# Estate Planning in Light of One-Year "Repeal" of Estate and GST Tax in 2010

January 2010
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com
www.bessemertrust.com

## I. WILL THE ESTATE AND GST TAX BE REENACTED IN 2010; WILL IT BE RETROACTIVE TO JANUARY 1?

A. Legislation During 2010? The House of Representatives passed H.R. 4154 to permanently extend the 2009 system ($3.5 million exemption, 45% rate) on December 3, 2009. The permanent extension passed the House without a single Republican vote — the Republicans are holding out for a larger exemption and lower rates; one proposal is for a $5 million exemption and a 35% rate.

The Senate failed to act before the end of the year. A number of senators oppose the permanent extension, hoping to get more favorable provisions (such as a $5 million exemption with a 35% top rate). When it became apparent that the Senate would not approve the permanent extension of the 2009 system, Democratic leaders in the Senate proposed several potential compromises, including extensions of the 2009 system for as short as two months to as long as two years. All of the efforts failed.

At this point, there is "massive, massive confusion" in the words of Senate Finance Committee Chairman, Max Baucus. Some Republicans and conservative Democrats view the one-year repeal as creating leverage to insist on larger exemptions and lower rates (such as the $5 million exemption, 35% rate proposal). If the estate and GST taxes are repealed for a full year, their view is that returning to a $1 million exemption, 55% rate system would be viewed as a massive increase of the unpopular estate tax that would be politically unfathomable for all. However, some Democrats will view the situation as giving them leverage since 60 votes in the Senate will be required to avoid returning to a $1 million exemption, 55% rate system. Key lawmakers expect the fight over the estate tax to intensify next year when the tax is gone, particularly in an election year. Furthermore, the carryover basis system will be extremely complex to administer and will be unpopular as well. Many believe that at some point, Congress will act on the estate and GST tax in 2010, but there is certainly the significant possibility that 60 Senators will never be able to agree on a single approach, and that 2010 will pass without further legislation. (What is different from December 31, 2009 to January 31 for the Congressmen to decide to agree? Or March 31, or May 31, etc.) Congressional staff members of the House Ways and Means and Senate Finance Committees confirmed on December 31, 2009 that a joint letter stating how the Committee members intend to address the estate tax in 2010 (such an agreed joint letter of intent is sometimes released when tax provisions expire at the end of a year) will not be issued because of the absence of any agreement on what to do at this point. One of the interesting effects of the current situation is that there may be many mid-wealth estates that are worse off in 2010 than in 2009. Estates under $3.5 million were covered by the estate tax exemption, but there may be many estates under $3.5 million that have more than $1.3 million of appreciation in the estate that will be subject to carryover basis for the appreciation in excess of $1.3 million.

Furthermore, bear in mind that the Administration's Budget Proposal includes various legislative proposals, include providing restrictions on valuation discounts (by revisions to §2704) and imposing a minimum 10-year term on GRATs. Other estate tax reform proposals have been suggested during the last several years, including the possibility of portability of the estate and gift tax exemptions between spouses and the possibility of unification of the gift tax exemption with the estate and GST tax exemptions. It is conceivable that legislative discussions may include some of those reform measures as well.

B. Legislation Retroactive to January 1, 2010? Representative Pomeroy [D-ND] reportedly has stated that the tax would not be applied retroactively to January 1. However, Senate Finance Committee Chairman Max Baucus has said "the correct public policy is to achieve continuity with the respect to the estate tax" and that Congress will "clearly work to do this retroactively." However, that could be viewed as very unfair to people who have died in the interim (and even more unfair for people who make gifts thinking they are subject to a 35% gift tax rather than a 45% or even high gift tax) and could be politically difficult to get through Congress in an election year.

John Buckley, Chief Tax Counsel to the House Ways and Means Committee, has expressed his opinion that reinstituting the estate and GST taxes retroactive to January 1, 2010 would be unconstitutional. While there have been a handful of cases (including U.S. Supreme Court cases) that have upheld the constitutionality of retroactive changes to the transfer tax system, those cases have generally involved retroactive tax rate increases. Supreme Court cases have upheld the validity of retroactive tax legislation, but none has involved a specific rule that has been in the law a long time (such as GRATs, the definition of fair market value, etc.). U.S. v. Hemme, S. Ct. 2071 (1985) upheld the retroactive application of what is now §2010(b). In addition, U.S. v. Carlton, 512 U.S. 26 (1994) upheld the validity of retroactive legislation regarding an estate tax deduction that was allowed at one time under one of the various provisions of §2057 for the sale of stock to ESOPs (adding that the stock had to be owned by the decedent at the date of death). Some experts believe that it will be more difficult to uphold the constitutionality of instituting an estate tax and GST tax system retroactively when no system exists, as opposed to just increasing rates retroactively. However, that is far from clear, and many experts think that a retroactive reenactment of the estate and GST tax effective January 1 would be constitutional. By analogy, the Supreme Court refused to uphold the retroactive effect of the gift tax, when it was instituted in 1924. Untermyer v. Anderson, 276 U.S. 440 (1928). The Supreme Court in U.S. v. Hemme summarized the Untermyer analysis:

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

Later, in U.S. V. Carlton, the Supreme Court emphasized the very strict scrutiny that is applied to any constitutional review of retroactive tax legislation:

> "In holding the 1987 amendment unconstitutional, the Court of Appeals relied on this Court's decisions in Nichols v. Coolidge, 274 U.S. 531 (1927), Blodgett v.

> Holden, 275 U.S. 142 (1927), and Untermyer v. Anderson, 276 U.S. 440 (1928). Those cases were decided during an era characterized by exacting review of economic legislation under an approach that "has long since been discarded." Ferguson v. Skrupa, 372 U.S. 726, 730 (1963). To the extent that their authority survives, they do not control here. Blodgett and Untermyer, which involved the Nation's first gift tax, essentially have been limited to situations involving "the creation of a wholly new tax," and their "authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws." United States v. Hemme, 476 U.S., at 568. Nichols involved a novel development in the estate tax which embraced a transfer that occurred 12 years earlier. The amendment at issue here certainly is not properly characterized as a "wholly new tax," and its period of retroactive effect is limited."

The gift tax was a brand new concept in the 1920's not only in the U.S. but also in Europe. Prior to that, only gifts in contemplation of death were taxed. So when the Court referred to a "new tax" in those opinions, it really meant a "new tax." The estate tax and GST tax may not be viewed as a "new tax" if reenacted. (If the GST tax were "new," how could it apply to trusts that were established between Sept. 1985 and Dec 2009, without it being considered retroactive?) Furthermore, tax legislation is not infrequently made effective as of the date that legislative proposal came out of the House Ways and Means Committee. Keep in mind that the House of Representatives passed a provision for a permanent extension of the 2009 estate, gift and GST tax system, and a reference to a January 1, 2010 date would seem to be consistent with that approach in light of the House activity.

Another possible issue is whether a retroactive increase in the gift tax from 35% to 45% (or even higher) is constitutional. Relying on <u>Carlton</u>, courts have upheld the constitutionality of retroactive gift and estate tax rate increases. <u>Quarty v. United States</u>, 83 AFTR2d ¶ 99-597 (9th Cir. 1999)(increase in gift and estate tax rates from 50% to 53% and 55% in OBRA, signed on August 10, 1993, retroactive to January 1, 1993, was constitutional where the decedent died on January 12, 1993 having made taxable gifts earlier in that year).

Another possibility is that the estate and GST tax system will not be reenacted retroactively, but carryover basis would be eliminated retroactively. If the estate and GST taxes are reenacted retroactively to January 1, no doubt there will be numerous lawsuits over the constitutionality of the provision, which probably will ultimately be resolved by the U.S. Supreme Court after years of litigation in the lower courts.

## II. OVERVIEW OF LAW IN 2010 IN LIGHT OF ONE-YEAR "REPEAL" OF ESTATE AND GST TAX.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") included provisions for increasing the estate and GST "exemptions" in steps to $3.5 million in 2009, and then provides a one year repeal of the estate and generation-skipping transfer tax with carryover basis.

A. <u>Estate and GST Tax</u>. There is commonplace discussion of the estate and GST taxes being "repealed" in 2010. However, § 2210 (added by the 2001 Tax Act) of the Internal Revenue Code says that chapter 12 (the estate tax) "shall not apply to the estates of decedents dying after December 31, 2009" except as provided otherwise in §2210 (b) regarding qualified domestic trusts (discussed below). Section 2664 (also added by the

2001 Tax Act) similarly provides that chapter 13 (the GST tax) "shall not apply to generation-skipping transfers after December 31, 2009." Accordingly, all of chapters 12 and 13 remain in the Code, but just do not apply to transfers after December 31, 2009.

B. Gift Tax. The gift tax will continue in 2010, but at a 35% top rate rather than the current 45% top rate. (Section 511(d) of the 2001 Tax Act is entitled "Maximum Gift Tax Rate Reduced to Maximum Individual Rate After 2009," but the body of the statutory provision just refers to a 35% top bracket.) The 35% rate applies to gifts over $500,000, effectively meaning that there is a flat 35% tax once the aggregate gifts exceed the gift tax applicable exclusion amount of $1.0 million. Reasons quoted for keeping the gift tax system intact are (1) to provide a backstop against income tax abuse through transfers to relatives with lower income tax brackets, and (2) to provide a barrier to wholesale transfers in 2010 before the re-emergence of the estate and GST tax system in 2011 under the sunset provision. One significant change to the gift tax in 2010 is to add §2511(c), discussed immediately below.

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

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

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

## III. OVERVIEW OF CHANGES IN 2011 IN LIGHT OF 2011 SUNSET PROVISION.

Under the Senate bill of the 2001 Tax Act (and eventually the 2001 Tax Act), all of provisions of the 2001 Tax Act sunset effective January 1, 2011. Section 901 of the 2001 Tax Act provides as follows:

Section 901 Sunset of Provisions of Act.

a. IN GENERAL. All provisions of, and amendments made by, this Act shall not apply — … (2) in the case of title, V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

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

Therefore, for decedents dying, gifts made, or generation skipping transfers after 2010, "[t]he Internal Revenue Code of 1986… shall be applied and administered … as if the provisions and amendments [of the Act] had never been enacted." The Senate version included Section 901(a) but not 901(b). There is no discussion in the Conference Report of the reasons for adding the "had never been enacted" provision in Section 901(b).

The "bottom line" is that all of the provisions in the 2001 Tax Act sunset on January 1, 2011. Steve Leimberg aptly summarizes this result by observing that the military would simply say "AS YOU WERE." In 2001, planners assumed (incorrectly) that the sunset provision assured that there would be future tax legislation in the upcoming years that would, among other things, address the estate tax provisions.

A. Purpose of Sunset Provisions. The purpose of including the sunset provision was to avoid a 60% Senate vote requirement in the Senate. The 2001 Tax Act was part of a "budget reconciliation" authorized by the Congressional Budget Act of 1974, which provides that a budget reconciliation process may occur only once a year, and that legislation under a budget reconciliation procedure is not subject to filibuster in the Senate (which may only be broken by a vote of 60 Senators.) The Congressional Budget Act of 1974 was amended in 1990 to provide what is now called the Byrd Rule (named after the amendment's author, Senator Byrd of West Virginia). The Byrd Rule makes out of order inclusion of any items that are "extraneous" to budget resolution. This would include increases in deficits beyond the fiscal years covered by the reconciliation and decreases in revenue beyond the scope of the budget resolution. Because the budget reconciliation covers up to ten years, it is "extraneous," and out of order, to reduce taxes beyond the ten-year budget window. The Byrd rule can be waived only by a majority vote of 60 Senators. See generally Aucutt, Still Debating the Prospects for Estate Tax Repeal, 28 EST. PLAN. 383 (August 2001). Senate leaders believed that the Act would not be supported by 60 Senators. Based on the history of Senators voting on estate tax repeal in the prior legislative session, it appeared that 60 Senators would not vote for total estate tax repeal. Eventually 62 Senators voted for the 2001 Tax Act — with the sunset provision included.

B. Estate, Gift and GST Tax Impact. Following sunset, all rates in effect in 2001, including the 5% surtax, will apply. The applicable exclusion amount will be $1 million (as scheduled beginning in 2006 under the pre-2001 Tax Act law) for both estate and gift taxes. The GST exemption will be $1 million indexed for inflation since 1997.

C. Carryover Basis Impact. The carryover basis provisions would expire and there would be a step-up in basis at death. (Applying the sunset provisions literally as to the carryover basis provisions means that the carryover basis rules are just a concern for recipients of persons who die in 2010.) (The carryover basis provisions are discussed in more detail in Sections V-VII of this outline, and carryover basis planning strategies are discussed in Section XVII of this outline, below.)

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

E. Uncertain Effect of "Had Never Been Enacted" Provision. Read literally, Section 901(b) of the 2001 Tax Act raises a host of surprising results. For example:

- If a trust is created in 2008 and GST exemption is automatically allocated to the trust under the new automatic allocation rules in the 2001 Tax Act, will the trust be treated in 2011 as if there had been no GST exemption allocation to the trust? If the 1986 Code is applied after 2010 as if the provisions and amendments in the 2001 Tax Act "had never been enacted", then will the trust be treated as if none of the automatic GST exemption allocations had been made (because they clearly would not have been made if the 2001 Tax Act "had never been enacted")?
- If a decedent dies in 2010, such that carryover basis applies, and if a beneficiary sells the asset in 2012, is there a stepped up basis to the date of death value in 2010?
- If a $3.5 million gift was made to a trust and $3.5 million GST exemption was allocated to the trust, and if there is a taxable distribution in 2011, is the inclusion ratio no longer zero, because the available GST exemption in 2009 as if the 2001 Tax Act "had never been enacted" would only be $1.0 million indexed after 1997?
- If a trust was created in 1990, but GST exemption was not allocated until 2008 under a "9100 relief" ruling (as allowed in the 2001 Tax Act), is that allocation of GST exemption (based on the date of gift value) still effective?
- If trusts were severed in 2008 under the qualified severance rules, when a taxable distribution occurs in 2011 from the "GST-exempt" severed trust, will the distribution

be treated as having been made from the combined trust, which is only partially GST exempt?

## IV. TRANSFERS TO TRUSTS BEGINNING IN 2010 ARE GIFTS EXCEPT FOR TRANSFERS TO GRANTOR TRUSTS

A. General Rule. Section 2511(c) treats transfers in trust after December 31, 2009 as taxable gifts unless the trust is treated as wholly owned by the donor or the donor's spouse under §§671-679 of the Code. The purpose of this change is to prevent transfers to shift income tax without being subject to the gift tax by having the transfer made to a non-grantor trust with the donor retaining sufficient control (such as the power to shift the asset among donees) to make the gift incomplete for gift tax purposes. Perhaps the primary (though not intended) impact of this provision is to remove the planning strategy of creating "Defective Intentional Non-Grantor Trusts" (or "DING Trusts") that may save state income taxes without having to make a taxable gift for federal gift tax purposes.

