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ESTATE PLANNING AFTER THE 2010 TAX RELIEF ACT: BIG CHANGES, BUT STILL NO CERTAINTY

BY JONATHAN G. BLATTMACHR, MITCHELL M. GANS,
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Taxpayers may have been relieved to hear that Congress, at virtually the last minute, put off the "dreaded" return of the estate tax to its 2001 levels. What may have been lost in the hoopla—as far as clients are concerned—is that the reprieve is only temporary, at least so far. The complex changes offer some considerable advantages, particularly for wealthier clients, but there are no "one-size-fits-all" approaches.

Congress has passed and the President has signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312, 12/17/10; the "2010 Tax Relief Act").¹ This law broadly changes the estate, gift, and generation-skipping transfer (GST) tax rules for 2010, 2011, and 2012, and then permits the pre-EGTRRA 2001 law to be resurrected on 1/1/13. If these new rules become permanent, they will dramatically change the way in which estate planning is conducted and the economics of the typical estate planning practice. If they do not become permanent, they will represent a two-year window during which several important estate planning opportunities will exist.

Estate planners must now evaluate all estate plans in light of the new tax rules, the increased exemptions and lowered rates, and other features of the new law. They must determine how to change existing estate plans to address the opportunities offered by these changes and the problems they create. This additional level of complexity will alter the utility and features of most estate planning documents, render certain estate planning tools irrelevant, and render other estate planning tools especially important. Nevertheless, in determining what planning changes should or should not be made, it is critically important that practitioners realize that the changes expire at the end of 2012. There is no cer-

tainty they will be extended beyond then. That makes dealing with the changes especially challenging.

REPEAL OF 2010 ESTATE TAX REPEAL

The 2010 Tax Relief Act reinstates the estate tax, together with its estate-tax-value basis rules, effective 1/1/10. The estate tax is retroactively reinstated with a full \$5 million applicable exclusion amount (now referred to as the "basic exclusion amount") and a 35% top tax rate (which, because it applies to all estates above \$500,000, creates a flat 35% estate tax rate above the basic exclusion amount). Therefore, the estate of any decedent dying in 2010 will be subject to the estate tax, but with a \$5 million exemption (adjusted for certain lifetime gifts) and subject to a special election discussed below.

Election Out for 2010 Decedents

The 2010 Tax Relief Act gives the executor of a 2010 decedent's estate the power to elect to apply either the estate tax regime (with a basis equal to estate tax value and a \$5 million basic exclusion amount) or the carryover basis regime (with no estate tax) to the estate.² If no election is made, the estate will be subject to the estate tax regime.

Procedural issues. The manner of making the election will be determined

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by the IRS, and once made the election is revocable only with the Service's consent. Presumably, IRS will issue a special form by which an executor can make the election out of the estate tax, report the basis of the decedent's assets, and allocate the various carryover basis adjustments. This is likely to be Form 8939, "Large Transfers at Death," a draft of which has been released for comment, and which is designed for use under the version of Section 6018 that applied during that part of 2010 in which there was no estate tax.

Only the executor can make this election. The decedent's "executor," for this purpose, means the executor or administrator of the decedent, as properly appointed by the local court. If there is no executor or administrator appointed, qualified, and acting within the U.S., "executor" means any person in actual or constructive possession of any property of the decedent.³ Reg. 20.2203-1 states that:

All estate plans must be evaluated in light of the new tax rules, the increased exemptions and lowered rates, and other features of the new law.

"The term 'person in actual or constructive possession of any property of the decedent' includes, among others, the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country."

It is not uncommon for a decedent's entire estate to be held in forms of title that do not require the probate of a will or the appointment of an executor. The trustee of the decedent's revocable trust and the beneficiaries under life insurance policies and retirement benefit plan beneficiary designations may all be deemed to be executors of the decedent's estate if no executor is acting in the U.S. If there is no executor appointed by the local court, all of these people will be required to decide whether to make the election not to be subject to the estate tax, and to file the estate tax return or the Large Transfers at Death return required under Section 6018.

Procedural problems making this election can be expected to arise in at least two situations:

- When there is an executor appointed by the probate court who lacks information regarding the decedent's assets includable in the decedent's gross estate or subject to the carryover basis rules, that are held by other persons.
- When there is no executor appointed by a probate court and multiple persons are deemed to be executors for tax purposes.

In the first situation, the actual executor must make the best decision that the executor can make and file with the IRS as complete a return as possible.⁴

In the second situation, where there is no executor appointed by a probate court and multiple persons qualify as "executors" for tax purposes, and where they cannot or will not file a return together, none of them is likely to have all of the data required to make a fully informed decision regarding this election and to file either an estate tax return or a Large Transfers at Death return. Each executor, in such a situation, must file as complete a return as possible, report all

of the property known to be passing from the decedent, and include a "description of such property and the name of every person holding a legal or beneficial interest therein." It appears the IRS will then notify the other persons who qualify as executors because they are receiving property from the decedent, and they will be required to "make a return as to such property."⁵

Litigation is certain to ensue where such multiple "executors" do not freely exchange information or where they disagree on the appropriate allocation of basis increases. The practical estate planner should stress to the executor the potential problems that may arise if the executor is someone who also is a beneficiary and who is personally affected by either the election to have the estate tax not apply or the allocation of the decedent's aggregate and spousal property basis increases under the carryover basis rules.

Factors to consider. The decision whether or not a particular estate should be subject to the estate tax and estate-tax-value basis regime under Section 1014, with a \$5 million exemption and 35% top rate, or the carryover basis regime with no estate tax, often will be difficult. Usually, calculating the estate taxes that will be due will be relatively easy, and the \$5 million basic exclusion amount (even adjusted for lifetime gifts) and the unlimited estate tax marital deduction will result in most estates not being subject to estate taxes.⁶

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¹ Section 1(a) of the 2010 Tax Relief Act refers to the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" as the "short title." This should be enough to caution readers about the bizarre developments that lie ahead.

² 2010 Tax Relief Act section 301(c).

³ Section 2203. See also Stephens, Maxfield, Lind, Calfee, and Smith, *Federal Estate and Gift Taxation* (Thomson Reuters/WVG&L), ¶ 8.02.

For this purpose, "property of the decedent" relates to property includable in the decedent's gross estate, because the definition is created solely for estate tax purposes. This is the definition that applies with respect to the election out of the estate tax, too, so that even if the election out of the estate tax is made, it should be made by those people who hold property that would be included in the decedent's gross estate for estate tax purposes.

⁴ A question may arise whether the executor has a duty to make the election decision that is best for the probate legatees or that is best for all persons who receive property that is included in the decedent's gross estate for federal estate tax purposes. This will depend on the state law interpretations of the duties and responsibilities of the executor, and may vary from state to state.

⁵ See Section 6018(b)(4), applicable before the 2010 Tax Relief Act.

⁶ As a general rule, the exemption for 2010 decedents will be at least \$4 million, even if the decedent's lifetime taxable gifts already took advantage of the entire \$1 million applicable exclusion amount. Lifetime (post-1976) gifts beyond \$1 million will not reduce the \$4 million additional applicable exclusion amount available in 2010.

For estates that will not owe an estate tax, tax considerations often will favor accepting the estate tax regime, because it affords all of the decedent's appreciated property a basis equal to the value of the assets on the date of death or, if properly elected, the alternate valuation date.⁷ Even for these estates, however, the executor should consider whether there may be a potential estate tax advantage at the surviving spouse's death to elect out of the estate tax and have the decedent's assets held in one or more trusts that will not be subject to estate taxes when the surviving spouse later dies. A trust that would be eligible for QTIP estate tax treatment, but as to which no QTIP election is made to deduct the gift for estate tax purposes, still will be eligible for the \$3 million spousal property basis increase under the modified carryover basis rules, while the assets passing to this trust should not be subject to estate taxes at the surviving spouse's death.

Even estates that have substantial assets whose bases exceed their value will not benefit from the modified carryover basis regime, because that regime gives the estate and its beneficiaries a basis in the decedent's assets that cannot exceed the lesser of the decedent's adjusted basis or the FMV of the asset as of the decedent's death.⁸ Thus, both the estate tax regime and the carryover basis regime eliminate built-in losses (except as provided in Section 1022 with respect to certain losses of the decedent occurring before death that may be used to increase the ba-

sis of carryover basis property but never above date of death FMV).

Substantial complications attend this election. Projecting the effect of modified carryover basis will be quite difficult, even if the executor has access to all of the relevant data regarding estate assets. Projecting the tax effects of the modified carryover basis rules requires calculation of the net appreciation in each asset, the character of the gain on the sale of each asset, the tax rate applicable to the gain on the sale of each asset, the length of time it has been held, when each asset is likely to be sold, and whether there are tax benefits that might reduce the tax on such sales (such as the \$250,000 exclusion for gain on the sale of a principal residence). These calculations themselves depend on the identity of the beneficiaries receiving the assets.

The executor of a 2010 decedent's estate has the power to elect the carryover basis regime, with no estate tax. Problems in making this election may arise.

Assets passing to charity can, of course, be sold without current tax, unless the gain would be unrelated business taxable income.⁹ Assets passing to a beneficiary who is a dealer in such assets, however, may generate ordinary income on their sale.¹⁰ The decedent's principal resi-

dence passing to a beneficiary may be sold with favorable tax treatment by using the decedent's \$250,000 gain exclusion under Section 121.¹¹

The executor also must determine the allocation of the available \$1.3 million aggregate basis increase and \$3 million spousal property basis increases, in order to determine the modified carryover basis. The Service has not yet issued any guidance regarding the carryover basis adjustments, and it is not certain when and if any significant guidance will be issued. Therefore, this determination will be quite difficult to make with any degree of certainty.

It appears that the generation-skipping transfers made under the decedent's will or trust will not affect the election out of the estate tax regime. The Staff of the Joint Committee on Taxation has stated that a \$5 million GST exemption is available for allocation to transfers made in 2010, whether or not the executor of the decedent's estate elects out of the estate tax.¹² Nevertheless, while this is an important declaration in what constitutes the only legislative history for the 2010 Tax Relief Act, the statutory language actually seems to render the GST exemption inapplicable where the executor elects out of the estate tax regime. Therefore, until clarification is received from Treasury regarding whether it will construe the GST exemption as available to an executor electing out of the estate tax regime, practitioners should take into account the possibility that the GST exemption will not be available within the carryover basis regime.

Conflicts of interest and gift tax consequences. As discussed briefly above, one of the most significant questions regarding the election to apply the estate tax regime or the carryover basis regime concerns the conflicts of interest that it may create. In the simplest situations, a beneficiary who also is an executor may find that the estate taxes and potential capital gains taxes do not fall equally on the beneficiaries. Deciding to have the estate tax apply to the estate may distinctly favor the bene-

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⁷ Under Section 2032, the alternate valuation date is elected on a timely filed estate tax return and allows the valuation of estate assets on the date six months after the date of death. See the discussion of the alternate valuation date election in Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* (Thomson Reuters/WG&L), ¶ 50.07; Kasner, Strauss, and Strauss, *Post Mortem Tax Planning* (Thomson Reuters/WG&L), ¶ 7.01; Stephens et al., *supra* note 3, ¶ 4.03.

⁸ Section 1022(a)(2).

⁹ If the estate sells the asset and the gain or income is set aside for charity pursuant to Section 642(c), there will be no tax on the unrelated business taxable income. The result may be different, however, if a trust recognizes the gain or income. See Section 681.

¹⁰ Even if the inheritor is not a dealer in the property but the decedent was, the ordinary income nature of the inherent gain may pass through to the inheritor.

¹¹ If at death the decedent did not meet the "two out of the past five years" criterion for the exclusion, the beneficiary may "tack" his or her time using the home as a principal residence after the decedent's death to achieve the requisite holding period; see Section 121(d)(11).

