Estate Planning Effects and Strategies Under the "Tax Relief... Act of 2010"

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I. Brief Historical Background of TRA 2010

Republican leaders came to agreement with President Obama on December 6, 2010 to extend the "Bush income tax rates" for two years, not limited to just "middle class" taxpayers with less than $200,000 ($250,000 joint returns) and to extend unemployment benefits. Surprisingly, the agreement included extension of the estate tax for two years with a $5 million exemption and 35% rate (the exemption amount and rate urged by various Republican leaders over the last several years). (Apparently, the final "sticking points" in "making a deal" on the overall agreement were the estate tax provisions requested by Republican leaders and the renewal of "refundable tax credits" as urged by the Administration, and the final agreement came in meetings between Vice President Biden and Senate Minority Leader Mitch McConnell.)

Following discussions (and probably negotiations) with Congressional staffers about the details of the estate tax provisions and all of the other details of the broad agreement regarding taxes and unemployment insurance, the Senate Finance Committee released an amendment sponsored by Senators Harry Reid and Mitch McConnell containing the statutory language being considered by the Senate. The bill is an amendment of H.R. 4853 (which authorizes funding of the Airport and Airway Trust Fund), and proposes the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." (This proposal is referred to in this summary as "TRA 2010.")

The TRA 2010 proposal comes on the heels of a proposal by Senate Finance Committee Chair Max Baucus on December 2, 2010 of a Senate amendment of the same H.R. 4853, which amendment proposed the "Middle Class Tax Cut Act of 2010." That bill was defeated by the Senate on December 4, 2010, but of interest to the estate planning community are various estate and gift tax measures that were included in it. The following is a link to the "Baucus bill" containing the proposed Middle Class Tax Cut Act of 2010, a Summary of the proposal, and estimated budget effects of the proposal: http://finance.senate.gov/legislation/details/?id=bda915fc-5056-a032-5262-6a1899fee4e3. The following summary sometimes refers to differences between TRA 2010 and the "Baucus bill."

TRA 2010 was approved by the Senate on December 15 (by a vote of 81-19) and by the House on December 16 (by a vote of 277-148). President Obama signed the legislation on December 17, 2010 (the date of enactment). Text of the legislation is available at http://finance.senate.gov/legislation/details/?id=10874ed6-5056-a032-52cd-99708697eff0. Joint Committee on Taxation revenue estimates of the bill are available at http://op.bna.com/dt.nsf/r?Open=vmar-8bz3bn.

II. Title and Temporary Relief

A. Short Title. The "short" title is "Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010." [TRA 2010 § 1.] How's that for a *short* title?

B. Temporary Extension of Tax Relief. TRA 2010 generally provides various tax provisions that apply for just two years. This is accomplished first by extending the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") generally for two years, including the extension of the "Bush tax cuts" and the estate tax provisions. [TRA 2010 § 101(a) amends EGTRAA (effective as if enacted as part of EGTRRA in 2001) by amending section 901 of EGTRRA (the sunset provision) to extend the EGTRRA sunset to specified events occurring after December 31, 2012 (instead of December 31, 2010). Therefore, all of the provisions of EGTRRA generally are extended through 2012.]

In addition, TRA 2010 provides that the EGTRRA sunset provisions in section 901 of EGTRRA apply to all of the amendments in the title containing the estate and gift tax provisions. [TRA 2010 § 304 says that section 901 of EGTRRA applies "to the amendments made by this section" (apparently it meant to say "this title" to refer to all of the "Temporary Estate Tax Relief" provisions in title III of TRA 2010), so the estate, gift and GST tax amendments made by TRA 2010 also sunset after 2012.]

III. Brief Summary of Tax Provisions Other Than Estate, Gift and GST Tax Provisions

A. Income Tax Rates. Taxpayers at every income level would have the lower rates enacted in EGTRRA continued for two years. The top rate, on taxable income above $379,150, would stay at 35% instead of increasing to 39.6%. (Two-year cost: $186.8 billion)

B. Itemized Deductions. The personal exemption phase-out and itemized deduction limitation were both repealed for one year under EGTRRA. The repeal of both of these provisions is extended for an additional two years. This is important, for example, with respect to deductions available for large charitable contributions. Prior to the phase-out of the limitations on itemized deductions, the allowable total amount of itemized deductions was reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeded a threshold amount that was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80%. For high income taxpayers, reducing the otherwise allowable charitable deductions (as well as other itemized deductions) by as much as 80% is a substantial tax detriment. (Cost: $20.7 billion)

C. Capital Gains and Dividends Rates. Lower capital gains and dividend rates are extended for two years. The lower rates are: taxpayers below 25% bracket: 0%, taxpayers above 25% bracket 15%. If those rates expire, the rates would become 10% and 20%, respectively, and dividends would be taxed as ordinary income. (Cost: $53.2 billion)

D. Social Security Tax Cut of 2%. All taxpayers, including self-employed individuals, have a one year reduction in the "social security payroll tax" of 2 percentage points in 2011. For individuals, the employee rate is reduced from 6.2% to 4.2% (the old age, survivors, and disability insurance tax on the taxable wage base ($106,800 in 2010)). The employer tax rate remains at 6.2%. For self-employed individuals, the rate is reduced from 12.4% to 10.4% for taxable years of individuals that begin in 2011. (Cost: $112 billion)

E. Alternative Minimum Tax. The AMT exemption amounts are increased to $47,450 ($72, 450 for joint returns) for 2010 and to $48,450 ($74,450 for joint returns) for 2011. (Over 20 million households are spared from tax increases averaging $3,900 as a result of this change.) (Cost: $136.7 billion)

F. IRA Charitable Rollover. Among the tax extenders are the IRA Charitable Rollover provisions, which technically expired at the end of 2009. The IRA Charitable Rollover is extended for two years, through 2011, which allows individuals who are at least 70 ½ to transfer up to $100,000 per year directly to a qualified public charity (not a donor advised fund or supporting organization) without being treated as a taxable withdrawal from the IRA. The transfer can be counted toward the required minimum distribution. The measure applies to all charitable distributions throughout 2010, and distributions made any time during 2010 or in January of 2011 can be counted toward the $100,000 limit for 2010. Individuals who have already taken their 2010 required minimum distributions cannot "undo" those distributions and instead make a charitable distribution to satisfy their 2010 required minimum distributions. (Cost: $979 million)

G. Deduction for State and Local Sales Taxes. The federal deduction for state and local sales taxes is extended for 2010 and 2011. (This is near and dear to residents of Texas and the other eight states without state income taxes.) (Cost: $5.5 billion)

H. Estate, Gift and GST Tax Cost. The estate, gift and GST provisions are discussed in detail below. (Cost: $68.1 billion)

IV. General Summary of Estate, Gift and GST Tax Provisions

A. Estate, Gift and GST Tax Exemptions and Rates. TRA 2010 generally sets the estate, gift and GST exemption at $5.0 million, indexed from 2010 beginning in 2012, [TRA 2010 § 302(a)(1)] and sets the maximum rate at 35%. [TRA 2010 § 302(a)(2)]. The $5 million exemptions generally apply in 2010 [TRA § 302(f)], except that the gift exemption remains at $1.0 million for 2010 [TRA § 302(b)(1)(B)].

B. Estate Tax in 2010.

1. Default Rule — Estate Tax Applies in 2010. The estate tax applies to estates of decedents dying in 2010. As discussed above, the estate tax exemption in 2010 is $5.0 million and the rate is 35%. (For various issues discussed below, it is important to keep in mind that the *default* rule is that the estate tax applies in 2010.) This reenactment of the estate tax for 2010 is in a complicated section of TRA 2010 that sunsets certain provisions of EGTRRA as if they had never been enacted. TRA 2010 §301(a) provides that "[e]ach provision of subtitle A or E of title V of [EGTRRA] is amended to read as such provision would read if such subtitle had never been enacted." Subtitle A contains I.R.C. § 2210, which says that Chapter 11 [containing the estate tax provisions] does not apply to decedents dying after 2009 (except as to certain distributions from QDOTs) and I.R.C. § 2664 (which says that Chapter 13 does not apply to GST transfers after 2009). Subtitle E contains the carryover basis provisions. The Code would be interpreted as if those provisions of EGTRRA (repealing the estate and GST tax and enacting carryover basis) had never been enacted. [TRA 2010 § 301(a).] The provision retroactively applies to decedents dying after and generation skipping transfers after December 31, 2009. [TRA 2010 § 301(e).]

2. Carryover Basis Election for 2010 Decedents. Executors (within the meaning of I.R.C. § 2203) of estates of decedents who die in 2010 (all of 2010, not just decedents who die on or before the date of enactment, as provided in the Baucus bill) may elect to have the modified basis rules of I.R.C. § 1022 apply "with respect to property acquired or passing from the decedent" within the meaning of I.R.C. § 1014(b)) instead of the estate tax. [TRA 2010 § 301(c).]

Large estates (not covered by the $5 million exemption) that would otherwise have to pay substantial estate taxes will likely make this election. However, the executor will have to consider a variety of factors in making this decision, such as whether the election will change the amounts passing under formula bequests (see section IX.A.1 of this outline); the amount of estate tax payable currently vs. the gain that would be subject to income tax on a future sale of assets (keeping in mind that income tax rates may *exceed* estate tax rates), anticipated dates of sale, the character of the gain (for example, the Joint Committee on Taxation Technical Explanation say that "real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir");

whether future depreciation can be used to derive current income tax benefits even without selling an asset, ability to allocate basis adjustments up to fair market value at the date of death for assets that will likely be sold in the near future, anticipated future capital gains rates (and ordinary income rates for "ordinary income property"), and weighing the present value of anticipated income tax costs against the current estate tax amount. Some rather subtle effects of making the election include: there will be no benefit of a deduction against federal estate taxes for the payment of state death taxes; there will be no § 691(c) deduction for estate taxes attributable to income in respect of a decedent property; there will be no ability to use a prior transfer credit under § 2013; the election may impact the ability to make a QTIP election for only state purposes, and expenses of administering the estate may be affected (by making or not making the election).

Practical Planning Pointer: The executor should carefully document and retain the analysis of the rationale for whatever decision is made regarding the carryover basis election.

Section 301(c) says the election is to be made "at such time and in such manner" as prescribed by the Secretary of the Treasury or his delegate (interestingly, not requiring regulations). Presumably, the IRS will promulgate a new form to make this election. In light of the fact that the statute extends the due date of the estate tax return for 2010 decedents who died before December 17, 2010 to no earlier than September 19, 2011, we could anticipate that there would be a similar due date for the election for the estate tax not to apply to the estate.

Practical Planning Pointer: Estates of decedents dying in 2010 with gross estates under $5 million would not be required to file an estate tax return under I.R.C. § 6018(a)(1), and there is nothing in TRA 2010 changing that result. Those estates will not make the carryover basis election, so those estates apparently will not have to file either an estate tax return or the carryover basis report that would apply under § 6018 to estates that make the carryover basis election. (There has been no official confirmation of this by the IRS, but it seems the clear answer under the statutory language.) For estates that are over $5 million and that may want to make the carryover basis election so that the estate tax will not apply, planners are quite anxious to find out exactly what must be filed and when in order to make sure that the estate tax does not apply. For estates of decedents who died earlier in 2010, there seems to be no necessity of filing an extension of time to file the estate tax return, because of the extended September 19, 2011 due date. (However some cautious planners may do so anyway.) Query whether a further discretionary six-month extension under I.R.C. § 6081(a) will be allowed?

This carryover basis election is described in TRA 2010 § 301(c). It is a complicated section, applying double and triple negatives.

> "Notwithstanding subsection (a) [which says that subtitle A or E of title V of EGTRAA are treated as having never been enacted], in the case of a decedent dying after December 31, 2009, and before January 1, 2011, the executor (within the meaning of section 2203 of the Internal Revenue Code of 1986) may elect to apply such Code as though the amendments made by subsection (a) do not apply with respect to chapter 11 of such Code and

> with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code.)" TRA 2010 § 301(c).

Applying this language in steps:

- If this election is made, the amendments made by TRA 2010 § 301(a) do not apply. This involves a triple negative. The estate tax was repealed by I.R.C. § 2210 ("chapter 11 shall not apply…"), which was included in subtitle A of title V of EGTRRA, for decedents dying after 2009 (Negative 1-estate tax does *not* apply). The repeal of the estate tax is repealed, effective 1-1-2010, under TRA 2010 § 301(a) (as if subtitle A "had never been enacted") (Negative 2, negating Negative 1-so estate tax *does* apply). If the carryover basis election is made, the "repeal of the repeal" in TRA 2010 § 301(a) does not apply (Negative 3). This means that the estate tax does *not* apply. (Is your head swimming yet?)
- Similarly, carryover basis does apply under a similar stepped analysis if the election is made. Carryover basis was instituted under I.R.C. § 1022, as included in subtitle E of title V of EGTRRA for decedents dying after 2009. The carryover basis provisions are repealed, effective 1-1-2010, under TRA 2010 § 301(a) (as if subtitle E "had never been enacted"). If the carryover basis election is made, the amendments in TRA 2010 § 301(a) do not apply, so the repeal of carryover basis is undone, so carryover basis *does* apply.
- The election (which undoes the "repeal of the repeal" of the estate tax and reinstitutes carryover basis) applies "*with respect to chapter 11 of such Code*…." This clause, perhaps among other things, means that the amendment in § 301(a) that repeals subtitle A of title V of EGTRRA, which contained I.R.C. § 2210 repealing the estate tax and §2664 repealing the GST tax, does not apply with respect to chapter 11 (meaning that the estate tax *is* repealed), but does continue to apply with respect to the repeal of §2664. Therefore, the repeal of the GST tax repeal is not undone. That is a technical correction of the similar provision in the Baucus bill.
- The election applies "with respect to property acquired or passing from such decedent (within the meaning of section 1014(b)…)." This is an obvious reference to carryover basis applying for property acquired or passing from the decedent. (It would seem that the provision could have referred just to property "acquired from such decedent" because I.R.C. § 1022(e), which remains in effect because subtitle E of title V of EGTRRA is not repealed as a result of the election, defines "property acquired from the decedent" as including property passing from the decedent by reason of death to the extent that it passes without consideration.)

If the carryover basis election is made, the last sentence of TRA 2010 § 301(c) adds that for purposes of I.R.C. § 2652(a)(1), "the determination of whether any property is subject to the tax imposed by such chapter 11 shall be made without regard to any election made under this subsection." Section 2652(a)(1) defines "transferor" for GST tax purposes as the last person who was subject to a transfer tax. This sentence means that for GST purposes the decedent is deemed to be subject to the estate tax and is therefore the "transferor" even though chapter 11

does not apply to the decedent in that circumstance. See section VIII.G of this outline for a discussion of this last sentence.

3. Extension of Time to File and Pay Estate Tax and GST Tax and to Make Disclaimers.

   a. Estate Tax. The estate tax return and payment date of estate tax is extended to no earlier than nine months after the date of enactment. The extension applies to estates of decedents dying from January 1, 2010 to the day before the date of enactment. (The extension in the Baucus bill was only for four months rather than nine months.) [TRA 2010 § 301(d).]

      Practical Planning Pointer: The date of enactment is December 17, 2010, so the due date is extended to September 17, 2011, which falls on a Saturday, so the due date of estate tax returns for 2010 decedents is no earlier than September 19, 2011.

   b. Carryover Basis Report. Under current law, the carryover basis report under § 6018 is required to be filed with the decedent's final income tax return. I.R.C. § 6075(a). The due date for filing this report may also be deferred to nine months after the date of enactment. [TRA 2010 § 301(d)(1)(A).] EGTRRA amended I.R.C. § 6018 for decedents dying after 2009 to refer to a carryover basis information return instead of the estate tax return (because the estate tax does not apply under EGTRRA to decedents dying after 2009). That amendment to § 6018 (and the change to § 6075(a) regarding the due date of the carryover basis report) were in subtitle E of title V of EGTRRA, and TRA 2010 § 301(a) interprets the Code as if subtitle E had never been enacted. Therefore, the default rule under TRA 2010 is that § 6018 now refers to the estate tax return, not the carryover basis information report. However, if the carryover basis election is made, the amendment in §301(a) does not apply as to the estate tax or carryover basis, so § 6018 continues to refer to the carryover basis report and not the estate tax return and § 6075(a) continues to require that the report be filed with the decedent's final income tax return. Section 301(d)(1)(A) extends the filing date of the estate tax return, but *not* the carryover basis report. While it refers to extending the due date for filing any return under § 6018 and while that will mean the carryover basis report if the carryover basis election is made under § 301(c) of TRA 2010, § 301(d)(1)(A) specifically says the extension applies to any return under § 6018 "as such section is in effect after the date of this enactment of this Act *without regard to any election under subsection (c)*." Therefore, this provision in § 301(d)(1)(A) does not override I.R.C. § 6075 regarding the due date of the carryover basis report.

      The IRS issued a draft of Form 8939 for comments on December 16, 2010. The draft form does not include instructions. The draft form does not contain any election provision (in light of the fact that the draft was prepared before TRA 2010 was enacted providing for the election). The form contemplates that the specific assets passing to each distributee (together with the carryover basis, value, holding period and basis adjustment allocation for each asset) will be listed on the form. (The form

does not address what will happen if the executor has not paid all debts and expenses, paid all taxes and made final distributions of the assets to the beneficiaries by the time the form is due. Until all of that has happened, the executor cannot know what specific assets will pass to the respective beneficiaries.)

c. Disclaimers. The time for making any disclaimer under I.R.C. § 2518(b) for property passing by reason of the death of a decedent (who dies after 2009) is extended to nine months after the date of enactment. [TRA § 301(d)(1)(C).] (The Baucus bill applied the disclaimer extension, as well as the other extensions, only for 2010 decedents who die before the date of enactment and referred to an extension before the time of "receiving" a disclaimer rather than the time for "making" a disclaimer.) This opens up additional planning flexibility, in light of the dramatic change in estate tax treatment under TRA 2010. Concerns with being able to take advantage of this additional time include (1) that beneficiaries may have already accepted benefits, not realizing that the disclaimer period would be extended, and (2) state law requirements for disclaimers often refer to nine months after the transfer, so disclaimers during the extended time period may not satisfy the state law requirements. Query whether states will respond by amending their disclaimer statutes for decedents dying in 2010 before the date of enactment? Keep in mind that I.R.C. § 2518(c)(3) provides that transfers that do not qualify as disclaimers under local law may still constitute a qualified disclaimer under federal law, as long as the disclaimer operates as a valid transfer under local law to the persons who would have received the property had it been a qualified disclaimer under local law.

Practical Planning Pointer: Recite in the deed or other transfer document that the transfer is intended as a qualified disclaimer for federal tax purposes and that the assets are passing to the same persons who would have received the property had the transferor made a valid disclaimer.

Extended Due Date: The extended disclaimer period runs until September 19, 2011 for 2010 decedents who die before December 17, 2010. Presumably the "holiday" rule under I.R.C. § 7503 will apply because it refers to the day "prescribed under authority of the internal revenue laws for performing any act;" it is not limited just to tax returns. (For decedents who die on or after December 17, the 9-month period will run as usual, which will be sometime on or after September 17, 2011.)

d. GST Tax Returns. The date for filing any return under I.R.C. § 2662 to report a "generation-skipping transfer" made in 2010 before the date of enactment (December 17) is extended to no earlier than 9 months after the date of enactment (or September 17, 2011, which is a Saturday, so the extended due date would be no earlier than September 19, 2011). [TRA § 301(d)(2).]

