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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1563

Date: 17-Dec-09

From: Steve Leimberg's Estate Planning Newsletter

Subject: Nothing Quite As Sure As Change: 2010 - The Year Without Estate Tax

As this week comes to a close, estate planners throughout the country have been buzzing about an event that many thought was highly unlikely to happen. Namely, that for all or a portion of 2010, we will see the elimination of the estate and GST taxes, coupled with the introduction of a carryover basis for those dying in 2010.

At this point in the legislative session, it appears to many pundits that Congress may have simply run out of options and time for crafting a compromise to fix the estate tax. Not helping matters is the fact that the House's holiday recess is scheduled to start Friday, December 18th, and the Senate is laser-like focused on passing healthcare reform legislation before year-end.

As many news outlets have reported, a defense appropriations bill was viewed by many as the perfect vehicle to attach an estate tax compromise provision to, but at this late hour, it appears as if those efforts may have fallen through. Although the House passed a permanent extension of 2009 estate tax law on December 3rd, pending a last-minute agreement in the Senate, Congress will likely run out of options for handling the estate tax before it adjourns for the year.

As these events began to sink in this week, planners everywhere started asking the types of questions one might expect: "What will 2010 look like?" "Will Congress pass some kind of retroactive bill in the next session?" and most importantly "What should I tell my clients?"

In their commentary, **Carlyn S. McCaffrey** and **Jonathan G. Blattmachr** provide **LISI** members with their insights into an extraordinary event that looks like it is about to occur: the repeal of estate and generation-skipping taxes and the adoption of a carryover basis regime for inherited property for individuals who die in 2010.

Jonathan and Mike Graham of Dallas, Texas, once wrote about this topic in an article published in the May/June 2007 issue of *Probate & Property*, entitled "Thinking About the Impossible for 2010: A Year Without Estate Tax and Carryover Basis." Members may want to get a copy because, as **Jonathan** and **Carlyn** explain, for most people, it is still not too late to take this extraordinary event into account. They also educate members on some of the planning opportunities and potential pitfalls that will arise next year.

Jonathan G. Blattmachr is the author of five books and hundreds of article. Jonathan's first book, written with Tom McGrath, "Carryover Basis Under the 1976 Tax Reform Act" was published in 1977 by the *Journal of Taxation*. Although the 1976 version of carryover basis has been repealed, the book contains several insights about such a regime which will be appropriate to consider next year.

Carlyn S. McCaffrey is a partner and head of the estate planning group at **Weil, Gotshal & Manges** in New York, a past president of the American College of Trust & Estate Counsel (ACTEC), an adjunct professor at the New York University School of Law and the Miami University Law School and a prolific author and frequent lecturer.

Here is their most timely and important commentary:

EXECUTIVE SUMMARY:

In the 2001 Tax Act known as EGTRRA, many changes were made to the transfer tax system including increasing the estate and generation-skipping transfer (GST) exemptions for this year to \$3.5 million, lowering the top rate for all three transfer tax systems to 45%, eliminating the state death tax credit and repealing the estate and GST taxes (but not the gift tax), dropping the top gift tax rate to 35%, and the elimination of the "step up" in basis under section 1014(a) of the Internal

Revenue Code so the decedent's basis will "carryover" to those who inherit his or her property.

The 2001 Act, however, also included a "sunset" provision that eliminates all of the changes the Act made (including the transfer tax changes) at the end of 2010. Unless the Code is changed, beginning in 2011, the estate tax exemption will drop to \$1 million, the top estate, gift and GST tax rate will become 55% as it was before the 2001 Act (and it can be 60% for some estate and gift tax transfers), the estate and gift tax system will again be "unified," the state death tax credit under section 2011 will be restored and several other important provisions will again be as they were before EGTRRA.

These fundamental changes in the transfer tax law present an extraordinary opportunity for advisors and their clients, along with significant potential dangers. Because of the possibility of retroactive legislation that reinstates the transfer tax system as it exists in 2009, there is risk that any action taken on the premise that the estate and GST taxes are gone for the year and that the gift tax rate will be only 35% could produce unexpected transfer taxes.

COMMENT:

Complications for Formula Gifts

Many gifts under wills and trusts are defined in terms of tax concepts. For example, many married people divide their estates into two broad portions: one portion equal to the unused estate tax exemption (typically passing into a non-marital deduction trust often called the "credit shelter trust" for the benefit of the surviving spouse and descendants) and the other portion passing outright to a spouse or to a marital deduction trust for the spouse's benefit. In some cases, the bequest intended to qualify for the marital deduction is phrased as "the lesser of the maximum marital deduction allowable in my estate or minimum amount necessary to reduce my Federal estate tax to zero."

In other cases, an individual, whether or not married, will have a portion of his or her estate equal to his or her "unused GST exemption" pass in a way different from the balance of his or her estate, such as to a trust for the benefit of his or her grandchildren and more remote descendants.

These formulas are used because they produce what appears to be the optimal division or disposition of a decedent's property. But they have no meaning if the concepts used to define them are no longer part of the

tax law.

For example:

- What is the "minimum amount necessary to reduce my Federal estate tax to zero" if there is no Federal estate tax or Federal estate tax marital deduction?
- Similarly, if the estate tax exemption is defined as "applicable credit amount within the meaning of section 2010 of the Internal Revenue Code," how much is that if there is no such applicable credit in effect in 2010?
- And, if the estate tax exemption is defined as "the largest taxable estate I can have for Federal estate tax purposes without my estate paying any Federal estate tax," how large in that amount in a year in which there is no estate tax?

Some existing wills and trusts reflect the possibility of there being no estate tax. But there are many that do not because, at least until very recently, most estate planners did not believe the estate tax would be repealed.

Further complications arise for individuals who die with estates that are subject to a state death tax. Approximately a dozen states have "independent" death tax systems. These will not be automatically repealed simply because there is no Federal estate tax.

Again, perhaps, in an ideal situation, wills and trusts will have made an explicit provision for the disposition of someone's estate if there were no Federal estate tax but there were a state death tax. But virtually none have.

Estate planners should begin a review of their clients' wills and revocable trust agreements as soon as possible in order to determine which, if any, of those documents need to be changed to reflect the likely repeal of the Federal estate and GST tax.

Eliminate Most Outright Bequests to Surviving Spouses

In addition to clarifying formula bequest, consideration should be given to changing all bequests to spouses to transfers in trust, which, with an exception for the amounts that receive special treatment under the carryover basis rules of section 1022, do not require any fixed pattern of

distributions. Such trusts should provide the maximum creditor and estate tax protection for assets that could pass to family members at the death of the surviving spouse at a time when the estate tax may be back in effect.

Carryover Basis Considerations

Under Section 1022, the income tax bases of assets acquired from an individual who dies in 2010 will not equal their estate tax values. Instead, the bases of his or her assets will "carryover" to those who inherit the property. There are two "exceptions" to the carryover basis rule, which will provide some relief to the beneficiaries who receive these assets.

The first exception permits the decedent's executor (or personal representative) to allocate up to \$1,300,000 to increase the bases of assets. This increase, however, may not increase the basis above the fair market value of the asset on the date of death. In addition to the \$1,300,000 step-up in basis, the decedent's executor (or personal representative) can also allocate up to \$3,000,000 to increase the bases of assets that the surviving spouse receives outright or through a QTIP trust (called "qualified spousal property").

Clients' wills (and it must be the will because it is the executor who gets to allocate the basis increases) should have language to authorize the executor (or personal representative) to allocate the basis increase, in the executor's sole and absolute discretion. Wills or will substitutes (such as a revocable trust) of married clients should be revised to make a special bequest to the spouse or a QTIP trust to permit the use of the \$3 million basis increase for "qualified spouse property."

Making this special bequest is complicated because it is not \$3 million worth of property that need to pass outright to the surviving spouse or a QTIP type trust but property having unrealized gain of \$3 million. Sample language and advice is contained in the Blattmachr/Graham article mentioned above.

Year-End Action or Inaction?

Many estate planners have been urging their clients to take action before the end of this year in light of the possibility of enactment of adverse changes to the estate and gift tax system, such as the elimination of grantor retained annuity trusts (GRATs), qualified personal residence trusts (QPRTs) and discounts in valuation. In light of the likelihood

that gift tax rates will drop to 35% in 2010, an important question is presented: is it better to wait?

