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The Impossible Has Happened: No Federal Estate Tax, No GST Tax, And Carryover Basis For 2010

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As things stand at the time of publication, the estate tax and generation-skipping tax have been repealed for 2010 but will return in 2011 in the form they took before EGTRRA was enacted in 2001. In addition, assets passing from a decedent will no longer take a stepped-up basis. This situation may or may not continue. As a result, estate planners must consider myriad factors in coping with the dangers posed by existing documents and acting to take advantage of several new opportunities that may have a limited window.

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As of January 1, 2010, the U.S. has no federal estate tax for the first time since 1915. This also is the first year since 1976 that there is no federal generation-skipping transfer (GST) tax. The top gift tax rate of 35% this year is the lowest in decades. This extraordinary situation is scheduled to last only during 2010. Beginning in 2011, the federal estate, gift, and GST tax systems will revert to their forms prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16, 6/7/01). Although the Code has provided that there would be no estate or GST tax for 2010 since the passage of EGTRRA, few thought it could happen. Indeed, many persons forecast nearly until the end of 2009 that last year's estate and GST tax parameters (a $3.5 million exemption and top rate of 45%) would be extended into 2010, but that did not happen.

Congress could adopt legislation retroactively reinstating the estate and GST taxes to the beginning of 2010, despite some question about the constitutionality of doing so. Nevertheless, estate planners and their clients need to take the current situation into account as well as the possibility the estate and GST taxes will be imposed retroactively to the beginning of this year.

A further complicating factor for practitioners and their clients is that, during the period that the estate tax is repealed, the income tax bases of assets acquired from or passing from a decedent, including most but not all assets acquired from a decedent, will not be made to be equal to their FMV at the date of death. With some exceptions, the decedent's basis in those assets will carry over to the recipient.

EGTRRA

EGTRRA made many changes to the estate, gift, and GST transfer tax systems. These included increasing the estate and GST exemptions, culminating in 2009 exemptions of $3.5 million, and decreasing the top rate for all three tax systems to 45%. It also replaced the state death tax credit with a state death tax deduction. The culmination of the EGTRRA changes was to eliminate the federal estate and GST taxes for 2010. The sunset provision,[1] however, means that all of the changes EGTRRA made (including such income tax changes as reducing the top income tax bracket from 39.6% to 35% and reducing the top bracket for long-term capital gains and dividends to 15%) will expire at the end of 2010. Unless the law is changed in the future, therefore, the following will occur on January 1, 2011:

- The estate tax exemption will drop to $1 million.

- The GST exemption will drop to an inflation-adjusted $1 million (it is likely this amount will be at least $1,340,000).
- The top estate, gift, and GST tax rate will increase to 55% (60% for estate and gift tax transfers between $10 million and $17,184,000).
- The estate and gift tax system will again be unified.
- The state death tax credit under Section 2011 will be restored.
- Several other important provisions, such as the qualified family-owned business interest (QFOBI) rules under Section 2057, will return to the way they were before EGTRRA.

As noted above, most practitioners anticipated that this would never happen; almost no one thought that Congress would allow the estates of decedents who die in 2010 to escape federal estate tax.

Congress could reinstate the estate and GST taxes retroactive to the beginning of 2010, despite some question about the constitutionality of doing so.

The current situation presents more problems than opportunities for estate planners and their clients. For example, the possibility of retroactive restoration of the estate and GST taxes presents a risk in taking any action at all on the premise that the estate and GST taxes are gone for the year and that the gift tax rate will be only 35%. Even those individuals who die this year, while the estate and GST taxes are not applicable, will leave estates facing potentially serious problems that must be addressed promptly.

Scope of the Sunset Provision

Although the major focus of this article is on the estate, gift, and GST tax provisions for 2010 (or the lack thereof) and what may be viewed as related income tax provisions that are in effect for this year, application of these provisions in future years also needs to be considered.

1. Planners must take into account what the law likely will be in the future. For example, the will of an individual who will probably not die very soon should take into account not just what tax law provisions will apply if he or she dies this year but what rules may apply if he or she dies in a future year.

2. As will be discussed later in this article, some transactions (such as the creation of a trust by a decedent who dies this year for his or her grandchild) may be treated differently in a subsequent tax year because EGTRRA expires by its terms on 12/31/10.

3. As strange as this may initially seem, some of the words used to effect the sunset of EGTRRA may mean that certain transactions are, in effect, treated for years after 2010 as having happened before EGTRRA even if the transfer occurred while EGTRRA was in effect.

These factors are interrelated in many ways and in order to set a more complete framework of looking at the estate tax and related laws for 2010, this article discusses the third factor (the EGTRRA expiration provisions) first.

Construing statutes. Before turning to the provision by which EGTRRA "expires," it seems appropriate to briefly discuss statutory construction. EGTRRA was pushed through the legislative process with haste. It was signed into law on 6/7/01, which historically is very early in a calendar year for the enactment of a major tax bill. Many of its provisions are unclear. The meaning and scope of the expiration provision, as will be discussed below, seem quite uncertain. Lawyers and courts are saddled with the written words of a statute, but a literal construction of a statute that produces an absurd result generally will not be adopted.[2]

Words are also an imperfect means of communicating. Viewing words from different perspectives or at different times may suggest significantly different meanings for them. These general principles should be kept in mind when reading the discussion of the expiration provision of EGTRRA.

Background of expiration. In order to help understand what the expiration provisions of EGTRRA mean, an awareness of why EGTRRA had to expire is important. Although certain provisions of the Code have expired in the past,[3] there has been no general sunset provision in other tax legislation.[4]

EGTRRA includes such a provision to ensure compliance with the Congressional Budget Act of 1974. That Act contains rules to enforce the scope of items permitted to be considered by the Congress under the budget reconciliation process (that is, in adopting a federal budget). One of these rules, known as the "Byrd rule" after its sponsor, Senator Robert C. Byrd (D-W.Va.), prohibits legislators from enacting tax provisions with respect to a budget reconciliation that would reduce revenues after the years covered by the reconciliation. Sixty votes are required in the Senate to override the Byrd rule. Because fewer than 60 senators voted to enact EGTRRA, all of its changes to the Code expire, as a general rule, after 2010 so that its provisions would not increase federal deficits after 2010. The expiration provisions of EGTRRA, therefore, probably should be read consistently

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1 See P.L. 107-16, section 901.

2 See Nixon v. Missouri Municipal League, 541 U.S. 125 (2004) (indicating that courts should avoid a construction that would lead to an absurd or futile result).

3 For example, Section 68, relating to the overall limitation on itemized deductions, was originally scheduled to expire on 12/31/95; see former Section 68(f), deleted by RRA '93 (P.L. 103-66, 8/10/93), section 13204.

4 See Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 107th Congress* (2003) (hereafter, "Blue Book"), page 171. The Blue Book is not, strictly speaking, legislative history, but the courts routinely use it as an important reference to the legislative intent behind tax statutes. See, e.g., United Dominion Industries, Inc., 532 U.S. 822, 87 AFTR2d 2001-2377 (2001); Amerada Hess Corp. v. Director, Div. of Tax'n, N.J., 490 U.S. 66 (1989); and Ptasynski, 462 U.S. 74, 52 AFTR2d 83-6495 (1983).

with its goal—to not produce deficits after this year—in mind.

The expiration provisions. The "repeal" of the estate tax and GST tax, as well as all other changes made by EGTRRA, expire or "sunset" at the end of 2010. EGTRRA section 901(a) states:

"IN GENERAL. All provisions of, and amendments made by, this Act shall not apply—

"(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

"(2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010."

Title V of EGTRRA deals with the estate, gift, GST taxes, and related income tax provisions (such as providing for the basis of inherited property to be equal to the lesser of its value on the decedent's date of death or the decedent's adjusted basis (the carryover basis rule)). If the sunset provision that relates to Title V ended with subsection (a), it would simply mean that the estate, gift, GST taxes and related income tax changes made by EGTRRA no longer applied after 2010. Nevertheless, section 901 (b) seems to provide an additional rule. It states:

"(b) APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted."[5]

It may be reasonable to construe section 901(b) as simply reinforcing the meaning of section 901(a). Construing subsection (b) as requiring the Code to be applied to gifts made after 2010 as though the EGTRRA gift tax provisions had never been enacted reinforces or restates the gift tax portion of subsection (a), and would imply an application only to future gifts.[6]

On the other hand, suppose an individual, who creates a trust in 2010 that is not treated as a grantor trust in its entirety, is treated as making a taxable gift by reason of Section 2511(c) (but otherwise under the law prior to EGTRRA the gift would be treated as incomplete).[7] Section 2511(c) expires and is of no effect after 2010. In determining gift tax due on future gifts, how should the 2010 gift be treated? Should it be considered as being complete under EGTRRA, or possibly as incomplete under post-EGTRRA law?

Section 2502(a) directs that, in computing the gift tax, prior taxable gifts must taken into account. One literal reading of EGTRRA section 901(b) is that the existence of the 2010 gift, which was deemed complete and therefore constituted a taxable gift in 2010, is ignored because the calculation of gift tax after 2010 is determined as though EGTRRA "had never been enacted." This reading also would lead to the conclusion that the taxpayer could be subject to a second tax on the same gift if the power he or she retained that caused the gift to be incomplete lapses before his or her death.

There will be other possible readings of section 901(b) in such a context. In any event, such an application of subsection (b) would actually seem contrary to the Byrd rule. The reason is that ignoring the taxable gift treated as made in 2010 by reason of Section 2511(c) could reduce federal gift tax collected after that year.

That, in turn, raises the question of whether in applying the Code "to years, estates, gifts, and transfers" after 2010, only those provisions of EGTRRA that would reduce tax collections (thereby increasing the deficit) are treated as never having been enacted. Because the Byrd rule has never been applied to tax reduction provisions of a budget reconciliation act, it is very difficult to reach a conclusion about this.

Carryover or stepped-up basis. The issue also arises with regard to a death in 2010. Throughout the balance of 2010, under Section 1022 the legatee would have a carryover basis in assets received from the decedent. But if the legatee sells the asset in 2011, a literal application of section 901(b) appears to permit the legatee's basis to be determined under Section 1014 so that basis would be equal to the date of death (or alternate valuation date) value.

The current situation presents more problems than opportunities for estate planners and their clients.

At first blush, EGTRRA section 901(b) does appear to provide that the Code should be administered in post-2010 years as if EGTRRA had never been enacted, thus suggesting that basis should be determined in 2011 under Section 1014. Nonetheless, it is difficult to imagine that Congress contemplated such an outcome for assets received from an estate that was not subject to estate tax. And it is certainly possible to read section 901 as consistent with Congress's purpose to link estate-tax-free treatment with carryover basis even if the asset is sold in a post-2010 year. EGTRRA section 901(a)(2), in dealing with Title V of the statute, focuses on the date of the transfer (the date of death, the date of the gift, or the date of the generation-skipping transfer). This should be contrasted with section 901(a) (1), which focuses instead on the tax year (i.e., EGTRRA does not apply to tax years after 2010). Thus, in terms of Section 1022, which was enacted as part of Title V of EGTRRA, it will no longer apply in post-

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[5] For simplicity, the phrase "and the Employee Retirement Income Security Act of 1974," which appears after "The Internal Revenue Code of 1986" and before "shall be applied," has been omitted.

[6] But see Flores-Figueroa v. U.S., 129 S.Ct. 1886 (2009) (indicating that a construction under which language in a statute is treated as surplus should be avoided).

[7] Essentially, and as is discussed in more detail later in this article, Section 2511(c) provides that an individual will be treated as making a completed gift for federal gift tax purposes if the individual transfers property in 2010 to a trust that is not a grantor trust in its entirety even if the individual retains such dominion and control over the transferred property that the gift would be considered incomplete under Reg. 25.2511-2.

2010 years if the transfer (i.e., death) occurs after 2010. Thus, where death does occur in 2010, Section 1022 should, under this reading, remain applicable even if the asset is sold in 2011. Nevertheless, if the application of the Byrd rule is to make the tax revenue impact the same for years after 2010 (when Section 1014(a) is back in effect) as it would have been before the enactment of EGTRRA, it is arguable that the potential step-up in basis is not inconsistent with the purpose of the Byrd rule.

GST tax. There is even more ambiguity in the language of the sunset provision with respect to the GST tax provisions, primarily because a transfer in trust can lead to generation-skipping transfers that occur in more than one year.

Suppose a grandmother creates a trust in 2010 for the current benefit of her grandson. Her transfer to the trust would be a direct skip, a type of generation-skipping transfer, and would produce a GST tax except for the fact that under Section 2664 the GST tax provisions do not apply in 2010 to any generation-skipping transfer occurring that year. Yet, when distributions are made after 2010 to the grandson from the trust, another type of generation-skipping transfer—a taxable distribution—may be deemed to occur.

Had the trust been created before 2010, Section 2653(a) (discussed in more detail below) would have precluded the later distribution from being a generation-skipping transfer. But it remains unclear (as also discussed below) whether Section 2653(a) can apply to a transfer made in 2010. Yet, the sunset provision might be construed to provide that, with respect to any transfer after 2010, Section 2653(a) will be deemed to have applied in 2010 because Section 2664 (which arguably blocked the application of Section 2653(a)) itself is ignored after 2010 because it became part of the Code by the enactment of EGTRRA.

Impact. All these possible readings create great uncertainty for taxpayers and practitioners. It seems that one logical approach would be to construe the sunset provisions as simply confining the tax benefits of EGTRRA to the years that EGTRRA was in effect. Another would be to conclude that the tax benefits comprise not only the benefits achieved while EGTRRA was in effect but also all tax benefits that derive therefrom in later tax years.

In determining gift tax due on future gifts, how should a 2010 gift be treated? Is it complete under EGTRRA, or possibly incomplete under post-EGTRRA law?

To find the latter construction consistent with the Byrd rule, one would have to conclude that the resulting increase in the deficit would be deemed attributable to the years EGTRRA was in effect, not to the subsequent years in which the continuing tax benefits apply. Under that construction, if a taxpayer contributed $3.5 million to a trust and allocated his or her $3.5 million GST exemption to the trust in 2009, that trust would remain wholly exempt from GST tax, even though if EGTRRA had never been enacted the taxpayer would never have had a $3.5 million exemption. The tax benefit in future years perhaps would attributed to the years EGTRRA was in effect.

Suppose a taxpayer dies in 2010, establishing a testamentary trust for grandchildren and more remote descendants. Similarly, that trust might not be subject to GST at any time: in 2010 the GST tax was not applicable to the direct skip to the trust, and in subsequent years the trust might possibly remain exempt because in the year it was established there was no estate tax, and thus no transferor within the meaning of Section 2652(a)(1)(A), and so no person could be defined as a skip person under Section 2613.

The same trust created inter vivos in 2010 is more difficult to analyze. Clearly, no GST is due on formation. In 2011, the trust may once again be subject to tax. The trust does have a transferor, and perhaps in this situation the rule of Section 2653(a) would apply as if EGTRRA had never been enacted, so that distributions to grandchildren do not trigger tax but distributions to great-grandchildren do. Again, this requires the Byrd rule to be construed as set forth above.

The only thing that is clear is that we will not know the scope of EGTRRA's sunset provisions until Congress, a court, or perhaps Treasury through the issuance of Regulations, clarifies it.

COMPLICATIONS—WORD FORMULAS

Many dispositions under wills and trusts are phrased in terms of tax concepts. This may lead to additional complications for married persons and others using word formulas to accomplish their estate planning goals.

Division Into Estate Tax Exemption and Marital Deduction Shares

Many married people have directed the division of their estates into two broad portions: one portion equal to the unused estate tax exemption[8] (usually passing into a nonmarital deduction trust, often called the

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[8] The term "estate tax exemption" is currently a misnomer, but one with a valid historical basis. Until 1977, the Code contained a true estate tax exemption ($60,000 for persons dying in 1976). It functioned as a deduction that was subtracted, dollar for dollar, from what otherwise would have been the decedent's taxable estate on which the estate tax was imposed. Starting in 1977, however, a credit (called initially the "unified credit" and now sometimes referred to as the "applicable credit") is allowed under Section 2010 instead of an exemption. The unified credit reduces the amount of tax due on the taxable estate, dollar for dollar. The credit, however, also may be viewed as an "exemption equivalent," which is the maximum taxable estate of a decedent without owing any estate tax by reason of the credit, assuming he or she had not used any portion of the credit by making certain lifetime gifts. Throughout this article, this exemption equivalent will be referred to as the estate tax exemption.

credit-shelter trust,[9] usually held for the benefit of the surviving spouse and descendants),[10] and the other portion equal to the "optimum" marital deduction amount, typically expressed as the minimum amount necessary to qualify for the federal estate tax marital deduction to reduce the federal estate tax to zero or, if reduction to zero is not possible, to its minimum.[11]

Based on the literal language of these bequests, the results could be radically different if the property owner dies in 2010. There is no federal estate tax for 2010, so a bequest of the maximum amount that passes free of that tax could be a bequest of the entire estate. Similarly, there is no unified credit, and a bequest of the maximum that can pass under such credit would be zero.