Practical Impact: For generation skipping transfers (i.e., direct skips, taxable distributions or taxable terminations), the due date for reporting the transaction on an appropriate return is extended to no earlier than September 19, 2011. (The GST transfer would be reported on the form, but

the GST tax rate would be zero. Query whether there is any penalty for failing to file the return on time if the penalty is based on the amount of unpaid tax?) The time for filing a timely return to make a timely allocation of GST exemption or to make a timely election out of automatic allocation to a direct skip would be extended to September 19, 2011. (For a lifetime direct skip that would be reported on a gift tax return, if the income tax return is extended, the extended due date (October 17, 2011) would be past the September 19 date in any event.)

Practical Planning Pointer: While the time to file GST returns to report "generation-skipping transfers" that occur before December 17 in 2010 is extended, there does not appear to be an extension of time for filing a return to make timely allocations of GST exemption (or elect out of automatic allocations) for "indirect skip" transfers to trusts that are not direct skips.

e. Applicable for Estates of Decedents Dying in 2010 Before Date of Enactment. The extension period for filing returns and paying taxes and for making disclaimers applies to estates of decedents dying in 2010 and before the date of enactment (December 17, 2010). Similarly, the extended due dates for GST returns applies for a generation-skipping transfers made in 2010 before the date of enactment. [TRA 2010 § 301(d).]

C. Portability. The executor of a deceased spouse's estate may transfer any unused estate exemption to the surviving spouse. [TRA 2010 § 303.]

1. Estate Tax Exclusion Amount Definition Change. The portability concept is accomplished by amending I.R.C. § 2010(c) to provide that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" ($5.0 million, indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount." [I.R.C. § 2010(c)(2), as amended by TRA § 302(a).]

2. Deceased Spousal Unused Exclusion Amount. The "deceased spousal unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in new § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under I.R.C. § 2001(b)(1)").

The first item limits the unused exclusion to the amount of the basic exclusion amount. Therefore, if the estate tax exclusion amount decreases by the time of the surviving spouse's death, the lower basic exclusion amount would be the limit on the unused exclusion of the predeceased spouse that could be used by the surviving spouse.

The second item is the last deceased spouse's remaining unused exemption amount. Observe that it is strictly defined as the predeceased spouse's basic exclusion amount less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a privity requirement (discussed below in section IV.C.6 of this outline).

3. Statute of Limitations on Review of Predeceased Spouse's Estate to Determine Unused Exclusion Amount. Notwithstanding the statute of limitations on assessing estate or gift taxes for the predeceased spouse, the IRS may examine the return of a predeceased spouse at any time for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. I.R.C. § 2010(c)(5)(B), as amended by TRA 2010 § 303(a).

4. Must be Timely Filed Estate Tax Return and Election for Predeceased Spouse's Estate. The Act continues the position of prior portability bills that the executor of the first spouse's estate must file an estate tax return on a timely basis and make an election to permit the surviving spouse to utilize the unused exemption. (Therefore, even small estates of married persons must consider whether to file an estate tax return for the first deceased spouse's estate.)

5. Only Last Deceased Spouse's Unused Exclusion Amount Applies. Only the most recent deceased spouse's unused exemption may be used by the surviving spouse (this is different from prior portability legislative proposals). I.R.C. § 2010(c)(5)(B)(i), as amended. An explanation of TRA 2010 by the Joint Committee on Taxation reiterates that this requirement applies even if the *last* deceased spouse has no unused exclusion and even if the *last* deceased spouse does not make a timely election. 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 State Senate, 52 n.57 (Dec. 10, 2010)[hereinafter Joint Committee on Taxation Technical Explanation].

6. Privity Requirement. A spouse may not use his or her spouse's "deceased spousal unused exclusion amount." This is sometimes referred to as the "privity" requirement. For example, assume H1 dies and W has his deceased spousal unused exclusion amount, and assume W remarries H2. If W dies before H2, H2 may then use the deceased spousal unused exclusion amount from W's unused basic exclusion amount, but may not utilize any of H1s unused exclusion amount. The definition of the "deceased spousal unused exclusion amount" has no element at all that might include a deceased person's unused exclusion from a prior spouse in determining how much unused exclusion can be used by a surviving spouse. However, the Joint Committee on Taxation Technical Explanation has an Example that appears inconsistent with this conclusion.

> "Example 3. [Husband 1 dies with $2 million of unused exclusion amount.] Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife." Joint Committee on Taxation Technical Explanation at 53.

This example assumes that Wife's deceased spouse unused exclusion amount, which could be used by Husband 2, is Wife's $7 million exclusion amount (which includes the deceased spousal unused exclusion from Husband 1) less her $3 million taxable estate. This would suggest that Husband 2 *does* get to take advantage of the unused exclusion amount from Husband 1. One might argue that this is just a matter of determining whether Wife first uses her own exclusion or first uses Husband 1's unused exclusion before using her own. If she first uses the unused exclusion that she received from Husband 1, her $3 million taxable estate, less Husband's 1's $2 million exclusion, would leave $1 million of taxable estate to be offset by $1 million of Wife's basic exclusion, leaving unused exclusion of $4 million for Husband 2. However, that approach is not consistent with the statutory definition of the "deceased spousal unused exclusion amount." Under the statutory definition, the deceased spousal unused exclusion amount that Husband 2 could have from Wife is determined as follows:

Lesser of:

(1) Basic exclusion amount		$5 million
Or		
(2) Wife's basic exclusion amount	$5 million	
Less		
Wife's taxable estate plus adjusted taxable gifts	$3 million	
Item (2)		$2 million

There is nothing in the statutory definition that makes any references whatsoever to the amount of Wife's unused exclusion from Husband 1 in determining the amount of the unused exclusion that Husband 2 has from Wife. However, the Joint Committee on Taxation Technical Explanation appears to adopts a concept of first using any deceased spousal unused exclusion at the death of a surviving spouse, and the IRS might be expected to interpret the statute in that manner.

7. Applies for Gift Tax Purposes. Portability applies for the gift exemption as well as the estate exemption. TRA 2010 § 303(b)(1) amends I.R.C. § 2505(a)(1), which describes the "applicable credit amount" for gift tax purposes, by referring to the applicable credit amount under § 2010(c) "which would apply if the donor died as of the end of the calendar year…" (Under § 2505(a)(2), the credit amount is further reduced by the amounts of credit allowable in preceding years.) The applicable credit amount under § 2010(c) includes the deceased spousal unused exclusion amount, so that amount is also included in the gift exemption amount.

Example 1. Husband 1 dies in 2011 with a taxable estate of $1 million, leaving a "deceased spousal unused credit amount" for Wife of $4 million. If later in 2011 Wife makes a large gift, her gift exemption under § 2505(a) is the estate tax applicable credit amount under § 2010(c) that would apply if Wife died as of the end of 2011. If Wife died at the end of 2011, her estate tax applicable credit amount would be her basic exclusion amount ($5 million) plus the amount of her deceased spousal unused credit amount ($4 million), or $9 million.

Example 2 (Gift in 2011). Assume the same facts as Example 1, but assume Wife makes a taxable gift of $4 million in 2011. (Apparently, it makes no difference

whether Wife makes the gift before or after Husband 1 dies — her gift exemption is determined as if she had died on the last day of the calendar year, which would be after Husband 1 died.) Does the 2011 gift utilize Wife's own gift exemption amount first, or does it utilize her deceased spousal unused exclusion amount from Husband 1 first? Example 3 in the Joint Committee on Taxation Technical Explanation might be read as saying that the deceased spousal unused credit would be used first (at least for estate tax purposes). However, there is nothing in the statutory language suggesting that either spouse's credit would be used first. It just says that Wife has a credit on $9 million of exclusion in 2011 (or $3,130,800 of credit). Her gift of $4 million generates no gift tax:

Gift tax on $4 million	$1,380,800
Less gift unified credit	- 1,380,800
Gift tax paid	0

Example 3 (Additional Gift in 2012). Assume the same facts as in Examples 1-2, assume Wife makes another taxable gift of $4 million in 2012, and assume there is no inflation adjustment to the $5 million basic exclusion amount. (If there had been an inflation adjustment, Wife's basic exclusion amount would be inflation adjusted, but the $4 million of deceased spousal unused exclusion would not be adjusted.) Wife's gift unified credit is (1) the estate tax applicable credit amount she would have if she died at the end of 2012 [§ 2505(a)(1)], less (2) the amounts allowable as credit against the gift tax for preceding years [§ 2505(a)(2)]. This amount is:

(1) Estate tax applicable credit amount if die at end of 2012 (tentative tax on basic exclusion amount ($5 million assuming no inflation adjustment) and deceased spousal unused exclusion amount ($4 million, never inflation adjusted), combined $9 million)	$3,130,800
Less (2) Amounts allowable as credit for preceding years	- 1,380,800
Available gift tax unified credit amount for 2012	1,750,000

Gift tax calculation:

Gift tax on gifts for all periods ($8 million)	$2,780,800
Gift tax on $4 million gifts in 2011	- 1,380,800
Gift tax before credit	1,400,000
Less gift unified credit	- 1,400,000
Gift tax paid	0

Available gift tax unified credit available for future years (as long as Wife has this same deceased spousal unused exclusion amount):

Credit amount on $9 million	$3,130,800
Gift credit used in 2011	- 1,380,800
Gift credit used in 2012	- 1,400,000
Remaining gift credit	350,000

(That would cover additional gifts of $1 million.)

Example 4 (Husband 2 Dies, Additional Gift in 2013). Assume the same facts as in Examples 1-3, assume Husband 2 dies in 2013 with a taxable estate of $6 million and no unused exclusion amount, assume TRA 2010 is extended to apply in 2013, and assume the estate tax basic exclusion amount has been inflation adjusted to $5,020,000. Assume Wife makes a gift of $1 million in 2013.

Wife's gift tax unified credit:

(1) Estate tax applicable credit amount if die at end of 2013 (tentative tax on basic exclusion amount ($5.02 million) and deceased spousal unused exclusion amount (0), combined $5.02 million	$1,737,800
Less	
(2) Amounts allowable as credit for preceding years (1,380,800 for 2011 + 1,400,000 for 2012)	- 2,780,800
Remaining gift credit	0

Gift tax calculation:

Gift tax on gifts for all periods ($9 million)	$3,130,800
Gift tax on $8 million gifts in 2011-2012	- 2,780,000
Gift tax before credit	350,000
Less gift unified credit	- 0
Gift tax paid	350,000

Practical Planning Pointers.

(a) There is no concept of "using Husband 1's unused exclusion first," leaving Wife with $1.0 million of her own gift exemption amount after Husband 2 died, and Wife no longer had any deceased spousal unused exclusion after Husband 2 died. However the Joint Committee on Taxation Technical Explanation Example 3 suggests that there is a concept of using the deceased spousal unused exclusion first in the estate tax context. Whether this would be extended to the gift tax context is not clear.

(b) A surviving spouse should use the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries) so that she does not lose it if the new spouse predeceases or if the basic exclusion amount is decreased (remember that the deceased unused exclusion amount is the lesser of the basic exclusion amount or the amount from the unused exclusion calculation).

(c) There is no way that Wife can utilize her deceased spousal unused exclusion amount with out using her own basic exclusion amount.

(d) The recapture/clawback issue discussed in section IV.E.2-5 of this outline can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exclusion" for making gifts. If the spouse later remarries and the subsequent spouse dies, with less exclusion, the spouse will not have as much deceased spousal unused exclusion for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes

will be less than for gift tax purposes when the gifts were made. This may result in additional estate taxes being due at the donor's death.

8. Not Apply for GST Tax Purposes. Portability does not apply to the GST exemption.

9. Effective Date — Decedents Dying After 2010. The provision applies to the estates of decedents dying and gifts made after 2010. [TRA § 303(c)(1).] The Joint Committee on Taxation Technical Explanation takes the clear position that portability applies only if the first spouse dies after 2010. Joint Committee on Taxation Technical Explanation, at 51-52 ("Under the provision, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the 'deceased spousal unused exclusion amount'), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.")

10. Planning Observations.

    a. Heightened Significance in Light of Exemption Amount Increase. Portability takes on increased importance in light of the increase of the exemption amount to $5.0 million. Marrying a poor dying person to be able to use his or her unused exemption amount (which could be close to the full $5.0 million) may yield dramatic tax savings.

    b. Impact on Decision to Remarry. Portability may impact the decision of a surviving spouse to remarry. If the new spouse should predecease the surviving spouse, the unused exemption of the first deceased spouse would no longer be available to the surviving spouse, and the new spouse may have little or no unused exemption.

    c. Impact of Decision to Divorce. Portability could even encourage the spouses of wealthy families to divorce, each to remarry poor sickly individuals, and not to remarry after the new poor spouses die. This could add an additional $10 million of estate and gift tax exemption available to the family.

    d. Gift Tax Exclusions of Multiple Deceased Spouses. The statute itself has no limits on being able to take advantage of the exemptions from multiple deceased spouses for gift tax purposes. For example, if H1 dies with substantial unused exclusion, the surviving spouse (W) could make lifetime gifts using her own exclusion and H1s unused exclusion. (As discussed above, Wife would have to use her own basic exclusion amount in order to use the deceased spousal unused exclusion amount from H1.)) If Wife remarries and H2 also dies with unused exclusion, W could then make additional gifts using H2's unused exclusion (before she remarries and her next husband dies). Courts or the IRS may address a "sham marriage" concept to put some limits on using the exclusions of multiple poor sickly spouses. Also, there will be a recapture of estate tax attributable to the excess of the gift exemptions utilized with lifetime gifts over the estate exemption at the donor's death. See section IV.E.5 of this outline for a summary of the conclusions from the analysis of examples regarding the recapture issue.

Only Available Two Years. Like the rest of the estate and gift tax provisions in TRA 2010, the portability provision expires after 2012. The apparent anticipation is that Congress will extend this benefit following 2012, but there are no guarantees. In light of this, few will be willing to rely on portability and forego using bypass trust planning in the first deceased spouse's will. The possible exception would be if the surviving spouse intends to make gifts soon after the first spouse's death to utilize the unused exclusion — but if the spouse is willing to do that, it would seem better to just use bypass trust planning in the spouses' wills.

e. Reasons for Using Trusts Even With Portability. There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including, (a) there is no assurance that portability will apply after 2012, (b) the deceased spousal unused exclusion amount is not indexed, (c) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse, (d) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (e) there is no portability of the GST exemption, and (f) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse. On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death.

Practical Planning Pointer: Few individuals will be willing to rely on portability of the estate tax exemption in planning their estates, because of the fact that portability only exists for two years and because there are a variety of other reasons for continuing to use appropriate "bypass" planning with trusts.

D. Gift Exemption and Change in Method for Calculating Gift Tax.

1. Unification of Gift Exemption Beginning in 2011. The gift exemption remains at $1,000,000 in 2010. [TRA § 302(b)(1)(B).] Beginning in 2011, the gift exemption amount is the same as the estate tax exclusion amount, or $5.0 million, indexed from 2010 beginning in 2012. Following amendments to I.R.C. § 2505(a) in TRA 2010 §§ 301(b) & 302(b)(1), § 2505(a)(1) will provide that the unified gift tax credit is:

"(1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year…"

(The last phrase, beginning with "which would apply if the donor died as of the end of the calendar year" is the clause that provides portability of the gift exclusion.)

The Baucus bill did not unify the gift and estate exclusion amounts.

Practical Planning Pointer--Huge Implications for Future Transfer Planning Opportunities: The $5.0 million gift exclusion amount beginning in 2011 will open up a new paradigm of thinking regarding transfer planning strategies. The ability to make transfers of up to $10 million per couple without having to pay gift taxes paves the

way for many transfer planning opportunities that, with leveraging strategies, can transfer vast amounts of wealth outside the gross estate. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Perhaps the notion of the estate tax being a "voluntary tax" will become reality.

2. Change in Gift Tax Calculation Method; Effect of Changed Calculation Method. For gift tax purposes, the gift tax calculation includes subtracting a unified credit, and the amount of unified credit available for a particular year is determined after subtracting the amount of credit already used from prior gifts. In calculating the amount of credit used on prior gifts, use the gift tax rate for the year of the current gift to determine the tentative tax on the applicable exclusion amount that was applicable for offsetting the gift tax on prior gifts. [TRA § 302(d)(2), amending I.R.C. § 2505(a).] (Query how to apply the rates in the current year for purposes of subtracting the gift credit amounts used in prior years when gifts were made in years before 1998 for which there was a fixed credit amount rather than an applicable exclusion amount? For example, in 1987-1997, the unified credit against gift tax was $192,800. For those years, will the actual amount of gift credit used in the prior year be subtracted under § 2505(a)(2) or will an implicit amount of exclusion attributable to the credit in that prior year be determined and then use the current year rate to determine the tentative tax on that implicit amount of exclusion?)

The effect of this change is to "correct" an anomaly that existed under prior law. If an individual had made gifts before 2010 over $500,000, the gifts used more credit (calculated at 37% and 39% rates) than gifts would use at a 35% rate. The result was that donors who had made prior taxable gifts over $500,000 could not make additional gifts in 2010 (at a 35% rate) equal to the difference between $1 million and the prior gifts. (For example, a donor who had made taxable gifts before 2010 of $961,538.46 would not be able to make additional gifts in 2010 (calculating the credit at a 35% rate) without paying gift tax.)

Practical Planning Pointer: The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts without having to pay gift tax.

Steven Schindler, attorney in Seattle, Washington, provides this example of the effect of the amendments to § 2505(a):

> "For example, a donor who, in 2009, made her first taxable gift in the amount of $900,000, utilized $306,800 in credit (when $345,800 was available). The same donor in 2010 only has $330,800 in total credit, and, having used $306,800 in 2009, only has $24,000 in remaining credit to apply against 2010 gifts. At the 35% gift tax rate, this amount of credit only protects $68,571 in taxable gifts. If the donor makes a gift of the remaining $100,000, thinking that she has $1 million in total lifetime exemption equivalent, the donor would owe gift tax of $11,000 under the unamended § 2505(a).

Under TRA 2010 § 302(d)(2) we would not look to the 2009 return to determine how much credit was used. Instead, we would re-determine in 2010, for purposes of calculating gift tax on any 2010 gift, the amount of credit that would have been used on the 2009 gift if the tax rates in effect in 2010 were applicable in 2009. Applying the maximum 35% rate to the $900,000 gift, only $295,800 in credit would have been used, leaving $35,000 in remaining credit for 2010, permitting a full $100,000 gift."

3. Gift Tax Effects if Donor Previously Made Gifts Above $5 Million in Prior Years. If a donor has made over $5 million of gifts in prior years, can the donor make use of the additional $4 million of gift exemption in 2011? Yes. The donor paid gift taxes on the excess of gifts over the $1 million exemption (or less) in prior years, and the donor can still take advantage of the additional $4 million of gift exemption. Under § 2505(a), the donor's gift tax unified credit amount would be the applicable credit amount on the $5 million basic exclusion less the "amounts allowable as a credit to the individual under this section for all preceding calendar periods" (which would reflect the credit amount on $1 million of gifts, so there would be lots of unified credit left).