Any gift a taxpayer might make in creating a GRAT in 2011 would be exposed to a potentially lower gift tax (maximum 35%) than if created in 2010 (45%). The same is for a QPRT. In fact, this is true for any potential gift which might occur, such as by an installment sale to a grantor trust.

On the other hand, if the amount of the potential gift is small, action this year may be preferable to protect any transfers against adverse changes in the transfer tax law that may take place retroactively at the beginning of 2010.

Individuals who have not used their entire \$3,500,000 GST exemption should consider doing so before the end of 2009. This may be advisable because under the current Code there will be no GST exemption available in 2010 and when the GST tax is restored in 2011, the amount of available GST exemption will be substantially smaller, \$1 million adjusted for inflation.

There are at least two ways to use GST exemption without the imposition of gift tax. First, married individuals can fund QTIP trusts with an amount equal to their unused GST exemptions and make "reverse" QTIP elections for GST tax purposes (provided their spouses are US citizens). Second, individuals who have funded existing trust to which GST exemption has not been allocated can make late allocations before the end of this year.

Other Planning Action for 2010

Is it better to wait until next year to avoid GST tax? Almost any transfer to a so-called "skip person," such as grandchild or a trust for grandchildren or more remote descendants, is subject to GST tax this year if the transfer is in excess of the GST exemption (limited to \$3.5 million). Next year, there may be no GST tax. If that is the case, taxpayers will not need to limit such transfers to \$3.5 million (or whatever their remaining GST exemption is) to avoid the GST tax.

It may be possible for a married person to avoid the GST tax forever (even after 2010) on transfers made next year through the use of QTIP trusts. For example, a married woman might transfer substantial property to a so-called "qualified terminable interest property" or "QTIP" trust for her husband, if he is a US citizen, without paying any

gift tax.

Although the trust property will be included in his estate when he dies under section 2044, it may be that this QTIP will be "grandparented" from the GST if the tax is reinstated in 2011. That planning option was available for QTIP trusts created before the effective date of the 1986 version of the GST tax. In any event, there seems to be little risk in trying that, as long as the spouse creating the QTIP for his or her husband and wife is comfortable in doing so.

It may be possible to make outright gifts to grandchildren in 2010 when there will be no GST tax. For clients with unused GST exemption, the risk of GST tax exposure, if Congress retroactively reinstates the GST tax back to the beginning of 2010 would seem to be minimal if the amount of the transfer is within the available exemption. This is so because any reinstated GST tax is like to have the same amount of exemption as existing law and the exemption would automatically apply to the transfer.

It also may be appropriate to have trusts make what otherwise would be "taxable terminations" and "taxable distributions" in early 2010. Although under current law, these transfers would be subject to GST tax, there will be no such tax next year. The risk of course is that Congress will reinstate that tax retroactively.

It seems, however, politically unlikely that it would not grant some relief to those who took action based on the law at the time of the transfer—that is, that there was no GST tax. Perhaps, someone will figure out a way to "recall" the transfer if the tax is reinstated retroactively.

Carryover Basis Records

As Jonathan and Tom McGrath detailed in their book on carryover basis, there are ways to run down what the decedent's basis was in his or her assets at death. Jonathan reports that the bids on eBay for copies of that monograph are soaring!

The best solution is to get the information from clients now. So, contact your clients sooner than later to gather that important information.

Other Matters

As mentioned above, the entire pre-EGTRRA estate tax system, including the special exclusion rule for certain conservation easements

under section 2031(c) and the QFOBI provisions under section 2057 will come back into the law in 2011. Also, the rules for extension of estate tax payments with respect to closely held business interests will change and some are adverse (e.g., reducing the number of owners to make it closely held from 45 to 15). See, Jonathan Blattmachr & Elisabeth (Lisi) Madden (now Mullen), "Untangling Installment Payments of Estate Tax under Section 6166," 36 Estate Planning 3 (July 2009).

In addition, practitioners must be aware that new section 2511(c) will be effective next year. It provides that a transfer in trust is treated as a transfer of property by gift unless the trust is treated in its entirety as a grantor trust with respect to the donor or the donor's spouse. Planners need to focus on these changes well before the end of next year.

Conclusion

The end of 2009 and the beginning of 2010 are likely to be enormously busy times for estate planners. The elimination of the estate and GST taxes coupled with the introduction of a carryover basis for those dying in 2010 is an extraordinary event.

This development opens tremendous but temporary planning opportunities and creates many risks. The real dangers are inaction by practitioners and political risk. Will Congress retroactively reintroduce these taxes? What will happen in 2011?

While it is impossible to be at all certain about these matters, how we advise and counsel our clients now is extremely important. And most important of all, estate planners need to counsel their clients right away.

EDITOR'S NOTE:

If history offers any lessons, reports of the demise of the estate tax may be entirely premature. In an election year, with hardly a Representative or Senator up for re-election wanting to go on record as having voted to re-institute a tax, some think the ultimate irony would be if Congress were to do nothing, and allowed the estate tax to automatically come back with a vengeance in 2010 with a top rate of 60% in some cases and a \$1 million exemption. Although not addressed by our esteemed commentators, life insurance often is an integral part of a well-planned estate, and clients who read headlines proclaiming "Estate Tax Repealed" may be tempted into precipitous actions regarding their existing life insurance, or prospective acquisitions. With crushing deficits in need of revenue, clients who act precipitously may do so at

their peril.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A
POSITIVE DIFFERENCE!**

*Carlyn McCaffrey
Jonathan Blattmachr*

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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1570

Date: 31-Dec-09
From: Steve Leimberg's Estate Planning Newsletter
Subject: FLASH - Problems for Married Persons Who Die in 2010 in States with Independent Death Taxes

In their important and timely commentary, **Jonathan Blattmachr**, **Michael Graham** and **Mitchell Gans** provide LISI members with insights into a most extraordinary side effect to next year's repeal of the Federal estate tax and the adoption of a carryover basis regime for inherited property: namely, their impact on state death tax systems, as well as their impact on the estates of married persons. This commentary is a "must read" for anyone who practices in a state with an independent state death tax system.

Jonathan G. Blattmachr and **Michael L. Graham** are co-authors and developers of Wealth Transfer Planning, a software system that provides specific client advice about estate planning matters and automatically prepares client documents, such as wills, revocable trusts, GRATs and much more. Many of the suggestions for coping with the extraordinary circumstances of 2010 repeal of estate and generation skipping transfer (GST) tax, along with the probable attempt by Congress to retroactively reinstate those taxes and the certain return of estate and GST tax in 2011, are derived from their work and strategy embodied in Wealth Transfer Planning. You can learn about Wealth Transfer Planning at

www.interactivelegal.com.

Jonathan G. Blattmachr is the author of five books and hundreds of articles. Michael L. Graham is the founder of the Graham Law Firm of Dallas, Texas and a frequent national speaker and writer on various estate planning matters.

Professor Mitchell M. Gans teaches at **Hofstra Law School** in Hempstead, New York, co-authors a book with Jonathan and is author or co-author of dozens upon dozens of articles.

Here is their commentary:

EXECUTIVE SUMMARY:

For the first time since 1915, the United States has no Federal estate tax. This amazing situation is scheduled to last only for 2010.

After that year, the Federal estate, gift and GST tax system will revert to previous law, as set forth in the Internal Revenue Code prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Estate planners and their clients need to take the current no estate tax/no GST tax situation into account.

A further complication for practitioners and their clients is that, during the period that the estate tax is repealed, the income tax bases of assets acquired from or passing from a decedent, including most but not all assets included in the decedent's gross estate, will not be made to be equal to their estate tax values. Rather, the decedent's basis in those assets will "carry over."

For those who represent married individuals domiciled in states with independent state death tax systems, complications compound. Without careful planning, an inadvertent state death tax may well be imposed upon the death of the first to die of the spouses. To put this issue into context, it is first necessary to consider the Federal estate tax regime for 2010.

COMMENT:

Complications for Word Formula Dispositions.

As is widely known, many dispositions under wills and trusts are phrased in terms of tax concepts. For example, many married people

have directed the division of their estates into two broad portions: one portion equal to the unused estate tax exemption (typically passing into a non-marital deduction trust, often called the "credit shelter trust," for the benefit of the surviving spouse and descendants) and the other portion, equal to the "optimum" marital deduction amount, often expressed as the "minimum amount necessary as the Federal estate tax marital deduction to reduce my Federal estate tax to its minimum."

Additionally, or alternatively, it is sometimes true that an individual, whether or not married, will have a portion of his or her estate equal to his or her "unused GST exemption" pass in a way different (such as to a trust for the benefit of his or her grandchildren and more remote descendants) than the balance of his or her estate.

