Lapse of the Estate and GST Taxes in 2010? — FAQs

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1. What happens to the estate tax and GST tax if Congress does not pass something before December 31?

In 2010. For 2009, there is a $3.5 million exemption and a 45% top rate for the estate and GST tax. There will be dramatic changes in 2010 under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act"). The estate and GST tax- - but NOT the gift tax- - are set to be repealed for one year beginning January 1, 2010.

For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2). (**Observe, that while no step-UP in basis is allowed, the basis of property can be stepped-DOWN.**) The Conference Report refers to this as the "modified carryover basis regime." Determining the decedent's carryover basis may be a formidable task for many assets. There are two exceptions from the carryover basis provisions: (1) The executor can allocate up to $1.3 million (increased by unused losses and loss carryovers) to increase the basis of assets; and (2) the executor can also allocate up to $3.0 million to increase the basis of assets passing to a surviving spouse, either outright or in a QTIP trust. This is an increased basis of $1.3 and $3.0 million, not assets having a value of $1.3 or $3.0 million, so the allocation process may get complicated. Observe that there may be many estates impacted by the carryover basis provisions that did not have to file estate tax returns with a $3.5 million estate tax exemption. (House officials have estimated that an extension of the estate tax [with a $3.5 million exemption, 45% rate] would have impacted 6,000 estates, but the new carryover basis provisions will affect more than 70,000.) As an example, for highly appreciated estates where there is not a surviving spouse to take advantage of the $3.0 million basis increase, an estate valued at well below the $3.5 million current estate tax exemption level may be subject to carryover basis on some of the estate assets if unrealized appreciation in the estate assets exceeds $1.3 million.

Persons who are subject to various "recapture" provisions are not off the hook in 2010. For example, the QDOT tax (with respect to a qualified domestic trust created to obtain a marital deduction for amounts passing to a noncitizen spouse) on distributions continues for 10 years after the estate tax is repealed, but the QDOT tax that applies at the surviving spouse's subsequent death does not apply if the surviving spouse dies after 2009. Also, the recapture provisions for special use valuation, QFOBI deductions, §6166 installments, and qualified conservation easements continue to apply in 2010.

Section 2511(c) applies to gifts after December 31, 2009. It provides that except as provided in regulations, a transfer in trust is treated as a transfer by gift unless the trust is a wholly owned grantor trust as to the donor or the donor's spouse. This is a rather strange provision. Apparently, the purpose is to prevent an individual from making an "incomplete gift" to a non-grantor trust that avoids gift taxes but still takes advantage of the trust's lower income tax brackets. However, the section might apply in other situations as well and raises many uncertainties. For example, the section could conceivably be interpreted to mean that transfers to the donor's wholly grantor trust will not be treated as gifts even though they otherwise would be treated as gifts under traditional principles. Could the transfer avoid gift taxation as well as avoid estate inclusion if none of the estate tax inclusion sections are triggered? Obviously, this section will need a great deal of clarification by regulations if it is not repealed or revised sometime in 2010.

The gift tax will continue in 2010, but at a 35% top rate rather than the current 45% top rate.

In 2011. **The estate and GST tax returns in 2011 with a $1 million exemption (the GST exemption is $1 million, indexed for inflation) and a 55% top rate (with an additional 5% surtax for certain large estates)**. The gift tax will return to the pre-2001 system ($1 million exemption, 55% top rate) in 2011. The carryover basis provisions of §1022 would no longer apply after the estate tax returns in 2011.

Various other changes made in the 2001 Tax Act would also be eliminated when the estate tax returns in 2011. These include eliminating the conservation easement exclusion under §2031(c), restoring the QFOBI deduction under §2057, eliminating the changes to §6166 regarding installment payments of estate taxes with respect to closely held businesses (for example, the owner requirement to be "closely held" would revert to 15 instead of 45), and eliminating the very helpful provisions regarding the qualified severance rules for GST tax purposes.