Example ($5 million of Gifts in 2009). Assume Donor made $5 million of taxable gifts in 2009, and wishes to make an additional $4 million of gifts in 2011 (to make use of her additional $4 million of gift exemption.)

Gift tax in 2009 on $5 million gift:

Gift tax before credit (applying 45% rate)	$2,130,800
Gift tax credit on $1.0 million	- 345,800
Gift tax paid for 2009 gifts	1,785,000

Gift tax in 2011 on additional $4 million gift:

Gift tax on aggregate gifts of $9 million (applying 35% rate), § 2502(a)(1)(a)		$3,130,800
Less gift tax on prior $5 million gift (also applying 35% rate), § 2502(a)(1)(b)		- 1,730,800
Gift tax before credit		1,400,000
Less available gift unified credit (using 35% rate, even for determining amount of credit used in 2009 when the marginal rate was 45%, under § 2505(a), as amended by TRA 2010 § 302(d)(2))		
(1) Estate tax applicable credit amount on $5 million basic exclusion amount in 2011, § 2505(a)(1)	$1,730,800	
Less (2) Amounts allowable as credit for preceding years (on $1 million), using 35% highest marginal rate that applies in current year, rather than 39% highest rate that applied in 2009)	- 330,800	
Available gift credit for 2011	$1,400,000	
Gift tax for 2011 after credit		
Gift tax before credit (calculated above)		$1,400,000
Less gift unified credit		- 1,400,000

Gift tax payable for 2011	0

Practical Planning Pointer: If a donor previously made taxable gifts exceeding $1 million prior to 2011, the donor can make additional gifts of exactly $4,000,000 that will be covered by the $5 million gift exemption in 2011. Even though the gift credit on up to $1 million was previously calculated using 45% (or higher rates), in the current year calculation the amount of credit previously used is calculated using current year (35% rates) rather than the amount of credit actually applied at the higher rates.

4. <u>Gift Tax Effects if Donor Previously Made Taxable Gifts Above $1 Million Prior to 2011</u>. As illustrated by the preceding example, if the donor has previously made taxable gifts of at least $1 million prior to 2011, the client can make an additional taxable gift of exactly $4 million in 2011 without having to pay gift tax.

5. <u>Gift Tax Effects if Donor Previously Made Taxable Gifts, But Under $1 Million Prior to 2011</u>. Similarly, if the donor has made prior taxable gifts prior to 2011 of less than $1 million, the donor can make gifts of exactly $5 million less the amount of taxable gift made previously.

Example ($900,000 of Prior Gifts). Assume the donor made gifts of $900,000 in 2009.

Gift tax in 2009 on $900,000 gift:

Gift tax before credit (highest marginal rate is 39%)	$ 306,800
Gift tax credit on $900,000	- 306,800
Gift tax paid for 2009 gifts	0

Gift tax in 2011 on additional $4.1 million gift:

Gift tax on aggregate gifts of $5 million (applying 35% rate), § 2502(a)(1)(a)	$1,730,800
Less gift tax on prior $900,000 gift (also applying 35% rate), § 2502(a)(1)(b)	- 295,800
Gift tax on additional $4.1 million before credit	1,435,000

Credit on 2011 gift

Credit on $5.0 million applicable exclusion	$1,730,800	
Credit used on prior period gifts (35% rate)	- 295,800	
Credit left		$1,435,000
Gift tax payable on 2011 gift		$ 0

E. <u>Change in Estate Tax Calculation Method Regarding Effects of Prior Gifts</u>. The estate tax calculation method is changed to reflect the effects of changing gift tax rates. The calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits), I.R.C. § 2001(b)(1),

- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The Form 706 instructions for the "Line 7 Worksheet" clarify that the gift unified credit attributable to the applicable credit amount available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year. There is uncertainty as to how this will be applied if the estate tax applicable exclusion amount has decreased below the gift exemption amount utilized by lifetime gifts, particularly if there is a sunsetting of TRA 2010 to interpret the Code as if the $5 million gift tax exemption amount "had never been enacted." In that case, will the gift unified credit amount that is subtracted in determining the amount of the reduction under Step 2 be limited to the credit amount on a $1 million exclusion? This is discussed in detail below.)
- Step 3: Subtract the applicable credit amount.

TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The gift unified credit equals--

(1) the estate tax applicable credit amount for the year of the gift (§ 2505(a)(1)), less

(2) the aggregate gift unified credits for preceding years (§ 2505(a)(2)), and as discussed above in section IV.D.2 of this outline regarding the calculation of the gift tax, TRA 2010 amends § 2505(a) to provide that in calculating the aggregate gift unified credits used in prior years under § 2505(a)(2), rates in effect for the year of each current gift are used in lieu of the actual rates of tax in effect during the preceding years.

1. General Estate Tax Effects of Prior Gifts. Generally speaking, the estate tax calculation method of § 2001(b) is designed (1) to tax the estate at the highest estate tax rate brackets, taking into consideration prior gifts (by determining the tax on the combined taxable estate plus adjusted taxable gifts and subtracting the taxes on just the adjusted taxable gifts), and (2) to reflect that the individual has already utilized unified credit that would otherwise be available at death for any taxable gifts made previously (this is done by reducing the amount of tax that is subtracted attributable to just the adjusted taxable gifts by the amount of unified credits attributable to those adjusted taxable gifts.) This is accomplished under the rather complicated estate tax computation procedures under § 2001. A brief refresher on the estate tax computation system, building on the description above, will assist in understanding the estate tax affects of large gifts.

   Step 1: Calculate tentative tax on gross estate + adjusted taxable gifts

   Step 2: Subtract from that the gift tax on just the adjusted taxable gifts that would have been paid, based on the rates in effect at the date of death. This gift tax amount is reduced by unified credit used in making the gift (again based on rates in effect at the date of death). Basic math principles tells us that the "negative of a negative is a positive." Reducing the amount of gift tax that is subtracted in Step 2 by the unified credit used in the gift in effect adds the gift unified credit to the tax calculation.

   Step 3: The full estate unified credit amount is then subtracted at the end of the computation.

Therefore, if a $5 million gift has been made and the estate tax exclusion amount is $5 million, the calculation effectively adds $1,730,000 (the credit amount on $5 million with a 35% top rate) in Step 2 (i.e., there is no reduction in the amount of the tentative tax by the chapter 12 tax that would be paid on the adjusted taxable gifts) and subtracts $1,730,000 in Step 3. Thus, we get the generalization that the taxable gift "uses up" the estate tax exemption amount.

2. Controversial Calculation Issue: "Recapture" vs. "Clawbacks" If Estate Exemption Is Reduced in the Future ("Line 7 Issue"). If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift exemption amount, it is not clear how Step 2 of the estate tax calculation described above will be interpreted. Following the Form 706 instructions, the hypothetical "chapter 12" offset amount (reported on Line 7 of the Form 706) is calculated using the applicable credit amount "in effect for the year the gift was made," (see the last two lines of the Form 706 Instructions, Line 7 Worksheet) which would be the credit amount for an applicable exclusion amount of $5 million. That means that the gift unified credit amount would fully cover the gift and no gift tax calculated under chapter 12 would be reduced in calculating the tentative estate tax. In effect, the tentative tax (before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously.

The change under § 2001(g) says to use the date of death estate tax *rates* in calculating the gift credit amount for this hypothetical gift tax. This seems to connote that the Form 706 instructions approach would be applied by using the exclusion amount that was used in the year of the gift and determining a hypothetical gift credit amount using the date of death rate.

That situation, of the estate tax unified credit amount being lower than the gift unified credit amount for prior years, has never happened. It is not clear whether the Form 706 instructions would apply literally in that circumstance or not. On the other hand, if the amount of the chapter 12 tax on just the adjusted taxable gifts, to be subtracted from the tentative tax in Step 2 and reported on Line 7 of the Form 706, is calculated assuming the gift unified credit amount were determined on just the lower estate tax applicable exclusion amount, there would be chapter 12 tax that would be subtracted in Step 2, thus giving the estate the benefit of having removed the "excess" exclusion amount from the estate without gift or estate tax.

The listservs are full of comments about this issue. Some planners say that the additional estate tax is an appropriate "recapture" of using the excess exemption, and others take the position this is an unfair "clawback" of the tax benefits allowed in making gifts. The reasoning under the first position (that "recapture" should be appropriate with additional estate taxes at death on the prior gifts if the exemption amount is reduced in the future) is that this approach reflects the basic structure of the unified gift/estate tax system by adding back adjusted taxable gifts into the estate tax calculation and allowing one *unified* credit for estate tax purposes. Eric Viehman, attorney in Houston, Texas summarizes:

> "From a policy standpoint, it is hard to argue that two taxpayers dying in the same year who each made a total of $10 million of taxable transfers during lifetime and at death should pay dramatically different amounts in total tax simply because one made $5 million of lifetime gifts and the other made none… If new estate tax legislation is enacted but the post-2012 estate tax exemption is something less than $5 million, then Congress certainly might eliminate any recapture possibility, but it seems hard to make a persuasive policy argument for doing so."

The position of the unjust "clawback" group is that the taxable gifts are not part of the gross estate and are just part of the estate tax calculation procedure to tax the estate in the highest marginal brackets considering lifetime gifts.

Richard Franklin, an attorney in Washington D.C., summarizes:

> "Adjusted taxable gifts are not part of the taxable estate. Section 2001(a) imposes an estate tax on the taxable estate. Gifts are not part of the taxable estate. If the clawback analysis is correct, the total estate tax to be paid could exceed the maximum estate tax rate as a percentage of the taxable estate. I cannot think of another situation in which the total tax paid is over the maximum rate as a percentage of the taxable estate (even ignoring the applicable credit). Even the 5% surtax "bubble bracket" just took away the advantage of the lower brackets, but did not push the estate tax in excess of the maximum bracket as a percentage of the taxable estate. While I cannot say there is no risk of a clawback, the arguments against it are strong, it was not intended, it is beyond the purpose of the 2001(b) and I don't even believe the statute currently mandates that result. The 706 instructions lead to the clawback, but that arises out of the context of the IRS never envisioning the exemption upon gift being higher than at death."

Another argument of this group is that if TRA 2010 sunsets in two years and the EGTRRA/TRA sunset kicks in to apply the Code with respect to estate of persons dying after 2012 as if the EGTRRA and TRA provisions had never been enacted, then there would not have been a $5 million exemption for gift tax purposes, so the hypothetical gift tax on just the adjusted taxable gifts would be calculated assuming a gift exemption of only $1 million and there would be a big offset in the estate tax calculation. They argue that the "clawback" potential, while substantial or even likely, "doesn't 'feel right' or square with the original thought behind 'paid or payable' that actually benefitted taxpayers."

With respect to the sunsetting reasoning, keep in mind that there is the possibility that there may not be a general sunset of the EGTRRA and TRA provisions but, consistent with the sunsetting rule in TRA which leaves most of the estate and gift tax provisions of EGTRRA intact, would merely revise §2010(c)(2)(A) (as amended by TRA 2010) to say that the applicable exclusion amount is $3,500,000 (or whatever number is reached in the political discussions), and § 2505(a), which describes the gift tax unified credit amount, would continue simply to refer to § 2010(c) but without the parenthetical clause "(determined as if the applicable exclusion amount were $1,000,000)."

Here is a different way of stating the issue: One of the purposes of the estate tax calculation procedure is to reflect that using gift exemption also uses the estate

exemption. Does that mean that it uses the estate exemption only to the extent of the estate exemption at death, or does it require a "recapture" to the extent that the gift exemption utilized exceeds the estate exemption?

There are indications from Congressional staffers that the "clawback" effect if the exclusion amount is reduced in future years was not intended.

In any event, the result is uncertain. One attorney has summarized it well: "One person's glitch is another's tax logic."

3. Impact of Gifts Utilizing $5 Gift Exemption on Later Estate Tax Calculation. In each of the following examples, the line of the calculation that is impacted by the "Line 7" issue of whether to determine the § 2001(b)(2) offset by using the gift credit amount based on the applicable exclusion amount for the year of the gift or for the year of death is italicized.

Example 1 (Gift of $5 Million; Death in 2012). Assume A has an estate of $15 million and makes a $5 million gift (ATG) in 2011, and dies in 2012 with a taxable estate (TE) of $10 million. (Because death occurs within three years, any gift tax paid would be brought back into the estate, but a gift of $5 million in 2011 will not require the payment of any gift tax.)

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million)		$5,230,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (35% top rate)	1,730,800	
Less gift unified credit on $5M exclusion (35% rate)	*- 1,730,800*	
		- 0
(3) Estate tax before unified credit		5,230,800
(4) Less unified credit on $5 million exclusion		- 1,730,800
(5) Estate tax		3,500,000

Conclusion. The total gift tax and estate tax is $3,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same $3,500,000. Making the gift did not cost any additional tax. The simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an overall savings — without having to pay a current gift tax.

If the decedent's estate is passing to a surviving spouse or charity, so that it qualifies fully for the marital or charitable deduction, the additional estate taxes would not qualify for the marital or charitable deduction, resulting in a circular calculation of the estate taxes. However, if the estate exemption remains at $5 million, there would be no estate tax payable at the donor's death. The tentative tax on the $5 million of adjusted taxable gifts would be completely offset by the estate tax unified credit on a $5 million applicable exclusion amount. The rest of

the estate qualifies for the marital or charitable deduction. There is no added tax that begins a circular tax calculation.

Example 2 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $3.5 Million and Rate Has Been Increased to 45%; Follow Form 706 Instructions). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $3.5 million and the rate is increased to 45% (the 2009 system). Assume the calculation follows the Form 706 instructions in calculating the § 2001(b)(2) "Line 7" offset for the gift taxes on adjusted taxable gifts by taking into consideration the amount of gift tax applicable credit amount in each year the gift was made but applying date of death rates (i.e., the gift credit amount using the 45% rate table on a $5 million applicable exclusion amount).

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1)	Tentative tax on TE + ATG ($15 million) (45% table rate)		$6,630,800
(2)	Less gift tax on ATGs using date of death rates		
	Gift tax on $5 million (45% top rate)	2,130,800	
	Less gift unified credit on $5M exclusion (45% table)	*- 2,130,800*	
			- 0
(3)	Estate tax before unified credit		6,630,800
(4)	Less unified credit on $3.5 million exclusion		- 1,455,800
(5)	Estate tax		5,175,000

Conclusion. The total gift tax and estate tax is $5,175,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same $5,175,000. Making the gift did not cost any additional tax, even if TRA sunsets and there is a later decrease in the applicable exclusion amount and increase in the gift tax rate. Stated differently, the estate ultimately receives just the benefit of the applicable exclusion amount at the individual's death. However, future appreciation attributable to the gift or income taxes paid on gift assets in grantor trusts will reduce the gross estate that would otherwise be subject to estate taxes.

The estate tax on just the $10 million taxable estate would have been $2,925,000. Therefore, there is $2,250,000 ($5,175,000-$2,925,000) attributable to assets not in the taxable estate. (Check: The added $5 million x 45% = $2,250,000.) The recipients of the taxable estate will have to pay $2,250,000 of estate tax attributable to the $5 million of taxable gifts. If the taxable gifts were made to persons other than the recipients of the taxable estate, hard feelings may result (at the least). Tax apportionment issues are critically significant in light of the estate tax recapture for lifetime gifts, particularly this possible result if the estate tax exemption is decreased below the utilized gift tax exemptions. See section IV.E.4 of this outline.

If the decedent's estate is passing to a surviving spouse, so that it qualifies fully for the marital deduction, the additional estate taxes would not qualify for the marital

deduction, resulting in a circular calculation of the estate taxes. The calculation results in a tax of $1,227,272.73. (Check it: The tentative tax on TE + ATG, or [$1,227,272.73 + $5 million] is $2,673,072.73. Subtracting the $1,455,800 unified credit leaves an estate tax of $1,227,272.73.)

Example 3 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $1 Million and Rate Has Been Increased to 55%; Follow Form 706 Instructions). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $1 million and the rate is increased to 55% (the pre-2001 system). Assume the calculation follows the Form 706 instructions in calculating the § 2001(b)(2) offset for the gift taxes on adjusted taxable gifts by taking into consideration the amount of gift tax applicable credit amount in each year the gift was made but applying date of death rates (i.e., the gift credit amount using 55% rate table on a $5 million applicable exclusion amount).

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million) (55% table rate)		$7,890,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (55% top rate)	2,390,800	
Less gift unified credit on $5M exclusion (55% table)	*- 2,390,800*	
		- 0
(3) Estate tax before unified credit		7,890,800
(4) Less unified credit on $1 million exclusion		- 345,800
(5) Estate tax		7,545,000

Conclusion. The total gift tax and estate tax is $7,545,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same $7,545,000. Making the gift did not cost any additional tax, even if EGTRRA and TRA sunset, resulting in a later dramatic decrease in the applicable exclusion amount and increase in the gift tax rate. The simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an overall savings — without having to pay a current gift tax.

The estate tax on just the $10 million taxable estate would have been $4,795,000. Therefore, there is $2,750,000 ($7,545,000-$4,795,000) of estate tax attributable to assets not in the gross estate. (Check: $5 million of ATGs x 55% = $2,750,000.)

Example 4 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $3.5 Million and Rate Has Been Increased to 45%; Limit § 2001(b)(2) Gift Tax Offset Based on Date of Death Applicable Exclusion Amount; Comparison to Example 2). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $3.5 million and the rate is

increased to 45% (the 2009 system). Assume in calculating the § 2001(b)(2) offset for the gift taxes on adjusted taxable gifts that the gift tax unified credit amount is calculated by applying the 45% rate table to the applicable exclusion amount for the date of death (i.e., $3.5 million) rather than in each year that gifts were made (i.e., $5 million).

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million) (45% table rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (45% top rate)	2,130,800	
Less gift unified credit on $3.5M exclusion (45%	*- 1,455,800*	
		- 675,000
(3) Estate tax before unified credit		5,955,800
(4) Less unified credit on $3.5 million exclusion		- 1,455,800
(5) Estate tax		4,500,000

Conclusion. The total gift tax and estate tax is $4,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been $5,175,000. Making the gift saved $675,000 of estate tax (even before considering the removal of future appreciation in the gift assets from the estate). Stated differently, the estate ultimately receives the benefit of the applicable exclusion amount at the individual's death AND removes $1.5 million from the transfer tax base ($1.5 million x 45% = $675,000 savings).

The estate tax on just a $10 million estate would have been $2,925,000, so there is $1,575,000 of estate tax attributable to assets not in the taxable estate. (Compare this to Example 2 where there was an additional $2,250,000 of estate tax attributable to the adjusted taxable gifts. The difference is $675,000 — which is the amount attributable to the excess exemption used in taxable gifts times the estate tax rate ([$5 million - $3.5 million] x 45% = $675,000).)

If the entire estate passes to a surviving spouse that qualifies for the estate tax marital deduction, there would be no estate tax produced as a result of the $5 million of gifts under this approach for determining the "Line 7" offset amount.

