“Tax Relief... Act of 2010” Being Considered By Senate (Including Republican Agreement With President on Estate Tax)

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

Following discussions (and probably negotiations) with Congressional staffers about the details of the estate tax provisions and all of the other details of the broad agreement regarding taxes and unemployment insurance, the Senate Finance Committee released an amendment sponsored by Senators Harry Reid and Mitch McConnell containing the statutory language being considered by the Senate. S. Amdt. 4753. The bill is an amendment of H.R. 4853 (which authorizes funding of the Airport and Airway Trust Fund), and proposes the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." (This proposal is referred to in this summary as "TRA 2010.") Among other things, TRA 2010 includes an extension of the "tax-free IRA/charitable rollover extension" for 2010 and 2011. [TRA 2010 § 725.] Text of the legislation is available at http://op.bna.com/dt.nsf/r?Open=vmar-8bz3b7. Joint Committee on Taxation revenue estimates of the bill are available at http://op.bna.com/dt.nsf/r?Open=vmar-8bz3bn.

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

General Provisions

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

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

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

General Summary of Estate, Gift and GST Tax Provisions

(1) Estate, Gift and GST Tax Exemptions and Rates. TRA 2010 generally sets the estate, gift and GST exemption at $5.0 million, indexed from 2010 beginning in 2012, [TRA 2010 § 302(a)(1)] and sets the maximum rate at 35%. [TRA 2010 § 302(a)(2)]. The exemption generally applies in 2010 [TRA § 302(f)], except that the gift exemption remains at $1.0 million for 2010 [TRA § 302(b)(1)(B)]. (Also, as discussed below, the bill appears not to have a $5.0 million estate or GST exemption in 2010 for estates that elect for carryover basis to apply instead of the estate tax in 2010, but this is a technicality that may be corrected before the Senate acts on the bill.)

(2) Estate Tax in 2010.

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

b. Carryover Basis Election for 2010 Decedents. Executors (within the meaning of I.R.C. § 2203) of estates of decedents who die in 2010 (all of 2010, not just decedents who die on or before the date of enactment, as provided in the Baucus bill) may elect to have the modified basis rules of I.R.C. § 1022 apply "with respect to property acquired or passing from the decedent" within the meaning of I.R.C. § 1014(b)) instead of the estate tax. [TRA 2010 § 301(c).] Large estates (not covered by the $5 million exemption) that would otherwise have to pay substantial estate taxes will likely make this election. However, the executor will have to consider a variety of factors in making this decision, such as the amount of estate tax payable currently vs. the gain that would be subject to income tax on a future sale of assets, anticipated dates of sale, ability to allocate basis adjustments up to fair market value at the date of death for assets that will likely be sold in the near future, anticipated future capital gains rates (and ordinary income rates for "ordinary income property"), and weighing the present value of anticipated income tax costs against the current estate tax amount.

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

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

respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code.)" TRA 2010 § 301(c).

Applying this language in steps:

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

If the carryover basis election is made, the last sentence of TRA 2010 § 301(c) adds that for purposes of I.R.C. § 2652(a)(1), "the determination of whether any property is subject to the tax imposed by such chapter 11 shall be made without regard to any election made under this subsection." Section 2652(a)(1) defines "transferor" for GST tax purposes as the last person who was subject to a transfer tax. This sentence means that for GST purposes the decedent is deemed to be subject to the estate tax and is therefore the "transferor" even though chapter 11 does not apply to the decedent in that circumstance. See the discussion below in Item (3) the **GST Issues** section of this summary.

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

(1) Estate Tax. The estate tax return and payment date of estate tax is extended to no earlier than 9 months after the date of enactment. The extension applies to estates of decedents dying from January 1, 2010 to the day before the date of enactment. (The extension in the Baucus bill was only for 4 months rather than 9 months.) [TRA 2010 § 301(d).]