¹² Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010"* (Scheduled for Consideration by the United States Senate (Comm. Print, 12/10/10), page 50, fn. 53.

fiary who is the executor, particularly if the executor also is a U.S. surviving spouse on whose share no estate taxes will be charged. In such a situation, the executor-beneficiary could benefit from the election, while other beneficiaries might be substantially penalized.

Litigation is certain to ensue where multiple 'executors' do not freely exchange information or where they disagree on the appropriate allocation of basis increases.

It is not uncommon for a fiduciary who is a beneficiary to be in a position to exercise a tax option or election in his or her own favor. There may be serious potential gift tax consequences to an interested fiduciary who makes or refrains from making an election to his or her own detriment.

The gift tax broadly defines a taxable gift as every completed transfer for less than full and adequate consideration in money or money's worth, regardless of the presence or absence of donative intent, unless a specific exemption, exclusion, or deduction applies.¹³ A transfer of trust property to a beneficiary, by a trustee who has no beneficial interest and is acting merely in his or her fiduciary capacity, is not a taxable gift.¹⁴ Clearly, an executor who is not also a beneficiary of the estate should not have a personal gift tax problem merely because the executor makes or declines to make the election out of the estate tax regime. The same may not hold true, however, with respect to an executor who is also a beneficiary of an estate and whose decision to elect or not to elect out of the estate tax reduces his or her interest in the estate. Such an executor-beneficiary may be deemed to have made a taxable gift to the beneficiaries whose shares are thereby increased.

Section 2514 states that a power to appoint property that does not

belong to one, among a class that includes the holder personally, is a general power of appointment, the lapse or exercise of which in favor of someone else is a taxable gift.¹⁵ The gift tax rules do state, however, that a trustee's administrative powers are not deemed to be general powers of appointment, even if they may benefit the trustee personally, as long as the trustee "has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties...."¹⁶

The question arises, however, whether this exception applies to some of the situations described above, in which the executor's decision whether to elect out of the estate tax can very directly reduce the executor's interest in an estate. This may be more than merely the incidental consequence of the discharge of the executor's fiduciary duties, and may raise serious gift tax problems for a beneficiary who also is the executor of a 2010 decedent's estate. In those situations, the exercise (or non-exercise) of the election out of the estate tax arguably may be viewed as the equivalent of the exercise, release, or lapse of a general power of appointment held by the executor-beneficiary, or the executor-beneficiary may be deemed to have transferred a property interest he or she holds individually. Either

analysis could result in a significant gift tax liability for the executor-beneficiary.¹⁷

Such a fiduciary and tax problem may arise under a will or trust that makes different dispositions if an estate tax applies with respect to the decedent's estate than it makes if no estate tax applies. This election, in such cases, could determine both the amount of tax due from the estate and also who receives the estate itself.¹⁸

Eighteen states have enacted statutes that construe a formula clause in a will or trust of a decedent who dies in 2010 as referring to the estate tax rules in effect on 12/31/09.¹⁹ These statutes usually also include language such as the following (taken from the Virginia statute): "If the federal estate or generation-skipping transfer tax becomes effective before that date, the reference to January 1, 2011, in this subsection shall refer instead to the first date on which such tax becomes legally effective." Under such statutes, an election to apply the carryover basis regime also could create a nonmarital share equal to \$3.5 million, rather than a nonmarital share equal to \$5 million.²⁰

Once again, the election by a beneficiary serving as executor will raise extensive issues of interpretation of the dispositive instruments, self-dealing, self-interest, and possibly tax effects to the beneficiary himself

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¹³ Reg. 25.2511-2(b).

¹⁴ Reg. 25.2511-1(g)(1).

¹⁵ Reg. 25.2511-1(a).

¹⁶ Reg. 25.2514-1(b)(1).

¹⁷ See a thorough analysis of this issue, including other arguments that may be raised to avoid such gift tax liability, in Gans, Blattmachr, and Heilborn, "Gifts by Fiduciaries by Tax Options and Elections," 18 *Probate & Property* No. 6 (November/December 2004), republished in *Digest of Tax Articles* (March 2005).

¹⁸ It is arguable that the election will determine the disposition of property where the governing instrument provides for one disposition if there is a federal estate tax applicable to the estate and another if it is not. In that event, however, it may be that a court would find such a literal application of the terms of the instrument should not apply. *Cf.* generally Klein, "The Ultimate Irony: In Light of the Passage of President Obama's Tax Proposal, State Formulaic Construction Statutes May Face Their Own Construction Issues ... And Time for a Construction Proceeding May be Running Out," *ABA Real Property Trust and*

Estate eReport. It also is possible that a court might take the view that the state statute anticipated that there either would be an estate tax or would not be an estate tax, and that it simply did not anticipate, and should not apply to, the situation in which the existence of the estate tax turns on an election.

¹⁹ See 12 Del. Code section 3335; D.C. Code section 20-1108; Ga. Code section 53-4-75; Idaho Code section 15-1-501; Ind. Code section 30-4-2.1-13; Md. Est. & Tr. Code section 11-110; Mich. Rev. Stat. section 700.2723; Minn. Stat. section 524.2-712; Neb. Rev. Stat. section 30-2342.02; N.Y.E.P.T.L. section 2-1.13; N.C. Gen. Stat. section 36C-1-113; 20 Pa. Stat. sections 2801-2803; S.Dak. Cod. Laws section 10-40A-11; Tenn. Code section 32-3-113; Utah Code section 75-3-917; Va. Code section 64.1-62.4; Rev. Code of Wash. section 11.108; Wisc. Stat. section 854.30. See also Fla. Stat. section 733.1051 and S.Car. Code section 62-2-612, which allow the court to construe the intent of the decedent in such situations, but do not create a presumption regarding the meaning of a reference to an estate tax-based term.

²⁰ But *cf.* Klein, *supra* note 18.

or herself by the manner in which the election is made.²¹ It is likely that this election will become the subject of extensive litigation in a great many instances.

HIGHER ESTATE TAX EXEMPTION AND LOWER RATES

The 2010 Tax Relief Act increases the basic exclusion amount to \$5 million, indexed for inflation after 2011.²² The 2010 Tax Relief Act also reduces the top estate tax rate to 35%, creating a flat 35% estate tax on estates above the basic exclusion amount. These rules apply with respect to estates of decedents dying after 2009 and before 2013.

The increase in the estate tax basic exclusion amount should also increase the GST exemption, because the latter is determined with reference to the former.²³ As is discussed below, this increased GST exemption appears allocable to transfers made in 2010 whether or not the estate elects out of the estate tax regime and into the carryover basis regime.

GST TAX AND 2010 TRANSFERS

One of the most interesting features of the 2010 Tax Relief Act is how it finesses the many GST tax problems created by EGTRRA's 2010 rules.²⁴ All estate planning was complicated in 2010, but generation-skipping transfer (GST) tax planning is by far the most difficult element in an estate plan, because of the manner in which EGTRRA rendered this tax inapplicable in 2010 and then proposed restoring it in 2011. The net effect of the EGTRRA machinations

was to make the GST tax clearly inapplicable to outright transfers to skip persons in 2010, but otherwise to leave in somewhat considerable doubt how the GST tax would apply after 2010 to transfers in trust that occurred in 2010.

The Uncertain Scope of Section 2664

GST tax planning in 2010 was complicated by the difficulty of determining precisely what GST taxes would be imposed after 2010 on taxable distributions from and taxable terminations of interests in generation-skipping trusts created by 2010 transfers. The precise scope of the GST tax after 2010 required careful examination of both Section 2664 and EGTRRA's sunset rule.

Section 2664 stated that Chapter 13 (which contains virtually all the GST tax rules) did not apply to "generation-skipping transfers" after 2009. This simple statement, however, raised several complicated and sometimes unanswerable questions.

The basic statement of Section 2664 was itself internally inconsistent. Chapter 13 could not be entirely inapplicable to generation-skipping transfers after 2009, both because Section 2664 was itself part of Chapter 13, and because the only definition of "generation-skipping transfer" in the tax law is in Chapter 13. Chapter 13, therefore, must be required to remain applicable in 2010, at least to the extent required to define "generation-skipping transfer."²⁵

Section 2664 limited itself to generation-skipping transfers, and so appeared to leave Chapter 13 fully operational with respect to 2010 events that are not generation-skipping transfers, but which have a sig-

nificant impact on the GST tax imposed in later years on trusts and other arrangements created in 2010.

Section 2611(a) defines "generation-skipping transfer" as including only (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip transfer. Section 2612(b) defines a "taxable distribution" as "any distribution from a trust to a skip person (other than a taxable termination or a direct skip)."²⁶

Section 2612(a) defines a "taxable termination" as "the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless— (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person."²⁷

Section 2612(c) defines a "direct skip transfer" as a gift during life or a transfer at death from a transferor directly to a skip person.²⁸

Until clarification is received, practitioners should consider the possibility that the GST exemption will not be available within the carryover basis regime.

All three of these definitions rely on the definition of a "skip person." Section 2613(a) defines a skip person as "a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor," a trust all of the interests in which are held by skip persons, or a trust in which no person holds an interest in the trust and "at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person."²⁹ A "non-skip person" is "any person who is not a skip person."³⁰

Section 2664, therefore, clearly stated that no GST tax was imposed

21 See Gans, Blattmachr, and Heilborn, *supra* note 17.
22 2010 Tax Relief Act section 302(a).
23 Section 2631(c).
24 For a more complete discussion of the GST tax problems raised by the absence of an estate tax in 2010, see Zaritsky, *Practical Estate Planning in 2010* (Thomson Reuters/WG&L), ch. 4.
25 To argue that the definition of generation-skipping transfer also was eliminated after 2009 by Section 2664 was unsupportable because it would create an illogical and unworkable result. See *Nixon v. Missouri Mun. League*, 541 U.S. 125 (2004), and *U.S. v. American Trucking Ass'ns*, 310 U.S. 534 (1940) (the courts will not construe a statute in a manner that leads to absurd or futile results).
26 See Harrington, Kwon, Plaine, and Zaritsky, *Generation-Skipping Transfer Taxes* (Thomson Reuters/WG&L), ¶ 2.05[3].
27 *Id.*, ¶ 2.05[2].
28 *Id.*, ¶ 2.05[1].
29 *Id.*, ¶ 2.04[1].
30 Section 2613(b); Harrington, et al., *supra* note 26, ¶ 2.05[2].

on a direct skip transfer, a taxable distribution, or a taxable termination occurring in 2010. Beyond that, however, construction problems arose.

The solution adopted by the 2010 Tax Relief Act was quite simple. The 2010 Tax Relief Act reinstates the GST tax for transactions in 2010, together with a \$5 million GST exemption. Section 2664, which previously stated that the GST tax rules did not apply to transfers in 2010, is repealed retroactively. In addition, the "applicable rate" for the GST tax on taxable transfers in 2010 is zero percent.³¹

Generation-Skipping Transfers in Trust and the Generation Move-Down Rule

A direct skip gift made in trust in 2010 was clearly not subject to GST tax, but post-2010 distributions from the trust to a skip person and the termination of the interests of a skip person could themselves be subject to the GST tax, because of the inapplicability of the generation move-down rule of Section 2653(a). That section states that, if immediately after a generation-skipping transfer of property the property is held in trust, then the determination whether any GST tax is imposed on subsequent transfers from the trust is made by treating the trust "as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer."³²

Section 2653(a) is part of Chapter 13, however, and Section 2664 stated that Chapter 13 did not apply to direct skip transfers made in 2010. Therefore, Section 2664 appeared to negate the protection afforded by the generation move-down rule to a generation-skipping transfer in trust made in 2010, unless the EGTRRA sunset rule required a different result.³³ The inapplicability of the generation move-down rule would mean that when property was distributed after 2010 out of a trust created in 2010 for a skip person, a GST tax would apply.