These word formulas are used because they produce what has been the optimal division or disposition of a decedent's property. But do these formulas have meaning, and what is that meaning, if the concepts used to define the formula clauses are repealed.

An imperfect, but somewhat similar analogy is as if a man said in his will, "I give to my daughter Laura an amount equal to the property tax exemption provided at the time of my death under the law of the Soviet Union." At the date of his death, there is no Soviet Union and, therefore, no exemption under that law.

Perhaps, in that case, the amount passing to the daughter is zero. Would the result would be different if the bequest were phrased as "the largest amount of my estate that can pass to my daughter without generating any property tax under the laws of the Soviet Union in effect at my death"?

Arguably, with such wording, Laura receives her father's entire estate because even if she does receive it all there will be no property tax under Soviet Union law. But uncertainty exists if there is no property tax under Soviet Union law and the bequest is premised on there being such law in effect at the decedent's death.

The uncertainty of what passes pursuant to word formulas under United States tax law would seem to have the same difficulties. For example, what is the "minimum amount necessary as the Federal estate tax marital deduction to reduce my Federal estate tax to its minimum" if there is no Federal estate tax or Federal estate tax marital deduction? It might be argued that nothing passes under such a formula because no marital deduction is needed to reduce the Federal estate tax to zero and all

property disposed of under the instrument, therefore, passes into the credit shelter trust.

Similarly, if the bequest of the estate tax exemption is defined as "applicable exclusion within the meaning of section 2010(c) of the Internal Revenue Code," what amount is that if there is no applicable exclusion in effect in 2010? Alternatively, if the amount passing into the credit shelter trust is defined as "the largest taxable estate I can have for Federal estate tax purposes without increasing the Federal estate tax in my estate," how large is that amount if there is no taxable estate and no Federal estate tax in the law for that year? While the initial reaction may be that all property passes to the credit shelter trust, an alternative construction might be that everything passes as part of the marital deduction share if there is no such thing as a "taxable estate."

There are at least two caveats that need to be mentioned. First, all of these formula clauses are designed to accomplish the same goals: (i) minimize (to zero if possible) the amount of estate tax that will be paid when the first spouse dies, (ii) minimize the amount of estate tax that will be paid when the surviving spouse dies with respect to property passing to or for the surviving spouse from the first spouse to die, and (iii) provide for all of the property to be available to benefit the surviving spouse.

It would be odd, since the goals are the same whether the document defines the credit shelter amount or defines the marital deduction amount, that the result would be different—that is, in one case, the instrument is construed as having all the property pass into the credit shelter trust and another having it all pass into the marital deduction share. We know that the intent of the testator must control, and we know that there will be declaratory judgment actions and expert testimony on many of these matters in an environment that, even as recently as the beginning of December of 2009, no one expected to exist.

The second caveat is that neither the IRS nor the Federal courts will be bound by a local court construction of the instrument under the rational of *Commissioner v. Bosch*, 387 US 456 (2d. Cir. 1967). Hence, even if a local court determines that the entire estate passes into a credit shelter trust, the IRS may take the position that property instead passed to the surviving spouse, if the marital deduction bequest is outright, and that either the surviving spouse made a gift by permitting that to occur and/or the credit shelter trust is included in the gross estate of the surviving spouse, assuming the surviving spouse dies in 2011 or later, when the

estate tax is reinstituted.

Further Complication: Carryover Basis Increases.

Under Section 1022, the income tax bases of assets acquired from someone who dies in 2010 will not be equal their estate tax values; rather the bases of his or her assets will "carryover" to those who inherit the property. To complicate matters, the Code provides certain basis increases for carryover basis property. One is that the decedent's executor may allocate up to \$1,300,000 to increase the basis of property. This allocation, however, may not increase the basis of an asset above its fair market value as of the decedent's date of death.

Note that the allocation of increased basis provision is not to increase the basis of property worth \$1,300,000 to \$1,300,000 but rather to increase basis by \$1,300,000. For example, a child of the decedent inherits land worth \$5 million in which the decedent's basis at death was \$1,500,000.

The executor may elect to increase the basis of the land to \$2,800,000. If the land were worth only \$2,300,000 when the decedent died, the executor could increase the land's basis from \$1,500,000 by \$800,000 to \$2,300,000 (and no higher) and could allocate the remaining \$700,000 of basis increase to other appreciated property (limited, again, to the fair market value of such asset at the decedent's death).

In addition to the \$1,300,000 increase in basis, if the decedent is married, the decedent's executor can also allocate up to \$3,000,000 to increase the basis of assets that the surviving spouse receives outright or through a QTIP trust (called "Qualified Spousal Property"). A QTIP trust qualifies for the estate tax marital deduction, when there is an estate tax, only to the extent the executor elects under section 2056(b)(7) for it to so qualify. However, no such election is necessary for a trust otherwise described in that section to constitute Qualified Spousal Property to which the \$3 million basis increase may be allocated by the executor.

Before turning to other matters relating to the carryover basis rules, it is appropriate to go back and explain how they complicate the division of the estate of a married person who dies in 2010.

Married Persons: No Estate Tax Plus Carryover Basis.

For a married person who had directed his or her estate to be divided into two shares if his or her spouse survives, that is, into an amount

equal to his or her unused estate tax exemption equivalent and the balance in a form that may qualify for the estate tax marital deduction, it may seem that he or she would want to have his or her estate pass entirely into the estate tax exemption equivalent share, usually, in the form of a credit shelter trust that benefits the surviving spouse and descendants.

Such as person would have provided for a constantly increasing amount to pass into the credit shelter trust: \$675,000 before EGTRRA and then \$1,000,000, then \$1,500,000, then \$2,000,000 and then \$3,500,000. This suggests that if the exemption were to increase, for example, to \$5,000,000, which was proposed several times in Congress in recent times, the married person would want the first \$5,000,000 to pass into the credit shelter trust.

And now, of course, without any estate tax, his or her entire estate (whether \$5 million or \$500 million) may pass estate tax free into the credit shelter trust. And perhaps that is how an instrument making the credit shelter trust/optimum marital deduction division will be construed—that is, the whole estate passes into the credit shelter trust. Of course, if the surviving spouse cannot benefit from the credit shelter trust (e.g., it is exclusively for the benefit of the decedent's descendants from a prior union), the result seems harsh at least from the view of the widow or widower.

But assuming that it would occur and even assuming it is exactly what all surviving family members want or assuming the estate planning documents are revised to expressly provide for that result, there is a potentially important additional tax issue. Unless the credit shelter trust is in the form of a QTIP type trust (e.g., all income paid at least annually to the surviving spouse with no ability to pay any part of the trust to anyone else during the survivor's lifetime), there may be insufficient Qualified Spousal Property against which the executor may allocate the \$3 million basis increase. See, generally, Blattmachr & Graham, "Thinking About the Impossible for 2010," 21 Probate & Property 12 (May/June 2007).

On the other hand, if the instrument is construed so that (or it is revised to provide expressly that) the entire estate is to pass into a QTIP trust if there is no estate tax, then there presumably will be the maximum amount of property to which the executor may allocate the \$3 million basis increase. As mentioned above, a QTIP trust is a form of Qualified Spousal Property.

At the same time, using a QTIP trust limits some other planning opportunities such transferring property to children free of gift tax or "splitting" income with the trust and/or descendants which normally would be available if the trustee of the credit shelter trust holds the discretion either to accumulate all income or to pay income or corpus to descendants as well as the spouse. Perhaps, any part of the QTIP trust disclaimed by the spouse under section 2518 would pass over to such a discretionary credit shelter trust. And, even though the gift tax remains in effect in 2010, the spouse can make a qualified disclaimer under section 2518 and remain a beneficiary of any trust to which the disclaimed property passes by reason of the renunciation without being deemed to have made a taxable gift.

Revising Existing Documents for Married Persons.

In a more perfect world, wills and trusts will have taken into account the possibility of there being no estate tax and there being a carryover basis system. But it is known that most such documents do not cover those possibilities because almost everyone thought it was impossible that it could happen. In any case, it may well be appropriate for practitioners to contact married clients and ask how they want their property disposed of if they die when there is no estate tax.

Although there are many options, two planning options seem essentially likely to be used, at least if the situation is not complicated by a state death tax, which is discussed below. First, the married property owner could leave his or her estate to a QTIP trust, described in section 2056(b)(7), which qualifies for the estate tax marital deduction only to the extent the executor elects.