Arguably, these bequests (one based on the maximum that can pass free of federal estate tax and the other based on the estate tax exemption) may produce wildly different results if there is no estate tax when the individual dies, but they are almost certainly intended to produce the same result. The usual purpose of a will or trust construction (interpretation) proceeding is to ascertain the individual's intent and construe (interpret) the document to carry out that intent.[12] But such proceedings usually seek to ascertain only that intent expressed by the terms used in the instrument, and extrinsic evidence often is not admissible unless the court determines that the ambiguity in the governing instrument is a latent one that cannot be shown to exist without such information.[13]

Division Into GST Tax Exempt and GST Tax Non-Exempt Shares

An individual, whether or not married, will sometimes have a portion of his or her estate equal to his or her unused GST exemption[14] pass in a way (such as to a trust for the benefit of his or her grandchildren and more remote descendants) differently from the balance of his or her estate, which might be to or for his or her spouse or children. An unmarried person, for instance, might direct "I bequeath to the trustee of the trust hereunder for my grandchildren and more remote descendants an amount equal to the maximum amount that may be transferred to a skip person without the imposition of generation-skipping transfer tax" or "I bequeath to the trustee of the trust hereunder for my grandchildren and more remote descendants an amount equal to my unused GST exemption."

Based on the literal language of these bequests, the results could be radically different if the property owner dies in 2010. There seems to be no GST exemption amount for 2010, so a bequest of that amount would seem to be zero. Alternatively, the maximum such a person could transfer without the imposition of GST tax this year apparently is unlimited.

As with the marital deduction formula clause, it is arguable that these GST-tax-based bequests (one based on the amount of GST exemption and the other on the amount that may be transferred without GST tax) may produce different results if there is no GST tax when the individual dies, but they are almost certainly intended to produce the same result.

Tripartite and Quadripartite Documents

Married persons often have three- or four-part wills or revocable trusts. One portion of the estate is equal to the estate tax exemption. A second portion is equal to the optimum marital deduction amount. A third portion is, in essence, a part of the optimum marital deduction amount, equal to the married decedent's unused GST exemption, and passes to a QTIP trust with respect to which the decedent's executor makes a "reverse QTIP" election—that is, although the executor elects under Section 2057 (b)(7) to cause the trust to qualify for the estate tax marital deduction, which in turn would cause it to be included in the gross estate of the surviving spouse under Section 2044, thus making that spouse the transferor for GST tax purposes, the executor reverses the QTIP election for GST tax purposes under Section 2652(a)(3) so that the decedent, rather than the surviving spouse, remains the transferor. This reverse QTIP election permits the executor to allocate any balance of the decedent's GST exemption to the reverse QTIP trust.[15]

The reverse QTIP portion of the estate is usually described as the difference between the decedent's available GST exemption and the amount of the nonmarital share. As the amount of the nonmarital share may be difficult to ascertain because of the formula issues described above, and because there is no available GST exemption in 2010, the size of the reverse QTIP trust portion of the estate may not be clear if the decedent dies in 2010. Depending on

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9 So called because its size is determined by the federal estate tax that is avoided ("sheltered") by the unified credit.

10 A credit-shelter trust may be structured as a QTIP trust, although that has led certain estates inadvertently to elect for the trust to qualify for the estate tax marital deduction. See Rev. Proc. 2001-38, 2001-1 CB 1335.

11 Some individuals provide for the credit shelter share to pass outright or in trust for descendants to the exclusion of the surviving spouse even if the individual is married at death.

12 See, e.g., Matter of Fabbri, 2 N.Y.2d 236, 140 N.E.2d 269, 159 N.Y.S.2d 184 (N.Y., 1957).

13 See, e.g., Restatement (Third) of Property (Wills & Don. Trans.) § 11.1 (2003); Uniform Prob. Code section 2-603 ("The intention of a testator as expressed in his will controls"); In re Estate of Stiefel, 24 A.D.3d 994, 807 N.Y.S.2d 159 (App. Div., 3d Dept., 2005); Matter of Estate of Campbell, 171 Misc. 2d 892, 655 N.Y.S.2d 913 (N.Y. Surr., 1997); In re Hyde's Will, 122 N.Y.S.2d 304 (N.Y. Surr., 1953), *aff'd* 282 A.D. 1100, 126 N.Y.S.2d 468 (App. Div., 3d Dept., 1953).

14 The GST exemption, described in Section 2631(a), is not a true exemption. It is a rate reducer: to the extent that GST exemption has been allocated to a transfer, the rate of GST tax is reduced; see Sections 2641 and 2642. For example, if $1 million of GST exemption is allocated to a $4 million transfer, the effective rate of tax is reduced by 25%. If the amount of GST exemption allocated is equal to the amount transferred, the effective GST tax rate is reduced to zero. In that instance, the GST exemption acts as a true exemption.

15 See generally Blattmachr, Hastings, and Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 Trusts & Estates 47 (April 1988); Gans and Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 Est. Plan. No. 4 (April 2005), page 3.

how one construes the various components, the reverse QTIP portion could consist of the entire estate, the entire optimum marital deduction portion of the estate, or nothing. This is particularly problematic if the married decedent has directed that, on the death of the surviving spouse, the property in the reverse QTIP trust will pass in a manner (such as in further trust for grandchildren and more remote descendants) different from how any other trust for the surviving spouse is to pass (such as to or for the decedent's children).

A quadripartite document also creates a separate QTIP trust equal to the difference between the federal estate tax exemption and the state estate tax exemption if the decedent lives or has assets in a state with a state estate tax. As is discussed below, this formula may create even more construction problems than those creating the first three portions of the estate.

Back to Word Formulas

Word formulas based on federal estate tax provisions are used because it is believed that they will produce, at least while there was a federal estate tax and GST tax, what appears to be the optimal tax division or disposition of a decedent's property. The formulas, however, have no meaning if the concepts used to define them are not part of the law on the date of the decedent's death. What is the "minimum amount necessary as the federal estate tax marital deduction to reduce my federal estate tax to its minimum" if there is no federal estate tax or federal estate tax marital deduction? It might be argued that nothing passes under the bequest because no marital deduction is needed to reduce the federal estate tax to zero and all property disposed of under the instrument passes into the credit-shelter trust, but because there is neither a concept of federal estate tax nor a concept of a federal marital deduction, it just is not clear.

Similarly, if the bequest of the estate tax exemption amount is defined as "applicable exclusion within the meaning of Section 2010(c)," how much is that when there is no applicable exclusion in effect on the date of death? Alternatively, if the amount passing into the credit-shelter trust is defined as "the largest taxable estate I can have for federal estate tax purposes without increasing the federal estate tax in my estate," how large is that amount if there is no concept of a taxable estate and no federal estate tax in the law? In that situation, the construction might be that everything passes as part of the marital deduction share.

There are at least two caveats that need to be mentioned. First, all of these marital division formula clauses are designed to accomplish the same goal: minimize (actually to zero if possible) the estate tax that will be paid when the first spouse dies, minimize the estate tax that will be paid when the surviving spouse dies with respect to property passing to or for the surviving spouse from the first spouse to die, and provide for all of the property to be available to benefit the surviving spouse. It would be odd, since the goal is the same whether the document defines the credit-shelter amount or defines the marital deduction amount, that the results would be so different—that is, in one instance the instrument is construed as having all the property pass into the credit-shelter trust and in the other having it all pass into the marital deduction share.

As mentioned above, the purpose in construing or interpreting an instrument is to ascertain the individual's intent as expressed in the governing instrument, and then to construe the instrument to carry out that intent, including adding or eliminating provisions, changing negatives to affirmatives and the reverse, etc.[16] It should be possible to argue that any ambiguity caused by the lack of an estate tax or GST tax on the date of death is a latent ambiguity that can be cleared up by testimony of the drafter as to the goals the clause was intended to meet. But it also could be argued that the clause is not ambiguous, and that a clause that leaves the children the maximum amount of the estate tax exemption is designed to leave them nothing if there is no such exemption, while a clause that leaves the spouse the minimum amount required to reduce the estate tax to zero is intended to disinherit the spouse if possible, if that will still reduce the estate tax to zero.

Are only those provisions of EGTRRA that would reduce tax collections (thereby increasing the deficit) treated as never having been enacted?

The second caveat is that neither the IRS nor the federal courts will be bound by a local court's construction of the instrument.[17] The Service may take the position, even if a local court determines that the entire estate passes into a credit-shelter trust, that for tax purposes it has passed to the surviving spouse (if the marital deduction bequest is outright) and that the surviving spouse made a gift by permitting the property to go into the trust and/or that the credit-shelter trust is included in the gross estate of the surviving spouse.[18]

Gifts to Spouse Likely to Die Soon

It seems appropriate for one spouse to transfer virtually all of his or her wealth to his or her spouse (although not more than the gift tax annual exclusion if the donee spouse is not a U.S. citizen) if the donee spouse is expected to die this year and the donor spouse is expected to survive past the end of the year. If the donee spouse does die this year and there is no retroactive reinstatement of the federal estate tax that

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16 See, e.g., Matter of Fabbri, *supra* note 12.

17 Estate of Bosch, 387 U.S. 456, 19 AFTR2d 1891 (1967).

18 *Cf.*, e.g., Rev. Rul. 84-105, 1984-2 CB 197, but see Harris, 340 U.S. 106, 39 AFTR 1002 (1950); Estate of DiMarco, 87 TC 653 (1986), *acq. in result only.*

will apply to the estate of the spouse who dies this year, the couple will be able to protect their entire wealth from estate tax. If instead the federal estate tax is retroactively reinstated to apply to the estate of the spouse who dies this year, the property received by gift, as well as all other property of the donee spouse, may be transferred free of federal estate to the surviving spouse using a combination of the federal estate tax exemption and the federal estate tax marital deduction.

In fact, if the federal estate tax is reinstated, it is at least arguable that at least a portion of the assets given to the deceased spouse before death by his or her spouse will be entitled to the step-up in basis under Section 1014(a) notwithstanding Section 1014(e), which essentially provides that there is no step-up in basis with respect to any property received by the decedent within one year of death that is transferred back at the donee's death to the donor. Section 1014(e), by its terms, applies only to the extent the gift "property is acquired from the decedent by (or passes from the decedent to) the donor of such property." If the gift property is placed in trust for the donor, then the section may not apply.[19]

FURTHER COMPLICATIONS: CARRYOVER BASIS INCREASES

Under Section 1022, the income tax bases of assets acquired from someone who dies in 2010 will not equal their estate tax values; rather the bases of the decedent's appreciated assets will carry over to those who inherit the property.[20] This section, however, provides certain basis increases for carryover basis property, to relieve small- and moderate-sized estates from the need to maintain detailed records of basis.

It is arguable that the potential step-up in basis after 2010 is not inconsistent with the purpose of the Byrd rule.

The executor may allocate up to $1.3 million to increase the basis of property. This allocation, however, may not increase the basis of an asset above its FMV as of the decedent's date of death. This allocation does not increase the basis of property worth $1.3 million *to* $1.3 million, but rather increases its basis *by* $1.3 million. Therefore, a relatively large estate may end up with a full date-of-death value basis, if the property held by the decedent has no significant appreciation. This is likely to be the case for many estates in light of recent stock market declines.

EXAMPLE: A child of the decedent inherits land worth $5 million in which the decedent's basis at death was $1.5 million. The executor may elect to increase the basis of the land to $2.8 million. If instead the land was worth only $2.3 million when the decedent died, the executor could increase the land's basis from $1.5 million by $800,000 to $2.3 million (and no higher), and could allocate the remaining $700,000 of basis increase to other appreciated property (limited, again, to the FMV of such property at the decedent's death). If instead the land was worth $10 million and its basis was $8.7 million, the executor could allocate all of the $1.3 million basis adjustment to the land and bring its basis up to $10 million.

A decedent's executor also can allocate up to $3 million to increase the basis of assets (but, again, not to an amount greater than the FMV of the assets at death) that the surviving spouse receives outright or through a QTIP trust[21] ("qualified spousal property"). This is in addition to the $1.3 million general increase in basis.

A QTIP trust qualifies for the federal estate tax marital deduction, when there is an estate tax, only to the extent the executor elects under Section 2056(b)(7) for it to so qualify. No such election is necessary for a trust otherwise described in that section to be qualified spousal property, so that the executor may allocate all or part of the $3 million basis increase to its assets. No qualified domestic trust (QDOT) election under Section 2056A is required either, and it does not seem that the basis increase provision is limited to a surviving spouse who is a U.S. citizen.

Married Persons: No Estate Tax Plus Carryover Basis

Before turning to other important matters relating to the carryover basis rules, it is appropriate to explain how they complicate the division of the estate of a married person who dies in 2010.

A married person, who had directed that his or her estate be divided into two shares if his or her spouse survives (that is, an amount equal to his or her unused estate tax exemption to pass to a nonmarital share gift or trust, and the balance to pass in a form that may qualify for the estate tax marital deduction), may want to have his or her estate pass entirely into the estate tax exemption equivalent share to be held in the form of a credit-shelter trust that benefits the surviving spouse and descendants. Such a person, who may have had his or her estate planning documents in effect for some time, would have provided for a constantly increasing amount passing into the credit-shelter trust: $675,000 before EGTRRA and then $1 million in 2001 and 2002, $1.5 million in

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19 In Ltr. Ruls. 9321050 and 9026036, the IRS held that Section 1014(e) applied only to the extent of the actuarial (tax) value of the income interest of the donor spouse in a trust created for that spouse by the donee spouse of the gift property.

20 Under TRA '76, a carryover basis regime was adopted with respect to property included in the gross estates of individuals dying after 1976. See Section 1023 before its repeal by the Crude Oil Windfall Profits Tax Act of 1980 (P.L. 96-223, section 401). The regime was retroactively repealed, although estates of individuals who died before the repeal could elect to have the carryover basis rules apply.

21 Section 1022(c) contains a definition of QTIP almost identical to that in Section 2056(b)(7), without the requirement of an election.

2004 and 2005, $2 million in 2006, 2007, and 2008, and $3.5 million in 2009.[22] This suggests that if the exemption were increased, for example, to $5 million,[23] the decedent would have wanted the first $5 million to pass to the credit-shelter trust. And now, of course, without any estate tax, his or her entire estate (whether $5 million or $500 million) may pass federal estate tax free to the credit-shelter trust. That may be how an instrument making the credit-shelter trust/optimum marital deduction division will be construed. Of course, if the surviving spouse cannot benefit from the credit-shelter share (e.g., it is exclusively for the benefit of the decedent's descendants from a prior marriage), the result no doubt would seem harsh from the viewpoint of the widow or widower.[24]

Assuming that, if there is no federal estate tax applicable at death, the instrument explicitly directs or is construed so that the estate of the married person is to be transferred exclusively into a credit-shelter trust, there is another potentially important tax issue. Unless the credit-shelter trust is in the form of a QTIP type trust (e.g., all income paid at least annually to the surviving spouse with no ability to pay any part of the trust to anyone else during the survivor's lifetime),[25] there may be insufficient qualified spousal property against which the executor may allocate the $3 million basis increase.[26]

If, however, the instrument were construed so that the entire estate passes to a QTIP trust if there is no estate tax, or if the instrument so directs expressly, there could be the maximum amount of property to which the executor may allocate the $3 million basis increase, because the QTIP trust is qualified spousal property. In addition, the $1.3 million basis increase also could be allocated to the QTIP. Of course, using a QTIP trust limits some other planning opportunities, such as being able to transfer property to children without making a taxable gift or splitting income with the trust and/or descendants, which normally would be available if the trustee of the credit-shelter trust has the discretion to accumulate or distribute all income and corpus among descendants and the spouse. An instrument might provide that any part of the QTIP trust disclaimed by the spouse under Section 2518 would pass over to such a discretionary credit-shelter trust, affording the surviving spouse the option of taking advantage of such additional tax planning opportunities. The gift tax remains in effect in 2010, and the spouse can make a qualified disclaimer under Section 2518 and remain a beneficiary of any trust to which the disclaimed property passes by reason of the renunciation without being deemed to have made a taxable gift.