This problem made it very difficult to make GST-tax-free gifts to

minor grandchildren in 2010. The problem was exacerbated by the fact that, for GST tax purposes, a transfer to a Uniform Transfers (or Gifts) to Minors Act custodial account is treated as a transfer in trust.³⁴ Furthermore, key IRS personnel had stated in informal conversations that the Service might well treat a legal guardianship of a minor as a trust equivalent, for this purpose. This made it extraordinarily difficult to make a significant outright gift to a minor skip person, and increased the likelihood that transfers in 2010 would produce GST tax problems.

On the other hand, one might have argued that Section 2664 was meant only to remove the GST tax on certain events that occur in 2010, and that it was not intended to generate additional taxes on trusts created in 2010. This argument would support the notion that the generation move-down rule of Section 2653(a) should apply after 2010, despite the fact that no GST was tax imposed on the original creation of the trust. The Code appeared neither to preclude nor to support this construction.

The repeal of Section 2664 means that the generation move-down rule of Section 2653(a) will protect 2010 generation-skipping transfers in trust that are treated as skip persons from imposition of GST tax on post-2010 distributions to skip persons occupying the second generation (or greater) below that of the transferor.

Basis Adjustments for Certain Taxable Terminations

Section 2654(a)(2) states that the adjusted basis of property that is the subject of a taxable termination on the death of an individual is adjusted in a manner similar to Section 1014(a), which moves the basis of assets up or down to the estate tax value of the property.³⁵

Under Section 2664, however, the taxable termination of a beneficiary's interest in a trust occurring in 2010 was exempt from the operation of the GST tax rules, including the basis rule for certain taxable terminations. Furthermore, Section 1014(a) did

not determine the basis of property received from a decedent who died in 2010. It appears, therefore, that under EGTRRA, before amendment by the 2010 Tax Relief Act, no basis increase would occur with respect to property that is the subject of a taxable termination at death in 2010.

A conflict of interest may arise where the executor's decision to elect out of the estate tax very directly reduces the executor's interest in an estate

The repeal of Section 2664 and the reinstatement of the estate tax and the estate tax value basis rules should give a certain basis increase for the taxable termination of a beneficiary's interest in a trust occurring on account of death in 2010. This is a very favorable tax treatment, particularly when viewed together with the zero percent GST applicable rate on 2010 transfers.

Lack of a GST Exemption in 2010

Section 2664 rendered the GST tax rules inapplicable only to generation-skipping transfers that occurred in 2010, which includes only direct skip transfers, taxable distributions, and taxable terminations. The GST rules continued to apply to a 2010 transfer to a generation-skipping trust the interests in which were held by both skip persons and non-skip persons. Such trusts are not themselves skip persons, because an

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³¹ 2010 Tax Relief Act section 301(a) repeals "[e]ach provision of law amended by subtitle A or E of title V of" EGTRRA. Section 2664 was added by subtitle A of title V of EGTRRA.

³² See Harrington et al., *supra* note 26, ¶ 5.05.

³³ EGTRRA section 901(b) provides, in part, that after 2010 the Code is to be applied as though EGTRRA—including Section 2664—had never been enacted, which could mean that after 2010 the "move down" rule of Section 2653(a) does apply.

³⁴ Reg. 26.2652-1(b)(2), Example 1.

³⁵ See Harrington et al., *supra* note 26, ¶ 5.08[5]. Normally, the adjusted basis of property to which a taxable termination occurs is adjusted, but not above FMV, to reflect the GST tax paid. See Section 2654(a)(2).

interest in the trust is held by a non-skip person and a transfer to such a trust is not a "generation-skipping transfer."³⁶

One usually could minimize or avoid the GST tax on future distributions from and terminations of interests in such trusts by allocating to the transfer some of the transferor's GST exemption. Unfortunately, EGTRRA tied the amount of the GST exemption to the amount of the estate tax basic exclusion amount.³⁷ Thus, the absence of a federal estate tax in 2010 produced a basic exclusion amount of zero and, consequently, a GST exemption of zero.³⁸ A transferor, therefore, had no GST exemption under EGTRRA to allocate to 2010 transfers to avoid future imposition of the GST tax on taxable terminations and taxable distributions from such trusts.

Repeal means that the move-down rule will protect 2010 generation-skipping transfers in trust that are treated as skip persons from imposition of GST tax on distributions.

The retroactive restoration of the estate and GST taxes to 2010, albeit with a GST "applicable rate"³⁹ of zero, also gives a donor or decedent a \$5 million GST exemption that can apparently be allocated to GST transfers in 2010. The Staff of the Joint Committee on Taxation states explicitly that the exemption is available even to a 2010 decedent's estate that elects not to be subject to estate

taxes, although it is difficult to find support in the text of the statute.⁴⁰

Identifying the Transferor of a 2010 Testamentary Transfer

Generation-skipping trusts created at the death of an individual in 2010; whether or not the trust itself was a skip person, arguably were exempt from the GST tax even with respect to distributions and terminations of interests that occurred in later years. This protection from GST tax was based on the absence of an estate tax in 2010, rather than the absence of a GST tax.

As discussed above, the definitions of "direct skip transfer," "taxable termination," and "taxable distribution" require that there be a transfer to or for the benefit of a skip person or that, after the termination of interests, one or more skip persons have interests in the trust. There can be no taxable distribution or taxable termination unless an interest in the trust is held by a skip person.

A "skip person" is defined in Section 2613(a) as either "a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor," a trust all of the interests in which are held by skip persons, or a trust in which there is no person holding an interest in the trust and "at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person." A "non-skip person" is defined by Section 2613(b) as "any person who is not a skip person."

The definitions of "taxable termination" and "taxable distribution," therefore, ultimately depend on the existence of a "transferor." Identifying

the transferor is essential because the generation assignments of the transferees are based on their relationship to the transferor. If there were no transferor, there could be no generation-skipping transfer.

The transferor is the individual with respect to whom property was most recently subject to federal estate or gift tax.⁴¹ A transfer on account of the death of a decedent in 2010 to a trust that had as beneficiaries both skip persons and nonskip persons was not subject to either gift or estate tax. It was arguable, therefore, that there was no transferor for such a trust, and thus no skip persons, and thus no taxable distributions or taxable terminations.

The IRS, of course, could have argued under EGTRRA's sunset rule that the status of the transferor must be redetermined after 2010 as if EGTRRA had not been enacted, and therefore the transferor of a testamentary transfer should be treated as if he or she had paid a federal estate tax on the transfer. This argument, however, would have ignored the very fundamental absence of an estate tax on transfers in 2010. Of course, this argument is now academic, because the 2010 Tax Relief Act states that, whether or not the estate of a 2010 decedent elects out of estate taxation and into carryover basis, the decedent is the transferor for GST tax purposes.⁴²

2010 Gifts to Section 2642(c) Annual Exclusion Trusts

Section 2642(c)(1) states that a direct skip transfer that is not a taxable gift, because it qualifies for the gift tax annual exclusion or unlimited exclusion for direct payment of medical or educational expenses,

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³⁶ These terms require that there be a transferor. Therefore, they are applicable to lifetime gifts in 2010 because the gift tax continued to apply in 2010. It was arguable that they did not apply to testamentary transfers in 2010, because there was no estate tax in 2010.

³⁷ Section 2631(c).

³⁸ Section 2010(c).

³⁹ The "applicable rate" is the effective rate of GST tax. It is expressed as a decimal and multiplied by the amount of the GST transfer to determine the tax due. The applicable rate is defined as the product of the inclusion

ratio and the highest stated estate tax rate (expressed as a decimal) in effect at the time of the transfer; see Section 2641(a). The inclusion ratio is 1 minus the "applicable fraction" under Section 2642(a)(1). The applicable fraction is a fraction the numerator of which is the amount of GST exemption allocated to the trust and the denominator of which is the value of the property transferred to the trust (reduced by the sum of federal estate tax or state death tax recovered from the trust and the amount of any gift or estate tax charitable deduction allowed with respect to the transferred property); see Section 2642(a)(2).

⁴⁰ See note 12, *supra*. This statement is well-come, but it does not find much support in the Code or the language of the 2010 Tax Relief Act. The election to have no estate tax apply should render the estate tax basic exclusion amount, with respect to the electing estate, zero. This should produce a similar lack of GST exemption. Nonetheless, such statements by the Joint Committee Staff usually may be relied on.

⁴¹ Section 2652(a)(1). See also Harrington et al., *supra* note 26, ¶ 2.02.

⁴² 2010 Tax Relief Act section 301(c).

will not be subject to the GST tax and will have an inclusion ratio of zero for GST tax purposes.⁴³ Section 2642(c)(2) limits this rule, however, by stating that a direct skip transfer in trust will have an inclusion ratio of zero under this rule only if both of the following conditions are met:

1. During the life of the individual transferee, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and

2. If the trust does not terminate before the individual dies, the assets of such trust will be includable in the gross estate of such individual.

This creates what is sometimes referred to as the GST annual exclusion, under which a gift to a trust for the benefit of a grandchild or other skip person has an inclusion ratio of zero without allocation of GST exemption if the gift qualifies for the gift tax annual exclusion, no distributions can be made to anyone other than the transferee, and the undistributed trust fund must be included in the transferee's gross estate if he or she dies during the trust term.⁴⁴

A 2010 transfer to a Section 2642(c) trust created the problem discussed above with respect to other direct skip transfers in trust. The transfer was not itself taxable, because even though it was a generation-skipping transfer in 2010, no portion of Chapter 13 arguably applied to protect the trust from future GST taxes. Distributions from the trust after 2010 could be taxable distributions or taxable terminations, because Section 2653(a)'s generation move-down rule arguably would not apply to generation-skipping transfers made in 2010.

It also could be argued that the zero inclusion ratio rule of Section 2642(c) would not apply to direct skip transfers in 2010. This would further bolster the argument that post-2010 distributions from the trust or terminations of interests in the trust would be subject to GST tax. This appears to be a particularly

harsh interpretation of Section 2664, and it may be countered by noting that the GST tax must be applied to transfers after 2010 as if EGTRRA had never been enacted. Had EGTRRA not been enacted, both the zero inclusion ratio under Section 2642(c) and the transferor move-down rule under Section 2653(a) would have applied, and the distributions from or terminations of interests in this trust would have been protected from subsequent GST taxes.

Under EGTRRA, a transferor had no GST exemption to allocate to 2010 transfers to avoid future imposition of the GST tax on taxable terminations and taxable distributions.

The retroactive repeal of Section 2664 also clarifies that 2010 gifts to Section 2642(c) annual exclusion trusts will create a zero inclusion ratio for the trust as that is exactly what the section states and the section retroactively came back into effect. Therefore, no GST tax will be imposed on any subsequent distributions to the donee skip person.

Estate Tax Inclusion Periods in 2010

Under Section 2642, special rules apply when the transferred property would be included in the transferor's gross estate for federal estate tax purposes if the transferor were to die immediately after the transfer (other than by reason of the transfer within three years of death rule of Section 2035). Section 2642(f) states that determination of the inclusion ratio is not made until the end of the estate tax inclusion period (ETIP). An allocation of GST exemption can be effective no earlier than the end of the ETIP.

Section 2642(f)(3) states that an ETIP ends on the earliest of:

1. The first date on which the value of the property involved in such transfer would not be includable in the gross estate of the transferor for

federal estate tax purposes if the transferor died.

2. The date on which there is a generation-skipping transfer with respect to such property.

3. The date of the transferor's death.

If there were no federal estate tax with respect to any decedent who dies in 2010, all ETIPs from all trusts the transferors of which were alive on 1/1/10 arguably should terminate on that date.