From the time this legislation system was put into motion in the 2001 Tax Act, most planners believed that Congress would revise the estate and GST tax before 2010 to avoid the one-year estate and GST tax repeal with carryover basis, and return to the pre-2001 system in 2011.

2. Will Congress act before December 31 to avoid the one-year repeal of the estate and GST tax?

It appears likely that Congress will not act in time. The House of Representatives passed H.R. 4154 to permanently extend the 2009 system ($3.5 million exemption, 45% rate) on December 3, 2009. The permanent extension passed the House without a single Republican vote — the Republicans are holding out for a larger exemption and lower rates; one proposal is for a $5 million exemption and a 35% rate.

It appears that the Senate will not act before the end of the year. A number of senators oppose the permanent extension, hoping to get more favorable provisions (such as a $5 million exemption with a 35% top rate). When it became apparent that the Senate would not approve the permanent extension of the 2009 system, Democratic leaders in the Senate proposed several potential compromises, including extensions of the 2009 system for as short as two months to as long as two years. They proposed attaching those to the 2010 Defense appropriations bill, but at least one Democratic senator plans to oppose that bill. So far, Democrats reportedly have not been able to locate any Republican senator who would support an estate tax extension, and it now appears that the Senate probably will not act on the estate and GST tax before December 31.

Even if the Senate did act, any differences between what it passed and the House bill would then have to be ironed out in conference, and the compromise between both bills then brought back to the House and Senate to be passed again as approved by the conference committee. Since the House is planning to adjourn soon for the balance of the year, there does not appear to be time to avert the lapse of the estate and generation-skipping taxes on January 1st.

3. What should clients do in the waning days of 2009 in light of this confusion?

Some respected planners have suggested to their clients who want to create GST exempt trusts that they should do so before December 31, because there will not be a system in place after January 1 to allocate GST exemption, and there is no certainty that a later reenactment of the GST tax will "grandfather" trusts created before the effective date of the reenactment. However, many planners believe that trusts created in early 2010 when there is no GST tax would not later become subject to the GST tax or- - at the very least- - that there would be provisions permitting late allocation of GST exemption to trusts established in the gap period.

Clients who are considering funding grantor retained annuity trusts ("GRATs") but who really want to have the remainder after the GRAT period continue in trust for grandchildren may want

to hold off until after January 1. There is the possibility that a GRAT created in 2010 before the expected reenactment of the estate tax and the GST tax will not be subject to the GST tax; if so, the GRAT and any trust into which GRAT assets pass would not be subject to the GST tax regime. Under the current GST rules that apply to GRATs, by contrast, no GST exemption can be allocated to a GRAT until the end of the GRAT term, when the assets would pass to long-term trusts for descendants. At that point, substantial GST exemption may be needed to exempt the trust from the GST tax in the future.

Similarly, clients who are considering making large gifts that would require the payment of gift tax may want to wait until 2010, when the gift tax rate would be reduced to 35% (if there is no Congressional action before December 31 to change that result). Also, installment sales where there is a possible gift element if the IRS should determine that the transferred value exceeds the note amount could benefit from a similar delay to 2010.

Remember, that the gift tax is being reduced to a maximum 35% rate, but that it will still exist for all transfers over the $1 million exemption and $13,000 annual exclusions, so there are limited tax-free ways to transfer assets during life, even next year.

4. Will the estate and GST tax be reenacted next year?

At this point, there is "massive, massive confusion" in the words of Senate Finance Committee Chairman, Max Baucus. Some Republicans and conservative Democrats view the one-year repeal as creating leverage to insist on larger exemptions and lower rates (such as the $5 million exemption, 35% rate proposal). If the estate and GST taxes are repealed for a full year, their view is that returning to a $1 million exemption, 55% rate system would be viewed as a massive increase of the unpopular estate tax that would be politically unfathomable for all. However, some Democrats will view the situation as giving them leverage since 60 votes in the Senate will be required to avoid returning to a $1 million exemption, 55% rate system. Key lawmakers expect the fight over the estate tax to intensify next year when the tax is gone, particularly in an election year.