(2) Carryover Basis Report. Under current law, the carryover basis report under § 6018 is required to be filed with the decedent's final income tax return. I.R.C. § 6075(a). The due date for filing this report may also be deferred to 9 months after the date of enactment. [TRA 2010 § 301(d)(1)(A).] EGTRRA amended I.R.C. § 6018 for decedents dying after 2009 to refer to a carryover basis information return instead of the estate tax return (because the estate tax does not apply under EGTRRA to decedents dying after 2009). That amendment to § 6018 (and the change to § 6075(a) regarding the due date of the carryover basis report) were in subtitle E of title V of EGTRRA, and TRA 2010 § 301(a) interprets the Code as if subtitle E had never been enacted. Therefore, the default rule under TRA 2010 is that § 6018 now refers to the estate tax return, not the carryover basis information report. However, if the carryover basis election is made, the amendment in §301(a) does not apply as to the estate tax or carryover basis, so § 6018 continues to refer to the carryover basis report and not the estate tax return and § 6075(a) continues to require that the report be filed with the decedent's final income tax return. Section 301(d)(1) of TRA 2010 is titled "Estate Tax," but § 301(d)(1)(A) refers to the date for filing "any return under section 6018." If the carryover basis election is made, § 6018 addresses the carryover basis information report and not the estate tax return. Therefore, this provision in § 301(d)(1)(A) appears to override I.R.C. § 6075 and change the due date to no earlier than 9 months after the date of enactment.

(3) Disclaimers. The time for making any disclaimer under I.R.C. § 2518(b) for property passing by reason of the death of a decedent (who dies after 2009) is extended to 9 months after the date of enactment. [TRA § 301(d)(1)(C).] (The Baucus bill applied the disclaimer extension, as well as the other extensions, only for 2010 decedents who die before the date of enactment and referred to an extension before the time of "receiving" a disclaimer rather than the time for "making" a disclaimer.) This opens up additional planning flexibility, in light of the dramatic change in estate tax treatment under TRA 2010. Concerns with being able to take advantage of this additional time include (1) that beneficiaries may have already accepted benefits, not realizing that the disclaimer period would be extended, and (2) state law requirements for disclaimers often refer to 9 months after the transfer, so disclaimers during the extended time period may not satisfy the state law requirements. (Query whether states will respond by amending their disclaimer statutes for decedents dying in 2010 before the date of enactment? Keep in mind that I.R.C. § 2518(c)(3) provides that transfers that do not qualify as disclaimers under local law may still constitute a qualified disclaimer under federal law, as long as the disclaimer operates as a valid transfer under local law to the persons who would have received the property had it been a qualified disclaimer under local law.)

(4) GST Tax Returns. The date for filing any return under I.R.C. § 2662 to report a GST transfer in 2010 before the date of enactment is extended to no earlier than 9 months after the date of enactment. [TRA § 301(d)(2).]

(5) Applicable for Estate of Decedents Dying in 2010 Before Date of Enactment. The extension period for filing returns and paying taxes and for making disclaimers applies to estates of decedents dying in 2010 and before the date of enactment. Similarly, the due dates for GST returns applies for an GST transfer made in 2010 before the date of enactment. [TRA 2010 § 301(d).]

(3) Portability. The executor of a deceased spouse's estate may transfer any unused estate exemption to the surviving spouse. [TRA § 303.] This is accomplished by amending I.R.C. § 2010(c) to provide that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" ($5.0 million, indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount." [TRA § 302(a).] The "deceased spousal unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in new § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under I.R.C. § 2001(b)(1)"). (In effect, this second item is the last deceased spouse's remaining unused exemption amount.)

The bill continues the position of prior portability bills that the executor of the first spouse's estate must file an estate tax return on a timely basis and make an election to permit the surviving spouse to utilize the unused exemption. (Therefore, even small estates of married persons must consider whether to file an estate tax return for the first deceased spouse's estate.)

Only the most recent deceased spouse's unused exemption may be used by the surviving spouse (this is different from prior portability legislative proposals). I.R.C. § 2010(c)(5)(B)(i), as amended.

Portability applies for the gift exemption as well as the estate exemption. TRA 2010 § 303(b) amends I.R.C. § 2505(a), which describes the "applicable credit amount" for gift tax purposes, by referring to the applicable credit amount under § 2010(c) "which would apply if the donor died as of the end of the calendar year…" The applicable credit amount under § 2010(c) includes the decease spousal unused exclusion amount, so that amount is also included in the gift exemption amount. However, portability does not apply to the GST exemption.