There was, of course, no GST exemption available to allocate to such trusts in 2010, before the 2010 Tax Relief Act, so all such trusts as to which an ETIP terminated in 2010 could be fully GST nonexempt, even if GST exemption had not been previously allocated to the transfer. An earlier allocation would seem literally to be deemed to become effective on 1/1/10, when the trust fund also would arguably no longer be includable in the gross estate of a deceased transferor.⁴⁵

One of the few GST problems created by EGTRRA and not resolved by the 2010 Tax Relief Act is whether the retroactively repealed estate tax repeal for 2010, or the executor's ability to elect out of the estate tax, terminates all existing ETIPs. It is not clear whether an ETIP that literally seemed to have terminated on 1/1/10—because the law then in effect provided there was no estate tax—was reinstated by the retroactive reinstatement of the estate tax. Furthermore, it is not clear whether the mere fact that a decedent's executor could have elected to render the estate tax inapplicable suffices to create a date on which the transferred property would not have

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⁴³ An inclusion ratio of zero means there is no GST tax imposed because the applicable (effective) GST tax rate is equal to the inclusion ratio times the highest rate of estate tax in effect when the generation-skipping transfer occurs.

⁴⁴ See Harrington et al., *supra* note 26, ¶ 5.02.

⁴⁵ See Reg. 26.2642-1(b)(2) for rules on allocation of GST exemption during an ETIP. Section 2210 provides, in general, that no part of Chapter 11 applies to anyone dying after 2009. Certainly, that means there would be no estate tax imposed on those who died in 2010 but it still might be arguable that property is included in the decedent's estate.

been includable in the decedent's gross estate whether or not the transferor did not die during 2010. It is also unclear whether an actual death and election out of the estate tax regime would be required to cause the ETIP to terminate, particularly since death automatically terminates an ETIP under Section 2642(f)(3)(B).

This issue is not merely of academic interest, because the donor's allocation of GST exemption is not effective until the ETIP ends. A donor who believes that an ETIP in a transfer has terminated in 2010, therefore, should consider either filing a timely gift tax return and allocating GST exemption to shelter the transfer from future GST taxes, or making an election out of automatic allocation, if an allocation of exemption is not desired. If GST exemption had previously been allocated but suspended in taking effect on account of the ETIP rule, it seems the donor could take the position the ETIP ended on 1/1/10, and therefore the allocation of GST exemption became effective.

2010 GST Applicable Rate is Zero

The 2010 Tax Relief Act states that 2010 generation-skipping transfers have an "applicable rate" of zero.⁴⁶ This means that a 2010 direct skip transfer, taxable distribution, or taxable termination would not produce a current GST tax obligation, despite the retroactive re-enactment of the GST tax, and without allocation of GST exemption to the transfer.

The 2010 Tax Relief Act states only that the applicable rate is zero. This raises a question whether the new law also creates a zero inclusion ratio for all 2010 transfers in trust, protecting them from future GST

taxes on distributions to, and terminations of interests in favor of, beneficiaries assigned to more remote generations. A careful analysis does not lead to a clear conclusion.

Identifying the transferor is essential because the generation assignments of the transferees are based on their relationship to the transferor.

The "applicable rate" is normally determined by multiplying the maximum estate tax rate by the inclusion ratio.⁴⁷ The maximum federal estate tax rate in 2010 is 35%, except if a 2010 decedent's executor elects not to have estate tax apply, in which event the maximum estate tax rate arguably is zero. Certainly, if the election out of estate tax is not made, the rate is 35% and, at least in that instance, it suggests that the inclusion ratio is zero.⁴⁸ This analysis would be that, the only way the applicable rate could be zero is if the estate tax rate were zero, the inclusion ratio were zero, or both the estate tax rate and the inclusion ratio were zero. The estate tax rate for 2010 is 35%, so it logically follows that the inclusion ratio must be zero. Thus, a trust created by a 2010 lifetime generation-skipping transfer in trust, such as a gift to a trust for grandchildren and more remote descendants, arguably is permanently exempt from the GST tax.

On the other hand, the applicable rate simply could be zero without regard to the usual computations to get there. Maybe there is no effect on the applicable fraction or the inclusion ratio without an allocation of GST exemption. The inclusion ratio could remain at 1, and superseding all normal computational rules, the applicable rate is simply zero for 2010. The Joint Committee Staff states only that the "generation skipping transfer tax rate for transfers made during 2010 is zero percent."⁴⁹ This suggests that Congress might

not have intended that a trust created in 2010 have an inclusion ratio of zero without allocation of GST exemption to the trust.

Furthermore, Section 2632(b)(1) states that there is automatic allocation of GST exemption to a direct skip to the extent necessary to make the inclusion ratio zero. If setting the applicable rate to zero for 2010 has no effect on the inclusion ratio, the automatic allocation rules could produce a zero tax rate and a full automatic allocation at the same time. Donors who transferred property in 2010 to a trust that is itself a skip person may want to elect out of the automatic allocation rules, unless the trust is likely to continue for the benefit of one or more generations beyond the highest generation of trust beneficiaries.

As it is unclear whether these transfers have an automatic inclusion ratio of zero, without allocation of GST exemption, practical estate planners should advise their clients of both the risks of making distributions from these trusts as if they had an inclusion ratio of zero, and the existence of a legitimate argument that all distributions from these trusts are exempt from the GST tax. Ultimately, the trustee of these trusts must make the choice of how to report subsequent distributions and terminations of interests.

Postponed Application of EGTRRA's Sunset Rule

EGTRRA section 901 contains its sunset rule. Section 901(a) states, in applicable part, that the GST tax changes made by EGTRRA do not apply to "generation skipping transfers ... after December 31, 2010." The 2010 Tax Relief Act merely extends this date from 12/31/10 to 12/31/12.

Section 901(b) provides the greater problem, stating that the tax laws are applied and administered "to ... transfers described in subsection (a) [those after 2009] as if the provisions and amendments described in subsection (a) had never been enacted." There is much debate and uncertainty regarding the meaning of the statement that the GST tax must be

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⁴⁶ 2010 Tax Relief Act section 302(c).

⁴⁷ Section 2641(a).

⁴⁸ Indeed, it seems that the estate tax rate in effect for 2010, whether or not an estate tax applies, is 35%. In fact, it is 35% whether or not the transferor has died. In other words, the applicable rate (of GST tax) is determined by the estate tax rate when the tax is imposed whether or not the transferor has died.

⁴⁹ See note 12, *supra*, page 50.

administered with respect to transfers after 2012 as if EGTRRA "had never been enacted."

The GST tax, to a far greater extent than the estate and gift taxes, includes many rules by which transactions and elections made in one year affect the tax treatment of events in subsequent years. Thus, the precise application of the sunset rule to the GST tax is often difficult or impossible to determine.

Unfortunately, while the 2010 Tax Relief Act postpones these issues, it does not really resolve them, because the sunset rules continue to operate effective 1/1/13.

EGTRRA's sunset rule, as amended by the 2010 Tax Relief Act, states that the tax laws, including Chapter 13, apply to transfers after 2012 as if EGTRRA had never been enacted. EGTRRA and the 2010 Tax Relief Act raised the GST exemption from \$1 million (indexed for inflation) to \$5 million. Section 901(b) of EGTRRA, as amended by the 2010 Tax Relief Act, however, states that the GST tax must be applied and administered "to ... transfers described in subsection (a) [those after 2012] as if the provisions and amendments described in subsection (a) had never been enacted." On January 1, 2013, absent additional legislation, the GST exemption appears poised to drop to \$1 million, adjusted for inflation.

The sunset rule requirement that the GST tax be applied after 2012 as if EGTRRA had never been enacted could force the recalculation of post-2012 inclusion ratios. The numerator of the applicable fraction of such redetermined inclusion ratio arguably would be the lesser of the amount of GST exemption that the transferor allocated to the transfer or trust and the GST exemption that would have been available had EGTRRA not been enacted.

EGTRRA, as amended by the 2010 Tax Relief Act, provides that a donor's GST exemption is automatically allocated to lifetime transfers that are not direct skips but that are instead made to generation-skipping trusts. These transfers are referred to as "indirect skips."⁵⁰ It remains unclear whether the IRS and the courts, after 2012,

will respect automatic allocations made under EGTRRA's rules between 2001 and 2013, because the GST tax rules are to be applied as if EGTRRA had never been enacted. This might be seen as requiring that transferors make late allocations of GST exemption in 2013 to transfers made between 2001 and 2013.

Presumably, late allocations would be based on the values of the transferred assets on the date of the late allocation, which could be substantially different (either higher or lower) than the value on the date of the original transfer.⁵¹ Therefore, if the automatic allocations are void because the law is construed as if EGTRRA were never enacted, and the transferors have not made actual individual allocations of GST exemption, they may be forced to make late allocations at much higher values, if the transferred property has appreciated. In addition, if the EGTRRA changes are allowed to sunset, the GST exemption available for allocation would drop to \$1 million, indexed for inflation after 1997, which for 2011, would be \$1,360,000. Were automatic allocations suddenly declared void ab initio, the transferors might not have sufficient GST exemption to allocate and produce a zero inclusion ratio.

This view, however, appears to be an unreasonable interpretation of the sunset rules. Nevertheless, until there is further clarification, practical estate planners should be cautious about recommending voluntary taxable distributions after 2012 from trusts that are exempt from the GST tax because of 2001-2012 automatic allocations.

EGTRRA-created rules for qualified severances under which the severance of a single trust into multiple trusts is recognized for GST tax purposes, and the resulting separate trusts are treated as independent trusts for GST tax purposes, are to sunset on 1/1/13.⁵² The manner in which EGTRRA's sunset rules apply to qualified severances that transpired between 2001 and 2013 is, however, unclear. It is not known whether the Service, after 2012, will respect as separate trusts, for GST

tax purposes, trusts that were divided by qualified severances between 2001 and 2013.

If the EGTRRA sunset provisions mean that the GST tax rules are to be administered after 2012 as if EGTRRA had never been enacted, and without EGTRRA qualified severances would not have been permitted, no qualified severance would be deemed to have taken place. This construction of the sunset rule would require trusts that were divided in a qualified severance to be treated as a single unit, and their inclusion ratios be recalculated accordingly (that is, back to what they were before the qualified severance). This appears to be an unreasonable requirement, but until there is further clarification, practical estate planners should be cautious about making voluntary post-2012 taxable distributions from trusts that were divided in a qualified severance between 2001 and 2013.

Unresolved is whether the retroactively repealed estate tax repeal for 2010, or the executor's ability to elect out of the estate tax, terminates all existing ETIPs.

EGTRRA added Section 2632(d), which allows a transferor to make a retroactive allocation of GST exemption to a transfer in trust if a beneficiary of the trust is a non-skip person, is a lineal descendant of the transferor's grandparent or of a grandparent of the transferor's spouse, is assigned to a generation below the generation of the transferor, and predeceases the transferor. It is not clear whether the Service, after 2012, will respect the inclusion ratio created by such a retroactive allocation that was made under this rule during the years 2001 through 2012.

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⁵⁰ EGTRRA section 561(a); Section 2632(c).

⁵¹ Section 2642(b)(3).

⁵² EGTRRA section 562; Section 2642(a)(3).

Arguably, the requirement that the IRS administer the GST taxes as if EGTRRA (including this special rule) had never been enacted should require distributions from and terminations of interests in such trusts to be taxed as if no retroactive allocation could ever have been made. This interpretation might compel trusts to recalculate their inclusion ratios after 2012 to treat such retroactive allocations as having been late allocations, rather than timely allocations. This would increase the inclusion ratio if the trust funds had grown in value between the date of the original transfer and the date of the retroactive allocation, even if the trust assets had dropped in value thereafter. One could certainly argue that this type of retroactive change in inclusion ratio would be unreasonable and was unintended, but, until there is further clarification, practical estate planners should be cautious about recommending voluntary post-2012 distributions from trusts that were the subject of such retroactive allocations between 2001 and 2013.