Furthermore, the carryover basis system will be extremely complex to administer and will be unpopular as well.

5. If the estate and GST taxes are reinstituted next year, will they be retroactive to January 1, 2010?

Representative Pomeroy [D-ND] reportedly has stated that the tax would not be applied retroactively to January 1. However, Senate Finance Committee Chairman Max Baucus has said "the correct public policy is to achieve continuity with the respect to the estate tax" and that Congress will "clearly work to do this retroactively." However, that could be viewed as very unfair to people who have died in the interim and could be politically difficult to get through Congress in an election year.

John Buckley, Chief Tax Counsel to the House Ways and Means Committee, has expressed his opinion that reinstituting the estate and GST taxes retroactive to January 1, 2010 would be unconstitutional. While there have been a handful of cases (including U.S. Supreme Court cases) that have upheld the constitutionality of retroactive changes to the transfer tax system, those cases have generally involved retroactive tax rate increases. Supreme Court cases have upheld the validity of retroactive tax legislation, but none has involved a specific rule that has been in the law a long time (such as GRATs, the definition of fair market value, etc.). U.S. v. Hemme, S. Ct. 2071 (1985) upheld the retroactive application of what is now §2010(b). In addition, U.S. v. Carlton, 512 U.S. 26 (1994) upheld the validity of retroactive legislation regarding an estate tax deduction that was allowed at one time under one of the various provisions of §2057 for the sale of stock to

ESOPs (adding that the stock had to be owned by the decedent at the date of death). Some experts believe that it will be much more difficult to uphold the constitutionality of instituting an estate tax and GST tax system retroactively when no system exists, as opposed to just increasing rates retroactively. By analogy, the Supreme Court refused to uphold the retroactive effect of the gift tax, when it was instituted in 1924. Untermyer v. Anderson, 276 U.S. 440 (1928). The Supreme Court in U.S. v. Hemme summarized the Untermyer analysis:

> "In Untermyer, this Court construed the Revenue Act of 1924, which was signed on June 2 of that year and imposed a gift tax on gifts made during the entire calendar year 1924. The Court concluded that, 'so far as applicable to bona fide gifts not made in anticipation of death and fully consummated prior to June 2, 1924, those provisions are arbitrary and invalid under the due process clause of the Fifth Amendment.' Id., at 445. The principal objection to the statute was the absence of notice; the Court endorsed the conclusion, ibid., reached in Blodgett v. Holden, 275 U.S. 142, 147 (1927), where a plurality had found it 'wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing.' … Moreover, Untermyer involved the levy of the first gift tax; its authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws, rather than the creation of a wholly new tax."

If the estate and GST taxes are reenacted retroactively to January 1, no doubt there will be numerous lawsuits over the constitutionality of the provision, which probably will ultimately be resolved by the U.S. Supreme Court after years of litigation in the lower courts.

Another possibility is that the estate and GST tax system will not be reenacted retroactively, but carryover basis would be eliminated retroactively.

6. What planning steps should clients consider in early 2010, when there is the possibility of having no estate or GST tax system in place?

First, consider transfers to long-term trusts for descendants that might be free of GST tax constraints. The trusts would be created at a time when there is no GST tax, and if the GST tax is reinstituted, existing trusts that are created during a time that no GST tax existed may be grandfathered from the new tax. Similarly, consider gifts to grandchildren or more remote descendants that would otherwise be subject to the GST tax as direct skips. (Query, whether the gift to a grandchild or a trust could be defined by a formula based on the maximum amount that can be conveyed currently without the imposition of a GST tax or without changing the GST inclusion ratio of the trust, taking into account any future retroactive legislative changes to the GST tax?) Of course, gifts in excess of the donor's $1 million exemption and $13,000 annual exclusions will be subject to gift tax, but clients who plan to make large gifts anyway should consider doing it early in 2010, when there is a chance that they may pay just a 35% gift tax rather than the 45% top rate that applies this year and the top 55% rate that will apply beginning in 2011.