The provision applies to the estates of decedents dying and gifts made after 2010. [TRA § 303(c)(1).]

Planning Observations:

- Portability takes on increased importance in light of the increase of the exemption amount to $5.0 million. Marrying a poor dying person to be able to use his or her unused exemption amount (which could be close to the full $5.0 million) may yield dramatic tax savings.
- Portability may impact the decision of a surviving spouse to remarry. If the new spouse should predecease the surviving spouse, the unused exemption of the first deceased spouse would no longer be available to the surviving spouse, and the new spouse may have little or no unused exemption.
- Portability could even encourage the spouses of wealthy families to divorce, each to remarry poor sickly individuals, and not to remarry after the new poor spouses die. This could make up to an additional $10 million of estate and gift tax exemption available to the family.

- The statute itself has no limits on being able to take advantage of the exemptions from multiple deceased spouses for *gift* tax purposes. For example, if H1 dies with substantial unused exclusion, the surviving spouse (W) could make lifetime gifts using her own exclusion and H1s unused exclusion. (Query whether W would be required to use her own gift exclusion before using any of H1's unused exclusion?) If she remarries and H2 also dies with unused exclusion, W could then make additional gifts using H2's unused exclusion (before she remarries and her next husband dies). Courts or the IRS may address a "sham marriage" concept to put some limits on using the exclusions of multiple poor sickly spouses.
- A spouse may not use his or her spouse's "deceased spousal unused exclusion amount." This is sometimes referred to a requiring "privity" between spouses. For example, assume H1 dies and W has his deceased spousal unused exclusion amount, and assume W remarries H2. If W dies before H2, H2 may then use the deceased spousal unused exclusion amount from W's unused basic exclusion amount, but may not utilize any of H1s unused exclusion amount.
- Like the rest of the estate and gift tax provisions in TRA 2010, the portability provision expires after 2012. The apparent anticipation is that Congress will extend this benefit following 2012, but there are no guarantees.
- There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including, (a) the deceased spousal unused exclusion amount is not indexed, (b) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse, (c) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (d) there is no portability of the GST exemption, and (e) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse. On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death.

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

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

(The last phrase, beginning with "which would apply…" is the clause that provides portability of the gift exclusion.)

The Baucus bill did not unify the gift and estate exclusion amounts. The unification of the gift exemption, to provide a $5.0 million exemption for gift (as well as GST) purposes, is huge and will open up a new paradigm of planning considerations for transfer planning by wealthy individuals. Future planning considerations are briefly addressed in the **Effects on Planning Going Forward** section of this summary below.

(5) GST Tax.

a. GST Applicable Rate in 2010 is Zero. For all of 2010, the GST tax "applicable rate determined under section 2641(a) . . . is zero" for all generation-skipping transfers made in 2010. [TRA 2010 § 302(c).] This change in nomenclature is particularly important because of its impact on direct skip gifts *in trust* for grandchildren (or more remote

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

Under § 2641(a), the applicable rate is the "maximum Federal estate tax rate" times "the inclusion ratio with respect to the transfer." The statutory language of TRA 2010 § 302(c), that the "applicable rate determined under section 2641(a)" is zero, does not make totally clear whether the GST tax rate is zero or whether the inclusion ratio is zero. If the inclusion rate is zero for any GST transfer made in 2010, direct skip gifts (which would be "generation-skipping transfers") would arguably result in a trust with an inclusion ratio of zero for generations to come. However, nothing in the statutory language suggests that is the intended result. A more likely interpretation is that there is no GST tax on GST transfers in 2010, but transfers to trusts in 2010 do not automatically result in a zero inclusion ratio for the trust. GST exemption would have to be allocated to the transfer to result in a zero inclusion ratio.