TIME TO COMPLY WITH 2010 REPORTING AND OTHER REQUIREMENTS

The 2010 Tax Relief Act extends the time for filing an estate tax return with respect to the estate of a decedent dying after 2009 and before the date of enactment, including any elections on such returns and any disclaimers of interests in such estates, until at least nine months after the date of enactment.⁵³ Specifically, this extension applies to:

- Filing a federal estate tax return.
- Filing any election required to be made on that return.
- Paying the estate tax.
- Disclaiming any interest in prop-

erty passing by reason of the death of a decedent who dies after 2009 and before the date of enactment of the 2010 Tax Relief Act.

- Filing any return to report a generation-skipping transfer made after 2009 and before the date of enactment of the 2010 Tax Relief Act.
- Making any election required to be made on the generation-skipping transfer tax return.

The provision that extends the time within which to file a tax return reporting any generation-skipping transfer made after 2009 and before the date of enactment is particularly helpful for inter vivos transfers in 2010, because it gives the transferor additional time to determine the best allocation of GST exemption. The GST reporting for a 2010 testamentary transfer would be made on the estate tax return, the filing date of which also is extended until nine months after the date of enactment.

The extension of time within which to make disclaimers may be a two-edged sword. It gives the disclaimant a significant time within which to determine the tax effects of the disclaimer, but it also gives the disclaimant substantial time within which to do something that could be perceived as accepting the bequest, and thus disqualify the disclaimer. Practical estate planners must take special care to assure that clients who may wish to file a disclaimer do nothing that would constitute acceptance of the bequest before they make their disclaimer.

Also, state laws do not always allow more than the original nine months within which to make a disclaimer. Using this extended time within which to make a disclaimer that is effective for federal tax purposes will probably require that the property be validly transferred to the persons who would have received it had the disclaimer been valid.⁵⁴

Oddly, the 2010 Tax Relief Act does not extend the time for filing a return reporting the modified carry-over basis of assets passing through a decedent's estate. Act section 301

(d)(1) states, in relevant part, that it extends the date due for: "(A) filing any return under section 6018 of the Internal Revenue Code of 1986 (including any election required to be made on such a return) as such section is in effect after the date of the enactment of this Act without regard to the election under subsection (c)." (Emphasis added.)

Arguably, a trust created by a 2010 lifetime generation-skipping transfer in trust is permanently exempt from the GST tax.

This appears to extend the time for filing the federal estate tax return, which is required by Section 6018 after the enactment of the 2010 Tax Relief Act, but not the Large Transfers at Death Return required under that section prior to the enactment of the 2010 Tax Relief Act. Therefore, if the election out of the estate tax regime is required to be filed on the return reporting the modified carry-over basis of the decedent's assets, that election will need to be made by 4/15/11—the date for filing the decedent's final income tax return, unless an extension is obtained.

REUNIFICATION OF THE ESTATE AND GIFT TAXES

The 2010 Tax Relief Act reunifies the estate and gift tax exemptions after 2010.⁵⁵ This means that, for gifts made in 2010, the gift tax lifetime exemption was \$1 million, but for gifts made after 2010 and before 2013 it is \$5 million.

This increased exemption will free some clients from the need to rely on annual exclusion gifts to make many of their lifetime nontaxable transfers. Grantors who are skeptical of their ability to control the actions of beneficiaries may choose not to include *Crummey* powers in irrevocable trusts, and rely instead on their newly enlarged lifetime exemption to avoid

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⁵³ 2010 Tax Relief Act section 301(d).
⁵⁴ Section 2518(c)(3). See also Reg. 25.2518-1(c)(1)(i) (a disclaimer may be qualified even though invalid under state law).
⁵⁵ 2010 Tax Relief Act section 302(b). This provision amends Section 2505(a)(1) to provide that the gift tax exemption will be "the applicable credit amount in effect [for gift tax purposes] under section 2010(c) [the estate tax provision] which would apply if the donor died as of the end of the calendar year..."

paying gift taxes on periodic gifts. The continued use of *Crummey* powers, however, still appears to be an appropriate first step for permanent gift and estate tax reduction, because the benefit of using the enhanced \$5 million gift tax exemption for 2011 and 2012 may be recaptured when significant lifetime gifts or death occurs thereafter (if the exemption has then been reduced).⁵⁶

The 2010 Tax Relief Act also changes the law regarding the computation of gift and estate taxes where a donor has made lifetime taxable gifts. Before the 2010 Tax Relief Act, the gift tax on taxable transfers is determined by computing a tentative tax on the cumulative value of current-year transfers and all gifts made by the same donor after 1976, and then subtracting from the tentative tax the amount of gift tax that would have been paid by the donor on taxable gifts after 1976 if the current year's tax rate schedule had been in effect in each year in which gifts were made. A similar approach is taken to computing the estate tax, by adding in the lifetime taxable gifts made after 1976 and crediting against the estate tax the gift taxes that would have been paid on those transfers had the gift tax rate been the same as it is on the date of death.⁵⁷ Under the 2010 Tax Relief Act, for purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate or gift tax rates in effect under Section 2001(c) at the time of the decedent's death are used to compute both the gift tax imposed with respect to such gifts, and the unified credit allowed against such gifts.⁵⁸

This change makes it certain that the credit against the estate tax for gift tax payable under Section 2001(b) is determined using consistent tax rates, regardless of what the rates actually were when the gifts were made.⁵⁹ For example, consider a donor who made, as her first lifetime taxable gift, a \$2 million taxable gift in 2009. The donor would have paid a gift tax of \$435,000. If that donor dies in 2011, the credit against the estate tax for the gift tax payable

would only be \$350,000 under the amendment, because the credit is based on the 35% tax rate in effect at the date of death (i.e., the tax on the amount of the taxable gift in excess of the \$1 million gift tax exemption in effect in 2009).

To accomplish this result, Section 2001(g) now provides that (1) the gift tax credit is determined by using the rate in effect at death, i.e., 35%, rather than the higher rates that were in effect in 2009, and (2) the unified credit taken into account in calculating the gift tax payable is \$350,000 (using the 35% rate produces a unified credit of this amount given the \$1 million exemption), rather than the greater unified credit that would result if the higher rates in effect at the time of the gift were used in making this calculation.

The precise application of the sunset rule to the GST tax is often difficult or impossible to determine. While the 2010 Act postpones these issues, it does not really resolve them.

The temporary nature of the 2010 Tax Relief Act should incline many clients who are willing to make gifts to accelerate their gratuitous transfers to take full advantage of their \$5 million gift tax exemption before 2013. There remain many in Congress who would like to see the \$5 million exemption rolled back to \$3.5 million, and it is reasonable to assume that no additional tax will be

assessed in such cases on gifts made while the exemption level is \$5 million. The advantage, notwithstanding potential recapture, is the time value of money as recapture may not occur for many, many years, if at all, and future appreciation would escape transfer tax without the imposition of current gift tax.

PORTABILITY OF A DECEASED SPOUSE'S UNUSED EXCLUSION

One of the most important changes under the new law is the addition of the portability of the first deceased spouse's unused basic exclusion amount, referred to now as the "deceased spousal unused exclusion amount."⁶⁰ The 2010 Tax Relief Act amends Section 2010(c)(4) to provide that an executor can elect to allow the decedent's surviving spouse (but no other beneficiary) to take advantage of the deceased spousal unused exclusion amount, for the spouse's estate and gift tax purposes. This rule applies with respect to estates of decedents dying after 2010.

This election must be made on a timely estate tax return that computes the amount of the unused basic exclusion amount and that affirmatively elects for the surviving spouse to receive this deceased spousal unused exclusion amount. The election, once made, is irrevocable.⁶¹

The IRS can examine a deceased first spouse's estate tax return to adjust the amount of the deceased spousal unused exclusion amount passing to the surviving spouse, without any limitations period on the examination.⁶² Therefore, if one spouse's executor elects in 2011 to

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⁵⁶ As indicated by the next following paragraph in the text of this article, Section 2001(b) requires that adjusted taxable gifts be included in determining the estate tax on a decedent's taxable estate but using only the estate tax exemption in effect when the decedent dies. If that exemption is smaller than the amount of exemption used in 2011 or 2012 for lifetime gifts, the benefit of the use of that gift tax exemption over the estate tax exemption in effect when the donor dies appears to be recaptured (although not with respect to growth or income earned after the gift was made).

⁵⁷ Sections 2001(b)(2) and 2502(a).

⁵⁸ 2010 Tax Relief Act section 302(d); Sections 2001(b)(2) and (g). This is different from applying the new law retroactively. For example, if \$5 million of prior gifts were made, although the donor will be treated as having paid less gift tax than the donor actually paid, the donor still may use the enhanced exclusion to shield current additional gifts.

⁵⁹ See note 12, *supra*, page 50, fn. 52.

⁶⁰ 2010 Tax Relief Act section 303(a).

⁶¹ Section 2010(c)(5)(A). Apparently the election cannot be revoked even with the Service's consent.

⁶² Section 2010(c)(5)(B).

pass the deceased spousal unused exclusion amount to the surviving spouse, the Service can audit the first deceased spouse's estate even if the surviving spouse dies decades later, but only in order to determine the deceased spousal unused exclusion amount and the correctness of the election.

The deceased spousal unused exclusion amount can be used by the surviving spouse to offset gift or estate taxes, but it does not increase the surviving spouse's GST exemption.⁶³ This means that anyone wanting to take full advantage of both spouses' GST exemptions must have the first spouse to die create a nonmarital trust or a reverse QTIP marital trust to take advantage of his or her GST exemption.

The increased basic exclusion amount also does not change the base amount on which the obligation to file an estate tax return is set.⁶⁴ The estate of a surviving spouse who has a combined applicable exclusion amount of \$10 million, including a deceased spousal unused exclusion amount of \$5 million and a basic exclusion amount of \$5 million, still would be required to file an estate tax return if the gross estate were over \$5 million.

The deceased spousal unused exclusion amount received by the surviving spouse is not indexed for inflation. Only the surviving spouse's basic exclusion amount benefits from future adjustments to the amount of the exemption to reflect inflation.⁶⁵

Remarriage Problems

The surviving spouse cannot take advantage of a deceased spousal un-

used exclusion amount from more than one predeceasing spouse. Only the deceased spousal unused exclusion amount of "the last such deceased spouse of such surviving spouse" can be used.⁶⁶

EXAMPLE: Harold and Wanda are married, and both are U.S. citizens. On 1/1/11, Wanda makes \$5 million of gifts to trusts for their children, using up all of her basic exclusion amount. Harold dies in 2012, leaving his entire estate outright to Wanda, who now has a \$5 million deceased spousal unused exclusion amount. Wanda then marries Hugo, and dies leaving her entire estate outright to Hugo. Hugo cannot receive any of Wanda's deceased spousal unused exclusion amount, because Hugo is not Harold's surviving spouse. Therefore, Hugo has his own basic exclusion amount, but Wanda's \$5 million deceased spousal unused exclusion amount is wasted.⁶⁷

The extension of time to file a return reporting any generation-skipping transfer is particularly helpful for inter vivos transfers in 2010.

This rule creates several interesting tax and social issues. The Staff of the Joint Committee on Taxation has included in its Technical Explanation an example that strongly suggests that, when a surviving spouse dies, he or she first uses up any deceased spousal unused exclusion amount, before using his or her own

basic exclusion amount. This often will mean that there is more basic exclusion amount remaining to pass to a subsequent surviving spouse.⁶⁸

EXAMPLE: Harold dies in 2011, having made lifetime taxable transfers of \$3 million and leaving his entire estate to his wife, Wanda. Harold has no taxable estate, because the bequests to Wanda qualify for the estate tax marital deduction. Harold's executor files a timely estate tax return and elects to permit Wanda to use Harold's deceased spousal unused exclusion amount. As of Harold's death, Wanda has made no taxable gifts. Thereafter, Wanda's combined exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Harold). Wanda may use this combined exclusion amount for lifetime gifts or for transfers at death.⁶⁹

EXAMPLE: The facts are the same as in the preceding example, except that Wanda later marries William. William also predeceases Wanda, leaving \$4 million of his estate to his children, and the rest to Wanda. William owes no estate tax, because his \$5 million basic exclusion amount exceeds the bequests he is making to his children, and the bequest to Wanda qualifies for the estate tax marital deduction. William's executor files a timely estate tax return electing to permit Wanda to use William's \$1 million deceased spousal unused exclusion amount.