Of course, qualification as such for the estate tax marital deduction seems to be of no importance if there is no estate tax. But as explained above, such a QTIP trust is Qualified Spousal Property and, therefore, the executor may allocate the \$3 million basis increase to it. And, as also mentioned, above, if the instrument is so structured, the spouse may make a formula disclaimer of the entire QTIP trust above the amount needed to allocate that basis increase and have the disclaimed assets pass into a credit shelter trust which may provide more flexibility than that of a QTIP trust.

Regardless of how much remains in the QTIP trust, no portion should be included in the gross estate of the surviving spouse even if he or she dies when the estate tax is back into effect. Although section 2044 puts a QTIP trust into the gross estate of the spouse for whom the trust was

created, the section only applies if the spouse who created the trust avoided estate or gift tax by reason of the gift or estate tax marital deduction.

For the married person who dies in 2010, there will be no estate tax on the trust, not by reason of the marital deduction but because there is no estate tax in effect. Of course, if the estate tax is retroactively reinstated, then presumably the executor of the spouse first to die may elect QTIP treatment under section 2056(b)(7) and avoid estate tax and, to the extent the executor so elects, the QTIP will be included in the gross estate of the surviving spouse when he or she later dies.

The second approach is to provide that, if there is no estate tax, then the entire estate, other than a separate formula bequest to fully use the basis increase for Qualified Spousal Property, should pass into the credit shelter trust. That way, there is no reliance on a disclaimer by the spouse. Professor Jeffrey Pennell has observed, at fn 85 in BNA Tax Mgt. Portfolio No. 843-2nd, that one of the three great lies is "Of course I'll disclaim if it will save taxes." This second approach avoids any concern about the disclaimer.

Other Drafting Considerations.

Without regard to the marital status of a client, there are other revisions to documents that could be made to take into account the no tax/carryover basis regime of 2010. First, the client's will (and it must be the will because it is the executor who gets to allocate the basis increases) could have language to authorize the executor to allocate the basis increase, in his or her sole and absolute discretion.

Under section 2203, the executor is the person who is the executor or administrator of the decedent but "if there is no executor or administrator appointed, qualified and acting with the United States, then any person in actual or constructive possession of any property of the decedent." There may be many of those persons.

And, if there is no executor, there may be disagreement among these many persons about which one gets to exercise options and elections, such as the allocation of the \$1,300,000 and \$3,000,000 basis increases under section 1022. Hence, it seems appropriate to make sure there is a will that is admitted to probate so an executor (or administrator) will be acting to make the allocation as the executor determines.

Second, when possible, it may be appropriate to provide expressly in the

will that only an executor who is not a beneficiary should be authorized to allocate the basis increase. Otherwise, there may be conflicts of interest and a question of whether an executor who is a beneficiary may allocate basis increase to himself or herself under local law and, if he or she may do so, the potential gift tax consequences of not doing so. See, generally, Gans, Blattmachr & Heilborn, "Gifts By Fiduciaries By Tax Options and Elections", 18 Probate & Property (November/December 2004); republished in Digest of Tax Articles (March 2005).

Third, whether or not an individual is married, some thought should be given to the interpretation of an instrument that makes a bequest or gift equal to the individual's unused GST exemption at death. As mentioned above, there is no GST tax for 2010 and, therefore, the meaning of such a bequest or gift may be uncertain. For example, a wealthy woman makes a bequest in her will equal to "the maximum amount I may transfer free of generation-skipping transfer tax to a skip person" to a perpetual trust for her grandchildren and more remote descendants, leaving the balance of her estate to or in trust for her children (or, if she is married, to or for her husband).

If she dies in 2010, it may be that the instrument would be construed so nothing passes to or for her children (or her husband). Hence, again, it may be appropriate to contact clients who have instruments containing such dispositions to determine their wishes and, if changes should be made, to implement them soon.

Potential Effects in States with an Independent Estate Tax.

Prior the enactment of EGTRRA, the vast majority of states imposed a state estate tax equal to the amount of Federal credit allowable against Federal estate tax otherwise owed to the Federal government, sometimes called a "sponge tax." That Federal credit for state death taxes was allowable under section 2011 for state death tax paid. EGTRRA eliminated the credit (although it allowed a deduction under section 2058 for such state death tax paid) which meant that a number of states no longer had an estate tax of any kind.

Many states, however, have retained state death tax systems which were either in lieu of, or in addition to, the state's so called sponge tax. These include Connecticut, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee and Washington (state).

It does not appear that the independent death tax systems of states have automatically been repealed by the repeal of the Federal estate tax for 2010. Hence, there may still be a state death tax and it may present a significant issue for individuals who die domiciled in or who own real or tangible personal property in such states. As a general rule, a decedent's domicile state may impose a death tax on all of the decedent's property at death other than real or tangible personal property actually situated in another state, which other state may impose its death tax on the real or tangible personal property actually situated there.

For example, suppose a married New Yorker died with a \$25,000,000 estate in 2009 and her estate planning documents provided for an amount equal to her Federal estate tax exemption (which we will assume is \$3,500,000) to pass into a credit shelter trust for the benefit of her husband and descendants and for the balance of her estate to pass in a form that qualifies for the Federal and New York marital deduction. The tax will be equal to the amount of credit that would have been allowable under section 2011.

Her taxable estate is \$3,500,000, and her estate would owe \$229,200 of New York estate tax. This represents an effective New York estate tax rate of about 6.5%--that is, a \$229,200 tax on \$3.5 million. And a New Yorker might well decide that paying that tax when he or she dies is very worthwhile because it removed an "extra" \$2.5 million from the gross estate of the surviving spouse. New York, in effect, only permits a \$1 million estate tax exemption.

But the result in 2010 could be very different. For example, if the married New Yorker died in 2010 with an estate (after estate tax deductible expenses and debts) of \$25,000,000, all of which passed into a credit shelter trust, then her estate would owe \$3,466,800 in New York estate tax, which represents an effective New York estate tax rate of nearly 14%.

Both the amount of tax due and the effective rate of tax are much higher than for the smaller estate. Although it should mean that \$24,000,000 (plus its growth or minus its decline in value) will be excluded from the gross estate of the surviving spouse when he later dies (assuming there is an estate tax in effect at that time) and, at a 45% bracket, would avoid \$10,800,000 in Federal estate tax, which is more than three times the amount that had to be paid to New York to achieve that result, some married New Yorkers might well decide it is just too high a price to be paid when they die.

Further Complications Without a State-Only QTIP Election.

And this "awkward" situation may arise even if the instrument is construed (or is revised to state expressly) so that the entire estate passes into a QTIP trust, if the individual resides in a state (or owns real or tangible personal property actually situated in a state) that does not permit a state-only QTIP election. Some jurisdictions, such as New York, New Jersey, Minnesota, Vermont, Iowa, and North Carolina, do not permit state only QTIP elections.

In other words, in those states, the marital deduction for a QTIP trust is permitted for state death tax purposes only if the QTIP election is made for Federal purposes. For someone dying in 2010, it seems no such Federal QTIP election may be made as there is no Federal estate tax and no Federal QTIP election, therefore, is available. Hence, for those individuals domiciled in or owning real or tangible personal property actually situated in a state that does not permit a state-only QTIP election, the form of marital deduction essentially would need to be changed to some other qualifying form, such as an outright disposition, a general power of appointment trust described in section 2056(b)(5) or an estate trust (where the trust terminates in favor of the surviving spouse's own probate estate).

It is certain that the outright bequest will constitute Qualified Spousal Property but it is not certain a general power of appointment marital deduction trust or estate trust would. Hence, if the married person decides to use a general power of appointment marital deduction trust or estate trust, he or she probably should have a formula bequest outright to the surviving spouse to ensure full use of the \$3 million additional basis increase for Qualified Spousal Property. Although as mentioned above, a QTIP trust is treated as Qualified Spousal Property, it will not qualify for the marital deduction for state death tax purposes, unless the state permits state only QTIP elections.

Arguably, the best course of action for a married person domiciled in New York and who might die in 2010 is to change his or her domicile to a state without an estate tax or at least a state that permits state only QTIP elections. That, of course, may be life altering in some ways. But the additional price of dying in a state that has an independent estate tax and that does not permit state-only QTIP elections may be more than enough incentive.