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

c. GST Exemption of $5.0 Million for 2010. The GST exemption equals the estate tax "applicable exclusion amount under section 2010(c) for such calendar year." I.R.C. § 2631(c). Because the estate tax applicable exclusion amount is changed to $5.0 million for 2010 (see item (1) above), [TRA § 302(a)(1)], the GST exemption is $5.0 million for 2010. This is important, because it clarifies that there is up to $5.0 million of GST exemption that can be allocated on a timely basis to transfers to trusts in 2010.

d. GST Exemption in Future Years. The GST exemption for 2011 will also be $5.0 million. The $5.0 million amount is indexed from 2010, beginning in 2012. (The GST exemption amount is the same as the estate tax applicable exclusion amount, and the estate tax exclusion amount is indexed beginning in 2012 as discussed in Item (1) above.)

e. GST Tax Rate. The "applicable rate" for determining the GST tax is the maximum estate tax rate times the inclusion of the trust. I.R.C. § 2641(a). Because the maximum estate tax rate is 35%, the GST rate is also 35%.

(6) Section 2511(c) Deleted. Section 2511(c), added by EGTRRA, provides that transfers to non-grantor trusts are treated as gifts. That section is deleted.

(7) Calculation Details With Respect to Prior Gifts. For estate tax purposes, having a lower gift tax rate in prior years (such as in 2010) does not create an opportunity to "game the system" when

the post-1976 gifts are included in the estate of the decedent as adjusted taxable gifts for purposes of calculating the estate tax. The tentative tax on the taxable estate plus adjusted taxable gifts is calculated at the current estate tax rate at the date of death and the tax on the adjusted taxable gifts alone, using the same rate, is subtracted. The effect is just to tax the estate at the highest estate tax rate brackets, taking into consideration prior gifts. TRA 2010 clarifies that in subtracting the amount of tax on the adjusted taxable gifts alone, the rate of tax at the date of death and the unified credit is also calculated using the rate schedule in effect at the date of death. [TRA § 302(d)(1), amending I.R.C. § 2001 to add § 2001(g).]

For gift tax purposes, the gift tax is generally calculated by subtracting a unified credit, and the amount of unified credit available for a particular year is determined after subtracting the amount of credit already used from prior gifts. In calculating the amount of credit used on prior gifts, use the gift tax rate for the year of the current gift to determine the tentative tax on $1.0 million that was available for offsetting the gift tax on prior gifts. [TRA § 302(d)(2), amending I.R.C. § 2505(a).]

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

Most of these uncertainties are resolved for 2011 and 2012. TRA 2010 § 301(a) says that each Code provision amended by subtitles A or E of title V of EGTRRA "is amended to read as such provision would read if such subtitle had never been enacted." Subtitle A contains I.R.C. § 2210, which says that Chapter 11 [containing the estate tax provisions] does not apply to decedents dying after 2009 (except as to certain distributions from QDOTs) and I.R.C. § 2664 (which says that Chapter 13 does not apply to GST transfers after 2009). Subtitle E contains the carryover basis provisions. The Code would be interpreted as if those provisions of EGTRRA had never been enacted. (The carryover basis provisions would still apply for 2010 decedents who elect to be subject to carryover basis instead of paying estate tax. TRA 2010 § 301(c) begins "Notwithstanding subsection (a)…", and subsection (c) specifically states that the amendments in subsection (a) repealing the carryover basis provisions do not apply if the election is made.)

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

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

Effective Dates

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

Interestingly, some of the changes are effective retroactively for all of 2010, mainly the re-enactment of the estate tax (but subject to the election to have carryover basis apply instead of the estate tax), technical computational details for calculating estate and gift taxes, increasing the GST exemption to $5.0 million for 2010, and clarifying that direct skip transfers in trust in 2010 will not result in the application of GST taxes when distributions are later made to the beneficiaries (at least to the oldest generation of direct skip beneficiaries when the trust is created).

Other changes are effective beginning in 2011. These include unification of the gift and estate exclusion amounts, and the portability of the unused estate tax exclusion amount.

One change only applies to estates of decedents dying in 2010 prior to and GST transfers made in 2010 prior to the *date of enactment* — the provision allowing a delay in filing and paying tax until no earlier than 9 months after the date of enactment. Similarly, the extended period for making disclaimers from transfers arising by the death of a decedent applies only to decedents who die in 2010 before the date of enactment.