B. Converse; Are Gifts to Grantor Trusts Automatically Incomplete Gifts? The statute says that gifts to non-grantor trusts are treated as completed gifts; it does not say that gifts to grantor trusts are treated as incomplete gifts, and that certainly does not seem to be the intent of the statute. The issue is of theoretical concern; some planners have raised the theoretical question of whether they can create grantor trusts after January 1 and know that the gift to the trust will be treated as a completed gift as of that date. The issue has been brought to the attention of the IRS and apparently the IRS will attempt to give guidance as soon as possible. Section 2511(c) itself says that it applies "except as provided in regulations," and it seems clear that the IRS will not want to take the position that gifts to grantor trusts are incomplete gifts, and leave the possibility that the assets would not be subject to gift tax at the time of the transfer and would not be subject to estate inclusion at the donor's death if none of the "string statutes" apply. (The client's death should not result in the completion of the gift for gift tax purposes. See Estate of DiMarco v. Comm'r, 87 T.C. 653 (1986) ("transfers of property do not become complete for gift tax purposes by reason of the death of the donor"); Treas. Reg. §25.2511-2(f).)

C. Legislative Intent. The little legislative history that exists for this provision indicates that the purpose is to prevent taxpayers form using multiple non-grantor trusts to shift income for income tax purposes with having to make taxable gifts. The Official Explanation to the 2002 Technical Corrections Act provides as follows:

*"Transfers in trust. — The provision clarifies that the effect of section 511(e) of the Act (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. sec. 25.2511-2(c)."*

D. Cannot Just Use Testamentary Power of Appointment to Make Gift Incomplete, Because May Not be a Wholly Grantor Trust. Query, how can a transfer be made to a trust, with a retained power in the grantor to avoid having a complete gift, without making the trust a grantor trust as to the grantor in its entirety? One way is to create an irrevocable trust for beneficiaries other than the grantor, but have the grantor retain a testamentary power of appointment to change the trust terms. Section 674(b)(3) provides an exception from the grantor trust rules for testamentary powers of appointment. However, that exception does not apply to the extent that the power can be exercised over income that is accumulated without the consent of an adverse party. Even in that situation, however, the grantor is treated as the owner of only the income of the trust. Therefore, the trust would not be treated as wholly owned by the grantor under the grantor trust rules, so §2511(c) would treat the transfer to the trust as a completed gift.

E. Availability of Annual Exclusions for Trust Transfers. Literally, this statue might seem to remove gift tax exclusions available under §2053 (such as the annual exclusion) for gifts to trusts. Apparently, this was not intended, and a technical correction, explanatory legislative history, or regulations will likely clarify this result. This possible uncertainty makes even more important drafting a Crummey trust to give a donor the right to direct that any particular gift is not subject to withdrawal rights. In the unlikely event that the legislation eventually is interpreted to disallow annual exclusions, a donor could direct that gifts in 2010 and afterward would not be subject to withdrawal rights, to avoid the risk that a beneficiary would exercise the withdrawal right if the withdrawal right does not allow an annual exclusion. (This flexibility for Crummey trusts is helpful in any event.)

F. Effect if Grantor Trust Later Becomes Non-Grantor Trust. There is no discussion in the statute or the legislative history of the gift tax effect if a grantor trust, which received an "incomplete gift" transfer after 12-31-2009, subsequently becomes a non-grantor trust during the grantor's lifetime. Presumably, a completed gift would result at that time, based on the value of the transferred asset (or trust assets attributable to the transferred asset) at that later time. If the particular asset transferred after 2009 is not still in the trust, making this determination could be cumbersome.

## V. CARRYOVER BASIS

A. General Rule — No Stepped Up Basis. Under current law, assets received from a decedent generally receive a basis equal to the fair market value of the property at the date of death of the decedent. I.R.C. § 1014. The general purpose of the stepped-basis rule is to avoid double taxation, subjecting the same property to both estate taxation and income taxation when the asset is sold after the decedent's death. The stepped-up basis rule avoids the capital gains tax on the sale, up to the gain in the asset at the date of death. With the repeal of the estate tax, there is no need for the stepped-up basis to avoid the double taxation. (As a more practical matter, coupling carryover basis with the repeal of the estate tax is necessary for fiscal reasons, to offset some of the revenue loss due to the estate tax repeal.) For decedents dying after December 31, 2009, §1014 will not apply, and the stepped-up basis under §1014 is no longer allowed. I.R.C. §1014(f). For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2). (Observe, that while no step-UP in basis is allowed, the basis of property can be stepped-DOWN.) The Conference Report refers to this as the "modified carryover basis regime."

B. "Property Acquired from the Decedent". The carryover basis regime, applies to "property acquired from the decedent." In addition, the permitted basis adjustments described below apply to "property acquired from a decedent" that was "owned by the decedent" at the time of death. Also, the information return required under new § 6018 applies to "property acquired from a decedent." "Property acquired from the decedent" includes the following: (1) Property acquired by bequest, devise or inheritance; (2) property acquired by the decedent's estate from the decedent; (3) property transferred by the decedent during his lifetime to a qualified revocable trust defined in §645(b)(1); (4) property transferred during lifetime to another trust over which the decedent reserved the right to alter, amend, or terminate the trust in a way that would change the enjoyment of the trust; and (5) any other property passing from the decedent by reason of death to the extent that it passes without consideration (for example, property held as joint tenants with right of survivorship or as tenants by the entireties). I.R.C. § 1022(e).

C. $1.3 Million Basis Adjustment. Under the existing estate tax and stepped-up basis rules, a certain amount of property can pass without either estate tax or capital gains tax on pre-death appreciation. To keep this same concept, the 2001 Tax Act provides two amounts of property that can still receive a stepped-up basis. The first is a $1.3 million basis adjustment. I.R.C. § 1022(b). (This is a basis increase of $1.3 million, not a stepped-up basis on assets having a date of death value of $1.3 million.)

1. Increased by Unused Losses and Loss Carryovers. The $1.3 million amount is increased by any capital loss carryover under §1212(b), the amount of any net operating loss carryover under section 172 which would (but for the decedent's death) be carried over from the decedent's last taxable year to a later year, plus the total amount of losses that would have been allowable under §165 if the property had been sold at fair market value immediately before the decedent's death. I.R.C. § 1022(b)(2)(C). Thus, while there can be a step DOWN in basis at death, the aggregate amount by which some estate assets receive a decrease in basis is added to the $1.3 million amount to result in additional increased basis for other assets that are appreciated at the time of death (assuming the estate has appreciation in appreciated estate assets exceeding the $1.3 million [and $3.0 million, if applicable] basis adjustments that would be allowed in any event.

2. Non-Resident Aliens. Decedents who are non-residents and non-citizens of the United States only get a $60,000, rather than a $1.3 million basis increase. Furthermore, they do not receive the benefit of increasing the basis adjustment by built-in losses and loss carryovers. I.R.C. § 1022(b)(3).

3. Anomaly for Many Decedents Dying in 2006-2009 vs. 2010. The disparity between the estate exemption ($2.0 million in 2006-08, and $3.5 million in 2009) and the $1.3 million basis adjustment after 2009 creates the anomaly that some people will actually be better off (for tax purposes, at least) dying in 2006-2009 rather than in 2010 after the estate tax is repealed and carryover basis is instituted. If the client has an estate that is covered by the exemption (up to $2.0 million in 2006-08 and $3.5 million in 2009), there will be no estate` tax, but the basis adjustment would be only $1.3 million, which might not provide a full basis step-up if the estate has a great deal of appreciation.

D. $3.0 Million Basis Adjustment For Property Passing to a Surviving Spouse. The basis of property transferred to a surviving spouse ("qualified spousal property") can be increased by an additional $3.0 million. (Thus, the basis of property transferred to surviving spouses can be increased by a total of $4.3 million (plus the amount of built-in losses and loss carryovers).) "Qualified spousal property" includes property passing outright to a spouse or passing as qualified terminable interest property.

1. Outright Transfer Property. Property passing outright to the surviving spouse includes any property acquired from the decedent by his or her surviving spouse, unless on the lapse of time or the occurrence of an event of contingency, the interest passing to the spouse will fail and (1) the property will pass to another person for less than an adequate and full consideration in money or money's worth, or (2) the property "is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust." For purposes of the second exception, an interest is not considered to terminate or fail merely because it is the ownership of a bond, note or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term. I.R.C. § 1022(c)(4)(B). In addition, an interest that is conditioned on survival for six months after the decedent's death will not be excluded from the definition of outright transfer property if the spouse does not in fact die within such six month period. I.R.C. § 1022(c)(4)(C). Observe that such a survivorship requirement should not be used for decedents dying after 12-31-2009, because if the surviving spouse in fact dies within such six month period, the $3.0 million basis adjustment available for property passing to a surviving spouse would not be available.

2. Qualified Terminable Interest Property. This is defined to mean property that passes from the decedent and the spouse is entitled to all the income for life payable annually or at more frequent intervals. In addition, no person can have a power to appoint any part of the property to anyone other than the surviving spouse during the spouse's lifetime. I.R.C. § 1022(c)(5). In addition, regulations may provide for an annuity to be treated in a manner similar to an income interest in property. Id.

   Generally speaking, this is property that would qualify for a QTIP election under current law. One possible difference from the QTIP trust rules is that income must be "payable annually or at more frequent intervals" under §1022. There is identical language in §2056(b)(5) (for life estate with general power of appointment marital trusts) and §2056(b)(7) (for QTIP trusts). Rulings and regulations under §2056 recognizing trusts that merely allow the spouse the right to withdraw income even if the income is not required to be distributed annually. Rev. Rul. 2000-2, 2000-1 C.B. 305; Treas. Reg. § 20.2056(b)-5(f)(8). It is not yet known whether regulations or rulings under §1022 will be as expansive as the rulings under §2056 (even though the statutory requirement is identical), and to be conservative, trusts intended to qualify for the $3.0 million spousal basis adjustment should mandate that income be paid at least annually until regulations or rulings make clear that a "right to withdraw" approach is sufficient. There would be no necessity of having anyone make a QTIP election (indeed, no estate tax return would be filed if the estate tax is repealed.)

Observe that property in a marital deduction "estate trust" would not qualify for the $3.0 million basis adjustment because the income would not be payable at least annually.

3. Coordination with $1.3 Million Basis Adjustment. The $3.0 million basis adjustment can ONLY be made with respect to property passing outright to a surviving spouse or to a QTIP trust. The $1.3 million basis adjustment is available for property that passes either to a surviving spouse or to others. Thus, the executor could elect for property passing to the spouse to receive a full $4.3 million increase in basis, or could choose to increase the basis of property passing to the surviving spouse by $3.0 million and to increase the basis of property passing to others by $1.3 million.

E. Requirements Common to Both Basis Adjustments.

1. Allocated on Asset-By-Asset Basis. The Conference Report makes clear that the basis increase is allocable on an asset-by-asset basis. For example, the basis increase can be allocated to a share of stock or a block of stock.

2. No Asset Can Have Basis Adjusted Above Fair Market Value. In no case can the basis of an individual asset be adjusted above its fair market value. I.R.C. § 1022(d)(2).

3. Allocation Made By Executor. The executor is to allocate the two basis adjustments to specific assets on "the return required by section 6018." I.R.C. § 1022(d)(3)(A). (Section 6018 describes the information return required for transfers at death of non-cash assets over $1.3 million and for appreciated properties received by a decedent within three years of death that do not qualify for the basis adjustments under §1022(d)(C). See Section VI.B of this outline.)

What if there is a revocable trust? Section 1022(d)(3)(A) says the "executor" shall allocate the basis adjustments on the return required by §6018. Section 6018 (a) says the "executor" shall file the information return, and §6018(b)(4), entitled "*Returns by trustees or beneficiaries*," provides that if the executor cannot make a complete information return for any property, the executor is to file a description of such property and the name of every person holding a legal or beneficial interest in the property. Section 6018 does not discuss revocable trusts. However, the Senate and Conference Report to §6018 says that the information report is to be filed by "the executor of the estate (or the trustee of a revocable trust)."

Presumably, regulations will eventually detail the procedures for the trustee of a revocable trust to file the information report, and to make the basis adjustments on the return due under §6018. The regulations also, hopefully, will make clear how the allocation responsibility will be divided between an executor under a pour-over will and the trustee of a revocable trust. For example, what if there is a will that pours over to a revocable trust, and an executor is appointed under the will? Would that executor be entitled to make all basis allocation decisions even if there are very few assets in the probate estate and very large assets in the revocable trust?

4. Allocation Can Be Changed Only With IRS Consent. Once the executor makes the basis adjustment allocation, it can be changed only as provided in regulations. I.R.C. § 1022(d)(3)(B).

5. Inflation Adjustment. The \$1.3 and \$3.0 million amounts (and the \$60,000 amount for a non-resident alien) are indexed for inflation occurring after December 31, 2009. I.R.C. § 1022(d)(4). The adjustments will be made in increments of \$100,000 for the \$1.3 million amount, \$250,000 for the \$3.0 million amount, and \$5,000 for the \$60,000 amount. I.R.C. § 1022(d)(4)(B).

6. Property Acquired From a Decedent. The carryover basis regime only applies to "property acquired from a decedent." Only such property may have its basis adjustment under either of the two adjustments. See Section V.B. of this outline.

7. Ownership. Property must be "owned by the decedent at the time of death." I.R.C. 1022(d)(A). Ownership is defined more narrowly than "property acquired from a decedent." A very important example of this distinction is that property in a QTIP trust at the surviving spouse's death is not treated as being "owned" by the surviving spouse, and therefore cannot qualify for the \$1.3 million basis adjustment at the surviving spouse's subsequent death (unless the trustee distributed the property to the surviving spouse outright prior to his or her death.) Similarly, assets that had been transferred by a spouse (the donor-spouse) during his or her lifetime to a QTIP trust for the other spouse would not qualify for the \$3.0 million spousal basis adjustment at the donor-spouse's death. The following ownership rules apply.

    a. Joint Tenancy With Surviving Spouse. Property held as joints tenants or tenants by the entireties with the surviving spouse is deemed to be owned one-half by the decedent (and therefore, one-half is eligible for the basis increase.) I.R.C. § 1022(d)(1)(B)(i)(I).

    b. Joint Tenancy With Others Than Spouse. Property held as joints tenants with right of survivorship with anyone other than the surviving spouse is deemed to be owned by the decedent to the extent the property is attributable to consideration furnished by the decedent. I.R.C. § 1022(d)(1)(B)(i)(II).

    c. Joint Tenants Acquired Interests by Gift, Devise or Inheritance. If multiple joint tenants acquired their interests by gift, devise or inheritance, and if their interests are not otherwise specified or fixed by law, the decedent joint tenant will be treated as the owner to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants. I.R.C. § 1022(d)(1)(B)(i)(III).

    d. Qualified Revocable Trust. Property transferred by the decedent during his lifetime to a qualified revocable trust (under §645(b)(1)) is considered to be owned by the decedent (and thus eligible for the basis increase). I.R.C. § 1022(d)(1)(B)(ii).

    e. Powers of Appointment. The decedent shall NOT be treated as owning any property solely be reason of holding a power of appointment with respect to such property. I.R.C. § 1022(d)(1)(B)(iii). (Accordingly, property in a general power of appointment marital trust appears not to qualify for the \$1.3 million basis adjustment at the surviving spouse's subsequent death, unless the spouse exercises the power of appointment to leave the assets to his or her estate.)

f. Community Property. The decedent is treated as owning the surviving spouse's one-half share of community property if at least one-half of the whole of the community interest in such property is treated as owned by, and acquired from, the decedent without regard to this clause. I.R.C. § 1022(d)(1)(B)(iv). Accordingly, the decedent's one-half interest in the community property and the surviving spouse's interest in the community property are both eligible for the $1.3 and $3.0 million basis adjustments.