And although, as mentioned above, the individual may bequeath his or her entire estate, above the state estate tax exemption, to a general power

of appointment trust or outright to his or her spouse, that property will be included in the gross estate of the surviving spouse, assuming he or she dies when the estate tax is back in effect. In addition to that unpalatable result, the individual may not wish his or her spouse to have the power to control the disposition of the individual's wealth which would be granted with an outright bequest or general power of appointment.

More Complications for States with Death Taxes.

There may be additional hurdle for those who die in 2010 domiciled, or owning real or tangible person property, in a state with an independent state death tax, and especially in those states not permitting a state-only QTIP election. That complication arises where property is already in an irrevocable trust which provides for the creation of a QTIP trust for the surviving spouse if the trust is included in the estate of the spouse first to die.

For example, a woman created a grantor retained annuity trust (GRAT) in June 2008 which is to terminate in June 2010. If she dies before the annuity term ends, all or a portion of the trust may be included in her gross estate under section 2036(a).

On account of that possibility, the trust agreement provides that, if the grantor of the GRAT dies before the annuity term ends, the trust property, other than any annuity due the grantor or the grantor's estate is to pass into a QTIP trust for the grantor's spouse if then living. If she dies in 2010 and before the GRAT ends, there would have been estate tax inclusion and that will trigger state death tax if the grantor was domiciled in a state with a state death tax. If there is a state only QTIP permitted, then the estate can make that election and avoid the state death tax. But in those states that do not seem to permit that election, there will be state death tax.

In fact, there could be a tax in a state that does permit a state only QTIP trust with respect to such a GRAT because of the way the disposition in favor of the QTIP trust is sometimes designed. Amazingly, there could even be a state death tax if the grantor provides for the trust to be paid outright to his or her surviving spouse, a disposition which would otherwise qualify for the marital deduction, unless the surviving spouse is not a US citizen and the state allows a marital deduction only if the transfer is to a QDOT.

The marital deduction may be lost if the GRAT provides that the amount

passing into the QTIP is limited to a portion of the trust "to the extent included in the grantor's gross estate for Federal estate tax purposes." Because in 2010 there is no estate tax, there would be nothing included in the grantor's gross estate for Federal estate tax purposes and, therefore, nothing would pass into the QTIP or outright to the surviving spouse.

A similar result could arise with respect to irrevocable life insurance trusts, which often have such "contingent" marital deduction provisions in the event part or all of the proceeds under the policy or policies owned by the trust are included in the insured's gross estate.

And the same result may arise if one spouse has created a lifetime QTIP trust for his or her spouse. Although if the beneficiary spouse dies in 2010, the QTIP will not be included in his or her Federal gross estate (as there is no estate tax), a state death tax could apply.

Not infrequently, a lifetime QTIP trust will "automatically" provide that, if the grantor spouse survives the beneficiary spouse, the trust property will be put in a QTIP trust for the grantor spouse. If so, a state only QTIP election, if permitted, could be made to avoid state death tax on the amount in the trust. But if a state only QTIP election is not permitted, the property presumably would be subject to state death tax.

It may be that the best course of action for such cases is to have the trust reformed by a court or, if permitted, "decanted" which is the act of paying the trust assets to a "new trust." See Zeydel & Blattmachr, "Tax Effects of Decanting—Obtaining and Preserving the Benefits," 111 J of Tax'n 288 (Nov. 2009). About a dozen states have statutes that permit decanting. But many of the states that have independent state death tax systems do not have decanting statutes.

In that event, one option is to use the Alaska decanting statute. AS 13.36.157 provides, in part, that if an Alaska resident or Alaska bank or trust company is appointed a co-trustee and the trustees agree that Alaska will be the primary place of trust administration, the trustees will have the Alaska decanting powers.

The Alaska statute is consistent with the law that a trustee derives its fiduciary powers from the place of administration. See Uniform Trust Code sec. 108 and Scott on Trusts sec. 615. In any case, the decanted trust would provide the appropriate provision such as an outright payment to the surviving spouse if the deceased spouse dies domiciled in a state with an independent state death tax and no state only QTIP and it

would not otherwise qualify for the state death tax marital deduction.

Suggestions for Action Steps.

Looking forward, the first step for practitioners, who do not wish to continue to put faith in Congress' ability to solve this issue (and it has now been unable to do so for nine years), is to contact clients about the 2010 law changes. A "generic" memorandum or an individually addressed letter or memo to each client might be used.

It may be appropriate to invite clients to contact the firm to make an appointment to determine what, if any, steps should be taken. As mentioned above, for clients using word formulas, it seems appropriate to determine explicitly how they want their property to be disposed of if they die when there is no Federal estate tax and no GST tax and there is carryover basis. For those living in state death tax states, other factors probably also should be discussed including the possibility of changing domicile.

It may be appropriate for lawyers to prepare documents to effect any changes the client may wish implemented. For example, married clients could explicitly state how their estates are to pass if they die when there is no estate tax.

As mentioned above, this might be a direction for the entire estate to pass into a credit shelter trust, except for a bequest to take full advantage of the \$3 million increase in basis permitted for Qualified Spousal Property. Moreover, any married client living in a state with an independent estate tax likely should consider whether he or she wishes:

- 1) To have state death tax paid at his or her death and avoid both Federal and state estate tax when the surviving spouse dies; or
- 2) To avoid both Federal and state death tax when the first spouse dies even if it means considerably more tax when the surviving spouse dies.

That will be easier if the state permits a state only QTIP election and the "optimum" marital deduction share passes into a QTIP trust. In that event, the decision of whether to pay state death tax if the first spouse dies when there is no Federal estate tax may be postponed until the state death tax return is filed and the election may be made or not.

For those living in a state with an independent state death tax, a decision

likely should be made now as to whether state death tax will or will not be paid if the first spouse to die passes on when there is no estate tax. But there is a strategy in which this decision also can be postponed until after the first spouse dies. If the estate planning documents provide for the amount passing to the credit shelter trust to be equal to the state death tax exemption and for the marital deduction share to pass either outright to the surviving spouse or to a general power of appointment marital deduction trust, there will be no state death tax due but the surviving spouse may change that outcome by making a qualified disclaimer within nine months of the death of the first spouse to die.

For those who prefer for the marital deduction share to pass into a QTIP trust but who live in a state with an independent state death tax and no state only QTIP, the following language might be used in such person's will or revocable trust used as a will substitute:

"If there is no Federal estate tax in effect at my death (including no retroactive reenactment of such tax) and if the state of my domicile imposes a state death tax at my death but does not permit my estate to make an election to treat any property that would be described in section 2056(b)(7) of the Internal Revenue Code of 1986, as amended, to qualify for the marital deduction for purposes of the state death tax, I hereby grant my husband/wife a power to appoint at his/her death by his/her Will by specific reference to this general power of appointment the property in any trust that is so described to his/her estate so that the trust will be described in section 2056(b)(5)."

Conclusion.

The elimination of the estate and GST taxes and introduction of carryover basis for those dying in 2010 represents an extraordinary event for estate planners and their clients. In many ways, it opens tremendous planning opportunities. But as explained, it also poses dangers.

Practitioners can find a sample letter to clients about this at the home page of www.interactivelegal.com which can be downloaded in word format and modified. As that letter indicates, married clients need to decide on the disposition of their wealth if they die this year. That decision is complex, and will be more complex if they live in a state with an independent death tax system.

Action needs to be taken. The real dangers are inaction by practitioners and political risk. Will Congress retroactively reintroduce these taxes? What will happen in 2011? While it is impossible to be at all certain

about these matters, advice and counsel to clients now is extremely important.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A
POSITIVE DIFFERENCE!**

*Jonathan Blattmachr
Michael Graham
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THE IMPOSSIBLE HAS HAPPENED: NO FEDERAL ESTATE TAX, NO GST TAX, AND CARRYOVER BASIS FOR 2010

BY JONATHAN G. BLATTMACHR, MITCHELL M. GANS,
HOWARD M. ZARITSKY, AND DIANA S.C. ZEYDEL

As things stand at the time of publication, the estate tax and generation-skipping tax have been repealed for 2010 but will return in 2011 in the form they took before EGTRRA was enacted in 2001. In addition, assets passing from a decedent will no longer take a stepped-up basis. This situation may or may not continue. As a result, estate planners must consider myriad factors in coping with the dangers posed by existing documents and acting to take advantage of several new opportunities that may have a limited window.