Example 5 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $1 Million and Rate Has Been Increased to 55%; Limit § 2001(b)(2) Gift Tax Offset Based on Date of Death Applicable Exclusion Amount; Compare to Example 3). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $1 million and the rate is increased to 55% (the pre-2001 system). Assume in calculating the § 2001(b)(2) "Line 7" offset for the gift taxes on adjusted taxable gifts that the gift tax unified credit amount is calculated by applying the 55% rate table to the applicable exclusion amount for the date of death (i.e., $1 million) rather than in each year that gifts were made (i.e., $5 million).

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million) (55% table rate)		$7,890,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (55% top rate)	2,390,800	
Less gift unified credit on $1M exclusion (55% rate)	*- 345,800*	
		- 2,045,000
(3) Estate tax before unified credit		5,845,800
(4) Less unified credit on $1 million exclusion		- 345,800
(5) Estate tax		5,500,000

Conclusion. The total gift tax and estate tax is $5,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been $7,545,000. Making the gift saved $2,045,000 of estate tax (even before considering the removal of future appreciation from the gift). Stated differently, the estate ultimately receives the benefit of the applicable exclusion amount at the individual's death AND removes $4 million from the transfer tax base that would have been subject to estate tax at rates ranging from 41% to 55%.

Practical Planning Pointer: If the estate tax is calculated under the Form 706 instructions, making a taxable gift merely has the effect of excluding future appreciation of the gift property from the estate as well as income tax that the donor may pay on grantor trust income if the gift is made to a grantor trust. The estate ultimately receives just the benefit of the applicable exclusion amount at the individual's death. As illustrated in Examples 2-3, if an individual makes a $5 million gift in 2011 and the applicable exclusion amount is later reduced, the individual still has the benefit of making a $5 million gift (and shifting future appreciation and income payments attributable to a grantor trust) without taking away the estate's right to take advantage of the applicable exclusion amount at death, whatever amount that might be. If the donor has not paid gift taxes, the effect is that the estate is subject to estate tax (using rates in effect at the date of death) on the combined taxable estate plus adjusted taxable gifts, with the benefit of the unified credit that applies at the date of death.

However, if the estate tax is calculated by determining the Line 7 gift tax offset from adjusted taxable gifts using the applicable exclusion amount at the date of death rather than in the year of the gift, substantial tax savings are generated. In effect, the difference between the $5 million exemption utilized in taxable gifts and the date of death applicable exclusion amount is removed from the tax base.

The next examples address the effects if gift taxes have been paid during life.

Example 6 (Gift of $10 million in 2011; Death in 2012 With Same Exclusion and Rate). Assume A makes a gift of $10 million in 2011 and dies in 2012 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift).

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amount	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million)		$5,230,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (35% top rate)	3,480,800	
Less gift unified credit on $5M exclusion (35% table)	*- 1,730,800*	
		- 1,750,000
(3) Estate tax before unified credit		3,480,800
(4) Less unified credit on $5 million exclusion		- 1,730,800
(5) Estate tax		1,750,000

<u>Conclusion</u>. The total gift tax and estate tax is $1,750,000 gift tax plus $1,750,000 estate tax, or $3,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same $3,500,000. Making the gift did not cost any additional tax. The simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an overall savings.

Example 7 (Gift of $10 Million in 2011; Death in 2013 With Exclusion of $3.5 Million and Top Rate of 45%; Follow Form 706 Instructions). Assume A makes a gift of $10 million in 2011 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $3.5 million and has increased the top rate to 45% for 2013.

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amt	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (45% table) (at 45% top rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (45% top rate)	3,480,800	
Less gift unified credit on $5M exclusion (45% table)	*- 1,730,800*	
		- 1,750,000
(3) Estate tax before unified credit		3,480,800
(4) Less unified credit on $3.5 million exclusion		- 1,730,800
(5) Estate tax		1,750,000

Conclusion. The total gift tax and estate tax is $1,750,000 gift tax plus $2,925,000 estate tax, or $4,675,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been $5,175,000. Making the gift saved $500,000 of combined tax. (The $10 million gift had a 35% tax rate apply to $5 million — the amount of the gift not covered by the $5 million exemption. If the gift is not made, that $5 million would have been taxed at 45%. The additional 10% of the $5 million amount accounts for the additional $500,000 that would be paid if the gift were not made.)

Example 8 (Gift of $10 Million in 2011; Death in 2013 With Exclusion of $1 Million and Top Rate of 55%; Follow Form 706 Instructions). Assume A makes a gift of $10 million in 2011 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $1 million and has increased the top rate to 55% for 2013.

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amt	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (45% table) (at 55% top rate)		$7,890,800
(2) Less gift tax on ATGs using DOD rates		
Gift tax on $10 million (55% top rate)	5,140,800	
Less gift unified credit on $5M exclusion (55% table)	*- 2,390,800*	
		- 2,750,000
(3) Estate tax before unified credit		5,140,800
(4) Less unified credit on $1 million exclusion (55% top rate)		- 345,800
(5) Estate tax		4,795,000

Conclusion. The total gift tax and estate tax is $1,750,000 gift tax plus $4,795,000 estate tax, or $6,545,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been 7,545,000. Making the gift saved $1 million of combined tax. (The $10 million gift had a 35% tax rate apply to $5 million — the amount of the gift not covered by the $5 million exemption. If the gift is not made, that $5 million would have been taxed at 55%. The additional 20% of the $5 million amount accounts for the additional $1 million that would be paid if the gift were not made.)

Practical Planning Pointer: As a general rule, if a gift over the $5 million exemption amount is made and if the estate/gift tax rate is later increased, there will be savings equal to the difference in rates times the excess gift over the gift exemption amount. A change in the estate tax applicable exclusion amount alone does not result in a change of the combined estate and gift tax (if the Form 706 instructions approach is used for "Line 7"). Also, this example is designed so that there is no benefit of savings attributable to having gift taxes removed from the estate tax if

the donor lives at least three years after the gift; this is on purpose to more readily compare the tax effects of making gifts attributable to changing rates and exclusion amounts. However, the advantage of having gift taxes removed from the estate is more pronounced as larger gift taxes are paid. Furthermore, this simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an even greater overall savings.

4. Tax Apportionment Impact. The added estate taxes attributable to the prior gifts can be substantial. How are the additional estate taxes attributable to adjusted taxable gifts apportioned among the recipients under the will and the donees of the gifts? Howard Zaritsky provides this summary:

> "There are several cases that have examined this issue, and they are split on whether state law should apportion the taxes against the donees, versus against the residuary (marital) share. In re Metzler, 579 N.Y.S.2d 288, 290 (App. Div. 1992) and In re Estate of Coven, 559 N.Y.S.2d 798, 799-800 (Sur. Ct. 1990) (taxes not apportioned to donees); In re Estate of Finke, 508 N.E.2d 158, 162 (Ohio 1987) (taxes not apportioned to donees); Shepter v. Johns Hopkins University, 637 A.2d 1223 (Md. Ct. App. 1994) (taxes apportioned to donee); Bunting v. Bunting, 760 A.2d 989 (Conn. App. Ct. 2000) (taxes apportioned to donee); Necaise v. Seay (In re Estate of Necaise), 915 So. 2d 449 (Miss. 2005) (taxes apportioned to donee).
>
> There are even two or three states (including Virginia) that directly permit apportionment to donees of tax increases caused by adjusted taxable gifts. See Fla. Stat. § 733.817(1)(d) (nonprobate property subject to apportionment "does not include interests or amounts that are not included in the gross estate but are included in the amount upon which the applicable tax is computed, such as adjusted taxable gifts"); Md. Code Tax-General § 7-308 (the legislative history states that nonprobate assets subject to apportionment "specifically do not include an adjusted taxable gift of the decedent as defined in § 2001 of the Internal Revenue Code", effectively reversing Shepter, cited above); and Va. Code § §64.1-160 (stating that the decedent's gross estate, for apportionment purposes, "includes any property or interest which is required to be included in the gross estate of the decedent under the estate tax law of the United States, increased by any 'adjusted taxable gifts' as defined in § 2001(b) of the Internal Revenue Code.").
>
> In states that have no express law, however, there is a question whether a will can even apportion estate taxes to people who are not beneficiaries of the estate. Therefore, I would recommend that, where large gifts are made in 2011 or 2012, and all or a major portion of the $5 million unified credit is used, the donor should both include an apportionment provision in his or her will, and have an agreement with the donee for the latter to bear the increased estate taxes."

What if the taxable gifts are so large that the remaining assets in the gross estate are not sufficient to pay all of the added estate tax? The entire probate estate

would be applied to estate taxes (or other expenses that have priority over estate taxes), but there does not appear to be any way for the IRS to collect the remaining tax deficiency from the gift recipients. (If there is a state law apportionment statute that apportions estate taxes to donees of gifts or if there is an agreement of donees to reimburse the estate for added estate taxes, as addressed in the following paragraph, that obligation presumably would be an estate asset that the IRS could pursue for payment.)

One possible approach may be to have a net gift agreement with the donees of the gifts, so that they would agree to pay the estate tax attributable to the adjusted taxable gift inclusion in the event the exclusion amount is reduced in later years. (Whether there would be any offset in determining the amount of net gift attributable to such agreement is not clear, because of the speculative nature of whether and by how much the estate exclusion might be reduced in future years. See McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). In McCord, the donees assumed all gift, GST and estate tax liability attributable to the transfer, specifically including potential estate tax liability under the gift tax gross-up rule of §2035(b) if the donor were to die within three years. The Tax Court viewed that potential liability as too speculative to consider as an offset to the gift value. The Fifth Circuit reversed, viewing it as even less speculative than the "built-in gains tax" discount that has been allowed in recent years. The Fifth Circuit distinguished Armstrong Trust v. United States, 132 F. Supp.2d 421 (W.D. Va. 2001), which dealt with the donees' general transferee liability under §6324(a)(2) for additional estate taxes under §2035(b) if the donor died within three years of the gift. That involves much more uncertainty, because not only must the donor die within three years, but the estate must be depleted to the point that it cannot pay the additional estate tax before the donees are liable under the transferee liability rule.)

However, if a reduction in the exclusion amount did occur such that the donees had to reimburse the estate for the additional estate tax, that reimbursement right would likely be an estate asset subject to inclusion in the gross estate.

If there are other bequests being made to the donees under the donor's will, the tax apportionment clause may effectively charge the estate tax against the donees, by treating the tax as an advancement against their bequests.

5. Summary of Planning Conclusions; Practical Planning Pointers.

a. How Much Can the Donor Afford to or Want to Give? While substantial additional gifts can be made without having to pay gift taxes, the initial question is how much can the donor afford to or want to give? Spouses collectively could give up to $10 million without having to pay gift taxes. Few couples can afford to give $10 million without potentially impacting their lifestyle in later years. Furthermore, the increased estate exemption may mean that the donor is not as concerned about estate taxes as in the past. However, TRA 2010 only lasts for two years and the estate exemption could be decreased in future years; alternatively, the estate exemption could be increased or the estate tax could be repealed in future years in which event the donor may have preferred to retain the gift assets.

These questions inevitably will involve issues of whether the donor can make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. One possible approach would be to make gifts to a lifetime credit shelter trust for the donor's spouse (or even trusts created by each of the spouses for each other with enough differences so they are not treated as "reciprocal" trusts for tax purposes). Alternatively, self-settled trusts may be considered in jurisdictions that allow discretionary distributions to the settlor without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). These issues are explored further in sections X.B and X.M of this outline.

b. Can Make Gifts of Full Additional Gift Exemption Amount. The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts without having to pay gift tax.

c. Can Make Gifts of Full Additional Gift Exemption Amount Even If Made Prior Gifts Exceeding Gift Exemption Amount. If a donor previously made taxable gifts exceeding $1 million prior to 2011, the donor can make additional gifts of exactly $4,000,000 that will be covered by the $5 million gift exemption in 2011. Even though the gift credit on up to $1 million was previously calculated using 45% (or higher rates), in the current year calculation the amount of credit previously used is calculated using current year (35% rates) rather than the amount of credit actually applied at the higher rates.

d. Gift Does Not Remove Gift Assets From Base For Calculating Estate Tax. The adjusted taxable gifts are added in making the estate tax calculation, with an offset for gift taxes that would be payable on just the adjusted taxable gifts. The gifts in effect are just an "advance" on distributions from the estate (without gift tax as long as the gifts do not exceed the exclusion amount), but the gifts are included in the transfer tax base. The amount of the additional estate tax attributable to the taxable gifts is the amount of the taxable gifts times the estate tax rate. If there are $5 million of taxable gifts and the estate tax rate is 35%, the added estate tax is $1,750,000; if the estate tax rate is 45% the added estate tax would be $2,250,000. The total estate tax is the same whether or not the gifts are made. However, there will be estate taxes attributable to assets that have been given away and that are not in the probate estate (or in the federal gross estate) at the donor's death. Because of this effect, it is still preferable, to the extent possible, to shift value that would otherwise be in the taxable estate without making taxable gifts (e.g., using strategies such as GRATs, sales to grantor trusts, fractionalization discounts, paying income taxes on grantor trusts, etc.).

Making gifts never increases the total aggregate taxes as opposed to just retaining the assets and paying estate tax on the full amount (unless the gift assets were to depreciate, in which event it would have been better not to

have made the gift or unless gift taxes are paid at a higher rate than the later estate tax rate).

e. Gift Advantages. Even though the overall transfer tax is generally the same whether or not gifts are made, other factors can make gifts advantageous (generally resulting in an eventual tax savings equal to the appreciation/income removed times the estate tax rate), including removal of appreciation/income for gift assets from gross estate, utilizing fractionalization discounts, and paying income taxes on income from grantor trusts that receive gifts. Being able to make larger gifts without paying gift taxes increases these advantages. (In addition, if gift taxes are paid and the donor lives more than three years after making the gift, the gift tax amount is removed from the gross estate. Also, if the estate tax rate is later increased, there will be tax savings generally equal to the amount of the gift subject to payment of gift taxes times the amount of the percentage rate increase.)

f. Recapture/Clawback of Tax Attributable to Excess Exemption If Estate Tax Exemption Is Later Reduced. If the Form 706 instructions are followed, and the Line 7 gift tax offset amount is calculated using the applicable exclusion amount for the year of the gift, the estate will pay estate tax on all of the taxable gifts, including the excess of the exclusion utilized by gifts over the estate tax exclusion amount. All of the gifts are included in the tax base and the estate ultimately receives just the benefit of the applicable exclusion amount at the individual's death. The amount of the "recapture" is the same as described in subparagraph 5.c above — the amount of taxable gifts times the estate tax rate. In effect, there is no way to "lock in" the use of the larger exemption by making gifts in case the exemption amount is later reduced if the Form 706 instructions approach is used for the Line 7 gift tax offset determination.

The issue, stated briefly, is this: If gifts are made under a gift exclusion amount that exceeds the estate exclusion amount, does the excess amount pass free of gift or estate taxes?

Even if the "clawback" applies, the estate will not pay more taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value or unless gift taxes are actually paid at higher rates than the estate tax rate). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death.

g. Warn Donor That Significant Recapture/Clawback Could Apply. The amount of the estate tax recapture can be substantial — the amount of taxable gifts times the estate tax rate. The donor should be warned at the outset that substantial recapture will apply. Utilizing the gift exclusion amount also uses the estate exclusion amount.

The estate tax recapture perhaps will not be avoided even if the estate tax exemption is later decreased. Making taxable gifts under a $5 million gift exemption does not "lock in" benefits of making gifts under a higher gift exemption than the estate exemption *if* the Form 706 instructions approach

is used in determining the Line 7 gift tax offset amount. For example, if a donor makes $5 million of taxable gifts and if estate tax exemption amount is reduced to $3.5 million, the difference ($1.5 million) times the estate tax rate at death represents the tax exposure attributable to the "Line 7" issue of how the estate tax is calculated in light of the reduced exemption amount. If the estate tax rate increases to 45% and if the exemption decreases to $3.5 million, the tax exposure hinging on this issue is $675,000 (i.e., $1.5 million x 45%).

Legislative staffers have indicated that this "clawback" effect, if the exclusion amount is reduced in the future, was not intended.

If the residuary estate passes to different persons than the donees of the gifts, significant conflicts of interest may arise. The client could consider this in the tax allocation clause. Absent a state tax allocation to donees of gifts (a few states do that), the testator may not be able to allocate taxes to a donee. However, if other assets are passing under the will to the donees of the gifts, the added estate taxes could be charged as an advancement against the bequest to the donees.

h. Estate Tax Recapture With Marital/Charitable Estate Beneficiaries Results in Interrelated Calculation If Exemption Amount Decreases in the Future. If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax hit.

If there are $5 million of taxable gifts and if the estate tax exemption is also $5 million, there is no additional estate tax due at the donor's death if the estate passes entirely to a spouse or charity. The tentative tax on the $5 million of adjusted taxable gifts is offset by the estate tax unified credit on a $5 million applicable exclusion amount. (See the discussion following Example 1.)

Under the same $5 million gift with full marital/charitable estate beneficiaries scenario, if the estate tax exemption is reduced to $3.5 million and the rate is increased to 45%, the estate tax will be $1,227,272.73 if the Line 7 gift offset is determined under the Form 706 instructions approach (see Example 2). If Line 7 is determined by using the date of death exemption amount to calculate the gift credit in determining the hypothetical gift tax offset, there is no estate tax in a full marital/charitable deduction estate. In effect, the estate tax recapture is totally offset by the estate tax unified credit (see Example 4).

i. Recapture of Estate Tax If Portability Exclusion Is Utilized by Gifts. This recapture/clawback issue can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exclusion" for making gifts. If the spouse later remarries and the subsequent spouse dies, with less exclusion, the spouse will not have as much deceased spousal unused exclusion for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes will be less than for gift tax purposes when the gifts were made. Alternatively, if the surviving spouse

makes gifts to utilize the unused exclusion from the deceased spouse and if portability is not extended in future legislation, the estate exemption available to the surviving spouse would be lower than the gift exemption utilized in lifetime gifts, raising the same "Line 7" issue. If the "Line 7" issue is resolved in favor in a taxpayer-friendly manner by allowing a gift tax offset based on the amount of estate exemption, rather than the larger amount of gift exemption at the time of the gift, and if this same approach is applied to gifts utilizing the deceased spousal unused exclusion amount, there would be substantial benefits of making lifetime gifts to utilize the amount of additional exclusion acquired from each prior deceased spouse.

j. <u>Resolution of Recapture/Clawback Issue Is Uncertain If Exemption Amount is Later Reduced</u>. It is not clear what position the IRS will take regarding the estate tax calculation if the estate exemption amount is later reduced below the $5 million gift exemption amount. We have never had a time that the estate tax exemption amount decreased from the amount of the gift exemption amount in prior years. Perhaps the IRS will change the position that it takes in the current Form 706 instructions regarding the "Line 7" determination. Furthermore, it is possible that future legislation could change the result. If the Line 7 gift tax offset amount is determined by applying a gift credit based on the amount of the lower estate tax exemption, the estate ultimately receives the benefit of the applicable exclusion amount at the individual's death AND removes the difference between $5 million and the estate tax exemption amount from the transfer tax base. That amount times the estate tax rate equals the direct tax savings that would result from making the $5 million gift. (An alternate legislative approach would be to change the estate calculation so that it mirrors the gift tax calculation approach—determine a tentative tax on taxable estate plus adjusted taxable gifts, subtract the tentative tax on just adjusted taxable gifts, and then subtract an estate tax unified credit that has been reduced by prior lifetime uses of the unified credit.)