Revising Existing Documents for Married Persons

In a more perfect world, existing wills and trusts would have taken into account the no-estate-tax and carryover-basis possibilities.[27] Most such documents, however, do not cover those possibilities, because almost everyone thought it was impossible that repeal of the estate and GST taxes for 2010 would happen. Practitioners, therefore, should contact married clients to discuss how they want their property disposed of if they die when there is no estate tax. Although there are many options, two seem most likely to be used, at least if the situation is not complicated by a state death tax, as discussed below.

First, the married property owner could leave his or her estate to a QTIP trust that qualifies for the estate tax marital deduction to the extent the executor so elects. That seems to be of no importance if the property owner dies when there is no estate tax, but as explained above, such a QTIP trust is also qualified spousal property, and therefore the executor may allocate the $3 million basis increase to it. Also as discussed above, if the instrument is structured to allow for it, the spouse may make a formula disclaimer of the entire QTIP trust above the amount needed to allocate that basis increase and have the disclaimed assets pass into a credit-shelter trust that may provide more flexibility with respect to distributions than a QTIP trust does. The surviving spouse also should be able to disclaim specific assets, which may enhance the after-tax benefits of the disclaimer.

Regardless of how much remains in the QTIP trust, no portion should be included in the gross estate of the surviving spouse even if the estate tax is back in effect when he or she dies. Section 2044 includes the assets of a QTIP trust in the gross estate of the surviving spouse, but applies only if an election is made to obtain a marital deduction for the trust so that the spouse who created the trust avoids estate or gift tax by reason of the deduction. For the married person who dies in 2010, there will be no election to deduct the QTIP trust and no estate tax on the trust, because there is no estate tax applicable. Of course, if the estate tax is retroactively reinstated, then presumably the executor of the first spouse to die may elect QTIP treat-

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22 See Section 2010.

23 A level that was proposed several times in Congress in recent years; see, e.g., H.R. 498, 111th Cong., 1st Sess. (1/19/09); H.R. 2658, 111th Cong., 1st Sess. (6/2/09); H.R. 3841, 111th Cong., 1st Sess. (10/15/09); and H.R. 3905, 111th Cong., 1st Sess. (10/23/09).

24 Some individuals, even though they are married and wish the optimum tax division of their estate, direct that the estate tax exemption (or credit-shelter) share pass exclusively to or for descendants to the exclusion of the surviving spouse, figuring that the exemption amount is such a small part of their total wealth that the surviving spouse will be well taken care of. Under an interpretation of their estate planning documents that passes the entire estate to or in trust for descendants, this objective will be completely frustrated. It has been suggested that tax formula divisions should never be used if the shares do not pass essentially the same way. See, e.g., Blattmachr, "Don't Be Driven by Tax Driven Formula Clauses," 5 Probate & Property 34 (September/October 1991).

25 In some instances, the credit-shelter trust will be in the form of a QTIP trust. See, e.g., Rev. Proc. 2001-38, *supra* note 10.

26 See generally Blattmachr and Graham, "Thinking About the Impossible for 2010," 21 Probate & Property 12 (May/June 2007).

27 See Zaritsky, *Waiting Out EGTRRA's Sunset Period: Practical Planning While Congress Debates Estate Tax Repeal* (Thomson Reuters/WG&L, 2004), ¶ 3.02.

ment under Section 2056(b)(7) and avoid estate tax. To the extent the executor so elects, the QTIP will be included in the gross estate of the surviving spouse when or she later dies.

Because of formula issues, and because there is no available GST exemption in 2010, the size of a reverse QTIP trust portion may not be clear if the decedent dies in 2010.

It is possible that Congress, even if it does not retroactively reinstate the estate tax, could decide to cause QTIP trusts created by the first spouse to die in 2010 to be included in the gross estate of the surviving spouse. It seems difficult to imagine that Congress would single out QTIP trusts for this treatment—as opposed, for example, to a credit-shelter trust created by a married person who dies in 2010, especially if the credit-shelter trust is in a form that could constitute a QTIP trust. Nevertheless, with political matters there is no certainty.[28]

The second approach is to provide that, if there is no estate tax, then the entire estate (other than a separate formula bequest to take full advantage of the basis increase for qualified spousal property) should pass into the credit-shelter trust.[29] Professor Jeffrey Pennell has observed that one of the three great lies is "of course I'll disclaim if it will save taxes."[30] This second approach avoids any concern about the ultimate execution of a disclaimer by the surviving spouse. But there may be another factor in favor of providing for the entire estate of an individual who may die in 2010 to use a QTIP rather than a credit-shelter trust.

Using a QTIP Trust in All Events?

There may be one additional factor in favor of a married person's leaving his or her entire estate to a QTIP trust whether or not there is estate tax. If there is no estate tax applicable at the individual's death but there is a possibility of the retroactive reenactment of the tax, then the executor can wait until 15 months (assuming an extension to file is obtained) after death to determine to what degree a QTIP election should be made.[31] Or, instead, the surviving spouse could make a qualified disclaimer of all or a portion of the QTIP trust and have it pass over to a credit-shelter trust (or other alternative disposition). Whether there is an estate tax at the individual's death, whether one is retroactively reenacted, or whether there is no estate tax that applies to the estate, the disposition in favor of the spouse does not change (other than by the execution of a disclaimer by the surviving spouse).

The spouse's interest will vary if the will (or trust used as a will substitute) provides for the entire estate to pass into a credit-shelter trust if there is no estate tax or substantially into a QTIP trust (or other form of marital deduction) if there is an estate tax. Although that would not seem to affect the allowance of the marital deduction if there were an estate tax applicable when the individual dies, as it is not changed by any post-death event (other than a disclaimer by the surviving spouse), it could vary by post-death events if the disposition of the estate to the credit-shelter trust or to the marital deduction disposition does not just depend on there being an estate tax applicable when the individual died but on the retroactive reinstatement of the estate tax.

For example, suppose there is no estate tax when the individual dies in 2010, so the entire estate is to pass into a credit-shelter trust. But if the estate tax is retroactively reenacted so that it does apply to the individual's estate, the estate does not pass to the credit-shelter trust as would occur as of the moment of death when no estate tax existed, the disposition is "switched" to pass substantially to the surviving spouse in some form that qualifies for the federal estate tax marital deduction. That raises the question of whether such a post-death transfer to the surviving spouse will qualify for the marital deduction. Although, as of the reenactment of the tax, the estate would pass in a form that would qualify for the estate tax marital deduction, it is not absolutely certain that the IRS would not contend that, because the marital deduction disposition was not actually in effect when the decedent died, the marital deduction should not be allowed. It does seem that result is unlikely to occur but there is no guarantee it will not happen.[32]

Thus, a case can be made that providing for the entire estate to be transferred to a QTIP trust is a "safer" choice, at least until the law is

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28 Exhibit 1 for this proposition is the repeal of the estate and GST taxes for 2010.

29 Conditioning the disposition of property on "if I die when there is no federal estate tax applicable to my estate" may not be clear as to whether that condition applies if there is no federal estate tax applicable at the time of death but is retroactively reenacted to apply to the decedent's estate. Therefore, some consideration also may be given to conditioning the disposition on "and no retroactive reinstatement of that tax." Of course, in theory, that could occur decades from now. Therefore, it also may make sense to state the condition as only being for the current year, such as "if I die in 2010 when there is no federal estate tax applicable to my estate (including any retroactive reinstatement of such tax in 2010)."

30 Pennell, 843-2nd T.M. (BNA), *Estate Tax Marital Deduction*, fn. 85.

31 If there is no estate tax in effect when the individual dies, there is no duty to file a Form 706. If the tax is retroactively reinstated, it seems very likely estates of decedents who died before such legislation was enacted would have at least nine months from that time to file the return. Even if the return is required to be filed nine months after death, an extension for an additional six months can be obtained, so the executor would have at least into 2011 to file the return and make the QTIP election to the extent the executor determines appropriate. It seems unlikely that the 112th Congress, which will be sworn in at the beginning of 2011, would retroactively reimpose the estate tax on those who died in 2010.

32 The IRS might make its argument under the doctrine set forth in Procter, 142 F.2d 824, 32 AFTR 750 (CA-4, 1944), *cert. den.*, discussed in more detail below. Nevertheless, the predicate in the Fourth Circuit's application of the doctrine was that the taxpayer was "trifling" with the audit and judicial processes. That would not seem to apply where the result is based on the action of Congress and the President.

clarified as to whether the estate tax might be retroactively reinstated.

Some Other Drafting Considerations

Regardless of whether a client is married, there are other revisions to documents that should be considered to address the no estate or GST tax/carryover basis regime of 2010.

First, the client's will (and it should be the will because it is the executor who gets to allocate the basis increases) should include express authority for the executor to allocate the basis increases, in the executor's sole and absolute discretion. Under Section 7701(a)(47), the executor is the person who is the executor or administrator of the decedent's estate. If there is no executor or administrator appointed, qualified and acting within the U.S., any person in actual or constructive possession of any property of the decedent is the executor for tax purposes. There may be many such persons, however, and there may be disagreement among them concerning who may exercise options and elections, such as the allocation of the $1.3 million and $3 million basis increases under Section 1022. Such disputes would be resolved if the decedent has a will admitted to probate so that an executor (or administrator) is appointed.

Second, it may be appropriate to provide expressly in the will that only an executor who is not a beneficiary is authorized to allocate the basis increase. Otherwise, there may be conflicts of interest and a question may exist whether an executor who is a beneficiary may allocate basis increase to himself or herself under local law without incurring personal liability and surcharge. If the executor who is also a beneficiary may allocate basis increase to himself or herself under state law, there may be potential gift tax consequences for failing to do so.[33]

Third, whether or not an individual is married, some thought should be given to the interpretation of an instrument that makes a bequest or gift equal to the individual's unused GST exemption at death, as discussed above, because the absence of a GST tax for 2010 may render the meaning of such a bequest or gift uncertain.

STATES WITH AN INDEPENDENT ESTATE TAX

Prior the enactment of EGTRRA, the vast majority of states imposed an estate tax equal to the credit allowable under Section 2011 for state death taxes paid. EGTRRA repealed this credit and substituted a deduction under Section 2058. The repeal of the state death tax credit meant that many states no longer had an estate tax of any kind.

Certain basis increases for carryover basis property are provided to relieve small- and moderate-size estates from the need to maintain detailed records of basis.

Some jurisdictions, such as Connecticut, the District of Columbia, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, and Washington, have instituted stand-alone state estate taxes. It does not appear that all of the independent state estate tax systems were eliminated by the repeal of the federal estate tax for 2010, although, no doubt, some may argue that at least some of them have been.[34] There still may be a state death tax and it may present a significant issue for individuals who die domiciled in or who own real or tangible personal property in such states.[35]

EXAMPLE: A married New Yorker died in 2009 with an adjusted gross estate of $25 million (the total estate, less expenses and debts deductible on the estate tax return). The decedent's estate planning documents provided for an amount equal to her unused federal estate tax exemption to pass to a credit-shelter trust for the benefit of her husband and descendants; the balance of her estate passes to her husband in a form that qualifies for the estate tax marital deduction. The decedent's federal estate tax exemption for 2009 was $3.5 million,[36] which also would be the amount of her taxable estate for federal and New York estate tax purposes. The applicable credit under Section 2010 will protect the estate from any federal estate tax, but because the New York estate tax exemption is effectively limited to $1 million, New York will impose an estate tax equal to the amount of credit that would have been allowable under Section 2011 on $3.5 million, which would

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33 See generally Gans, Blattmachr, and Heilborn, "Gifts by Fiduciaries by Tax Options and Elections," 18 Probate & Property 39 (Nov./Dec. 2004), republished in Digest of Tax Articles (March 2005).

34 One of the more interesting series of events involving the repeal of the state death tax credit occurred in the state of Washington. When EGTRRA was enacted, Washington had an estate tax. A 1981 initiative had expressly limited the Washington estate tax to "an amount equal to the federal credit." Rev. Codes Wash. section 83.100.030(1). In 2001, the legislature enacted an amendment that stated that references to the Internal Revenue Code were to "the United States Internal Revenue Code of 1986, as amended or renumbered as of January 1, 2001." Rev. Codes Wash. section 83.100.020(15). Several executors sued to contest the validity of this provision, and the state supreme court held in Estate of Hemphill v. Washington, 153 Wash. 2d 544, 105 P.3d 391 (Wash., 2005), that the repeal of the federal credit for state death taxes automatically repealed the state estate tax, notwithstanding the actions of the legislature. The state then adopted an independent Washington estate tax. Rev. Codes Wash. sections 83.100.010-83.100.906. See Mumford, "Up and Down and Back Again: Troubled Childhood Notwithstanding, Washington's Stand Alone Estate Tax Deserves to be Defended," 29 Seattle U.L. Rev. 687 (Spring 2006).

35 As a general rule, a decedent's state of domicile may impose a death tax on all of the decedent's property at death other than real or tangible personal property actually situated in another state; that other state may impose its death tax on the real or tangible personal property actually situated there. See Blodgett v. Silberman, 277 U.S. 1, 8 AFTR 10243 (1928). See also Hellerstein and Hellerstein, *State Taxation*, Third Edition (Thomson Reuters/WG&L, 2009), ¶ 21.03.

36 Certain lifetime gifts reduce the amount of estate tax exemption that will be effectively available to the individual's estate for federal estate tax purposes. See, e.g., Section 2001(b).

be $229,200.[37] This represents an effective New York estate tax rate of about 6.5% ($229,200/$3,500,000). A New Yorker might well decide that paying such a tax when he or she dies is worthwhile, because it removes an extra $2.5 million from the federal gross estate of the surviving spouse.

In 2010, however, the result could be very different. If the married New Yorker died in 2010 and her will (or revocable trust) leaves her entire estate to a credit-shelter trust that does not qualify for the New York marital deduction, her New York taxable estate, on which a tax determined under the rates set forth in Section 2011 will be imposed, will be $25 million. The New York estate tax would be $3,466,800, which represents an effective New York estate tax rate of nearly 14%. Both the amount of tax due and the effective rate of tax are much higher for this decedent than for a decedent dying in 2009, because the latter would have a much smaller New York taxable estate. This arrangement should also mean that $24 million (plus any growth or minus any decline in value and consumption) will be excluded from the federal gross estate of the surviving spouse at his later death (assuming there is a federal estate tax applicable at that time). At a 45% estate tax bracket, this would avoid $10.8 million in federal estate tax in the estate of the surviving spouse—more than three times the amount that had to be paid to New York to achieve that result. Some married New Yorkers might well decide, however, that it is just too high a price to be paid when they die.

This awkward situation may arise, even if the decedent's governing instrument leaves the entire estate to a QTIP trust (other than, perhaps, an amount equal to the state estate tax exemption that might pass, for example, into a credit-shelter trust), if the individual dies domiciled in (or owns real or tangible personal property situated in) one of the states that imposes an independent estate tax and does not allow a state-only QTIP election.[38] Some jurisdictions, such as New York,[39] New Jersey,[40] Minnesota, Vermont, Iowa, North Carolina, and the District of Columbia, appear not to permit state-only QTIP elections.[41] A distinction may be made, however, in those states between disallowing state-only QTIP elections where an inconsistent election is made for federal estate tax purposes and allowing or disallowing a state-only QTIP election when the federal estate tax is not applicable. It would appear to be improper for a state that bases its estate tax on the federal estate tax law to disallow a marital deduction allowed by the "old" federal estate tax regime that it is following. Nevertheless, there is a risk that a decedent who dies in 2010 will not be allowed a QTIP election for state death tax purposes.

In a more perfect world, existing wills and trusts would have taken into account the no-estate-tax and carryover-basis possibilities.

A married individual domiciled in or owning real or tangible personal property situated in a state[42] that does not permit a state-only QTIP election may have to make sure that the marital share is left in a form other than a QTIP, such as an outright disposition, a general power of appointment trust described in Section 2056(b)(5), or an estate trust,[43] assuming that such forms qualify for the estate tax marital deduction under the state death tax system in question, to avoid a significant state death tax to be paid if he or she dies in 2010. The most significant potential downside of this approach is that if the federal estate tax is reinstated, as it is currently scheduled to be in 2011, the other forms of bequest will be subject to estate tax when the surviving spouse later dies. In all, potential payment of state estate tax may be a small price to pay to obtain federal estate tax exclusion.