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As of January 1, 2010, the U.S. has no federal estate tax for the first time since 1915. This also is the first year since 1976 that there is no federal generation-skipping transfer (GST) tax. The top gift tax rate of 35% this year is the lowest in decades. This extraordinary situation is scheduled to last only during 2010. Beginning in 2011, the federal estate, gift, and GST tax systems will revert to their forms prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16, 6/7/01). Although the Code has provided that there would be no estate or GST tax for 2010 since the passage of EGTRRA, few thought it could happen. Indeed, many persons forecast nearly until the end of 2009 that last year's estate and GST tax parameters (a \$3.5 million exemption and top rate of 45%) would be extended into 2010, but that did not happen.

Congress could adopt legislation retroactively reinstating the estate and GST taxes to the beginning of 2010, despite some question about the constitutionality of doing so. Nevertheless, estate planners and their clients need to take the current situation into account as well as the possibility the estate and GST taxes will be imposed retroactively to the beginning of this year.

A further complicating factor for practitioners and their clients is that,

during the period that the estate tax is repealed, the income tax bases of assets acquired from or passing from a decedent, including most but not all assets acquired from a decedent, will not be made to be equal to their FMV at the date of death. With some exceptions, the decedent's basis in those assets will carry over to the recipient.

EGTRRA

EGTRRA made many changes to the estate, gift, and GST transfer tax systems. These included increasing the estate and GST exemptions, culminating in 2009 exemptions of \$3.5 million, and decreasing the top rate for all three tax systems to 45%. It also replaced the state death tax credit with a state death tax deduction. The culmination of the EGTRRA changes was to eliminate the federal estate and GST taxes for 2010. The sunset provision,¹ however, means that all of the changes EGTRRA made (including such income tax changes as reducing the top income tax bracket from 39.6% to 35% and reducing the top bracket for long-term capital gains and dividends to 15%) will expire at the end of 2010. Unless the law is changed in the future, therefore, the following will occur on January 1, 2011:

- The estate tax exemption will drop to \$1 million.

- The GST exemption will drop to an inflation-adjusted \$1 million (it is likely this amount will be at least \$1,340,000).
- The top estate, gift, and GST tax rate will increase to 55% (60% for estate and gift tax transfers between \$10 million and \$17,184,000).
- The estate and gift tax system will again be unified.
- The state death tax credit under Section 2011 will be restored.
- Several other important provisions, such as the qualified family-owned business interest (QFOBI) rules under Section 2057, will return to the way they were before EGTRRA.

As noted above, most practitioners anticipated that this would never happen; almost no one thought that Congress would allow the estates of decedents who die in 2010 to escape federal estate tax.

Congress could reinstate the estate and GST taxes retroactive to the beginning of 2010, despite some question about the constitutionality of doing so.

The current situation presents more problems than opportunities for estate planners and their clients. For example, the possibility of retroactive restoration of the estate and GST taxes presents a risk in taking any action at all on the premise that the estate and GST taxes are gone for the year and that the gift tax rate will be only 35%. Even those individuals who die this year, while the estate and GST taxes are not applicable, will leave estates facing potentially serious problems that must be addressed promptly.

Scope of the Sunset Provision

Although the major focus of this article is on the estate, gift, and GST tax provisions for 2010 (or the lack thereof) and what may be viewed as related income tax provisions that

are in effect for this year, application of these provisions in future years also needs to be considered.

1. Planners must take into account what the law likely will be in the future. For example, the will of an individual who will probably not die very soon should take into account not just what tax law provisions will apply if he or she dies this year but what rules may apply if he or she dies in a future year.

2. As will be discussed later in this article, some transactions (such as the creation of a trust by a decedent who dies this year for his or her grandchild) may be treated differently in a subsequent tax year because EGTRRA expires by its terms on 12/31/10.

3. As strange as this may initially seem, some of the words used to effect the sunset of EGTRRA may mean that certain transactions are, in effect, treated for years after 2010 as having happened before EGTRRA even if the transfer occurred while EGTRRA was in effect.

These factors are interrelated in many ways and in order to set a more complete framework of looking at the estate tax and related laws for 2010, this article discusses the third factor (the EGTRRA expiration provisions) first.

Construing statutes. Before turning to the provision by which EGTRRA "expires," it seems appropriate to briefly discuss statutory construction. EGTRRA was pushed through the legislative process with haste. It was signed into law on 6/7/01, which historically is very early in a calendar year for the enactment of a major tax bill. Many of its provisions are unclear. The meaning and scope of the expiration provision, as will be discussed below, seem quite uncertain. Lawyers and courts are saddled with the written words of a statute, but a literal construction of a statute that produces an absurd result generally will not be adopted.²

Words are also an imperfect means of communicating. Viewing words from different perspectives or at different times may suggest significantly different meanings for them.

These general principles should be kept in mind when reading the discussion of the expiration provision of EGTRRA.

Background of expiration. In order to help understand what the expiration provisions of EGTRRA mean, an awareness of why EGTRRA had to expire is important. Although certain provisions of the Code have expired in the past,³ there has been no general sunset provision in other tax legislation.⁴

EGTRRA includes such a provision to ensure compliance with the Congressional Budget Act of 1974. That Act contains rules to enforce the scope of items permitted to be considered by the Congress under the budget reconciliation process (that is, in adopting a federal budget). One of these rules, known as the "Byrd rule" after its sponsor, Senator Robert C. Byrd (D-W.Va.), prohibits legislators from enacting tax provisions with respect to a budget reconciliation that would reduce revenues after the years covered by the reconciliation. Sixty votes are required in the Senate to override the Byrd rule. Because fewer than 60 senators voted to enact EGTRRA, all of its changes to the Code expire, as a general rule, after 2010 so that its provisions would not increase federal deficits after 2010. The expiration provisions of EGTRRA, therefore, probably should be read consistently

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¹ See PL. 107-16, section 901.

² See *Nixon v. Missouri Municipal League*, 541 U.S. 125 (2004) (indicating that courts should avoid a construction that would lead to an absurd or futile result).

³ For example, Section 68, relating to the overall limitation on itemized deductions, was originally scheduled to expire on 12/31/95; see former Section 68(f), deleted by RRA '93 (PL. 103-66, 8/10/93), section 13204.

⁴ See Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 107th Congress* (2003) (hereafter, "Blue Book"), page 171. The Blue Book is not, strictly speaking, legislative history, but the courts routinely use it as an important reference to the legislative intent behind tax statutes. See, e.g., *United Dominion Industries, Inc.*, 532 U.S. 822, 87 AFTR2d 2001-2377 (2001); *Amerada Hess Corp. v. Director, Div. of Tax'n*, N.J., 490 U.S. 66 (1989); and *Ptasynski*, 462 U.S. 74, 52 AFTR2d 83-6495 (1983).

with its goal—to not produce deficits after this year—in mind.

The expiration provisions. The “repeal” of the estate tax and GST tax, as well as all other changes made by EGTRRA, expire or “sunset” at the end of 2010. EGTRRA section 901(a) states:

“IN GENERAL. All provisions of, and amendments made by, this Act shall not apply—

“(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

“(2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.”

Title V of EGTRRA deals with the estate, gift, GST taxes, and related income tax provisions (such as providing for the basis of inherited property to be equal to the lesser of its value on the decedent’s date of death or the decedent’s adjusted basis (the carryover basis rule)). If the sunset provision that relates to Title V ended with subsection (a), it would simply mean that the estate, gift, GST taxes and related income tax changes made by EGTRRA no longer applied after 2010. Nevertheless, section 901(b) seems to provide an additional rule. It states:

“(b) APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.”⁵

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⁵ For simplicity, the phrase “and the Employee Retirement Income Security Act of 1974,” which appears after “The Internal Revenue Code of 1986” and before “shall be applied,” has been omitted.

⁶ But see *Flores-Figueroa v. U.S.*, 129 S.Ct. 1886 (2009) (indicating that a construction under which language in a statute is treated as surplus should be avoided).

⁷ Essentially, and as is discussed in more detail later in this article, Section 2511(c) provides that an individual will be treated as making a completed gift for federal gift tax purposes if the individual transfers property in 2010 to a trust that is not a grantor trust in its entirety even if the individual retains such dominion and control over the transferred property that the gift would be considered incomplete under Reg. 25.2511-2.

