

**ESTATE PLANNING AND ADMINISTRATION IN 2011 AND 2012: IS THE CURE
WORSE THAN THE DISEASE?**

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I. Introduction

- A. After ten years of uncertainty concerning the fate of the estate, gift, and generation-skipping tax systems in 2010 and beyond, at the end of December 2010 Congress enacted and President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Act”)(P.L. 111-312), which resolved most of the issues related to the application of those taxes in 2010. The 2010 Act also made a number of important changes to the estate, gift, and GST tax law that took effect on January 1, 2011, including some unexpected changes. Congress, however, decided to continue the guessing game for estate planning advisers by giving the 2010 Act a two-year lifespan. So once again we are faced with new laws for both 2010 and for 2011 and 2012 as well as the potential expiration of tax laws and the revival of old tax laws in 2013. While we are all relieved that Congress resolved most of the uncertainty related to EGTRRA with the 2010 Act, Congress effectively doubled down by making a series of even more confusing two-year changes to the tax law. As a result, we as estate planning advisers are again in the difficult position of not knowing what the law is now and not knowing what it will be in 2013. How can we effectively advise clients with this state of affairs?
- B. Many authors have thoroughly examined the 2010 Act, and it is not necessary to repeat their efforts in this outline. For those readers who are interested in a particularly good analysis of the 2010 Act, you should read Steve Akers’ outline on the subject entitled “Estate, Gift and Generation-Skipping Transfer Tax Provisions of “Tax Relief... Act of 2010,” Enacted December 17, 2010,” which you can find at <http://www.actec.org/public/AkersTaxRelief.asp>. Mr. Akers

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does an excellent job of analyzing the nuances of the 2010 Act, including the complicated issues surrounding the sunset of EGTRRA, the potential sunset of the 2010 Act, and the possible reinstatement of the 2001 system in 2013.

- C. The purpose of this outline is to describe some issues that we as practicing lawyers have encountered advising clients in 2011 in the wake of the 2010 Act as well as EGTRRA. The outline will address these topics:
1. Understanding the effect of 2010 taxable gifts and generation-skipping transfers and how to report them to the IRS.
 2. Issues related to the law that applies to the estates of decedents who died in 2010 and how to administer those estates.
 3. How to advise clients who wish to take advantage of the greatly increased gift tax-free amount that came into effect in 2011 and will last until the end of 2012.
 4. How to draft estate planning documents in light of the changes to the law made by Congress in the 2010 Act, including the increased estate tax-free amount and portability, and in light of the fact that further changes to the laws appear quite likely.

II. **2010 Taxable Gifts and Generation-Skipping Transfers**

A. *General Rules*

1. One thing Congress *did not* change much in the 2010 Act was the way the gift tax applies in 2010. The gift tax applicable exclusion amount remained at \$1 million, although Congress lowered the top gift tax rate to 35%, which means that a flat 35% rate applies to taxable gifts made in 2010.
2. Congress increased the GST exemption from \$3.5 million to \$5 million for 2010 in the 2010 Act, so clients may have some increased GST exemption available to allocate to generation-skipping transfers that occurred in 2010 or to trusts from which generation-skipping transfers may later occur. The outline discusses issues related to the use of the increased exemption below.
3. When Congress enacted EGTRRA in 2001, it left open numerous questions about how the GST tax would apply in 2010 and in future years due to issues with the repeal of the GST tax in 2010 and its expected revival under the “sunset” provisions of EGTRRA. For example, it was unclear whether a trust that received gifts in 2010 would have a “transferor” for GST tax purposes, making it unclear how a post-2010 generation-skipping transfer from the trust would be taxed. It was also unclear whether the transferor move-down rule would apply to gifts to

trusts that were skip persons, leading many practitioners to encourage their clients to make outright gifts to grandchildren and great grandchildren in 2010. Fortunately, Congress cleared up much of the confusion of this kind in the 2010 Act. For example, it is now clear that the move-down rule does apply to trusts that are skip persons and that trusts created in 2010 will have a “transferor” for purposes of determining the current or later application of the GST tax. In making these changes, however, the 2010 Act raised some other issues, most of them stemming from the fact that the GST tax was no longer repealed in 2010 but was imposed at a zero rate. As discussed below, the issues manifest themselves on 2010 gift tax returns (as well as on estate tax returns).

B. *2010 Gift Tax Return Issues*

1. In 2010, the top gift tax rate dropped to 35% (part of EGTRRA), which raised issues for clients in computing the gift tax applicable credit for gifts in 2010.
 - a. In computing gift tax, a client would ordinarily add the amount of his or her pre-2010 adjusted taxable gifts to the 2010 gifts and compute a tax of 35% on the sum. The client would then subtract the amount of credit – unified or applicable - previously used to compute a gift tax. In previous years, however, the credit was either a fixed amount determined without regard to gift tax rates or was determined with respect to gift tax rates that Congress kept changing. If in 2010 a client subtracted the amount of gift tax credit previously used and that credit sheltered gift tax at a rate above 35% (this could happen because the credit sheltered tax at 37% and 39% in previous years), he or she would owe a gift tax that would be slightly larger than he or she expected.
 - b. For example, assume a client made a \$600,000 taxable gift in 1992 when the unified credit was \$192,800. In 2010 the maximum applicable credit was \$330,800 because at a 35% rate, that was the amount necessary to produce zero tax on a \$1 million gift. Because the client had used \$192,800 in 1992, he or she would have appeared to have only \$138,800 of credit remaining, which means that a \$400,000 gift in 2010 would have generated \$2,000 of gift tax. But a client with no previous taxable gifts could make a \$1 million gift in 2010 without the payment of gift tax.
 - c. Congress recognized this anomaly and tried to fix it in the 2010 Act by adding a new sentence to IRC § 2505(a):

For purposes of applying paragraph (2) for any calendar year, the rates of tax in effect under section 2502(a)(2) for such calendar year shall, in lieu of the rates of tax in effect

for preceding calendar periods, be used in determining the amounts allowable as a credit under this section for all preceding calendar periods.

This new sentence applies to gifts in 2010 and thereafter.

- d. The IRS took the position on the Instructions to the 2010 Form 709 that the effect of this new sentence is that a taxpayer should determine his or her “used” credit based on 2010 rates, which fixes the anomaly described above. In the example of the client with the \$600,000 gift in 1992, he or she would subtract \$190,800 from his or her total credit amount of \$330,800 to determine the gift tax on his or her \$400,000 gift in 2010. This approach produces a 2010 gift tax of zero.
- e. The explanation of how the IRS came up with a unified credit of \$190,800 is that they are calculating an “applicable credit amount” for a period during which there was no applicable credit amount -- there simply was a unified credit of a fixed amount. If you use 2010 rates, \$190,800 of “applicable credit amount” produces an “applicable exclusion amount” of \$600,000. The catch is that the first applicable exclusion amount was \$625,000 for 1998. Before 1998, as mentioned, there was only a unified credit of \$192,800.
- f. Consider the current language of IRC § 2505(a) as modified by the 2010 Act:

The credit is an amount equal to . . .

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

2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.

For purposes of applying paragraph (2) for any calendar year, the rates of tax in effect under section 2502(a)(2) for such calendar year shall, in lieu of the rates of tax in effect for preceding calendar periods, be used in determining the amounts allowable as a credit under this section for all preceding calendar periods

- g. It is difficult to see how the flush language that Congress added to IRC § 2505(a) in the 2010 Act authorizes the IRS to override a hard number unified credit in favor of an “imaginary” applicable exclusion amount of \$600,000. Applying the gift tax rates in effect

- b. If a client made a gift to a trust that is a skip person (i.e. all beneficiaries are skip persons), that gift is a direct skip and subject to GST tax at a rate of zero. Under the GST tax rules, however, distributions from the trust to the client's great grandchildren and more remote descendants will be subject to the GST tax under the transferor "move down" rule. Therefore, while the transfer to the trust might not have triggered GST tax in 2010, GST tax could be payable on a later distribution to a trust beneficiary. A client in this situation should consider whether to apply GST exemption to the trust because doing so will exempt such a later distribution from GST tax. The automatic allocation rules of IRC § 2632(c) may be helpful to such a client. If, however, the trust was funded with an amount larger than the client's remaining GST exemption, taking the 2010 increase to \$5 million into account, the automatic allocation rules will result in the trust having an inclusion ratio of more than zero, which means that all future generation-skipping distributions, taking the move-down rule into account, will trigger GST tax, just not at the top rate. It is possible that a formula provision the trust agreement takes care of this problem, as could a "downstream split" of the trust into a trust with an inclusion ratio of zero and a trust with an inclusion ratio of one.
- c. Clients also may have made gifts in 2010 to trusts that are not skip persons but from which generation-skipping transfers may later occur ("indirect skips"). Assuming such a trust is a "GST trust" within the meaning of IRC § 2632(c)(3)(B), GST exemption will be automatically applied to that trust unless the client opts out of those rules. Clients in this situation and their advisers should consider whether to opt out of the automatic allocation provisions, opt in, or manually allocate GST exemption on the 2010 Form 709.