This change in form, however, must be undertaken with consideration of the carryover basis rules. It is clear that the outright bequest to a spouse of nonterminable interest property constitutes qualified spousal property to which the $3 million basis increase under Section 1022(c)

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37 See New York Tax Law (McKinney's), sections 951-961. Actually, the calculation of the New York estate tax is more complicated. It is the lesser of (1) what the federal estate tax would be on the taxable estate if the federal exemption were only $1 million (not $3.5 million) and (2) what the state death tax credit would be under Section 2011. The state death tax credit was determined based on the decedent's federal taxable estate reduced by $60,000. That is, in computing the state death tax credit, the amount is not reduced by $1 million. There is some question as to whether there is any New York estate tax exemption in 2010, which is an issue beyond the scope of this article.

38 Some states expressly prohibit state-only QTIP elections. See Iowa Code section 450.3; Minn. Regs., Revenue Notice 06-04 (5/8/06).

39 It is possible that these jurisdictions will allow a state-only QTIP election while there is no federal estate tax. For example, New York has ruled that an estate that is not required to file a federal Form 706 may elect to use alternate valuation even though, under Section 2032, no election is permitted for federal estate tax purposes because the amount of federal estate tax will not decline by reason of the election. See N.Y. Comm'r of Tax'n and Finance Advisory Opinion TSB-A-09(2)M, Pet. No. M090420A (9/22/09), 2009 WL 3253934. This opinion could indicate that New York will permit the alternate valuation for New York estate tax purposes during 2010 and will permit the equivalent of a state-only QTIP election.

40 See N.J. Admin. Code sections 18:26-3A.8(d); 18:26-11.13 (7/21/08). This regulation has been reported as having been repealed, but the effect of repeal seems to be uncertain. See Practical Drafting at 9464 (October 2008). It is, therefore, possible that a New Jersey state-only QTIP election will be allowed.

41 It appears that a dozen states do permit state-only QTIP elections: Conn. Gen. Stat. section 12-391; 45 Ind. Admin. Code, rule 4.1-3-5(c); Ky. Rev. Stat. section 140.080(1)(a); 36 Me. Rev. Stat. section 4062 (2-B); Md. Code, Tax-General, section 7-309(b)(5)(ii); 830 Mass. Admin. Code section 65C.1.1; Ohio Stat. section 5731.15(B); Ore. Admin. Regs. section 150-118.010(7); 72 Pa. Stat. Ann. section 9113(a); R.I. Tax Division Ruling Request No. 2003-03; Tenn. Code section 67-8-315(a)(6); Rev. Codes Wash. section 11.108.025(4); Wash. Excise Tax Advisory No. 2013.57.015 (5/19/03).

42 See note 35, *supra*.

43 An estate trust is one that is transferred on the surviving spouse's death to his or her probate estate. Rev. Rul. 68-554, 1968-2 CB 412.

may be allocated.[44] A general power of appointment marital deduction trust[45] would constitute qualified spousal property provided that the spouse has a qualifying income interest for life and no person has a power to appoint the assets to anyone other than the spouse. It seems highly unlikely, however, that an estate trust would qualify.[46] A married person who decides to use a general power of appointment marital deduction trust that includes an inter vivos power or an estate trust, therefore, should consider making a formula bequest outright to the surviving spouse to ensure full use of the $3 million additional basis increase for qualified spousal property.

A case can be made that transferring the entire estate to a QTIP trust is "safer," at least until clarification as to whether reinstatement might be retroactive.

The best course of action for a married person domiciled in a state that has a state death tax but that does not permit a state-only QTIP election and who is likely to die in 2010 may be to change domicile to a state without an estate tax, or at least a state that permits state-only QTIP elections. That, of course, may be life altering in many ways, but the additional price of dying in a state that has an independent estate tax and that does not permit state-only QTIP elections may be more than the individual (particularly if he or she is highly tax-adverse) is willing to undertake.[47]

An unusual situation in New Jersey brings to light one more point worth discussing with respect to dispositions to a surviving spouse in 2010. New Jersey revoked its regulation that had provided that it would not recognize an unnecessary federal QTIP election. It has been suggested that this revocation reflects a concern that the state would lose the ability to impose its estate tax when the surviving spouse died, if the surviving spouse's executor, relying on Rev. Proc. 2001-38, 2001-1 CB 1335, treated the election as not having been made. Regardless of the purpose of the revocation, it reinforces the important point that many states impose their state death taxes on the amount of the decedent's taxable estate as determined for federal estate tax purposes. A QTIP created by a decedent who dies in 2010 would not be included in the gross estate of the surviving spouse for federal estate tax purposes when he or she later dies and would not be subject to state death taxation when the survivor dies if the state imposes its death tax based solely on the decedent's federal gross estate. Therefore, any such state may be reluctant to permit a state-only QTIP election because it would not be able to tax the QTIP property when the surviving spouse dies (as it would not be in the survivor's gross estate for either federal or state death tax purposes) and would have the opportunity to tax the property only when the first spouse dies.

More Complications for States With Death Taxes

There may be additional hurdles for those who die in 2010 domiciled (or owning real or tangible person property situated) in a state with an independent state death tax, especially if that state tax does not permit a state-only QTIP election. That complication arises where property is already in an irrevocable trust, such as a grantor retained annuity trust (GRAT) or qualified personal residence trust (QPRT), which provides for the creation of a QTIP trust for the surviving spouse to the extent the trust otherwise is included in the grantor's gross estate for federal estate tax purposes.

EXAMPLE: A grantor created a GRAT in October 2008 which is to terminate in October 2010. If she dies before the annuity term ends, all or a portion of the trust may be included in her gross estate under Section 2036(a).[48] On account of that possibility, the trust agreement provides that, if the grantor dies before the annuity term ends, the trust property (other than any annuity due the grantor or the grantor's estate) passes to a QTIP trust for the grantor's spouse, if then living. If the grantor dies in 2010 and before the GRAT term ends, there would have been estate tax inclusion that will cause a state death tax to be imposed, if the grantor was domiciled in a state with a state death tax and no state-only QTIP is permitted. There is no state estate tax if a state-only QTIP is permitted, assuming the grantor's estate can and does make the state-only QTIP election and avoids the state death tax. In those states that impose a state estate tax but that do not permit a state-only QTIP election, a state death tax may be imposed.

There might be a state death tax even in a state that permits a state-only QTIP election with respect to such an irrevocable trust, because of the way the disposition in favor of

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44 The statute makes it clear that a usufruct interest qualifies, but does not say whether the analogous and more typical legal life estate also qualifies.

45 A QTIP trust described in Section 2056(b)(7) is similar to a general power of appointment trust described in Section 2056(b)(5). But a trust granting the spouse the power to withdraw all property from the trust for his or her own benefit and also to appoint it during his or her lifetime to someone else likely would not be qualified spousal property.

46 An estate trust described in Rev. Rul. 68-554, *supra* note 43, is not required to pay all of its income at least annually to the surviving spouse, although a trust that has such direction and otherwise meets the requirements of the Regulations would seem to be described in Section 2056(b)(7), and therefore would be a QTIP trust.

47 One changing domicile should be careful to make the change completely, or not at all. States can reach inconsistent conclusions regarding residency and the U.S. Constitution affords no protection against the same decedent being subjected to estate or inheritance taxes as a resident of more than one state. See Dorrance v. Martin, 12 F. Supp. 746 (DC N.J., 1935), *aff'd sub nom.* Hill v. Martin, 296 U.S. 393 (1935); Texas v. Florida, 306 U.S. 398 (1938); and the discussion in Hellerstein and Hellerstein, *supra* note 35, ¶ 21.09.

48 Reg. 20.2036-1(c). See generally Blattmachr, Zeydel, and Gans, "Final Regulations on Estate Tax Inclusion for GRATs and Similar Arrangements Leave Open Issues," 109 JTAX 217 (October 2008).

the QTIP trust is designed. In fact, there also could be a state death tax, even if the grantor provides for the trust to be paid outright to his or her surviving spouse, which would qualify for the marital deduction because the property passes outright (unless the surviving spouse is not a U.S. citizen and the state allows a marital deduction only if the transfer is to a QDOT). The marital deduction may be lost because, sometimes, the GRAT will provide that the amount passing into the QTIP is limited to the portion of the trust included in the grantor's gross estate for federal estate tax purposes. In 2010 there is no federal estate tax, and there would be nothing included in the grantor's gross estate for federal estate tax purposes. Nothing would, therefore, pass into the QTIP or to a surviving spouse.

It may be appropriate to provide expressly in the will that only an executor who is not a beneficiary is authorized to allocate the basis increase.

A similar result could arise with respect to irrevocable life insurance trusts, which often have such contingent marital deduction provisions in the event part or all of the proceeds under policies owned by the trust are included in the insured's gross estate.[49] Such inclusion is common if the insured transfers an existing policy to the trust and dies within three years of the date of the transfer.[50]

The same result may also arise if one spouse has created a lifetime QTIP trust for the other. Such a QTIP will not be included in the donee spouse's gross estate if he or she dies in 2010, because there is no estate tax, but a state death tax could apply. The QTIP trust would be included under Section 2044 in the gross estate of the donee spouse for whom it was created, but many lifetime QTIP trusts automatically provide that, if the donor spouse survives the donee spouse, the trust property will be held in a QTIP trust for the donor spouse. A state-only QTIP election, if permitted, could be made to avoid state death tax on the assets in such a trust, but if a state-only QTIP election is not permitted the property presumably would be subject to state death tax. If the spouse who is the beneficiary of the inter vivos QTIP trust has a power of appointment, perhaps consideration should be given to exercising the power if such exercise may correct the problem.

Alternatively, the best course of action where property is held in an irrevocable trust with a contingent QTIP provision is to have the trust reformed by a court or by action of the beneficiaries and the grantor, if permitted by state law, prior to the death of the donee spouse.[51] Another option is to reform the trust by decanting, which is the act of paying the trust assets to a new trust.[52]

About a dozen states have statutes that permit decanting of the assets of one trust to another trust to be held on terms different from those of the transferring trust. Many states that have independent state death tax systems do not permit decanting. One option is to use the Alaska decanting statute, which provides, in part, that if an Alaska resident or Alaska bank or trust company is appointed as co-trustee, and if the trustees agree that Alaska will be the primary place of trust administration, the trustees will have decanting powers under Alaska law.[53] In any event, the decanted trust would provide the appropriate provision such as an outright payment to the surviving spouse if the deceased spouse dies domiciled in a state with an independent state death tax and it would not otherwise qualify for the state death tax marital deduction.

SUGGESTED ACTION STEPS

Looking forward, the first step for practitioners who do not wish to continue to put faith exclusively in Congress's ability to solve these complex issues—which it has been unable to do for eight years—is to contact clients about the 2010 law changes. A generic memorandum or an individually addressed letter or memo to each client might be used.

A practitioner may wish to consider inviting clients to contact his or her firm to make an appointment to determine what, if any, steps should be taken.[54] As mentioned above, it seems appropriate to determine explicitly how clients whose documents contain word formulas actually wish to dispose of their property if they die when there is no federal estate tax and no GST tax, but there is carryover basis. For those living in state death tax states, other factors probably also should be discussed, including the possibility of changing domicile.

Lawyers will almost certainly be preparing many documents in 2010 to cover this situation. For example,

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49 See Zaritsky and Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, Second Edition (Thomson Reuters/WG&L, 2009), ¶ 5.03[5][b]; Zeydel, "A Complete Tax Guide for Irrevocable Life Insurance Trusts," 34 Estate Planning No. 7 (July 2007), page 13.

50 Section 2035(a).

51 Uniform Trust Code section 411 permits the grantor and all beneficiaries of a trust to modify or terminate the trust "even if the modification or termination is inconsistent with a material purpose of the trust." Court approval would not be required under the U.T.C. generally, but a variation in Alabama, Maine, Nebraska, New Mexico, Ohio, and Virginia requires that the modification agreement be submitted to a court to assure that the grantor and the beneficiaries did all agree to the proposed modification. These versions of the U.T.C. do not, however, require that the court determine the appropriateness or desirability of the proposed modification. See Ala. Code section 19-3B-411; 18-B Me. Rev. Stat. section 411; Neb. Rev. Stat. section 30-3837; N.M. Stat. Ann. section 46A-4-411; Ohio Rev. Code section 5804-11; Va. Code section 55-544.11.

52 See Zeydel and Blattmachr, "Tax Effects of Decanting—Obtaining and Preserving the Benefits," 111 JTAX 288 (November 2009).

53 Alaska Stat. section 13.36.157. The Alaska statute is consistent with the legal principle that a trustee derives its fiduciary powers from the place of administration. See U.T.C. section 108 (principal place of administration); 5A *Scott on Trusts* (4th ed., W. Fratcher 1987), § 615.

54 Practitioners can find a sample letter to clients about this at the home page of www.interactivelegal.com.

married clients could explicitly state how their estates are to pass if they die when there is no estate tax. As mentioned above, this might be a direction for the entire estate (other than, perhaps, small pre-residuary bequests) to pass into a credit-shelter trust if there is no federal estate tax applicable when the married person dies, except for a bequest to take full advantage of the $3 million increase in basis permitted for qualified spousal property. Alternatively, the documents might provide for the entire estate (other than, perhaps, small pre-residuary bequests) to pass into a QTIP trust.

It does not appear that all of the independent state estate tax systems were eliminated by the repeal of the federal estate tax for 2010.

Furthermore, a client who wishes to allocate to a spouse that amount of property sufficient to take advantage of the $3 million spousal basis adjustment will need to decide whether this gift should involve selecting assets whose value is the smallest possible amount that will absorb the entire $3 million adjustment, the largest possible amount that will absorb this adjustment, or an amount that fairly reflects the appreciation and depreciation in the estate assets generally.

Moreover, any married client living in a state with an independent estate tax likely should consider whether he or she wishes (1) to have state death tax paid at his or her death and avoid both federal and state estate tax when the surviving spouse dies, or (2) to avoid both federal and state death tax when the first spouse dies even if it means considerably more tax when the surviving spouse dies. That decision likely will be easier to make if the state permits a state-only QTIP election and the "optimum" state marital deduction share passes into a QTIP trust.

If the state permits a state-only QTIP election and the "optimum" state marital deduction passes to a QTIP trust, the decision of whether to pay state death tax if the first spouse dies when there is no federal estate tax may be postponed until the state death tax return is filed and the election to elect or not elect QTIP trust treatment must be made. Alternatively, if the married person lives in a state with a state death tax that does not permit a state-only QTIP trust, the document might provide for the entire estate (other than, perhaps, pre-residuary bequests and one equal to the state death tax exemption) to pass into a general power of appointment marital deduction trust (assuming such a trust would qualify for the state marital deduction or exemption). That, of course, will mean that the trust automatically will qualify for the state death tax marital deduction and could be included in the gross estate of the surviving spouse for federal estate tax purposes under Section 2041. The surviving spouse would have the option of making a qualified disclaimer pursuant to Section 2518 of the general power of appointment, converting that trust into a QTIP trust and thereby preventing the trust from being included in his or her gross estate for federal estate tax purposes, thereby also potentially forgoing the state law marital deduction.

Another consideration, as mentioned above, for any person residing in a jurisdiction with an independent state death tax, is the possibility of changing domicile to a state that has none. For those who own real or tangible personal property actually situated in a state with an independent state death tax, some consideration should be given to eliminating that property from tax. That, of course, is a matter that individuals have had to consider since EGTRRA eliminated the state death tax credit, which resulted in eliminating state death tax systems in a majority of states. Such action may include selling such assets, giving them away prior to death (although that could produce a gift tax liability), and converting such property into an intangible. It might be appropriate, for example, for someone who is likely to die in 2010 to give such property to his or her spouse under the protection of the gift tax marital deduction if the spouse is expected to survive this year.[55]

A decision likely should be made now as to whether state death tax will or will not be paid if the first spouse to die passes when there is no estate tax, for clients living in a state with an independent state death tax. This decision also can be postponed until after the first spouse dies, however, if the client's estate planning documents provide for the amount passing to the credit-shelter trust to be equal to the state death tax exemption and for the marital deduction share to pass either outright to the surviving spouse or to a general power of appointment marital deduction trust. In such a situation, there will be no state death tax due, and the surviving spouse may change that outcome by making a qualified disclaimer within nine months of the death of the first spouse to die.

