



ESTATE PLANNING IN UNCERTAIN TIMES:

THE IMPACT OF THE REPEAL OF THE ESTATE TAX
AND WHAT YOU NEED TO CONSIDER

January 1, 2010

A White Paper for Clients and Their Advisors
Prepared by the Private Wealth Services Group of McGuireWoods LLP

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This white paper on the impact on estate planning of the failure of Congress to either temporarily or permanently retain the federal estate and generation-skipping transfer taxes in 2010 was prepared by the Private Wealth Services Group of McGuireWoods LLP, an international law firm with offices around the United States and in strategic foreign cities. The following members of the Private Wealth Services Group wrote this white paper:

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Use of White Paper

This white paper is intended to provide guidance on the impact of the repeal of the federal estate and generation-skipping transfer taxes as of January 1, 2010. These materials do not constitute, and should not be treated as, legal advice regarding the use of any particular estate planning technique or the tax consequences associated with any such technique. Each reader should consult with counsel or other advisors to determine both the tax and nontax consequences of using any particular estate planning technique discussed in these materials before using or recommending the use of that technique.

This white paper is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that the Internal Revenue Service may impose on the taxpayer.

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PART ONE – THE CURRENT UNCERTAIN ESTATE TAX ENVIRONMENT

The 2010 Estate Tax Earthquake

Because Congress did not act in 2009 to preserve the federal estate and generation-skipping transfer (“GST”) taxes in 2010, the federal estate, gift, and GST taxes, which are sometimes collectively referred to as transfer taxes, have changed greatly from what they were in 2009. As a result of the provisions of the 2001 Tax Act, the official title of which is the Economic Growth and Tax Relief Reconciliation Act of 2001 and which is sometimes referred to as “EGTRRA,” the estate and GST taxes have been repealed for one year while the gift tax remains in place with a \$1 million exemption and 35% maximum rate and a “modified carryover basis” regime has been implemented to generally deny a step-up in the basis of appreciated assets at death. Unless Congress acts, the estate, gift, and GST taxes as they existed before 2002 will be reinstated in 2011 with a 55% rate (with a 5% surcharge on estates or cumulative gifts between \$10 million and \$17.184 million), a \$1 million exemption for lifetime and testamentary transfers, and a \$1 million exemption from GST tax (as indexed for inflation since 1999). Because of this changed and unpredictable environment, clients and their advisors now face significant uncertainty in planning the gratuitous transfer of assets given the current state of transfer tax exemptions and rates.

	<u>2009</u>	<u>2010</u>	<u>2011</u>
Gift Tax Exemption	\$1,000,000	\$1,000,000	\$1,000,000
Maximum Gift Tax Rate	45 %	35 %	55 % with 5% surcharge on cumulative gifts between \$10,000,000 and \$17,184,000
Estate Tax Exemption	\$3,500,000	Unlimited	\$1,000,000
Maximum Estate Tax Rate	45 %	None	55 % with 5% surcharge on estates between \$10,000,000 and \$17,184,000
Exemption from GST Tax	\$3,500,000	Unlimited	\$1,000,000 indexed for inflation since 1999
GST Tax Rate	45 %	None	55 %

What Will Congress Do?

It is impossible in this time of increased polarization and partisanship in Congress to predict if and when Congress will act to eliminate the uncertainty and disparity in the transfer tax laws. If Congress acts, it is impossible to predict the effective date of the legislation, specifically whether the legislation will be retroactive to January 1, 2010 or effective as of the date of introduction or enactment. If Congress acts and the legislation is retroactive, there undoubtedly will be a constitutional challenge to the retroactive application of the legislation. Predicting the ultimate outcome of such a challenge is impossible.

Congressional action could involve any of the following possibilities:

- Congress could enact transfer tax legislation, *effective retroactively to January 1, 2010*, and either extend the 2009 transfer tax rates and exemptions or enact new rates and exemptions.
- Congress could enact transfer tax legislation, *effective as of the date of enactment, introduction, or some other action*, and either extend the 2009 transfer tax rates and exemptions or enact new rates and exemptions.
- Congress could continue the deadlock and not enact any legislation so the above transfer tax rates and exemptions will remain in place in 2010 and 2011 and beyond.

What Must We Do? – Review of Estate Plans

Congress's inaction may mean that some estate plans no longer meet the client's objectives and goals. In particular, plans based on formulas or decisions tied to transfer taxes may be significantly impacted by the current state of flux. For example, if a married client directs in the client's will or trust that property equal to the estate tax exemption is distributed to the client's children to the exclusion of the client's spouse or that property equal to the GST tax exemption is distributed to the client's grandchildren, the disposition of the client's assets will vary significantly depending on the year of the client's death and whether and in what manner Congress acts.

Also, many wealthy individuals have estate plans that use charitable gifts or techniques, such as charitable remainder trusts or charitable lead trusts that are designed to take advantage of the federal estate tax charitable deduction with the intention of lowering or eliminating the estate tax associated with a particular transfer. The changes in the estate tax rates and exemptions may affect the original motivation for a particular vehicle or plan.

There are other situations where a client's estate plan will no longer accomplish the client's estate planning objectives depending on when and how Congress acts. Accordingly, clients and their advisors should review their estate planning documents to determine whether changes are in order or necessary to accomplish the client's planning objectives. Also, clients should monitor activity in Congress to see if Congress quickly clears up this mess and thereby eliminates the need for changes.

If Congress fails to act quickly and there is a carryover basis regime for part or all of 2010, estate plans must be reviewed to make sure that adequate provisions have been or are made to take advantage of the adjustments available to reduce the impact on a decedent's estate because the appreciated assets it holds no longer receive a step-up in basis to the fair market value on the date of death.

What Can We Do? – Opportunities for Lifetime Transfers

The uncertain environment may provide opportunity. An individual planning on making taxable gifts in 2010 may pay less gift tax because of the 35% rate and transfer more assets to grandchildren because the GST tax has been repealed, depending on when and how Congress acts. If an individual makes a taxable gift in early January and Congress does not act or enacts legislation with an effective date after the date of the gift, the gift tax rate would be 35% (as opposed to 45% in 2009 and up to 55% in 2011). If the gift is to grandchildren or a trust for the benefit of grandchildren and Congress either does not act or enacts legislation with an effective date after the date of the gift, the gift would not be subject to GST tax and would not use any GST tax exemption.

Because it is impossible to predict what Congress will do, clients and their advisors must exercise caution. If Congress enacts legislation retroactive to January 1, 2010, the retroactivity of which withstands constitutional challenge, the gift tax rate may not be 35% but 45% or higher (although none of the legislative proposals have contained a gift tax rate higher than 45% for gifts in 2010). Clients who do not want to pay the increased gift tax rate and are risk averse should not make taxable gifts on the assumption that Congress will not effectively change the law retroactively.

A client may be able to use carefully designed techniques to take advantage of the possibility that the current transfer tax laws (35% gift tax rate and no GST tax) will be available during the early part or all of 2010 depending on congressional action but avoid or minimize the impact of retroactive changes. Some techniques the client may want to consider include:

- **Taking Advantage of 35% Gift Tax Rate but Avoiding 45% Gift Tax If There Is Retroactive Legislation.** Donor creates a qualified terminable interest trust which offers the ability to delay the decision of whether to make a taxable gift (if there is prospective legislation, the spouse disclaims the interest or no QTIP election is made and gift tax is paid, and if there is retroactive legislation, a QTIP election is timely made and there is no gift tax paid). Of course, one possibility is that Congress retroactively extends the estate and gift tax for one year in 2010 with a 45% rate for estate and gift tax purposes. Then, the pre-2002 law returns in 2011 with its maximum 55% estate and gift tax rate. In that scenario, gifts at either a 35% rate or 45% rate in 2010 would be preferable to gifts at a 55% rate in 2011.

- **Taking Advantage of Repeal of GST Tax but Avoiding Retroactive Legislation.**

- Donor makes a formula gift to an irrevocable trust and directs the trustee to give the amount not subject to GST tax to a properly structured dynasty trust and the balance to the donor's spouse, charity, or a grantor retained annuity trust.
- Donor creates a grantor retained annuity trust and directs that the remainder interest not subject to the GST tax be allocated to a properly structured dynasty trust and the balance to the donor's children.
- Donor creates a charitable lead trust and directs that the remainder interest not subject to the GST tax be allocated to a properly structured dynasty trust and the balance to the donor's children.

What Should We Do? – Building Flexibility into Estate Plans

To accommodate all of this uncertainty, estate planning documents, whether revocable or irrevocable, must include necessary and appropriate provisions to provide flexibility by enabling documents to be amended or other steps to be taken to achieve estate planning objectives while minimizing or eliminating exposure to transfer taxes, no matter what form those taxes may take in the future.

PART TWO – HOW THE ESTATE TAX WAS REPEALED

Background – 2001

EGTRRA was enacted in 2001 by the Republican-controlled Congress by votes of 240-154 in the House of Representatives and 58-33 in the Senate. With economists forecasting budget surpluses over the coming decade of several trillion dollars, EGTRRA undertook to return some of those surpluses to taxpayers in the form of approximately \$1.3 trillion dollars of tax cuts, spread throughout the decade. Those tax cuts included phased increases in the federal estate tax exemption¹ from \$675,000 to \$3.5 million, phased reductions in the top federal estate tax rate from 55% to 45%, similar changes to the gift tax and GST tax, a phase-out of the federal estate tax credit for state death taxes paid, and other related changes. But the capstone of the legislation was that the phased estate and GST tax reductions culminated in the repeal of those taxes, effective January 1, 2010.

Also effective January 1, 2010, EGTRRA added carryover basis rules that change the way that executors and beneficiaries determine the income tax basis of property acquired from a decedent, which is used to calculate gain or loss upon sale of the property and in some cases to calculate depreciation deductions. Instead of a basis equal to the value on the date of death (or "alternate valuation date," generally six months after death), the basis will be the value on the date of death or the decedent's basis in the property, *whichever is less*. That means that many estates will include assets with a basis lower than value. In other words, unrealized appreciation in these assets will become a taxable capital gain upon sale by either the executor or beneficiary. As somewhat of a substitute for the estate tax exemption, each decedent's estate will be allowed \$1.3 million of basis increase, which the executor may allocate to individual assets to eliminate up to \$1.3 million of that unrealized appreciation. The executor will also be able to allocate an additional \$3 million of basis increase to any assets passing to a surviving spouse, either outright or in certain kinds of trusts. The \$1.3 million and \$3 million amounts are indexed for inflation after 2010.

The gift tax was not repealed, but was left in place to discourage indiscriminate transfers of income-producing or appreciated assets from one taxpayer to another to inappropriately avoid or reduce income tax liabilities. Consistent with that objective, the gift tax rate in 2010 was reduced from 45% to 35%, which was the top long-term income tax rate enacted by EGTRRA. Moreover, unlike the estate and GST tax exemptions, which were increased to \$3.5 million, the gift tax exemption was capped at \$1 million, which was thought to better serve the income tax objectives of the gift tax in a post-estate tax world.

Finally, all of the tax changes made by EGTRRA expire – or "sunset" – on December 31, 2010, and EGTRRA states that after that date the tax law "shall be applied ... as if the provisions and amendments [of EGTRRA] had never been enacted." This was not targeted to the estate tax repeal, but was true of the entire Act. It was done to ensure compliance with a 1985 amendment of the Congressional Budget Act, sponsored by Senator Robert Byrd (D-WV) (and hence known as the "Byrd rule"), that makes it out of order in the Senate to include "extraneous" provisions in budget reconciliation. "Extraneous" is defined to include the reduction of tax receipts beyond the period provided for in the Congressional Budget Resolution. Because the 2001 budget resolution covered 10 years, it would have been out of order to reduce taxes beyond the tenth year.

¹ Technically, there is no estate or gift tax "exemption"; there is a "unified credit" applied against the calculated tax. The amount of the unified credit, however, is based on an "applicable exclusion amount" set forth in the statute; it is simply the tax tentatively calculated on a taxable estate or cumulative lifetime gifts equal to the applicable exclusion amount. Because of that derivation of the unified credit, it is customary to refer to the applicable exclusion amount in effect from time to time as the "exemption" equivalent to the unified credit, and there is no doubt that lawmaker's think of it as an "exemption" when they consider changes to the law. The simple and convenient term "exemption" is used throughout this paper, even though, in some scenarios, it is not precisely accurate. In contrast, the GST exemption is a true exemption, allocated as a dollar amount to transfers with GST tax implications.