It may be reasonable to construe section 901(b) as simply reinforcing the meaning of section 901(a). Construing subsection (b) as requiring the Code to be applied to gifts made after 2010 as though the EGTRRA gift tax provisions had never been enacted reinforces or restates the gift tax portion of subsection (a), and would imply an application only to future gifts.⁶

On the other hand, suppose an individual, who creates a trust in 2010 that is not treated as a grantor trust in its entirety, is treated as making a taxable gift by reason of Section 2511(c) (but otherwise under the law prior to EGTRRA the gift would be treated as incomplete).⁷ Section 2511(c) expires and is of no effect after 2010. In determining gift tax due on future gifts, how should the 2010 gift be treated? Should it be considered as being complete under EGTRRA, or possibly as incomplete under post-EGTRRA law?

Section 2502(a) directs that, in computing the gift tax, prior taxable gifts must taken into account. One literal reading of EGTRRA section 901(b) is that the existence of the 2010 gift, which was deemed complete and therefore constituted a taxable gift in 2010, is ignored because the calculation of gift tax after 2010 is determined as though EGTRRA “had never been enacted.” This reading also would lead to the conclusion that the taxpayer could be subject to a second tax on the same gift if the power he or she retained that caused the gift to be incomplete lapses before his or her death.

There will be other possible readings of section 901(b) in such a context. In any event, such an application of subsection (b) would actually seem contrary to the Byrd rule. The reason is that ignoring the taxable gift treated as made in 2010 by reason of Section 2511(c) could reduce federal gift tax collected after that year.

That, in turn, raises the question of whether in applying the Code “to years, estates, gifts, and transfers” after 2010, only those provisions of EGTRRA that would reduce tax collections (thereby increasing the

deficit) are treated as never having been enacted. Because the Byrd rule has never been applied to tax reduction provisions of a budget reconciliation act, it is very difficult to reach a conclusion about this.

Carryover or stepped-up basis. The issue also arises with regard to a death in 2010. Throughout the balance of 2010, under Section 1022 the legatee would have a carryover basis in assets received from the decedent. But if the legatee sells the asset in 2011, a literal application of section 901(b) appears to permit the legatee’s basis to be determined under Section 1014 so that basis would be equal to the date of death (or alternate valuation date) value.

The current situation presents more problems than opportunities for estate planners and their clients.

At first blush, EGTRRA section 901(b) does appear to provide that the Code should be administered in post-2010 years as if EGTRRA had never been enacted, thus suggesting that basis should be determined in 2011 under Section 1014. Nonetheless, it is difficult to imagine that Congress contemplated such an outcome for assets received from an estate that was not subject to estate tax. And it is certainly possible to read section 901 as consistent with Congress’s purpose to link estate-tax-free treatment with carryover basis even if the asset is sold in a post-2010 year. EGTRRA section 901(a)(2), in dealing with Title V of the statute, focuses on the date of the transfer (the date of death, the date of the gift, or the date of the generation-skipping transfer). This should be contrasted with section 901(a)(1), which focuses instead on the tax year (i.e., EGTRRA does not apply to tax years after 2010). Thus, in terms of Section 1022, which was enacted as part of Title V of EGTRRA, it will no longer apply in post-

2010 years if the transfer (i.e., death) occurs after 2010. Thus, where death does occur in 2010, Section 1022 should, under this reading, remain applicable even if the asset is sold in 2011. Nevertheless, if the application of the Byrd rule is to make the tax revenue impact the same for years after 2010 (when Section 1014(a) is back in effect) as it would have been before the enactment of EGTRRA, it is arguable that the potential step-up in basis is not inconsistent with the purpose of the Byrd rule.

GST tax. There is even more ambiguity in the language of the sunset provision with respect to the GST tax provisions, primarily because a transfer in trust can lead to generation-skipping transfers that occur in more than one year.

Suppose a grandmother creates a trust in 2010 for the current benefit of her grandson. Her transfer to the trust would be a direct skip, a type of generation-skipping transfer, and would produce a GST tax except for the fact that under Section 2664 the GST tax provisions do not apply in 2010 to any generation-skipping transfer occurring that year. Yet, when distributions are made after 2010 to the grandson from the trust, another type of generation-skipping transfer—a taxable distribution—may be deemed to occur.

Had the trust been created before 2010, Section 2653(a) (discussed in more detail below) would have precluded the later distribution from being a generation-skipping transfer. But it remains unclear (as also discussed below) whether Section 2653(a) can apply to a transfer made in 2010. Yet, the sunset provision might be construed to provide that, with respect to any transfer after 2010, Section 2653(a) will be deemed to have applied in 2010 because Section 2664 (which arguably blocked the application of Section 2653(a)) itself is ignored after 2010 because it became part of the Code by the enactment of EGTRRA.

Impact. All these possible readings create great uncertainty for taxpayers and practitioners. It seems that

one logical approach would be to construe the sunset provisions as simply confining the tax benefits of EGTRRA to the years that EGTRRA was in effect. Another would be to conclude that the tax benefits comprise not only the benefits achieved while EGTRRA was in effect but also all tax benefits that derive therefrom in later tax years.

In determining gift tax due on future gifts, how should a 2010 gift be treated? Is it complete under EGTRRA, or possibly incomplete under post-EGTRRA law?

To find the latter construction consistent with the Byrd rule, one would have to conclude that the resulting increase in the deficit would be deemed attributable to the years EGTRRA was in effect, not to the subsequent years in which the continuing tax benefits apply. Under that construction, if a taxpayer contributed \$3.5 million to a trust and allocated his or her \$3.5 million GST exemption to the trust in 2009, that trust would remain wholly exempt from GST tax, even though if EGTRRA had never been enacted the taxpayer would never have had a \$3.5 million exemption. The tax benefit in future years perhaps would attributed to the years EGTRRA was in effect.

Suppose a taxpayer dies in 2010, establishing a testamentary trust for grandchildren and more remote descendants. Similarly, that trust might not be subject to GST at any time: in 2010 the GST tax was not applicable

to the direct skip to the trust, and in subsequent years the trust might possibly remain exempt because in the year it was established there was no estate tax, and thus no transferor within the meaning of Section 2652(a)(1)(A), and so no person could be defined as a skip person under Section 2613.

The same trust created *inter vivos* in 2010 is more difficult to analyze. Clearly, no GST is due on formation. In 2011, the trust may once again be subject to tax. The trust does have a transferor, and perhaps in this situation the rule of Section 2653(a) would apply as if EGTRRA had never been enacted, so that distributions to grandchildren do not trigger tax but distributions to great-grandchildren do. Again, this requires the Byrd rule to be construed as set forth above.

The only thing that is clear is that we will not know the scope of EGTRRA's sunset provisions until Congress, a court, or perhaps Treasury through the issuance of Regulations, clarifies it.

COMPLICATIONS—WORD FORMULAS

Many dispositions under wills and trusts are phrased in terms of tax concepts. This may lead to additional complications for married persons and others using word formulas to accomplish their estate planning goals.

Division Into Estate Tax Exemption and Marital Deduction Shares

Many married people have directed the division of their estates into two broad portions: one portion equal to the unused estate tax exemption⁸ (usually passing into a nonmarital deduction trust, often called the

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⁸ The term "estate tax exemption" is currently a misnomer, but one with a valid historical basis. Until 1977, the Code contained a true estate tax exemption (\$60,000 for persons dying in 1976). It functioned as a deduction that was subtracted, dollar for dollar, from what otherwise would have been the decedent's taxable estate on which the estate tax was imposed. Starting in 1977, however, a credit (called initially the "unified credit" and now sometimes referred to as the "applicable credit") is allowed under Section 2010

instead of an exemption. The unified credit reduces the amount of tax due on the taxable estate, dollar for dollar. The credit, however, also may be viewed as an "exemption equivalent," which is the maximum taxable estate of a decedent without owing any estate tax by reason of the credit, assuming he or she had not used any portion of the credit by making certain lifetime gifts. Throughout this article, this exemption equivalent will be referred to as the estate tax exemption.

credit-shelter trust,⁹ usually held for the benefit of the surviving spouse and descendants),¹⁰ and the other portion equal to the "optimum" marital deduction amount, typically expressed as the minimum amount necessary to qualify for the federal estate tax marital deduction to reduce the federal estate tax to zero or, if reduction to zero is not possible, to its minimum.¹¹

Based on the literal language of these bequests, the results could be radically different if the property owner dies in 2010. There is no federal estate tax for 2010, so a bequest of the maximum amount that passes free of that tax could be a bequest of the entire estate. Similarly, there is no unified credit, and a bequest of the maximum that can pass under such credit would be zero.