In any event, clients should be aware of the possibility of the additional estate tax. But clients should also realize that the combined estate/gift tax would not be greater than if no gift were made in the first place.

k. <u>Effects of Paying Gift Tax If Rates Stay the Same or the Rates Later Increase</u>. If gifts are made requiring the payment of gift tax, if the donor dies within three years of the gift (so that the gift tax is brought back into the estate), and if the estate tax rate is the same as the gift tax rate, there is no reduction in the combined gift and estate tax. (See Example 6.) The gift tax merely "prepays" the transfer tax, but the advantages of making gifts described in subparagraph 5.d above would apply. By using the rates in effect at the date of death to calculate the gift tax that would have been payable on the adjusted taxable gifts, the system grants an advantage to making gifts at a lower rate than the ultimate estate tax rate. The amount of savings is generally equal to the amount of gifts in excess of the gift exclusion amount times a percentage equal to the difference between the marginal estate tax rate and the marginal gift tax rate. (See Examples 7-8.)

l. Consider Apportionment of Estate Tax Recapture. There are estate tax implications of gifts. All adjusted taxable gifts are brought into the estate tax base, and the donor may wish to have the donees pay a portion of the federal estate tax to the extent the donees have received the benefit of using up some of the donor's lifetime gift/estate exclusion amount. Furthermore, if the estate exemption is reduced below the gift exemption used in lifetime gifts, the excess exemption used by gifts over the eventual estate exemption amount may be subject to estate tax, depending on IRS interpretation of the estate tax calculation procedure. The donor may explore having an agreement with the donees to pay either or both of these types of added estate taxes. In a few states, the donor could apportion estate taxes proportionately against the donees of lifetime gifts. In other states, it is not clear whether attempts to apportion the tax against donees would be respected. If the donees are also estate beneficiaries, estate taxes attributable to the lifetime gifts could be apportioned against their share of the testamentary estate. These issues are explored further in Section IV.E.4 of this outline.

F. GST Tax — Overview of Changes. The general GST effects of the amendments in TRA 2010 are summarized below. A more detailed discussion of changes and planning implications is in section VIII of this outline.

1. GST Applicable Rate in 2010 is Zero. For all of 2010, the GST tax "applicable rate determined under section 2641(a)... is zero" for all generation-skipping transfers made in 2010. [TRA 2010 § 302(c).] This change in nomenclature makes clear that generation-skipping transfers may be made in further trust. This issue is discussed in sections VIII.B.1 and VIII.C.2 of this outline below.

2. GST Tax Applies After 2010. TRA § 301(a) in effect repeals § 2664 added by EGTRRA, which section provided that Chapter 13 would not apply to generation skipping transfers after 2009. This change is made effective for transfers made after 2009. However, as discussed immediately above, TRA § 302(c) provides the special rule resulting in a zero GST tax rate for generation skipping transfers in 2010.

3. GST Exemption of $5.0 Million for 2010. The GST exemption equals the estate tax "applicable exclusion amount under section 2010(c) for such calendar year." I.R.C. § 2631(c). Because the estate tax applicable exclusion amount is changed to $5.0 million for 2010 [TRA § 302(a)(1)], the GST exemption is $5.0 million for 2010. This is important, because it clarifies that there is up to $5.0 million of GST exemption that can be allocated on a timely basis to transfers to trusts in 2010. (See section VIII.H of this outline for a more detailed discussion of the applicability of the $5 million GST exemption in 2010 and planning implications in connection with that exemption.)

4. GST Exemption in Future Years. The GST exemption for 2011 will also be $5.0 million. The $5.0 million amount is indexed from 2010, beginning in 2012. (The GST exemption amount is the same as the estate tax applicable exclusion amount, and the estate tax exclusion amount is indexed from 2010 beginning in 2012. TRA 2010 § 302(a)(1).) If the GST exemption amount is not changed by future

legislation, after the TRA sunsets following 2012, the GST exemption will be $1.0 million, indexed from 1997.

5. GST Tax Rate After 2010. The "applicable rate" for determining the GST tax is the maximum estate tax rate times the inclusion ratio of the trust. I.R.C. § 2641(a). Because the maximum estate tax rate is 35%, the GST rate is also 35% (except that the rate is zero for generation-skipping transfers in 2010).

G. Section 2511(c) Deleted. Section 2511(c), added by EGTRRA, provides that transfers to non-grantor trusts are treated as gifts. That section, which has raised considerable confusion, is fortunately deleted.

H. Sunset Provision of EGTRRA. Planners have been very concerned about the unintended possible effects of the sunset provision in EGTRRA following 2010. Section 901 of EGTRRA says that the Code will be interpreted as if the provisions of EGTRRA had never been enacted with respect to estates of decedents dying after, gift made after, and generation skipping transfers after 2010. However, there are many taxpayer favorable provisions in EGTRRA that might conceivably expire under EGTRRA § 901.

Most of these uncertainties are resolved for 2011 and 2012. TRA 2010 § 301(a) says that each Code provision amended by subtitles A or E of title V of EGTRRA "is amended to read as such provision would read if such subtitle had never been enacted." These subtitles only address the estate and GST tax repeal following 2009 and carryover basis. See section IV.B.1-2 of this outline.

All of the other provisions of EGTRRA would be given effect for 2011 and 2012, including the reduction of estate and gift tax rates (subtitle B), increase of unified credit exemption equivalent and GST exemption and setting the gift exemption at $1.0 million (subtitle C), replacing the state death tax credit with a state tax deduction (subtitle D), expansion of conservation easement rules for estate tax purposes (subtitle F), modifications of GST provisions, including automatic exemption allocations, retroactive allocations, qualified severances, modification of certain valuation rules, and the GST "9100 relief provisions"(subtitle G), and the relaxation of the requirements for deferred estate tax payments under I.R.C. § 6166 (subtitle H). This eliminates the concern about the effect of the sunset rule in EGTRRA on all of those other provisions for 2011 and 2012.

However, TRA 2010 provides for temporary tax relief (generally for just two years), and TRA 2010 § 101(a) states that Section 901 of EGTRRA is applied by replacing "December 31, 2010" with "December 31, 2012." This means that the sunset rule of EGTRRA is now delayed for two years, until following 2012. All of the uncertainties that we have had previously about the EGTRRA sunset provision remain, but are "punted forward" for two years to 2013.

V. Effective Dates

There are a variety of effective dates, described above for the various provisions.

A. Applicable for 2010. Interestingly, some of the changes are effective retroactively for all of 2010, mainly the re-enactment of the estate tax with a $5 million exclusion amount and 35% rate (but subject to the election to have carryover basis apply instead of the estate tax), technical computational details for calculating estate and gift taxes, increasing the GST exemption to $5.0 million for 2010 with a zero rate for any generation-skipping

transfers, and clarifying that direct skip transfers in trust in 2010 will not result in the application of GST taxes when distributions are later made to the beneficiaries (at least to the oldest generation of direct skip beneficiaries when the trust is created).

B. Applicable Beginning in 2011. Other changes are effective beginning in 2011. These include unification of the gift and estate exclusion amounts (by increasing the gift exemption to $5 million), and the portability of the unused estate tax exclusion amount.

C. Changes Effective For Decedents Dying Before Date of Enactment. Several changes apply only to estates of decedents dying in 2010 prior to and generation skipping transfers made in 2010 prior to the *date of enactment* — the provision allowing a delay in filing and paying tax until no earlier than nine months after the date of enactment. Similarly, the extended period for making disclaimers from transfers arising by the death of a decedent applies only to decedents who die in 2010 before the date of enactment.

D. No Changes Based on Date of Introduction of Bill. A very key change from the Baucus bill is that the changes to the gift tax in the Baucus bill (imposing a 45% rate) and reinstituting the GST tax on generation skipping transfers applied to transfers after the *date of introduction* of that bill (December 2, 2010). This would have removed many opportunities for year-end transfer planning in December. Fortunately, that issue did not arise under TRA 2010.

VI. What's Left Out?

Several provisions in the Baucus bill, including some provisions that we have seen in various bills in the last several years, are not included in TRA 2010. The following provisions in the Baucus bill and several other proposals that have received some attention over the last several years were not included.

A. Farmland. Estate taxes on farmland could be deferred under the Baucus bill until the farmland is sold or transferred outside the family or ceases to be used for farming. The executor would have to make a special election to exclude the farmland from the gross estate, attach a qualified appraisal of the farmland to the estate tax return, and file an agreement that provides for a never-ending estate tax recapture provision when the farmland is later sold, transferred outside the family, ceases to be used as farmland, or is encumbered by a nonrecourse indebtedness secured in whole or in part by the farmland. (There are complex provisions regarding the amount of the recapture tax payable by intervening generations, taking into account subsequent appreciation in the farmland, and requiring that "qualified heirs" file annual information returns describing whether any of the recapture triggering events has occurred.)

B. Special Use Valuation. The Baucus bill would have increased the special use valuation adjustment amount from $750,000 (indexed to $1.0 million in 2010) under current law to $3.5 million (indexed from 2009 beginning in 2011). Therefore, up to a $3.5 million (indexed) reduction in value would have been allowed for farm or business property that satisfied the special use valuation requirements. This provision was effective for estates of decedents dying after and gifts made after 2009 (and therefore applied for 2010 decedents).

C. GRAT 10-Year Minimum Term. The Baucus bill included the proposal in the President's Budget Proposal for the last two years of a GRAT 10-year minimum term. Under the proposal, grantor retained annuity trusts must have a 10-year minimum term, the annuity

amount cannot decrease in any year, and the remainder interest must have a value greater than zero determined at the time of the transfer to the trust. The Baucus bill would have applied this minimum 10-year GRAT provision to *transfers after the date of enactment*.

At this point, there has been no indication whether the deletion of this provision reflects Congressional policy not to impose a 10-year minimum term on GRATs, or whether the Congressional writers are just saving this revenue raising provision for subsequent legislation. The discussions surrounding the passage of TRA 2010 did not include any element of needing revenue offsets to "pay for" the changes. Indeed, the entire package is viewed as an economy and job creation stimulus. At some point in the future, the revenue impact of legislation will again matter, and revenue raisers, such as this one, may re-emerge.

D. Consistency of Basis. The Baucus bill also included the consistency of basis proposal in the President's Budget Proposal for the last two years The basis of property in the hands of heirs would be the same as its value as finally determined for estate tax purposes, and the basis of property in the hands of donees for purposes of determining loss would be limited by the fair market value (under I.R.C. § 1015) as finally determined for gift tax purposes. (This provision in the Baucus bill was retroactive, applying to "transfers for which returns are filed after the date of enactment.")

As with GRATs, the deletion of this provision may just mean that it is being saved for future legislation when revenue offsets will be needed because this is a revenue raising provision.

E. Gift Tax Separate Years for 2010 Gifts Before and After Date of Introduction. The Baucus bill would have resulted in different gift tax rates for gifts made in 2010 before and after December 2, 2010. A provision in the Baucus bill addressing the mechanics of reporting those gifts was not needed in TRA 2010.

F. Section 2704. TRA 2010 (as well as the Baucus bill) does not contain any provisions addressing I.R.C. § 2704 (as requested in the President's Budget Proposal the last two years). (This provision has not been included in *any* statutory proposal.)

G. State Death Tax Deduction. The extension of the estate tax provisions of EGTRRA means that the state death tax credit does not get reinstituted in January (which would have caused the re-emergence of state death taxes in many states that just have a "federal credit pick-up system" and that therefore have no state estate taxes if there is not a federal death tax credit). Furthermore, some have speculated that as a revenue raiser, Congress may at some point delete the deduction for state death taxes that now exists under I.R.C. § 2058. That was not done in TRA 2010.

VII. Effects on Year-End Planning

While 2010 year-end planning obviously is no longer possible, 2010 year-end planning concepts and issues are addressed because planners will be dealing with the effects of 2010 year-end transactions that were implemented to take advantage of special opportunities in the last few weeks of 2010 after TRA 2010 was passed.

A. Lack of Date of Introduction Effective Date Opened the Door to Year-End Planning. The Baucus bill would have had a major impact on year-end planning. Many individuals have been waiting until the end of the year to make 35% gifts, to make direct skip gifts, and to make distributions to skip persons from trusts that are non-exempt for GST tax purposes,

in order to make sure that the 45% gift tax rate and GST tax are not applied retroactively. There has been no prior public discussion of making the gift and GST tax provisions effective on the date of INTRODUCTION of a bill, and the inclusion of the date of introduction effective date in the Baucus bill was quite surprising. Fortunately, TRA 2010 has no such early effective date, and year-end planning opportunities continued throughout the end of 2010.

The following is a general framework for year-end transfer planning strategies.

B. Certainty. The passage of TRA 2010 provides a substantial degree of certainty regarding various effects of year-end planning transfers that we did not have previously.

C. No Gift Tax Advantage of Making Gifts in 2010 Unless Donor is Willing to Pay Gift Tax. There was generally no advantage to making gifts in December rather than in January if the donor did not want to pay gift tax. The rate would be the same (35%) if there is gift tax, and there is more gift exemption in January to cover gift transfers in case the IRS argues for higher gift values on audit. (One exception to this general rule is deathbed planning for estates that would not owe federal estate taxes under the $5.0 million estate exemption in 2010 under TRA 2010, but would owe significant state estate taxes. In many states, pre-death gifts (even deathbed gifts) are excluded from the estate for state estate tax purposes.)

Furthermore, some planners indicate that there could be long term benefits of making gifts in December rather than January if (1) the donor had been willing to pay current gift taxes, and (2) if future legislation were to decrease the exemptions and increase the rates from the levels set in TRA 2010. There are several contributing factors to tax savings by making gifts in 2010 in order to pay larger current gift taxes than if the gift is made in January. (1) Gift taxes are removed from the gross estate if the donor lives at least three years, resulting in some of the estate being taxes on a "tax-exclusive" basis. Making the gift in December involves paying greater taxes, so this potential advantage would be larger. (2) Paying transfer taxes on a portion of the estate at rates below the ultimate estate tax rate can save overall combined transfer taxes. This would be important if the estate tax rates were to be increased in the future. Each of these factors is addressed below.

1. Taxing Portion of Estate on Tax-Exclusive Basis if Donor Lives Three Years (By Removing Gift Tax From Taxable Base). If a donor lives three years after making a gift, any gift taxes paid are removed from the gross estate. This can result in a significant overall tax savings. If a client is willing to entertain that planning strategy, making the gift in December, when there is only a $1 million gift exemption rather than the $5 million gift exemption that will apply in January, will result in a larger gift tax payment, which in turn results in a larger amount being removed from the gross estate if the donor lives at least three years after making the gift. Detailed calculations would be required to determine the overall effects of paying additional gift taxes (taking into account the assumed appreciation rate of the transferred assets, the time value of the tax payments, and the assumed future level of estate tax exemption amounts and rates).

2. Taxing Portion of Estate at Lower Rates In Case Estate Tax Rates Rise in the Future. If gifts are made in December rather than January, savings results from paying gift taxes on a portion of the estate at a 35% rate if the later estate tax rate were to be increased (for example, to 45% or 55%). (See the examples in section IV.E.3 of this outline for a general discussion of the impact of gifts on later estate

tax determinations.) The following examples compare making gifts in December and January, assuming that the estate tax rate at the date of death increases to 45%. The examples isolate the effect of the changing rates by not including the advantage of paying some of the tax on a tax-exclusive basis by removing the gift tax from the estate if the donor lives three years after making the gift. That factor would further increase the advantage of paying larger gift tax by making the gift in December (with a $1 million exemption) rather than in January (with a $5 million exemption).

Example 1 (Gift of $10 million in January 2011; Death in 2013 With Exclusion of $3.5 Million and Top Rate of 45%). Assume A makes a gift of $10 million in January 2011 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $3.5 million and has increased the top rate to 45% for 2013. Assume the "Line 7" gift tax offset in the estate tax calculation is determined using the approach in the Form 706 instructions. (The "Line 7" issue is discussed in section IV.E.2-3 of this outline.)

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amt	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (at 45% top rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (45% top rate)	4,380,800	
Less gift unified credit on $5M exemption (using 45% rate)	- 2,130,800	
		- 2,250,000
(3) Estate tax before unified credit		4,380,800
(4) Less unified credit on $3.5 million exclusion (using 45% top rate)		- 1,730,800
(5) Estate tax		2,650,000

Example 2 (Gift of $10 million in December 2010; Death in 2013 With Exclusion of $3.5 Million and Top Rate of 45%). Assume A makes a gift of $10 million in December 2010 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $3.5 million and has increased the top rate to 45% for 2013. Assume the "Line 7" issue is resolved the same as in Example 1, above.

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $1 million exclusion amt	- 330,800
Gift tax payable for 2011 gift	3,150,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (at 45% top rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (45% top rate)	4,380,800	
Less gift unified credit on $1M exemption (45% rate)	- 345,800	
		- 4,035,000
(3) Estate tax before unified credit		2,595,800
(4) Less unified credit on $3.5 million exclusion (using 45% top rate)		- 1,455,800
(5) Estate tax		1,140,000

Observations Regarding Example 2. The total gift tax and estate tax is $3,150,000 gift tax plus $1,140,000 estate tax, or $4,290,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been 5,175,000. Making the gift saved $885,000 of combined tax. The $10 million gift had a 35% tax rate apply to $9 million — the amount of the gift not covered by the $1 million exemption. If the gift were not made, that $9 million would have been taxed at 45%. The additional 10% of the $9 million amount would represent $900,000 of savings. This is offset by $15,000 of reduced savings because the gift tax credit on the $1 million of gift exemption was only in the 39% bracket. To get to the 45% bracket of credit, there would be an additional 2% of $250,000 (the $1,000,000 to 1,250,000 bracket) and 4% of 250,000 (the $1,350,000 to 1,500,000 bracket), or $15,000.)

Comparison of Examples 1 and 2.

January 2011 Gift, combined gift and estate tax: $1,750,000 + 2,650,000 = $4,400,000

Dec. 2010 Gift, combined gift and estate tax: $3,150,000 + 1140,000 = $4,290,000

Savings by making gift in December rather than January: $ 110,000

Observe, if the donor had lived for three years after making the gift, so that the gift tax was excluded from the gross estate, resulting in paying transfer tax on a tax-exclusive basis on $9 million rather than just $5 million of the estate, there would have been even greater savings by making the gift in December rather than in January.

Practical Planning Pointer: If a donor was willing and able to pay current gift taxes, making a large gift in December 2010 rather than in January 2011 could result in significant overall tax savings attributable to (1) paying a portion of the transfer tax on a tax-exclusive basis if the donor lives three years after making the gift, and (2) paying a portion of the transfer tax at a lower rate if the estate tax rate increases above 35% by the time of the donor's death. These savings would have to be offset by the lost time value of the gift tax payment as compared to paying estate tax at a later time (but the growth attributable to the retained gift tax amount would have been subject to estate tax).