The following language might be used in the will or revocable trust of a married person who prefers for the marital deduction share to pass into a QTIP trust but who lives in a state with an independent state death tax and no state-only QTIP:

> If there is no federal estate tax applicable to my estate at my death (including no retroactive reenactment of such tax enacted by the end of the calendar year of my death making it applicable to my estate) and if the state of my domicile imposes a state death tax at my death but does not permit my estate to make an election to treat any property that would be described in Section 2056(b)(7) of the Internal Revenue Code of 1986, as amended (the "Code"), to qualify for the marital deduction or exemption for purposes of the state death tax, I hereby grant my husband/wife a power to appoint at his/her death by his/her Will by specific reference to this general power of appointment

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55 The gift tax marital deduction is not allowed for transfer to or for a spouse who is not a U.S. citizen. See Section 2523(i). Nevertheless, the annual exclusion for 2010 for transfers to a non-U.S. citizen spouse is $130,000.

the property in any trust that is so described to his/her estate so that the trust will be described in Section 2056(b)(5) of the Code.

In some respects, a plan that forces all property into a QTIP trust in the event the federal estate tax is not applicable at the decedent's death (at least in states with a state-only QTIP) might be safest for the following reasons. At the present time, no one can predict whether the federal estate and GST taxes will be retroactively reinstated, and whether any such retroactive reinstatement will ultimately be upheld against possible constitutional challenge. It is not entirely certain whether formulas providing for property to pass to a trust that qualifies for the marital deduction only if the tax is applicable or if the tax is retroactively reinstated would qualify for a marital deduction.

Will a state that bases its estate tax on the federal estate tax law disallow a marital deduction allowed by the 'old' federal estate tax regime that it is following?

The problem is that qualification for a marital deduction generally requires property to pass to or for the benefit of the surviving spouse at the date of the decedent's death. If at the date of death the tax is repealed, and thus the formula causes nothing to pass to or for the benefit of the surviving spouse (except possibly sufficient property to absorb the $3 million basis adjustment for qualified spousal property), would the shift in the estate plan after the fact, on a possible retroactive reinstatement of the tax, be effective to obtain a marital deduction? No one can predict the answer. It may seem obvious to some what the "fair" answer would be, but as we all know life under the tax law is not always fair. Should taxpayers take that risk vs. the risk that a spouse who receives the entire estate in a QTIP would not disclaim if the tax is in fact not in effect? These are, of course, client calls.

In fact, perhaps, the simplest plan of all for a married person is to have his or her entire estate (other than small pre-residuary bequests) pass into a QTIP trust and take advantage of any federal or state death tax exemption by a disclaimer made by the surviving spouse of his or her interest in the QTIP trust or by a partial QTIP election by the executor. That is, the bequest of the entire estate to the QTIP trust (and none to the "bypass" trust) would not be conditioned on there being a federal or state death tax (retroactive or otherwise) in effect at the decedent's death. It would instead provide for the entire residuary estate to pass to a QTIP trust in all events, with an express provision that if the surviving spouse disclaims any portion of his or her interest in the QTIP trust, the disclaimed portion would pass to a bypass trust.

If the decedent is domiciled in a state that may not permit a state-only QTIP election, the QTIP trust also should grant the surviving spouse a general power to appoint the trust to his or her estate at death so that the trust will qualify for the state estate tax marital deduction. The surviving spouse could disclaim the general power to avoid inclusion in his or her gross estate for federal estate tax purposes if the first decedent dies when there is no federal estate tax in effect (including no retroactive reenactment of the tax). The only limitation is that any disclaimer by the surviving spouse (unless he or she is under the age of 21 years) must be made within nine months of the death of the first spouse to die in order for the disclaimer to be qualified under Section 2518.

MORE ON CARRYOVER BASIS

As indicated above, the basis of an asset acquired from a decedent or from whom the property passed by reason of death in 2010 generally will not be equal to the asset's value on the decedent's date of death under Section 1014(a).[56] Instead, the decedent's adjusted basis will carry over to those who acquire the property.

There will be no income-tax-free step-up in basis at death, but there may be a "step down" in basis if the decedent's adjusted basis is greater than the asset's FMV. Section 1022(a) states that the income tax basis of carryover basis property is the lesser of (1) the decedent's adjusted basis in the property or (2) the FMV of the property at the date of the decedent's death.

As the country's prior experience with a carryover basis regime demonstrated, it is a complicated tax system. Some practitioners will bemoan the fact that there will be no federal estate tax return prepared for any individual dying in 2010, but returns and reports are still required for carryover basis property. The number of decedents' estates affected by carryover basis will, in fact, be many times the number that were affected by the federal estate tax last year.[57] Individuals will need significant professional advice and guidance, as occurs in all circumstances involving a new tax system. As a result, it should be a good year for those who administer decedents' estates and those who advise them.

An entire book could be written about the current carryover basis regime, as was done under the prior carryover basis rules.[58] This regime is virtually certain to be short term, however, so that may not occur again. Nonetheless, professionals need to become familiar with the

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56 There are exceptions to the rule under Section 1014(a) that the basis of an asset acquired from or passing from a decedent is equal to its date of death value. If alternate valuation is elected pursuant to Section 2032, the basis is the value on such alternate valuation date. There are other exceptions as well.

57 According to a New York Times editorial entitled "An Estate Tax Mess" (12/27/09), the number of estates affected by carryover basis will be 70,000, compared to 5,500 that would have been affected had the estate tax been retained with the 2009 parameters.

58 See McGrath and Blattmachr, *Carryover Basis under the 1976 Tax Reform Act* (Journal of Taxation, 1977). Although there are many technical distinctions between the 1976 and 2010 carryover basis rules, a great many of the planning implications and solutions are the same.

rules, including filing requirements, and the planning opportunities and dangers they present. The impact of the carryover basis regime will be felt for quite some time and well beyond 2010, as property is sold, exchanged, depreciated, or otherwise dealt with for income tax purposes.[59] This article will not attempt to discuss these rules in complete detail, but it will highlight certain critical parts of these rules and also discuss how basis information of a decedent's property may be obtained.

Section 1022: A Synopsis

Significant aspects of the carryover basis rules are as follows.

No automatic long-term holding period. Basis will not be determined pursuant to Section 1014(a), so the automatic long-term capital gains holding period provided under Section 1223(9) will no longer apply. The decedent's holding period may be added (or tacked) to that of the estate or inheritor, but only if the basis is determined, in whole or in part, from the decedent's basis. An estate's or inheritor's basis would not be determined even in part by the decedent's basis if the decedent's basis was greater than the property's FMV at death, and these assets will not immediately after death be treated as long-term capital gain property.[60] This may suggest that these assets should be sold immediately prior to death if the decedent is likely to die this year.

Increases in basis. As noted above, under Section 1022(b) the executor may increase the bases of property "owned by the decedent" and "acquired from a decedent" by $1.3 million. Additional increases are allowed for the sum of capital loss carryovers of the decedent under Section 1212 (b) and NOL carryovers under Section 172, plus the sum of any losses that would have been allowable under Section 165 if the property had been sold before death for its FMV. Such increases cannot exceed an asset's FMV at death. For property acquired by a decedent who was at death a non-U.S.-domiciliary alien,[61] the basis increase under Section 1022(b) is limited to $60,000.

As mentioned above, the decedent's executor may increase the basis of qualified spousal property (but not above the FMV of any asset at death) by an additional $3 million. Qualified spousal property does not include any terminable interest.[62] The estate tax marital deduction under Section 2056(a) is allowed for a transfer to a non-U.S.-citizen surviving spouse only if it is in the form of a QDOT described in Section 2056A, but qualified spousal property need not be transferred to a QDOT even if the surviving spouse is not a U.S. citizen. Therefore, a QDOT is not required with respect to a decedent dying in 2010 when leaving property to a surviving spouse who is not a U.S. citizen. This too represents an additional challenge in drafting a will (or a revocable trust used as a will substitute) for a married person whose spouse is not a U.S. citizen.

Property to which the basis increases apply. The basis increase rules apply only to property owned by and acquired from the decedent ("basis adjustment property"), which includes property in a revocable trust with respect to which the election to treat it as part of the decedent's probate estate for post-death income tax purposes under Section 645 could be made (a "qualified revocable trust").[63] One-half of property owned jointly with rights of survivorship between the decedent and his or her spouse is treated as basis adjustment property.[64]

Only that portion of property jointly owned by the decedent and someone other than his or her surviving spouse that would have been included in the decedent's gross estate under the estate tax rules is treated as basis adjustment property. Thus, for property owned jointly with a right of survivorship between the decedent and someone other than his or her spouse, and in which the decedent furnished consideration for the acquisition of the property, the decedent will be treated as the owner to the extent of the part of the property that is proportionate to such consideration; that portion of the property will be basis adjustment property.[65]

Furthermore, property owned jointly with a right of survivorship between the decedent and someone other than his or her spouse in which the property has been acquired by gift, bequest, devise, or inheritance by the decedent and such other person and in which their interests are not otherwise specified or fixed by law, the decedent will be treated as the owner to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants with right of survivorship; that portion will be basis adjustment property.[66]

The surviving spouse's half of community property owned together with the decedent, as well as the

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59 See Berall, Harrison, Blattmachr, and Detzel, "Planning for Carryover Basis That Can Be/Should Be/Must Be Done Now," 29 Estate Planning 99 (March 2002)—in all likelihood, the most comprehensive discussion of the carryover basis rules applicable in 2010. This article should be studied by every professional who intends to be involved in the administration of estates of individuals who die this year.

60 It has been suggested that if the property is sold after Section 1014(a) becomes effective again, it may be that basis is restored. See Berall et al., *supra* note 59, pages 99-100.

61 Section 1022(b)(3) uses the phrase "nonresident not a citizen," which appears to have been taken from Section 2101. For estate tax purposes, "resident" means an individual who has his or her "domicile" in the U.S. (a subjective intent test); see Reg. 20.0-1(b). That phrase should be distinguished from "nonresident alien" defined in Section 7701 (b), used for income tax purposes, which relates to physical presence in the U.S.

62 See Section 1022(c)(4)(B). The rules for not applying the basis adjustment for qualified spousal property seem to be nearly identical to those for not allowing the estate tax marital deduction under Section 2056(b).

63 A QTIP trust that had been created by the decedent's spouse and which would have been included in the gross estate of the decedent under Section 2044 if the decedent had died when the federal estate tax was in effect will not be basis adjustment property because it will not be "owned by the decedent."

64 Section 1022(d)(1)(B)(i)(I).

65 Section 1022(d)(1)(B)(i)(II).

66 Section 1022(d)(1)(B)(i)(III).

decedent's half of such property, is treated as basis adjustment property.[67] Property over which the decedent held any power of appointment, however, is not basis adjustment property.[68] The statute does not distinguish between a general or a limited power of appointment for this purpose.[69]

A plan that forces all property into a QTIP trust if the federal estate tax does not apply (at least in states with a state-only QTIP) might be safest for several reasons.

An individual who holds a power to withdraw appreciated property from a trust (that is, to appoint such property to himself or herself) should consider exercising the power in favor of himself or herself, if the individual is very likely to die in 2010. This would be appropriate, of course, only to the extent that the property will not pass to charity at the individual's death, and that the individual's executor could allocate some of the individual's $1.3 million aggregate basis increase or, if the individual is married and the property would pass to his or her spouse or a QTIP trust, some of the individual's $3 million spousal basis adjustment, to these assets.

An individual who holds a testamentary power of appointment over property that may be appointed to his or her estate might choose to exercise it pursuant to a word formula that would appoint only the amount to which available basis adjustment could be allocated. Such a formula would be particularly complicated, for three reasons:

1. It may be uncertain how much inherent gain will be present in the assets when the individual dies, as the assets may increase or decrease in value between the date on which the exercising instrument is executed and the date of death.

2. The individual (and his or her advisors) must determine whether to minimize the amount over which the power should be exercised or maximize the potential tax savings, as discussed in greater detail below.

3. It is not certain that property appointed at death to the individual's estate will be treated as "owned by the decedent" and "passing from the decedent," which are general prerequisites for the basis adjustments under Section 1022 to apply.

There are other potential problems that can arise when exercising a power of appointment over appreciated property. Assets so appointed, to the extent that the power of appointment is exercised in favor of the individual's estate, or if held by the decedent's estate to the extent withdrawn prior to death, will become subject to the claims of the decedent's creditors and may be taken into account in determining the assets on which the executor's commissions (or attorneys' fees) are based. Moreover, property subject to a general power of appointment created before 10/22/42 is included in the powerholder's gross estate for federal estate tax purposes only to the extent it is exercised; it is not included merely because it lapses.[70]

It may, therefore, be best to provide that a general power is exercised only if no federal estate tax (including no retroactive reenactment of the tax) would be imposed on account of the exercise, and if no state estate tax based on the federal gross or taxable estate is thereby increased. The IRS might argue that providing for an exercise of a power of appointment to be effective only if there is no retroactive reenactment of the federal estate tax somehow violates public policy and should be ignored so the power should be treated as exercised, which would result in the inclusion of the property subject to the power (to the extent of the deemed exercise) in the powerholder's gross estate.[71] Such an argument, however, should be rejected, because the condition has been made necessary by an unusual state of the law, and is required to address the inequities inherent in retroactive tax law.

A trustee also might consider distributing appreciated property to a distributee who is expected to die in 2010, if that distributee lacks sufficient appreciated property to take full advantage of both the $1.3 million aggregate basis adjustment and, if applicable, the $3 million spousal basis adjustment. Such a distribution, however, is somewhat of a risk, because Congress could retroactively reinstate the estate tax and cause the distributee's estate to become liable for a higher estate tax than otherwise. Thus, consideration also might be given to the size of the distributee's estate, so that the ideal distributee would have both unused aggregate basis adjustment and unused estate tax exemption, or would plan to leave property to a surviving spouse (or a QTIP for such a spouse) and have both unused spousal basis adjustment and have a spouse with unused estate tax exemption.

A gift of appreciated property to a donee (other than a spouse) who is expected to die in 2010 will not be effective; property acquired by the decedent by gift for less than adequate and full consideration within the three-year period ending with the date of death is not basis adjustment property.[72] An exception to this three-year rule is made for property acquired by the decedent as a gift from his or her spouse, and such property still is not basis adjustment property if the donor spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration.[73] Thus, a client should

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67 Section 1022(d)(1)(B)(iv). This rule is similar to the concept used in Section 1014(b)(6), which provides for the bases of both spouses' halves of community property to be stepped up when the first spouse dies, in most instances.

68 Section 1022(d)(1)(B)(iii).

69 *Id.*

70 Section 2041(a).

71 See, by analogy, Procter, *supra* note 32, in which the court held that a clause that returned property to a transferor if it was determined to be a taxable gift was not effective because it interfered with the proper administration of the tax law.

72 Section 1022(d)(1)(C)(i).

73 Section 1022(d)(1)(C)(ii).

consider giving property to his or her spouse, if the donee is significantly more likely to die this year than the donor, to the extent that the donee spouse does not already hold assets with sufficient appreciation to take advantage of both the $1.3 million aggregate basis adjustment and the $3 million spousal basis adjustment.

Property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent, property transferred by the decedent during life to a qualified revocable trust or any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust, and any property passing from the decedent by reason of death to the extent that such property passed without consideration, is basis adjustment property unless otherwise expressly excluded.[74] Expressly excluded are stock or securities of a foreign personal holding company, stock of a DISC or former DISC, stock of a passive foreign investment company unless such company is a qualified electing fund (as defined in Section 1295) with respect to the decedent, and the right to income in respect of a decedent.[75]

Other rules. Gain will be recognized in satisfying a pecuniary bequest (a fixed sum of money) with carryover basis property, but only to the extent the property on the date of such satisfaction exceeds the asset's value on the decedent's date of death.[76] The recipient's basis is the asset's carryover basis determined under Section 1022, increased by any gain recognized by such distribution.[77]

One who acquires the decedent's principal residence as carryover basis property also can use the decedent's unused $250,000 gain exclusion under Section 121. The inheritor's use of the property as his or her principal residence may be combined with that of the decedent for purposes of satisfying the two-of-five-year occupancy test for the exclusion under that section to apply.[78]

Negative basis property. Many individuals own commercial real estate or other property with liabilities in excess of the property's adjusted income tax basis. Gain is recognized on any lifetime transfer of such "negative basis property," at least to the extent such liability exceeds the basis, even if transferred without consideration.[79]

No such gain is recognized, however, by a transfer occurring at death. That rule is respected under the carryover basis rules, unless the property is transferred at death to a "tax-exempt beneficiary." Section 1022(g)(2) defines a tax-exempt beneficiary as "(A) the United States, any State or political subdivision thereof, any possession of the United States, any Indian tribal government (within the meaning of section 7871), or any agency or instrumentality of any of the foregoing, (B) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter 1, (C) any foreign person or entity (within the meaning of section 168(h)(2)), and (D) to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance."