The Byrd rule could have been waived by a vote of 60 Senators (just as a Senate filibuster against general legislation can be broken by a vote of 60 Senators) but the Senate voting in 2001 indicates that 60 votes might not have been available. H.R. 1836, which became EGTRRA, originally passed the Senate, on May 23, 2001, by a vote of 62-38 (while the conference report on EGTRRA ultimately passed the Senate on May 26, 2001, by a vote of only 58-33). H.R. 1836, however, garnered 62 votes only with a “sunset” provision in it. The Senate was not asked to vote on a non-sunset repeal, and presumably the votes were just not there. In the Senate consideration of H.R. 1836, amendments to eliminate the estate tax repeal were defeated by votes of 43-56 and 42-57. Even an amendment to preserve the estate tax only for estates greater than \$100 million was defeated by a vote of 48-51.

Thus, with respect to the estate and GST taxes, EGTRRA has created the very strange result of a tax declining from 2002 through 2009, disappearing altogether in 2010, and returning in 2011 at its higher pre-2002 level.² Nevertheless, while the result is preposterous, its historical components, viewed separately, are understandable. Since the 2001 tax cuts were tied to ten years of projected surpluses, it is understandable that some of those cuts, in this case the repeal of the estate tax, would occur in the tenth year. The unwinding of the repeal in 2011 is a result of preexisting budget rules and a politically balanced Senate in 2001 and was not targeted to the estate tax or invented to create the 2010-2011 estate tax two-step.

Attempts to Avoid the Unthinkable – 2001-2009

Since 2001, Congress has made other provisions of EGTRRA permanent on a targeted basis, and considerable efforts have been made to find a compromise permanent estate tax structure that could attract 60 votes in the Senate. In September 2005, a House-passed permanent repeal bill was scheduled to be brought up for debate in the Senate as the vehicle for such a compromise, but that was postponed because Hurricane Katrina had hit the Gulf Coast just the weekend before. The Republican Senate leadership tried again in the summer of 2006, but failed to attract more than 58 of the 60 votes needed to begin debating the issue, perhaps because of the waning enthusiasm after Katrina and the leadership’s own declining influence in the run-up to the 2006 elections in which the Democrats gained control of the Senate. For their part, the Democratic leadership of the Senate since 2007 held a series of Finance Committee hearings on ways to reform and stabilize the estate tax and supported provisions in the fiscal 2008, 2009, and 2010 Congressional Budget Resolutions to accommodate making 2009 law permanent.

The Final Push – December 2009

Finally, on December 2, 2009, the House of Representatives, by a vote of 225-200, passed a leadership-backed bill, H.R. 4154, making 2009 law – with its \$3.5 million estate and GST tax exemptions and 45% rate – permanent. The vote was partisan; no Republican voted for the bill, while 26 Democrats voted against it. The supporters of the bill in the floor debate focused on the need for predictability in planning and the unfairness of carryover basis. Those voting no presumably did so mainly because they would have preferred to see the estate tax permanently repealed or more significantly reduced – the current House of Representatives includes over 170 members who were among the 272 votes for permanent repeal the last time that came before the House in April 2005. Indeed, the opposition in the floor debate before the vote supported an alternative bill that would have phased in a \$5 million exemption and 35% rate by 2019 and indexed the exemption for inflation after that. A few voting no, however, were Democrats who have expressed a preference for a higher tax, including, for example, a reduction of the exemption to \$2 million and a return to a top rate of 55%. Other Democrats of that view voted yes.

H.R. 4154 reached the Senate when the Senators were preoccupied with health care reform. On December 16, 2009, Finance Committee Chairman Max Baucus (D-MT) asked the Senate for unanimous consent to bring H.R. 4154 to the floor, approve an amendment to extend 2009 law for only two months (not permanently), and approve the bill as amended. In response, the Republican Leader, Senator Mitch McConnell (R-KY), asked Senator Baucus to agree to consideration of an amendment reflecting, as Senator McConnell described it, “a permanent, portable, and unified \$5 million exemption that is indexed for inflation, and a 35-percent top rate.”

- By use of the word “permanent,” of course, Senator McConnell was advocating legislation that would eliminate not just all or part of the 2010 repeal year, but also the return to a higher tax in 2011.
- By “portable,” he was affirming the ability of a surviving spouse to use any estate tax exemption available to but not used by the first spouse to die.

² Although the estate and gift tax exemptions in 2001 were \$675,000, under EGTRRA they will revert in 2011 to \$1 million, which they were already scheduled to be under phased-in increases enacted in 1997. The GST exemption will revert to a statutory level of \$1 million, adjusted with reference to inflation since 1999. Because in 2010 the inflation-adjusted GST exemption would have been \$1,340,000 (see Rev. Proc. 2009-50, 2009-45 I.R.B. 617, with reference to the identical “2-percent portion” under Code sections 6166 and 6601(j)(2)), in 2011 it is likely to be that amount or somewhat higher.

- By “unified,” Senator McConnell was supporting the increase of the \$1 million gift tax exemption to be equal to the estate tax exemption, as it had been before 2004.
- By “indexed for inflation,” he was embracing annual increases in the unified exemption with reference to increases in the consumer price index, as the GST exemption was indexed from 1999 through 2003 (and will be indexed again in 2011 unless Congress changes the law).

Portability, unification, and indexing had been approved in two bills passed by the House of Representatives in 2006 and included in S. 722 introduced by Chairman Baucus in March 2009. A \$5 million exemption and 35% top rate, along with unification, indexing, and portability, had been part of an amendment, sponsored by Senator Blanche Lincoln (D-AR), that received 51 votes in the consideration of the fiscal 2010 Congressional Budget Resolution in April 2009.

Senator Baucus objected to Senator McConnell’s request, whereupon Senator McConnell objected to Senator Baucus’s request, and all practical hopes of transfer tax legislation in 2009 died.

On December 24, 2009, after the Senate had passed the health care reform legislation, the Senate leadership arranged, without objection, to place H.R. 4154 on the Senate calendar as “read for the first time” and, as a practical matter, scheduled the “second reading” for the Senate’s next legislative day, probably January 20, 2010, which in effect could place consideration of H.R. 4154 one day away at that time. But the Senate adjourned for the year without further action, and on January 1, 2010, there was no federal estate tax.

Anticipation of a New Congressional Session – January 2010

The Senate returns to work on the 19th or 20th of January 2010. (The House will return a week or so before that, but it is probably the Senate that must make the next move.) The parliamentary maneuvering of Christmas Eve might indicate that someone is optimistic that the key Senators in this debate might come together during the year-end break and craft a compromise that can either garner 60 votes or proceed under an agreement that there will be no objection. That would be similar to what some Senators were hopeful of accomplishing during the 2005 August break before Hurricane Katrina intervened. The question is whether the tsunami of health care partisanship has left the Senate even more inundated today than Katrina did in 2005. Many observers, including authors of this paper, think that is such a crucial factor that they are not expecting the Senate in 2010 to be any better able to break the deadlock than was the same Senate in December 2009. If so, then the only task is to try to understand 2010 law while we have it and brace ourselves for 2011.

Meanwhile, for those looking for the breakthrough that will permit Congress to achieve a compromise in 2010, the following questions arise:

- When will Congress act?
- What will the compromise provide?
- What will be the effective date? Will it be prospective only from the date the President signs it? Or will it be retroactive to the date of some earlier Congressional action – announcement, introduction, action in committee, action in one house, or something else?
- Will the legislation be retroactive all the way to January 1, 2010, so that it will be as if there were no gap at all, or as if Congress had acted in 2009 after all?
- If the legislation is not retroactive to January 1, 2010, how will the terms of any permanent fix be affected by the greater cost of estate tax relief, caused by the loss of estate tax revenue for some or all of 2010?
- If the legislation is not retroactive to January 1, 2010, how will estate planning actions taken during the gap be treated? (This is similar to the question of what long-term consequences any estate planning actions in 2010 will have if Congress does not act at all.)
- If the legislation is retroactive, how will estate planning actions taken during the period of retroactive application be treated?
- If the legislation is retroactive, will it be constitutional?

- Finally, if and when Congress acts to reinstate the estate and GST taxes, will it make other changes to the transfer taxes? Possibilities include
 - unification of the gift and estate tax exemptions, indexing of the exemption for inflation, and portability of the exemption between spouses, as Senator Baucus included in S. 722 and Senator McConnell advocated on December 16,
 - special estate tax relief for family-owned farms and businesses, a type of which Senator Baucus also included in S. 722, and
 - limiting valuation discounts for family limited partnerships and limited liability companies and imposing restrictions such as a minimum term on grantor retained annuity trusts (“GRATs”), both of which were recommended in the Administration’s fiscal 2010 revenue proposals published in May 2009.

While speculation about Congress’s political choices can be entertaining, there simply is no way to predict what Congress will do. On December 16, 2009, after objections to Senator Baucus’s attempt to bring up the House-passed H.R. 4154 and substitute a two-month extension for it, Senator Baucus stated: “Mr. President, clearly, the right public policy is to achieve continuity with respect to the estate tax. If we do not get the estate tax extended, even for a very short period of time, say, 3 months, we would clearly work to do this retroactively so when the law is changed, however it is changed, or if it is extended next year, it will have retroactive application.” Similar sentiments were heard from members of the House of Representatives. Other comments have suggested that even if Congress avoids the political and constitutional hassle of retroactively imposing an estate, gift, and GST tax compromise, it still might retroactively repeal, or provide other relief from, carryover basis. But all such comments still represent only the aspirations of a few lawmakers and do not guarantee the necessary level of support. Congressional activity must be monitored closely. Until Congress acts, and perhaps even after it does, it will continue to be the case that many estate planning actions, as well as inaction, in 2010 will have uncertain long-term consequences and may carry both the possibility of tax savings and the risk of a tax cost.

PART THREE – THE CONSTITUTIONALITY OF RETROACTIVE TAX LEGISLATION

One issue of great concern is whether, if Congress acts, the estate and GST taxes could be reinstated retroactively to January 1, 2010, as Senator Baucus pledged to work for in the December 16 Senate debate and other members of Congress have suggested on other occasions. Questions have been raised about whether a retroactive tax, even one that was retroactive for a very short period of time, would pass muster under the United States Constitution. Instinctively, retroactive legislation is unfair and inappropriate and, therefore, must be unconstitutional. Courts, however, have been more tolerant, leaving the constitutional issues very much in doubt.

The most likely basis for a constitutional challenge is the Due Process Clause of the Fifth Amendment. Over the years, courts have recognized that taxpayers have a substantive economic right under this provision that may be violated if the retroactivity is not a “rational means” of furthering “a legitimate legislative purpose.”³ In approving the retroactive application of a 1987 amendment to the estate tax that denied a deduction then allowed with respect to sales of stock to an ESOP unless the stock was owned by the decedent before death, the Supreme Court observed in *United States v. Carlton* that the amendment had a reasonable and legitimate purpose (preventing abuse of a loophole in previous legislation), and was only retroactive for “a modest period” “only slightly greater than one year.”⁴ Although the taxpayer in *Carlton* had relied on the previous law and had no notice that the law on which he relied would later be changed, the Court rejected his due process argument and deemed the retroactive application permissible.

The *Carlton* case appears to establish a fairly low due-process threshold for the constitutionality of retroactive tax laws: as long as the retroactivity is justified by a legitimate legislative purpose and is not excessive in length, it will not be held to violate the Due Process Clause. In the case of 2010 retroactive transfer tax legislation, both of these elements would appear to be satisfied. It is arguably a legitimate legislative purpose to raise revenue and to do so in a manner that provides continuity, and the maximum potential period of retroactivity, twelve months, is less than the fourteen months the Supreme Court approved in *Carlton*.⁵

³ *United States v. Carlton*, 512 U.S. 26, 30-31 (1994), quoting *Pension Benefit Guaranty Corporation v. R. A. Gray & Co.*, 467 U.S. 717, 729-30 (1984).

⁴ 512 U.S. at 32-33.