D. Significant GST Opportunities. The major year-end planning opportunities relate to GST planning. Opportunities to take advantage of the GST tax not applying to generation-skipping transfers in 2010 are significant. The GST planning opportunities include (1) direct skip gifts for grandchildren (or even for great-grandchildren), (2) making distributions from non-exempt trusts to remote beneficiaries (skip person beneficiaries) without the imposition of a GST tax, or (3) terminating non-exempt trusts this year and

distributing assets to younger generation beneficiaries without the imposition of a GST tax. Furthermore, TRA 2010 makes clear that generation-skipping transfers can be made in trust without risking having GST tax apply to later transfers to the oldest generation level skip person beneficiaries of the trust when the transfer is made in 2010.

This opportunity can be applied to non-married partners where one partner is more than 37.5 years older than the younger partner; transfers could be made in 2010 to the younger partner without the imposition of the GST tax. (The GST opportunities are discussed in more detail in section VIII of this outline.)

E. Retroactive Legislation Taxing Gifts and GST Transfers in 2010 is Extremely Remote. It seems extremely unlikely that the 2011 Congress will retroactively change the estate, gift and GST tax rules back into 2010, particularly changes that would adversely impact gifts and generation skipping transfers made in 2010. The fact that Republicans control the House and have picked up more seats in the Senate in 2011 make the likelihood of such possible retroactive legislation, effective back into 2010, so remote as to be nonexistent.

VIII. GST Planning Issues

A. Sunset Rule Uncertainties. The sunset rule changes, discussed above in section IV.H of this outline, remove many of the uncertainties we have had about the GST tax for 2010 and about whether and how the GST relief provisions in EGTRRA (increased GST exemptions, automatic allocation, qualified severances, "9100 relief" for late allocations, etc.) would still be given effect after 2010. Unfortunately, the relief under TRA 2010 only lasts for two years, and all the uncertainty will arise again following 2012. However, TRA 2010 shows how the EGTRRA adverse effects can easily be solved by a legislative change, and making that change is not controversial at all. There seems little doubt that the sunset will be further extended following 2012, or that the various estate, gift and GST changes in EGTRRA (other than the repeal of the estate tax with carryover basis and the repeal of GST tax) will be extended permanently. But with Congress, nothing can be certain.

B. GST Applicable Rate in 2010 is Zero. For all of 2010, the GST tax "applicable rate determined under section 2641(a)... is zero" for all generation-skipping transfers made in 2010. [TRA 2010 § 302(c).]

1. Impact of Transfers in Trust. The change in nomenclature is particularly important because of its impact on direct skip gifts *in trust* for grandchildren (or more remote beneficiaries). This change clarifies that "direct skip" gifts for grandchildren *to trusts* that were made earlier in 2010 will not result in having the GST tax apply when distributions are made from the trust to the grandchild in later years. This provision replaces I.R.C. § 2664 as added in EGTRRA, which section says that Chapter 13 "does not apply to generation-skipping transfers after December 31, 2009." While § 2664 results in a zero GST tax for direct skip gifts in 2010, saying that all of Chapter 13 does not apply raises the possibility that direct skip gifts in trusts may be subject to later GST taxation upon distribution to the beneficiary because the "move-down rule" in I.R.C. § 2653(a), which is in Chapter 13, would not apply. Under the new nomenclature, Chapter 13 (including the move-down rule as well as the rule in I.R.C. § 2642(c) saying that annual exclusion gifts to single beneficiary vested trusts have an inclusion ratio of zero) does apply to generation skipping transfers in 2010 (so the potential uncertainty about direct skip gifts to trusts is resolved).

The same issue applies regarding a taxable distribution or taxable termination in 2010 that results in the assets passing to another trust. The move down rule will apply in that situation as well, because it applies whenever there is a generation-skipping transfer (even though the rate on the generation-skipping transfer in 2010 is zero). I.R.C. § 2653(a).

2. Inclusion Ratio Is Not Automatically Zero for Generation Skipping Transfers in 2010. Under I.R.C. § 2641(a), the applicable rate is the "maximum Federal estate tax rate" times "the inclusion ratio with respect to the transfer." The statutory language of TRA 2010 § 302(c), that the "applicable rate determined under section 2641(a)" is zero, does not make totally clear whether the "maximum Federal estate tax rate" is deemed to be zero or whether "the inclusion ratio" is zero. The argument could be made that if the result of the multiplication of the maximum estate tax rate times the inclusion ratio is zero, and if the maximum estate tax rate is set by statute, the inclusion ratio must, by basic mathematical principles, be zero. If the inclusion rate is zero for any generation skipping transfers made in 2010, direct skip gifts (which would be "generation-skipping transfers") would arguably result in a trust with an inclusion ratio of zero for generations to come. However, nothing in the statutory language suggests that is the intended result. Apparently the intent is just to provide that there is no GST tax this year by saying that the applicable rate is zero, without a mathematical exercise of how that is achieved under the statutory formula. The more likely interpretation is that there is no GST tax on generation skipping transfers in 2010, but transfers to trusts in 2010 do not automatically result in a zero inclusion ratio for the trust. GST exemption would have to be allocated to the transfer to result in a zero inclusion ratio. The Joint Committee on Taxation Technical Explanation agrees that the inclusion ratio will not be zero, but that the amendment means that the highest estate tax rate that is used in the formula is zero in 2010:

> "…the generation skipping transfer tax rate for transfers made during 2010 is zero percent. The generation skipping transfer tax rate for transfers made after 2010 is equal to the highest estate and gift tax rate in effect for such year (35 percent for 2011 and 2012)." Joint Committee on Taxation Technical Explanation at 50.

In any event, the statute would have been clearer if it had stated that for purposes of § 2641(a), the "maximum Federal estate tax rate" would be deemed to be zero for generation-skipping transfers in 2010.

C. Direct Skip Gifts in Trust. Under TRA 2010, direct skip gifts made to trusts in 2010 do not risk having the GST tax apply when the trust later makes a distribution to a grandchild-beneficiary. Taking advantage of this opportunity will require making a transfer that for sure is a direct skip.

1. Outright or Custodianship Gifts. A transfer directly to or to a custodianship for a grandchild (or more remote beneficiary) will clearly be a direct skip.

2. Gifts in Trust. For gifts in trust, we need to examine the definitional provisions in the GST rules.

a. Move-Down Rule. The move-down rule of § 2653 applies if there is a generation-skipping transfer of property (a direct skip, taxable distribution

or taxable termination, § 2611(a)) and the property is held in trust. The effect is that for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to one generation above the highest generation of any person who has an "interest" in the trust immediately after the transfer. (So if a grandchild has an interest in the trust, the transferor level will be moved down to the child-level so that a subsequent distribution to a grandchild would not be a distribution to someone two or more generations below the transferor that would generate a GST tax.)

b. Skip Person Definition. The key is that for the move-down rule to apply, there must be a distribution to a skip person (whether it is a direct skip, taxable distribution or taxable termination). Skip persons are defined in § 2613. A trust is a skip person if (1) all "interests" in the trust are held by skip persons, or (2) if no person holds an "interest" in the trust and at no time may a distribution (including distributions on termination) be made to a non-skip person. I.R.C. § 2613(a)(2). As to item (2), the regulations add that if no one holds an immediate interest in the trust, for purposes of determining whether any distribution could be made to a non-skip person, a possible distribution that has a probability that is so remote as to be negligible (applying actuarial standards showing there is less than a 5% probability) is disregarded. Treas. Reg. § 26.2612-1(d)(2).

c. Interest Definition. An "interest" in a trust is defined in § 2652(c). A person holds an interest if, at the time the determination is made, the person (1) has a right (other than a future right) to receive income or corpus from the trust, or (2) is a permissible current recipient of income or corpus. (There are other special rules if the trust is a charitable trust.) I.R.C. § 2652(c)(1). However, an interest that is used primarily to postpone or avoid any GST tax is disregarded. I.R.C. § 2652(c)(2). Also, the fact that a distribution may satisfy another person's support obligation is disregarded if such use is discretionary or is pursuant to a UGMA or UTMA transfer. I.R.C. § 2652(c)(3).

d. Application of Definitions to Trusts. Under these definitions, a trust will be a skip person (and therefore, result in application of the move-down rule) if a second generation below the transferor or more remote beneficiary must have a right to receive current distributions or is a permissible current recipient of distributions and if there are no interests held by non-skip persons. If that is the case, it does not matter that non-skip persons may be contingent remaindermen or future beneficiaries. (The possibility that non-skip persons may receive benefits in the future applies under the statute and regulations only if there are no persons that hold interests in the trust when it is created (for example if no distributions can be made to anyone for a period of years).)

e. "Generation Jumping." If the distribution is made to a trust for great grandchildren only, the transferor will be moved down to the grandchild level, so that future distributions to the great grandchild will not be

generation-skipping transfers. Some planners have termed this "generation jumping.""

f. Addition of Upper Generation Beneficiaries at a Later Time. Some planners suggest that some independent party (an independent trust, a trust protector, or anyone other than the donor) could provide that upper level generations could later be added as beneficiaries without causing the trust to lose its status as a skip person trust (resulting in application of the move-down rule). The older generation beneficiaries could only be added at a later time — long enough to provide comfort that such persons could not be viewed as having an interest in the trust currently. (Jonathan Blattmachr suggests waiting five years.) This would help to counter any argument that the non-skip person should be treated as an intended current beneficiary by implication or under some kind of application of a step transaction theory. Some planners even suggest that the trust agreement could provide that older generation beneficiaries would automatically become discretionary beneficiaries after a stated period of time — such as five years.) However, other planners prefer a more conservative approach of not adding upper level beneficiaries at a later time.

g. No Current Grandchildren. If an individual has no current grandchildren but would like to take advantage of the unique opportunity in 2010 to make transfers to direct skip trusts, consider having the individual make transfers to a trust for grandnieces or grandnephews (if the individual has any), or other beneficiaries who are in a generation assignment two generations below the individual. The trust could provide that any future grandchildren would also be potential beneficiaries. However, to avoid the rule disregarding nominal interests, consider providing for certain mandatory distributions to the existing grandnieces and grandnephews (or other designated second generation individuals) to avoid an argument that the trust was really just created for the benefit of non-existent grandchildren at the time it was created.

D. Move-Down of Transferor vs. Allocation of GST Exemption to Trust. If the move-down rule applies, the transferor is merely moved to one generation above the oldest generation beneficiary of the trust, but the trust does not become fully exempt. For example, if a direct skip is made to a trust for a grandchild, the move-down rule treats the trust as if the transferor were in the child-generation, so that a future distribution to a grandchild (one generation down from the transferor) is not subject to the GST tax. However, a distribution to a more remote beneficiary (whether on termination of the trust or during the term of the trust) would generate a GST tax if no GST exemption has been allocated to the transfer.

On the other hand, if GST exemption is allocated to the transfer, so that the trust results in having a zero inclusion ratio, all future distributions from the trust to any generation levels of beneficiaries would be GST exempt.

Donors in 2010 had to decide whether (a) to make direct skip transfers in trust (which could be unlimited in amount) and forego using up any GST exemption to allocate to the transfer, or (b) to make transfers to GST exempt trusts, which could last for as many generations as would be allowed under applicable rules against perpetuities, but which

would be limited in amounts that be covered by the $5.0 million of GST exemption available in 2010.

E. Taxable Distributions or Taxable Terminations in 2010 Could Be Made Without GST Tax. The Baucus bill would have eliminated the ability to make GST tax-free taxable distributions or taxable terminations from trusts after December 2, 2010. Under TRA 2010, distribution opportunities from non-exempt trusts remain before the end of 2010. As with direct skips, if taxable distributions or taxable terminations result in the assets being held in further trust, the move-down rule applies. Before TRA 2010, it was not clear that taxable distributions could be made in further trust for trust beneficiaries (for example under a decanting statute or pursuant to discretion granted to the trustee under the trust agreement) without the possible imposition of a GST tax when later distributions were made to those beneficiaries.

F. Timing of Actual Distribution. The direct skip or taxable distribution had to occur *during 2010* to take advantage of the special opportunity available only during 2010 to have a GST tax rate of zero. There is nothing in the statute or regulations about specifically when title must pass under state law to determine when the direct skip, taxable distribution or taxable termination occurs. However, transfers that are mandated under the instrument should be treated as occurring on that date, even if the trustee does not make the physical transfer until a later date. (Otherwise, planners could manipulate the timing of the payment of GST taxes by merely delaying mandated distributions until a later year or years.) Similarly, a specific bequest under a will of a person who dies in 2010, that is vested and is not subject to the discretion of an executor as to the amount of the bequest, should be treated as occurring as of the date of death, even if the executor delays for years in making the physical distribution of assets satisfying the bequest. However, in light of the very special treatment of generation-skipping transfers in 2010, best practices would include making physical distribution of the assets, if at all possible, in 2010 in order to avoid any possible argument that the direct skip did not occur in 2010.

Practical Planning Pointer: An important planning implication of the timing issue is that disclaimers in 2011 from 2010 estates that result in assets passing to grandchildren (or younger generation beneficiaries) should be treated as 2010 direct skips resulting in a zero GST tax.

Discretionary distributions, on the other hand, result in generation-skipping transfers occurring on the actual distribution date pursuant to the exercise of discretion.

A case that involved an agreement with the IRS regarding the timing of generation-skipping transfers, albeit in an unusual fact situation, is Robertson v. U.S., 97 A.F.T.R.2d 589 (N.D. Tex. 2006). That case involved a charitable lead annuity trust that passed to grandchildren at the end of the trust term. The trustee had total discretion as to what charities would receive distributions during the term of the trust, so no person held an "interest" in the trust during its stated term. The conclusion was that there was no taxable termination at the end of the stated term, because that required the termination "of an interest in property" and no person held an interest in the trust prior to the stated termination date. Therefore distributions from the trust were treated as taxable distributions. The IRS did not contest the position of the taxpayer that the taxable distributions occurred in the year following the stated termination date of the trust, and the parties stipulated that the date of actual distribution was the appropriate date for valuation of the GST amount and for applying the GST tax rate (the rate decreased in the

year following the stated termination date of the CLAT). That stipulation seems to conflict with the generally accepted approach of treating transfers that are mandated in an instrument as occurring on the mandated vesting date.

G. Testamentary Transfers From 2010 Decedents. The possibility that 2010 testamentary transfers are forever exempt from the GST tax would be eliminated under TRA 2010 because the estate tax would apply (or be deemed to apply) to 2010 decedents so the decedent would be a "transferor" under the GST definitions. TRA 2010 § 301(c)(last sentence). (Under the provisions of EGTRRA applicable in 2010, there was an argument that testamentary trusts created by 2010 decedents were exempt from the GST tax, because under the GST rules the "transferor" is the last person subject to a transfer tax, and decedents who die in 2010 are not subject to estate tax [before TRA 2010]. The definitions of skip persons and non-skip persons are tied to the definition of "transferors." Non-skip persons are everyone other than skip persons (§ 2613(b)), and if skip persons cannot be identified because of the lack of a transferor, perhaps the whole world would constitute non-skip persons. If so, future transfers from the trust arguably would not be subject to GST tax.) TRA 2010 clearly removes that argument that had existed under EGTRRA.

H. 2010 GST Exemption of $5.0 Million. Under TRA 2010, there is 2010 GST exemption of $5.0 million (because the estate tax exemption in 2010 is $5.0 million and the GST exemption is the same as the estate exemption, § 2631(c)). (Without this legislation, it appears that there is no GST exemption for 2010, because the GST exemption equals the estate tax applicable credit amount and in § 2010(c), as amended by EGTRRA, the table for the applicable credit amount ends with 2009; there is nothing listed for 2010 or beyond. While there is no GST exemption in 2010 under EGTRRA, in 2011 there may have been a GST exemption equal to $1.0 million, indexed for inflation since 1997, depending on how the "had never been enacted" rule was applied. See I.R.C. § 2631(c) (prior to amendment by the 2001 Act). That number is $1.34 million for 2010.

A possible exception to having $5 million of GST exemption for 2010 is that, as currently drafted, the statute arguably would not result in a 2010 GST exemption amount for estates that make the carryover basis election. In that circumstance, the "repeal of the repeal of the estate tax" under TRA § 301(a) does not apply, so literally chapter 11 does not apply to the estate. If chapter 11 does not apply, the amendment in TRA 2010 of I.R.C. § 2010 providing a $5.0 million applicable exclusion amount is irrelevant because § 2010 is in chapter 11 and it does not apply. An argument to the contrary is that the election for the estate tax not to apply under TRA § 301(c) applies only "with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code)," and therefore does not apply for GST purposes. Therefore, the reference in I.R.C. § 2631(c) to the "applicable exclusion amount under section 2010(c)" may continue to refer to the $5.0 million amount. The possibility of having no GST exemption for testamentary transfers in estates making the carryover basis election apparently is unintended (it certainly would be unjust to apply the GST tax scheme to testamentary transfers but not afford an opportunity to use GST exemptions). This result apparently is unintended, and the Joint Committee on Taxation Technical Explanation clearly takes the position that the $5 million GST exemption applies for 2010 decedents whether or not the carryover basis election is made:

> "The $5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules." Joint Committee on Taxation Technical Explanation at 50 n.53.

Having 2010 GST exemption of $5.0 million is very important for various reasons. First, consider electing out of automatic allocation of the 2010 GST exemption to direct skip gifts. Second, the $5.0 million of GST exemption can be allocated on timely filed returns, based on the values of gifts to trusts on the dates of the gifts in 2010. Third, there is $5.0 million of GST exemption that can be allocated to transfers in prior years on a late allocation.

1. Elect Out of Automatic Allocation for Direct Skip Transfers in 2010. The change in nomenclature in TRA 2010 to avoid saying that chapter 13 does not apply to GST transfers in 2010 has two important implications for direct skip gifts in trust: (1) Automatic allocation of GST exemption to the direct skip will occur under I.R.C. § 2632(b)(1) to the extent necessary to result in a zero inclusion ratio for the transfer unless there is an election out of such automatic allocation; and (2) the move-down rule of I.R.C. § 2653(a) will apply and the zero inclusion rule under I.R.C. §2642(c) for single beneficiary-vested annual exclusion gifts in trust will apply, so that future distributions to the grandchild-beneficiary of the trust will not be subject to the GST tax. These effects are discussed below.

   There is generally automatic allocation of any unused GST exemption to direct skip gifts (whether or not in trust). I.R.C. § 2632(b)(1). Such automatic allocation to direct skip gifts can be avoided by electing out of automatic allocation on a timely filed gift tax return. I.R.C. § 2632(b)(3); Treas. Reg. § 26.2632-1(b)(1).

   Under TRA 2010, the nomenclature that chapter 13 does not apply has been dropped, so § 2632(b)(1) would apply to all direct skips, whether or not in trust, but only "to the extent necessary to make the inclusion ratio for such property zero." Therefore, automatic allocation will apply for direct skips generally (whether or not in trust), but will not apply to annual exclusion gifts to single beneficiary-vested trusts, because the inclusion ratio for such transfers is already zero under I.R.C. § 2642(c). (Under the law before TRA 2010, the same result may have occurred for direct skips in trust, though under a much more convoluted analysis. Under EGTRRA, chapter 13 does not apply to direct skips, so the automatic allocation rule of §2632(b)(1) would not apply. However, under the sunset rule of EGTRRA (before it was amended by TRA 2010), the Code would be interpreted as if EGTRRA had never been enacted with respect to future generation skipping transfers, so the chapter 13 rules would be applied to have allocated GST exemption automatically to direct skip trusts when a later taxable distribution or taxable termination occurs with respect to that trust.)