C. *2010 GST Tax Return Issues*

- 1. Many clients and trustees engineered taxable distributions in 2010 in order to take advantage of what everyone thought was a repeal of the GST tax on generation-skipping transfers in 2010. Of course, Congress repealed the repeal and instead provided that the rate of tax on generation-skipping transfers in 2010 was zero, so clients and trustees who organized taxable distributions will avoid the imposition of the GST tax. Strangely enough, however, the IRS nevertheless appears to require taxpayers to report 2010 generation-skipping transfers.
- 2. By way of background, IRC § 2662 provides that the IRS has the authority to impose return requirements in Treasury Regulations. Those regulations provide that the various returns for taxable distributions and taxable terminations must be filed in accordance with their instructions. Treas. Reg. §§ 26.2662-1(b)(1), (2).

3. The instructions applicable for 2010 taxable distributions (Form 706-GS(D)) provide that a trustee of any trust that makes a taxable distribution must file a Form 706-GS(D) for each skip person (this probably means each skip person who received a distribution). The instructions to this form on p. 1, under Who Must File specifically state that the trustee must file even if the inclusion ratio is zero. So trustees must file the return with the distributees. The instructions for Form 706-GS(D) (to be filed by the distributee) state on p. 1 under Who Must File that anyone who receives a taxable distribution from a trust must file. However, on p 2, 1st sentence of Part II, the distributee is directed to report taxable distributions with an inclusion ratio greater than zero. There does not appear to be an exception from reporting when the tax rate on the taxable distribution is zero; the form clearly is designed to have the taxpayer report. In fact, the forms have the zero percent tax rate typed in, which should cut down considerably on taxpayers accidentally paying a tax they do not owe.
4. The instructions for 2010 taxable terminations (Form 706-GS(T)) p. 1, under Who Must File provide as follows: "In general, the trustee of any trust that has a taxable termination (defined below) must file Form 706-GS(T) for the tax year in which the termination occurred." It is unclear what the "In general" means, but that is what it says.
5. Because the definitions of taxable distributions and taxable terminations apply without regard to the inclusion ratio or the tax rate, these events are required to be reported by the instructions to the forms and thus under the statute. This means that clients apparently must file these returns.
6. As to valuation, the instructions do not require that any property be appraised, only that taxpayer explain how the reported values were determined and the state that the taxpayer should attach copies of "any" appraisals. Instructions Form 706-GS(D), p. 2, 3rd column, 2d full sentence, and Form 706-GS(T), p. 5, 1st column, last sentence under Column e. Value.
7. Congress extended the due date for reporting generation-skipping transfers that occurred in 2010 to no earlier than nine months after the date of enactment of the 2010 Act. This means that a 706 – GS(D) or 706-GS(T) reporting a (nontaxable) 2010 generation-skipping transfer is not due until at least September 19, 2011. If a decedent made a taxable direct skip, however, he or she must report that on a timely filed gift tax return, and Congress did not change the due date for 2010 gift tax returns. Therefore, as a practical matter a client will report a direct skip on a Schedule R on a timely filed gift tax return.

III. Estates of Decedents Who Died in 2010

A. *Applicable Rules*

1. In the 2010 Act, Congress effectively repealed the repeal of the estate tax in EGTRRA with the result that as a general matter the federal estate tax applies to estates of decedents who died in 2010. The applicable estate tax exclusion amount for such a decedent's estate is \$5 million less lifetime adjusted taxable gifts. The single tax rate applicable to the estate of a 2010 decedent is 35%. The assets included in a 2010 decedent's estate will receive a new basis for federal income tax purposes under IRC § 1014.
2. The personal representative of the estate of a 2010 decedent, however, may elect for the federal estate tax to not apply to the decedent's estate. *See* 2010 Act § 301(c). If the personal representative makes this election, the decedent's assets will not receive a new basis under IRC § 1014. Instead, the carry over basis rules in IRC § 1022 will apply to the decedent's assets. Among other things, this means that the decedent's personal representative may apply \$1.3 million of new basis to the decedent's assets. IRC § 1022(b). The \$1.3 million new basis applies to gains inherent in assets, not to the date of death or value of assets. If assets included in the decedent's estate pass to the decedent's surviving spouse or a QTIP-type trust for the spouse's benefit, the personal representative can allocate \$3 million of additional new basis to the assets passing to the surviving spouse. *See generally* IRC § 1022(c). A decedent's personal representative, however, may not elect to allocate new basis to assets held in a QTIP trust that would have otherwise been subject to federal estate tax on a surviving spouse's death. Both halves of a decedent's and his or her surviving spouse's community property are eligible for an application of the \$1.3 million or \$3 million basis allocation under IRC § 1022. *See Akers* at 8. Other complicated rules apply, including special rules dealing with loss carryforwards, all of which Steve Akers ably summarizes in his outline.
3. In EGTRRA Congress repealed the GST tax for 2010 generation-skipping transfers. In the 2010 tax legislation, however, Congress repealed the repeal of the GST tax and instead provided that the rate of GST tax applicable to generation-skipping transfers in 2010 was zero. Congress also reinstated the GST exemption for 2010 in the amount of \$5 million, which means that whether or not a decedent's personal representative elects out of the application of the federal estate tax to an estate, the personal representative may allocate a decedent's remaining GST exemption to trusts from which later generation-skipping transfers may occur. Because the GST exemption had been \$3.5 million in 2009, all decedents would have at least \$1.5 million of exemption to allocate to trusts created by reason of the decedent's death in 2010 assuming no

application of the increase in the exemption to 2010 lifetime transfers that occurred before the decedent's death.

4. In the 2010 Act Congress extended the time in which a person who received property by reason of a 2010 decedent's death could disclaim that property without triggering a gift tax (i.e. make a "qualified" disclaimer) to nine months after the date of enactment, which was December 17, 2010. The critical date, therefore, is September 19, 2011 (taking the provisions of IRC § 7503 into consideration). To be safe, a person who wishes to take advantage of the extension should make the disclaimer on or before September 17, 2011. The nine-month extension is available only if the decedent died before the effective date of the 2010 Act. In other words, the standard nine-month rule of IRC § 2518(b)(2) applies to estates of decedents who died on or after December 17, 2010, but a legatee in this situation would have until after September 17, 2011, to disclaim in any event. In addition, an extended disclaimer must be otherwise qualified. For example, a legatee cannot disclaim a legacy if he or she has accepted the benefits of the disclaimed property. The Washington legislature recently amended the Washington disclaimer statute to conform to this change in federal law: RCW 11.86.031(2)(d) now provides that a disclaimer of an interest received by reason of the death of a decedent who died between January 1, 2010 and December 17, 2010, must be disclaimed no later than nine months after December 17, 2010.

B. *Compliance with 2010 Tax Laws*

1. For an estate of a 2010 decedent, the decedent's personal representative must file a federal estate tax return for the decedent's estate unless the personal representative elects out of the estate tax.
2. For an estate to which the estate tax will apply, the federal estate tax return is due no earlier than nine months after the effective date of 2010 Act, which means a federal estate tax return will be due no earlier than September 19, 2011. *See* 2010 Act § 301(d)(1). Congress limited this extension to estates of decedents who died before December 17, 2010. Estates of decedents who died after December 16, 2010, to which the estate tax applies will have the standard nine-month period to file a return. As of the date of this outline, the IRS has not released a 2010 Form 706 or instructions to the form, though the form will likely be similar to the 2009 form. The filing threshold for 2010 estate that is subject to the federal estate tax will presumably when the sum of the decedent's adjusted taxable gifts and gross estate exceeds \$5 million.
3. If a personal representative will elect the application of the basis rules of IRC § 1022 in lieu of the estate tax, the personal representative must file a "carryover basis report," which will be IRS Form 8939. As of the date of this outline, the IRS has not released a usable Form 8939 or instructions

for the form. According to the IRS, a personal representative will file the Form 8939 separate from the decedent's final income tax return. Because the IRS has not issued the Form 8939, no one can be sure of its due date. According to the IRS, taxpayers will have at least 90 days from the date of the release of the Form 8939 to prepare and file it. In a press release dated March 31, 2011, the IRS suggested it will release the Form 8939 sometime in May 2011. In the meantime, the IRS directed taxpayers not to file an IRS Form 8939 with a 2010 decedent's final individual income tax return.