8. Ineligible Property. The following types of property are not eligible for the basis adjustments.

a. Gifts to Decedent Within Three Years Other Than Spousal Gifts. Property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the three year period ending on the decedent's death generally does not qualify for the basis adjustments. I.R.C. § 1022(d)(C)(i). However, property gifted to the decedent within three years of death by the decedent's spouse do qualify for the basis adjustments, unless the spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration. I.R.C. § 1022(d)(C)(ii). Query what happens if the property is acquired within the proscribed three year period for partial consideration. Is the entire property ineligible for the basis adjustment, or only a portion of the property attributable to the gift element of the transfer?

This section clearly allows pre-mortem interspousal transfers to transfer low basis assets to a dying spouse in order to be able to fully utilize the spouse's $1.3 and $3.0 million basis adjustments. Observe that a one year restriction applies in similar situations under current law to achieve a step-up in basis. Section 1014(e) provides that if a decedent had acquired appreciated property within one of his death and such property passes from the decedent to the donor of such property (or the spouse of such donor), no step-up in basis is allowed for such property at the decedent's death. All of § 1014 (including §1014(e)) no longer applies to decedents dying after 12-31-2009.

This provision is not as important in community property states as in common law states, because both halves of community property qualify for the basis adjustments, without the necessity of transferring assets to the dying spouse.

b. Income In Respect of a Decedent. Property that constitutes a right to receive income in respect of a decedent under §691 does not qualify for a basis adjustment. I.R.C. § 1022(f).

c. Stock of Certain Entities. Stock in the following entities does not qualify for the basis adjustments: (1) foreign personal company; (2) domestic international sales corporation (of a former DISC); (3) foreign investment company; and (4) passive foreign investment company unless the decedent shareholder had made a qualified electing fund election. I.R.C. §1022(d)(D).

## VI. REPORTING REQUIREMENTS AFTER 2009

The 2001 Tax Act requires certain new returns to be filed to provide information for administration of the new basis rules.

A. Lifetime Gifts. Within 30 days of filing a gift tax return, each recipient of a gift must receive a copy of the information included in the return with respect to the gift. I.R.C. § 6019(b). This section presumably applies to gifts made after December 31, 2009. The effective date provision in the legislation is not totally clear, because the effective date for the section of the Act in which this change is included is for "estates of decedents dying after December 31, 2009." 2001 Tax Act § 542(f)(1). Presumably, this will be interpreted to apply to gifts after 2009.

B. Transfers at Death. For decedents dying after December 31, 2009, two types of transfers at death of "property acquired from the decedent" (with the same meaning as is afforded to that term under § 1022(e)) must be reported on returns to the IRS under new §6018. The two types of property that must be reported are: (1) transfers at death of non-cash assets in excess of $1.3 million; and (2) appreciated property received by a decedent within three years of death that does not qualify for the basis adjustments by reason of §1022(d)(1)(C) and which was required to be reported on a gift tax return. The return is to be filed by the executor. I.R.C. §6018 (a). If the executor is unable to make a complete return with all the information described below, the executor is still required to file a return under §6018 giving a description of the property and the name of every person holding an interest in the property. The IRS may contact those persons in turn to file an information return. I.R.C. §6018(b)(4).

The information required to be furnished to the IRS with the return under § 6018 is as follows:

(1) the name and TIN of the recipient of the property,

(2) an accurate description of the property,

(3) the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,

(4) the decedent's holding period in the property,

(5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,

(6) the amount of basis increase allocated to the property under the $1.3 million and $3.0 million basis adjustments, and

(7) any other information that regulations may prescribe. I.R.C. §6018(c). The return to the IRS is required to be filed with the decedent's final income tax return or such later date specified in regulations. I.R.C. §6075(a). Observe that this could be a short period of time for decedents who die late in the calendar year (unless the decedent's final income tax return is extended.)

In addition to the return required to be filed with the IRS, the person required to file that return must also furnish to each recipient of property described in the return a written statement giving similar information with respect to the property passing from the decedent to such person. I.R.C. §6018(e).

There is no statute of limitations operating against the IRS with respect to values reported on the §6018 report. The IRS could question those values years later when beneficiaries sell the assets. (This is probably the same as under current law. Values listed on an estate tax return, even after the period for assessment of additional estate taxes has run, probably are not binding on the IRS for income tax purposes [i.e., determining the amount of the basis step-up].)

C. Penalties for Failure to File Required Information.

1. Failure to Report to Beneficiaries or Donees. Any person required to report to beneficiaries or donees under §6018(e) or §6019 shall pay a penalty of $50 for each failure to report such required information. I.R.C. §6716(b).

2. Failure to Report to IRS. Any person required to report to the IRS under §6018 (for transfers of non-cash assets over $1.3 million or for certain transfers within three years of death) who fails to do so in a timely filed return shall pay a penalty of $10,000 for each such failure (except that the penalty is limited to $500 in the case of a failure to furnish information required under § 6018(b)(2) — which requires reporting certain gifts within three years of death.) I.R.C. §6716(a).

3. Reasonable Cause Exception. No penalty is imposed with respect to any failure that is due to reasonable cause. I.R.C. §6716(c).

4. Intentional Disregard. If any failure to report to the IRS or a beneficiary is due to intentional disregard of the rules, the penalty is 5 percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) of determined at the time of gift (for a life time gift.) I.R.C. §6716(d).

## VII. SPECIAL GAIN PROVISIONS

Many of the special gain provisions are included to coordinate with the modified carryover basis rules that would apply for decedents dying after December 31, 2009.

A. Transfer of Property Subject to a Liability. Gain is not recognized at the time of death when the estate or any beneficiary (other than a tax-exempt beneficiary) acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, no gain is recognized by the estate on the distribution of such property to a beneficiary of the estate (other than to a tax-exempt beneficiary) by reason of the liability. I.R.C. §1022(g). The term "tax-exempt beneficiary" is defined to include specified governmental entities, an organization exempt from income tax, and foreign person or entity, and to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance. I.R.C. §1022(g)(2).

If a beneficiary is bequeathed property with liabilities in excess of the basis of the property, the beneficiary may realize substantial gain on the disposition of the property. For example, if a beneficiary receives property with a gross value of $120,000, basis of $10,000, and subject to a $110,000 liability, the bequest would have a net value of $120k minus $110k or $10,000. However, a sale of the property would generate a taxable gain of $120k minus $10k, or $110,000, which would generate a capital gains tax (at 20%) of $22,000. The income tax liability would exceed the net value of the bequest. See Berall & Harrison, Should We Anticipate 2010 and the Arrival of Carryover Basis? Is There Planning That Can Be/Should Be/Must Be Done Now? What About a "Head-In-The-

Sand" Prayer That It Never Becomes a Reality (Or "I'll Be Retired By Then"), ANNUAL NOTRE DAME TAX & ESTATE PL. INST. at 23-10 (2001). The beneficiary would want to disclaim the bequest. Indeed, there would be a rush by all beneficiaries to disclaim the bequest. Pity the second (or third or fourth) cousin who fails to get notice of the problem (or cannot be located) and fails to disclaim the property. The statute prevents the family from being able to avoid the income tax liability by having the property escheat to the state or affirmatively leaving the property to a government or other tax-exempt entity. (Indeed, the purpose of this provision is to prevent taxpayers from borrowing against their property, leaving the cash to beneficiaries [obviously with a full basis], and leaving the encumbered property to charity. Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act — More Than You Can Count, 95 J. TAX'N 74, 81 (Aug. 2001).)

To be fair to the unsuspecting beneficiary who would get stuck with the tax liability, the estate should sell or allow the foreclosure of the property so that the inherent income tax liability would be borne by the estate generally. (In fact, query whether the executor-beneficiary of the estate who disclaims and does not dispose of the property at the estate level, but "sticks" the income tax liability on other remote family members, would have liability for the deceitful action.)

B. Exclusion for Gain on the Sale of a Principal Residence. The income tax exclusion of up to $250,000 on the sale of a principal residence is extended to estates and beneficiaries and trusts which, immediately before the decedent's death, met the definition of a qualified revocable trust as defined in §645(b)(1). I.R.C. §121(d)(9). The Conference Report indicates that if the decedent's estate or an heir sells the decedent's principal residence, $250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of ownership and occupancy of the property as a principal residence can be added to the heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence.

There does appear to be any time limit on when the estate or beneficiary can avail itself of the decedent's $250,000 exclusion under §121. Observe that a testamentary trust does not qualify for the exclusion under §121. Therefore, if all of the estate passes to testamentary trusts, the estate should sell the residence and then distribute the sale proceeds to the testamentary trust.

C. Transfer of Property in Satisfaction of a Pecuniary Bequest. Distributions of property in kind from trusts or estates that are in satisfaction of pecuniary bequests or pecuniary amounts are treated as taxable sales or exchanges, and gains or losses may result. See Reg. § 1.661(a)-2(f)(1); Kenan v. Comm'r, 114 F.2d 217 (2nd Cir. 1940); Rev. Rul. 60-87, 1960-1C.B. 286 (funding pecuniary marital deduction bequest); Rev. Rul 74-178, 1974-1 C.B. 196 (distribution in satisfaction of a debt). This could produce enormous gain under a carryover basis regime. Fortunately, the 2001 Tax Act provides that gain is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis). I.R.C. § 1040(a). A similar rule will apply to certain trusts (to be described in future regulations.) I.R.C. §1040(b). (Before such regulations are issued, a

§645 election should be made for "qualified revocable trusts," to treat them as an estate, if they will make in-kind distributions to satisfy pecuniary bequests.)

Losses generally cannot be recognized for transactions between various categories of related parties, including transactions between an estate and a beneficiary of the estate. However, The Taxpayer Relief Act of 1997 made clear that the loss disallowance rules for estates does not extend to a sale or exchange that is in satisfaction of a pecuniary bequest. I.R.C. §267(b)(13). How will losses on funding pecuniary bequests be treated under the 2001 Tax Act? The Act itself does not address losses. However, the Senate Report, which was accepted in the Conference Agreement, states that gain "or loss" is recognized only to the extent that the fair market value at the time of transfer exceeds the fair market value at the date of death.

The basis of property acquired in a transaction of funding pecuniary bequests with in-kind assets is the basis of the property immediately before the exchange increased by the amount of the gain recognized to the estate or trust on the exchange. I.R.C. §1040(c).

D. Transfers to Foreign Trusts, Estates and Nonresident Aliens. The present law rule, providing that a transfer by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange, is expanded. The new law adds that transfers by a U.S. person to a nonresident who is not a U.S. citizen is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor. I.R.C. §684(a). Exceptions from the gain recognition rule include transfers to grantor trusts, and lifetime transfers to non-resident aliens. I.R.C. §684(b).

E. Private Foundation Rules Extended to Certain Nonexempt Split-Interest Trusts. Under §4947(a)(2), non-exempt split-interest trusts are subject to certain of the private foundation excise taxes (excess business holdings, jeopardy investments and taxable expenditures) if contributions to the trust were deductible for income, estate or gift tax purposes under §§170, 2055, or 2522. The 2001 Tax Act adds that non-exempt split-interest trusts are also subject to those excise taxes if distributions from the trust are deductible under §642(c) of the Code. I.R.C. §4947(a)(2)(A). For example, a "non-qualified" charitable lead trust would (providing that all trust income is distributed annually to charitable beneficiaries) would be covered by this rule.

What does extending the private foundation restrictions have to do with estate tax repeal and carryover basis? This special rule is reflective of Congressional staffers' attempts to respond to the comments of various experts about the effects of estate tax repeal and potential planning "loopholes." For example, John Wallace, in the 2001 Joseph Trachman Memorial Lecture at the American College of Trust and Estate Counsel meeting, relayed a technique being suggested by some creative planners. If there were no estate tax and no need for an estate tax deduction for "qualified" charitable gifts, astute planners might suggest that charitable bequests be made to non-exempt trusts, for which no tax deduction is permitted for contributions to the entity. Such entities are not subject to some of the restrictive private foundation restrictions (5% minimum payout rule, and restrictions on self-dealing, excess business holdings, inappropriate political activities, and expenditures), but avoid paying any income taxes (under §642(c)) so long as the trustee makes charitable distributions pursuant to the agreement equal to the trust's annual income. Wallace, A

View Through a Glass Darkly: The Impact of Transfer Tax Repeal on Trusts and Estates Lawyers, 27 ACTEC J. 6, 19 (2001).

F. Effective Date. The changes described in this Section VII are all in connection with the adoption of the carryover basis system and apply to decedents dying after or transfers after December 31, 2009.

## VIII. ESTATE TAX PROVISIONS THAT EXTEND BEYOND DATE OF ESTATE TAX "REPEAL."

A. QDOTS. If the first spouse died before January 1, 2010, the QDOT tax (which applies generally when distributions are made from the QDOT to the spouse or at the surviving spouse's subsequent death) will apply to distributions to the surviving spouse before his or her death if the distributions are made on or before December 31, 2020. I.R.C. § 2210(b)(1). Thus for distributions to the surviving spouse, the QDOT tax on distributions continues to apply for eleven years after the estate tax is repealed. (This seems to be an unduly harsh penalty on noncitizen surviving spouses that does not apply to citizen spouses.) The QDOT tax that applies at the surviving spouse's subsequent death does not apply if the surviving spouse dies after December 31, 2009. I.R.C. § 2210(b)(2).

B. Recapture Provisions. The 2001 Tax Act does not specifically mention whether various recapture rules will apply for estates of decedents who die before the estate tax is repealed. However, the Senate Report addresses this issue directly:

> "Prior to repeal of the estate tax, may estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax or other estate tax. Because repeal of the estate tax is effective for decedents dying after December 31, 2010 [which was the effective date of the repeal provision in the Senate bill], these estate tax recapture provisions generally will continue to apply to estates of decedents dying before January 2, 2011."

The various recapture and other provisions that would continue to apply are summarized below.

1. Special Use Valuation. The recapture tax imposed under § 2032A(c) continues to apply for estates of decedents who die before December 31, 2009. The recapture tax applies if certain disqualifying events occur within 10 years of the decedent's death.

2. QFOBI Deduction. The QFOBI recapture provisions, which apply, for example if an heir ceases to use the property in a qualified manner within 10 years of the decedent's death, would continue to apply for estates of decedents who die before December 31, 2009.

3. Section 6166 Installments. Estates of decedents who die before December 31, 2009 that qualify for extended payments of estate tax under §6166 would continue to make payments after 12-31-09. The acceleration rules would continue to apply (for example if more than 50% of the value of the business is distributed, sold or otherwise disposed of).