   TRA 2010 makes clear that the move-down rule of I.R.C. § 2653(a) would apply to direct skip gifts in trust in 2010. For example, if a direct skip gift is made in trust for the donor's grandchild, the move-down rule would cause the grandchild's parent to be treated as the transferor to the trust with respect to future transfers, so that subsequent transfers to the grandchild-beneficiary would not cause a GST tax to apply. In that circumstance, GST exemption that is automatically allocated to

the trust would have been wasted if it is likely that distributions from the trust will ultimately be made to the grandchild-beneficiary. (On the other hand, if the intent is to keep the trust intact for the grandchild's descendants, allocation of GST exemption to the trust would be appropriate and desirable.)

Practical Planning Pointer: Planners must carefully examine all direct skip gifts in 2010 (whether or not in trust and whether inter vivos or by testamentary transfers) to determine whether a timely filed tax return should be filed electing out of automatic allocation.

2. Timely Allocation of 2010 GST Exemption. If a timely allocation is made, I.R.C. § 2642(b)(1)(B) says that the GST exemption allocation is made effective as of the date of the gift using values on that date. Late allocations are effective as of the date of the allocation, §2642(b)(3)(B), or as of the time the late allocation is made in 2011 (using values on that date, thus requiring allocation of GST exemption to the appreciation occurring up to that date). A late allocation cannot be filed until April 19, 2011 at the earliest (the due date is April 18). If the donor's income tax return is extended, that automatically extends the gift tax return as well to October 15 (or October 17 in 2011). In 2011, a late return for the October deadline could not be filed until October 18, 2011. Before TRA 2010, there was no GST exemption in 2010 and it was unclear under the sunset rule whether 2010 GST exemption would be deemed to have existed with respect to generation-skipping transfers occurring after 2010. If there was no 2010 GST exemption, there would be a necessity of waiting to file a late allocation of 2011 GST exemption, based on the appreciated values at the time of the allocation. Fortunately, that potential problem has been resolved by TRA 2010.

3. Late Allocations of 2010 GST Exemption to Transfers in Prior Years. Individuals sometimes wish to allocate more GST exemption to prior trust transfers than the individual has remaining. Having the additional $1.5 million of GST exemption (above the $3.5 million available in 2009) opens up the possibility of being able to allocate substantial additional GST exemption to prior trust transfers at current trust values. (However, this opportunity has minimal effect at the late date in 2010 that TRA 2010 was enacted. The only benefit of making a late allocation in 2010, rather than waiting until 2011, is that the allocation could be made based on current values as opposed to values in January (or some later date).)

I. 2010 Transfers Not Grandfathered. Transfers to trusts in 2010 are not grandfathered or exempt from the GST tax. Trusts with contributions in 2010 will be GST exempt only if GST exemption is allocated to those transfers.

J. May Provide Clarity Regarding ETIPs. GST exemption cannot be allocated to transfers subject to an "estate tax inclusion period" (or ETIP) during which the assets would be included in the gross estate of the transferor (or his or her spouse). I.R.C. § 2642(f). An example is a transfer to a GRAT, because some or all of the trust may be included in the transferor's gross estate if he or she dies during the GRAT term. GST exemption can be allocated at the end of the ETIP, and indeed there are rules for automatically allocating GST exemption at the end of the ETIP in certain situations. See Treas. Reg. § 2632-1(c). During 2010, chapter 11 did not apply under EGTRRA so arguably ETIPs ended as of January 1, 2010 because the trust assets would not have been included in the transferor's gross estate if he or she died after 2009. There were questions as to whether the ETIP

would be reinstated at the end of 2010 when the EGTRRA sunset occurred and the estate tax would again apply. If the ETIP terminated on January 1, 2010, could GST be allocated when the ETIP terminated in 2010 — even there is no GST exemption for 2010? EGTRRA raised many uncertainties regarding the treatment of ETIPs. The result of TRA 2010 is not clear, but TRA 2010 may remove many of the uncertainties. It would provide that the estate tax did continue to apply after 2009 (subject to the election of carryover basis instead). Does this mean that an ETIP that we thought had ended on January 1 really did not end, so the ETIP continues without interruption and the uncertain results under EGTRRA are no longer a concern? Is this issue impacted by whether the carryover basis election is made for 2010 decedents? The legislation itself does not answer these questions. Perhaps IRS guidance about the legislation will do so.

IX. Construction Issues

A. Formula Bequests. The change in the law raises various potential construction issues in construing formula bequests. (For an excellent discussion of similar construction issues that arose during the 2010 estate tax hiatus, see Medlin, Zaritsky & Boyle, Construing Wills and Trusts During the Estate Tax Hiatus in 2010, 36 ACTEC L.J. 273 (2010).) For example, consider the effect of TRA 2010 in construing several possible types of formulas, keeping in mind that the estate tax and the $5 million applicable exclusion amount apply from January 1, 2010.

- "Maximum amount that can pass free of estate tax" now appears to mean $5 million rather than the entire estate.
- "An amount equal to the federal estate tax applicable exclusion amount" now appears to mean $5 million rather than zero.

However, while the law seems to say that the amount passing under each of those formulas would be $5 million for decedents dying any time in 2010, there are various uncertainties. Observe that the resolution of each of these issues is a matter of state law, and as a practical matter will be determined in each separate case based on the equities of the case and what the parties can convince the court to be the testator's intent.

1. Does Decision to Make Carryover Basis Election Change Construction? Does the construction of the formula change if the executor makes the carryover basis election? In that event, TRA 2010 § 301(c) says that the "repeal" of § 2210 in TRA 2010 § 301(a) does not apply, so Chapter 11 does not apply, so the amended § 2010(c) changing the applicable exclusion amount to $5 million for 2010 does not apply. If making the carryover basis election changes the formula bequest, the executor not only has to make decisions of whether the overall tax result is better to apply carryover basis than the estate tax (which depends on a variety of factors, some of which are mentioned in section IV.B.2 of this outline) and how to treat beneficiaries fairly in implementing carryover basis and making the basis adjustments, but the executor also has to consider that the election may drastically change the amounts of the bequests passing under the will. A further complexity is that we do not know the due date of the carryover basis election (see section IV.B.2 of this outline), but it is possible the election will not be made until the fall of 2011, and the election could conceivably change the construction of the values of bequests assets passing under the will of a decedent who died perhaps over 20 months earlier.

2. Do Interests Passing Under Will Vest as of Date of Death Under State Law? The change in the law could be almost twelve months after the date of death in 2010 and arguably should not change the amounts passing under the will. Some state laws provide that assets passing under a will vest as of the moment of death, subject to the administration of the estate.

3. What if Assets Have Been Distributed? Does it make a difference if bequests have already been funded? Changing the construction based on the new law, which is now effective as of January 1, 2010, may require that beneficiaries refund previously distributed amounts. Will that change the court's interpretation of the formula bequests?

4. Practical Scenario. Assume a fairly typical scenario of a situation in which the decedent's children are not children of the surviving spouse and are hostile to the surviving spouse. Assume the will provided that the formula "tax-free" amount passes directly to the children and that the balance of the estate passes to the spouse. Assume the local court determines that amounts passing under the formula bequest depend on the carryover basis election. This means that if the executor makes the carryover basis election, in which event chapter 11 does not apply, the entire estate would pass to the children, but if the executor does not make the carryover basis election, only $5 million passes to the children and the balance passes to the surviving spouse. Assume the executor does not make the carryover basis election, so most of the estate passes to the surviving spouse. Later the children sue, and assume the court construes the formula bequest to mean that all of the estate passed to the children. That state law ruling would mean that although the estate is subject to the estate tax, nothing qualifies for the marital deduction. Furthermore, it may be too late at that point (perhaps several years later) to change the decision not to make the carryover basis election. (TRA 2010 § 301(c) states that the carryover basis election

> "shall be made at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide. Such an election once made shall be revocable only with the consent of the Secretary…"

Perhaps that would be a situation in which the IRS would permit a change in the election. Does it make a difference that in this circumstance, the executor chose not to make the election so perhaps did not file anything making an affirmative election but merely filed a timely estate tax return? (The statute, quoted above, says that an election into carryover basis is revocable only with the Secretary's consent, and in this scenario there was never an election into carryover basis.)

B. Construction in States With Legislation Tying Formula Bequests to 2009 Law. Twenty states (including the District of Columbia) have statutes regarding the construction of formula "tax-free" bequest clauses for 2010. A number of those state statutes refer to estate tax rules on December 31, 2009. (Those states are Delaware, District of Columbia, Georgia, Idaho, Indiana, Maryland, Minnesota, Michigan, Nebraska, New York, North Carolina, Pennsylvania, South Dakota, Tennessee, Utah, Virginia, Washington, and Wisconsin. In addition Florida and South Carolina have "go-to-court" statutes that do not specifically apply 2009 law.) Will formula "tax-free" bequests in those states mean that $3.5 million continues to pass under the clause rather than $5 million that could pass without estate tax under TRA 2010? Most of those statue statutes say that the special

construction applies only for 2010 decedents, but if the federal estate or generation-skipping transfer tax becomes effective before January 1, 2011, the statute will no longer apply as of the date the tax becomes legally effective.

Various uncertainties will apply in these states in light of the changes by TRA 2010.

- If the state has passed a statute providing that formula bequests are construed as if 2009 law applied, will the bequest of the tax-free amount be limited to $3.5 million even though $5.0 million could pass to the bypass trust without incurring estate tax?
- Will state legislatures change their construction statutes?
- Will courts construe the formula to mean $5.0 million despite the state statute?
- For purposes of the sunsetting provision in a state construction statute, does TRA 2010 cause the federal estate tax to be legally effective as of January 1, 2010 so that the sunsetting provision applies as of January 1, 2010, meaning that the state construction statute does not apply at all?
- Does the carryover basis election change the result? (For example, if the carryover basis election is made, the estate tax does not apply so the state statute says the tax-free amount means $3.5 million, but if there is no election, the estate tax does apply as of January 1, 2010 so the state construction state does not apply and the tax-free formula means $5 million.)
- Observe the difficulty the executor faces isn addressing this uncertainty. If the tax-free formula bequest is $5 million if the estate tax applies but $3.5 million if carryover basis applies, Howard Zaritsky concludes: "Would you want to be that executor?"
- Many of statutes allow estates to bring a legal proceeding to ascertain whether the decedent intended to apply 2009 law in determining the amount passing under the formula, but require that "such a proceeding shall be commenced within 12 months following the death of the testator or grantor" (quoting the Virginia statute). For decedents who died in early 2010, that one-year limit is fact approaching. (Some states are considering amending their statutes to allow a longer time to bring such suits, such as through the end of 2011.)

C. Formula Bequests Equal to GST Exemption Amount. The specific language used in a GST formula transfer must be closely reviewed to determine the effect of TRA 2010 on the formula. For example, if the formula transfer applies "if Chapter 13 does not apply," that clause arguably is not triggered in light of TRA 2010, because it says that Chapter 13 *does* apply for all of 2010 (but the GST rate is zero). If the formula is an "amount that can pass free of GST tax," that might be everything passing under the instrument. If the formula is an "amount equal to the GST exemption," that would be $5 million under TRA 2010. That would be the starting point of the analysis, but this is still a state law construction issue, depending on the court's interpretation of the intent of the specific instrument and the donor.

X. Estate Planning Strategies Going Forward In Light of Changed Planning Paradigm Under TRA 2010

The $5.0 million estate and gift exclusion amount (and GST exemption) beginning in 2011 will open up a new paradigm of thinking regarding estate planning and transfer planning strategies. The ability to make transfers of up to $10 million per couple without having to pay gift taxes paves the way for many transfer planning opportunities that, with leveraging strategies, can transfer vast amounts of wealth outside the gross estate. On the other hand, the increased estate

exclusion amount may remove the motivation for many clients to do any transfer planning if their estates are lower than that amount.

A. <u>Categorizing Client Situations</u>. Planners will need to apply a triage approach to considering client situations. Taxpayers with estates well over $5 million ($10 million for couples) will probably continue to be interested in sophisticated transfer planning, and to take advantage of what may be just a window of opportunity to do transfer planning with a $5 million gift exclusion and $5 million GST exemption amount.

Married couples with estates approaching $10 million may feel that they no longer have estate tax concerns or need sophisticated estate planning. However, those clients should be cautioned that the $5 million exclusion was very contentious in this Congress and it make not be renewed in two years. Furthermore, future growth in the estate may take the client well above the estate tax threshold amount. These clients will likely be interested in transfer planning strategies but may be comfortable using simpler more straightforward strategies.

Couples with estates under $3-5 million or even more may feel comfortable that the combined exclusions of both spouses (perhaps using portability) takes them out of having estate tax concerns, particularly taking into account that the couple may anticipate depleting the estate through living expenses. They may have no interest in any transfer planning at this point. They may even decide to stop making annual exclusion gifts or to drop insurance that was acquired for paying estate taxes. They may want to "undo" prior transactions that may have the effect of creating valuation discounts because of the impact they may have on limiting a basis step-up at death. Again, those clients should be cautioned that the $5 million estate exclusion is not permanent.

Planners must counsel clients about the current law and possible changes in two years, and gauge the clients' appetite for further planning and the level of sophistication in planning that is acceptable. Clients should be advised of the extreme degree of uncertainty in our estate tax system. If Congress comes to loggerheads again in late 2012 (like it did at the end of 2009 regarding the estate tax), there is the possibility of returning to a $1 million exemption system with a 55% rate. The next two years provide what may turn out to be a narrow window of opportunity.

B. <u>Simple Gifts; Lifetime Credit Shelter Trusts; Reciprocal Trusts</u>. The ability to move $5 million per individual ($10 million per couple) out of the gross estate opens up the possibility for many individuals to transfer as much as they would want to transfer to their descendants during life without any gift tax concerns.

<u>Lifetime Credit Shelter Trusts</u>. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse. The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. In that manner, the trust could still be used for the "marital unit" if the client has concerns that gifts of that magnitude may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estate of the donor's spouse. Such a trust would likely be a grantor trust as to the spouse under I.R.C. § 677 (unless the consent of an adverse party were required for distributions to the spouse). Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

Reciprocal Trusts. If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated", the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. United States v. Grace, 395 U.S. 316 (1969). In Grace, the trust terms were identical, the trusts were created at the same time, and the trusts were of equal value. The Court said that the principal factor in determining whether trusts are sufficiently interrelated is "whether the trusts created by the settlors placed each other in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary." Id. If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. Estate of Levy v. Comm'r, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not); Letter Ruling 200426008 (citation to and apparent acceptance of Estate of Levy; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries). For an extended discussion of the reciprocal trust doctrine in the context of spouses' creting lifetime QTIP trusts for each other, see Gans, Blatmachr & Zeydel, Supercharged Credit Shelter Trust, 21 PROB. & PROP. 52, 57-60 (July/August 2007).

The Grace case involved reciprocal interests rather than powers. Subsequent cases have differed as to whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under section 2036(a)(2) or 2038. Estate of Bischoff v. Comm'r, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to section 2036(a)(2) and 2038 powers); Exchange Bank & Trust Co. of Florida v. U.S., 694 F.2d 1261 (Fed. Cir. 1984); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); but see Estate of Green v. Comm'r, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. Estate of Cole v. Comm'r, 140 F.2d 636 (8th Cir. 1944).

C. Estate Tax Implications; Tax Effects of Gifts; Tax Apportionment Considerations. There is a "recapture" of estate taxes attributable to lifetime gifts. Gifts do not remove assets from the base for calculating the estate tax; adjusted taxable gifts are added in making the estate tax calculation, with an offset for gift taxes that would be payable on just the adjusted taxable gifts. The gifts in effect are just an "advance" on distributions from the estate (without gift tax as long as the gifts do not exceed the exclusion amount), but the gifts are included in the transfer tax base. The amount of the additional estate tax attributable to the taxable gifts is the amount of the taxable gifts times the estate tax rate. If there are $5 million of taxable gifts and the estate tax rate is 35%, the added estate tax is $1,750,000; if the estate tax rate is 45% the added estate tax would be $2,250,000. The total estate tax is the same whether or not the gifts are made. However, there will be estate taxes attributable to assets that have been given away and that are not in the probate estate (or in the federal gross estate) at the donor's death.

Furthermore, there is no assurance that the donor cannot "lock in" the benefit of a $5 million exclusion in case the exclusion amount is reduced in later legislation. Because of the adjusted taxable gift calculation, the donor will include the adjusted taxable gifts in the tax base, and in reducing the tentative tax on the augmented estate by the gift tax that

would be payable on just the adjusted taxable gifts, there may be no offset if the gifts were fully covered by gift tax exclusions at the time of the gift. Therefore, the adjusted taxable gifts effectively are included in the estate, and the donor would only have the benefit of the estate tax exclusion that is in effect at his or her death. This could be particularly surprising at the death of the first spouse, because the resulting estate tax would not qualify for the marital deduction, thus resulting in a cascading tax calculation of additional estate tax.

One possible approach may be to have a net gift agreement with the donees of the gifts, so that they would agree to pay the estate tax attributable to the adjusted taxable gift inclusion in the event the exclusion amount is reduced in later years. (There would likely be no offset in determining the amount of net gift attributable to such agreement, because of the speculative nature of whether and by how much the estate exclusion might be reduced in future years. However, if a reduction in the exclusion amount did occur such that the donees had to reimburse the estate for the additional estate tax, that reimbursement right would likely be an estate asset subject to inclusion in the gross estate.)

If there are other bequests being made to the donees under the donor's will, the tax apportionment clause may effectively charge the estate tax against the donees, by treating the tax as an advancement against their bequests.

An individual may attempt to apportion estate taxes directly to the donees of lifetime gifts, but without a state statute recognizing such apportionment, there is no assurance that the apportionment to gift donees can be enforced.

If TRA 2010 and EGTRRA sunsets in two years, the estate tax computation conceivably would be made by calculating a tentative tax on the augmented estate including adjusted taxable gifts, and then subtracting the gift tax that would be payable on just the adjusted taxable gifts, as if the gift exclusion amount were limited to $1 million. If TRA 2010 had never been enacted, the gift exclusion amount would never have exceeded $1 million. Under that approach, there would likely be some offset in the amount of the tentative estate tax (in determining the tax on just the adjusted taxable gifts), even before subtracting the estate tax unified credit amount. Therefore, the amount of additional estate tax (that would be payable if gifts have been made that were covered by the gift exclusion but are greater than the estate exclusion at the date of death) would be reduced.

It is important to keep in mind that the tax advantage of gifts is not to remove the gift assets from the estate, because they are included as adjusted taxable gifts in the estate tax competition. However there are significant tax advantages of gifts: (1) future appreciation and income from the gift asset is removed from the estate; (2) fractionalization discounts might be permitted that would not be allowed if the asset were retained until death; and (3) if the gift is made to a grantor trust, income taxes that the grantor will pay on the grantor trust income will be removed from the estate and over a long period of time may be very substantial (particularly if income tax rates increase in the future).