4. GST tax compliance for estates of 2010 decedents is similarly up in the air. If a decedent's estate files a Form 706, that form will presumably include Schedule R on which the personal representative can allocate GST exemption. No tax will be due on generation-skipping transfers, of course, because the rate of GST tax on 2010 generation-skipping transfers is zero. If the decedent's personal representative elects for IRC § 1022 to apply, it is unclear how the personal representative will allocate the decedent's remaining GST exemption.
5. As discussed below, if a taxable termination occurred in 2010 by reason of the death of a decedent, the trustee must apparently file a 706-GS(T) reporting the termination even though the tax rate is zero.
6. It appears that if the estate of a Washington resident decedent will opt out of the federal estate tax, the personal representative must file a Washington state estate tax return if the decedent's gross estate (as defined in RCW 83.100.020(5)) exceeds \$2 million. *See* RCW 83.100.050(1). The estate of a Washington resident decedent with a gross estate of less than \$2 million must also file a Washington estate tax return if the estate must file a federal estate tax return. This would occur if the decedent's gross estate was less than \$2 million but the decedent had adjusted taxable gifts in an amount that when added to the gross estate exceeded \$5 million.

C. *Selected Issues for 2010 Decedents' Estates*

1. It would appear to be easy for a personal representative to decide whether to opt out of the federal estate tax if a decedent's estate would otherwise pay federal estate tax that could not possibly be offset by the benefit of a step-up in basis. Likewise, it would appear obvious that a personal representative should not opt out of the estate tax if the decedent's estate would not be subject to estate tax, taking adjusted taxable gifts into consideration, and could only serve to benefit from a step-up in basis. The cases that fall in the middle tend to be more complicated, particularly when a personal representative is in the uncertain position of having to select when tax is payable and by whom. In these borderline situations, the personal representative is best advised to evaluate the situations from a "total tax due" perspective and a "who gets what" perspective, both of

which are discussed in great detail by Mickey R. Davis in *Update on Administering 2010 Estates – What Have We Learned So Far?*, which was prepared for the meeting of the American College of Trust and Estate Counsel's Estate and Gift Tax Committee that took place at the 2011 ACTEC Annual Meeting (copies on file with the authors).

- a. As Davis describes, the “total tax due” perspective is not simply a matter of comparing estate tax due now to gain potentially subject to income tax at some later time. The availability of certain deductions, such as for state death taxes paid and income in respect of a decedent, as well as certain credits, such as the credit for tax on prior transfers, should be considered. Additionally, a personal representative should evaluate the timing of a possible income tax triggering event (whether to pay estate expenses or satisfy beneficiary needs), the character of gain, likely changes to the capital gains and ordinary income tax rates, the impact of any applicable holding period, the effect of funding pecuniary bequests in kind, state income taxes, and the increased cost associated with collecting the information necessary to compute carryover basis, among a myriad of other factors.
 - b. Similarly, there are a wealth of factors to consider when evaluating the “who gets what” perspective, not the least of which is the personal representative’s potential liability for making a decision that causes a beneficiary to receive less than he or she would have otherwise received had the personal representative not elected out of the estate tax regime. As Davis describes, critical to the personal representative’s analysis is whether the election would increase or decrease the amount of assets that would pass under a formula bequest, to what extent is the tax burden shifted between beneficiaries who would bear estate taxes and beneficiaries who may be subject to income tax in the future because of the carryover basis and whether the IRS would respect a local court construction of a will or trust or family settlement agreement with respect to any shifted wealth.
2. Numerous questions have arisen related to application of the carryover basis regime and how to comply with it. Until the IRS releases Form 8939 and its instructions, all we can do is speculate about how these rules may apply and how personal representatives and families will deal with them. The government’s prolonging of this uncertainty is unfair to taxpayers, though to be fair no one, including the IRS, knew what Congress would do in 2010.
 3. The complexity of the decisions facing personal representatives of estates of decedents dying in 2010 and the potential for various outcomes is best illustrated by way of examples. One situation in which a personal

representative might consider filing an estate tax return is when an estate would be subject to estate tax but for a marital deduction and that a new basis in assets would be meaningful.

- a. Assume, for example, a decedent with an estate of \$10 million of separate property with a zero basis and that the decedent's estate plan had a typical credit shelter trust – QTIP marital trust formula provision. If the personal representative did not elect the carryover basis regime, no estate tax would be due in the estate and the assets would receive a new basis. On the surviving spouse's death, his or her estate could shelter the assets in the QTIP trust from estate tax with the survivor's applicable exclusion amount and get yet more basis.
- b. If the personal representative of the estate of the first spouse to die opted out of the estate tax, there would, presumably, be no tax on the surviving spouse's death, so that factor is potentially neutral. The new basis, however, may be valuable. On the other hand, there is no guarantee that the assets in the QTIP marital trust would not attract some estate tax at the surviving spouse's death.
- c. The surviving spouse could hedge his or her bets in this situation by releasing his or her income interest in the QTIP trust and make a taxable gift of the \$5 million under IRC § 2511 and IRC § 2519 in order to preserve the \$5 million excludable amount. But that might leave the spouse with insufficient assets on which to live.
- d. If a 2010 decedent's estate plan left some or all of his or her assets to a surviving spouse outright or in a general power of appointment marital trust, opting out of the estate tax might appear pointless because the assets passing to the spouse outright or in a general power of appointment marital trust would be subject to estate tax on the surviving spouse's death. A qualified disclaimer by the spouse might allow the assets in question to pass to a credit shelter trust or to other beneficiaries, thereby "saving" the benefit of the opt-out. On the other hand, the spouse might need the income from those assets or possibly even the principal. In this situation, the decedent's estate plan will be quite important: how do the disclaimed assets pass? Remember that the spouse does have an extra nine months to make the disclaimer, provided he or she has not accepted the benefits of the assets he or she wishes to disclaim. If the spouse received the assets outright, he or she could also make a gift of those assets using his or her \$5 million gift tax-free amount, though a disclaimer would work better because it uses the decedent's unlimited 2010 estate tax-free amount.

4. One issue that can arise for an estate that elects the carry over basis regime is the potential for gain on the distribution of appreciated property.
 - a. Under general fiduciary income tax principles, the distribution of appreciated property to satisfy a pecuniary disposition will trigger a capital gains tax on the appreciation. This was usually of little concern in pre-2010 estates because the decedent's property would receive a new basis. If the personal representative of a 2010 decedent's elects out of the estate tax, however, there will be no new basis, which raises the potential for taxable capital gains on the distribution of appreciated property to satisfy pecuniary amounts.
 - b. Fortunately Congress anticipated this and in 2001 enacted a new IRC § 1040, which provides that an estate's gain on a distribution of appreciated property to satisfy a pecuniary bequest will be the difference between the value of the property on the decedent's date of death and the date of distribution. IRC § 1040(a).
 - c. Of course, not all distributions of appreciated property by reason of a person's death are made by estates and their executors. Revocable trusts, for example, may call for pecuniary distributions. Unless the trustee makes an IRC § 645 election to treat the trust as an estate, the rule of IRC § 1040(a) would not apply. Congress, however, anticipated this and directed the Treasury to issue regulations to apply this rule in situations in which "a person has a right to receive from a trust a specific dollar amount which is the equivalent of a pecuniary bequest." IRC § 1040(b)(1). As of the date of this outline, the IRS has not issued any such regulations. The lack of regulations, however, raises a question for a trustee of a trust that satisfies a pecuniary distribution with appreciated property: how to report the transaction on an income tax return. The government will hopefully issue guidance on this matter in due course.
5. One transfer tax issue that personal representatives who opt out of the estate tax will face is the allocation of GST exemption. As discussed above, in the 2010 Act Congress rejiggered the GST tax so that taxpayers had a maximum \$5 million GST exemption in 2010 even though the GST tax rate was zero in 2010. This means that if a decedent's estate plan creates trusts with respect to which a later generation-skipping transfer could occur, the personal representative has an opportunity to allocate GST exemption to such a trust. As noted above, it is unclear on what form a personal representative will make such an allocation.
6. A particular problem for 2010 estates in which the decedent's estate planning documents had formula provisions is how to interpret those

provisions in light of the way the 2010 Act actually turned out. It is, of course, difficult to generalize about this issue because estate planning documents differ considerably from one another. There are, however, some common themes.

a. In many situations, the decedent's estate planning documents may not have addressed the possibility of repeal.

(i) Marital deduction formulas, for instance, may be difficult to interpret or may produce odd results. It is difficult to generalize about formulas of this kind because they differ so greatly from client to client.