It is not entirely clear what entities are included as tax exempt under this rule. A charitable remainder trust is exempt from tax under Section 664(c), but it may not clearly fall within the definition of a "tax-exempt beneficiary" under Section 1022(g)(2). Moreover, a charitable remainder trust funded from an estate that was not subject to estate tax appears not to satisfy the definition of a charitable remainder trust that would be tax exempt. Regulations provide that a trust is not exempt unless a tax deduction was allowed for transfers to the trust, and no estate tax deduction would apply when the trust was funded from a decedent's estate if the estate tax was not then in effect.[80]

A potential way to defeat the carryover basis rule with respect to negative basis property is to borrow heavily against a highly appreciated asset and bequeath the asset (which would then have a negative basis) to an individual or non-exempt entity for whom the decedent wishes to create a tax problem. There would presumably be no gain when the individual dies and the negative basis property would be inherited by the named individual or non-exempt entity.[81] This is why Treasury has regulatory authority to impose gain on the estate—see "D" above—but of course there are no Regulations at this time. The cash so borrowed would be bequeathed to the chosen objects of the borrower's bounty and the income tax basis of the cash, of course, would equal its face amount.

As the country's prior experience with a carryover basis regime demonstrated, it is a complicated tax system. Returns and reports are still required for such property.

An inheritor should be able to disclaim a negative basis asset, but it is uncertain if that would prevent the disclaimant from being treated as transferring the negative basis asset and recognizing the inherent gain. The disclaimer rules of Section 2518 generally apply for gift, estate and GST tax purposes, but not for income tax purposes.[82] Moreover, the disclaimer under Section 2518 must usually be made within nine months

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74 Section 1022(e).

75 Sections 1022(d)(1)(D) and 1022(f).

76 Sections 1040(a) and (b).

77 Section 1040(c).

78 Section 121(d)(11).

79 See, generally, Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 JTAX 149 (September 2002).

80 Reg. 1.664-1(a)(1)(iii)(a).

81 The purpose of leaving a negative basis asset to one's enemy, for example, would not seem to be for a tax-avoidance purpose but rather to cause distress to an individual by having the tax imposed on him or her.

82 See GCM 39858, 9/23/91 (applying Section 2518 disclaimer rules to income tax treatment with respect to a disclaimer of retirement plan benefits). See also Rev. Rul. 66-167, 1966-1 CB 20.

of the decedent's death, and the inheritor may not even be aware of the bequest of the negative basis property until after that time.[83]

More generally, Treasury also is given authority to issue Regulations "as may be necessary to carry out the purposes of" the carryover basis rules.[84] As noted above, no such Regulations have been issued.

In any event, practitioners probably need to reconsider the estate plan of any individual who holds significant negative basis property.

Certain transfers to foreign trusts. Section 684 treats a transfer to a foreign trust or estate as a sale or exchange. Before 2010, Section 684 applied only to transfers to a foreign trust or estate, but for 2010 it also applies to a transfer to a nonresident alien individual.[85]

This deemed sale or exchange treatment does not apply to a transfer to a foreign trust that is a grantor trust, to the extent that the trust is deemed owned by a U.S. person.[86] Grantor trust status ceases on the death of the grantor, which causes the transferor to then be treated as having sold or exchanged the transferred assets to the trust.[87] The general rule of gain recognition does not apply by reason of the death of the U.S. transferor, if the basis of the property in the hands of the foreign trust is adjusted to the date-of-death value under Section 1014(a).[88]

To the extent the assets are included in the grantor's gross estate for federal estate tax purposes, therefore, no deemed sale or exchange would occur under this rule, but if basis is not so determined (e.g., for life insurance proceeds, stock in a DISC defined in Section 992(a), and the right to income in respect of a decedent primarily dealt with under Section 691), there would be no exception when the transferor dies and the trust loses its grantor trust status.

If the transferor to a foreign grantor trust owned by a U.S. person dies in 2010, of course, no trust assets can take a basis under Section 1014(a), and therefore a sale or exchange would be deemed to occur on the grantor's death. This suggests that some consideration be given to converting a foreign grantor trust into a domestic trust, at least until the end of 2010, which can often be accomplished by removing foreign trustees.[89] Moreover, it is not at all certain that the increases in basis permitted under the carryover basis rules will apply to the assets in such a foreign trust.[90]

Carryover basis reporting requirements. The executor, if a decedent dies in 2010 with carryover basis property (other than cash) in excess of the $1.3 million aggregate basis adjustment under Section 1022(b), must file a return with the IRS to facilitate enforcement of these rules.[91] No such return form has yet been published.

It seems likely that the $1.3 million threshold of Section 1022(b) is used to establish the filing obligation under Section 6018 because, regardless of what the carryover basis of the property is, it will be increased to at least $1.3 million (or the FMV of the property on the date of death, if lower), under Section 1022(b). The executor, apparently, need not make an affirmative allocation if the FMV at death for carryover basis property does not exceed $1.3 million, and no return would be required.

The executor also must report any property acquired by the decedent within three years of death that is not treated as carryover basis property (e.g., was not acquired by his or her surviving spouse), and which was not reported on a Form 709 gift and GST tax return.[92]

The form is to be filed with the decedent's income tax return for the year of death.[93] If a person dies at or near the end of a calendar year, this does not provide much time to collect the required information.

The duty to file a decedent's U.S. estate tax return, including reporting and paying estate tax on all property included in the decedent's gross estate, falls on the decedent's executor even with respect to assets not under the fiduciary's control.[94] Section 6018(b)(4), however, now provides that an executor who is unable to make a complete carryover basis return still must file a return that includes a description of such property and the name of every person holding a legal or beneficial interest therein. On notice from the IRS, each such person must submit a return to the Service. The executor logically can report only property of which the executor has knowledge, as was required of an executor filing an estate tax return under Section 6018 before 2010.

Section 6018(c) specifies the information that must be included in the return, including:

1. The name and TIN of the recipient of such property.
2. An accurate description of such property.
3. The adjusted basis of such property in the hands of the decedent and its FMV at the time of death.
4. The decedent's holding period for such property.
5. Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income.
6. The amount of aggregate or spousal basis increase allocated to the property.
7. Such other information as may be required by Regulations.

Instructions for the form will likely enumerate all of the information required to be included.

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83 For other ways in which the carryover basis rules might be defeated, see Sheppard, "News Analysis—Debt in Contemplation of Death," 2001 TNT 136-6 (7/16/01).

84 Section 1022(h).

85 Section 684(a).

86 Section 684(b)(1).

87 Reg. 1.684-2(e).

88 Reg. 1.684-3(c).

89 See Section 7701(a)(30)(E).

90 See Berall et al., *supra* note 59, page 100.

91 Section 6018(a). If the decedent is a nonresident alien, Section 6018(b)(3) makes the filing requirements applicable if the value of tangible property in the U.S. and any other property acquired from the decedent by a U.S. person exceeds $60,000.

92 Section 6018(b)(2).

93 Section 6075.

94 See Section 6018 as in effect before 2010, and Section 2002.

The executor also is required to furnish to each person whose name is required to be set forth on the carryover basis return (other than the executor) a written statement showing both:

- The name, address, and phone number of the person required to make such return.
- The information provided to the IRS with respect to property acquired from, or passing from, the decedent to the person required to receive such statement.[95]

The impact of the carryover basis regime will be felt for quite some time and well beyond 2010, as property is sold, exchanged, depreciated, or otherwise dealt with.

A $10,000 penalty is imposed on an executor who fails to file the carryover basis return on time.[96] This return is due when the decedent's final income tax return is due to be filed, including extensions.[97] Additional penalties are imposed for an intentional failure to supply the required information and for failure to supply the information to those who have acquired the property that is required to be disclosed on the return.[98]

How to acquire basis information. The following sources of information may prove useful:

- The decedent's own personal records.
- The decedent's U.S., state, or local income tax returns (which may be obtainable from his or her return preparer, or from the IRS or other taxing authority).
- The decedent's family members, friends, and business associates.
- The decedent's brokerage account statements.
- The decedent's investment advisors.
- Death tax returns of family members who have predeceased the decedent and from whom the decedent may have acquired property.
- Personal property tax returns.
- Trust accounts.
- Those who have acted as a guardian or conservator for the decedent and their (or court) records.
- Insurance companies.
- Deeds and other public records.
- The decedent's professionals (such as his or her accountant or business lawyer).
- Government records.

The best source of information, of course, is likely to be the individual. Asking clients to put records together "just in case" is more than merely appropriate. Clients who live past 2010 will not be disadvantaged from having assembled this information.[99]

Planning—overview. Clearly, trying to have property owners make records of their bases in assets is extremely important. This likely will be especially important for individuals owning collections, such as works of art.[100]

A review of the client's assets and testamentary instruments should be undertaken to determine the consequences of bequests (including formula bequests) that will be made at death if there is no step-up in basis permitted. This may be somewhat similar to considerations for a person whose estate will include significant rights to income in respect of a decedent.

As indicated at the beginning of this article, some consideration must be given to ensuring that the $3 million basis increase for qualified spousal property will be available to its maximum extent, assuming it is otherwise compatible with the client's goals.

GST transfers at death. Under Section 2654(b), the basis of property transferred in a taxable termination at death is to be adjusted in a manner similar to the manner provided under Section 1014(a). Section 2654(b) does not apply in 2010 with respect to generation-skipping transfers that occur in 2010.[101]

The lack of a GST tax in 2010 suggests that trusts that are not exempt from GST tax should be restructured so that a taxable termination or distribution occurs in 2010, rather than thereafter, as long as the trustee and beneficiaries are willing to assume the risk of the retroactive reenactment of the GST tax.

NEW LIMITED GIFT TAX RULE

New Section 2511(c), effective 1/1/10, states that "[n]otwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part 1 of subchapter 1 of chapter 1."

The legislative history makes it clear that the purpose of the subsection is to provide that a transfer to a trust will be treated as a completed gift, regardless of the dominion and control that the donor retains, to the extent property is transferred to a trust that is not a grantor trust in its entirety.[102] This should be of little concern as it is virtually impossible to make a transfer to a U.S. (domestic) trust that is not a grantor trust and prevent the gift from being complete.

The powers that the grantor would have to retain to prevent the transfer from being complete for federal gift tax purposes are set forth

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95 Section 6018(e).

96 Section 6716. Section 6019, which imposes the duty to file Form 709, is changed for 2010 as well. The donor must not only file the return but supply certain information about the gifts to the donees. Penalties under Section 6716 now apply to such gift tax reporting information.

97 Sections 6075(a) and 6075(b)(3).

98 Sections 6716(b) and 6716(d).

99 For extensive advice about how to attempt to acquire information about the decedent's basis in assets, see McGrath and Blattmachr, *supra* note 58.

100 *Id.*

101 Section 2664.

102 See the Blue Book, *supra* note 4, pages 249-250.

in Reg. 25.2511-2. Virtually all of the powers that render the gift incomplete would cause the trust to be a grantor trust. The IRS has, however, issued several private letter rulings holding that the transfer to a specifically designed trust was incomplete but the trust is not a grantor trust.[103] A transfer to such a trust would, therefore, be a completed gift under Section 2511(c).

An IRS argument that conditioning exercise of a power on no retroactive reenactment of the estate tax somehow violates public policy should be rejected.

There have been discussions among practitioners, based on suspicions and concerns, rather than legislative history or Treasury declarations, that Section 2511(c) means that any transfer to a trust that is a wholly grantor trust is not subject to gift tax because transfers to it would be treated as incomplete by reason of Section 2511(c). That is not what Section 2511(c) provides, and is completely inconsistent with the legislative history. Some practitioners incorrectly contend that, because Section 2511(c) states that any gift to a trust other than a wholly grantor trust is a completed gift, then any gift to a wholly grantor trust must not be a completed gift. This appears to be an incorrect reading of the section. It is preposterous to think that the Congress wanted to repeal the gift tax on all transfers to grantor trusts (even where the trust would not be included in the grantor's gross estate should the grantor die after 2010).

Asserting that a transfer to a grantor trust is not a completed gift could have consequences more adverse to the taxpayer than treating the initial transfer as a completed gift. The IRS could contend with some confidence, for example, that because the gift to the trust was incomplete, it must be included in the grantor's gross estate when he or she dies,[104] or that it becomes a completed gift when transfers from the trust are made to others during the grantor's lifetime.

Practitioners are cautioned not to take action on the premise that Section 2511(c) prevents any lifetime transfer to a wholly grantor trust from being a completed gift.

GST TAX MATTERS FOR 2010

Although EGTRRA is described as repealing the GST tax for 2010, the method by which that has occurred may produce a result far different than if Chapter 13 (comprising all the GST tax provisions) had in fact been repealed. The provision of the law that effects the GST tax "repeal" is Section 2664, which states: "This chapter shall not apply to generation-skipping transfers after December 31, 2009." That is, no GST tax is imposed on any generation-skipping transfer that occurs in 2010. To interpret Section 2664, however, at least the provisions defining a "generation-skipping transfer" must remain in effect. And other provisions may remain in effect as well, which will have implications for the application of the GST tax in 2011, including to GST transfers made in 2010.

The meaning of Section 2664. Absent Section 2664, Section 2601 imposes a tax "on every generation-skipping transfer." Section 2611(a) states that "the term 'generation-skipping transfer' means—(1) a taxable distribution, (2) a taxable termination, and (3) a direct skip." Those terms are defined in Section 2612 and generally turn on whether a transfer is being made to or for a "skip person" as defined in Section 2613.

Section 2664 results in no tax being imposed in 2010 on a generation-skipping transfer that occurs in 2010. But Section 2664 is broader—it says Chapter 13 does not apply to any generation-skipping transfer that occurs in 2010. Accordingly, it seems, although it is not certain, that in addition to the tax being inapplicable, none of the collateral provisions in Chapter 13 (other than apparently Section 2664 itself) apply to a generation-skipping transfer that occurs in 2010.

Consequently, any rule in Chapter 13 that is directed to or involved with a generation-skipping transfer also does not apply in 2010. If that is correct, then some of the provisions that avoid double GST tax may not apply, as described more fully below, reducing the potential to avoid GST tax over the long term by making generation-skipping transfers in 2010 (except perhaps some outright GSTs), although there still may be opportunities for planning this year.

GST-tax-free taxable distributions and terminations. Unless the federal government retroactively reinstates the GST tax, any taxable distribution, taxable termination, or direct skip made in 2010 is not subject to GST tax. As a result, it may be appropriate to consider making such a transfer this year.

For example, the trustee of a trust that is not exempt from the tax by reason of "grandparenting" or prior allocation of GST exemption (a "GST non-exempt trust") might make a taxable distribution or tax-

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103 See, e.g., Ltr. Ruls. 200502014, 200612002, 200637025, 200647001, 200715005, 200729005, and 200731009. See also IR-2007-123, 7/9/07, stating that the Service was considering withdrawing these rulings because of inconsistency with Rev. Rul. 76-503, 1976-2 CB 275, and Rev. Rul. 77-158, 1977-1 CB 285. In Rev. Rul. 76-503, a trust was created by three siblings, each of whom named an adult child as one of the three trustees who, acting unanimously, had complete discretionary power over the assets of the trust, and who individually had the right to name a relative as successor. A trustee would be replaced on death or resignation by a successor trustee. The Service stated that the surviving trustees were in no better position to exercise the power after a decedent-trustee's death than before the death, and that the interests of the co-trustees were not adverse to exercise of the power in favor of the decedent-trustee. The IRS stated that one third of the trust fund was includable in a decedent-trustee's estate as property subject to a general power of appointment under Section 2041.

104 Such a contention would, however, be inconsistent with Estate of DiMarco, *supra* note 18.

able termination this year without any GST tax being imposed. Thus, the trustee could make a distribution to the transferor's grandchild from a GST non-exempt trust without GST tax this year. The problem is the specter of retroactive reinstatement of the tax.

What about distributions to skip-person trusts? Similarly, the trustee, if authorized under local law or the terms of the governing instrument, might make a distribution to another trust, transfers to which constitute a taxable distribution from or taxable termination of the original trust.

For instance, the trustee of a GST non-exempt trust created for a child that permits distributions to more remote descendants might make a distribution in 2010 to a trust exclusively for grandchildren. Such a trust would be treated as a skip-person trust under Section 2613. Unless the tax is retroactively reinstated, that distribution would seem not to be subject to GST tax.