A very key change from the Baucus bill is that the changes to the gift tax in the Baucus bill (imposing a 45% rate) and reinstituting the GST tax on GST transfers applied to transfers after the *date of introduction* of that bill (December 2, 2010). This would have removed many opportunities for year-end transfer planning in December. Fortunately, TRA 2010 does not apply an effective date for gifts or GST transfers before 2011.

What's Left Out?

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

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

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

(3) GRAT 10-Year Minimum Term. The Baucus bill included the proposal in the President's Budget Proposal for the last two years of a GRAT 10-year minimum term. Under the proposal, grantor retained annuity trusts must have a 10-year minimum term, the annuity amount cannot decrease in any year, and the remainder interest must have a value greater than zero determined at the time

of the transfer to the trust. The Baucus bill would have applied this minimum 10-year GRAT provision to *transfers after the date of enactment*.

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

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

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

Effects on Year-End Planning

The Baucus bill would have had a major impact on year-end planning. Many individuals have been waiting until the end of the year to make 35% gifts, to make direct skip gifts, and to make distributions to skip persons from trusts that are non-exempt for GST tax purposes, in order to make sure that the 45% gift tax rate and GST tax are not applied retroactively. There has been no prior public discussion of making the gift and GST tax provisions effective on the date of INTRODUCTION of a bill, and the inclusion of the date of introduction effective date in the Baucus bill was quite surprising. Fortunately, TRA 2010 has no such early effective date, and year-end planning opportunities will continue throughout the end of the year (if the legislation passes in its current form).

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

(1) Wait and See. Wait to see if the TRA 2010 package passes or fails (or if there are changes). There is no reason to make transfers in the upcoming week, before knowing whether the legislation passes and its final form. The omission in TRA 2010 of the date of introduction and date of enactment provisions from the Baucus bill means that there is no reason to take action before the bill passes or fails. (There are no opportunities that are removed at the date of enactment under TRA 2010.)

(2) If TRA 2010 Passes, No Gift Advantage. If TRA 2010 passes, there is no advantage to making gifts in December rather than in January. The rate would be the same (35%), and there is more gift exemption in January to cover gift transfers in case the IRS argues for higher gift values on audit. Furthermore, gifts before the very end of the year run the risk that the donor may die before the end of the year, in which event the carryover basis election could be made to avoid any transfer taxes at all on the estate assets. (One exception to this is deathbed planning for estates that would not owe federal estate taxes under the $5.0 million estate exemption in 2010 under TRA 2010, but would owe significant state estate taxes. In many states, pre-death gifts (even deathbed gifts) are excluded from the estate for state estate tax purposes.)

(3) Whether or Not TRA 2010 Passes, Significant GST Opportunities. Whether or not TRA 2010 passes, opportunities to take advantage of the GST tax not applying to GST transfers in 2010 are significant. The only reason for waiting, at this point, is to make sure that TRA 2010 is not revised before passage to include a provision like in the Baucus bill applying the GST tax to

transfers after December 2. The GST planning opportunities include (1) direct skip gifts for grandchildren (or even for great-grandchildren), (2) making distributions from non-exempt trusts to remote beneficiaries (skip person beneficiaries) without the imposition of a GST tax, or (3) terminating non-exempt trusts this year and distributing assts to younger generation beneficiaries without the imposition of a GST tax. (As mentioned in the following item, direct skip gifts in trust will have more certainty if the legislation passes.)

(4) Direct Skip Gifts in Trusts and Taxable Distributions to Skip-Person Trusts Easier If TRA 2010 Passes. Waiting to see if the legislation passes will make the decision easier as to whether a direct skip gift or a taxable distribution from a non-exempt trust can be made in trust without risking having GST tax apply to later transfers to the grandchild-beneficiary of the trust. If the legislation passes, there are no problems with making direct skip gifts in trust or making taxable distributions to skip-person trusts. If the legislation does not pass, the planner and client will have to weigh carefully the possible risks of making direct skip gifts or taxable distributions in trust.