4. Qualified Conservation Easements. A donor may retain a development right in the conveyance of a conservation easement. However, the advantage of an estate tax deduction for the easement is disallowed if there is not an agreement to extinguish the development rights within two years after the decedent's death, or the date of the sale of the land subject to the easement. This liability for additional tax is

continued after 12-31-09 for the estates of decedents who die on or before that date.

## IX. ESTATE TAX INSTALLMENT PAYMENTS

The following provisions regarding §6166 payouts were included in the 2001 Tax Act. These provisions would no longer apply under the 2011 sunset, as discussed in Section III of this outline.

A. Permissible Number of Shareholders or Partners Expanded to Meet "Closely-Held" Test. Section 6166(b)(9)(B)(iii)(l) is revised to expand from 15 to 45 the number of shareholders or partners that are permitted in order for the business to meet the "closely-held" test. The alternative 20% test (i.e., 20% or more capital interest in a partnership or 20% or more voting stock in a corporation) was not changed. The provision applies to decedents dying after 12-31-01.

B. Qualified Lending and Financing Business. Interests in a qualifying lending and financing business (as defined in §6166(b)(1)(B)) is treated as stock in an active trade or business and qualifies for the installment payment provisions. For this business interest, the installment payments must be made over 5 years. §6166(b)(10)(A)(ii-iii). The Conference Report says that no inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under present law. The provision applies to decedents dying after 12-31-01.

C. Holding Companies; Stock of Operating Subsidiaries Do Not Have to be Non-Readily Tradable. The installment payment provisions are expanded to include holding companies where the holding company stock is not readily tradable, but the stock of operating subsidiaries is readily tradable. For this type of holding company stock, the estate tax must be paid over five years. §6166(b)(8)(ii). (The holding company rules have previously provided that the five year deferral of principal provision does not apply. For this special type of holding company, the entire tax must be paid over the first five years.) The provision applies to decedents dying after 12-31-01.

## X. QUALIFIED CONSERVATION EASEMENT

A. Background. An executor can elect to exclude from the taxable estate 40% of any land subject to a qualified conservation easement, up to a maximum exclusion of $400,000 in 2001 and $500,000 thereafter. The 40% amount is reduced by 2 percentage points for each percentage point by which the value of the qualified conservation easement is less than 30 percent of the value of the land. Such percentage amount, as so reduced, is the "applicable percentage" that may be excluded from the taxable estate.

B. Eliminate Distance Requirement. The 2001 Tax Act expands the availability of the qualified conservation easement exclusion by eliminating the requirement that the land by located within 25 miles of a metropolitan area, national park or wilderness area or within 10 miles of a an Urban National Forest. The land may be located anywhere in the United States or its possessions. I.R.C. §2031(c)(8)(A)(i).

C. Clarification of Valuation Date. For purposes of determining the "applicable percentage," values to be used are the values as of the date of the contribution. I.R.C. §2031(c)(2).

D. Effective Date. The qualified conservation easement amendments are effective for decedents dying after December 31, 2000. 2001 Tax Act §551(c). However, they would be removed after 2010 under the 2011 sunset provision.

## XI. GENERATION-SKIPPING TRANSFER TAX REVISIONS

A. GST Exemption Increases. In 2009, the GST exemption is the same as the estate tax applicable exclusion amount, or $3.5 million.

B. Repeal. In 2010, the GST tax does not apply. There is commonplace discussion of the estate and GST taxes being "repealed" in 2010. However, §2664 (added by the 2001 Tax Act) says that Chapter 13 (the GST tax) "shall not apply to generation-skipping transfers after December 31, 2009." Accordingly, all of Chapter 13 remains in the Code, but just does not apply to transfers after December 31, 2009.

C. Sunset — Generally. The sunset provision in Section 901(a) of the 2001 Tax Act includes provisions of and amendments to the Act affecting generation-skipping transfers after December 31, 2010. Section 901(b) provides that "[t]he Internal Revenue Code of 1986... shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted." Thus, after December 31, 2010, the Internal Revenue Code of 1986 "springs back" and is to be applied as if the provisions and amendments made by the 2001 Act had never been amended. Presumably the GST exemption will be the 2003 amount of the GST exemption, indexed for inflation from 1997 to 2011.

The "had never been enacted" sunset provision creates a variety of uncertainties regarding the application of the GST tax. See Section III.E of this outline. The new Act is unclear as to decedents who die in 2010 creating GST trusts under their wills. The transfer in 2010 will not be subject to estate tax, so no transferor can be determined under the GST tax rules. Therefore, even though the GST tax "springs back" in 2011, "without a transferor, generation assignments cannot be determined and thus it appears that the GST tax would not apply." Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 120-21 (2001). Another alternative approach is to apply the GST tax but since there was no GST tax system and the ability to make GST exemption allocations, perhaps distributions from the trust after 2010 would be treated as taxable distributions or taxable terminations from a trust that is not fully exempt from the GST tax. Some of the particular GST provisions enacted in the 2001 Tax Act, which would all be sunset in 2011 without further legislation, are discussed below.

D. Additional Automatic Allocations Under 2001 Tax Act. The automatic allocation provisions of the 2001 Tax Act would be removed as part of the 2011 sunset.

E. Retroactive Allocation of GST Exemption Under 2001 Tax Act.

1. Rationale. If a taxable termination occurs from a trust because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and GST exemption had not been allocated to the trust (because the transferor anticipated that the assets would pass to the child), the GST tax would be due even if the transferor had unused GST exemption. "The Committee believes it is appropriate to provide that when there is an unnatural

order of death (e.g., when the second generation dies before the first generation transferor), the transferor can allocate generation-skipping transfer tax exemption retroactively to the date of the respective transfer to the trust." (House Report to the 2001 Tax Act, p. 37)

2. General Rule Allowing Retroactive Allocation. If a lineal descendant of the transferor predeceases the transferor, then the transferor can retroactively allocate any unused GST tax exemption to any previous transfer (or transfers on a chronological basis). The retroactive allocation can be made if: (a) A non-skip person has an interest or a future interest in a trust to which any transfer has been made, (b) such person is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) such person is in a generation younger than the generation of the transferor, and (d) such person dies before the transferor. I.R.C. §2632(d)(1).

3. 2011 Sunset. The 2011 sunset will remove this retroactive allocation possibility.

F. Valuation of Exemption Allocations to Transfers Effective at Death. The general rule is that the value for GST purposes of property includible in the decedent's gross estate is the same as its value for estate tax purposes. Treas. Reg. §26.2642-2(b)(1). If alternate valuation is used for estate tax purposes, that value will apply for GST purposes also. Property valued under the special use valuation provisions of Section 2032A will use the special use value for GST purposes (but only if the recapture agreement provides for the recapture of GST tax.) Id. The 2001 Tax Act codifies that the finally determined estate tax value controls for transfers as a result of the transferor's death. I.R.C. §2642(b)(2)(A). However, if the regulatory requirements (as described in Reg. §26.2642(b)) regarding post-death changes are not met, the value of property shall be determined as of the time of the distribution concerned. Id.

G. Relief From Late Elections Under 2001 Tax Act.

1. IRS Has Discretion to Recognize Late Elections As If Timely Made. The Treasury Secretary is directed to adopt regulations (which are now close to being finalized) describing the circumstances and procedures for granting extensions of time to make the election to allocate GST exemption and to grant exceptions to the time requirement. If such relief is granted, the gift or estate tax value of the transfer to trust would be used for determining the GST exemption allocation. I.R.C. § 2642(g)(1)(A). The IRS has granted many of these extensions since 2001. This creates very helpful flexibilities.

2. 2011 Sunset. This very helpful provision would be removed in the 2011 sunset.

H. Severances Under 2001 Tax Act. If a trust is severed in a "qualified severance," the resulting trusts are treated as separate trusts for GST purposes. I.R.C. §2642(a)(3)(A).

1. Significance. The significance of this severance authorization in the 2001 Tax Act cannot be underestimated. It can be extremely useful in planning with trusts that are not tax efficient with respect to the GST tax. For example, for partially exempt trusts, every year that a distribution is made to a younger generation beneficiary, a return must be filed and some GST tax must be paid.

   Under prior law, there was no possibility of dividing a partially exempt trust into two trusts — one of which was fully exempt and one of which was fully non-exempt. In addition, there was no authority under the prior severance regulations to sever an inter vivos trust that is not included in the grantor's estate for GST purposes — so that the trust could be severed before GST exemption is allocated to the newly created trusts (again, to create fully exempt and fully non-exempt trusts).

2. <u>2011 Sunset</u>. This incredibly helpful provision would be removed in the 2011 sunset (without further legislation).

## XII. PLANNING — REVIEW EXISTING DOCUMENTS

A. <u>Meaning of Documents</u>. Formula provisions in documents may be nonsensical if there is no estate tax. The formula provisions may be tied to concepts that are meaningless. For example, what does a bequest of property qualifying for a marital deduction up to a certain amount mean, when there is no marital deduction? What does a bequest of the maximum amount of taxable estate without causing or increasing the federal estate tax mean when there is no federal estate tax and no concept of a "taxable estate?" What does a bequest of the remaining GST exemption amount mean when there is no concept of a GST exemption? What is the meaning of a formula bequest setting the term or payout rate for a charitable lead annuity trust so that the estate is not subject to estate tax? There may be a number of will construction suits over the coming years to resolve these ambiguities. (Even if Congress acts to reinstitute the estate and GST tax retroactively to January 1, 2010, there may be lawsuits as to the state law meaning of the instruments at time of the testator's death.)

Similarly, ambiguities may exist in light of state estate taxes. For example, a state marital deduction may be allowed for QTIP bequests only if the estate makes the federal QTIP election (and there would be no way of doing so in 2010 if no federal estate tax return is required.)

These uncertainties can impact other trusts as well. For example, GRATs may grant a power of appointment to the grantor over the portion of the GRAT included the grantor's gross estate (so that the grantor could exercise the power of appointment to leave those assets in a manner that qualify for the marital deduction). Even if there is no federal estate tax, being able to exercise that power of appointment may be important to qualify for the marital deduction for *state* estate tax purposes. What does that term mean if there is no federal estate tax and no federal gross estate?

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

C. Some Documents Prepared After 2001 Address These Issues. Some documents created after 2001 have addressed the possible scenarios of how the estate is disposed under various circumstances, including whether there is or is not an estate tax. For example, the approach of one firm has generally been to provide in documents that if the federal estate tax does not apply to the estate, the bequest to the credit shelter trust is limited to the amount of the state estate tax exemption, but if there is a federal estate tax, the full federal estate tax exemption amount passes to the credit shelter trust. Those types of documents may need no further revisions. Even with those documents, it makes sense to review the bequests that will pass under the documents in light of the current values and assets in the client's estate. However, many planners (and clients) operated under the belief that Congress would extend the federal estate tax after 2009 and did not address the contingency of having no estate tax when the client dies. Furthermore, documents signed before the 2001 Tax Act no doubt will not address this contingency.

D. Codicil "Fix." Is it possible to have a fairly short and simple codicil to "fix" these potential problems, depending on the client's intentions? For example, the codicil might provide generally that if the client dies during 2010 at a time when the estate and GST tax do not apply to the client's estate and if the taxes are not retroactively reinstated prior to December 31, 2010 to apply to the client's estate, notwithstanding any contrary provisions in the Will, for purposes of all computations that are required to be made under the revenant sections, it shall be presumed that Chapters 11 and 13 of the Code as in effect on December 31, 2009 are in effect at the time of the client's death and that all elections under those Chapters shall be deemed to be available for purposes of the computations. That type of clause is one way to address the mechanical/computational ambiguities that may arise, but the clause would have to be tailored to fit the client's intentions. (For example, the client may prefer that the credit shelter trust be funded with the entire estate rather than just having it funded with the exemption amount available on December 31.)

## XIII. TESTAMENTARY PLANNING FOR MARRIED CLIENTS IN 2010 IN LIGHT OF UNCERTAINTY

During 2001-2009, planners had to deal with the effect of increasing exemptions and the possibility of estate tax repeal on plans. The same uncertainties still exist. There is uncertainty as to whether and when the estate and GST tax is reinstituted and there is uncertainty over the possible increase (or decrease) in the estate tax and GST tax exemptions from the 2009 $3.5 million level. The planning is particularly complicated for married individuals who are concerned with how much to leave to a credit shelter trust, QTIP or outright to a spouse, as well as complications because of the possibility of taking advantage of a $3.0 million basis adjustment for assets passing to a QTIP-type trust.

A. Scenarios of Problem Situations.

1. All to Credit Shelter Trust/Marital Trust Plan. Some clients wish to leave the entire estate to trusts for the spouse and descendants (either a credit shelter trust or a QTIP trust) for non-tax reasons, including the ability to control where assets will pass at the second spouse's death and to provide asset protection for the surviving spouse. These reasons should continue to apply even if there is no estate tax. Those clients may not be concerned with the possibility of increasing exemptions. If the estate tax is not in effect and no marital deduction is needed, the formula clause

may leave the entire estate to the credit shelter trust for the spouse and descendants. On the one hand, that is preferable in that is allows flexibility to include the possibility of making discretionary distributions to descendants, which would not be possible from the QTIP trust. However, assets passing to the credit shelter trust would not qualify for the $3.0 million spousal basis adjustment.

2. Exemption Formula Bequest to Credit Shelter Trust/Balance Outright to Surviving Spouse. This is the classic problem situation in planning for exemption increases. The client wants to leave the exemption to a credit shelter trust to save estate taxes at the second spouse's death, but wants to leave the balance of the estate outright to the surviving spouse. The client may be thinking that a substantial part of the estate will pass outright to the surviving spouse. Continued estate tax repeal or future exemption increases may result in the entire estate may pass to the bypass trust, leaving nothing to pass outright to the surviving spouse. This may be contrary to the client's (and the spouse's) wishes.