(ii) Formulas tied to a decedent's remaining amount of GST exemption could also be problematic. It may have been a client's intention to maximize property allocated to skip persons or trusts from which generation-skipping transfers would be made if the GST tax was repealed. If, however, the client's estate planning documents use a formula tied to his or her remaining exemption, those direct skips could be fairly small because Congress preserved the GST exemption in the 2010 Act at the increased amount of \$5 million. Again, disclaimers may allow a family to sort out an unclear situation.

(iii) The Washington legislature attempted to help in situations of this kind here by enacting RCW 11.108.090, which provides:

(1) A will or trust of a decedent who dies after December 31, 2009, and before January 1, 2011, is deemed to refer to the federal estate and generation-skipping transfer tax laws as they applied with respect to estates of decedents dying on December 31, 2009, if the will or trust contains a formula that:

(a) Refers to any of the following: "Unified credit," "estate tax exemption," "applicable exemption amount," "applicable credit amount," "applicable exclusion amount," "generation-skipping transfer tax exemption," "marital deduction," "maximum marital deduction," or "unlimited marital deduction;"

(b) Measures a share of an estate or trust based on the amount that can pass free of

federal estate taxes or the amount that can pass free of federal generation-skipping transfer taxes; or

(c) Is otherwise based on a provision of federal estate tax or federal generation-skipping transfer tax law similar to the provisions in (a) or (b) of this subsection.

(2) This section is presumed to not apply with respect to a will or trust that (a) is executed or amended after December 31, 2009, or (b) clearly manifests an intent that a contrary rule applies in cases where the decedent dies on a date on which there is no then-applicable federal estate or federal generation-skipping transfer tax and such tax has been permanently repealed and not merely temporarily repealed for calendar year 2010.

(3) The reference to January 1, 2011, in this section refers, if the federal estate and generation-skipping transfer tax becomes effective before that date, to the first date on which such tax becomes legally effective.

(4) Construction of a will or trust under this section may be confirmed pursuant to the procedures set forth in the trust and estate dispute resolution act in chapter 11.96A RCW.

It is too early to tell what the effect, if any, is of this statute and how families use it – or try to get out of its application – in order to resolve open questions related to estate plans.

b. Even if a decedent's estate planning documents contemplated repeal, because Congress "repealed" the estate tax and GST tax in such a convoluted way, determining how to distribute such a decedent's estate plan may be complicated.

(i) A decedent's estate plan may have anticipated the possible repeal of the estate tax by providing for dispositions in a certain manner if the estate tax was in fact repealed at the decedent's death. Of critical importance in these situations is how the estate planning documents defined repeal because, of course, it turns out that the federal estate tax was not in fact repealed for 2010 under the 2010 Act. Instead, the estate tax applies unless the decedent's

personal representative elects the carryover basis regime of IRC § 1022 to instead apply. On the other hand, if the client died before December 17, 2010, the estate tax was in fact repealed at his or her death. So how do you interpret the document? In most of these situations, the intent of the decedent was probably for the alternate no-estate-tax provisions to apply no matter how the 2010 Act turned out as long as it did not reinstate the estate tax. But the document might be clear enough in its provisions so as to be unambiguous, which means that relying on the decedent's intent might be inappropriate. In these situations disclaimers might be able to provide a suitable fix up.

- (ii) The same issue could arise for an estate planning document that conditioned certain transfers on the repeal of the GST tax. It turns out that the GST tax was not in fact repealed in 2010, but was imposed at a rate of zero. This can lead to issues on how to interpret dispositions that were defined by reference to the GST being repealed.

IV. Planning with the New \$5 Million Gift Tax-Free Amount

A. Overview

1. One of the most significant changes Congress made in the 2010 Act was the ostensible reunification of the estate tax-free amount and the gift tax-free amount and the increase in that amount to \$5 million for 2011 and 2012. The \$4 million increase in the gift tax-free amount for 2011 has significant implications for clients with large estates because it allows them to make significant additional gifts without the payment of gift tax in 2011 and 2012. The potential expiration of the increase, however, complicates the picture for these clients.
2. The way Congress changed the gift tax-free amount in the 2010 Act was to link the credit that is applied after a tentative gift tax is computed to the “applicable credit amount” under IRC § 2010(c) that would apply “if the donor had died as of the end of the calendar year” in which the gift is made. The applicable credit amount for estates of decedents who die in 2011 and 2012 is \$1,730,800 which shelters \$5 million of gifts from gift tax.
3. Congress, of course, has changed the gift tax-free amount numerous times since the unification of the gift tax and estate tax system in 1976. And each time they did so in different ways. For example, from 1977 to 1997, the maximum unified credit under IRC § 2505 was a hard number. After 1997, Congress defined the gift tax “applicable credit” as the tentative tax

calculated on an applicable exclusion amount. For example, in 1998 the applicable exclusion amount was \$625,000 and the tax on that amount under the then applicable rate schedule was \$202,050.

4. Subject to a few computational quirks, which are described below, the effect of this change is to give clients who have previously made taxable gifts the ability to make at least \$4 million of taxable gifts in 2011 and 2012 without the payment of gift tax. In making this change, however, Congress, in a move reminiscent of EGTRRA, left open a number of issues that make the use of this increased gift tax-free amount more complicated than it appears.

B. *Computing the Gift Tax-Free Amount for Clients in 2011 or 2012*

1. If a client has never made any taxable gifts, computing his or her gift tax-free amount in 2010 is easy: it is \$5 million. But it is only for these clients that the computations are easy.
2. The reason why computations become difficult for clients with previous taxable gifts is because Congress in the 2010 Act again changed the way in which the gift tax-free amount is determined. In general, the way a person is supposed to compute his or her gift tax in 2011 and 2012 is to add his or her 2011 or 2012 gifts to all previous adjusted taxable gifts (i.e. post-1976 taxable gifts). The person would then compute a tentative tax on the sum using the 35% rate in effect in 2011 or 2012 and then subtract \$190,800. *See* IRC § 2505(a) (flush language added by 2010 Act); Instructions to 2010 IRS Form 709. If the sum is zero or less, then he or she owes no gift tax.
3. Congress and the IRS apparently intended this apparently simple method of computing the gift tax as a fix to the fact that tax computed on gifts made in years before 2010 would have been paid at a rate higher than 35%, which as described above with respect to 2010 gifts could have understated a client's available gift tax-free amount in 2011 and 2012.
4. For 2010 the IRS took the view that a client's used credit should be based on the 2010 rates, though as discussed above this approach is questionable. The IRS is likely to take the same approach for 2011 and 2012 gifts.
5. For clients who have not previously paid gift tax, the apparent method of computing their gift tax-free amount in 2011 and 2012 should result in the client being able to make tax-free gifts in an amount equal to the difference between \$5 million and the amount of previous adjusted taxable gifts. For example, a client who made \$600,000 gifts in 1996 when the unified credit of \$192,800 sheltered \$600,000 of taxable gifts should be able to make \$4.4 million of taxable gifts in 2011. Similarly, a client who

made a \$1 million gift in 2003, when \$1 million was the maximum gift tax-free amount, would be able to make a \$4 million gift in 2011 without the payment of gift tax.

6. Clients who paid gift tax before 2002 but who made no taxable gifts thereafter may be able to make gifts in excess of \$4 million in 2011 and 2012 because they have not yet received the benefit of the increased gift tax-free amount that came into effect in 2002. For example, assume a client made a \$1 million gift in 2001 when the maximum gift tax-free amount was \$675,000. He or she could make a tax-free gift in 2011 of \$4,325,000, which gives the client the benefit of the \$325,000 increase in the gift tax free amount in 2002. For a client who paid gift tax before 1998, the numbers become more complicated. For example, a client who made a \$1 million gift in 1994 can make a tax-free gift in 2011 of \$4,394,200. You would have thought the tax-free amount in 2011 should be \$4.4 million because the gift tax-free amount in 1994 was \$600,000. But such a gift would trigger \$2,000 of gift tax. The outline explains the reason for this anomaly above in detail, which has to do with the fact that the unified credit was a hard number until 1998 and was not tied to a particular tax rate.

C. *Lifetime Gift Planning in 2011 and 2012: Using the New Gift Tax-Free Amount*

1. Clients who have sufficient assets and income flow should consider making lifetime gifts to use the newly increased gift tax-free amount. Assuming the continued existence of the federal estate tax, making such large tax-free gifts will take advantage of the time value of money by freezing the transfer tax value of the property at its value as of the date of the gift. If a client gives property away during lifetime, any appreciation subsequent to the gift is generally free from transfer tax until the donee transfers the property. By contrast, if a client retains an asset until his or her death, all the appreciation at his or her death will be subject to federal estate tax.
2. In particular, Washington resident clients with large estates should seriously consider making lifetime gifts to use the new gift tax-free amount.
 - a. Washington does not have a gift tax, and its estate tax applies only to transfers by reason of a decedent's death. This gives clients who live in Washington an incentive to make wealth transfers by gift rather than at death. If the client makes a wealth transfer during life, federal gift tax may apply to the transfer. If the client makes a wealth transfer at death, both federal estate tax and Washington estate tax may apply to the wealth transfer.