(5) If TRA 2010 Does Not Pass, Retroactive Legislation Taxing Gifts and GST Transfers in 2010 is Extremely Remote. It would seem extremely unlikely that the 2011 Congress will retroactively change the estate, gift and GST tax rules back into 2010, particularly changes that would adversely impact gifts and GST transfers made in 2010. (However, it is conceivable that the estate tax/carryover basis election would be applied retroactively to decedents dying after January 1, 2010. That is a taxpayer favorable provision, giving each estate the ability to choose which approach is best for that estate. It would mean that thousands of estates that would not owe estate taxes in any event could avoid having to deal with carryover basis.)

(6) Efforts to Rescind or Recharacterize Prior 2010 Transfers. If gifts have previously been made in 2010 that require the payment of gift tax or that might arguably on audit be valued at more than the donor's remaining gift exemption, there may be efforts to rescind the prior transfers or recharacterize them in some way. The gift could then be made in January, when the gift exemption increases to $5.0 million, without gift tax exposure. If gift tax is payable on the transfer, the time for paying the gift tax would be delayed by a year.

GST Issues

(1) Sunset Rule Uncertainties. The sunset rule changes, discussed above in Item 8 of the **General Provisions** section, remove many of the uncertainties we have had about the GST tax for 2010 and about whether and how the GST relief provisions in EGTRRA (automatic allocation, qualified severances, "9100 relief" for late allocations, etc.) would still be given effect after 2010. Unfortunately, the relief under TRA 2010 only lasts for two years, and all the uncertainty will arise again following 2012. However, TRA 2010 shows how the EGTRRA adverse effects can easily be solved by a legislative change, and making that change is not controversial at all. There seems little doubt that the sunset will be further extended following 2012, or the various estate, gift and GST changes in EGTRRA (other than the repeal of the estate tax with carryover basis and the repeal of GST tax) will be extended permanently.

(2) Direct Skip Gifts in Trust. Under TRA 2010, direct skip gifts made to trusts in 2010 do not risk having the GST tax apply when the trust later makes a distribution to a grandchild-beneficiary. (There may even be the possibility of including provisions that would permit a trust protector or some other individual other than the donor to add higher generation beneficiaries of the trust at a later time, assuming there is no intent to do so when the trust is created.) Donors this year will have to decide whether (a) to make direct skip transfers in trust (which could be unlimited in amount), or (b) to make transfers to GST exempt trusts, which could last for as many generations

as would be allowed under applicable rules against perpetuities, but which would be limited in amounts that be covered by the $5.0 million of GST exemption available in 2010.

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

(4) 2010 GST Exemption of $5.0 Million. Under TRA 2010, there is 2010 GST exemption of $5.0 million (because the estate tax exemption in 2010 is $5.0 million and the GST exemption is the same as the estate exemption). (Without this legislation, it appears that there is no GST exemption for 2010, because the GST exemption equals the estate tax applicable credit amount and in § 2010(c), the table for the applicable credit amount ends with 2009; there is nothing listed for 2010 or beyond. While there is not GST exemption in 2010, in 2011 there may be a GST exemption equal to $1.0 million, indexed for inflation since 1997, depending on how the "had never been enacted" rule is applied. See I.R.C. § 2631(c) (prior to amendment by the 2001 Act). That number is $1.34 million for 2010.)

A possible exception is that, as currently drafted, the statute *may not* result in a 2010 GST exemption amount for estates that make the carryover basis election. In that circumstance, the "repeal of the repeal of the estate tax" under TRA § 301(a) does not apply, so literally chapter 11 does not apply to the estate. If chapter 11 does not apply, the amendment in TRA 2010 of I.R.C. § 2010 providing a $5.0 million applicable exclusion amount is irrelevant because § 2010 is in chapter 11 and it does not apply. An argument to the contrary is that the election for the estate tax not to apply under TRA § 301(c) applies only "with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code)," and therefore does not apply for GST purposes. Therefore, the reference in I.R.C. § 2631(c) to the "applicable exclusion amount under section 2010(c)" may continue to refer to the $5.0 million amount. The possibility of having no GST exemption for testamentary transfers in estates making the carryover basis election apparently is unintended (it certainly would be unjust to apply the GST tax scheme to testamentary transfers but not afford an opportunity to use GST exemptions), and if the statutory language cannot be adjusted, hopefully the IRS will adopt the contrary argument described above.