D. Gifts to Grantor Trusts. Making transfers to grantor trusts, where the donor continues to pay income taxes on the trust income, has a huge impact on the amounts that can be transferred over time. The trust assets compound free of income tax, and the payment of income taxes by the donor further depletes his or her estate (substantially over time). Simple $5 million (or $10 million for couples) gifts to grantor trusts can move huge amounts of value out of the donor(s)' gross estates over time. A very simple additional strategy would be to make a $5 million (or $10 million for couples) gift to a grantor trust

and then loan up to nine times that with a very low interest AFR note to the trust, substantially leveraging the amount of future income and appreciation that could be shifted to the trust.

E. Gifts and Sales to Grantor Trusts. The transfer planning opportunities of gifts to grantor trusts can be magnified by leveraging the amounts transferred with sales to the trusts. Sales to grantor trust transactions traditionally are often complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The $5 million gift exemption ($10 million for couples) relieves many of those difficulties. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Huge estate tax savings could result over time from freezing future appreciation from coming into the estate and from "burning" the estate by making the income tax payments. The grantor trust status could be left intact until the grantor had depleted the estate as much as he or she was willing to deplete it.

If prior sale to grantor trust transactions have been structured using guarantees to provide "seed" equity to justify the sale, the clients might make additional gifts to the trust and terminate the guarantee agreements.

F. GRATs. GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes or utilizing any gift exemption. Even though clients can make larger gifts without paying gift taxes, GRATs still have the advantage of being able to move future appreciation (above the § 7520 rate) without having to use up any of the donor's gift exclusion amount. Making taxable gifts in effect uses up that much of the donor's exclusion amount for estate tax purposes as well as gift tax purposes. Everything else begin equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

The 10-year minimum term provision is not included in TRA 2010. Does that mean that rolling two-year GRATs can be created within the next two years before TRA 20120 sunsets? We cannot be sure. Congressmen may have simply wanted to save the GRAT 10-year minimum term revenue raising provision for some subsequent bill in 2011 that needs a revenue raiser to offset the cost of some new bill.

G. Advantage of Sales to Grantor Trusts Compared to GRATs. Sales to grantor trusts have various advantages over GRATs, including (most importantly) that GST exemption can be allocated to the grantor trust at the outset so that all appreciation in the trust is also GST exempt, but GST exemption cannot be allocated to GRATs until the end of the retained annuity term. Because there will not be as many concerns about making large gifts with the $5 million gift exemption, sales to grantor trusts make take on increased importance over the use of GRATs. GRATs have the advantage of being able to shift future appreciation without using up any of the donor's unified gift and estate tax exclusion amount, but the ability to move up to $5 million without having to pay current gift tax is certainly an important factor to consider in comparing the advantages of sales to grantor trusts with GRATs.

H. Qualified Personal Residence Trusts. One of the disadvantages of a qualified personal residence trust (QPRT) is that there is a significant (though highly discounted) gift element. The $5 million ($10 million for a couple) gift exemption may permit the transfer of even very valuable residences to a QPRT while still allowing the gift element to be covered by the gift exclusion to avoid having to pay gift taxes when the QPRT is created.

I. Gift Splitting. If one spouse has most of the marital wealth, the couple can still take advantage of both spouses' $5 million gift exemptions by making the split gift election. I.R.C. § 2513. This can be achieve the advantages of gifts (i.e., removal of appreciation in the gift assets from the estate, use of fractionalization discounts, "burning" the grantor's estate by paying income taxes on grantor trust income) with respect to $10 million worth of gifts instead of just $5 million.

A consenting spouse should be aware of possible effects of consenting to the election. Fortunately, the election is just effective for gift and GST purposes (*see* I.R.C. § 2652(a)(2)), not for the purpose of treating the consenting spouse as the transferor for applying the estate tax "string" statutes (*see, e.g.*, Rev. Rul. 82-198, 1982-2 C.B. 206; Rev. Rul. 74-556, 1074-2 C.B. 300). However, possible bad effects may result for the consenting spouse. (1) At the consenting spouse's death, one-half of the gift assets will be added to the estate as adjusted taxable gifts, and the estate tax calculation operates in a manner that the consenting spouse's gift exclusion utilized in the split gift will effectively use up the consenting spouse's estate tax exclusion amount as well. (As discussed in section IV.E. of this outline above, if the estate tax exclusion amount has decreased by the time the consenting spouse dies, this could result in additional estate taxes being payable by the consenting spouse's estate even if all of the estate is passing to a surviving spouse.) (2) If the gift is included in the donor-spouse's gross estate under some section other than § 2035 (for example, a QPRT may be included under § 2036), both halves would be included in the donor-spouse's estate because the donor is treated as the transferor of both halves for estate tax purposes, but the consenting spouse's unified credit is not restored. (If the assets are included in the donor spouse's gross estate under § 2035, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation, but that only applies if the asset is included in the estate under § 2035 I.R.C. § 2001(e). (3) If the gift is included in the donor's gross estate under § 2035, as mentioned immediately above, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation. While this solves the estate tax problem for the consenting spouse, the consenting spouse's gift tax unified credit is not restored for purposes of later gifts by the consenting spouse. If there is any risk that the gift assets may be included in the donor spouse's estate under any of the string statutes, the spouse should be especially cautious about whether to consent to split-gift treatment. See generally Zeydel, Gift-Splitting — A Bondage of a Bad Idea? A Comprehensive Look at the Rules, J TAX'N (June 2007).

In light of these potential adverse affects for the consenting spouse, consider whether the consenting spouse should have separate counsel in considering whether to consent to split gift treatment.

J. Leveraging Transfers Through Valuation Discounts. If the transferred assets are discounted to reflect lack of control or marketability, the value that can be transferred via the $5 million gift exemption is further expanded.

On the other hand, clients who think the estate tax will no longer apply to them (because of the $5 million estate exclusion amount) may wish to avoid transactions that will have the effect of creating valuation discounts. They may even want to dissolve partnerships, despite the non-tax advantages of the partnerships, if the loss of basis step-up for assets in the partnership is critical.

K. Gifts of Undivided Interests. Gifts of undivided interests in real estate result in the donated interest being valued with a discount, and the remaining interest owned by the grantor at his or her death would also receive an undivided valuation discount. Transfers of undivided interests in real estate result in this double leveraging (both the transferred interest and the retained interest). In Estate of Stewart, 106 AFTR2d 2010-5710 (2d Cir. 2010), the IRS and taxpayer stipulated to a 42.5% undivided interest discount both for a 49% interest in a building transferred by gift and the remaining 51% undivided interest held in the donor's estate at her subsequent death.

L. Same-Sex Couple Planning. Planning for same-sex couples is difficult because of the lack of a gift or estate tax marital deduction. The increased $5 million gift tax exclusion opens up significant possibilities for transferring assets between the partners without current gift tax consequences.

M. Self-Settled Trusts. Clients who are concerned about possible future estate taxes may want to take the opportunity to make a $5 million gift (to shift future appreciation from the gift assets, shift income taxes that the donor pays on a grantor trust that receives the large gift and to take advantage of fractionalization discounts). However, that may be a large enough part of the client's estate that he or she would like to have the possibility of an independent party being able to make the decision to distribute some of the gift funds back to the donor in case "hard times come knocking." This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities' occur, without triggering § 2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Twelve states have adopted varying approaches regarding "self-settled spendthrift trusts:" Alaska, Colorado, Delaware, Missouri, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Nevada and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help alleviate concerns that § 2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential § 2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under § 2036 is tested at the moment of death, and § 2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as there is no prearrangement).

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot revest beneficial title or change the beneficiaries. (Various cases have held that there is no completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.) The ruling also discussed § 2036.

The "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." While this is only a private letter ruling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7 holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under § 2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

The ruling does not address the result if the grantor is not a resident of Alaska. Many commentators view the analysis as applying even if the grantor does not reside in the state in which the trust is created. <u>See</u> Letter Rulings 9332006 (U.S. grantors created self settled spendthrift trusts under the laws of a foreign country and IRS held no estate inclusion) & 8037116; <u>Estate of German v. United States</u>, 7 Ct. Cl. 341 (1985) (Maryland trust created by Florida grantor). However several bankruptcy cases have denied a discharge to grantors of a foreign situs self-settled spendthrift apparently because the law of the grantor's domicile did not permit such trusts.

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under § 2036 in part based on whether trust assets can be reached by any of the grantor's creditors. <u>Estate of Uhl v. Comm'r</u>, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under § 2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); <u>Estate of Paxton v. Comm'r</u>, 86 T.C. 785, 818 (1986)(self-settled trust assets included under § 2036 because grantor's creditors could reach income and corpus); <u>Outwin v. Comm'r</u>, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); <u>Estate of German v. U.S.</u>, 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on § 2036(a)(1), because grantor's creditors could not reach trust assets where trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries). Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

N. Life Insurance Transfers. A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having $5 million ($10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life insurance coverage that can pass free of transfer tax to younger generations. For example, a $2 million premium can often purchase $20 million of second-to-die life insurance coverage.

Split dollar agreements have often been used in the past to help finance the payment of large premiums by an irrevocable life insurance trust where the insured could not make gifts to the trust large enough to cover the premiums without having to pay current gift taxes. If split dollar arrangements have been used in the past, large gifts (within the $5 million gift exclusion amount) could be made to the trust to roll out of the split dollar arrangement and simplify the planning.

Consider making a large gift to the trust currently (while the $5 million gift exclusion still exists), rather than just making increased gifts as premiums become due. Lock in the ability to make a $5 million transfer to pay future premiums without having to pay a current gift tax. There is always the possibility that the gift exclusion returns to $1 million after 2012.

Some clients may be inclined to drop coverage, under the theory that they have no estate tax concerns with a $5 million ($10 million for a couple) exclusion from the estate tax. Those clients should understand that they may not qualify for insurance if they subsequently find they have a need for it. Furthermore, the estate tax system is in a state of flux, and anything could happen in 2013 (including going back to a $1 million exemption/55% system).

O. Transfers May Impact Section 6166 Deferral. Closely held business interests often represent highly appreciating-high income producing assets that can be the perfect vehicle for gifts. Making $5 million ($10 million for a couple) of gifts in a closely held business may take the business interest in the estate below the 35% of adjusted gross estate level needed to qualify for § 6166 estate tax deferral.

P. State Estate Tax Planning. While state estate taxes are considerably lower than federal estate taxes, they are still significant. Planning for domicile of the client will still be important. Formula clauses should be reviewed in light of the increased federal exclusion amount. Some clients may have opted previously to fully fund a bypass trust even though doing so would generate some state estate tax at the first spouse's death. The client may have been willing to do that with a $3.5 million federal exclusion but may not be willing to do that with a $5 million federal exclusion. For example, if the state has a $1 million exemption (which is the case for most of the states that have state estate taxes), paying state estate tax on the excess $4 million would incur $391,600 of state estate taxes if the state tax is charged against the bypass trust (leaving a net funding of $4,608,400) and would incur $444,091 of state tax if the state tax is not paid out of the bypass trust. A possible strategy to avoid paying this state tax is to fund the bypass trust with only the state exemption amount and rely on portability to take advantage of the balance of the first deceased spouse's federal exemption amount. However, as discussed in section IV.C of this outline, there are a variety of uncertainties in relying on portability (not the least of which is that the portability provisions expire in two years unless renewed by Congress).

In states that allow a state-only QTIP election, planning to accommodate the increased federal exemption amount is more flexible. For example, in states with a $1 million state exemption, the bypass trust could be funded with the state exemption amount ($1 million), and a "QTIPable" trust could be funded with the remainder of the federal exemption amount (the remaining $4 million). A state-only QTIP election would be made for the $4 million trust. In this manner, the full $5 million federal exemption is utilized without incurring state estate taxes at the first spouse's death.

Gift planning may also save significant state estate taxes, because gifts are not included in the state gross estate base. The ability to make a $5 million gift without federal gift tax means that very substantial state estate taxes may be saved via gift planning. This is particularly important for deathbed planning.

Q. GST Planning Issues.

1. GST Exemption Allocations; Opting Out of Automatic Allocations. There is now 2010 GST exemption ($5 million) that can be allocated on a timely basis to transfers that were made in trust during 2010. It is also important to remember to "opt out" of automatic allocations to direct skip gifts in 2010 that are intended to pass to the current beneficiary rather than future generations. Because the GST tax rate is zero on direct skip gifts in 2010, allocating GST exemption to the transfer would waste the exemption (unless a direct skip trust will remain in existence for the life of the current beneficiary and then pass to younger generations).

2. Adding Non-Skip Beneficiaries of Direct Skip Trusts. Some planners have suggested adding non-skip beneficiaries to direct skip trusts after the lapse of some period of time (such as five years). Amounts transferred to a direct skip trust in 2010 incurred no GST tax. If non-skip persons (beneficiaries at the children level) could be added at a later time, in effect, the trust could benefit children and grandchildren without any GST tax being due when distributions are made to grandchildren during the trust term or upon termination. There is some concern, however, that a court might ultimately find that to be an abusive "end-run" around taking advantage of the zero tax rate on direct skips in 2010. A key factor would seem to be whether there was an intent subsequently to add children as beneficiaries when the transfer was made to the direct skip trust.

3. Disclaimers. Disclaimers in 2011 may result in direct skips having been made in 2010 with a zero GST tax rate. For testamentary transfers, the general thinking is that direct bequests under the will are deemed to have occurred at the time of death for GST purposes. (Otherwise there would be too much possibility for manipulation of the GST tax system by indefinitely delaying the funding of bequests.) A corollary is that disclaimers also operate as of the date of death for testamentary transfers. Under this reasoning, disclaimers made in 2011 (and keep in mind the extended period for disclaimers up to September 17, 2011) may result in transfers for younger generation beneficiaries that are treated as 2010 direct skips, thus qualifying for the zero GST tax rate.

R. Voluntary Tax? With the various transfer planning opportunities discussed above, perhaps the notion of the estate tax being a "voluntary tax" will become a reality.

S. Roth Conversions. TRA 2010 may impact Roth conversions in several ways. First, some taxpayers who made Roth conversions in 2010 have planned not to use the special

exception allowing income taxes on the Roth conversion to be paid in the 2011 and 2012 tax years, for fear that the income tax rates would be higher than in 2010. That is now not the case, and in most situations the two-year deferral approach will now be advantageous. Second, a possible advantage of a Roth conversion is that the income tax payment is removed from the taxpayer's gross estate and can result in estate tax savings. If the increased $5 million exclusion means that the taxpayer will not pay estate tax, this is no longer a relevant factor.

T. Graegin Loans Not as Favorable. Graegin loans are not as advantageous as under prior law. The income tax rate may approach or even exceed the estate tax rate. Trading income inclusion (from the interest on the note) for an estate tax deduction may not be favorable. However, there is still the significant present value advantage of benefiting from the estate tax deduction effective as of the estate tax payment due date even though the income recognition may not occur for years later.

U. Powers of Attorney and Revocable Trusts. In drafting powers of attorney, explore the principal's intent regarding the ability of the agent to make gifts in light of the greatly increased gift exemption amount. Does the principal want to allow $5 million in gifts, or does the principal want to place an upper ceiling on gifts that may be made under the power of attorney? Perhaps the client has no estate tax concerns under a $5 million estate tax exclusion amount and would want to severely restrict the power of the agent to make gifts as long as the estate tax exclusion remains above a certain amount.

On the other hand, some clients will want to broaden and reinforce the ability to make gifts in order to provide flexibility to take advantage of planning opportunities in case the principal becomes incompetent or to make adjustments in case of future law changes. Indeed, for those clients, the increased gift exclusion and the inherent estate tax uncertainty that we face may be a factor favoring revocable trusts in light of the increased flexibility that the trustee could have to consider changing circumstances.

V. Will Drafting. Formulas in wills may be more important than ever, as a result of the inherent uncertainty of what future legislation may provide regarding the federal estate tax system, but formulas must be reviewed in light of the changing conditions.

- Should formulas in wills being drafted currently taking into consideration what should happen based on various possibilities of Congressional action (or inaction) in late 2012? What if there is no Congressional action (think December 2009), and there is no estate tax but there is carryover basis in 2013? ("Fool me once—shame on you. Fool me twice—shame on me.")
- Formulas should be reviewed for their impact on the estate plan. Many clients did not do any estate planning in 2010 until the dust settled on the estate tax laws. Unfortunately, we still do not have any "permanent" settling (whatever that means in the tax world), but we likely do have some settling in the law for the next two years.
- In early 2010, we were concerned that the repeal of the estate tax might dramatically impact how assets pass under formula clauses. The situation may not be as extreme with a $5 million exemption rather than an unlimited exemption, but the dramatic increases in the estate exemption from $3.5 to $5 million may still result in bequests that were never intended nor desired by the testator.
- In light of the continuing uncertainty over the estate tax and in light of the increased $5 million exemption, there may be continued use of "one-lung" QTIP-able trusts,

giving give the surviving spouse the discretion of making a QTIP election over the portion of trust that is appropriate based on circumstances following the first spouse's death.

- Many clients may think they will not have estate tax concerns with an estate tax exemption of $10 million per couple, and clients may want to leave the flexibility to cause assets in a bypass trust to be included in the surviving spouse's estate if doing so will not result in payment of estate tax but will achieve a basis step-up. One possible approach would be to give an independent trustee wide discretion to make distributions to the surviving spouse. Another would be to give an independent person the power to grant a general power of appointment to the surviving spouse over some or all of the bypass trust. A corollary to that approach is to give the spouse a general power of appointment in the will or trust agreement, exercisable only with the consent of a non-adverse party if the testator/settlor wants to impose that limitation on the spouse's power to redirect the distribution of the trust, but give an independent trustee the power to remove the power of appointment over part or all of the trust property. Another approach is to give the surviving spouse a special power of appointment (exercisable only with the consent of a non-adverse party if the testator/settlor wants to impose that limitation on the surviving spouse); the surviving spouse could exercise the power of appointment in a way that cause the assets to be included in the spouse's gross estate by "springing the Delaware tax trap" (i.e., exercising the power in a way that creates another special power the exercise of which could postpone the vesting of ownership without reference to a time period based on the creation of the original power of appointment). *See* Bove, *Using the Power of Appointment to Protect Assets—More Power Than You Ever Imagined*, 36 ACTEC L.J. 333, 353-55 (2010); Blattmachr & Pennell, *Using Delaware Tax Trap To Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242 (1988).
- The particular wording of formulas is critical. A bequest of the "applicable credit amount" would now seem to be $5 million, but a bequest of "the maximum amount that can pass free of estate tax" may be the entire estate, particularly if the executor of a 2010 estate makes the carryover basis election. However, courts may interpret those clauses to mean something different than that in order to carry out the testator's intent. A review of all formulas in light of the law change is critical.
- GST formulas have the same possible uncertainties. For example, a formula transfer in 2010 based on there being "no imposition of the GST tax" raises questions. The GST tax does apply — it's just zero in for GSTs in 2010.
- Some formulas are based on values "as finally determined for federal estate tax purposes." How does this apply to a 2010 decedent if the estate makes the carryover basis election and the estate tax does not apply? How does the formula apply to estates that, because of the increased estate tax exclusion, will never file estate tax returns?

W. <u>Non-Tax Planning Issues</u>. A $5 million estate exclusion amount means that very few families will pay estate taxes. Planners must keep in mind the myriad other nontax issues that must be addressed in estate planning. Some of these include asset protection, special needs planning, disability planning, elder financial planning, marital planning, planning for management for beneficiaries, planning for appropriate disposition among beneficiaries, charitable planning, etc.

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