⁵ The *Carlton* analysis is not without its critics. Some judges may find retroactivity to be so harsh that “the gap between law and justice is too stark to be ignored.” *NationsBank of Texas, N.A., v. United States*, 269 F.3d 1332, 1338 (Fed Cir. 2001) (Plager, J., dissenting).

Five of the Justices who decided *Carlton* (Justices Stevens, Scalia, Kennedy, Thomas, and Ginsburg) are still on the Court. Justices Scalia and Thomas question the fundamental premise of an economic substantive-due-process right,⁶ but other Justices might find *Carlton* distinguishable if a retroactive reinstatement of the estate and GST taxes came before them. For example, the Court in *Carlton* itself drew a distinction between modifications to the existing tax regime and the imposition of “a wholly new tax.”⁷ When the federal government first enacted the gift tax, taxpayers mounted several successful challenges to its purported retroactivity,⁸ and a number of more modern cases have repeated this distinction.⁹

Significantly, the original challenges to the retroactive enactment of the gift tax had stressed the absence of notice, and the Supreme Court 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.”¹⁰ In light of the extensive discussion, by lawmakers and commentators alike, about extending 2009 law before the end of 2009, or reinstating 2009 law in 2010, it might be awkward to argue a lack of notice or that the pre-2010 tax law would be “a wholly new tax.” On the other hand, when even the leaders of the congressional tax-writing committees were unable to agree on a “letter of intent” before the end of 2009 (a technique used in the past to reassure the public about legislative plans for the new year), it might also be awkward for supporters of retroactive legislation to argue that the public should have known exactly what was coming.

In addition, *Carlton* might be distinguished because the retroactive legislation in *Carlton* arguably corrected a drafting error. “It seems clear that Congress did not contemplate such broad applicability of the deduction [that is, to stock not owned by the decedent but purchased by the executor after death] when it originally adopted” the deduction provision.¹¹ In the case of the 2010 repeal of the estate and GST taxes and reduction of the rate of gift tax, the whole phenomenon might well be viewed as a mistake of policy or judgment, but there is no doubt that it is exactly what Congress knew in 2001 that EGTRRA, if not amended, would achieve.¹²

But even if the outcome of a constitutional challenge would be hard to predict, it seems virtually certain that someone would challenge almost any period of retroactivity, calling the tax law into question while litigation and appeals, maybe all the way to the Supreme Court, are ongoing. Because lawmakers are undoubtedly aware of that possibility, perhaps all that can be said is that those in Congress who seek such legislation will seek it quickly, and that the longer it takes to resolve differences the less likely it is that Congress will invite the constitutional fight by making any change retroactive.

6 512 U.S. at 39-42 (Scalia, J., joined by Thomas, J., concurring in the judgment).

7 *Id.* at 34.

8 *Blodgett v. Holden*, 275 U.S. 142 (1927) (invalidating retroactivity of the nation’s first gift tax); *Untermeyer v. Anderson*, 276 U.S. 440 (1928) (same).

9 *Quarty v. United States*, 170 F.3d 961, 966-67 (9th Cir. 1999); *Furlong v. Commissioner*, 36 F.3d 25, 27 (7th Cir. 1994), *aff’g* T.C. Memo. 1993-191; *Wiggins v. Commissioner*, 904 F.2d 311, 314 (5th Cir. 1990), *aff’g* 92 T.C. 869 (1989).

10 *Blodgett v. Holden*, 275 U.S. 142, 147 (1927).

11 512 U.S. at 31.

12 In the past, some have also challenged retroactive tax laws by asserting that they are “ex post facto laws” barred by Article I of the Constitution, but this prohibition has been limited since the late Eighteenth Century to criminal statutes. *Calder v. Bull*, 3 U.S. 386, 390-91 (1798). While the tax law does contain criminal sanctions, the entire tax law itself is not considered criminal in nature. *NationsBank of Texas, N.A. v. United States*, 269 F.3d 1332, 1336 (2001). Challenges to the retroactive application of tax laws as an uncompensated taking barred by the Fifth Amendment have also had some success in the past. See, e.g., *Nichols v. Coolidge*, 274 U.S. 531, 542-43 (1927). But to be treated as a taking, the retroactivity must be “so arbitrary and capricious as to amount to a confiscation” (*id.*) and must extend beyond the “short and limited periods required by the practicalities of producing national legislation.” *United States v. Darusmont*, 449 U.S. 292, 296-97 (1981). Under this latter standard, retroactivity reaching back eight and even 14 months has been held not to be an unconstitutional taking. *Id.*

PART FOUR – THE NEED TO REVIEW CURRENT ESTATE PLANNING DOCUMENTS

In General

Many wills and revocable trusts contain references to the Internal Revenue Code (the “Code”) and use terminology tied to definitions and other provisions found in the transfer tax provisions of the Code. Many of the bequests under these documents are defined in terms of tax concepts. Common phrases include “maximum marital deduction” and “unified credit amount.” Some estate planning documents may contain some form of interpretational clause related to tax terms, such as:

Tax-related terms shall be construed in the context of the federal revenue laws in effect at my death.

If the words and concepts used in a formula to define the size of a bequest are no longer part of the Code, do they have any meaning in interpreting and administering the estate?

With no estate tax on the books, it appears easy to conclude that nothing passes under a provision that leaves to a beneficiary “...the minimum amount needed to reduce the federal estate tax to zero.” Whereas, everything would pass to a beneficiary under a provision that leaves to the beneficiary “...the maximum amount that can pass free of federal estate tax.” The problem of interpretation arises when the document also contains words such as “marital deduction” and “unified credit.”

Because most estate planners believed that Congress would act before the end of 2009, many documents drafted after 2001 do not contain provisions reflecting the possibility of repeal, and most documents drafted before 2001 do not address repeal.

Marital Formulas

For a married couple, it is customary for the estate of the first to die to be divided into a Marital Trust and a Family Trust (sometimes called a B Trust, a Credit Shelter Trust, a Bypass Trust, or a Residual Trust) according to a formula under which the Family Trust would be funded with the deceased spouse’s unused exemption and the Marital Trust would receive the balance of the estate. A typical formula would fund the Family Trust first by use of a fraction and contain language such as the following in arriving at the numerator:

...the largest value of the Trust Assets that can pass free of federal estate tax by reason of the unified credit (which is also known as the “applicable credit amount”)...

Other documents may create and fund the Marital Trust first and use language such as:

...the lesser of the maximum marital deduction allowable to my estate or the minimum amount necessary to reduce my federal estate taxes to zero.

The fractional formula language frequently used defines the denominator of the fraction as follows:

The denominator of the fraction shall equal the value of the Trust Assets as finally determined for federal estate tax purposes.

If there is no federal estate tax, and therefore no estate tax audit process, how would those values be determined once one has cleared the hurdle of interpreting the numerator?

Charitable Formulas

Many charitable bequests are phrased in terms of a percentage of the “adjusted gross estate” or have a floor or ceiling based on such a concept. For example, the following would be typical:

I leave \$1 million to ABC University, provided in no event shall such amount exceed 10% of my adjusted gross estate as computed by subtracting from the entire value of my gross estate as finally determined for federal estate tax purposes the aggregate amount of the deductions actually claimed and allowed to my estate for funeral expenses, debts and claims against my estate, and the costs of administering my estate.

For larger estates that take advantage of testamentary charitable lead annuity trust planning, the following language is frequently used:

The Annuity Amount shall be an amount equal to the amount found by (1) multiplying the net fair market value of the assets of the Charitable Trust as of the date of my death by (2) such percentage as shall be required at that time in order to reduce the value of the remainder of the Charitable Trust to zero for federal estate tax purposes.

How will these provisions be interpreted?

Where there is no spouse and the estate owner was charitably inclined, an amount equal to the unused unified credit may have been given to family members, with the residue going to charity. Without an estate tax, does charity get the entire estate?

GST Formulas

Many sophisticated estate plans contain provisions establishing generation-skipping trusts or at least contain “overlay” provisions to avoid the imposition of the GST tax. When done by a formula, the numerator is frequently phrased:

The numerator of the fraction shall equal the amount of my available GST exemption....

If there is no GST tax regime, the numerator is zero and the generation-skipping trust would receive nothing as a result of the formula.

Existing irrevocable generation-skipping trusts may contain language providing for the creation of separate trusts in the event of a partial inclusion ratio. This may create a question for the trustee if a new gift is made to the trust during repeal (when the automatic GST exemption allocation rules do not exist) and later the GST tax is reinstated.

State Laws

To the extent that repeal creates ambiguities in how to interpret and apply a formula bequest, a formula division, or any calculation involving a formula, an executor or trustee may determine to seek advice and direction from a court to construe the formula language or take steps to reach agreement with all the beneficiaries. But the Internal Revenue Service and the federal courts may not feel bound by whatever interpretation applies for state law purposes even though the parties themselves are bound under state law. For example, in the case of a decedent who dies in January 2010, if the state court finds that, in spite of the repeal of the GST tax provisions, a portion of an estate passes by formula into a dynasty trust that might be outside of any transfer tax regime for generations, the Internal Revenue Service could argue that, for federal tax purposes, the property should have passed outright to the children where it would possibly be subject to estate tax at their deaths under whatever estate tax regime exists at the time. (In addition, the basic premise that such a dynasty trust would escape GST tax in the future is not free from doubt, as discussed in Part Five below.)

Review of Current Estate Planning Documents for Repeal Language

The first and most important step is to examine current estate planning documents to determine whether they contain provisions that take into account the possibility of estate tax repeal, such as:

...however, if at my death the federal estate tax does not exist or does not apply to my estate, all such assets shall constitute the Family Trust.

Such a provision should work just fine in 2010 if the terms of the Family Trust are acceptable to the estate owner and do not accidentally exclude an intended beneficiary. For example, if the surviving spouse is the sole income beneficiary of both the Marital Trust and the Family Trust and can receive discretionary principal distributions, there may be no problem. However, if the Family Trust is for the benefit of children to the exclusion of the surviving spouse, the quoted language would in effect disinherit the spouse and likely cause the spouse to file for an elective or statutory share of the estate or to institute legal proceedings to prevent this result.

If a document says “if the federal estate tax has been repealed,” would a probate court construe this as applying to the actual 2010 law which, although popularly referred to as “repeal,” states only that “[t]his [estate tax] chapter shall not apply to the estates of decedents dying after December 31, 2009”? If so, would “has been repealed” be interpreted after 2010 or after congressional action to include “has been repealed but has since been reinstated”?

Review of Current Estate Planning Documents for Savings Provisions

Estate planning documents that do not contain language explicitly addressing estate tax repeal should be examined to determine whether they contain any other form of “savings” clauses. For example, many marital deduction formula provisions contain language such as:

My Trustee shall segregate and add to the Family Trust all assets that are not included in my gross estate, and such assets shall not be subject to the fractional division described in this Article.

A logical interpretation of this language is that if the estate tax provisions do not apply, there is no concept of a gross estate, and if there is no gross estate, no assets are included in a gross estate. Thus all assets are allocated to the Family Trust.

Update of Documents

Obviously, the best course of action at this time is to review and if necessary revise all estate planning documents that contain formula dispositions to make it absolutely clear what happens if death occurs when there is no estate tax or GST tax or when the exemption amounts are lesser or greater than those in existence at the end of 2009. The quick fix may simply involve a short codicil or trust amendment, but an overall review is important to confirm that the estate disposition serves the owner’s objectives in accordance with the owner’s intent and understanding. This is particularly true with spousal bequests and trusts because of the marital deduction under any reinstated estate tax, and generation-skipping trusts because of the importance of maintaining a zero inclusion ratio.

This period of uncertainty regarding the estate tax may be very short or could continue at least through 2010. For individuals currently preparing new estate plans, new documents should maintain maximum flexibility. For example, a surviving spouse’s interest in a Marital Trust may be contingent on a QTIP election by the fiduciary. Any assets over which a QTIP election is not made, whether because it is not appropriate for the family or not necessary under the law at that time, may pass outright to the surviving spouse or to the decedent’s other beneficiaries outright or in trust. The “Clayton QTIP” allows a fiduciary to wait and see how the tax law, beneficiary needs, and other factors fall into place before determining how much of the estate the surviving spouse should receive.