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

a. Elect Out of Automatic Allocation for Direct Skip Transfers in 2010. The change in nomenclature in TRA 2010 to avoid saying that chapter 13 does not apply to GST transfers in 2010 has two important implications for direct skip gifts in trust: (1) Automatic allocation of GST exemption to the direct skip will occur under I.R.C. §

2632(b)(1) to the extent necessary to result in a zero inclusion ratio for the transfer unless there is an election out of such automatic allocation; and (2) the move-down rule of I.R.C. § 2653(a) will apply and the zero inclusion rule under I.R.C. §2642(c) for single beneficiary-vested annual exclusion gifts in trust will apply, so that future distributions to the grandchild-beneficiary of the trust will not be subject to the GST tax. These effects are discussed below.

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

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

TRA 2010 makes clear that the move down rule of I.R.C. § 2653(a) would apply to direct skip gifts in trust in 2010. For example, if a direct skip gift is made in trust for the donor's grandchild, the move down rule would cause the grandchild's parent to be treated as the transferor to the trust with respect to future transfers, so that subsequent transfers to the grandchild-beneficiary would not cause a GST tax to apply. In that circumstance, GST exemption that is automatically allocated to the trust would have been wasted if it is likely that distributions from the trust will ultimately be made to the grandchild-beneficiary. (On the other hand, if the intent is to keep the trust intact for the grandchild's descendants, allocation of GST exemption to the trust would be appropriate and desirable.)

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

b. Timely Allocation of 2010 GST Exemption.

If a timely allocation is made, I.R.C. § 2642(b)(1)(B) says that the GST exemption allocation is made effective as of the date of the gift using values on that date. Late allocations are effective as of the date of the allocation, §2642(b)(3)(B), or as of the time the late allocation is made in 2011 (using values on that date, thus requiring allocation of GST exemption to the appreciation occurring up to that date). A late allocation cannot be filed until April 19, 2011 at the earliest (the due date is April 18). If the donor's income tax return is extended, that automatically extends the gift tax return as well to October 15

(or October 17 in 2011). In 2011, a late return for the October deadline could not be filed until October 18, 2011.

c. Late Allocations of 2010 GST Exemption to Transfers in Prior Years. Individuals sometimes wish to allocate more GST exemption to prior trust transfers than the individual has remaining. Having the additional $1.5 million of GST exemption (above the $3.5 million available in 2009) opens up the possibility of being able to allocate substantial additional GST exemption to prior trust transfers at current trust values.

(5) 2010 Transfers Not Grandfathered. Transfers to trusts in 2010 are not grandfathered or exempt from the GST tax. Trusts with contributions in 2010 will be GST exempt only if GST exemption is allocated to those transfers.

(6) Taxable Distributions or Taxable Terminations This Year May Be Made Without GST Tax. The Baucus bill would have eliminated the ability to make GST tax-free taxable distributions or taxable terminations from trusts after December 2, 2010. Under TRA 2010, distribution opportunities from non-exempt trusts remain before the end of 2010. Furthermore, TRA 2010 makes clear that the transfer is subject to chapter 13 (but the rate is just zero). This means that taxable distributions to skip-person trusts this year would receive the benefit of the move-down rule so that future distributions to the skip persons would not be subject to GST taxation. (As discussed in Item (2) above regarding direct skip gifts in trust, there may even be the possibility of including provisions that would permit a trust protector or some other individual other than the donor to add higher generation beneficiaries of the trust at a later time, assuming there is no intent to do so when the trust is created.)