3. All to Credit Shelter Trust/Marital Trust; Desire for More Flexibility in Marital Trust If No Marital Deduction Needed. Even if the client wants to leave the entire estate to a credit shelter trust or to a marital trust, there may still be a desire to revise the terms of the trusts if there is no need to qualify for the marital deduction at the first spouse's death or if there is no estate tax.

   a. Revision to Marital Trust Terms if Marital Deduction Not Needed. If the applicable exclusion amount is large enough so that no estate taxes are due at the first spouse's death even if there is no marital deduction, there may be a desire to revise the terms of the marital trust, to delete some of the terms that are necessary to qualify the trust for the marital deduction. These include (i) deletion of the mandatory income requirement, (ii) permitting the trustee to make distributions to beneficiaries other than the surviving spouse, and (iii) giving the surviving spouse a lifetime power of appointment to appoint the assets to persons other than the surviving spouse. Under the "Clayton trust" regulation, the terms of the marital trust may be revised under the trust document (for example, to include these additional provisions) if the executor does not make a QTIP election for the marital trust. See the discussion of using Clayton trust provisions in section XIII.B.2 of this outline, below.

   b. Revisions to Credit Shelter Trust Terms if No Estate Tax Concerns. If there is no estate tax, or if the applicable exclusion amount is large enough to cover the surviving spouse's estate even if the assets of the credit shelter trust are included in the surviving spouse's estate, the client might wish to give the surviving spouse increased flexibility over the credit shelter trust, including serving as trustee without an ascertainable standard on distributions or having a power to withdraw whatever he or she wants to from the trust. (However, including broad withdrawal powers for the surviving spouse will impact the degree of asset protection available for the surviving spouse.)

   c. Bequest to Trust For Children. If the will or revocable trust leaves a formula bequest of as much as possible without causing estate taxes to be paid (typically, the applicable exclusion amount) to a trust for the client's children, there may be a desire to change the will or revocable trust if there is continued repeal or if the applicable exclusion amount increases. The formula clause could end up leaving the client's entire estate to the trust for children, with nothing passing to or for the benefit of the surviving spouse.

d. Outright Formula Bequest to Children. The surviving spouse may be even less inclined to leave substantially increased amounts under a formula bequest that passes outright to children. Furthermore, as the applicable amount increases (or if there is estate tax repeal), the client may wish for a significant part of the bequest to pass to a trust for the children to provide management assistance and asset protection for the children.

e. Bequest to Children of Prior Marriage. The situation is particularly sensitive if the client leaves a formula bequest to children by a prior marriage. For example, if husband has two children by a prior marriage and two children of his current marriage and if the marital estate is predominantly community property, the husband's plan current plan may be to leave all of his applicable exclusion amount to his children by prior marriage, anticipating that his wife will leave her one-half of the community estate to the children by the current marriage. However, if the husband dies first, he may be unwilling to leave *all* of his one-half of the community estate to his children by a prior marriage, in order to make sure that his wife has sufficient assets to provide for her support.

B. Planning Approaches to Afford Desired Flexibility to Accommodate Continued Repeal or Increasing Exemptions or $3.0 Million Spousal Basis Adjustment.

1. Use QTIP Trust Bequest. A key to maximizing planning flexibility during this time of uncertainty is to use a QTIP bequest for the spousal bequest (rather than an estate-type trust or outright bequest to the surviving spouse). Assets in a QTIP trust for which an estate tax marital deduction is not allowed at the first spouse's death are not includible in the surviving spouse's estate under §2044. I.R.C. §2044(b); Treas. Reg. §20.2044-1(a). Therefore, if there is no estate tax in 2010 when the first spouse dies, and all of the estate is left to a QTIP trust, and if the estate tax is reinstituted before the surviving spouse dies, there should be no inclusion of the QTIP assets in the surviving spouse's estate. If the estate had been left outright to the surviving spouse at a time when there is no estate tax but the estate tax is reinstituted before the surviving spouse's subsequent death, the assets would be subject to estate tax at that time. In effect, the QTIP would act as a credit shelter trust. Furthermore, an advantage of leaving all of the estate to a QTIP trust is that the assets would qualify for the $3.0 million spousal basis adjustment (in the event that carryover basis is not repealed retroactive to January 1, 2010).

A disadvantage of leaving all of the estate to a QTIP trust is that it does not permit distributions directly to descendants. If the spouse wanted to transfer assets from the trust to the children, the spouse would have to receive a distribution and make a gift to the children. For this purpose, having the descendants as discretionary potential beneficiaries would be more flexible. Ways of achieving that flexibility are discussed below.

2. QTIP Trust With Clayton Provision or Authority to Add Beneficiaries If Marital Deduction Not Needed. Under the "Clayton trust" regulation, the terms of the

marital trust may be revised under the trust document (for example, to include descendants are discretionary beneficiaries, to delete the mandatory income distribution to the spouse requirement, and to give the spouse a lifetime special power of appointment) if the executor does not make a QTIP election for the marital trust. Reg. § 20.2056(b)-7(d)(3). A typical "Clayton trust" clause provides that the provisions of the QTIP trust would be revised to the extent that the executor does not make the QTIP election for the trust. Implementing that type of clause could be problematic for decedents dying in 2010 when there is no estate tax and no estate tax return will be filed.

More specifically, the regulation provides the converse."[A] qualifying income interest for life that is contingent upon the executor's election under §2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the elcetion is not made passes to or for the benefit of persons other than the surviving spouse." Presumably, the clause could be drafted to provide that if no estate tax return is filed on which the executor makes the QTIP election within a specified period, the terms of the trust would revert to the credit shelter trust terms. The problem with that approach is that there is no assurance that the definition of a "qualifying income interest for life" that qualifies for the $3.0 million spousal adjustment under §1022(c)(5) will include the concept of a Clayton-type election in regulations that will apply to that Code section. If there is any concern that there may be more than $1.3 million of appreciation in the client's estate, for which the additional $3.0 million spousal adjustment would be important, Clayton provisions for the QTIP trust cannot comfortably be used, without employing a complicated formula approach directing that if carryover basis applies, the terms of the QTIP would be relaxed only for the amount in excess of a defined formula amount of assets to qualify for the $3.0 million spousal basis adjustment. (That kind of formula can be quite complicated, because the value of the assets to which the provision would apply could vary dramatically, depending on how much inherent appreciation there is in the assets.)

Another approach may be to give an independent party the authority to add potential beneficiaries to the QTIP trust to the extent that the existence of the power will not jeopardize the federal estate tax marital deduction. If there is no federal estate tax applicable to the decedent's estate, that authority would permit the flexibility to broaden the base of beneficiaries. However, such a provision would likely disqualify the trust for any available state marital deduction (if the state recognizes QTIP marital deductions). Furthermore, such a provision may endanger qualification for the $3.0 million spousal basis adjustment.

3. QTIP Trust With Disclaimer. The will or revocable trust could leave all of the decedent's estate to a QTIP trust, and provide that any assets disclaimed by the spouse would pass to a bypass trust having the spouse as a potential beneficiary (or the will could provide that disclaimed assets would pass to the decedent's children or trusts for children.) The spouse could then disclaim any assets in excess of the amount needed for the $3.0 million spousal basis adjustment. If desired, the spouse could also disclaim as to any assets for which a marital deduction is not needed at the first spouse's death (which might be all of the remaining assets in the trust for

which the $3.0 million spousal adjustment is not important) if there is no estate tax that applies to the decedent's estate.

To utilize this type of planning, it will be very important to include a clause providing where the disclaimed assets will pass, and that assets disclaimed form the QTIP will pass to the credit shelter trust, perhaps to a special portion of the credit shelter trust with special provisions applying to that portion (i.e., the spouse would have no limited power of appointment over that portion). Under the disclaimer regulations, the spouse could disclaim using a formula amount, to provide a "savings clause" against disclaiming "too much" and generating an estate tax at the first spouse's death if there is an estate tax that applies to the first spouse's estate. Reg. §25.2518-3(d), Ex. 20. It may be possible to fashion a formula disclaimer regarding the $3.0 million spousal adjustment provision as well, but that could be very complicated because the amount of assets to fully utilize the basis adjustment depends on which assets are selected for that purpose and the amount of appreciation in those assets.

The spouse could disclaim as to specific assets, as long as the disclaimed assets actually "leave" the trust and pass to someone other than the disclaimant. Reg. §25.2518(a)(2). (A removal of the disclaimed property to another trust under the same instrument is sufficient. Ltr. Rul. 8951041.) Various letter rulings have approved disclaimers of percentage undivided interests, even though the executor could use his discretion in selecting which assets would fund the disclaimed portion, <u>e.g.</u>, Ltr. Rul. 8652016, but that discretionary authority is implicit in many rulings that have approved formula disclaimers. <u>E.g.</u>, Ltr. Rul. 200420007 (approved disclaimer of fractional share of residuary estate by child, with disclaimed assets passing to foundation; numerator of fraction is $X and denominator is value of residue determined on the basis of values, deductions, and other information reported on the federal estate tax return),. The spouse could disclaim a pecuniary amount, or a "reverse pecuniary amount" (i.e., everything in excess of $X.) Reg. §25.2518-3(c). The disclaimed assets can pass into a trust having the spouse as a beneficiary. I.R.C. §2518(b)(4)(A). The surviving spouse can serve as a fiduciary over the disclaimed assets as long as he or she does not retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Reg. §25.2518-2(d)(2). The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Reg. § 25.2518-2(e)(1)(i), §25.2518-2(e)(2), & §25.2518-2(e)(5)(Ex. 12). In effect, the spouse has a great deal of flexibility in making disclaimers.

There are several disadvantages of relying on the disclaimer approach. The most important is that the spouse may refuse to disclaim assets, even though a disclaimer would be appropriate based on the tax situation. However, that is much more of a concern where property passes outright to a spouse, and where the spouse may not want to give up full ownership of the asset. Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a limited power of appointment over disclaimed assets. Reg. §25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). However, a family member other than the surviving spouse-disclaimant (such as the spouse's brother or sister) could have a power of appointment that could be exercised at the spouse's death (or earlier if that is desired). In addition, there is the risk that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible, or that the spouse dies before signing a written disclaimer. Estate of Chamberlain, 87 A.F.T.R.2d 2001-2386 (9th Cir. 2001), *aff'g by unpub'd order*, T.C.M. 1999-181. See Zaritsky, Disclaimer-Based Estate Planning — A Question of Suitability, 28 EST. PL. 400 (Aug. 2001).

Sample clauses for your consideration utilizing the All to QTIP/Disclaimer approach to make use of the $3.0 million spousal adjustment are as follows (graciously provided by Mickey Davis, Houston Texas):

*A. Simplest Approach: If I die at a time when the federal estate tax is not applicable to my estate but Section 1022 of the Code is applicable, [I give to the Trustee of the QTIP Trust] all of my interest in any assets passing under this Will the adjusted basis of which is less than their fair market value at the date of my death, if any.*

*B. Approach Using QTIP Trust For Assets Selected by Executor to Qualify for $3.0 Million Spousal Basis Adjustment: If I die at a time when the federal estate tax is not applicable to my estate but Section 1022 of the Code is applicable, and the basis increase for my estate exceeds the amount otherwise allowed by Section 1022(b)(2) of the Code, [I give to the Trustee of the QTIP Trust] all of my interest in those assets passing under this Will selected by my Executor the adjusted basis of which is less than their fair market value at the date of my death, that would not otherwise be eligible for a basis adjustment but for Section 1022(c), if any.*

*C. Approach Directing Minimum Amount to QTIP Trust to Fully Utilize $3.0 Million Basis Adjustment (the underlined phrases address the minimum bequest matter; Realize that using this approach mandates the assets that would pass to the QTIP Trust and what assets could not be sold to pay administration expenses): If I die at a time when the federal estate tax is not applicable to my estate but Section 1022 of the Code is applicable, and the basis increase for my estate exceeds the amount otherwise allowed by Section 1022(b)(2) of the Code, [I give to the Trustee of the QTIP Trust] all of my interest in those assets passing under this Will having the lowest combined value as of the date of my death as finally determined for federal tax purposes, the adjusted basis of which is less than their fair market value at the date of my death, that would not otherwise be eligible for a basis adjustment but for Section 1022(c), if any. The purpose of this gift is to take maximum advantage of the basis increase allowed under Code Sec. 1022(c) if I die when the carryover basis rules are in effect, but to minimize the amount of property passing to the Marital Deduction Trust, and I direct that this provision be construed to achieve that result.*

Exoneration provisions are appropriate for the executor if the executor has extremely wide discretion in selecting assets to receive the basis adjustment. This type of provision would be especially important for a clause similar Approach B, in which the total value of assets passing to the QTIP Trust depends on the assets selected by the executor and whether they have a high or low amount of appreciation.

*Exoneration. I authorize my Executor in the Executor's sole and absolute discretion to make any election or allocation to adjust the federal income tax cost basis of assets passing as a result of my death to the extent authorized by law,* *whether or not those assets pass under my will, by allocating any amount by which the basis of assets may be increased. My Executor shall be under no duty to allocate basis increase exclusively, primarily or at all to assets passing under this will as opposed to other property passing as a result of my death, or to allocate basis equally or pro rata among various recipients of those assets. Neither any such allocation nor any failure to make such an allocation shall cause my Executor to be liable to any person.*

4. Leaving Bulk of Estate to Credit Shelter Trust. Some clients (and spouses) may not be concerned with leaving the bulk of the estate to a credit shelter trust (at least the portion in excess of the amount needed to utilize the $3.0 million spousal basis adjustment) if there is no estate tax at the first spouse's death. Giving the surviving spouse considerable powers over and interests in the credit shelter trust will facilitate making the client comfortable with this approach. These would include (1) naming the spouse as a co-trustee or as a sole trustee (with appropriate restrictions on distributions so that the spouse does not have a general power of appointment under section 2041 over the credit shelter trust if the estate tax applies at the time of the spouse's subsequent death); (2) giving the spouse a testamentary limited power of appointment over the credit shelter trust; (3) giving the spouse an inter vivos limited power of appointment over the credit shelter trust; (4) naming the spouse as the sole or at least the preferred beneficiary of the credit shelter trust; (5) including specific precatory directions to the trustee (other than the spouse) to be extremely generous in making distributions to the spouse if the assets passing to the credit shelter trusts exceed X% of the estate; (6) giving a trustee other than the spouse, or a "trust protector" the authority to make distributions of as much or all of the trust outright to the spouse as the trustee or trust protector deems to be in the best interest of the spouse, and (7) providing that the surviving spouse would no longer be a beneficiary if the spouse remarried.

5. Formula Limitations. Instead of utilizing the simplicity and flexibility of a disclaimer approach (or a Clayton approach if qualifying for the $3.0 million spousal basis adjustment if not important), the will or revocable trust could try to take into account possible different scenarios based on formulas. For example, the bequest could put a "cap" on the amount of the estate that would pass to the credit shelter trust (so that the entire estate would not pass to the credit shelter trust under a "maximum amount that can pass without estate tax" clause as the exemptions increase or if the estate tax remains repealed.) Alternatives would include (1) a dollar cap, (2) a percentage cap, (3) a cap based on the greater of a dollar amount or a specified percentage, or (4) a cap based on the lesser of a dollar amount or a specified percentage, or (5) other creative formulations.

   For example, a formula credit shelter pecuniary bequest (or the numerator in a formula credit shelter fractional bequest) could include the following after the existing formula language: *"provided that the determined amount shall not exceed one million five hundred thousand dollars ($1,500,000)."* Howard Zaritsky suggests adding language to clarify the testator's intent: "*I recognize that leaving only one million five hundred thousand dollars ($1,500,000) as the Estate Tax Exemption Share may, in some cases, increase the estate taxes due at my *spouse's* death, but I choose to impose this limitation on the Estate Tax*

*Exemption Share in order to assure that my *spouse* receives an amount that I believe to be sufficient."*

6. Coordination of Formulas With $3.0 Million Spousal Basis Adjustment. Using formulas to define the amounts passing to various recipients, including the QTIP trust of a sufficient amount to fully utilize the $3.0 million spousal basis adjustment (at least to the extent needed to fully adjust the basis of the estate property) can be quite complex. The complexity derives from the fact that the amount of assets that must be left to the trust to fully utilize the $3.0 million basis adjustment varies dramatically based on which assets are chosen for that purpose and how much appreciation there is in those assets. A direction to fund the QTIP with as much or as little value as possible to fully utilize the $3.0 million basis adjustment in effect directs exactly which assets to use to fund the bequest (and presumably takes away the ability of the executor to choose to sell those assets to raise cash for paying administration expenses.) Furthermore, if that approach is used and the planner models what assets will likely pass to the QTIP to satisfy the formula clause, it is possible that the results may change dramatically over just several years based on investment performance of the assets. Detailed planning considerations regarding carryover basis issues are discussed in Section XVII of this outline, below. However, in light of the fact that carryover basis is politically very unpopular and that there is a good likelihood that it will be repealed, a better use of resources (and brain cells) may be to rely on the relative simplicity of a QTIP with disclaimer based plan to accommodate being able to leave enough assets to a QTIP trust to fully utilize the $3.0 million spousal basis adjustment.