Because a retroactive reinstatement of the estate tax is a possibility, it is important to make sure that the language used in any updating of marital and charitable bequests does not make such bequests indefinite or otherwise jeopardize any otherwise applicable estate tax deduction.

Disclaimers and Spousal Elections

For those decedents who die without having given attention to their estate planning documents, state law provides families and fiduciaries with tools that can help them fulfill the decedent’s intended goal.

If the repeal of the estate tax causes more of an estate to pass to a surviving spouse than was intended by the decedent, a disclaimer may allow the family to achieve the intended disposition. For example, if an estate plan calls for a Family Trust that benefits only the decedent’s children and a Marital Share that passes outright to the surviving spouse, certain formula division language could result in the Marital Share receiving the full amount of the estate. In a harmonious family, and assuming the appropriate remainder beneficiaries, a disclaimer by the surviving spouse could achieve the result that the decedent presumably intended.

If the reverse occurs and a formula division results in a Family Trust or other beneficiaries receiving the entire estate and a surviving spouse receiving nothing, a surviving spouse has certain rights under state law (unless waived by premarital or other agreement). In most states, a surviving spouse has the right to take an elective share of the deceased spouse’s estate instead of the share provided in the decedent’s estate plan. The elective share typically ranges from one-third to one-half of the estate. Unless waived, a surviving spouse also has certain automatic rights to a deceased spouse’s retirement benefits.

When to Act

Because no one knows when and how Congress will address transfer taxes, prudence dictates that all formula clauses be reviewed and revised as soon as possible even though that may mean taking a second look and making further revisions once Congress acts.

PART FIVE – GST TAX PLANNING

Fundamental Dilemma with the GST Tax

In the absence of further legislation, the GST tax, like the estate tax, “shall not apply to generation-skipping transfers after December 31, 2009.” Even if there is further legislation, the GST tax will not apply to generation-skipping transfers until the effective date of the legislation. If the legislation is retroactive and survives any constitutional challenge, then the GST tax will apply after all, perhaps without interruption from December 31, 2009, to January 1, 2010. After 2010, under section 901(b) of EGTRRA, the suspension of the GST tax shall no longer be in effect, and “[t]he Internal Revenue Code [including the GST tax] ... shall be applied and administered to ... transfers ... as if the provisions and amendments [made by EGTRRA in 2001] had never been enacted.”

The dilemma is this. The temporary suspension of the GST tax in 2010 might provide a window in which to make transfers free from GST tax that would be subject to GST tax if made at other times, thereby saving GST tax. But, if such transfers that otherwise would not be made are made in 2010 to obtain that GST tax savings and the GST tax is retroactively imposed after all, the action intended to produce a savings could attract, aggravate, or accelerate a GST tax that otherwise would have been avoided or deferred. These decisions will therefore have to be made very carefully and will be very much informed by the risk-tolerance of the individuals involved. There will be no one-size-fits-all magic answer.

On top of that, unlike the application generally of the estate and gift tax (but like the determination of basis), actions taken for GST tax reasons can have long-term effects, because the GST tax typically arises in the context of a long-term trust with potential generation-skipping events spanning many years. Thus, with few exceptions, actions taken in 2010 with regard to the GST tax could create GST tax implications in future years. This risk is complicated by the statutory mandate that the GST tax will be applied in those future years as if the temporary suspension in 2010 “had never been enacted.” It is clear that that will not result in a look-back to 2010 events to recharacterize *those events themselves* for GST tax purposes (unless there is retroactive legislation). But, it is not clear how the events in those future years will be treated.

Three Contexts for Asking GST Tax Questions in 2010

There are three broad contexts in which such GST tax issues might arise. One is the administration of existing non-exempt generation-skipping trusts – trusts, generally created and funded since September 25, 1985, that have an “inclusion ratio” for determining taxability of greater than zero. Another context is the lifetime creation of new generation-skipping trusts this year. Finally, there is the special case of trusts created upon the death of someone in 2010.

Administration of Existing Generation-Skipping Trusts

In the case of an existing generation-skipping trust subject to the GST tax, there will be a GST tax on “taxable distributions” from that trust to “skip persons” (persons in a generation two or more generations below that of the transferor) and on a “taxable termination” when the interests in the trust shift from one generation to the next. For example, suppose a grantor created a trust in which the trustee has discretion to make distributions to or for any of the grantor’s descendants, but did not allocate GST exemption to the trust (or did not allocate enough GST exemption to give the trust an inclusion ratio of zero). In general, while any child of the grantor is alive, distributions to a child are not subject to GST tax, but distributions to grandchildren (or younger descendants) are taxable distributions subject to GST tax. The death of the last surviving child causes a taxable termination, subjecting the trust to GST tax. Thereafter, while any grandchild of the grantor is alive, distributions to a grandchild are not subject to GST tax, but distributions to great-grandchildren (or younger descendants) are taxable distributions subject to GST tax, and so forth through each generation until the termination of the trust, which is also a taxable transfer to the extent the trust assets are distributed to beneficiaries in younger generations than the oldest generation represented at the time.

Pluses: In 2010, unless Congress changes the law, none of those taxable distributions or taxable terminations will be subject to tax. Therefore, if there are substantial distributions to skip persons that it makes sense for the trustee to make, 2010 might be a good time to take those actions, because, for 2010 only, those actions will not be subject to GST tax. This includes a total or partial termination of the trust, or distributions to other trusts, that the trustee has discretion to accomplish. *Postponing those actions until after 2010 or any other time that the GST tax is again in effect could result in the payment of tax that could have been avoided.*

Minuses: Care must be taken, however. Moving assets out of a trust like that will generally mean that in the future those assets will be subject to estate tax or gift tax when they are further transferred by the recipients. During the time that those assets are not in trust, they might be subject to claims, against which the original trust was designed to protect. If those assets are

transferred to additional trusts and not to beneficiaries outright, then generally the inclusion ratio and the identity of the transferor will not change. Furthermore, if Congress then reinstates the GST tax for 2010 retroactively, those very actions might be subject to GST tax, and the negative consequences will still follow. In that case, *taking those actions in 2010 could result in the payment or acceleration of tax that could have been avoided or deferred.*

In addition to protection against claims, there can be other benefits of keeping assets in a generation-skipping trust, even if the trust is not exempt from GST tax. For example, distributions from such a trust to a non-skip (next-generation) beneficiary will never be subject to GST tax. Likewise, payments by such a trust directly to a school for a beneficiary's tuition or to a provider of health care or insurance for a beneficiary will never be subject to GST tax, regardless of the status of the trust or the generation of the beneficiary. Thus, pushing assets out of a trust in 2010 just because it can be done will avoid no GST tax to the extent the assets would eventually have been distributed to non-skip persons or used for beneficiaries' tuition or health care payments anyway, while still exposing the assets to claims against the beneficiaries and incurring the risk of immediate GST tax if Congress changes the tax law retroactively. Thus, at a minimum, if a 2010 extraordinary distribution is contemplated, it might be prudent to consider a reserve for assets reasonably projected to be needed in the future for distributions to non-skip persons or for the tuition or health care of any beneficiaries.

Creation of New Generation-Skipping Trusts

As a general rule, the creation and funding of a generation-skipping trust is not subject to GST tax; the trust simply becomes subject to the rules governing taxable distributions and taxable terminations in the future, to the extent its inclusion ratio is greater than zero. Ordinarily, there does not appear to be a significant benefit in creating such a trust in 2010. Although the definitions and other provisions of the GST tax law are suspended in 2010, so that, for example, it arguably is impossible to tell who the transferor is, it is likely that all such issues will be resolved in 2011 (or earlier, if Congress acts) when the GST tax law is revived. Taxable distributions and taxable terminations with respect to the trust will then presumably be taxed just as in the case of any trust created in any other year. Meanwhile, because the GST tax does not apply in 2010, it may not be clear how to allocate GST exemption to the trust, which could cause it to be taxed in the future even more severely than a trust created in another year.

One exception from the general rule discussed in the previous paragraph is the creation and funding of a trust which itself is a "skip person" because no non-skip person has an interest in the trust. An example is a trust that skips the grantor's children and is to be administered solely for the benefit of the grantor's grandchildren and younger generations. In ordinary times, the creation and funding of such a trust would be a "direct skip" subject to GST tax. In 2010 (unless Congress changes the law), there is no GST tax on that direct skip. Thus, a grantor may create a trust exclusively for present and future grandchildren, or exclusively for present and future great-grandchildren, and the like, and there is no GST tax on that action. There will be a gift tax, but the lower gift tax rate in 2010 is another benefit of creating the trust this year.

Pluses: In the future administration of the "skip person" trust, there is uncertainty, but possibly also some opportunities. In the first place, distributions to beneficiaries during the remainder of 2010, unless Congress changes the law, will be exempt from GST tax. In addition, as discussed previously in the context of an existing trust, payments by a trust to a school for a beneficiary's tuition or to a provider of health care or insurance for a beneficiary will never be subject to GST tax, regardless of the status of the trust or the generation of the beneficiary. Thus, one long-term benefit of creating such a trust in 2010 is to provide, at a reduced gift-tax cost, a fund for the education (and health care) of the designated generation.

More Pluses: It is possible, though not free from doubt, that the trust could provide even more long-term benefits. Ordinarily, a "direct skip" transfer to a trust for, say, the grantor's grandchildren would be a "generation-skipping transfer" and the "drop down" rule of Code section 2653(a) would treat the trust as if the transferor were one generation above the generation of the trust's beneficiaries. In other words, the trust would be treated as if a child of the grantor were the transferor, and the grandchildren, the beneficiaries of the trust, would be non-skip persons. Because the creation and funding of the trust would not be a "direct skip" in 2010, it might seem as if this "drop-down" rule would not apply, the grandchildren would remain skip persons, and distributions to the grandchildren would be subject to GST tax.

But, as stated above, all the provisions of EGTRRA, including the suspension of the GST tax in 2010, are treated after 2010 as if they "had never been enacted." In 2011, if the suspension of the GST tax is treated as if it "had never been enacted," that would mean that the transfer to the trust *is* treated as a "direct skip" after all, not so as to impose a GST tax *in 2010*, but so as to trigger the "drop down" rule for purposes of defining taxable distributions *in 2011 and beyond*. If so, the grandchildren would be treated as non-skip persons, and distributions to them after 2010 would not be subject to GST tax. Distributions after 2010 to descendants of grandchildren could still be taxable distributions, and the death of the last surviving grandchild could still be a taxable termination.

In addition, it is possible – although it does not seem likely – that legislation enacted in 2010 would prospectively reinstate 2009 law or some variation of it and, following the pattern of the Tax Reform Act of 1986 which originally enacted the present GST tax, would “grandfather” any irrevocable trusts created before the effective date of the legislation. In that case, all distributions from the trust would be exempt from GST tax.

Possible Minuses: Again, there is no guarantee that such a have-it-both-ways result would be secured. But the wording of EGTRRA arguably supports this result. The downside, apart from the possibility of retroactive legislation in 2010, is that general distributions to the trust beneficiaries would be subject to GST tax. Even in that case, the trust would still be available for the payment of tuition and health care costs for those beneficiaries.

Testamentary Generation-Skipping Trusts

If a generation-skipping trust is created under the will or revocable trust of someone who dies in 2010, the decedent’s death does not result in any federal estate tax or GST tax (unless Congress changes the law).

Under Code section 2652(a), the “transferor” for purposes of the GST tax is defined as the decedent or donor with respect to whom the property transferred in trust *is subject to estate or gift tax*. If no estate tax applies (because the death occurs in 2010) and no gift tax applies (because this is a transfer at death, not by gift), it appears that there is no transferor for GST tax purposes. If there is no transferor, arguably there are no skip persons, because no one could ever be assigned to a generation two or more generations below the generation of the transferor. This is not an anomaly that would necessarily be cured after 2010 when the suspension of the estate and GST taxes is treated as if it “had never been enacted,” because under Code section 2652(a) the identification of the transferor, and thus skip persons, depends not on the design of the trust, but on the fact that the assets are “subject to the [estate] tax,” which will never be true of the assets of a decedent who dies in 2010 (unless Congress changes the law).

Thus, testamentary generation-skipping trusts created by reason of the decedent’s death in 2010 can receive very favorable treatment, if Congress does not change the law. For someone who appears unlikely to survive to 2011, the creation of generation-skipping trusts should be considered.