What about future GSTs from the same trust? Prior to 2010, under Section 2653(a), someone in the generation of the grantor's children would be treated as the transferor of the trust for GST tax purposes under the "change-transferor rule." That rule provides that subsequent distributions to grandchildren would not be subject to GST tax because the transferor to the trust is deemed to have moved down to the generation immediately above the highest generation of any person who has an interest in the trust.

Section 2653(a) applies, however, only "if ... there is a generation-skipping transfer of any property." Certainly, the distribution from the non-GST-exempt trust to the trust for grandchildren is a generation-skipping transfer (a taxable distribution if less than all of the trust property is distributed, or a taxable termination if it all is distributed). The question is then whether Section 2664 forecloses the application of Section 2653(a), which provides the beneficial rule of moving the generation of the transferor down one or more generations, because Section 2653(a) applies only when there is a generation-skipping transfer and Section 2664, by its terms, forecloses the application of any part of the GST tax chapter (presumably including Section 2653(a)) to any generation-skipping transfer.

Arguably, it does foreclose the application of Section 2653(a), at least during 2010. Conversely, one might maintain that the rule of Section 2664 was meant only to capture taxable events and nothing else, or, alternatively, that in 2011 Section 2653(a) applies as if Section 2664 had never been enacted.

What difference does it make? Suppose a grandmother creates a trust in 2010 for her ten-year-old grandson, to be paid to him when he reaches age 25. The transfer of property by her to that trust is, of course, a direct skip defined in Section 2613, and therefore a generation-skipping transfer under Section 2612. Because Chapter 13 does not apply to any generation-skipping transfer in 2010, there is no GST tax imposed. And distributions from the trust to the grandson in 2010 also would not be subject to GST tax even if the rule of Section 2653(a) does not apply, because they would then be taxable distributions, another type of generation-skipping transfer with respect to which, in 2010, no tax is imposed.

But unless the change-transferor rule applies in the future, the distribution from the trust to the grandson at 25, when under current law the GST tax will have been restored, would be a taxable termination and subject to GST tax. Such a construction would make taxpayers who make GSTs in trust in 2010 worse off than they were in 2009, except for the one year without GST tax. This then raises the question of the meaning of the EGTRRA section 901(b) sunset provision, which states that the Code is to be applied after 2010 as if the provisions of EGTRRA "had never been enacted." That language can possibly be construed to mean that the change-transferor rule applies in 2011 and going forward, because it certainly would have applied to a direct skip in trust if EGTRRA had never been enacted.

So, in addition to the risk of a retroactive reinstatement of the GST tax, there is a risk if a taxable distribution or taxable termination is made in a later year. If, however, one believes that Section 2653(a) would apply in 2011 and thereafter, then it would be preferable to make the distribution to a trust for the most remote generation of living descendants, such as great-grandchildren. In fact, if the only beneficiaries of the trust to which the distribution may be made are great-grandchildren for at least some period, then potentially children and grandchildren could later become trust beneficiaries without changing the fact that someone in the grandchildren's generation is treated as the transferor.

The executor, apparently, need not make an affirmative allocation or file a return if the FMV at death for carryover basis property does not exceed $1.3 million.

The reason that appears to occur is the definition of skip person under Section 2613, which includes a trust if all interests in the trust are held by skip persons, and under Section 2652(c) an interest in a trust generally requires a present interest, even though discretionary. By definition, only great-grandchildren would have an "interest" in the trust at the time of creation, causing the "transferor" of the trust to move down to the level of a grandchild. Subsequent reintroduction of higher-generation beneficiaries would not seem to change that result, with the consequence that distributions to great-grandchildren and any more senior skip generation would never become subject to GST tax.

It seems the "risk" with respect to the retroactive reintroduction of GST tax is no greater if the distribution is made to a trust for great-

grandchildren rather than grandchildren. In either event, only one GST tax would be imposed if the pre-2010 GST tax system were retroactively adopted.

GST-tax-free gifts to skip persons. Another possibility is for an individual to make gifts in 2010 to descendants more remote than children. Under Section 2664, these direct skips are not subject to GST tax although they would be subject to gift tax. These transfers may perhaps suffer less from the prospect of potential retroactive reinstatement of the tax. But that risk is likely too much for most clients to accept—especially because if transfer taxes were retroactively applied, the total tax could exceed 110% of the transfer, i.e., a 45% GST tax and a 45% gift tax on both the gift and the GST tax under Section 2515.

Lifetime "reverse" QTIP trusts. A "relatively safe" step for an individual who is married may be to create a lifetime QTIP trust in 2010 for his or her spouse who is a U.S. citizen. By making the election under Section 2523(f), transfers to the trust will qualify for the gift tax marital deduction and not be subject to gift tax. Of course, such a trust, if the beneficiary spouse dies when the estate tax is back in effect, will be included in his or her gross estate for federal estate tax purposes under Section 2044. Because the trust would be included in his or her estate, the beneficiary spouse would be treated as the transferor of the trust property for GST tax purposes, which could result in a GST tax if the GST tax is back in effect when the beneficiary spouse dies.[105]

But the beneficiary spouse will not be treated as the transferor for GST tax purposes if the grantor spouse makes the reverse QTIP election for GST tax purposes pursuant to Section 2652(a)(3).[106] It seems that such a reverse election may be made in 2010 because, as mentioned above, Chapter 13 is not repealed for 2010—it is just made inapplicable to any generation-skipping transfer this year, and neither the transfer to the QTIP trust nor the making of the reverse QTIP election constitutes or involves a generation-skipping transfer as defined in Section 2612.

Practitioners are cautioned not to take action on the premise that Section 2511(c) prevents any lifetime transfer to a wholly grantor trust from being a completed gift.

If it develops that the reverse QTIP election may not be made or that, even if made, the QTIP trust is not exempt from the GST tax, there seems to be little downside as long as the spouse creating the lifetime QTIP trust is "comfortable" in creating such a trust for his or her spouse. And if the election is permitted and Chapter 13 is restored, it seems the grantor spouse would be able to make a late allocation of GST exemption, which may restore some of the GST benefits.[107]

Is there any GST exemption this year? It is not clear whether a trust created in 2010, such as a QTIP trust even if the transferor makes the reverse QTIP election, would be exempt from GST tax. Although the ability to create a lifetime QTIP trust for one's spouse and make the reverse QTIP election has been available since 1986 when the current Chapter 13 became effective, it avoided GST tax only if the grantor spouse also allocated GST exemption to the trust. And, it seems that in 2010 the grantor spouse has no GST exemption to allocate because Section 2631(a) cross-references Section 2010(c) and there is no amount for the year 2010 in Section 2010(c).

This, in turn, raises the question of whether an individual could create a generation-skipping trust this year for his or her family and make it exempt from GST tax. For example, an individual might create a long-term trust for his or her spouse and/or for more remote descendants. Such a trust might be subject to gift tax but arguably would be exempt from GST tax. Prior to 2010, an individual could create such a GST-tax-exempt trust by allocating sufficient GST exemption to it (up to $3.5 million in 2009).[108] No one would appear to have any GST exemption in 2010, however. Under Section 2631(c), the GST exemption amount for any year is equal to the applicable exclusion amount for estate tax purposes under Section 2010(c). And there is no applicable exclusion amount for the year 2010 under Section 2010(c), so it seems the GST exemption for 2010 has fallen to zero. It seems unfair to prevent individuals from creating GST-tax-exempt trusts in 2010 when they could be created in prior years and presumably in 2011 and thereafter.

Substantial uncertainty. Unfortunately, and especially taking into account that the GST tax might be reinstated retroactive to the beginning of 2010, it appears that there is significant uncertainty as to whether or how the GST tax rules will apply, especially for years after 2010. It may be "safer" to wait until Congress adjourns in 2010 and see what (if anything) has been done. If Congress has not reinstated the GST tax, action might be taken—such as making taxable distributions or taxable terminations—with the expectation that a new Congress would not likely enact a law after 2010 that would reinstate the tax for transfers in 2010. That possibly still could happen, however. In addition, it may be that Congress will reintroduce the tax in 2010 retroactive to the date a bill to do so was introduced, rather than to January 1. If clients delay taking action while waiting to see what Congress would do, the opportunity to make tax-free transfers might disappear.

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105 See Section 2652.

106 See generally Blattmachr, "Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation," The Chase Review (Spring 1996).

107 See Reg. 26.2632-1(b)(4)(ii)(A).

108 See Sections 2631 and 2642.

Conditional or formula distributions? Perhaps a trustee making a taxable distribution or taxable termination could make it "conditional" so it would be "recalled" if it would be subject to tax by a retroactive reenactment of the GST tax. The IRS, however, might contend that the effect of the condition (e.g., having the distributed property returned to the trust if the distribution would be subject to GST tax) should be ignored as a condition subsequent under the doctrine of *Procter*, 142 F.2d 824, 32 AFTR 750 (CA-4, 1944), *cert. den.*, thereby rendering the condition void as against public policy. Although the Tax Court in *Estate of Petter*, TCM 2009-280, seems to have limited the application of *Procter*, it is uncertain whether *Procter* would apply with respect to a retroactive reenactment of the GST tax. Nevertheless, in the circumstance where formulas are necessitated by the uncertain state of the tax law, the use of a formula would not appear to constitute "trifling with the judicial process" as proscribed by *Procter*.

Alternatively, the trustee or an individual could make a "formula" distribution or gift such as the following:

> The trustee/I hereby distribute from this trust/give to [the skip-person beneficiary] the lesser of (1) [amount desired to be distributed] or (2) that fractional share of the trust estate/my interest in XYZ the numerator of which is the largest amount that can be distributed/given to the beneficiary without the imposition of any federal generation-skipping transfer tax (including without the imposition of any federal generation-skipping transfer tax that is retroactively reinstated to apply to this distribution/gift), and the denominator of which is equal to the fair market value as finally determined for federal tax purposes of the trust estate/my interest in XYZ.

Nevertheless, it seems likely the IRS might contend nothing was distributed or, alternatively, the *Procter* doctrine has been violated.

Do ETIPs end? Under Section 2642 (f), known as the "estate tax inclusion period" (ETIP) rules, an allocation of GST exemption is "suspended" during any period that the value of the property transferred during lifetime would be included in the transferor's federal gross estate (other than by reason of Section 2035). Because the federal estate tax is not applicable to decedents dying in 2010, it is possible that the ETIP period for any lifetime transfer before 2010 has now closed and any previous allocation of the exemption is effective.

It would seem, however, that no automatic allocation could take effect in 2010 because no GST exemption appears to be available in 2010. Therefore, since it is unlikely that an individual would have affirmatively allocated GST exemption to a trust with an ETIP, perhaps the close of the ETIP period in 2010 has no practical consequence. Nevertheless, that result is uncertain, as many matters with respect to the GST tax currently are.

What about transfers to Section 2642(c) trusts? Under the law before 2010, Section 2642(c) permitted certain transfers of property that qualified for the gift tax annual exclusion under Section 2503(b) to satisfy the definition of a nontaxable gift, with the result that the transfer has a zero inclusion ratio for GST tax purposes. If certain additional requirements were met, transfers in trust could qualify for this special treatment.

The problem now is that to qualify, the transfer must be a direct skip, which is a type of generation-skipping transfer. It would appear that because Section 2642(c) applies to a generation-skipping transfer, and Section 2664 says that Chapter 13 does not apply to generation-skipping transfers after 2009, the zero-inclusion-ratio rule also does not apply. This could be problematic even for transfers to existing Section 2642(c) trusts, not because the transfer would be taxable (because in 2010 the GST tax does not apply) but because in 2011 and thereafter it is not clear that the change-transferor rule of Section 2653(a) would apply.

The consequence, if Section 2653 (a) does not apply, is that distributions to the skip-person beneficiary of the trust would be taxable. The transfer is in effect caught in the middle—no zero-inclusion-ratio rule, and possibly no change-transferor rule. This would appear to be an unduly harsh result, and perhaps future legislation or interpretation of Section 2664 and the sunset provisions will clarify the result. It is a trap for the unwary, as many clients may continue to make transfers to such trusts that were created in prior years. The safer route would be to make an outright annual exclusion gift to the grandchild if that were appropriate under the facts.

What happens in 2011? Several provisions in Chapter 13 were added by EGTRRA. As things now stand, in 2011 the provisions under Section 2631(c) dealing with increasing amounts of GST exemption, Section 2632(c) dealing with deemed alloca-

Practice Notes

The first step for practitioners who do not wish to continue to put faith exclusively in Congress's ability to solve the complex issues arising from the EGTRRA sunset provisions—which it has been unable to do for eight years—is to contact clients about the 2010 law changes. A generic memorandum or an individually addressed letter or memo to each client might be used.

A practitioner may wish to consider inviting clients to contact his or her firm to make an appointment to determine what, if any, steps should be taken. It seems appropriate to determine explicitly how clients whose documents contain word formulas actually wish to dispose of their property if they die when there is no federal estate tax and no GST tax, but there is carryover basis. For those living in state death tax states, other factors probably also should be discussed, including the possibility of changing domicile.

tions of GST exemption, Section 2631(d) dealing with retroactive allocations of GST exemption, Section 2642(a)(3) dealing with qualified severances, and Section 2642(g) providing relief from late allocations, will sunset as if never enacted. If no legislative fix is forthcoming, taxpayers will have to pay close attention to the need to make affirmative allocations of GST exemption in order to obtain the benefits of any restoration of the GST exemption in 2011.

If the sunset takes place and is interpreted to mean that benefits conferred while EGTRRA was in effect are ignored after 2010, then generation-skipping trusts created prior to 2010 would have different inclusion ratios in 2011 than in the years during which EGTRRA was in effect by virtue of the provisions of EGTRRA providing for (1) deemed allocations to GST trusts, (2) affirmative allocations of GST exemption in excess of $1 million indexed for inflation, (3) qualified severances, (4) relief under Section 2642(g), and (5) retroactive allocations under Section 2632(d).

Potential Planning Opportunities

Notwithstanding the uncertainties, the possibility that a transfer in trust in 2010 may avoid the application of GST tax for all time is enticing.

The best way to take advantage of that opportunity would appear to be through the use of formula transfers. For example, a donor might make a formula gift to an irrevocable trust that provides that the amount that will not be subject to GST tax, currently or at any time in the future, will pass to a dynasty trust for descendants and the balance will pass to the donor's spouse, a general power of appointment trust for the spouse (which will not require an election as a QTIP would), or charity. Of course, to the extent the transfer exceeds the donor's gift tax exemption, the transfer may attract gift tax, but perhaps only at a 35% rate.

Another alternative would be to establish a GRAT that provides a similar formula at the end of the GRAT term between a dynasty trust and a distribution outright to the donor's children. A "zeroed-out" charitable lead trust with a similar formula at the end of the lead term also might be considered. Of course, any transfer that does not involve a GST in 2010 is potentially less effective than one that does.

One also might consider a gift to an irrevocable trust that explicitly permits the trustees or certain adult beneficiaries to disclaim with the result that the gift property returns to the transferor.[109] Unfortunately, a qualified disclaimer under Section 2518 must be made within nine months of the gift, and we may not have clarification of the law by that time.

OTHER CHANGES AND RULES FOR 2010

The legislative history states that EGTRRA distinguishes between the imposition of the estate tax on a decedent dying after 2009 and the imposition of a special recapture tax after that date with respect to the estate of a decedent who dies before 2010. The Conference Report states that the disposition after 2009 of property for which the estate of a decedent who died before 2010 was allowed the tax benefits of special-use valuation (Section 2032A), the deduction for interests in qualified family-owned businesses (Section 2057), or deferral of estate taxes attributable to a business interest (Section 6166), still will result in the recapture of the previous estate tax benefits, to the extent provided under pre-EGTRRA law.[110] The repeal of the estate tax will not prevent the imposition of these recapture taxes.

> It seems the 'risk' of the retroactive return of GST tax is no greater if the distribution is made to a trust for great-grandchildren rather than grandchildren.

For example, assume that a decedent died on 1/2/07 and that an interest in real estate she owned and used as part of her farm was valued by her estate under the special-use valuation rules of Section 2032A. Under that section, if the property ceases to be used as a family farm or business within ten years after the decedent's death, an additional estate tax will be imposed, to recapture the estate taxes saved by the special-use valuation election. The decedent's family ceases to use the farm as a family farm in 2010, three years after the decedent's death. The recapture tax is imposed with respect to the decedent's estate, even though the cessation of the use of the property as a family farm or business occurred in 2010.