- b. Washington residents with substantial estates should consider using the new gift-tax free amount while it lasts to save on Washington estate taxes that may be due on their deaths.
- (i) Assume, for example, a Washington resident individual has a \$10 million estate. If he died owning the entire \$10 million, his estate would owe \$1,255,000 of Washington estate tax, taking the \$2 million Washington reduction into account, and federal estate tax of \$1,310,750 (taking into account the IRC § 2058 deduction for state death taxes, for a combined tax of \$2,565,750.
 - (ii) If the client makes a \$5 million lifetime gift, he will not owe any gift tax. If the client dies in 2012, he will have a Washington taxable estate of \$3 million and a federal taxable estate of \$4,280,000 (taking the IRC § 2058 deduction into account). The Washington estate tax on the decedent's estate will be \$720,000 and the federal estate tax will be \$1,498,000, for a total of \$2,281,000. This is \$284,750 less than if he died owning all \$5 million.
 - (iii) If the client made an \$8 million taxable gift in 2011, he could further reduce the total transfer taxes on his estate. The gift tax on the \$8 million gift would be \$1,050,000. Assume that the client dies in 2012 before paying the gift tax, so that the debt deduction neutralizes the inclusion of the gift tax in the client's estate. For federal purposes, the estate will have a tentative tax base of \$10 million, which generates a tentative tax of \$1,750,000. The estate will receive a credit for the gift tax of \$1,050,000, leaving \$700,000 in federal estate tax payable. Because the decedent's Washington estate is \$2 million – the Washington estate tax-free amount – the estate will pay no Washington estate tax. The total transfer tax bill for the client and his estate is \$1,750,000, which is \$815,750 less than his estate would have paid if he died owning all \$10 million of assets.
- c. One concern with making lifetime gifts of appreciated assets is the loss of the new basis currently available at the donor's death under IRC § 1014. In the case of a taxable gift, the gift will be includable in the donor's estate tax computation as an adjusted taxable gift based on its date of gift value. Thus, the federal transfer tax benefit produced by a lifetime taxable gift is to exclude all future growth in asset value and income from the asset from the estate tax. In many cases this benefit will greatly exceed the possible loss of new basis due to the difference between estate tax

and capital gains tax rates. While avoidance of the Washington estate tax is an additional benefit, the overall benefits must be compared closely to the potential capital gains tax cost where the planner is considering a taxable gift for a client who is elderly or in bad health.

- d. One way to avoid the lost basis step-up from a lifetime gift is for the client to obtain a line of credit from a bank or other lender. The credit line could be activated shortly before the client's death, allowing the client to make a cash gift. As a result, the client's estate will have a deductible debt to offset the estate taxable value of the retained assets and will still get a new basis for those assets.
 - e. To facilitate the possibility of making deathbed gifts, the client should have a durable power of attorney that specifically permits the designated agent to make gifts on his or her behalf, and to borrow money if appropriate. Without specific language, in most states an agent has no gift-giving power even if the power of attorney grants the agent the ability to do everything the principal could if not incompetent.
3. As always, clients should give assets with the most growth potential, although that can be a guessing game. Ordinarily we would advise clients to consider making gifts of discountable assets, such as fractional interests in real estate, shares in closely held companies, and interests in family partnerships. Valuation discounts, while still viable and in wide use, have become more controversial with the courts and the IRS, particularly in the case of family limited partnerships and other devices designed to generate discounts. For many clients, the substantial increase in the gift tax-free amount may mean that they will not need to depend on discounts, real or engineered, to make effective use of the gift tax-free amount. Clients in this situation can freely make gifts without discounts and achieve meaningful estate planning results, particularly when you consider the possibility of avoiding Washington estate tax.
4. Some clients may be "house rich" but otherwise not able to part with a lot of their liquid assets or may not have discountable assets to give. The gift of a valuable house to a QPRT is likely to be a good way use the increased gift tax-free amount.
- a. When a client creates a QPRT, he or she makes a gift of the residence less the actuarial value of his or her retained use of the residence and any reversionary interest the client retains. The client, however, need not part with possession of the residence; during the QPRT term, the client can use the residence rent-free and continue to pay its expenses. To this extent, while the client has made a taxable gift, the client has not actually parted with any

assets or otherwise made any sacrifice in his or her lifestyle. This could be an ideal gift for a client who has a valuable house but few other valuable assets, particularly when the value of the house exceeds \$2 million (the Washington estate tax-free amount).

- b. Of course, the potential disadvantage of a QPRT is that when the QPRT term ends, the client must relinquish possession of the house. A client, however, can create a “remainder” trust in the QPRT that will allow the trustee to retain the residence and rent it back to the client for a fair market rent for as long as the client wishes to reside in the residence. Alternatively, the remainder trust could be for the benefit of the client’s spouse, which would effectively allow the client to continue to use the residence as long as he or she is married to the spouse.
- c. Clients who build in a lease-back provision, however, are not usually keen on the idea of paying rent to live in a residence that they still consider their own, which means that sometimes clients fail to follow through with actually making rent payments, which potentially exposes their residence to inclusion in their estate pursuant to IRC § 2036. While we may not be able to change our clients’ opinions about the desirability of paying rent, we may be able to hedge the risk that their residences may be included in their taxable estates in the event they fail to pay rent. This could be done by adding a provision to the QPRT that provides that the client will have an option to rent any residence that the trust owns for its fair market rental value and that the option will be deemed to be exercised (in the absence of written notice of its exercise) if the client occupies the residence. Further, the trust agreement could provide that in the absence of a written lease agreement between the client and the trustee with respect to a residence over which the option is exercised, the client’s tenancy with respect to the residence is month-to-month.
- d. The benefit of granting the client the option to rent the residence following the end of the QPRT term that is exercisable by the client’s continued occupation of the residence, is that it may evidence the client’s intention and obligation to pay rent to the trustee even though the client failed to do so. In *Estate of Riese v. Comm’r.*, T.C. Memo. 2011-60, the Tax Court ruled that a decedent’s gross estate did not include the value of her personal residence that she transferred to her children through a QPRT where there was evidence of a longstanding agreement between the decedent and her children (the remainder beneficiaries of the QPRT) that she was obligated to pay fair market rent. Granting the client an option exercisable by continued occupancy of the residence also may provide a basis for arguing that any unpaid rent

payable to the trustee at the client's death should be deductible by the client's estate, as was permitted in *Estate of Riese*.

5. When making lifetime gifts, clients should consider establishing a long term, multigenerational irrevocable trust because such a trust is a particularly advantageous vehicle for clients whose estates exceed the newly increased gift-tax free amount.
 - a. A trust to which the client allocates the increased GST exemption should be free from estate, gift, and GST tax as long as those taxes are in existence. The tax planning benefits and creditor protection benefits of such "multigenerational" or "dynasty" trusts, whether they are grantor trusts or nongrantor trusts, have been well described elsewhere and we do not need to cover that ground in this outline. Clients and their advisers became used to planning of this kind in 1997 and even more so in 2001 when Congress successively increased the gift tax-free amount and the GST exemption.
 - b. Many clients who have sufficient assets and income flow to take advantage of the newly increased gift tax-free amount by making lifetime gifts may be hesitant to do so because of the risk that their circumstances may dramatically change in the future and they may unwittingly impoverish themselves. The sharp economic downturn that took place during the past few years is fresh in most clients' minds and may serve as a deterrent to their fully utilizing the exemptions available to them. Given the unprecedented amount of assets that clients could potentially transfer to future generations transfer tax-free, consideration should be given to structuring multigenerational trusts that serve not only as wealth transfer vehicles but also as safety nets for the clients.
 - c. For example, this could potentially be achieved if a husband were to establish a trust for the benefit of his wife and children, and a wife were to establish a trust for the benefit of her husband, which granted the husband a limited power of appointment over the assets and provided that the assets would be distributed among the children at the husband's death. It is possible that the IRS could view these trusts as "reciprocal" and take the position that each of the husband and wife created a trust for his or her own benefit that should be included in his or her respective taxable estate. However, given that the wife and the children are co-beneficiaries of the trust that the husband created and the husband is the sole beneficiary of the trust the wife created, an argument could be made that the trusts are not reciprocal because (1) the husband's interest in the trust that the wife established is not identical to the wife's interest in the trust that the husband created and (2) each of

them are not in approximately the same objective economic position as they would have been had they each created trusts for themselves, both of which were significant factors that the Supreme Court considered in determining whether two trusts were reciprocal in *United States v. Grace*, 395 U.S. 316 (1969). Nevertheless, if a client wanted to take a more conservative approach, the wife could consider establishing a trust for the benefit of her children that allows an independent third-party to add her husband as a beneficiary.