Keep in mind that the Administration proposes to dramatically change the rules regarding valuation discounts. If there is an estate and gift tax reform package adopted next year, it could include that provision. If there is no legislation, there are indications that the IRS will issue regulations under §2704 that would place significant restrictions on valuation discounts on entities that are valued on the basis of their liquidation value (such as family limited partnerships holding marketable securities or other assets other than operating businesses.)

Therefore, to have a chance to take advantage of the lower 35% rates in 2010 and to avoid the coming restrictions on valuation discounts, clients should consider make desired gifts and sales as early in the year as possible.

7. Are there possible planning steps in early 2010 for trusts that are now subject to the GST tax if the estate and GST tax is repealed?

If a trust that is subject to the GST tax makes a distribution or terminates and assets pass to beneficiaries two or more generations below the original donor, there is currently a 45% GST tax. If the trust makes a distribution or terminates in early 2010, and assets pass to such younger beneficiaries, there may be no GST tax imposed if there is no GST tax system in place. However, remember that there is a significant risk that the GST tax will later be enacted retroactive to January 1, and the GST tax would apply unless the courts hold that the retroactive application of the tax is unconstitutional. (Could a defined value clause be used, as mentioned above, to define the amount distributed by a formula based on the maximum amount that can be distributed currently without the imposition of a GST tax, taking into account any future retroactive legislative changes to the GST tax?) In light of the uncertainty, clients may be wary of making large transfers unless a GST tax is otherwise expected in the relatively near future. Of course, the distribution or early termination must be permissible under the terms of the trust agreement, as it currently exists or as it may be revised by court action.

If a client is a beneficiary of a marital trust that will be taxed at his or her death (if the estate tax is reinstituted), another planning possibility is to have the trustee make a significant distribution to the client, and have the client make gifts to children or grandchildren, again planning to take advantage of the possibility of the lower 35% gift tax rate and the ability to make such gifts in long-term trusts that may escape GST tax.

8. If the estate and GST taxes are repealed, how will that impact clients' estate plans, and must clients then have their estate planning documents reviewed?

A typical estate plan for married individuals is to leave as much as possible to trusts or individuals other than the surviving spouse without generating any federal estate tax (in order to avoid having those assets be subjected to estate tax at the surviving spouse's subsequent death). Those types of plans may be impacted dramatically by this law change. For example, if a client's plan is to leave as much as possible to a credit shelter trust for the decedent's children without generating federal estate taxes at the first spouse's death, with the balance of the estate passing to the surviving spouse, that plan may be construed to leave the entire estate to the trust for the children if there is no federal estate tax system in place (depending on the specific wording of the formula bequests). That might cut out the surviving spouse from receiving anything under the first decedent-spouse's will, and may not at all be what the client intended. In those situations, there may be expensive court fights over the construction of the document in light of the client's intent, but the laws of most states are that the client's intent is irrelevant if the document is not ambiguous. Particularly for married individuals with these kinds of formula driven clauses, it will be important for clients to have their estate plans reviewed.

Furthermore, planners may wish to take into account the possibility of a continuing carryover basis system. Planners have generally assumed we would never get to the point of having a carryover basis system, and have not included provisions in estate planning documents to provide flexibility in taking advantage of the $1.3 million (for any recipients) and $3.0 million (for surviving spouses) basis increase allocations by executors. Drafting to account for these provisions can be complex. Issues include:

- Leaving enough assets to spouses to be able to take full advantage of the $3.0 million of basis increase. Of course, the value that must be left to the spouse (or to a QTIP trust) depends on the amount of unrealized appreciation in those assets; and
- Giving the executor the discretion to make the allocations, including allocations to non-probate property and possible allocations to property passing to the executor

Some planners may continue to ignore these carryover basis complexities, under the assumption that the carryover basis provisions will ultimately be repealed.

Any change in the plan should, of course, take account of the very strong possibility that the estate tax will be reenacted and that the carryover basis provisions will be repealed, so that the plan would not have to be redrafted yet again if and when that happens.

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