Although the combined amount of unused exclusion of Harold and William is \$3 million (\$2 million for Harold and \$1 million for William), only William's \$1 million unused exclusion is available for use by Wan-

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⁶³ 2010 Tax Relief Act sections 303(b)(1), 303(b)(2). Section 302(b)(1) amends the gift tax rules to create a gift tax exemption equal to "the applicable credit amount in effect [for gift tax purposes] under section 2010(c) [the estate tax provision] which would apply if the donor died as of the end of the calendar year...." Portability of the gift tax exemption is derived from the phrase "which would apply if the donor died as of the end of the calendar year."

⁶⁴ 2010 Tax Relief Act section 303(b)(3); Section 6018(a)(1).

⁶⁵ Section 2010(c)(3)(B).

⁶⁶ Section 2010(c)(4)(B)(i).

⁶⁷ Read literally, the statute appears to call for this result, because it provides that a spouse may only inherit his/her predeceased spouse's unused basic exemption, not the exemption that the predeceased spouse had inherited from his or her prior spouse. As a policy matter, however, this is troubling. If Harold, in this example, had used his exemption in funding the trusts for their children, Wanda would have retained her full \$5 million exemption and she could have passed it along to Hugo. It seems problematic to permit the amount of the exemption that

Hugo can inherit from Wanda to turn on whose exemption was used in funding the trust. Indeed, one could argue that Example 3 in the Joint Committee Explanation (*supra* note 12) could be read as suggesting that Congress intended to permit someone in Hugo's position to inherit a \$5 million exemption from Wanda. The ultimate resolution of this issue will depend on the Regulations or perhaps an alteration in the statutory language.

⁶⁸ See note 12, *supra*, pages 52-53.

⁶⁹ *Id.*, page 52.

da, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount (\$5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, William's \$1 million unused exclusion). Thereafter, Wanda's basic exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million deceased spousal unused exclusion amount from William), which she may use for lifetime gifts or for transfers at death.⁷⁰

EXAMPLE: The facts are the same as in the preceding example, except that Wanda predeceases William. Following Harold's death, Wanda's basic exclusion amount was \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Harold). Wanda made no taxable transfers and had a taxable estate of \$3 million. Wanda's executor files a timely estate tax return and elects to permit William to use her deceased spousal unused exclusion amount, which is \$4 million (Wanda's \$7 million combined exclusion amount less her \$3 million taxable estate). William's applicable exclusion amount is increased by \$4 million—the amount of Wanda's deceased spousal unused exclusion amount.⁷¹

The Code contains no ordering rule, and the example in the Joint Committee's Technical Explanation does not expressly state that there is an ordering rule, though the last example above is difficult to explain without such a rule. Furthermore, the example involves only testamentary dispositions, and any ordering rule might not necessarily have to apply uniformly to testamentary and lifetime uses of a deceased spousal unused exclusion amount. One hopes that this will be clarified by either technical corrections legislation or Regulations.

A surviving spouse's remarriage to someone who uses all of his or her own basic exclusion amount to leave property to others and who also predeceases the surviving spouse will deprive the surviving spouse of the

basic exclusion amount received from the first deceased spouse. This might become a bargaining point in premarital agreement negotiations.⁷²

The determination of the last predeceased spouse of a surviving spouse can be made only when the second (or later) spouse has died. Therefore, it seems likely that the surviving spouse can make gifts using the basic exclusion amount received from the first deceased spouse, if they are made while the second spouse is still alive. The language is not absolutely clear, but it does not appear to require that the surviving spouse surrender the first deceased's spouse's unused basic exclusion amount until it is determined whether or not the surviving spouse survives his or her next spouse, so the use of this exclusion for lifetime gifts should be permissible.

Order of Death Issues

The statute does not address the issue of death of spouses in a common disaster. Regulations will have to clarify how portability will work in this context.

EXAMPLE: Harold and Wanda, a married couple, die in a common disaster under circumstances in which it is not possible to determine who died first. Wanda has \$10 million in assets and Harold has no assets. Under the Uniform Simultaneous Death Act, each spouse is presumed to have survived as to his or her separate assets, and those assets pass to the next persons named in the deceased spouse's governing instruments or under the laws of intestacy.⁷³ Therefore, Wanda's \$10 million estate passes to her alternative beneficiaries.

If Wanda can inherit Harold's unused exemption, there will be no tax liability for either estate, but if she cannot, then her estate will owe \$1,750,000 in estate taxes. Until clarification is provided, it is possible that the inability to establish that Wanda survived Harold will preclude Wanda's estate from using Harold's exemption.

Thus, pending clarification, in this situation Wanda should include a common disaster clause in her es-

tate planning documents that conclusively presumes that Harold survives her, in any situation in which it cannot be established which of them actually survived. Under current law, such a presumption would be respected.⁷⁴ If, as a result, \$5 million passes to Harold, each spouse would be able to fully use the exemption and thereby fully eliminate the tax liability.

Estate planners must take special care to assure that clients who may wish to file a disclaimer do nothing to accept the bequest before they disclaim.

A situation also might arise where death occurs in a clear order, but very close together. In such cases, the positive effects of portability could be forfeited in the absence of sound drafting.

EXAMPLE: The facts are the same as in the immediately preceding example, except that Harold actually survives Wanda by a few hours. Wanda's

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⁷⁰ *Id.*, page 53.

⁷¹ *Id.*, page 54.

⁷² It seems unlikely, however, that portability would actually convince a surviving spouse to marry another individual just because the potential new spouse is relatively poor, in order to obtain the new spouse's unused basic exclusion amount.

⁷³ The Uniform Simultaneous Death Act (1993) and its predecessor, the Uniform Simultaneous Death Act (1940), have been adopted in 49 jurisdictions, including the District of Columbia. Parts of the USDA are also incorporated into the Uniform Probate Code (Revised 1990), section 1-107.

⁷⁴ See Estate of Gordon, 70 TC 404 (1978) (facts in a murder-suicide showed that spouse who was shot first did not necessarily die first, leaving presumption in deceased murderer's will to control and resulting in allowance of the estate tax marital deduction). On problems of simultaneous death generally, see also Arcuri, "Does Simultaneous Really Mean Simultaneous? Interpreting the Uniform Simultaneous Death Act," 17 *Quinnipiac Prob. L.J.* 338-361 (2004); Pagano, "Simul et Semel: Estate Planning Principles and the Uniform Simultaneous Death Act's Corresponding Tax Consequences," 14 *Quinnipiac Prob. L.J.* 449-483 (2000); Pozzuolo and Lassoff, "Use Wills to Maximize Family Protection and Minimize Tax," 73 *Practical Tax Strategies* 81 (August 2004).

will states that no beneficiary is deemed to have survived her unless he or she is alive 120 hours after the date of Wanda's death. Harold would be deemed to have predeceased Wanda for state law purposes and her estate would pass entirely to her next designated beneficiaries. As a result, none of Wanda's assets pass to Harold or his estate, and Harold's unused estate tax exemption is wasted. Wanda's estate cannot use Harold's exemption because Harold actually survived Wanda.

To prevent this outcome, Wanda's document should rebut the presumption to allow half of Wanda's estate to pass to Harold. Harold's estate would then be able to use his exclusion amount fully, which would result in the elimination of the couple's estate tax liability.

Therefore, while at first blush it might appear that portability eliminates the need to take the common disaster into account in drafting, there is in fact a continuing need to draft for this contingency.

Portability vs. Nonmarital Trust

Relying on portability could result in a reduction of the aggregate available shelter from tax, if the exclusion amounts are subsequently reduced. This is specifically contemplated in the statute, which creates a ceiling on portability equal to the basic exclusion amount available at the second death.

Portability will convince a large number of clients that they do not need significant estate tax planning and, for some clients, this will be true. Clients whose total estates are between \$5 million and \$10 million can avoid all estate taxes on both estates, but using simple wills and trusts will have several important

deficiencies in comparison with an arrangement that creates a nonmarital trust at the first spouse's death.

The deceased spousal unused exclusion amount is not adjusted to reflect the appreciation of, or income generated by, specific assets. Coupled with the lack of indexing for the deceased spousal unused exclusion amount, the ability of a nonmarital trust to shelter future growth strongly favors its use.

A couple whose total estate is only slightly over \$5 million may find this point immaterial, but a couple whose total estate is close enough to \$10 million (two basic exemption amounts) that it may exceed that figure before the surviving spouse dies, should very seriously consider using a nonmarital trust at the first spouse's death to protect a greater sum from ultimate estate taxes.

EXAMPLE: Harold dies in 2012, having made no lifetime or testamentary taxable transfers. He leaves his entire estate to his wife, Wanda. Harold's adjusted gross estate is \$10 million, but he has no taxable estate, because the bequests to Wanda qualify for the estate tax marital deduction. Harold's executor files a timely estate tax return and elects to permit Wanda to use Harold's deceased spousal unused exclusion amount. Thereafter, Wanda's combined exclusion amount is \$10 million (her \$5 million basic exclusion amount plus \$5 million deceased spousal unused exclusion amount from Harold).

Wanda dies in 2020, not having remarried. Assume that the 2010 Tax Relief Act portability rules were continued after 2012 and the EGTRRA sunset rules were not permitted to apply to the portability rule or the basic exclusion amounts. Wanda has lived off of the income of her assets, but the corpus of her investments has appreciated by 4% per annum over eight years. Wanda dies with a total estate of \$13,686,000 (\$10 million increased by 4% for eight years).

Wanda's basic exclusion amount, but not her deceased spousal unused exclusion amount, will have been indexed for inflation. Assuming that the

entire 4% growth in the value of Wanda's assets was the same percentage as the rate of inflation, Wanda will have a total of \$11,843,000 of combined exclusion amount (\$5 million deceased spousal unused exclusion amount plus \$6,843,000 of inflation-adjusted basic exclusion amount). Therefore, Wanda will owe \$645,050 of estate taxes (\$13,686,000 adjusted gross estate - \$11,843,000 of combined exclusion amount = \$1,843,000; 35% x \$1,843,000 = \$645,050).⁷⁵

Second, any married couple wanting to take advantage of both \$5 million GST exemptions will need to create a nonmarital GST-exempt trust at the first spouse's death. Portability does not apply with respect to the GST exemption. Couples with estates of \$8 to \$10 million often appreciate the value of avoiding estate taxes for several successive generations, and portability will not really do much to simplify the estate planning for these clients.

Unlike a nonmarital trust, merely leaving one's estate outright to the surviving spouse or to the surviving spouse's revocable trust will not provide many of the other nontax benefits associated with good estate planning, including protection from the claims of creditors of the surviving spouse, protection from the claims of a new spouse, diversion of the assets from the first spouse's family to a new family created on remarriage of the surviving spouse, and professional asset management. Some of these benefits can be achieved with an estate plan that leaves the entire estate in trust for the surviving spouse, but they cannot all be achieved through an outright marital gift or a gift to a surviving spouse's revocable trust.