Other Difficult GST Tax Questions

There are other difficult questions related to the GST tax that arise from Congress’s direction that post-2010 law shall be applied “as if the provisions and amendments [of EGTRRA] had never been enacted.” Does that phrase mean that after 2010 we must pretend that EGTRRA never happened, so that it wasn’t in effect even for 2001-2010? Or does it mean that we simply go through the Code on January 1, 2011, and reverse everything that EGTRRA did? The answer to that question has very significant practical consequences. For example, in the context of the GST tax:

- If a grantor (or decedent) created and funded a generation-skipping trust during the years from 2004 through 2009 and the grantor (or executor) allocated GST exemption to the trust in excess of the \$1 million exemption (indexed for inflation since 1999) that would have been applicable if the increases in the GST exemption in EGTRRA “had never been enacted,” will the GST exemption be under-allocated, so that the trust’s inclusion ratio after 2010 will be greater than zero? If so, will there be any way to sever the trust into two trusts with inclusion ratios of one and zero, respectively, since the “qualified severance” rules were also enacted by EGTRRA and thus will be treated after 2010 as if they “had never been enacted”?
- If, during the years 2001 through 2009, a grantor created and funded a generation-skipping trust to which GST exemption was deemed allocated, will the trust be exempt after 2010, when the deemed allocation rules for trusts will be treated as if they “had never been enacted”?
- If a grantor created and funded a generation-skipping trust in 1990, neglected to timely allocate GST exemption to it, but obtained a ruling from the Internal Revenue Service since 2001 permitting an extension of time to make that allocation, will the grantor’s late allocation be effective after 2010, because the statutory basis for such an extension of time was also enacted by EGTRRA and thus will be treated after 2010 as if it “had never been enacted”?

These are not easy questions. We are not likely to know the answers for some time. But questions like this demonstrate why care is needed where the high-stakes GST tax is involved.

PART SIX – STATE LAW ISSUES

State Death Taxes

Before EGTRRA, almost every state imposed a state death tax equal to the federal state death tax credit available under Code section 2011. In addition, some states had stand-alone inheritance taxes. EGTRRA reduced the state death tax credit in stages from 2002 through 2004 and eliminated it in 2005, replacing it with a deduction under Code section 2058. Those states that tied (or “coupled”) their state death tax to the amount of the federal credit saw the reduction and elimination of their tax (and a significant loss of shared revenue) as a result of the elimination of the federal credit. Other states that had tied their state death taxes to a pre-EGTRRA version of the credit retained their state death taxes.

In response to the phase-out and elimination of the state death tax credit, many states acted to retain their state death taxes by various means, such as decoupling their state tax from the federal credit, determining the state tax by reference to pre-EGTRRA law, or imposing stand-alone state death tax regimes. Other states, such as Virginia, which had at first retained their state death tax, later repealed their state death tax. The states that currently have a separate state death tax are:

State	Type of Tax
Connecticut	Stand-Alone Estate Tax
Delaware	Estate
District of Columbia	Estate
Indiana	Inheritance
Iowa	Inheritance
Kentucky	Inheritance
Maine	Estate
Maryland	Estate and Inheritance
Massachusetts	Estate
Minnesota	Estate
Nebraska	County Inheritance
New Jersey	Estate and Inheritance
New York	Estate
Ohio	Stand-Alone Estate Tax
Oregon	Estate
Pennsylvania	Inheritance
Rhode Island	Estate
Tennessee	Inheritance
Vermont	Estate
Washington	Stand-Alone Estate Tax

Adding to the post-EGTRRA difficulty, not all states that retained a state death tax set the same threshold for the imposition of the tax or enacted consistent provisions concerning whether it would be possible to make an election to qualify a QTIP trust for a state marital deduction distinct from the federal election. The variation in state laws since the enactment of EGTRRA resulted in a dramatic increase in estate planning complexity for clients domiciled or owning real or tangible personal property in states with a state death tax. Clients have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and movables, and use of lifetime gifts.

Under EGTRRA, the state death tax credit is scheduled to return in 2011. If Congress fails to act, the following states will see a return of a state estate tax in 2011:

Alabama	Iowa	North Dakota
Alaska	Kentucky	Pennsylvania
Arkansas	Louisiana	South Carolina
California	Michigan	South Dakota
Colorado	Mississippi	Tennessee
Florida	Missouri	Texas
Georgia	Montana	Utah
Hawaii	Nebraska	Virginia
Idaho	Nevada	West Virginia
Illinois	New Hampshire	Wisconsin
Indiana	North Carolina	Wyoming

It is impossible to predict the impact congressional action on the federal estate tax will have on the future of the state death tax credit. Earlier compromise proposals maintained the elimination of the federal credit in favor of the deduction under Code section 2058. The resulting loss of state revenue and state budgetary shortfalls, and the unnecessary increase in planning complexity and end of life domicile shopping, tend to support a return to the structure of the 2001 law (perhaps with adjustments to the exclusion amount and rates) and the restoration of the state death tax credit. Because of the impact on federal revenue from the estate tax, however, it seems very unlikely that Congress would reinstate the state death tax credit without significantly raising gross estate tax rates.

If the federal credit were restored permanently, it is likely that most states without a state death tax would reinstate their state death taxes in at least the amount of the credit, and in many fully coupled states that would happen automatically. To that extent, the resulting return to uniformity in state law and the availability of the federal credit would eliminate the complex exercise of state death tax planning. In many states, however, there is no guarantee that the state legislature would permit the exemptions for state tax purposes to rise with increases in the federal estate tax exemption. But for now, and probably for the future, planning for state death taxes is a necessity that has been made yet even more difficult by the uncertain future of the state death tax credit.

The one-year repeal of the federal estate tax in 2010 will also add planning complexity in states with stand-alone death taxes. For example, some jurisdictions that impose a stand-alone death tax (such as New York, Delaware, North Carolina, and Washington, D.C.) do not allow a QTIP trust to qualify for the state marital deduction unless a federal QTIP election is made by the decedent's executor under Code section 2056. These jurisdictions do not allow a separate state QTIP election that is independent from the federal QTIP election. Because there is no federal estate tax in 2010 under EGTRRA, it is not necessary (and may not be possible) to make a federal QTIP election for 2010, and it is not certain that a protective election would be respected. Therefore, there exists the possibility that in these jurisdictions gifts to QTIP trusts for surviving spouses will be subject to state death tax.

The states with a separate state estate or inheritance tax that specifically permit a QTIP election are:

- Indiana (by administrative pronouncement)
- Kentucky (by administrative pronouncement)
- Maine
- Maryland
- Massachusetts
- New Jersey (only to the extent permitted to reduce federal estate tax)
- Ohio (for its stand alone tax)
- Oregon
- Pennsylvania
- Rhode Island
- Tennessee (for separate inheritance tax)

Married clients domiciled or with real or tangible personal property in states with a stand-alone state death tax and no separate QTIP election will need to carefully structure their planning to address this situation. One option could be to structure marital gifts to qualify for the marital deduction without the need for an election, such as outright gifts or general power of appointment trusts. Many clients, such as those in second marriages, may not find it palatable to give the surviving spouse the type of control over the marital gift that would be involved in these techniques. Also, care is required in using non-QTIP type trusts because the trusts may not be "Qualified Spousal Property" eligible for a basis allocation under the 2010 carryover basis regime. Irrevocable documents that may provide for the contingent creation of QTIP trusts (such as life insurance trusts, GRATs, lifetime QTIP trusts) may also present unanticipated state death tax challenges if the QTIP trust provisions come into effect in 2010.

More Concerns for Fiduciaries

The 2010 estate tax repeal will present unique and complex challenges for fiduciaries. The most significant of these challenges is likely to be the uncertainty in interpreting formula clauses in wills and trusts for decedents dying in 2010, for example, those that divide assets between marital and family or credit shelter shares or trusts or between generation-skipping exempt and non-exempt shares.

As discussed previously, many formula clauses will be based on tax determinations that will not exist in 2010, such as the applicable exclusion amount, unified credit, or GST exemption, and will not address death during the 2010 repeal (which no one thought would actually become law). The meaning of these terms is far from certain where the tax concepts are repealed from the tax laws. Formula clauses may have a radically different meaning on December 31, 2009 than in 2010 during repeal, and

could result in extreme situations such as the total disinheritance of the surviving spouse (and loss of property to which basis may be allocated), or just the opposite, in ways that are contrary to the testator's intent. Boilerplate provisions related to the marital deduction could also complicate the interpretation of these clauses. The interpretation of formula clauses in many cases will create inheritance "winners" and "losers", and disappointed heirs may seek to punish fiduciaries on the ground that the fiduciary improperly distributed assets in breach of a fiduciary duty (such as the duty of loyalty and the duty to treat beneficiaries equally). Complex family situations (such as second marriages) will increase the possibility of fiduciary risk in interpreting formula clauses.

Fiduciaries may need to seek the guidance of the court in dealing with formula clauses. Judicial relief, however, may be affected by limitations on admission of extrinsic evidence of the testator's intent. Furthermore, the Internal Revenue Service may not be bound by a state court decision. Therefore, it may be preferable for state legislatures to act quickly and impose default rules of construction for formula clauses that do not expressly contemplate estate tax repeal. Fiduciaries must handle formula clauses during 2010 estate tax repeal with extraordinary caution. For many, it will be necessary to obtain legal advice concerning the interpretation of formula clauses, carrying out fiduciary duties in light of uncertainty, basis allocation, state death taxes, the possible reinstatement of the estate tax during the administration, and other problems presented by the 2010 estate tax repeal.

PART SEVEN – CARRYOVER BASIS

The Basics of Carryover Basis

One complication of the repeal of the estate tax is the introduction of a modified carryover basis regime. Indeed, as discussed in Part Two, discomfort with the impending carryover basis regime was a principal argument cited in 2009 by congressional supporters of legislation to make the 2009 law permanent and prevent the 2010 law enacted in 2001 from taking effect.

Under pre-2010 law, a decedent's beneficiaries inherited assets with a basis for computing capital gains taxes equal to the fair market value of the assets on the date of the decedent's death. This basis adjustment is typically referred to as a "basis step-up," because it is assumed that one's basis in assets is lower than the fair market value of assets on the date of death. However, the adjustment actually works in both directions, and if the fair market value of an asset on the date of death is lower than the decedent's basis, the asset's basis is stepped down for all purposes, so that the beneficiaries inherit the lower basis. The apparent reason for the former basis adjustment rules was the unfairness of imposing a double tax on a beneficiary who inherited assets – first an estate tax and then a capital gains tax when the executor or beneficiary subsequently sold the asset, especially if the sale was necessary to raise money to pay the estate tax. This reasoning is no longer effective. The discussion that follows is intended to introduce some of the concerns that might arise when planning for carryover basis. Of course, if the estate tax is reinstated retroactively in 2010 or comes back in 2011 as provided in current law, the carryover basis rules will not apply or would only apply during any period in which the estate tax is actually repealed.

The basic rule in 2010 under Code section 1022 is that a decedent's basis in appreciated property will remain equal to the decedent's basis in the property if the fair market value of the property on the date of death is greater than the decedent's basis. If the fair market value of a decedent's property on the date of death is less than the decedent's basis, the basis will be lowered to the fair market value on the date of death, just as it would have been under former law.

EXAMPLE: Julie dies in 2010 with appreciated property with a fair market value of \$5 million on the date of death and for which her basis is \$3 million. Her beneficiaries' basis in the property remains at \$3 million and is not stepped up to \$5 million as would have occurred before 2010.

EXAMPLE: James dies in 2010 with depreciated property having a fair market value of \$2 million and for which his basis is \$3 million. His beneficiaries' basis in the property is \$2 million.

These rules will apply separately to each item of property owned by a decedent on the date of the decedent's death.

Two Modifications to Carryover Basis

Two modifications are provided in Code section 1022 which lessen the harshness of the new carryover basis regime. The first applies to property passing to any one or more individuals. The second applies with respect to property passing to a surviving spouse.

The Special Basis Adjustment. Under the first modification, sometimes called the "Special Basis Adjustment," the basis

of appreciated property owned by a decedent at the time of his or her death may be increased by \$1.3 million, but not in excess of the fair market value of the property as of the date of the decedent's death. The executor of the decedent's estate must make an election to take advantage of this increase.