7. Consider State Death Taxes in Credit Shelter Trust Bequest Formula. Credit shelter trust planning may be appropriate for state estate tax purposes even if there is no federal estate tax. This will be determined on a state by state basis. Depending on the precise wording of state estate tax laws, some states may not have a state estate tax when there is no federal estate tax (although one might anticipate that the state legislatures may change the wording of those provisions so as not to lose the revenue).This planning situation could apply in the event of continued estate tax repeal, or even if there is still a federal estate tax but the federal exemptions make the federal estate tax inapplicable to the client's (and spouse's) estate. If a state has a substantial estate tax on assets in excess of the exemption amount allowed in that state, the planner may want to leave assets to a credit shelter trust up to the amount of the state exemption amount, to the extent that the state does not have a complete marital deduction, to avoid imposition of the state taxes a second time at the spouse's subsequent death. The client may want to leave assets to the surviving spouse (or to a recognized marital trust), up to the amount of state exemptions for assets passing to a spouse. The spouse may move to another state prior to his or her subsequent death that does not have a significant state death tax, so that state death taxes could be avoided entirely. An example of such a clause is as follows:

> *"My 'Estate Tax Exemption' means the largest amount that can pass to the Family Trust as a Formula Gift without increasing my federal estate tax, or if I die when there is no federal estate tax, without increasing my state death tax if my state's death tax law permits an unlimited exemption or deduction for transfers to a surviving spouse and an exemption or credit against the state death tax regardless of the person to whom property*

*passes, and shall mean my entire estate, to the extent not effectively disposed of by the foregoing provisions of this document, if there is no federal estate tax or state death tax in effect at the time of my death."* Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act — More Than You Can Count, 95 J. TAX'N 74, 86-87 (Aug. 2001)

## XIV. GST PLANNING OPPORTUNITIES IN 2010

A. Direct Skip Gifts. Consider making gifts to grandchildren or more remote descendants that would otherwise be subject to the GST tax as direct skips. If the GST tax is not reenacted retroactively to January 1, 2010, there would never be any GST tax costs associated with that transfer. The obvious downside is that there can be no certainty at the time of making such a gift that Congress will not subsequently reinstitute the GST tax retroactively. Defined value clauses may assist in light of that uncertainty. See Section XIV.C of this outline, below.

B. Gifts to Long-Term Trusts. Consider transfers to long-term trusts for descendants that might be free of GST tax constraints. The trusts would be created at a time when there is no GST tax, and if the GST tax is reinstituted, existing trusts that are created during a time that no GST tax existed may be grandfathered from the new tax. However, if the GST tax is reenacted, whether or not it is reenacted retroactively, it seems likely that there will be no grandfathering of trusts created during the window of time from January 1 until the legislation is passed. No GST tax would be incurred when a contribution is made to such a trust, but a GST tax may apply whenever a distribution is made from the trust to a younger generation beneficiary if the GST tax is reinstituted. The may occur, as long as there is no grandfathering of trusts created during a window period beginning on January 1, even if the GST tax is not reinstituted retroactively to January 1, 2010. A downside to making gifts to long-term trusts in is that there would seem to be no mechanism for making GST exemption allocations to the trust, in light of the fact that Chapter 13 does not apply in 2010.

C. Defined Value Clauses. Consider making a gift to a grandchild or a trust defined by a formula based on the maximum amount that can be conveyed currently without the imposition of a GST tax or without changing the GST inclusion ratio of the trust, taking into account any future retroactive legislative changes to the GST tax. To carry this idea one step further, in a state that authorizes decanting, a trustee of a non-exempt trust might make a transfer to a new trust of the maximum amount that can be transferred free of GST tax, and the new trust might make a distribution to a younger generation beneficiary of the lesser of a specified amount or the amount that can be distributed free of GST tax.

D. Gift Tax Effects. These types of transfers for GST purposes are also obviously subject to the federal gift tax system. However, making gifts in early 2010 may have potential gift tax advantages as well. See Section XVI.A of this outline, below.

E. Planning Opportunities for Existing Trusts That Are Not GST-Exempt. If a trust that is subject to the GST tax makes a distribution or terminates and assets pass to beneficiaries two or more generations below the original donor, there is currently a 45% GST tax. If the trust makes a distribution or terminates in early 2010, and assets pass to such younger beneficiaries, there may be no GST tax imposed if there is no GST tax system in place. However, there is a significant risk that the GST tax will later be enacted retroactive to January 1, and the GST tax would apply unless the courts hold that the retroactive application of the tax is unconstitutional. (Could a defined value clause be used, as mentioned above, to define the amount distributed by a formula based on the maximum amount that can be distributed currently without the imposition of a GST tax, taking into account any future retroactive legislative changes to the GST tax?) In light of the uncertainty, clients may be wary of making large transfers from non-exempt trusts unless a GST tax is otherwise expected in the relatively near future. Of course, the distribution or early termination must be permissible under the terms of the trust agreement, as it currently exists or as it may be revised by court action.

## XV. MISCELLANEOUS DRAFTING ISSUES

A. Definition of "Repeal". The estate and GST tax provisions are not actually "repealed" in 2010, but they just "shall not apply" in 2010. Rather than referring to "repeal," a preferable approach would be to draft "if I die when the federal estate tax is not applicable… " Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 129 (2001).

In addition, such clauses should refer to federal, and not state death taxes, because it is likely that many states will continue to have state death tax systems even if the federal estate tax is repealed.

B. Reference to Estate and GST Tax Code Sections. The 2001 Tax Act does not repeal the estate tax sections from the Internal Revenue Code in 2010, but just states that for persons in 2010, that chapter 11 and chapter 13 "shall not apply." I.R.C. §§2210 & 2664. Technically, the estate tax provisions are not repealed — they would just have no effect for decedents dying in 2010. What if the will or revocable trust uses formulas based on estate or GST code provisions that no longer apply if a person dies after 2009? Lloyd Leva Plaine has suggested the following definition:

> *"(a) "Code" refers to the Internal Revenue Code of 1986, as amended, and reference to any provision or section of that Code shall be deemed to refer to the provision or section of the federal tax laws, in effect on the date of my death, that corresponds to the provision or section referred to that was in effect at the time of the execution of this instrument. Notwithstanding the provisions of the previous sentence, if there is no provision or section of the federal tax law at the date of my death that corresponds to such provision or section, and if the federal estate tax is not applicable (as defined in Paragraph (b) of this Item) at my death, then [for purposes of determining the amount of property that passes under a provision of this instrument and/or for any other purpose(s), even if not for all purposes or references to a provision or section of the federal tax law, a reference to a provision or section of the federal tax law shall nevertheless be deemed to refer to the provision or section that was in effect at the time of the execution of this instrument or the provision that was in effect immediately before the tax law became inapplicable, if the independent executor or nonbeneficiary trustee, in his sole discretion, determines that such result or results is more consistent with my intention.] [ALTERNATIVE FOR BRACKETED CLAUSE: such provision or term shall be interpreted by the independent executor or nonbeneficiary trustee in such manner as such independent executor or nonbeneficiary trustee considers advisable keeping in mind the general scheme of distribution of this instrument and*

*the purposes for which any trusts created herein are being established.] The provisions of the previous sentence shall not apply if their inclusion in this instrument would cause any property passing under this instrument that would otherwise qualify for the federal estate tax, marital deduction, charitable deduction, special use valuation or Qualified Family Owned Business deduction, to fail to qualify. The independent executor or nonbeneficiary trustee shall not bear any liability for any decision made by such person in good fiath pursuant to the power granted to him under the terms of the second sentence of this Subparagraph.*

*(b) For purposes of this instrument, the federal estate tax shall be "applicable" at a person's death if the federal estate tax of Subtitle B, Chapter 11 of the Code (Sections, 2001, et. seq.) is then applicable and a federal estate, federal inheritance, or other federal transfer tax is imposed on such person's assets on account of his or her death and shall not be applicable if the federal estate tax of Subtitle B. Chapter 11 of the Code (Sections 2001, et. seq.) is not then applicable and no federal estate, federal inheritance, or other federal transfer tax is imposed on such person's assets on account of his or her death.".*

Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 135-36 (2001).

C. Marital Deduction "Unidentified Asset" Clause. Formula marital deduction clauses often provide that any assets that would not qualify for the marital deduction must pass to the bypass trust. The "unidentified asset" clause is included because of Regulation §20.2056(b)-2, which provides that the marital deduction is reduced to the extent that it could be funded with assets that do not qualify for the marital deduction. If there is no estate tax, and therefore no marital deduction, no asset could qualify for the marital deduction, so this clause might be interpreted to leave the entire estate to the bypass trust. Plaine, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 133 (2001). The unidentified asset clause is of limited utility, following 1981 when it became possible to make a QTIP election for many types of previously nondeductible terminable interests. The clause should probably be eliminated in many plans, but in any event, give careful consideration of whether to leave this clause in wills and revocable trusts in 2010 as to decedents dying when the estate tax does not apply (and perhaps even afterward).

D. Interpretation of GST Formula Bequest After GST Repeal. If the GST tax is repealed, a formula GST bequest (equal to the amount of the testator's remaining GST exemption) will be ambiguous. If there is no GST exemption, this formula may be interpreted as being a bequest of zero. The instrument should clarify the testator's intent. For example: *"My 'Available GST Exemption' shall mean my entire estate [or other desired amount], to the extent not effectively disposed of by the foregoing provisions of this document, if there is no federal generation-skipping tax in effect at the time of my death."* Blattmachr & Detzel, Estate Planning Changes In the 2001 Tax Act — More Than You Can Count, 95 J. TAX'N 74, 88 (Aug. 2001).

## XVI. TRANSFER PLANNING OPPORTUNITIES

A. General Gift Tax Effects. Of course, gifts in excess of the donor's $1 million exemption and $13,000 annual exclusions will be subject to gift tax, but clients who plan to make large gifts anyway should consider doing it early in 2010, when there is a chance that they may pay just a 35% gift tax rather than the 45% top rate that applies this year and the top 55% rate that will apply beginning in 2011.

Keep in mind that the Administration proposes to dramatically change the rules regarding valuation discounts. If there is an estate and gift tax reform package adopted next year, it could include that provision. If there is no legislation, there are indications that the IRS will issue regulations under §2704 that would place significant restrictions on valuation discounts on entities that are valued on the basis of their liquidation value (such as family limited partnerships holding marketable securities or other assets other than operating businesses.) Therefore, to have a chance to take advantage of the lower 35% rates in 2010 and to avoid the coming restrictions on valuation discounts, clients should consider make desired gifts and sales as early in the year as possible.

B. Inter Vivos QTIP Trusts.

1. Goal. Using an inter vivos QTIP trust may allow a person to make a transfer and postpone the time of deciding whether to treat the transfer as a completed gift (for example, to take advantage of the 35% gift tax rate if the gift tax rate is not increased retroactively, especially if the assets appreciate substantially in value after the time of the transfer). The ability to defer making the decision during this time of uncertainty, coupled with the significant rate differential makes this strategy even more appealing than in the past. (A 35% gift tax rate translates to 25.9% tax inclusive equivalent. For example, if a person died owning $100.00 and paid an "equivalent" estate tax of $25.90 and left $74.10 to children, that would be the same amount as if the person made a gift of $74.10, and paid a gift tax of 35%, or $25.90.) The disparity between a 45% (or even higher) estate tax rate and a 25.9% rate is quite significant.

2. Description. An original donor-spouse [say, for example, the husband] would make a gift to an inter vivos QTIP trust for the spouse (in this example, the wife). Several important tax elections and special tax rules apply to this transfer. (1) The trustee could make a QTIP election (including a formula election) to elect for enough assets to qualify for the marital deduction so that no gift taxes are paid on the transfer. (2) Section 2652(c) provides that a trust for which the QTIP election is made may be treated as having been transferred by the original donor-spouse [the husband in this example] for GST purposes by making the "reverse" QTIP election. The ETIP rule does not apply to a QTIP trust if the "reverse" Q-tip election has been made. Treas. Reg. § 26.2632-1(c)(2)(ii)(C). (This would be important if the GST tax is restored retroactively in a manner that applies to this trust; otherwise there would seem to be no way to make the reverse QTIP election at a time when there is no GST tax.) (3) The original donor spouse [the husband] can be a contingent remainderman if the donee-spouse [the wife predeceases the donor-spouse [the husband] without invoking the ETIP rule for GST purposes and without requiring inclusion in the donor's [the husband's] estate if the donor [the husband] should predecease the donee-spouse [the wife]. See Treas. Reg. § 26.2523(f)-1(f), Ex. 11. (4) The Clayton regulations provide that the portion of

the assets for which the QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse that would not be in the spouse's estate for estate tax purposes. However, it is not clear that regulation applies for gift tax purposes to an inter vivos QTIP trust, as discussed below.

3. Formula QTIP Election. Furthermore, this strategy may allow limiting the amount of the completed gift if the donor wishes to put a cap on the amount of gift tax owed as a result of the transfer. Various examples in the regulations reiterate that formula QTIP elections may be used. See Treas. Reg. §§20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h) Exs. (7-8). For a discussion of the mechanics of making a formula election, see Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to least amount possible …"). By using a formula QTIP election, the planner can provide that the QTIP election is made over a sufficient portion of the transferred property so that only a maximum set amount gift tax is payable on the transfer. In this manner, making a formula QTIP election operates much like using a defined value clause — except that the formula QTIP election approach is clearly sanctioned in the regulations and existing rulings.

4. Clayton Uncertainty. The non-elected portion of an inter vivos QTIP should continue to give the spouse a mandatory income interest and permit distributions to no one other than the spouse during his or her lifetime. The Clayton regulation, Treas. Reg. § 20.2056(b)-7(d)(3), is only in the estate tax regulation and not in the the similar gift tax regulation, Reg. § 25.2523(f)-1(b). The gift tax regulation is not a model of clarity, and there would seem to be some uncertainty about this result. Section 25.2523(f)-1(a)(1) of the gift tax regulations states as follows:

"(c) *Qualifying income interest for life* — (1) *In general*. For purposes of this section, the term *qualifying income interest for life* is defined as provided in section 2056(b)(7)(B)(ii) and § 20.2056(b)-7(d)(1)."