The estate tax also will continue to be imposed after 2009 in certain instances with respect to QDOTs created for the benefit of a noncitizen surviying spouse, where the spouse whose will or trust created the QDOT died before 2010.[111] The estate tax will be imposed with respect to an estate of a decedent dying after 2009 in the following two situations:

1. On any distribution after 2009 and before 2021, from a QDOT, be-

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109 See Rev. Rul. 90-110, 1990-2 CB 209 (holding a disclaimer by trustees ineffective only because it was ineffective under state law). See also Estate of Christiansen, 130 TC 1 (2008), *aff'd* 586 F.3d 1061, 104 AFTR2d 2009-7352 (CA-8, 2009) (holding a formula disclaimer by the beneficiary under a will to be effective to obtain a charitable deduction for property devised to charity as a result of express provisions in the will setting forth the disposition in the event of a disclaimer).

110 See H. Rep't No. 107-84, 107th Cong., 1st Sess., (2001), 147 Cong. Rec. H2773-H2774 (5/25/01).

111 Section 2210(b); EGTRRA section 501(a). On the rules for QDOTs, see generally Bittker and Lokken, *Federal Taxation of Income, Estates, & Gifts* (Thomson Reuters/WG&L, 2009), ¶ 129.2.5; Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* (Thomson Reuters/WG&L, 2009), ¶ 52.11; Peschel and Spurgeon, *Federal Taxation of Trusts, Grantors and Beneficiaries* (Thomson Reuters/WG&L, 2009), ¶ 7.10; Stephens, Maxfield, Lind, Calfee, and Smith, *Federal Estate and Gift Taxation,* Eighth Edition (Thomson Reuters/WG&L, 2009), ¶ 5.08A; Spielman, *U.S. International Estate Planning* (Thomson Reuters/WG&L, 2009), ¶ 10.04; Westfall and Mair, *Estate Planning Law and Taxation,* Fourth Edition (Thomson Reuters/WG&L, 2009), ¶ 16.01.

fore the date of the death of the noncitizen surviving spouse.

2. On the value of the property remaining in a QDOT on the date of death of the noncitizen surviving spouse if such surviving spouse dies before 2010.

ESTATE ADMINISTRATION FOR 2010 DECEDENTS

The regime of no estate or GST tax and carryover basis presents new challenges in administering the estates of those who die in 2010. It may involve construction of instruments and certainly will mean new challenges in finding information about the adjusted basis of the decedent's assets.

The threat that the estate tax might be retroactively reinstated also complicates the administration. For example, under the 2009 rules, the executor or trustee might have decided to sell assets soon after death to ensure adequate cash to pay estate tax, debts, and expenses—especially if the estate or trust held highly volatile assets. Now, an executor or trustee who needs or desires to liquidate some or all of the decedent's low-basis assets soon after the decedent's death, in order to effect a diversification of the estate or trust investments or to raise cash to pay expenses and state or foreign death taxes or to facilitate distribution, will need to consider the recognition of capital gains because of a low carryover basis. Some fiduciaries may decide to buy a collar to protect the value of significant blocks of stock, while they wait to see if the estate tax is going to be reinstated. Other assets, such as works of art and real estate, cannot be so easily protected.

In almost all estates, consideration of disclaimers may make good sense in 2010. For example, if the will or revocable trust is construed to mean the entire estate passes to the surviving spouse, it may be best for the spouse to disclaim all or a portion of the property, particularly if the disclaimed assets will pass to a credit-shelter trust of which he or she is a beneficiary. Such a disclaimer will not cause the credit-shelter trust to be included in the spouse's gross estate when the federal estate tax is back in effect. Such a disclaimer would likely also make good sense even if there is no federal estate tax in effect, as long as the spouse continues to receive enough assets to take full advantage of the spousal basis adjustment in the decedent's estate. Because Congress may retroactively reinstate the estate tax, however, the disclaimer should not be of so large an amount that it would cause the estate to be subject to tax.

Any transfer that does not involve a GST in 2010 is potentially less effective than one that does.

The need for and utility of any disclaimer by a spouse or by other beneficiaries will depend on the proper construction of the formula clauses in the decedent's will or trust. The fiduciary should bring a suit to construe the will or trust promptly after the decedent's death, if there is any question whatsoever regarding the meaning of the formula clause in light of the absence of the estate or GST tax. A local court's determination of the meaning of the instrument will not be binding on the IRS or the federal courts, as noted earlier, unless it is the highest court of the state, but such lower court holdings are given due regard. Thus, if the opinions of the trial court are consistent with (or at least not inconsistent with) applicable state law, they generally should be followed by the Service.[112]

A disclaimer also could be drafted to disclaim "the largest amount that would pass free of federal estate tax with respect to the decedent's estate (whether applicable on the date of death or enacted after the date of death and applying retroactively to the decedent's estate)." Such a disclaimer should be qualified, although it raises a problem for the fiduciary who needs to distribute the assets, because the application of any retroactive statute may be uncertain for several years while the issues are litigated.

RETROACTIVE REINSTATEMENT

The Democratic leadership in both the House and the Senate have expressed a desire to reinstate the estate and GST taxes early in 2010, and to do so retroactively, to eliminate a period of effective repeal. Retroactive reimposition of these taxes will face legal challenges based on claims of unconstitutionality, but ultimately retroactivity should be permitted.

The Supreme Court has repeatedly upheld retroactive changes in the tax laws, where such retroactivity is "confined to short and limited periods required by the practicalities of producing national legislation."[113] Generally, due process permits retroactive tax legislation if the retroactivity serves a "rational legislative purpose."[114]

In *Carlton*, 512 U.S. 26, 73 AFTR2d 94-2198 (1994), *rev'g* 972 F.2d 1051, 70 AFTR2d 92-6199 (CA-9, 1992), the Supreme Court rejected a due process challenge to a retroactive elimination of an unintended loophole. TRA '86, enacted 10/22/86, included an estate tax deduction for one-half the proceeds of "any sale of employer securities by the executor of an estate" to an ESOP. On 12/10/86,

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112 Some state legislatures are likely to pass laws stating how to construe a will or trust formula clause in 2010, and such laws almost always will be binding on the IRS and the federal courts. Not many states are likely to accomplish that this year, however.

113 Carlton, 512 U.S. 26, 73 AFTR2d 94-2198 (1994); see also Hemme, 476 U.S. 558, 58 AFTR2d 86-6320 (1986); Darusmont, 449 U.S. 292, 47 AFTR2d 81-519 (1981); Welch v. Henry, 305 U.S. 134, 21 AFTR 973 (1938); Hudson, 299 U.S. 498, 18 AFTR 628 (1937); Milliken, 283 U.S. 15, 9 AFTR 993 (1931); and Cooper, 280 U.S. 409, 8 AFTR 10270 (1930). See also similar opinions from lower courts in NationsBank of Texas, 84 AFTR2d 99-5001 (Fed. Cl. Ct., 1999); Kane, 942 F. Supp. 233, 78 AFTR2d 96-6400 (DC Pa., 1996), *aff'd* 118 F.3d 1576, 80 AFTR2d 97-5141 (CA-3, 1997); Quarty, 170 F.3d 961, 83 AFTR2d 99-1562 (CA-9, 1999). See also discussions in Stephens, Maxfield, Lind, Calfee and Smith, *supra* note 111, ¶ 2.01[3]; Westfall and Mair, *supra* note 111, ¶ 9.02.

114 Carlton, *supra* note 113.

Carlton, as executor, bought for the estate 1.5 million shares of MCI Communications for $11,206,000, and two days later sold the stock (at a loss of 42¢ per share) to the MCI ESOP, deducting $5,287,000 (one-half of the sales price) on the decedent's estate tax return.

On 12/22/87, Congress retroactively amended the Code to limit the deduction to securities that were "directly owned" by the decedent "immediately before death." The amendment applied retroactively, as if it were incorporated in the original TRA '86 provision.

Carlton challenged the amendment on the grounds that its retroactivity violated the Due Process Clause. The district court granted summary judgment for the IRS, but a divided Ninth Circuit reversed, holding that such application was rendered unduly harsh and oppressive, and therefore unconstitutional. The Ninth Circuit stressed Carlton's lack of notice that the rule would be retroactively amended and his reasonable and detrimental reliance on the pre-amendment law.

The Supreme Court reversed and upheld the statute, without dissent (although with two concurring opinions reflecting the views of three justices). The Court stated that a retroactive law is constitutionally valid if (a) the government shows that the statute has a rational legislative purpose and is not arbitrary and irrational, and (b) the period of retroactivity is "modest."

The Court held that the amendment's retroactive application was rationally related to the legitimate legislative purpose of closing an unintended loophole that would result in revenue losses, and that the period of retroactivity (14 months) was modest and consistent with the time requirements inherent in enacting national tax legislation.

Justice Scalia wrote a concurring opinion, in which Justice Thomas joined, agreeing that the statute should be sustained, notwithstanding its retroactivity, but strongly criticizing the analysis that the majority had used. Justice Scalia started strongly, stating:

"If I thought that 'substantive due process' were a constitutional right rather than an oxymoron, I would think it violated by bait-and-switch taxation. Although there is not much precision in the concept '"harsh and oppressive,"' which is what the Court has adopted as its test of substantive due process unconstitutionality in the field of retroactive tax legislation, ... surely it would cover a retroactive amendment that cost a taxpayer who relied on the original statute's clear meaning over $600,000.... [H]ere the amendment "without notice, ... gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute." (Citations omitted.)

Justice Scalia was not impressed (at least not favorably) by the majority's characterization of the estate tax amendment as merely "a curative measure," nor was he inclined to accept the "post-legislation legislative history (another oxymoron) to show that, despite the uncontested plain meaning of the statute, Congress never meant it to apply to stock that was not owned by the decedent at the time of death." He believed that, whether Congress had treated a citizen oppressively should not depend on whether the oppression was, after all, only a "curing" of an earlier error.

More important, Justice Scalia rejected the majority's distinguishing of the earlier cases on retroactivity based on the fact that they involved the imposition of new taxes, rather than a change in tax rates. He characterized the elimination of a specifically promised tax break that was to have been a reward for costly action, after the action has been taken, as being more harsh and oppressive than merely imposing a new tax on past actions. He then stated that:

"The reasoning the Court applies to uphold the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid. To pass constitutional muster the retroactive aspects of the statute need only be 'rationally related to a legitimate legislative purpose.' ... Revenue raising is certainly a legitimate legislative purpose, see U.S. Const., Art. I, section 8, cl. 1, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal. I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees *no* substantive rights, but only (as it says) process...." (Citations omitted; emphasis in original.)

Carlton, even considering Justice Scalia's scathing concurring opinion, strongly suggests that any challenge to a 2010 retroactive reinstatement of the estate and GST taxes would be unsuccessful, but there is one area in which the reinstatement of the estate and GST taxes differs from the curative provision at issue in *Carlton.* The Ninth Circuit's decision in *Carlton* relied in part on two older Supreme Court decisions—*Blodgett v. Holden,* 275 U.S. 142, 6 AFTR 8003 (1927), and *Untermyer v. Anderson,* 276 U.S. 440, 6 AFTR 7789 (1928)—which had rejected retroactive imposition of the first federal gift tax. The Supreme Court rejected the relevance of these cases, stating that they "were decided during an era characterized by exacting review of economic legislation under an approach that 'has long since been discarded.'"

More important, the Court in *Carlton* also stated that "Blodgett and Untermyer, which involved the Nation's first gift tax, essentially have been limited to situations involving 'the creation of a wholly new tax,' and their 'authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws.'" (Citations omitted.)

As the Ninth Circuit stated in a later case, the law distinguishes between the imposition of a wholly new tax and changes in an extant tax, because the Constitution does not approve of the imposition of a new tax when the taxpayer has "no reason to suppose that any transactions of the sort will be taxed at all."[115]

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[115] Quarty, *supra* note 113, quoting Darusmont, *supra* note 113 (itself quoting Cohan, 39 F.2d 540, 8 AFTR 10552 (CA-2, 1930) (Learned Hand, J.)).

Reasonable minds may differ on whether the re-adoption of the estate and GST taxes constitutes the "creation of a wholly new tax." The government would certainly argue that reenacting an estate tax that dates to the First World War and a GST tax that has been in place for over 30 years should be distinguished from enacting the nation's first tax on lifetime donative transfers. Nonetheless, a reasonable argument can be made that the critical issue is the imposition of a new tax on a closed transaction, and that there are few ways to close a transaction more firmly than death.[116]

There are, however, serious questions of fairness in such a retroactive reinstatement, which could temper the legislative desire to avoid having any period in which there was no estate or GST tax. For example, the trustee of a trust that is not exempt from GST tax might make a distribution to a skip person in 2010 when Section 2664 states that there will be no such tax in effect. That affirmative action in reliance on the law as it existed when the distribution was made makes a retroactive reintroduction of the GST tax seem unfair and harsh. Congress, to eliminate such a politically unfavorable appearance of unfairness, might permit the trustee to reacquire the distributed property and thereby avoid the retroactively imposed tax. A similar relief was afforded under Section 2055(e)(3)(J), where the grantor of a charitable remainder trust may declare it null and void *ab initio* if it fails to provide for the value of the remainder to be at least 10% of the value of the property contributed to the trust, even though such a declaration presumably would cause the charity to lose what would be a vested property interest in the remainder in the trust.

Often, when Congress plans to retroactively change the tax law, the chairs of the tax-writing committees issue a statement warning taxpayers not to rely on the current state of the law. Congressional staff members from the House Ways and Means Committee and the Senate Finance Committee confirmed on 12/31/09 that no joint letter of this nature was forthcoming, because the lawmakers could not agree on how best to proceed with the estate and GST taxes.[117]

Practitioners should caution their clients about the chance of retroactive reimposition of an estate and GST taxes, but they also should consider taking advantage of planning opportunities that may exist during the hiatus, particularly where there would be limited downside risk from doing so.

Some practitioners recognized the possibility that a client might die in a year without federal estate tax and addressed this in the client's documents, but it is unlikely that anyone anticipated a year both without estate tax and with the possibility that the federal government might retroactively reinstate the tax. A will or revocable trust of a married individual, who otherwise would have divided his or her residuary estate into credit-shelter and optimum marital deduction portions, might have stated, "If I die when there is no federal estate tax applicable to my estate, I give my residuary estate to the Trustee of Credit-Shelter Trust hereunder." If he or she died today, there would be no federal estate tax applicable and so the residuary estate would pass to the credit-shelter trust. It is unclear, however, what will happen if Congress retroactively reinstates the tax so the estate is subject to estate tax.

The correct construction of such a will or revocable trust may be that the residuary estate passes into the credit-shelter trust, and the entire estate will be subject to federal estate tax unless that trust is in a form that qualifies for the marital deduction. The better construction is that the phrase "if I die when there is no federal estate tax applicable" means "if I die when there is no federal estate tax applicable including no retroactive reenactment of such tax." In preparing new or amending existing wills and trusts, that probably should be expressly stated.

Alternatively, the will or revocable trust could state that if the federal estate tax is not applicable at death, all property passes to a QTIP trust for the surviving spouse with an express provision that a disclaimer by the surviving spouse will fund the credit-shelter trust (but eliminating any power of appointment over the credit-shelter trust as to the disclaimed property). The risk of this approach is that the most efficient tax disposition, if repeal remains in effect, will require a spousal disclaimer. If the estate tax is retroactively reinstated, however, then either the formula would fund the credit-shelter trust retroactively in the usual fashion, or it could be funded by disclaimer, but there is no risk that the disposition would produce an inadvertent estate tax on a retroactive reinstatement of the estate tax due to a failed-qualification for a marital deduction.

CONCLUSION

It is amazing to think that we can remain certain only about death but not taxes. Still, the public perception of a windfall is widely overstated. Instead, we seem to have many more pitfalls for taxpayers and practitioners than planning opportunities. This result occurs primarily because of the hasty penning of the sunset provisions of EGTRRA that appear to say "as you were" but not quite. The married taxpayer may have the greatest flexibility to plan for the uncertainty created by a year of transfer tax law with which no one ever expected to contend. The ability to put in place a spousal QTIP trust that may qualify for a marital deduction by an election that will not need to be made until 2011 permits a married taxpayer to put off the need to determine whether the trust will or will not produce a gift or estate tax until such time that taxpayers should know what the state of the law in fact is. Estate planners are living in a most interesting time. ■

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116 For further discussion of this issue see Gans, "Retroactive Estate Tax: Can it Be Made Constitutional?," 2010 TNT 7-8 (1/11/10).

117 BNA Daily Tax Report, 1/5/09, page G-1.