EXAMPLE: Margaret dies in 2010 owning only one asset, her farm, Fairhaven. Margaret's basis in Fairhaven was \$9 million. The fair market value of Fairhaven at Margaret's death is \$10 million. Margaret leaves Fairhaven to her son, Bob. Margaret's executor allocates \$1 million of the \$1.3 million basis adjustment to Fairhaven. Bob's basis in Fairhaven as a result of special adjustment is \$10 million.

There are two technical adjustments to the Special Basis Adjustment. The Special Basis Adjustment is increased by the amount of a decedent's unused capital loss carryovers and net operating loss carryovers. Also, the Special Basis Adjustment is increased by the amount of losses that would have been recognized under Code section 165 if property owned by a decedent at the time of his or her death had been sold immediately before the decedent's death. Code section 165 is the provision authorizing claims for losses for theft losses and worthless securities and the like. Some commentators have concluded that this rule applies to any depreciated capital asset in the hands of the decedent. If this is true, it could have the effect of largely offsetting the step-down in basis for depreciated property. The increase in basis would not have to be allocated to the loss property that gave rise to the adjustment, but rather could be allocated to other property for which the fair market value exceeded basis.

EXAMPLE: Norman dies in 2010 owning stock in a closely held corporation, Loserco, and a tract of land, Greenacres, both of which pass to his daughter, Penny. The Loserco stock is valued at zero and Greenacres is valued at \$3 million. Norman's basis in the Loserco stock was \$1 million and his basis in Greenacres was \$400,000. Norman's executor could allocate the \$1.3 million Special Basis Adjustment plus the additional basis increase caused by the built-in loss of \$1 million for the stock of Loserco stock to Greenacres. If Penny subsequently sold Greenacres for \$3 million, she would have a \$300,000 gain (\$3 million sales price less basis of \$2.7 million).

It appears that the Special Basis Adjustment and the increases caused by built-in losses and loss carryovers cannot be applied to some property included in a decedent's estate. Under Code section 1022(a), carryover basis applies only to "property acquired from a decedent." Code section 1022(a) states that the basis of property "acquired from a decedent" dying after December 31, 2009 is the lesser of "(A) the adjusted basis of the decedent, or (B) the fair market value of the property at the date of the decedent's death." "Property acquired from a decedent" is defined in Code section 1022(e). The definition does not cover property that would have been included in a decedent's gross estate, such as property included in a decedent's gross estate under Code section 2041 because the decedent held a general power of appointment over the property. Also not covered is property which under pre-2010 law would have been included in the gross estate of a surviving spouse by reason of a QTIP election under Code section 2056(b)(7) at the first spouse's death. These same rules could also apply to property included in a decedent's estate because of Code sections 2036 or 2038 when a decedent dies during the term of a grantor retained annuity trust ("GRAT") or a qualified personal residence trust ("QPRT"). The impact of this rule on GRATs and QPRTs could be mitigated by giving the grantor of the trust a reversion that would cause the property to be considered owned by the grantor (although such a reversion might reduce the gift tax benefits of the GRAT). Property acquired by a decedent by gift within three years of the decedent's date of death from anyone other than the decedent's spouse also does not qualify for the Special Basis Adjustment.

Code section 1022 provides that some property interests that are not held through simple outright ownership will qualify as owned by a decedent, including a portion of joint tenancy property, the decedent's half of community property, the surviving spouse's half of community property if the deceased spouse owned at least half of the whole community property interest without regard to community property laws, and property included in revocable trusts.

The Spousal Basis Adjustment. The second modification is the \$3 million basis adjustment for property passing to the surviving spouse, sometimes called the "Spousal Basis Adjustment." The basis of property owned by the decedent at the time of his or her death may also be increased by \$3 million, but not in excess of the fair market value of the property as of the date of the decedent's death, if and only if such property is transferred to the surviving spouse, outright; or as "qualifying terminable interest property" for the exclusive benefit of the surviving spouse.

It is important to note that Code section 1022 provides its own definition of "qualifying terminable interest property" and does not simply refer to the definition of "qualifying terminable interest property" contained in the estate tax marital deduction provision of Code section 2056. The definitions in the two Code provisions parallel each other with the exception that a formal election must be made under Code section 2056 while a formal election does not have to be made to satisfy the provisions of Code section 1022. This means that a "QTIP-able" Trust (as opposed to a traditional QTIP Trust for estate planning purposes) for the exclusive benefit of the surviving spouse can qualify for the Spousal Basis Adjustment of \$3 million even though there is no estate tax and the QTIP election is not made for estate tax purposes. But because an election is not contemplated by the carryover basis rules, so-called *Clayton* QTIPs, in which the spouse's income interest is *conditioned* on the executor's QTIP election, appear ineligible for the Spousal Basis Adjustment. A general power of appointment marital trust that qualifies for the

marital deduction for estate tax purposes should satisfy the requirements of a “qualifying terminal interest property trust” under the provisions of Code section 1022.

In larger estates, planning will have to be done to ensure the full use of the Spousal Basis Adjustment in the first spouse’s estate. To do so, the first spouse’s estate must contain assets with appreciation of at least \$3 million. This \$3 million refers to appreciation and not to the fair market value of the property passing to the surviving spouse.

EXAMPLE: Richard dies owning the following assets:

Property	Basis	Fair Market Value
Profitco, LLC	\$100,000	\$1,000,000
Brownacre	\$250,000	\$1,700,000
PublicCo stock	\$5,350,000	\$6,000,000
Total	\$5,700,000	\$8,700,000

Ignoring the use of the Special Basis Adjustment of \$1.3 million, in order to take full advantage of the \$3 million Spousal Basis Adjustment, all of the property listed above would have to be transferred to the surviving spouse, or a trust for the exclusive benefit of the surviving spouse. This would leave no assets to transfer to any beneficiary other than the surviving spouse.

As noted above, the three-year rule does not apply to property acquired by the decedent from the decedent’s spouse unless, during the three-year period, the transferor spouse acquired the property by gift or inter vivos transfer. Pre-2010 law attempted to limit death bed transfers to a spouse in order to obtain a step-up in basis when the transferred property was given back to the surviving spouse. No such limitations appear in the new rules. Apparently, a transfer of property from a healthy spouse to a terminally ill spouse, with the property passing back to the healthy spouse, will be eligible for both the \$1.3 million and \$3 million basis increase adjustment.

Planning to Take Advantage of the Two Adjustments. Careful planning will be required to take account of both the Special Basis Adjustment and the Spousal Basis Adjustment. The first example discusses steps to maximize the amount of basis step-up.

EXAMPLE: Adam is married. Adam’s only asset is stock in a closely-held corporation. The stock is valued at \$10 million and his basis in the stock is \$2 million. If Adam dies in 2010, his stock would obtain a step-up in basis of \$1.3 million for the Special Basis Adjustment plus any unused loss carryovers and obtain a step-up in basis of as much as \$3 million for the Spousal Basis Adjustment if \$3.75 million of stock were to pass to his surviving spouse or a trust for her exclusive benefit.

As a result, the basis of the stock in the hands of his surviving spouse, a trust for the exclusive benefit of his surviving spouse, or other beneficiaries of the estate could have basis of as much as \$6.3 million ((i) \$2 million current basis plus (ii) \$1.3 million Special Basis Adjustment plus (iii) \$3 million Spousal Basis Adjustment. If the stock were not sold, there would obviously be no immediate tax consequences.

In addition to allocating to the surviving spouse stock valued at \$3.75 million in order to obtain the \$3 million Spousal Basis Adjustment, Adam’s estate should also allocate the non-stepped-up basis shares to the surviving spouse as well. As a result, the non-stepped up basis shares may obtain a step-up in basis upon the subsequent death of the surviving spouse to the extent of \$1.3 million if she were to die in 2010 or the entire fair market value if she were to die in a year in which the estate tax is reinstated.

The second example is an example of planning when assets have decreased in value.

EXAMPLE: Beverly owns a membership interest in an LLC valued at \$20 million. Her basis in her membership interest is \$27 million. If Beverly were to die in 2010, the basis in the LLC interest would be stepped down to \$20 million.

To mitigate this possible adverse consequence, Beverly could make gifts of membership interests in the LLC but for no more than her \$1 million gift tax applicable exclusion amount. These gifts would have a carryover basis under Code section 1015. Gifts of any more that do not qualify for the annual exclusion would incur gift tax at a 35% rate. One would have to consider if there is any benefit in paying gift tax in order to preserve basis and thus reduce the capital

gains tax if and when the LLC interest is ever sold by the donees of such gifts.

If Beverly had other property that has appreciated, Beverly could sell some of her LLC membership interests before her death and incur the loss. If Beverly is not able to utilize the loss during her lifetime, the loss carryover could be added to the \$1.3 million Special Basis Adjustment and allocated to her appreciated property following her death.

Considerations Regarding the Elections. The executor is responsible for allocating the Special Basis Adjustment and the Spousal Basis Adjustment. If the appreciation in assets at a decedent's death is greater than the amount of basis adjustment available, some beneficiaries may be unhappy with the executor's allocation. Clients should review and if necessary revise their wills to provide their executor with the express power to make this allocation in the event carryover basis applies to their estate. Executors without express authority to allocate basis should carefully review the will and state law to determine whether the power is nevertheless available. Many wills grant the executor broad power to make all elections and allocations necessary to administer the estate, or incorporate by reference lists of broad fiduciary powers provided by state statutes. Because no one expected carryover basis to actually become the law, few if any state fiduciary powers statutes will expressly address basis allocation. However, such power is arguably implicit in the commonly provided powers to "do all acts and things necessary for the management of the estate" and to "make any election under law relating to taxes". In the event of uncertainty, the executor should promptly petition the court to grant the power to make the allocation.

Even if a client has a fully funded revocable trust, every client should execute a will to clarify the person or persons with the power to make the basis allocation and avoid having that power vested in a class of persons that may be unable to agree under the definition of executor in Code section 2203. For some families, the allocation of basis may be a contentious issue and disputes may arise. For this reason, consideration should be given to protecting the executor by the terms of the will. For example, the will may provide that the basis allocation may be made in the executor's sole discretion and may not be challenged by any person. The will may also waive the duty of loyalty so that the executor who is also a beneficiary may allocate basis to the executor's personal share of the estate. The will may also exonerate the executor with respect to the allocation (within the limits of state law) or in severe situations use no-contest or forfeiture clauses to deter challenges. Consideration should also be given to vesting the power to make the allocation in an independent executor (or special co-executor) to minimize disputes and also eliminate any argument that the failure of an interested executor to allocate basis to his own interest amounts to a gift to the other beneficiaries subject to gift tax.

PART EIGHT – MAINTAINING FLEXIBILITY IN IRREVOCABLE DOCUMENTS TO ADDRESS THE CHANGING LANDSCAPE

In light of the changing transfer tax landscape, maintaining flexibility in estate planning documents is imperative. Estate planners should consider drafting techniques that provide sufficient flexibility for navigating the unknown waters of the future. Although beneficiaries, executors, trustees, and advisors will need to evaluate the tax and other effects before exercising powers or options under provisions that provide such flexibility, the following techniques may permit an estate plan to function more effectively.

Powers of Appointment

The inclusion of powers of appointment in irrevocable trusts allows beneficiaries to take a "second look" at a trust after its creation. Clients may wish to consider testamentary powers of appointment and inter vivos powers of appointment in their estate planning. A testamentary power of appointment permits a current beneficiary to make prospective changes that may affect future beneficiaries, effective upon the death of the current beneficiary. In contrast, an inter vivos power of appointment permits a current beneficiary to transfer property to other beneficiaries during the beneficiary's life. An inter vivos power of appointment may appear less favorable initially due to possible adverse tax consequences, but it allows a current beneficiary to act immediately. The donee of an inter vivos power of appointment does not need to wait until his or her death to modify the grantor's estate plan.