*On the one hand*, this statement would seem to incorporate the "Clayton regulation," because this statement provides that for gift tax purposes, the term "qualifying income interest for life" is defined as provided in section 2056(b)(7)B)(ii) of the Internal Revenue Code. The Clayton regulation is in the section of the regulations describing a "qualifying income interest for life." Therefore, the interpretation of that estate tax statutory term, as including an income interest that is contingent of the existence of a QTIP election, would seem to control for gift tax purposes also. More importantly, the gift tax QTIP statute itself provides that "rules similar to the rules of clauses (ii)… of section 2056(b)(7)(B) shall apply." Section 2056(b)(7)(B)(ii) defines the term "qualifying income interest for life." If the gift tax statute simply makes reference to the statutory definition of "qualifying income interest for life," an interpretation of that statute to include an income interest that is contingent on the existence of a QTIP election would seem to controlling for gift tax purposes also.

*On the other hand*, the general statement in the gift tax regulation, quoted above, refers not only to section 2056(b)(7)(B)(ii) of the statute, it also refers specifically to § 20.2056(b)-7(d)(1) of the regulations. However, the "Clayton regulation" is in § 20.2056(b)-7(d)(**3**). Furthermore, the gift tax regulation specifically restates (as a very similar mirror provision) what is in § 20.2056(b)-7(d)(**2**), (**4**), (**5**), and (**6**), thus suggesting that the omission of 7(d)(**3**) has particular significance, raising the question of whether an income interest that is contingent on whether a QTIP election is made would qualify for the gift tax marital deduction.

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

D. GRATs; Sales to Grantor Trusts. GRATs and sale to grantor trust strategies will be as important in 2010 as in prior years. Even if the estate tax should remain repealed, if the gift tax remains, clients will be interested in ways to transfer value to their descendants during their lifetimes rather than making the descendants wait until the clients' deaths to be able to enjoy the family assets. An issue that some planners have raised for gifts to GRATs and other grantor trusts in 2010 is whether §2511(c) will be interpreted to provide that any transfers to grantor trusts will be treated as incomplete gifts. However, §2511(c) merely says the inverse of that (i.e., that gifts to non-grantor trusts will be treated as completed gifts).

Furthermore, §2511(c) specifically says that it applies except as provided otherwise in regulations, and it seems clear that the IRS will not want to take the position that gifts to grantor trusts are incomplete gifts, and leave the possibility that the assets would not be subject to estate inclusion at the donor's death. Finally, the legislative history indicates that the provision is intended to deal with making gifts to non-grantor trusts (possibly multiple trusts) to be able to take advantage of low bracket taxpayers for income tax purposes without having to make taxable gifts. See a more detailed discussion of this issue in Section IV of this outline.

## XVII. CARROVER BASIS PLANNING STRATEGIES

A. Run the Numbers — Is There Even an Issue? The basis adjustment allowed to every estate will be $1.3 million. Typically, an estate would have to be considerably larger than $1.3 million to have unrealized appreciation (not counting income in respect of a decedent — or IRD-- items) in excess of $1.3 million. If a client's estate in 2010 will likely have appreciation of well under $1.3 million, there are no issues at all. All of the assets (except IRD items) can be stepped up to fair market value and all of the carryover basis complexities can be ignored for that client. (This will be the case for many clients.) Furthermore, the $1.3 million amount will be growing; the $1.3 million basis adjustment is indexed for inflation using 2009 as the base year. I.R.C. §1022(d)(4)(A)(ii).

B. Basis Adjustment Allocation Issue Closely Tied to Distribution Issues.

1. Discretionary Distributions of Low Basis and High Basis Property. Under a carryover basis system, deciding how to divide low basis vs. high basis assets among beneficiaries makes a huge difference in the potential tax costs to the various beneficiaries. This issue is every bit as important, if not more so, than deciding how to allocate basis adjustment among beneficiaries. Executors have dealt with this issue for years, but it has only been critical with respect to deciding

how to allocate income in respect of a decedent items or assets that have substantial post-death appreciation. (However, the basis adjustment issue seems to be getting all the attention, perhaps because it is a new issue that planners have not had to consider previously.)

2. Distributions to Spouse. Under the carryover basis regime, assets will have to be distributed to the spouse that have at least $3.0 million of appreciation to be able to utilize fully the $3.0 million basis adjustment of assets passing to a surviving spouse or QTIP.

3. Formula Bequest Tied to Basis. One possible planning approach is to use tax driven formula clauses tied to basis issues in determining the amount of various bequests under the will. For example, the testator may want to assure being able to take full advantage of the $3.0 million spousal basis adjustment, but may want to leave substantial assets for children. A formula clause could leave at least enough to the spouse to take advantage of the $3.0 million basis adjustment. Many complexities arise in drafting such a formula. For example, does the client want to leave as much value as possible to the spouse under that clause (by funding the bequest with assets that have relatively little appreciation), or does the client want to leave as little as possible to the spouse under this bequest (by funding the bequest with assets that have almost 100% appreciation)?

C. Allocation Issues and Alternatives.

1. Executor Can Allocate Basis Adjustment. The executor can choose which assets will receive the $1.3 million basis adjustment (for any bequests) and the $3.0 million basis adjustment (for bequests to a spouse or QTIP). Apparently, the basis may be allocated to any asset included in the decedent's estate, not just assets passing under the will. See Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 88 (August 2001). For a discussion of the coordination with the trustee of a revocable trust in making this basis adjustment allocation, see Section V.E.3. of this outline.

2. Big Dollar Issue. This decision can mean many hundreds of thousands (or millions) of dollars to the beneficiaries. (The first spouse's $1.3 + $3.0 million adjustment, plus the surviving spouse's $1.3 million adjustment, is a total of $5.6 million of basis adjustment for the couple. At a 20% capital gains tax [the 15% rate applies only through 2010], this would mean $1.12 million of tax savings for the recipients who receive the assets with the stepped-up basis.)

3. Fiduciary Issue. The executor owes fiduciary duties to the beneficiaries. Beneficiaries who feel slighted by the "big dollar" allocation decision by the executor may choose to hold the executor accountable to establish that he or she satisfied its fiduciary duties to beneficiaries. Corporate trustees have expressed concern over the potential responsibility associated with the basis adjustment allocation decision. Furthermore, to the extent that the executor allocates the basis increase to any assets passing outside the will, the beneficiaries under the will may complain that the fiduciary violated the fiduciary's duty of loyalty to the takers under the will. See Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 88 (August 2001).

4. Potential Conflicts of Interest. If a beneficiary is the executor, substantial conflicts of interest can arise. Exercise of the discretion in a manner that unduly benefits the executor will be scrutinized. Having an independent or corporate executor will be desirable in many situations to make the basis adjustment allocations and avoid the significant conflicts of interest that would arise if a beneficiary makes those decisions.

5. Exoneration From Liability. In light of the wide discretion and the potential for huge shifts of economic value by the basis adjustment decision, many fiduciaries are maintaining that it is only fair to exonerate the executor from liability for the basis adjustment allocation decision. Some planners have suggested that standard exculpation clauses for tax elections made by the executor should cover these elections also.

6. Beneficiary Consents; Probate Court Approval. Similar to the manner in which executors now seek consents from beneficiaries as to discretionary distribution decisions, the preferred approach will be to work with the beneficiaries in dividing the estate assets and in making basis adjustment allocations in a manner that is agreeable to all estate beneficiaries. Executors will seek consents to the basis adjustment decisions.

   In some states, where an executor can seek court approval for actions by the executor, executors may wish to seek court approval of basis adjustment decisions where the beneficiaries do not unanimously consent to the executor's decisions.

7. Various Issues for Direction or Guidance. Some of the possible factors that the executor might consider in the allocation process, and issues that the clients could address in the will or revocable trust, include the following factors.

   a. General Desire for Equality or Approach for Allocating Among Beneficiaries. Absent contrary directions or guidance in a decedent's will, the executor would have a fiduciary duty to treat the beneficiaries impartially. The will should give the executor guidance. For example, is the general goal to treat all beneficiaries of the residuary estate fairly, or does the client want the executor to favor some beneficiaries over others? If the executor is the surviving spouse, the client might want to give the spouse complete discretion, and explicitly provide that the spouse, as executor, would not be required to treat all beneficiaries fairly.

   b. Favor Particular Specific Bequests; Preference to Residuary or Particular Residuary Bequests? The will or revocable trust might want to favor particular specific bequests. For example, if the client contemplates that a highly appreciated closely held business would be sold relatively soon after the client's death, the client might want to specifically express that the basis adjustment should be allocated among the beneficiaries of that interest.

      To the extent that the value of the decedent's residence does not exceed $250,000, there should be no need to allocate basis adjustment to the residence, because of the availability of the $250,000 exclusion under §121.

If there are not particularly sensitive or valuable specific bequests, the client may wish to prefer allocating the basis adjustment among some or all of the beneficiaries of the residuary estate.

c. Allocate to Children of First Marriage? If there are children of a prior marriage and of the current marriage, the client may wish to allocate his or her $1.3 million adjustment among his or her children (or trusts for them). The client may feel that the surviving spouse (or more precisely, children of the surviving spouse who he or she may designate as the executor) will likely allocate the surviving spouse's $1.3 million basis adjustment among the surviving spouse's children. Also the surviving spouse or a QTIP trust may receive assets to which the first decedent-spouse's $3.0 million basis adjustment may be made, which may subsequently be distributed to the second spouse's children. (However, using a QTIP trust rather than an outright bequest can help to assure that assets remaining in the QTIP trust at the surviving spouse's subsequent death will be allocated among all of the decedent's children as his or she deems to be appropriate.)

d. Allocate to Easy to Value Assets? If the executor allocates the basis adjustment to difficult-to-value assets, the IRS may subsequently contest the date of death value ascribed to the assets by the executor. If the IRS succeeds in arguing that the executor overvalued the date of death value of the asset, the basis adjustment allocation would end up not having allocated the full possible basis adjustment. That complexity could be avoided by allocating the basis adjustment to easy-to-value assets (such as a stock and bond portfolio.)

e. Assets Most Likely to Be Sold in Near Future. The client may want the executor to prefer allocating the basis adjustment to assets that will likely be sold soon after the decedent's date of death.

f. Tax Brackets of Beneficiaries. The client may want the executor to favor allocating the adjustments to assets passing to high bracket beneficiaries, especially if the income tax brackets of the beneficiaries are dramatically different. The client might even make some additional bequest to low tax bracket beneficiaries to account for this difference.

D. Planning and Drafting Strategies.

1. Begin Maintaining Good Basis Records. Reviewing old records to determine the basis of assets can be cumbersome and expensive. At least going forward, maintain good basis information records, and update them on an annual basis. In this respect, the 2001 Tax Act version of carryover basis is more difficult to administer than the 1976 version — which provided a fresh start adjustment to 1976. (The 2001 version is also more difficult to administer because of all the basis adjustment allocation decisions — none of which were allowed under the 1976 version.)

2. Determine If There is a Potential Problem, Based on Anticipated Appreciation of the Estate Assets. Be aware that all of the monetary amounts described below will be indexed for inflation, beginning with a base year of 2009.

a. Under $1.3 Million of Appreciation. If the anticipated total appreciation of the client's or a married couple's (for married clients) estate in 2010 will be well under $1.3 million, there is no need for any action. The basis adjustment will provide a full step-up in basis regardless which spouse dies first and regardless where the assets pass at each spouse's death.

b. Over $1.3 Million of Appreciation. If it is anticipated that the total appreciation of a married couple's assets in 2010 will exceed $1.3 million, it is important to plan (in 2010) so that (1) the first spouse to die has sufficient assets to take advantage of the $1.3 and $3.0 million basis adjustments, and (2) sufficient assets pass to the surviving spouse to utilize the $3.0 million spousal basis adjustment.

c. Over $1.3 Million But Under $5.6 Million of Appreciation. If the $1.3 million and $3.0 million basis adjustment allowed at the first spouse's death plus the $1.3 million basis adjustment allowed at the second spouse's death (assuming he or she has that much appreciated assets other than assets in a QTIP trust), or a total anticipated appreciation of $5.6 million, is well more than the anticipated amount of appreciation at the second spouse's death, there is no need to be concerned with the difficulties of how to allocate the basis adjustment among beneficiaries. All beneficiaries could get a full stepped basis (except beneficiaries receiving income in respect of a decedent assets). However, it will be important to plan so to assure that the full $1.3 million plus $3.0 million basis adjustment can be utilized at the first spouse's death.

3. Classic Disclaimer Plan or All to QTIP Plan Accommodates Carryover Basis Planning. Planning for flexibility to accommodate increases in the exemptions and possible continued repeal often will utilize one of several approaches: (1) All to a QTIP trust, and depend upon partial QTIP elections (if there is an estate tax) to utilize the first decedent-spouse's exemption amount (or so much of it as seems appropriate based on the client's wishes as to minimum amounts that should pass exclusively for the surviving spouse) and to have assets shifted to a trust with more flexibility to the extent the marital deduction is not needed; (2) All to a QTIP trust, with provisions that disclaimed assets pass to a trust with more flexibility (so that assets not needed to qualify for the marital deduction or the $3.0 million spousal adjustment can be in a more flexible trust); or (3) All outright to spouse, and rely on disclaimers by the spouse to utilize the first spouse's exemption amount. Any of these approaches will also flexibly accommodate full use of the $1.3 adjustment and the $3.0 million spousal basis adjustment because assets in the QTIP trust or assets passing to the spouse outright that are not disclaimed would qualify for the $3.0 million spousal basis adjustment.

The only possible complicating factor is that if the will uses a "Clayton QTIP" approach, and provides that with a first spousal death beginning in 2010, some of the QTIP restrictions would no longer apply. In that case, the $3.0 million spousal basis adjustment would likely no longer be available for assets passing to that QTIP trust.

4. Consider Authorizing Outright Distributions to Spouse From QTIP. Assets in a QTIP trust at the second spouse's death will not qualify for the $1.3 million basis adjustment available to the surviving spouse. Property must be "owned" by a

decedent prior to death to qualify for either of the basis adjustments, and property in a QTIP does not meet that test.

Consider with the client whether to give an independent trustee or a trust protector (in particular, someone other than the surviving spouse) the authority to make unrestricted distributions of QTIP trust assets outright to the surviving spouse, not subject to an ascertainable standard. Without such an explicit provision in the instrument, the fiduciary would only be permitted to make principal distributions to the surviving spouse in accordance with any standards listed in the agreement. If the first spouse dies in the near future, leaving most of the estate to a QTIP trust, there may be no ability years later when the surviving spouse dies to take advantage of the surviving spouse's $1.3 million basis adjustment (if there is a carryover basis system in place at his or her subsequent death) if the spouse does not own (outright) assets with at least $1.3 million of appreciation at that time.

For the client who is using a QTIP trust to assure who will receive the remaining assets at the spouse's subsequent death, this may present a troublesome decision. The client in that situation might want to require the approval of more than one independent person. The client might to require the approval of persons who would be "affiliated" with remainder beneficiaries of the QTIP trust (for example, perhaps aunts or uncles of those beneficiaries, who are not related to the surviving spouse's anticipated beneficiaries.) The client also might want to condition the existence of the power on there being a carryover basis system in effect or on there being significant tax advantages from the exercise of the power, other than tax benefits that might result from subsequent gifts of the distributed assets by the surviving spouse (to avoid a potential argument that the power indirectly gives someone the right to make distributions to a person other than the surviving spouse).