- d. Regardless of which approach the client takes, while economic conditions are good, the assets in the multigenerational trusts would be allowed to accumulate and no distributions would be made. However, if there were another economic downturn, each of the husband and wife could potentially receive distributions from one another's trusts. Distributions also could be made to the children from the husband's trust in the trustee's discretion and from the wife's trust pursuant to the husband's limited power of appointment.
 - e. Another benefit of a trust of this kind is that the trust may serve as a family investment vehicle that may purchase assets that remain inside the client's taxable estate. Prior to the increase in the gift tax-free amount, many clients who were interested in freezing the value of cash-generating appreciable assets did not have sufficient gift tax exemption remaining to "seed" a trust with the necessary capital to enter into desirable sale transactions. Now those clients have another bite at the apple and are able to put into place vehicles that can be used for generations to come for value-freezing purposes.
 - f. Clients who do not have assets that are appropriate to sell to a multigenerational may want to consider lending funds to a multigenerational trust in exchange for a promissory note. The client will effectively transfer assets transfer tax free to the trust to the extent the trust earns a rate of return on the loaned assets in excess of the IRS minimum required interest rate for the month of the transaction. For example, if a client loans \$1 million to a trust in exchange for a nine-year interest-only balloon promissory note at a rate of 2.44% (the mid-term IRC § 1274(d) rate for May 2011) and earns a compounded annual rate of return of 8% on the loaned assets, the client will effectively transfer \$56,000 transfer-tax free to the trust each year.
6. Since 2001 GRATs, sales to grantor trusts, and other freeze devices were very popular because they allowed clients to make transfers without paying a gift tax. Clients thought that this was particularly important

because of the pending repeal of the estate tax and their unwillingness to pay gift tax when there was a nonunified system. Now that the gift tax-free amount has so dramatically increased, clients with more modest sized estates will not need to do freeze transactions and suffer the resulting complexity.

7. Clients who entered into intrafamily sales and loans in the last ten years as part of an estate freezing strategy may want to close out those transactions by giving away the associated promissory notes and installment obligations. For example, the client could forgive outstanding notes and make taxable gifts based on the fair market value of the notes, which is not necessarily the outstanding balance of the note plus accrued interest. Closing out transactions of these kind, particularly installment sales to grantor trusts, has the advantage of avoiding all of the well-documented income tax uncertainties that come into play if the grantor dies before the trustee has paid off the installment obligation.
8. For clients with more modest sized estates, the increase in the gift tax-free amount gives an opportunity to reconsider how to make annual exclusion gifts. The present interest requirement for annual exclusion gifts is a big nuisance in many situations because it requires the use of *Crummey* powers or IRC § 2503(c) trusts, all of which give the donee a power to withdraw assets on certain occasions. *Crummey* trusts can also be quite difficult to administer. Although a Uniform Transfers to Minors Act custodial account is a simpler option for some donees, the accounts are not particularly flexible and must terminate when the donee becomes an adult. The increase in the gift tax-free amount means that clients may want to consider making modest gifts that would otherwise be annual exclusion gifts to longer term trusts that are more flexible than the sorts of arrangements that qualify for the annual exclusion, at least for the next two years while the gift tax-free amount remains at \$5 million.

D. *Effect of Using the Gift Tax-Free Amount in 2011 or 2012*

1. A question frequently asked by clients who are considering utilizing the newly increased gift-tax free amount, as well as by estate planning professionals, is what happens if the gift-tax free amount is decreased in the future? Will clients who fully utilized their lifetime exemption from gift tax in 2011 or 2012 be subject to gift tax in the future if Congress reduces the applicable “unified” credit? Unfortunately there is no clear-cut answer to this question, although there is the wealth of speculation and conjecture on the matter.
2. The root of the confusion lies with how the estate tax is calculated. The amount of estate tax that a decedent’s estate owes is calculated as follows:

Step 1: Calculate the tentative tax due on the sum of (a) the taxable estate, plus (b) all post-76 taxable gifts. IRC § 2001(b)(1).

Step 2: Reduce the tentative tax due by the aggregate amount of tax that would have been payable with respect to such gifts (a) had the gifts been subject to the tax rate in effect at the decedent's death and (b) had the unified credit been calculated based on the tax rate in effect at the decedent's death. IRC § 2001(b)(2). This is done by multiplying the post-76 taxable gifts by the tax rate in effect on the decedent's death minus the unified credit in effect on the decedent's death (determined using the tax rate in effect on the decedent's death).

Step 3: Apply the unified credit in effect on the decedent's death to the tentative tax (as reduced by the amount calculated in Step 2). IRC § 2010.

3. The problem with this calculation is Step 2, which is intended to account for any difference between the marginal gift tax rate imposed for the year of the gift and a higher marginal estate tax rate imposed for the year of the decedent's death. Specifically, it is not clear whether the unified credit that is calculated in Step 2 (based on the tax rate in effect on the decedent's death) should be determined using the applicable exclusion amount in effect on the decedent's death or the applicable exclusion amount in effect on the date of the gift.
4. This glitch is problematic because if the applicable exclusion amount in effect on the date of death is used to determine the unified credit in Step 2, then the decedent could lose the benefit of the larger unified credit that was in effect on the date of the gift. This could have the effect of the decedent being treated as if he or she made his or her gift in the year of death instead of in the actual year that he or she made the gift. That is, the decedent's gift could be effectively pushed forward to the year of the decedent's death and the IRS could collect from the decedent's estate as estate tax the gift tax that would have owed had the client made all his or her taxable gifts in the year of death. The potential difference in tax payable can be illustrated by the following numerical examples:

Example 1 – Date of Gift Applicable Exclusion Amount Used in Step 2: Decedent makes a gift of \$5 million in 2011 and dies in 2013 with a taxable estate of \$10 million.

1.	Tentative tax on \$15 million (\$10 million estate + \$5 million post-1976 gifts)		\$6,630,800
2.	Less gift tax on \$5 million gift (using date of death rate (45%) <u>minus</u> unified credit (using date of gift applicable exclusion (\$5 million) and date of death rate (45%))	(\$2,130,800 - \$2,130,800)	(0)

3.	Less unified credit (using date of death applicable exclusion (\$3.5 million) and date of death rate (45%))		(\$1,455,800)
	Estate Tax		<u>\$5,175,000</u>

Example 2 – Date of Death Applicable Exclusion Amount Used in Step 2:
Decedent makes a gift of \$5 million in 2011 and dies in 2013 with a taxable estate of \$10 million.

1.	Tentative tax on \$15 million (\$10 million estate + \$5 million post-1976 gifts)		\$6,630,800
2.	Less gift tax on gift tax on \$5 million gift (using date of death rate (45%) <u>minus</u> unified credit (using date of death applicable exclusion (\$3.5 million) and date of death rate (45%))	(\$2,130,800 - \$1,455,800)	(\$675,000)
3.	Less unified credit (using date of death applicable exclusion (\$3.5 million) and date of death rate (45%))		(\$1,455,800)
	Estate Tax		<u>\$4,500,000</u>

Countless iterations of the foregoing examples can be conducted showing the various disconnects that may occur. The Akers outline has similar examples and additional examples that illustrate all the issues raised by the “clawback” provisions.

5. Congress attempted to resolve this problem by adding IRC § 2001(g), which provides that the tax rates in effect at the decedent’s death, instead of the tax rates in effect on the date of the gift, are used to calculate the tax imposed and the applicable credit. However, this does not resolve the problem because it only requires the substitution of the *current rates* in determining the amount of gift tax payable and not the substitution of the *applicable exclusion amount* in IRC § 2010(c). And even if IRC § 2001(g) did resolve the problem, the fix would only be temporary because IRC § 2011(g) will sunset after 2012 along with the rest of the 2010 Act.
6. Notwithstanding the confusion surrounding the calculation of the estate tax following the sunset of the 2010 Act and the possibility that a portion of gifts made in 2011 or 2012 could be recaptured upon the donor’s death, most commentators and estate tax practitioners agree that clients should nevertheless take advantage of the increased gift-tax free amount. Just as was the case in 2010, many feel confident that Congress will act before the 2010 Act sunsets and resolve these problems as Congress has done many

times in the past when it has enacted laws that have resulted in unintended consequences. Further, any detriment that a client may suffer from a partial recapture of a gift made in 2011 and 2012 may be offset by the future appreciation of the transferred assets that would escape current taxation.