Testamentary Powers of Appointment. In this time of uncertainty, clients may wish to consider using testamentary powers of appointment to provide flexibility in distributing trust principal to a new trust better designed to address new tax law, retaining more property in generation-skipping trusts if the GST tax is repealed, or distributing appreciated property to a beneficiary so that the beneficiary may allocate basis to the property. In drafting testamentary powers of appointment, clients and their advisors should consider the permissible appointees of a testamentary power of appointment (for example, whether permissible appointees should be limited to the grantor's spouse or descendants, or broadly defined) and whether the donee of a limited power of appointment may appoint trust assets outright or in further trust. If trust assets may be appointed in further trust, the grantor may consider imposing restrictions on the length of the new trust, the distribution of trust assets at trust termination, the ability of the donee to create separate trusts, or an appointee's ability to withdraw trust assets at specified ages.

Inter Vivos Powers of Appointment. With respect to inter vivos general powers of appointment, the exercise of the power will be treated as a gift by the holder, equal to the value of the trust interest surrendered by the holder. Additionally, an inter vivos power of appointment may cause otherwise excludable trust property to be taxed in the holder's estate. The adverse tax consequences of inter vivos powers of appointment may be lessened through the use of the holder's annual exclusion amount. The possible decreased gift tax rate in 2010 may also lessen the tax sting. In some cases, the resulting gift to the holder (that is, the value of the trust interest surrendered by the holder) may be zero or have a nominal value. For example, if a trustee has discretion to make distributions to a surviving spouse for health and support needs that are not adequately provided for out of the surviving spouse's other assets and income, and the surviving spouse has significant independent assets, the value of the trust interest surrendered by the surviving spouse will have little value because of the unlikelihood that the surviving spouse could receive trust distributions.

Estate planners must also be mindful of the tax treatment of general and limited powers of appointment. The holder of a general power of appointment is treated as owning the appointive property for estate tax purposes. If the holder dies holding a general power of appointment, the appointive property will be included in the holder's estate. Likewise, the exercise of a general power of appointment during the holder's life may trigger gift tax liability for the holder. In contrast, the holder of a limited power of appointment is not treated as owning the appointive property for estate tax purposes. However, adverse GST tax consequences may still apply.

Discretionary Distributions

The dispositive provisions of a trust provide instructions to the trustee on how trust assets should or should not be distributed to the beneficiaries. Permitting a trustee to make discretionary distributions to beneficiaries is a simple method to provide a trustee with flexibility to adapt to changing circumstances. Some individuals may not feel comfortable granting a trustee what may seem like unfettered discretion. Such concerns may be alleviated by carefully selecting the initial trustee, appointing a successor trustee, and directing when and under what conditions a trustee may be removed. The following is a list of drafting pointers and considerations with respect to discretionary distributions.

- Be specific and define the distribution standard.
- Consider the combination of an ascertainable and non-ascertainable standard.
- Consider the use of an independent trustee or trust protector to make discretionary distributions under a non-ascertainable standard.
- Permit the trustee to distribute trust principal to a qualified trust for the benefit of the beneficiary, such as a new trust better designed to address new tax law.
- Permit a surviving spouse who is the beneficiary of a marital trust to make annual exclusion gifts to children.
- Permit the trustee to make unequal distributions to beneficiaries with no duty to equalize distributions.
- Allow the trustee to consider a beneficiary's changed needs and circumstances, including other assets that may be available to the beneficiary, the beneficiary's maturity level, the beneficiary's need for asset protection, and whether the beneficiary would be motivated by the creation of an incentive system.
- Limit the discretionary power of a trustee to distribute trust property to himself or herself as a trust beneficiary to an ascertainable standard in order to prevent such power from being treated as a general power of appointment.

Trust Protectors

Trust protectors serve as the watchful eyes over an irrevocable trust and can be granted the power to amend a client's estate plan. For example, a trust protector can be granted the power to make administrative changes to a trust, such as making changes to removal and appointment of trustee provisions or trustee investment provisions. A grantor may also allow a trust protector to make substantive changes to trust terms to address changes in tax laws or other legal or factual changes that may impact the trust (for example, changing the situs or governing law of the trust). Some grantors may also choose to grant a trust protector the authority to make substantive changes affecting the beneficiaries of the trust, such as adding or removing beneficiaries, directing discretionary distributions, and altering an existing beneficiary's interest in the trust. The authority of a trust protector can also be limited to specific transfer tax regime changes, such as permitting a trust protector to act if the estate tax is permanently repealed or if the applicable exclusion amount or estate tax rate reaches a certain amount.

The selection of a trust protector requires careful consideration. Clients may wish to appoint a trusted individual or advisor or a committee to serve as trust protector. Often, if the client is unable to name a trust protector now, a provision could be included in an irrevocable document permitting one or more beneficiaries, trustees, or third parties to appoint a trust protector if one is needed in the future. Clients should also consider how and when a successor trust protector shall be appointed. The grantor of the trust should not serve as trust protector because the grantor will be treated as retaining a power over the trust leading to adverse tax consequences. Additionally, it is recommended that a current or future beneficiary not serve as trust protector because of risks of potential abuse of the power, adverse tax consequences, and potential liability from other

beneficiaries. Because of the authority granted to a trust protector and the potential for liability from other beneficiaries, a grantor should include exoneration and indemnification provisions in the trust document to shield the trust protector from liability and encourage them to serve as the watchdog over the trust.

Powers of Attorney

Most individuals with comprehensive estate plans have a power of attorney, whereby the principal grants one or more agents the authority to act on the principal's behalf during his or her life or upon incapacity. Powers of attorney may be used to add flexibility to an existing estate plan, but their effectiveness ceases at the principal's death. Some examples of how a power of attorney may be used with respect to estate planning include granting the agent the power to make gifts to individuals and charities (either annual exclusion gifts or large lifetime gifts) and granting the agent the ability to create, modify, or revoke a trust on behalf of the principal.

In order to be effective and induce reliance by third parties, estate planning related powers should be expressly granted and well-defined. The Uniform Power of Attorney Act requires that a principal expressly grant an agent the authority to create, amend, revoke, or terminate inter vivos trusts, make gifts, and disclaim or refuse an interest in property, a including power of appointment. Individuals and their advisors should carefully review their applicable state laws to see if similar requirements apply. With respect to the power to make gifts, the principal may wish to name permissible holders specifically or categorically, or permit the agent to make large gifts as consistent with the principal's pattern of lifetime giving. With respect to the power to deal with a principal's trust, the principal may wish to limit the agent's power to transferring assets to a revocable trust or condition certain powers on the principal's incapacity. In any event, powers of attorney for estate planning purposes should be durable to survive the principal's incapacity.

Lastly, it does not seem right to leave the topic of powers of attorney without discussing the ethical concerns raised by congressional inaction. We have entered the year of 2010 – the year where “pulling the plug on grandma” may result in significant estate tax savings for beneficiaries. Estate planning professionals have warned for years of the perverse incentives set up under the current transfer tax regime. In light of congressional uncertainty, clients may wish to review their healthcare powers of attorney or advance medical directives, paying specific attention to those provisions dealing with the life sustaining care of the principal.

Decanting

Several states have enacted decanting statutes that allow a trustee to appoint trust assets in favor of another trust with new or modified terms better suited for addressing changes in the tax law. Decanting statutes are a useful tool for dealing with changes in beneficiary circumstances, consolidating trust assets for administrative purposes, modifying trustee provisions (for example, removal power, appointment of successor trustees, and trustee compensation) or investment provisions, changing the situs or governing law of the trust, and correcting drafting errors. One major benefit of the state decanting statutes is that court approval is not necessary for the trustee to act.

The states that have enacted decanting statutes include New York, Alaska, Delaware, Tennessee, Florida, South Dakota, New Hampshire, North Carolina, Arizona, and Nevada. The state statutes vary in form with respect to the extent of the similarity required between the beneficiaries' interests in the old and new trust, whether the beneficiaries must be identical in the old and new trust, the ability of trustee who is also a beneficiary to exercise the decanting power, whether the trustee must provide notice to the beneficiaries, and whether the decanting statute permits the transfer of a trust to another state or applies to trusts that move into the state.

The interplay between state decanting statutes and GST tax consequences is unclear in this changing landscape. The extension of a trust that is exempt from the GST tax may jeopardize its exempt status. The regulations require that in order for a trustee to make distributions to a new or continuing trust without the consent of a court or beneficiaries, such laws must have been in effect at the time trust became irrevocable. It is unclear how the possible repeal and or reenactment of the GST tax will affect these considerations.

Individuals living in jurisdictions that have not enacted decanting statutes may wish to consider these drafting alternatives.

- Include a change of situs provision that allows the trustee to move the trust to a jurisdiction with a decanting provision.
- Include broad distribution provisions that permit the trustee to pour over assets to new trust for the benefit of the beneficiaries.
- Include a lifetime power of appointment that permits a beneficiary to appoint trust property to another trust with

- different terms.
- Include a merger provision.

Clients and their advisors may also wish to consider other state trust law provisions, including the Uniform Trust Code provisions adopted by many states, discussed below.

Uniform Trust Code

The Uniform Trust Code, adopted by many jurisdictions, provides statutory fixes for common trust problems. Unlike the state decanting statutes, many of these provisions require court consent. Nonetheless, these statutory provisions provide flexibility to grantors, trustees, and beneficiaries in dealing with irrevocable documents.

Section 411 of the Uniform Trust Code allows the modification of trusts by consent. A noncharitable irrevocable trust may be modified upon the consent of the settlor and all beneficiaries, even if modification is inconsistent with a material purpose of trust. Additionally, a noncharitable irrevocable trust may be modified upon the consent of all beneficiaries if the court concludes modification is not inconsistent with a material purpose of trust. Specific provisions govern who may initiate an action to approve or disapprove a proposed modification and who must signify consent. Court approval is required.

Section 412 of the Uniform Trust Code permits the modification of trusts due to unanticipated circumstances. Under this Section, a court may modify the administrative or dispositive terms of a trust if, because of circumstances not anticipated by the settlor, modification will further the purposes of the trust. A court may also modify administrative provisions if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. Court approval is required, and the court will consider the settlor's probable intention before permitting modification.

Section 415 of the Uniform Trust Code permits reformation to correct mistakes. A court may reform the terms of a trust to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of trust were affected by a mistake of fact or law. Action under this Section must meet the high standard of clear and convincing evidence.

Section 416 permits modification of a trust to achieve the settlor's tax objections. Under this Section, a court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention to achieve the settlor's tax objections. Further, the court may provide that such modification operates retroactively. In light of the uncertainty regarding the transfer tax regime, this Section may become the "hot" statute if estate tax repeal is made permanent for 2010. The depths of this provision have yet to be tested; however, it is likely that the effect of modifications permitted by a state court will be treated as a matter of federal law for federal tax purposes.

Lastly, Section 417 of the Uniform Trust Code permits the merger and division of trusts. Under this Section, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts if the result does not impair the rights of any beneficiary or adversely affect the achievement of the purposes of the trust. The trustee must provide notice to all qualified beneficiaries of the trust and will need to consider how tax attributes (for example, charitable deductions, capital loss carry forwards, and net operating losses) will be divided among the trusts.

In states which have not adopted the Uniform Trust Code, the provisions of the trust laws of those states may provide different ways in which to provide flexibility in irrevocable documents.

Conclusion on Providing Flexibility

Despite the changing transfer tax landscape, irrevocable trusts will continue to play an important role in estate planning. Trusts offer many non-estate tax benefits, including disability protection, asset protection, protection of privacy, avoidance of probate, income tax planning, and greater protection against challenges to an estate plan.

The above techniques allow individuals to defer decisions on how and when property will be distributed to beneficiaries. A grantor can place limits on how decisions will be made and what needs of beneficiaries or other matters should be considered. Although the above drafting techniques and other tools may not be appropriate in all circumstances, their inclusion in a comprehensive estate plan will provide flexibility in permitting grantors, trustees, and beneficiaries to adapt to changing circumstances. Irrevocable does not need to be synonymous with inflexible. Moreover, even if Congress moves quickly to reinstate the estate and GST taxes, no one can guarantee the permanency of such a fix, or of transfer tax rules generally. Undoubtedly, there will be changes in the laws governing transfer taxes in the future. The need to use the techniques discussed above to preserve flexibility will survive no matter what happens in the short term.

PART NINE – INTERNATIONAL ESTATE PLANNING IMPLICATIONS

The repeal of the federal estate tax has implication in planning for transfers to non-U.S. citizens.