(7) May Provide Clarity Regarding ETIPs. GST exemption cannot be allocated to transfers subject to an "estate tax inclusion period" (or ETIP) during which the assets would be included in the gross estate of the transferor (or his or her spouse). I.R.C. § 2642(f). An example is a transfer to a GRAT, because some or all of the trust may be included in the transferor's gross estate if he or she dies during the GRAT term. GST exemption can be allocated at the end of the ETIP, and indeed there are rules for automatically allocating GST exemption at the end of the ETIP in certain situations. *See* Treas. Reg. § 2632-1(c). During 2010, chapter 11 did not apply under EGTRRA so arguably ETIPs ended as of January 1, 2010 because the trust assets would not have been included in the transferor's gross estate if he or she died after 2009. There were questions as to whether the ETIP would be reinstated at the end of 2010 when the EGTRRA sunset occurred and the estate tax would again apply. If the ETIP terminated on January 1, 2010, could GST be allocated when the ETIP terminated in 2010 — even there is no GST exemption for 2010? EGTRRA raised many uncertainties regarding the treatment of ETIPs. The results of TRA 2010 is not clear, but TRA 2010 may remove many of the uncertainties. It would provide that the estate tax did continue to apply after 2009 (subject to the election of carryover basis instead). Does this mean that an ETIP that we thought had ended on January 1 really did not end, so the ETIP continues without interruption and the uncertain results under EGTRRA are no longer a concern?

Construction Issues

(1) Formula Bequests. The change in the law raises various potential construction issues in construing formula bequests. Standard formula bequests under wills of persons dying in 2010 of the maximum amount that can pass free of estate tax (whether or not the formula goes on to state "by reason of the unified credit under § 2010") now seems to mean $5.0 million. Does an election by the executor of the carryover basis election, so that chapter 11 does not apply, mean that the bequest becomes all of the estate, or is the executor's election irrelevant in construing the amount

of the bequest under the will? What if the executor has already made distributions, based on the meaning of the bequest under the law that has applied up until late in December?

(2) Construction in States With Legislation Tying Formula Bequests to 2009 Law. If the state has passed a statute providing that formula bequests are construed as if 2009 law applied, will the bequest of the tax-free amount be limited to $3.5 million even though $5.0 million could pass to the bypass trust without incurring estate tax? Will state legislatures change their construction statutes? Will courts construe the formula to mean $5.0 million despite the state statute?

(3) Formula Bequests Equal to GST Exemption Amount. A will for a 2010 decedent making a bequest equal to the GST exemption amount appears to be a bequest of $5.0 million. (A possible exception is if the 2010 estate makes the carryover basis election, there may be no 2010 GST exemption, as discussed in Item (4) above in the **GST Issues** section of this summary.)

Effects on Planning Going Forward

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

(1) Simple Gifts. The ability to move $5 million per individual ($10 million per couple) out of the gross estate opens up the possibility for many individuals to transfer as much as they would want to transfer to their descendants during life without any gift tax concerns.

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

(3) Gifts and Sales to Grantor Trusts. The transfer planning opportunities of gifts to grantor trusts can be magnified by leveraging the amounts transferred with sales to the trusts. Sales to grantor trust transactions in the past often are complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The $5 million gift exemption ($10 million for couples) relieves many of those difficulties. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free.

(4) Advantage of Sales to Grantor Trusts Compared to GRATs. GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes. Sales to grantor trusts have various advantages over GRATs, including (most importantly) that GST exemption can be allocated to the grantor trust at the asset so that all appreciation in the turst is also GST exempt, but GST exemption cannot be allocated to GRATs until the end of the retained annuity term. Because there will not be as many concerns about making large gifts with the $5 million gift exemption, sales to grantor trusts make take on increased importance over the use of GRATs.

(5) Gift Splitting. If one spouse has most of the marital wealth, the couple can still take advantage of both spouses' $5 million gift exemptions by making the split gift election.

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

(7) Gifts of Undivided Interests. Gifts of undivided interests in real estate result in the donated interest being valued with a discount, and the remaining interest owned by the grantor at his or her death would also receive an undivided valuation discount. Transfers of undivided interests in real estate result in this double leveraging (both the transferred interest and the retained interest) of the amount that can be transferred with gifts.

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

(9) Voluntary Tax? Perhaps the notion of the estate tax being a "voluntary tax" will again become reality.

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