V. **Drafting Estate Planning Documents in 2011**

A. *Introduction*

1. Lawyers and accountants often recommend that married clients use a formula disposition in their estate plans tied to the client's remaining applicable estate tax exclusion or "credit shelter" amount. Nonmarried clients, and some married clients, may use formulas tied to the client's remaining GST exemption. EGTRRA, of course, wreaked havoc with formula provisions. The 2010 Act prolongs these side effects of EGTRRA and raises additional issues. The near certainty of additional legislative tinkering with the estate tax statutes for 2013 and beyond and the sunset of the 2010 Act adds to the complications and the difficulty of drafting estate planning documents.
2. This section of the outline discusses some, but by no means all, of the issues that may arise with respect to formula dispositions in the estate plans of clients as the law changes, which will happen even if Congress does nothing.

B. *Drafting for the Increase in the Estate Tax-Free Amount*

1. The increase in the estate tax-free amount to \$5 million from \$3.5 million means that relative size of the credit shelter share of a decedent's gross estate has increased. The interaction of this increase in the credit shelter share and the formula disposition in the decedent's estate planning documents may be inconsistent with the client's objectives. This is, of course, now familiar to us following the ramp-up of the estate tax-free amount between 2002 and 2009.
2. If the decedent's estate plan creates a credit shelter trust and the surviving spouse is the only beneficiary of that trust, the relative sizes of the credit shelter share and the marital share would appear to not make much of a difference. Upon further analysis, however, several issues emerge:
 - a. If the spouse has a discretionary income interest in the credit shelter trust, his or her cash flow may be reduced significantly as the marital trust or gift shrinks and the credit shelter trust increases.
 - b. The standard for principal distributions in the credit shelter trust may also cause a problem. If the spouse is not acting as trustee of the credit shelter trust and distributions to him or her are based on

a discretionary, nonascertainable standard, the surviving spouse may have a more difficult time accessing the principal of the trust. This could in turn require the surviving spouse to compromise his or her lifestyle.

- c. Potential ways to address this problem include:
- (i) Use a non-tax based formula that allocates a specific amount or specific percentage of trust assets to the credit shelter trust and the balance to the marital trust.
 - (ii) Use a traditional tax-based formula with a cap on the size of the credit shelter trust or a minimum size for the marital share. This approach could result in a smaller credit shelter trust than permitted under the tax law. If, however, the marital gift was in QTIP trust form, the personal representative could use the balance of the decedent's remaining estate tax applicable exclusion amount by not electing to qualify all the marital trust for the marital deduction.
 - (iii) Use a single residuary trust in which the surviving spouse has a "qualifying income interest for life," making the trust eligible for a QTIP election. This will allow the decedent's personal representative to make a partial QTIP election that takes full advantage of the decedent's remaining applicable estate tax exclusion amount while retaining the surviving spouse's income stream and access to principal. This may work well for smaller estates, but in a larger estate, the mandatory income interest for the surviving spouse will leak assets out of the credit shelter portion. In this latter case, the client and his or her advisers might consider using a "Clayton" type approach that provides that the nonelected portion of the residuary trust assumes a form different than the marital deduction share. In other words, the nonelected portion could give the surviving spouse a discretionary income interest and less access to principal than he or she would have over the elected portion. *See* Treas. Reg. § 20.2056(b)-7(d)(3).
 - (iv) Another approach for a smaller estate would be to give the entire estate to the surviving spouse and provide for the creation of a credit shelter trust by disclaimer. The spouse can then disclaim an appropriate amount to fund the credit shelter trust, considering all of her circumstances. This will put the tax planning decisions in the hands of the surviving spouse.

- d. Issues could also arise if the decedent's estate plan creates a credit shelter trust of which the surviving spouse and other family members are beneficiaries.
- (i) If a significant amount of the family's wealth will end up in the credit shelter trust, the surviving spouse may be dependent on the income and principal of the trust to maintain his or her accustomed standard of living.
 - (ii) The trustee, however, will be under a fiduciary duty to balance the interests of the spouse and the other beneficiaries, some of whom may also have needs for cash flow and principal distributions. If the surviving spouse is not the trustee of the trust, he or she may have to live on less income and have less access to principal funds with a larger credit shelter trust.
 - (iii) This can be addressed by providing that the decedent intends that the surviving spouse be the primary beneficiary of the credit shelter trust. Consider the following paragraph, with the key language italicized:

Income and Principal. During my husband's life, the trustee shall pay to any one or more of my husband any my descendants so much of the income and principal in such proportions as is necessary from time to time for the respective support, maintenance, health and education of my husband and my descendants, *giving priority to my husband.*
 - (iv) Another way to approach this issue is to require the trustee to pay a certain amount of cash flow to the surviving spouse, either in terms of a mandatory income interest or a unitrust interest. The client could also give the surviving spouse a 5 x 5 withdrawal power over the trust assets.
- e. Difficult issues may arise when the surviving spouse is not a beneficiary of the credit shelter formula gift in a decedent's estate plan.
- (i) In some situations a client may not give the surviving spouse a beneficial interest in the credit shelter share. This could happen because the client thought he or she had used up most or all of his or her estate tax-free amount. This could also happen because the client's estate plan uses his or her remaining exclusion amount to make specific gifts or

because the client has children from a prior marriage whom he or she wishes to benefit.

- (ii) The increase in the estate tax-free amount presents a problem for this estate plan when it uses a formula tied to the decedent's applicable credit amount because that amount will swell in 2011 and 2012 and may distort the client's estate plan.
- (iii) Some of the client's options in this situation are:
 - (a) Divide the residue between the spouse and other family members based on a traditional tax-driven formula.
 - (b) Divide the residue based on a fraction or dollar amount not tied to the estate tax principles. This approach, however, may trigger a federal estate tax or state death tax.
 - (c) Make lifetime gifts to the surviving spouse, either outright or in trust. This would allow the client to avoid changing his or her estate plan as the tax laws change.

f. If you do use a formula, what sort of formula should you use?

- (i) The increase in the estate tax-free amount to \$5 million (following on the heels of the 2009 increase from \$2 million to \$3.5 million) is likely to have significant implications in the choice of formula for clients' estate planning documents, particularly for those clients who do not have massively large estates.
- (ii) A pecuniary credit shelter lead formula will generate a larger pecuniary gift as a consequence of the increase in the estate tax-free amount. If the will or revocable trust requires the fiduciary to fund the gift at date of distribution values, it is possible that funding the gift could generate capital gains taxes. The pecuniary gift is also a problem for a larger estate because it freezes the amount passing to the credit shelter trust, allowing the marital residue to receive all of the appreciation in the estate assets during estate administration.
- (iii) A pecuniary marital lead formula may be a better choice for a smaller estate because it minimizes the size of the pecuniary gift in an estate and, therefore, the potential for

capital gains on funding. The pecuniary marital lead formula, however, may inappropriately cap the size of the marital gift in a small estate, leading to less cash flow and ready access to funds for the surviving spouse. For larger estates, the pecuniary marital gift has always been beneficial because it allows the credit shelter residue to pick up all the appreciation on the estate assets during estate administration. The larger the estate, the larger the capital appreciation allocable to the transfer tax-exempt residue.

- (iv) As discussed above, a pecuniary formula gift could lead to unnecessary capital gains taxes and, in smaller estates, potentially inappropriate limits on a spouse's share of a decedent's estate. A fractional share formula avoids the capital gains tax problem because funding a fractional share formula gift does not give rise to capital gain. Furthermore, a fractional share formula evenly allocates the gains and losses between the credit shelter share and the marital share, thereby avoiding overfunding one share at the expense of the other.

C. *What About Another Repeal (or Further Changes)?*

1. Although the prospects for permanent repeal of the estate tax appear to be low, it is possible that Congress again will repeal the estate tax on a temporary or permanent basis. Even if Congress keeps the estate tax, the tax law will change. Congress's unfortunate reliance on temporary changes to the estate tax and gift tax laws makes advising clients and drafting documents very difficult. Without some certainty as to what the laws will be, how can clients make the right decisions for their families and we as advisers draft documents that will for sure implement their wishes?
2. When Congress continues to change the laws in unpredictable ways, tax-driven formulas can be real mischief makers in estate plans. At a very basic level, we should first consider whether formulas are necessary or even desirable in estate plans for clients. For example, for the next year and half, the estate tax-free amount is \$5 million. At the beginning of 2013, absent further changes in the law, the estate tax-free amount will be \$1 million. A client without a taxable estate today might have one in two years' time. What kind of formula, if any, should we use in such a client's estate planning documents? You might conclude that a formula is not necessary.
3. One way to address this is to not use formulas at all. If the estate tax (federal or state) or GST tax does not apply to the client's estate,

eschewing formulas will result in an estate plan that best reflects the client's desires. Or you could plan on relying on post-mortem planning through disclaimers and tax elections to optimize the tax planning for a decedent's estate. It turns out that post-mortem planning was one of the best ways to optimize the tax planning for 2010 estates in light of the elections allowed in the 2010 Act and the extended time period for disclaimers. This approach does count on an attentive personal representative, cooperative family, and good legal and tax advice, which may not always coincide, so it is a bit of a risky approach.

