. If a 10% rule ultimately becomes the law, a transfer of $10 million (for example) to a GRAT would require a $1 million taxable gift to be made, a price-tag that may effectively eliminate the viability of the technique. However, it is unclear whether a specific percentage requirement could be imposed in the absence of a legislative rule. There has been no indication of such a requirement in the legislation proposed so far. Accordingly, it has been suggested that the purpose of a requirement that the remainder interest have a "value greater than zero" (even if that is nominal) is merely to trigger a gift tax filing requirement.

The proposed amendments contained in five of the six bills would apply only to transfers made after the law is enacted. The provisions in "Extend COBRA Premium Assistance Program Act of 2010" would apply to transfers made after December 31, 2010.

There are potentially very significant transfer tax savings associated with ability to hedge both mortality risk and investment risk by using a series of short term GRATs under current law. In the desperate quest to find offsets for proposed legislation, the restrictions on GRATs certainly appear to be a popular choice. If the frequency of introduction of these restrictions is any indication of their traction, it appears that there is a limited window of opportunity to take advantage of the short-term zeroed out GRAT.