5. Provide Allocation Guidance. The client may want to give guidance to the executor in making the allocation decision.

   a. General Fairness Statement. There could be a very general statement that the client would want the executor to treat all beneficiaries of the estate in a fair manner.

   b. Particular Beneficiaries (or Class). The guidance could indicate that the basis adjustment generally should be allocated to particular beneficiaries (for example, children and children of deceased children of the client).

   c. Pro Rata Guidance. The guidance could suggest that the allocation generally would allocated on a pro rata basis (based on the ratio that the percentage of unrealized appreciation in each asset acquired from the decedent bears to the unrealized appreciation in all assets acquired from the decedent).

   d. Non-Probate Assets. The executor has the discretion to allocate the basis adjustment among all assets "owned" by the decedent, which would include non-probate assets. The guidance could specifically address whether the executor has the authority to allocate the basis adjustment to recipients of non-probate assets. (Without such a specific direction, beneficiaries under the will might complain that the executor is violating its duty of loyalty to the will beneficiaries.)

6. Consider Whether to Provide Broad Exoneration to Executor. The basis allocation decision may shift substantial value among estate beneficiaries. In light of the potential disputes that might arise, it would be appropriate to provide the executor with broad exculpatory provisions with respect to the basis allocation decisions.

7. Special Difficulties in Qualifying for $3.0 Million Spousal Basis Adjustment. Many of the really difficult drafting issues will evolve around qualifying for the $3.0 million spousal basis adjustment.

   a. Substantial Tax Advantage; Typically Want to Qualify. The advantage of an additional $3.0 million of basis step-up can yield substantial tax savings to the family (i.e., $3.0 million times 20% capital gains rate, or $600,000.) Typically, the client will want his or her family to be able to take advantage of $600,000 of tax savings, even in a split family situation.

   b. If Concern About Spouse's Disposition, Use QTIP. In a split family situation, the client would probably want to use a QTIP trust, to be able to control where the assets would pass following the second spouse's death.

   c. Do Not Use Survivorship Requirement. An interest that is conditioned on survival for 6 months after the decedent's death will not be excluded from the definition of outright transfer property if the spouse does not in fact die within such six month period. I.R.C. §1022(c)(4)(C). Observe that such a survivorship requirement should not be used for decedents dying after 12-31-2009, because if the surviving spouse in fact dies within such six month period, the $3.0 million basis adjustment available for property passing to a surviving spouse would not be available.

   d. Paradigm Shift — Bequests Based on Combination of Value and Basis. Drafting formula bequests to leave enough to the spouse (or QTIP trust) to take advantage of the $3.0 million spousal basis adjustment will be a significant paradigm shift from planning with traditional formula clauses based just on values. The primary focus of the bequest will be to on the difference between fair market value and the adjusted basis of assets (i.e. the "appreciation"), in order to leave assets with appreciation of at least $3.0 million to the spouse or QTIP trust. That creates a huge additional complication. To pass assets with a specified amount of appreciation can leave a substantial variance in the value passing under the bequest. If the bequest passes property that has a basis of zero, the bequest would be valued at $3.0 million. However, it conceivably could also be interpreted as a bequest of assets worth $100 million, having a basis of $97 million.

   e. Tax-Driven Formula Bequest. Formula bequests may be utilized to assure the availability of the $3.0 million spousal basis adjustment, but drafting such a formula bequest is a huge challenge.

      (1) Must Give Direction of Which Assets to Select. In light of the huge discrepancy of values that could pass to beneficiaries if the clause just left "assets having appreciation of $3.0 million" to the surviving spouse, the clause must give guidance to the executor as

to how to select assets in satisfaction of this bequest. A mere general direction to treat beneficiaries fairly is not sufficient. That really gives the executor no guidance at all as to the testator's thinking of what would be fair. This is not just a matter of allocating basis adjustment among the amounts received by the estate beneficiaries. Funding this bequest <u>determines</u> the amounts to be received by the various beneficiaries.

(2) <u>Smallest or Largest Amount Alternative</u>. One alternative would be to give the executor general guidance to fund the bequest with assets having as small appreciation as possible (which would have the effect of leaving more value to the spouse under this formula bequest) or to leave assets with as large appreciation as possible (which would minimize the value of this bequest to the spouse.) The executor at least needs guidance.

(3) <u>Likelihood of Sale</u>. Just funding the bequest based on the amounts of appreciation (smallest or highest) in the assets does not take into consideration other important factors, such as when the assets will likely be sold. It would be more advantageous to get the basis adjustment on the assets most likely to be sold first. If the clause is just tied to distributing assets in satisfaction of this formula bequest that have as much appreciation as possible, the executor may not have the flexibility to consider those other important factors.

(4) <u>Minimum Amount to Children</u>. Another alternative would be to leave the executor wide discretion in choosing which assets to use for funding, but specify that a minimum amount of value must be left to the non-spousal bequest.

(5) <u>Mechanical Valuation Difficulties</u>. The executor will be faced with difficult valuation complexities in funding the bequest. The values passing under this bequest to the spouse will be highly dependent on the adjusted basis and date of death values of the selected assets. If either of those are incorrect (and both could be difficult to determine with accuracy), the amount funded in satisfaction of the bequest will be incorrect. Filing the report under §6018 does not start the statute of limitations on the determination of the basis of the assets, and the IRS could contest the values years later as assets are sold and income tax returns are filed.

(6) <u>Disclaimer to Spouse May Not Work</u>. A client who strongly wishes to leave a certain amount of property to children or to trusts for descendants may want to rely on disclaimers to leave sufficient assets to the surviving spouse to qualify for the full $3.0 million spousal adjustment. However, it is not totally clear that disclaimed property, which passes to the surviving spouse as a result of the disclaimer, would qualify for the $3.0 million spousal adjustment. Blattmachr & Detzel, <u>Estate Planning Changes in the 2001 Tax Act--More Than You Can Count</u>, 95 J. TAX'N 74, 89 (August 2001). Section 1022(c)(4)(A) defines outright transfer property in

terms of property "acquired from the decedent." Section 1022(c)(5)(A)(i) defines qualified terminable interest property in terms of property "which passes from the decedent." Would these include interests passing by way of disclaimers?

The marital deduction rules provide an analogy. Section 2056(a) allows the marital deduction for property which "passes or has passed" from the decedent to the surviving spouse. Section 2518(a) provides that if a person makes a qualified disclaimer, "this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person." Regulation § 20.2056(d)-2(b) makes clear that if a beneficiary other than a surviving spouse makes a qualified disclaimer, which causes the property to pass to a surviving spouse, the disclaimed interest is treated as "passing directly from the decedent to the surviving spouse."

The uncertainty arises in that (i) there is no specific regulation addressing this issue as there is for the marital deduction, and we do not yet know if regulations to §1022 will adopt the same approach, and (ii) in 2010, §2518 continues in effect (the repeal provision provides that "chapter 11 of subtitle B" (the estate tax provisions) will not apply, and §2518 is in chapter 12 of subtitle B), but §2518 applies only "for purposes of this subtitle," i.e. subtitle B dealing with estate, gift and GST taxes. Section 1022 is in subtitle A, dealing with income taxes, so the disclaimer statute would not apply to §1022.

(7) Sample Clause. Do you want to be the first to draft this nightmare of a formula clause with funding directions? Fortunately, Ellen Harrison has given planners who want to address this issue from a detailed formula based approach with an excellent starting point to draft such a clause for their particular client situations. (An alternate approach that many planners will likely follow is just to use a QTIP/disclaimer approach without detailed formula clauses. See Sections XIII.B.3 and XIII.B.6 of this outline.) Observe that this clause addresses most of the various factors addressed in this section regarding tax-driven formula bequests:

> "*(B) Alternative Disposition if Federal Estate Tax is not in Effect If the federal estate tax is not in effect at my death, then: (1) If my Spouse and any Descendant survives me. If my wife/husband and any descendant of mine survives me, I devise and bequeath to my said Trustee, to hold in trust pursuant to the provisions of the Marital Trust described in FOURTH hereof the smallest amount, if any, that would be necessary to maximize the additional adjustments to basis allowed by section 1022(c)(2)(B) after taking into account basis adjustments allowed under section 1022(b) and basis adjustments allowable for qualified spousal property that is specifically bequeathed to my husband/wife or that passes to*

*him/her outside of the provisions of my Will; provided, however, that the amount of unrealized gain that would be excludable under Section 121 (hereinafter 'section 121 gain') shall not be considered an allowable adjustment. For purposes of this SIXTH (A) it shall be assumed, regardless of what in fact occurs, that my executor will allocate the adjustments allowed by section 1022(b) to assets that are eligible for a basis adjustment (other than section 121 gain) in the following order: first to assets passing outside of this Will to anyone other than my husband/wife or charity; second to property specifically bequeathed to anyone other than my husband/wife or charity; finally to those other assets passing under this Will that have the highest basis in order to maximize the value of the bequest to the Family/ Residuary Trust. I intend that the income interest of my wife/husband in the Marital Trust under FOURTH be a 'qualifying income interest for life' within the meaning of section 1022(c)(5) and any provision of this Will which would be inconsistent with my intent shall be void. My executor shall use date of death fair market value and basis to determine the amount of this bequest and to fund this bequest provided that the aggregate fair market value of assets used to fund this bequest on the date it is paid shall not be less than the amount of this bequest. The foregoing formula shall not be construed to require that my executor allocate basis to assets used to fund this or any other bequest or to assets passing outside of this Will. My executor is not required to make any specific allocation, and no equitable adjustments shall be required as a result of my executor's allocation of basis adjustments to any assets, whether or not passing under this Will."* Berall & Harrison, Should We Anticipate 2010 and the Arrival of Carryover Basis? Is There Planning That Can Be/Should Be/Must Be Done Now? What About a "Head-In-The-Sand" Prayer That It Never Becomes a Reality (Or "I'll Be Retired By Then"), ANNUAL NOTRE DAME TAX & ESTATE PL. INST. at 23-38 to 23-39 (2001).

8. "Reverse Discount Planning". If carryover basis becomes applicable, there will be a major paradigm shift between the IRS and taxpayers on valuation issues. The IRS will argue for low values and for large discounts for date of death values, and taxpayers will argue for high values and for low discounts (because basis can be stepped down if the fair market value at the date of death is lower than the decedent's basis in an asset). The planner can consider this in planning current transfers to take advantage of fractionalization discounts.

   a. Some Assets Cannot Be "Unfractionalized". Some types of assets will be difficult to "unfractionalize." For example, if a parent transfers sliver interests in a vacation home over the years, and only owns an undivided

75% interest in the vacation home before his death, that cannot be unfractionalized (unless he's willing to buy back the 25% interest that had been transferred over the years.) Without such a purchase, the interest will be valued as an undivided 75% interest in a vacation home at the parent's death.

b. Partnership Interests. On the other hand, some types of interests can be "unfractionalized" if all of the parties agree. For example, if various family members own interests in a partnership, all of the partners could collectively agree to amend the partnership agreement if the estate tax is repealed, to provide that any limited partner would have the right at any time to withdraw and receive a pro rata portion of the total value of the partnership assets. Alternatively, the partners could agree to have only one general partner, who would have the unilateral authority under state law at any time to withdraw and force the liquidation of the partnership. In that case, to the extent that the partnership holds in-kind assets (such as real estate), there may still be a fractionalization discount as to those specific assets. However, to the extent that the partnership owns liquid stocks and bonds, those assets would not be subject to a fractionalization discount.

c. Leave Flexibility for Pre-Mortem Repurchases to Convert Minority to Majority Interest. The parties may leave the flexibility for the client to repurchase sufficient interests to convert a minority interest into a majority interest, thus removing minority interest discounts. There is a three year look back window for purposes of the basis adjustment, but that only applies to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the three years prior to death. I.R.C. §1022(d)(c)(i). It would not apply to a repurchase for full consideration of an interest in the property. Of course, the IRS could still attempt to make a "sham transaction" argument, see Estate of Murphy, T.C. Memo 1990-472, but they would be battling uphill against the specific wording [and very apparent exception for full consideration transfers] in the statute. Indeed, another paragraph of §1022 [§1022(g)(2)(d)] adopts a "principal purpose of tax avoidance" exception, but §1022(d)(C) does not. Planning fractionalized transfer transactions with grantor trusts during the phase-in years will be very helpful in leaving open this flexibility. If a grantor trust owns the asset, it could be repurchased by the grantor in a pre-mortem transaction without having the seller recognize taxable income on the sale.

9. Maintain Community Property Status of Assets. The carryover basis rules maintain the basis step-up advantage given to spouses who own community property. Both the decedent's one-half and the surviving spouse's one-half of community property would be entitled to a basis step-up at death using the decedent spouse's $1.3 and $3.0 million basis adjustments. However, for clients with very large estates (who have unrealized appreciation well in excess of $4.3 million), there is not as strong of a basis step-up advantage for maintaining property as community property as there was in the past. (The unrealized appreciation in excess of $4.3 million at the first spouse's death would not receive a step-up in basis.)

10. Interspousal Transfers. The clients should consider whether to make interspousal transfers so that each spouse will own sufficient assets to take advantage of the full \$1.3 plus \$3.0 million of basis adjustment, regardless of which spouse dies first. (We're talking about pretty large estates here — where each spouse would own assets with assets having \$4.3 million of unrealized appreciation.)

For spouses having widely disparate estate values, QTIP trusts are often used to equalize the estates for estate tax purposes. That will not be effective for the basis adjustment rules, because assets in a QTIP trust for the benefit of the decedent-spouse will not be treated as "owned" by that spouse for purposes of the basis adjustment rules.

To take advantage of the basis adjustment for each spouse, in the event of a sudden unanticipated death, the "propertied" spouse would have to be willing to transfer outright ownership of assets to the other spouse. (The only other alternative, which may give at least the appearance of more control to the propertied spouse, would be to acquire assets in the names of both spouses as joint tenants with right of survivorship. Each spouse would be treated as owning one-half of joint tenancy property for purposes of the basis adjustments. I.R.C. §1022(d)(1)(B)(i). However, the "propertied" spouse would then run the risk of dying first, and having the spouse acquire all of the joint tenancy property under the survivorship provision.)

11. Pre-Mortem Gifts to Spouse. The interspousal transfers can be delayed until it is apparent that the non-propertied spouse will likely die first. The new carryover basis rules clearly permit pre-mortem interspousal transfers to transfer low basis assets to a dying spouse in order to be able to fully utilize the spouse's \$1.3 and \$3.0 million basis adjustment. There is no three-year waiting period for transfers to spouses, unless the "donor spouse" acquired the property in whole or in part by gift or inter vivos transfer for less than adequate and full consideration during within three years prior to the transferee-spouse's death. I.R.C. §1022(d)(1)(C)(ii). See Section V.E.8.a. for a discussion of how this compares to the current one-year rule that does apply to spouses in order to receive a step-up in basis at death if the property is left back to the original owner-spouse.