4. If you do want to use a formula in newly drafted estate planning documents, you should consider how the formulas should be applied and interpreted if Congress again repeals the estate tax, increases or decreases the estate tax-free amount or makes substantial changes to the system that would raises questions about how the formulas operate.
5. In lieu of a formula-with-interpretation provisions, the drafting lawyer could recommend an alternate disposition that takes effect if there is no federal estate tax.
 - a. For instance, the estate plan could use a traditional formula when there still is an estate tax, but provide for a wholly different disposition if there is no estate tax. Only the client's and the adviser's creativity limits how these dispositions could work.
 - b. The Washington estate tax, with its lower tax-free amount, complicates the analysis for some clients; a formula that operates in a particular way if there is no federal estate tax may give rise to significant Washington estate tax. State death taxes are, of course, a factor for a client who does not live in Washington because he or she might live in a state with a death tax or move to such a state. How, if at all, should you draft for such a client?
 - c. If the client will make a gift in his or her estate plan to the surviving spouse during a repeal period, the client should consider making the gift in trust and not outright. If Congress does not repeal the gift tax during the repeal period and the client gave the spouse the assets outright, the spouse could not make lifetime gifts of those assets without paying gift tax. If, however, the assets are held in a trust of which the spouse and the client's other family members are beneficiaries, the trustee could exercise its discretion to make distributions of assets to the nonspouse beneficiaries without gift tax. Alternately, the trust instrument could give the spouse a lifetime nongeneral power of appointment, though careful consideration must be given to the scope of the spouse's beneficial interest in the trust to avoid the spouse making a gift when he or she exercises the power. Another benefit of making a spousal gift

in trust in a repeal period is that Congress could bring back the estate tax during the surviving spouse's lifetime (as they did in 2010) or institute some other form of transfer taxation. If the family's assets are held in an irrevocable trust, the chances are good that the new tax scheme will not apply to assets held in pre-effective date trusts.

6. Whether you use a formula with interpretative provisions or an alternate set of dispositions if the federal estate tax is repealed, you have one further task: defining repeal.
 - a. After Congress enacted EGTRRA and lawyers began drafting documents with formula provisions that anticipated repeal or alternate dispositions in the case of repeal, they usually defined repeal by reference to how Congress drafted the repeal of the estate tax and the GST tax in EGTRRA. As originally enacted, the federal estate tax did not apply to the estates of decedents who died in 2010 and the GST tax did not apply to generation-skipping transfers that occurred in 2010. Formulas in estate planning documents often tracked the repeal language Congress used in EGTRRA.
 - b. Congress, however, retroactively changed the way the EGTRRA repeal worked in the 2010 Act. Instead of the estate tax not applying to estates of decedents who died in 2010, the tax applies unless the personal representative makes an election to have the IRC § 1022 basis regime apply. Similarly, instead of the GST tax not apply to generation-skipping transfer that occurred in 2010, the GST tax ended up applying to generation-skipping transfers that occurred in 2010 but at a zero rate. These changes by Congress undermined ten years' worth of careful drafting by lawyers to account for the potential for repeal.
 - c. So in light of this last-minute switch by Congress and the fact that it will no doubt act in a similarly capricious manner in the future, how can you be confident that the way you draft a definition of repeal will conform to what actually happens? Are you just better off without formulas at all? Or can you come up with something that covers all eventualities? Some people anticipated the elective regime for the estate tax, but no one anticipated the way that Congress "repealed" the GST tax.

D. *Does Portability Eliminate the Need for Credit Shelter Trust Planning?*

1. In addition to increasing the gift, estate and GST tax exclusions, in the 2010 Act Congress added the concept of "portability" to the estate and gift tax law to in theory allow a surviving spouse to take advantage of his or

her last deceased spouse's unused exclusion amount (referred to in new IRC § 2010(c)(4) as the "Deceased Spousal Unused Exclusion Amount").

2. A surviving spouse can take advantage of his or her deceased spouse's unused exclusion if the deceased spouse dies after December 31, 2010 and his or her personal representative affirmatively elects for the surviving spouse to benefit from his or her unused exclusion on a timely filed estate tax return. IRC § 2010(c)(5)(A). The surviving spouse is the only beneficiary that may benefit from the deceased spouse's unused exclusion.
3. The amount of the deceased spouse's unused exclusion is calculated on his or her timely filed estate tax return. IRC § 2010(c)(5)(A). The IRS may examine this amount at any time, even decades following the deceased spouse's death. No statute of limitations applies. However, the IRS's audit of the deceased spouse's estate tax return is limited to the calculation of the unused exclusion amount. IRC § 2010(c)(5)(B).
4. Notably, use of a deceased spouse's unused exclusion does not eliminate a surviving spouse's obligation to file an estate tax return, even if no estate tax is payable, where the surviving spouse's taxable estate exceeds his or her own exclusion. IRC § 6018(a)(1). For example, a surviving spouse dying in 2011 who made no prior taxable gifts, had a taxable estate of \$10 million and had a Deceased Spousal Unused Exclusion Amount of \$5 million would need to file an estate tax return even though he or she may not owe any federal estate tax.
5. Many clients who learn about portability may believe that portability eliminates the need for a sophisticated estate plan that incorporates a credit shelter or bypass trust. While portability provides a benefit to married couples, it does not render the typical marital trust – credit shelter trust estate plan obsolete.
 - a. Portability applies to the federal estate tax-free amount only. It does not apply to the federal GST exemption or to the \$2 million Washington estate tax-free amount. This means that if a client were to rely on portability exclusively, instead of establishing a credit shelter or bypass trust, the client would unnecessarily forfeit his or her Washington estate tax-free amount as well as the opportunity to leverage his or her federal estate tax-free amount by allocating GST to a trust so its assets may be transferred to future generations free of transfer taxes.
 - b. If a client relies on portability, he or she will forego the opportunity to protect the assets that he or she leaves to his her family from creditors. Assets left to a properly structured credit shelter or bypass trust should not be subject to the claims of the beneficiaries' creditors.

- c. The deceased spouse's unused exclusion amount is not indexed for inflation, so if a client were to rely on portability exclusively, the opportunity to transfer the growth on the deceased spouse's exemption amount between the time of the deceased spouse's death and the time of the surviving spouse's death may be lost. IRC § 2010(c)(3). Assets may appreciate significantly during the course of just a few years, so even if only five years were to pass between the deaths of the spouses, a significant tax-saving opportunity would be lost.
- d. Portability can become complicated when a decedent marries more than once. Given that a not insubstantial percentage of marriages in the United States end in divorce, this is a greater concern than it may initially seem on its face. Specifically, if a spouse leaves assets to his or her spouse in a credit shelter or bypass trust, he or she can ensure that the assets at the surviving spouse's death are allocated to the deceased spouse's children (or whomever else the deceased spouse designates). If a client instead relies on portability and leaves assets outright to his or her spouse, the surviving spouse can do whatever he or she wants with the assets, including giving such assets to his or her new spouse or family. Further, portability applies only to the last deceased spouse of an individual. This means that if a surviving spouse remarries and his or her second spouse also dies, he or she is limited to the second's spouse's unused exclusion amount, even if it is lower than the first spouse's unused exclusion amount. If each of the predeceased spouses had used credit shelter or bypass trusts, each of them could have preserved their respective exclusion amounts for their surviving spouse.
- e. Portability also does not preserve higher estate tax-free amounts. If a spouse were to pass away in 2011 when the exclusion amount is \$5 million, his or her surviving spouse would not have the opportunity to take advantage of his or her full exclusion amount if the exclusion amount is lower in the year of the surviving spouse's death. IRC § 2010(c)(4). For example, if the surviving spouse died when the exclusion amount was \$3.5 million and the deceased spouse only used \$3.5 million of his or her available \$5 million exclusion, the surviving spouse would not get the benefit of the deceased spouse's remaining \$1.5 million unused exclusion amount. The unused exclusion amount is capped at the lesser of the unused exclusion amount and the exclusion amount available at the second death.
- f. Portability sunsets along with the rest of the provisions of the 2010 Act. Clients that intend on relying on portability to take advantage of their exemption amounts may be faced with bearing the expense

associated with redrafting their estate plans in 2013 when the law will probably again change. Worse yet, a spouse who intended to take advantage of his or her deceased spouse's unused exclusion may be in for an unpleasant surprise if Congress eliminates portability altogether.

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