Unlike a nonmarital trust, the portable annual exclusion would give the surviving spouse a full step-up in basis at death.⁷⁶

This is a distinct advantage of the portable basic exclusion amount over a nonmarital trust, because the nonmarital trust does not receive such a second step-up in basis. On the other hand, the nonmarital trust takes a full basis increase on the first \$5 million of assets passing at the

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⁷⁵ Most of these calculations are rounded to the nearest \$1,000 for purposes of illustrative clarity.
⁷⁶ But see Gans, Blattmachr, and Zeydel, "Supercharged Credit Shelter Trustsm," 21 Probate & Property 52 (July/August 2007), suggesting a method so that the simulation of a "step-up" in basis for a credit-shelter trust can occur essentially at the death of the surviving spouse even though that trust is not included in the gross estate of the surviving spouse.

first spouse's death,* and avoids estate taxes on the balance. For taxable estates, this should almost always be a superior tax result to that produced by an outright gift to the surviving spouse coupled with use of the deceased spousal unused exclusion amount. For estates that are under the \$10 million tax-free level, the basis adjustment strongly favors use of the deceased spousal unused exemption amount.

EXAMPLE: Harold has an estate of \$5 million and his wife, Wanda, has a separate estate of \$1 million. Harold dies in 2012 and leaves his entire estate outright to Wanda. Harold has no estate tax because the gift to Wanda qualifies for the estate tax marital deduction. Harold's assets largely consisted of highly appreciated securities, with an aggregate basis on the date of his death of only \$2 million. Wanda inherits these assets with a full basis step-up to \$5 million.

Wanda dies in 2020, not having remarried. Assume that the 2010 Tax Relief Act portability rules were continued after 2012 and the EGTRRA sunset rules were not permitted to apply to the portability rule or the basic exclusion amounts. Wanda's \$6 million estate has grown by 5% per annum during the eight years between Harold's death and Wanda's death. The \$5 million of securities she inherited from Harold is now worth \$7,387,000. The \$1 million that Wanda already had is now worth \$1,477,000. Wanda's total estate is now worth \$8,864,000 (\$7,387,000 + \$1,477,000). Wanda's estate owes no estate tax, because she had both her own \$5 million basic exclusion amount and Harold's \$5 million deceased spousal unused exclusion amount. Also, Wanda takes a new basis in all of the assets equal to

their estate tax values, which eliminates the income tax on both her own appreciated assets, and also the \$2,387,000 (\$7,387,000 - \$5 million) in appreciation in the assets she inherited from Harold.⁷⁷

EXAMPLE: The facts are the same as in the preceding example, except that Harold had an estate of \$7 million and Wanda had a separate estate of \$3 million. Wanda dies in 2020, with an estate of \$14,775,000 (\$7 million + \$3 million = \$10 million; \$10 million plus 5% per annum for eight years = \$14,775,000). Assume that Wanda's basic exemption amount has been indexed for inflation at a rate of 4% per annum, producing a \$6,843,000 basic exemption amount on the date of her death. Therefore, Wanda owes \$1,026,200 in estate taxes (\$14,775,000 - \$6,843,000 basic exemption amount - \$5 million deceased spousal unused exemption amount = \$2,932,000; 35% × \$2,932,000 = \$1,026,200).

On the other hand, Wanda avoids capital gains taxes on her own estate (which would get a basis step-up under any estate plan) and also on the \$3,342,000 growth in the value of the property she inherited from Harold (\$7 million plus 5% for eight years = \$10,342,000; \$10,342,000 - \$7 million = \$3,342,000 growth). It seems unlikely, however, that the capital gains tax on \$3,342,000 would exceed the \$1,026,200 estate tax on Wanda's estate.⁷⁸

EXAMPLE: The facts are the same as in the preceding example, except that Harold left \$5 million of his \$7 million estate to a nonmarital trust for Wanda's benefit. When Wanda dies in 2020, her gross estate includes her own \$3 million, the appreciation in her own assets at a presumed 5% per annum for eight years

(\$1,432,000), the \$2 million she inherited free of trust from Harold, and the \$955,000 appreciation in the value of the assets she inherited from Harold. Her total estate is \$7,387,000. The \$2,387,000 growth in the value of the nonmarital trust, however, is not included in Wanda's gross estate. Therefore, Wanda's estate tax will be only \$190,000 (\$7,387,000 estate - \$6,843,000 indexed basic exemption amount = \$544,000; 35% × \$544,000 = \$190,000). The nonmarital trust, however, still will owe capital gains taxes on the \$2,387,000 in appreciation in the value of its assets. Of course, these taxes will not be due until the assets themselves are sold, whereas estate taxes are due nine months after the date of death.

Clients who are willing to make gifts may accelerate their gratuitous transfers to take full advantage of their \$5 million gift tax exemption before 2013.

Impact of state estate taxes. A nonmarital trust will be important in any state that still has a state estate tax with an exemption different from the federal basic exclusion amount, if it is anticipated that the estate of the surviving spouse also will be subject to that state's death tax. There are, as of this writing, 13 states with separate estate taxes and exemptions that are lower than the \$5 million basic exemption amount.⁷⁹ In such states, a nonmarital trust is important to take full advantage of both spouses' exemptions and minimize state estate taxes on the surviving spouse's estate. These taxes are often imposed at rates of up to 16%, and avoiding them is not immaterial.

The planner must consider carefully the amount of nonmarital trust that should be used in a state that has a state estate tax exemption lower than the federal exemption amount. Creating a nonmarital trust in the amount of the lower state exemption

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⁷⁷ See note 75, *supra*.
⁷⁸ *Id.*
⁷⁹ See Conn. Stat. section 12-391 (\$3.5 million exemption); D.C. Code sections 47-3701 and 47-3702 (\$1 million exemption); 35 Ill. C.S. section 405/2(b) (\$2 million exemption); Me. Rev. Stat., tit. 36, section 4061 *et seq.* (\$1 million exemption); Md. Tax Code sections 7-304 and 7-309 (\$1 million exemption); Mass. Gen. Stat. tit. 65C, section 2A(a) (\$1 million

exemption); Minn. Stat. section 291.005 (\$1 million exemption); N.J. Stat. section 54:3B-1 (\$675,000 exemption); N.Y. Tax Law section 951 (\$1 million exemption); Ohio Stat. section 5731.02 (\$338,333 exemption); Ore. Stat. section 118.010 (\$1 million exemption); R.I. Stat. section 44-22-1.1 (\$850,000 exemption); Vt. Stat. tit. 32, sections 7402(8), 7442a, and 7475 (\$2 million exemption); Wash. Stat. section 83.100.040 (\$2 million exemption).

figure will avoid all state estate taxes at the first spouse's death, but it will waste part of the federal exemption amount. Creating a \$5 million non-marital trust in the amount of the federal exemption amount will make the fullest use of the federal exemption, but it will generate a state estate tax.

One solution is to create two non-marital trusts, one of which can qualify as a QTIP. The executor would then elect to deduct the QTIP-style nonmarital trust on the federal estate tax return, while not electing to deduct it on the state estate tax return. Some states expressly authorize inconsistent QTIP elections,⁸⁰ while others expressly deny the right.⁸¹

Some practitioners have suggested that, even where state law does not permit a state-only QTIP election, one can be created through the auspices of Rev. Proc. 2001-38, 2001-2 CB 1335. In that Procedure, the Service provided relief for surviving spouses and their estates in situations where a predeceased spouse's estate made an unnecessary QTIP election that did not reduce the estate tax liability of the estate. The IRS explained that a QTIP election would produce no tax benefit for the electing estate where, for example, it was made with respect to an estate that would owe no tax because of the applicable exclusion amount, without regard to the deductibility of the qualifying income interest. Similarly, the Service observed that an estate would obtain no benefit from a QTIP election where the personal representative elected to deduct what was intended to be a nonmarital trust.

Practice Notes

One of the few GST problems created by EGTRRA and not resolved by the 2010 Tax Relief Act is whether the retroactively repealed estate tax repeal for 2010, or the executor's ability to elect out of the estate tax, terminates all existing ETIPs. It is not clear whether an ETIP that literally seemed to have terminated on 1/1/10—because the law then in effect provided there was no estate tax—was reinstated by the retroactive reinstatement of the estate tax. Furthermore, it is not clear whether the mere fact that a decedent's executor could have elected to render the estate tax inapplicable suffices to create a date on which the transferred property would not have been includable in the decedent's gross estate whether or not the transferor did not die during 2010. It is also unclear whether an actual death and election out of the estate tax regime would be required to cause the ETIP to terminate, particularly since death automatically terminates an ETIP under Section 2642(f)(3)(B).

This issue is not merely of academic interest, because the donor cannot allocate GST exemption during an ETIP. A donor who believes that an ETIP in a transfer has terminated in 2010, therefore, should consider either filing a timely gift tax return and allocating GST exemption to shelter the transfer from future GST taxes, or making an election out of automatic allocation, if an allocation of exemption is not desired. If GST exemption had previously been allocated but suspended in taking effect on account of the ETIP rule, it seems the donor could take the position the ETIP ended on 1/1/10, and therefore the allocation of GST exemption became effective.

The IRS stated that it will disregard the QTIP election if the taxpayer produces sufficient evidence that the election did not benefit the electing estate. Such evidence would include, for example, a copy of the decedent's estate tax return showing that the election was unnecessary to reduce the estate tax to zero. The taxpayer seeking to void a QTIP election should make the request on the surviving spouse's estate tax return, or in a private ruling request.

It has been suggested that a decedent's will or revocable trust should

create a separate state-only QTIP, equal to the difference between the decedent's remaining basic exclusion amount and spousal unused exclusion amount, and the state estate tax exemption. The executor could then make the QTIP election for both federal and state purposes with respect to this separate trust. The election for federal estate tax purposes would be ignored by the IRS under Rev. Proc. 2001-38.⁸²

This approach appears to be sound, though a state tax agency may view a federal QTIP election

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⁸⁰ See authority for a state-only QTIP election in Conn. Gen. Stat. section 12-391; Hawaii Info. Rel. 2010-09 (10/6/10); 35 Ill. C.S. section 405/2(b-1); 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); N.Y. TSB-M-10(1)M (3/16/10) (New York Office of Tax Policy Analysis, Taxpayer Guidance Division permits a separate state QTIP election when no federal estate tax return is required to be filed because the estate is under the basic exclusion amount, but otherwise a federal QTIP election is required in order to make a N.Y.

QTIP election); Ohio Stat. section 6731.15(B); Ore. Admin. Regs. section 150-118.010(7); 72 Pa. Stat. Ann. section 9113(a); R.I. Tax Div. Rul. Request No. 2003-03; Tenn. Code section 67-8-315(a)(6); Wash. Rev. Code section 11.08.025(4); Wash. Excise Tax Advisory No. 2013.57015 (5/19/03).

⁸¹ See Iowa Code section 450.3; Minn. Stat. section 291.03(1)(b) (permitting a state-only QTIP, but not allowing it to reduce the taxable estate to less than \$3.5 million); N.J. Admin. Code sections 18:26-3A.8, 19; 18:26-1113 (7/21/08). New Jersey does, however, permit a state-only QTIP election if no federal estate tax return is required to be filed. See 39 New Jersey State Tax News #4 (12/1/10).

⁸² See Gans and Blattmachr, "Quadrartite Will: Decoupling and the Next Generation of Instruments," 32 Estate Planning No. 4 (April 2005), page 3, and Graham, Gans, and Blattmachr, "Quadrartite Will Redux: Coping With the Effects of Decoupling," 32 Estate Planning No. 10 (October 2005), page 15. As discussed in these articles, a surviving spouse's executor might decide not to cause the QTIP election to be disregarded, if the basis adjustment under Section 1014 in the QTIP trust assets would save an amount of income taxes that is greater than the additional state or federal estate taxes imposed by including the QTIP assets in the surviving spouse's gross estate.

that is certain to be ignored by the IRS, if the surviving spouse's executor so requests, as a nullity for state estate tax purposes. A state taking this position would deem a state QTIP election as dependent on there being a federal QTIP election that the surviving spouse's estate cannot cause to be ignored. State statutes and administrative pronouncements requiring a consistent election may not necessarily support this analysis, though each state statute will have to be considered independently.