Qualified Domestic Trusts

Under prior law, property passing to a spouse who is not a U.S. citizen would not qualify for the estate tax marital deduction unless the property passed in a qualified domestic trust (Code sections 2056(d), 2056A). A qualified domestic trust, or QDOT, is a trust that satisfies the requirements of one of the permitted forms of marital trusts and also contains additional provisions intended to protect the federal government's interest in taxing the trust property on or before the surviving spouse's death. The QDOT was created in response to the concern that a non-U.S. citizen spouse, having received property from the estate of his or her deceased spouse in a nontaxable transfer qualifying for the marital deduction, could leave the United States with the assets and shelter those assets forever from the estate tax. Essentially, principal distributions to the surviving spouse during life, other than distributions for hardship, were taxed as if they had been part of the first spouse's estate. Likewise, at the surviving spouse's death, the property remaining in the QDOT at that time were taxed as if they were part of the first spouse's estate,

With the repeal of the estate tax, surviving spouses who are not citizens of the United States do not fare as well as spouses who are citizens. The 2001 Tax Act eliminated the additional estate tax on QDOT property remaining at a surviving spouse's death if that death occurs after December 31, 2009. However, a QDOT holding property of a decedent who died before January 1, 2010, remains subject to the additional estate tax for distributions made to the surviving spouse during the surviving spouse's life, before January 1, 2021. If these provisions take effect, there will be even greater tax motivation for a non-U.S. citizen spouse to become a U.S. citizen.

EXAMPLE: Andrew dies in 2009, leaving \$3.5 million in a family trust and \$3 million in a QDOT for wife, a citizen of France. In 2010 the trustee makes the first distribution of principal from the QDOT in an amount of \$500,000 to wife to allow her to buy a new yacht. As this distribution is unlikely to qualify as a hardship distribution, estate tax will be owed. The tax is calculated with reference to the marginal rate that would have been owed in husband's estate had the \$500,000 been taxable at his death, which would have been 45%. Thus, \$225,000 of estate tax would be owed as a result of the distribution. If wife dies later in 2010, no additional estate tax will be due on the remaining QDOT property.

Carryover Basis Rules

Although the modified carryover basis rules discussed above permit a \$1.3 million increase in basis for U.S. citizens and residents upon their deaths, the amount of basis increase for a non-resident, non-citizen with property subject to U.S. estate tax is \$60,000 indexed for inflation as provided in Code section 1022(b)(3). Strangely, the \$3 million of basis increase for property passing to surviving spouses is available for transfers to non-resident, non-citizen spouses.

Beginning January 1, 2010, Code section 684, which previously applied to transfers by a U.S. person to a foreign non-grantor trust or estate, will also apply to transfers to non-resident aliens upon the transferor's death. Code section 684 treats any such transfer as a sale or exchange, thus subjecting the appreciation to capital gains tax. This provision was included as part of EGTRRA to prevent U.S. persons, once there was no estate tax, from transferring assets at death to a non-resident alien to avoid capital gains tax. Until this year, the step-up in basis made this a non-issue.

Gifts by Non-Resident Aliens to United States Citizens

One technique will continue to be available to non-resident aliens no matter what happens with respect to the federal estate and GST taxes. Federal gift tax is imposed on non-resident foreign citizens only for gifts of real and tangible personal property located in the United States under Code section 2511(a). No gift tax is imposed on the transfer of intangible property by a non-resident foreign citizen under Code section 2501(a)(2). An exception applies to certain expatriated non-resident foreign citizens or certain individuals with dual citizenship.

The non-resident foreign citizen can make gifts of all U.S. assets, other than real or tangible property located in the United States, without being subject to any federal gift tax. Gifts of cash should be made from bank accounts located outside the United States. This is because the Internal Revenue Service considers gifts of cash from a U.S. bank account to be gifts of U.S. tangible property subject to U.S. gift tax. A non-resident foreign citizen with substantial U.S. and foreign assets should be able to provide for family and friends in the United States without federal transfer tax.

EXAMPLE: A non-citizen non-resident foreign citizen has a daughter living in the United States who is a U.S. citizen. He

contributes \$5 million of cash from a foreign bank account to an irrevocable perpetuities trust held by a U.S. trustee for the benefit of the daughter and her descendants. Because of the exception, he owes no U.S. gift tax on the transfer. In addition, the trust is protected from estate and generation-skipping taxes for as long as it is in existence. Thus, it is possible to establish the trust in one of the numerous jurisdictions that has eliminated or extended the rule against perpetuities and have the property available for many generations of family members without subjecting the assets to gift tax.

Foreign Taxes for Non-Resident Aliens

Although there are still planning techniques available to non-resident aliens with U.S. assets or U.S. relatives under EGTRRA, proper estate planning must take into account the tax laws of the non-resident alien's own tax jurisdiction, for example, the United Kingdom ("UK"). Overseas tax laws may impose taxes in relation to any proposed gift of U.S. assets that might negate the benefit of any estate planning in the U.S.

For instance, if the non-resident alien in the previous example is a UK domiciliary (that is, someone who is considered by UK tax law to be domiciled or deemed domiciled in the UK for UK inheritance tax purposes, regardless of where they are resident), the creation of the irrevocable perpetuities trust for his U.S. daughter and the transfer of the \$5 million in cash from the non-U.S. bank account will be a chargeable lifetime transfer for UK inheritance tax purposes.

The consequences of this are as follows:

- There will be an immediate inheritance tax liability equal to 20% of the value of the \$5 million cash transferred into the trust by the UK domiciliary/U.S. non-resident alien, amounting to \$1 million payable at the time of the transfer. (Certain exemptions and the availability of the nil rate band that excludes the first £325,000 of assets from any charge to inheritance tax will help to reduce this liability.) Furthermore, if the UK domiciliary dies within seven years of making the transfer to the trust, the lifetime charge is recalculated at the death rate of 40%, with credit for tax already paid and reduced rates if death occurs more than three years after the date of transfer (again the chargeable amount may be reduced further if the nil rate band is available for use).
- Any distributions out of the trust will (unless one of the exemptions applies) be subject to a tapering exit charge of a maximum of 6%.
- On the tenth anniversary of the creation of the trust, the trustees would have to pay a periodic inheritance tax charge equal to 6% of the value of the remaining trust property on that tenth anniversary. This periodic charge occurs every 10 years of the lifetime of the trust.

The potential overall UK tax treatment of this trust structure represents a considerable tax burden and needs to be taken into account when evaluating the merits of the U.S. estate planning benefits.

As this example shows, domicile in the context of UK tax planning is an exceptionally important factor. It can determine the extent of a person's liability for UK inheritance tax and (together with residence considerations) income tax. Unfortunately, the rules on the determination of domicile are not straightforward and often lead to determinations of domicile that are unexpected and unsatisfactory. To make matters worse, different domicile rules apply for inheritance tax and income tax, with the result that one can be deemed domiciled for inheritance tax without being domiciled in the UK for income tax. A person's domicile status must be considered thoroughly as part of any estate planning for a U.S. person with any connection to the UK. If this is not done before any estate planning is put in place, there could be adverse UK tax consequences. The same principle applies equally to the tax laws of other countries of relevance to any family.

Trusts may have UK income and capital gains tax implications for a UK surviving spouse of a trust established by a U.S. non-UK domiciled person, even if there is no income withdrawn from the trust. In such cases, surviving spouses should always seek advice on the extent of their UK tax reporting obligations and tax liability.

Foreign Estate Tax Planning for U.S. Taxpayers Resident Overseas or with Foreign Assets

Foreign Assets. Many countries charge estate tax on the value of local assets passing on the death of the owner, regardless of nationality and residence. Real estate and bank accounts are typical of the types of assets that will be subject to these local estate taxes. Relevant legal advice must therefore be sought before any U.S. persons purchase assets overseas.

In the UK, for instance, all UK property (other than excluded property) will be subject to UK inheritance tax at a rate of 40% on the death of the legal owner, whether or not that person is domiciled or resident in the UK (subject to any available double tax treaty relief, nil rate band exemption, and other exemptions such as the exemption to surviving spouses – see more

below). To avoid the UK inheritance tax regime altogether, therefore, U.S. persons may be best advised to structure the purchase of UK property via an offshore (that is, non-UK) trust and company structure which they then fund (a trust on its own without a company will not avoid the UK inheritance tax net).

But, even that solution raises other UK tax issues. For instance, the company may, depending on the residency of the U.S. persons, be considered to be managed and controlled from the UK, thereby subjecting the company to UK company taxation. If the U.S. person is a UK resident and occupies the property, personal income tax and capital gains complications can also arise from this structure. So care needs to be taken before implementing any structure, as liability will depend on the precise factual matrix of the relevant persons, involving consideration of their residence and domicile.

If U.S. persons have already purchased UK real estate in their own names, it would be too late for them to transfer it to a company owned by an offshore trust, because that would attract a 20% inheritance tax at the time of transfer and the periodic and exit charges outlined above, as well as potentially more serious income tax and capital gains tax problems. So this is not a good planning option. The best way to reduce exposure to inheritance tax in this case would be to retain the property in personal names (rather than create the trust structure) and obtain a mortgage secured against the UK property for as much as possible, topping this up every so often as house prices increase. This helps to reduce the net value of the property on death, and the inheritance tax burden will be reduced commensurately.

Domicile of the Surviving Spouse. In the UK, care must be taken with any estate where assets pass from a UK-domiciled or deemed domiciled spouse to a non-UK domiciled spouse. Again, the domicile rules, as they apply to inheritance tax, are a vital consideration in planning. A U.S. couple relocating to the UK on different dates in different tax years could well find themselves with different domiciles based on their dates of arrival. The implications of a finding of UK domicile or deemed domicile will significantly alter the planning available to the married couple and the potential inheritance tax payable on transfer.

Assets which pass from a UK domiciliary to a UK domiciled surviving spouse are completely exempt from any inheritance tax, which represents a significant tax planning benefit. Similarly, there is no inheritance tax payable on UK assets passing from a non-UK domiciliary to a UK domiciled or deemed domiciled spouse.

But the tax treatment where a non-UK domiciled spouse inherits from a UK domiciled or deemed domiciled spouse is much less favorable. In that case, only the first £55,000 of the UK domiciliary's worldwide assets is exempt from inheritance tax, with the balance liable to charge (subject to any other exemptions or double tax treaty reliefs) at the lifetime (20%) or death (40%) rates.

This is a considerable additional tax burden for spouses with different domiciles. If there is a possibility of transferring assets on death to other UK domiciliaries up to the value of the nil rate band exemption (which is currently the first £325,000 of chargeable assets), this will at least result in a saving of up to £130,000.

Income Tax Planning. For non-UK domiciliaries with significant foreign income or assets who are planning on relocating to the UK, their estate planning will go hand in hand with income and capital gains tax planning to take advantage of the remittance basis of taxation available to non-domiciliaries. Under this regime, broadly speaking, certain foreign income and capital gains that are earned by a non-UK domiciliary while resident in the UK will not be subject to tax in the UK unless remitted by that person. Overseas income or gains must therefore be structured so that they are received outside of the UK. Trust and company structures in traditional zero-tax jurisdictions are commonly used for this purpose, although the exact planning will depend on the specific circumstances of each person.

Foreign Inheritance Laws

Relevant foreign inheritance laws can be an important consideration in cross-border estate planning. Many civil law countries lay down minimum percentage amounts a surviving spouse and close family are entitled to inherit as a matter of law. Any transfer which ultimately results in the abrogation of those foreign forced heirship provisions may invalidate any transfer. This is relevant for any asset wherever located, but is particularly important in the context of assets that are located in a jurisdiction that has forced heirship rules, as those assets are fully exposed to that jurisdiction's legal processes compared with overseas assets. Disappointed heirs are more likely to succeed in enforcing claims against local assets. Although enforcement of judgments based on forced heirship claims would involve complex cross-border enforcement issues that may dissuade disappointed beneficiaries from taking action, the value of any transfer may be sufficient to warrant the expense and aggravation.

This is therefore an issue that should be carefully considered in the context of U.S. estate planning where overseas assets form a significant part of a person's estate and that person's estate planning will not follow the forced heirship rules of any relevant jurisdiction. Foreign legal advice should be sought in those circumstances.

The McGuireWoods Private Wealth Services Group

The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about this white paper. Please feel free to contact any member of the Group.

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