Portability actually may make it easier for some estates to cope with state estate tax exemptions that are lower than the federal exemption. The first spouse's estate could create a nonmarital trust sufficient to take advantage of the lower state exemption, and then leave the balance of the estate in a marital share. The surviving spouse could count on the portability of the unused exclusion amount from the first estate to shelter the surviving spouse's estate taxes, though as discussed above, this reliance on the deceased spousal unused exclusion amount will not provide protection from tax for income and appreciation in the assets inherited from the first spouse.

Optimal Portability Problems

The optimal planning for clients with estates of under \$7 million may be to leave the entire estate in a QTIP marital trust for the surviving spouse. This provides several distinct advantages:

- It is a very simple estate plan that the family can understand.
- It defers all estate taxes until the surviving spouse's death.
- It eliminates all estate tax on both estates, to the extent sheltered by an indexed \$5 million applicable exclusion amount of the surviving spouse and an unindexed \$5 million applicable

exclusion amount of the first spouse.

- Because the entire trust fund is included in the surviving spouse's estate under Section 2044, the entire trust fund should take an estate-tax-value basis at the surviving spouse's death.
- It offers asset protection planning, the traditional disability asset management and professional investment benefits of a trust.

Some commentators have suggested that one cannot make a QTIP election for a trust unless it is needed to reduce estate taxes, citing Rev. Proc. 2001-38, discussed above. This Procedure does not apply, however, to partial QTIP elections. Rather, it applies only when an election is made for an entire trust and there would be no estate tax were no election made. Therefore, an individual with an estate of more than \$5 million should be able to leave the entire estate to a QTIP for the surviving spouse, without application of Rev. Proc. 2001-38.

An individual with an estate of under \$5 million arguably might be unable to use this approach, because no election was required to reduce the estate tax to zero, although Rev. Proc. 2001-38 suggests otherwise. In that situation, the individual might create a trust for the spouse or the spouse and other family members, but give the surviving spouse a power to appoint the remainder of the trust to his or her estate, exercisable only with the consent of an independent co-trustee. The primary disadvantage of this arrangement is that it may limit the asset protection benefits of the trust, to the extent that state law would permit a creditor of the spouse to compel the co-trustee to consent to the exercise of the power of appointment in favor of the spouse's estate.

The \$7 million figure was selected in this situation because it leaves sufficient room for the estate to grow between the deaths of the first and second spouse without exceeding the combined basic exclusion amounts. Older clients who can expect a shorter time between the deaths of the two spouses may adopt this approach for an estate of \$8 million or \$9 million.

Clients who have large families and anticipate making substantial annual exclusion gifts (including gifts of tuition and medical expenses) also may select a relatively high threshold for adopting this estate plan.

Impermanence of Portability

Under the law as it is written, portability disappears after 2012. Hence, either both spouses must die before 2013 or at least one must die and the other make a significant taxable gift by the end of 2012 in order for portability to be effective. Practical estate planners likely will be hesitant to recommend that their married clients base their estate plans on portability unless and until Congress makes portability permanent.

REPEAL OF SECTION 2511(c)

The 2010 Tax Relief Act repeals Section 2511(c), retroactively.⁸³ EGTRRA had added Section 2511(c), which stated that, after the repeal of the federal estate and GST taxes, and except to the extent provided otherwise in Regulations, "a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under" the grantor trust rules.⁸⁴

The deceased spousal unused exclusion amount received by the surviving spouse is not indexed for inflation.

Section 2511(c) was probably intended to avoid the situation where a transfer might be incomplete for gift tax purposes but complete for income tax purposes, thereby shifting taxable income without incurring a gift tax. The scope of this rule, however, was quite unclear. The statute did not explain whether a transfer to a nongrantor trust that was still an incomplete gift before 2010 would become a completed taxable gift on 1/1/10. The 2002 amendment⁸⁵ clar-

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⁸³ 2010 Tax Relief Act section 301(a).

⁸⁴ EGTRRA section 511(e); Section 2511(c) before amendment by section 411(g)(1) of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147, 3/9/02).

⁸⁵ See note 84, *supra*.

ified that amounts transferred in trust would be treated as transfers of property by gift, despite the fact that they otherwise would have been incomplete under the law in effect before 2010. The 2002 legislation replaced the phrase "taxable gift under section 2503" with the phrase "transfer of property by gift," thereby clarifying that the gift tax annual exclusion and the gift tax marital and charitable deductions may apply to these transfers.⁸⁶

In Notice 2010-19, 2010-7 IRB 404, the Service attempted to clarify the scope of Section 2511(c). The Notice stated that further clarification would be issued, but that it was inaccurate to interpret Section 2511(c) as excluding from the gift tax transfers to a trust treated as a wholly owned grantor trust. The Notice also stated that Section 2511(c) broadened the types of transfers subject to the gift tax to include certain transfers to trusts that, before 2010, would have been considered incomplete, and thus not subject to the gift tax. Section 2511(c), the IRS stated, has no bearing on transfers to wholly owned grantor trusts, or to transfers that otherwise would have been completed gifts.

There still were several types of situations in which the application of Section 2511(c) was unclear. Thanks to the 2010 Tax Relief Act,

however, these are now a matter of historic importance only.

2010 TAX RELIEF ACT IN 2013 AND BEYOND

The 2010 Tax Relief Act reinstates the EGTRRA sunset rule for the changes made by the 2010 Tax Relief Act.⁸⁷ Therefore, if Congress does not make any further changes in the law, on 1/1/13 the estate tax basic exclusion amount and gift tax exemption will return to \$1 million, the GST exemption will return to \$1 million indexed for inflation after 1997, the top estate tax rate will return to 55% (with a 5% surtax on certain very large estates), the top gift tax rate will return to 55%, the GST tax rate will return to 55%, and portability will disappear.

Other Technical Changes

The other EGTRRA changes in the estate tax law—apart from the rates and exemptions—will be preserved at least through 2012 by the 2010 Tax Relief Act. These changes include:

1. Repeal of the state death tax credit (but the allowance under Section 2058 of a federal estate tax deduction for state death tax paid).
2. Expansion of the rules for the estate tax deduction of conservation easements.

3. Allowing automatic allocation of a donor's GST exemption to lifetime transfers that are not direct skips.

4. Allowing a transferor to make a retroactive allocation of GST exemption to a transfer in trust, if a beneficiary of the trust is a non-skip person and a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, assigned to a generation younger than the generation of the transferor, and if that beneficiary dies before the transferor.

5. Allowing the qualified severance of a trust into multiple trusts for GST tax purposes.

6. Providing that the value of property for purposes of determining the GST inclusion ratio, in connection with timely and automatic allocations of GST exemption, would be its value as finally determined for gift or estate tax purposes.

7. Directing the Secretary to grant extensions of time to allocate GST exemption and to grant exceptions to the time requirement, considering all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of

NOTES

⁸⁶ See Staff of the Joint Committee on Taxation, *Technical Explanation of the Job Creation and Worker Assistance Act of 2002* (Comm. Print, 2002), page 38.

⁸⁷ 2010 Tax Relief Act section 304.

transfer and such other factors as the Secretary deems relevant.

8. Providing that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption establishes that GST tax exemptions were allocated to a particular transfer or a particular trust.

9. Expanding the rules governing deferred payment of estate taxes attributable to closely held business interests under Section 6166, by (a) allowing Section 6166 deferral for interests in qualifying lending and financing businesses, but limiting such deferral to five years, and (b) raising from 15 to 45 the number of partners of a partnership or shareholders of a corporation that will be eligible for deferral under Section 6166.

Other Changes Under the 2010 Act

The 2010 Tax Relief Act also includes two other miscellaneous changes in the law that are of interest to estate planners. These are both extensions of tax benefits that were initially designated temporary.

Charitable payments from an IRA.

The 2010 Tax Relief Act extends through 2011 Section 408(d)(8)(F), which allows an individual to pay up to \$100,000 per year from his or her IRA directly to a qualified charity.⁸⁸ The Pension Protection Act of 2006⁸⁹ excludes from the gross income of an IRA participant who has already reached 70½ years of age, annual distributions of up to \$100,000 from a regular or Roth IRA to a qualified charity. This rule does not apply to distributions from a simplified employee pension, a simplified retirement account, or any qualified pension or profit sharing plan.⁹⁰

This rule applies only to distributions made directly to public charities and private foundations, the contributions to which are deductible subject to the 50%-of-AGI limitation. No

exclusion is allowed for distributions to certain donor-advised funds and supporting organizations.⁹¹

Qualified charitable distributions from an IRA count towards the minimum distribution requirements. Thus, by way of example, a participant who was required to withdraw 4% of plan assets under a program of substantially equal periodic payments over the participant's lifetime can instead distribute 3% of the plan assets to a qualifying charity and withdraw 1% personally.⁹²

The 2010 Tax Relief Act extends this rule for another year, and also allows the taxpayer to elect to treat any such qualified charitable distribution made in January 2011 as if it were made on 12/31/10. This election appears to be intended to give taxpayers time to effect the distributions, which sometimes take several weeks to implement.

Certain mutual funds held by NRAs.

The 2010 Tax Relief Act also extends through 2011 Section 2105 (d), under which a proportionate share of the stock in a regulated investment company owned by a non-resident alien decedent is treated as non-U.S. property for estate tax purposes.⁹³ This section excludes from U.S. situs that proportionate share of the property of the regulated investment company which, at the end of the quarter of the company's tax year immediately preceding the date of the decedent's death (or at such other time as may be designated in Regulations), the company's "qualifying assets" bears to all of its assets. For this purpose, qualifying assets include assets that, if owned by the decedent directly on the date of death, would have been excludable bank deposits or other debt obligations, or other non-U.S. situs property.

CONCLUSION

The 2010 Tax Relief Act changes will be good news for most clients, but less welcome by most estate planners.

Very wealthy clients should immediately take advantage of the \$5 million gift tax exemption to make sub-

stantial taxable gifts. Even if the exemption is ultimately reduced back to \$3.5 million—or even \$1 million—the donor will not likely be required to make up the difference for the tax on gifts made in 2011 or 2012.

The largest problem with the 2010 Tax Relief Act is that its provisions are temporary. All tax planning involves a certain degree of forecast and projection, but estate planning is virtually entirely long-term planning. Estate planners often are creating structures that will last for generations. We cannot expect to know now the tax laws that will apply in 20 years, but we should be able to reasonably anticipate that the laws will remain stable for at least more than two years.

Especially if they become permanent, portability and the increased applicable exclusion amount are likely to result in a substantial reduction in the number of clients who seek sophisticated estate tax planning. There may be many reasons for estate planning, but a large percentage of sophisticated planning tends to be prompted by fear of estate taxes.

If the gift tax remains in effect, a client who wishes to transfer substantial family wealth in a manner that permits current enjoyment will continue to require estate planning structures to accomplish these objectives, particularly if the family wealth involves interests in one or more family businesses.

Some clients who do see an estate planner are likely to find appealing the many advantages of an estate plan that uses one or more trusts. For estates that are large enough that an indexed basic exclusion amount and an unindexed deceased spousal unused exclusion amount will protect the surviving spouse's estate from tax (perhaps no more than \$7 million to \$8 million), a traditional estate plan with a nonmarital trust, a GST-exempt trust, a marital trust, and possibly a state-only marital trust, still will be desirable. For the very wealthy client, the enlarged gift tax exemption may prompt more lifetime gifts.

The problem will be getting the client in the door in the first place. ■

NOTES
⁸⁸ 2010 Tax Relief Act section 725.
⁸⁹ P.L. 109-280, 8/17/06.
⁹⁰ Sections 408(d)(8)(A), (B), and (F).
⁹¹ Section 408(d)(8)(B).
⁹² Section 408(d)(8)(D).
⁹³ 2010 Tax Relief Act section 726.