Arguably, these bequests (one based on the maximum that can pass free of federal estate tax and the other based on the estate tax exemption) may produce wildly different results if there is no estate tax when the individual dies, but they are almost certainly intended to produce the same result. The usual purpose of a will or trust construction (interpretation) proceeding is to ascertain the individual's intent and construe (interpret) the document to carry out that intent.¹² But such proceedings usually seek to ascertain only that intent expressed by the terms used in the instrument, and extrinsic evidence often is not admissible un-

less the court determines that the ambiguity in the governing instrument is a latent one that cannot be shown to exist without such information.¹³

Division Into GST Tax Exempt and GST Tax Non-Exempt Shares

An individual, whether or not married, will sometimes have a portion of his or her estate equal to his or her unused GST exemption¹⁴ pass in a way (such as to a trust for the benefit of his or her grandchildren and more remote descendants) differently from the balance of his or her estate, which might be to or for his or her spouse or children. An unmarried person, for instance, might direct "I bequeath to the trustee of the trust hereunder for my grandchildren and more remote descendants an amount equal to the maximum amount that may be transferred to a skip person without the imposition of generation-skipping transfer tax" or "I bequeath to the trustee of the trust hereunder for my grandchildren and more remote descendants an amount equal to my unused GST exemption."

Based on the literal language of these bequests, the results could be radically different if the property owner dies in 2010. There seems to be no GST exemption amount for 2010, so a bequest of that amount would seem to be zero. Alternatively, the maximum such a person could transfer without the imposition of

GST tax this year apparently is unlimited.

As with the marital deduction formula clause, it is arguable that these GST-tax-based bequests (one based on the amount of GST exemption and the other on the amount that may be transferred without GST tax) may produce different results if there is no GST tax when the individual dies, but they are almost certainly intended to produce the same result.

Tripartite and Quadripartite Documents

Married persons often have three- or four-part wills or revocable trusts. One portion of the estate is equal to the estate tax exemption. A second portion is equal to the optimum marital deduction amount. A third portion is, in essence, a part of the optimum marital deduction amount, equal to the married decedent's unused GST exemption, and passes to a QTIP trust with respect to which the decedent's executor makes a "reverse QTIP" election—that is, although the executor elects under Section 2057 (b)(7) to cause the trust to qualify for the estate tax marital deduction, which in turn would cause it to be included in the gross estate of the surviving spouse under Section 2044, thus making that spouse the transferor for GST tax purposes, the executor reverses the QTIP election for GST tax purposes under Section 2652(a)(3) so that the decedent, rather than the surviving spouse, remains the transferor. This reverse QTIP election permits the executor to allocate any balance of the decedent's GST exemption to the reverse QTIP trust.¹⁵

The reverse QTIP portion of the estate is usually described as the difference between the decedent's available GST exemption and the amount of the nonmarital share. As the amount of the nonmarital share may be difficult to ascertain because of the formula issues described above, and because there is no available GST exemption in 2010, the size of the reverse QTIP trust portion of the estate may not be clear if the decedent dies in 2010. Depending on

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⁹ So called because its size is determined by the federal estate tax that is avoided ("sheltered") by the unified credit.

¹⁰ A credit-shelter trust may be structured as a QTIP trust, although that has led certain estates inadvertently to elect for the trust to qualify for the estate tax marital deduction. See Rev. Proc. 2001-38, 2001-1 CB 1335.

¹¹ Some individuals provide for the credit shelter share to pass outright or in trust for descendants to the exclusion of the surviving spouse even if the individual is married at death.

¹² See, e.g., *Matter of Fabbri*, 2 N.Y.2d 236, 140 N.E.2d 269, 159 N.Y.S.2d 184 (N.Y., 1957).

¹³ See, e.g., Restatement (Third) of Property (Wills & Don. Trans.) § 11.1 (2003); Uniform Prob. Code section 2-603 ("The intention of a testator as expressed in his will controls"); *In re Estate of Stiefel*, 24 A.D.3d 994, 807 N.Y.S.2d 159 (App. Div., 3d Dept., 2005); *Matter of Estate of Campbell*, 171 Misc. 2d 892, 655 N.Y.S.2d 913 (N.Y. Surr., 1997); *In re*

Hyde's Will, 122 N.Y.S.2d 304 (N.Y. Surr., 1953), *aff'd* 282 A.D. 1100, 126 N.Y.S.2d 468 (App. Div., 3d Dept., 1953).

¹⁴ The GST exemption, described in Section 2631(a), is not a true exemption. It is a rate reducer: to the extent that GST exemption has been allocated to a transfer, the rate of GST tax is reduced; see Sections 2641 and 2642. For example, if \$1 million of GST exemption is allocated to a \$4 million transfer, the effective rate of tax is reduced by 25%. If the amount of GST exemption allocated is equal to the amount transferred, the effective GST tax rate is reduced to zero. In that instance, the GST exemption acts as a true exemption.

¹⁵ See generally Blattmachr, Hastings, and Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 *Trusts & Estates* 47 (April 1988); Gans and Blattmachr, "Quadripartite Will: Decoupling and the Next Generation of Instruments," 32 *Est. Plan. No.* 4 (April 2005), page 3.



how one construes the various components, the reverse QTIP portion could consist of the entire estate, the entire optimum marital deduction portion of the estate, or nothing. This is particularly problematic if the married decedent has directed that, on the death of the surviving spouse, the property in the reverse QTIP trust will pass in a manner (such as in further trust for grandchildren and more remote descendants) different from how any other trust for the surviving spouse is to pass (such as to or for the decedent's children).

A quadripartite document also creates a separate QTIP trust equal to the difference between the federal estate tax exemption and the state estate tax exemption if the decedent lives or has assets in a state with a state estate tax. As is discussed below, this formula may create even more construction problems than those creating the first three portions of the estate.

Back to Word Formulas

Word formulas based on federal estate tax provisions are used because it is believed that they will produce, at least while there was a federal estate tax and GST tax, what appears to be the optimal tax division or disposition of a decedent's property. The formulas, however, have no meaning if the concepts used to define them are not part of the law on the date of the decedent's death. What is the "minimum amount necessary as the federal estate tax marital deduction to reduce my federal estate tax to its minimum" if there is no federal estate tax or federal estate tax marital deduction? It might be argued that nothing passes under the bequest because no marital deduction is needed to reduce the federal estate tax to zero and all property disposed of under the instrument passes into the credit-shelter trust, but because there is neither a concept of federal estate tax nor a concept of a federal marital deduction, it just is not clear.

Similarly, if the bequest of the estate tax exemption amount is de-

fined as "applicable exclusion within the meaning of Section 2010(c)," how much is that when there is no applicable exclusion in effect on the date of death? Alternatively, if the amount passing into the credit-shelter trust is defined as "the largest taxable estate I can have for federal estate tax purposes without increasing the federal estate tax in my estate," how large is that amount if there is no concept of a taxable estate and no federal estate tax in the law? In that situation, the construction might be that everything passes as part of the marital deduction share.

There are at least two caveats that need to be mentioned. First, all of these marital division formula clauses are designed to accomplish the same goal: minimize (actually to zero if possible) the estate tax that will be paid when the first spouse dies, minimize the estate tax that will be paid when the surviving spouse dies with respect to property passing to or for the surviving spouse from the first spouse to die, and provide for all of the property to be available to benefit the surviving spouse. It would be odd, since the goal is the same whether the document defines the credit-shelter amount or defines the marital deduction amount, that the results would be so different—that is, in one instance the instrument is construed as having all the property pass into the credit-shelter trust and in the other having it all pass into the marital deduction share.

As mentioned above, the purpose in construing or interpreting an instrument is to ascertain the individual's intent as expressed in the governing instrument, and then to construe the instrument to carry out that intent, including adding or eliminating provisions, changing negatives to affirmatives and the reverse, etc.¹⁶ It should be possible to argue that any ambiguity caused by the lack of an estate tax or GST tax on the date of death is a latent ambiguity that can be cleared up by testimony of the drafter as to the goals the clause was intended to meet. But it also could be argued that the

clause is not ambiguous, and that a clause that leaves the children the maximum amount of the estate tax exemption is designed to leave them nothing if there is no such exemption, while a clause that leaves the spouse the minimum amount required to reduce the estate tax to zero is intended to disinherit the spouse if possible, if that will still reduce the estate tax to zero.

Are only those provisions of EGTRRA that would reduce tax collections (thereby increasing the deficit) treated as never having been enacted?

The second caveat is that neither the IRS nor the federal courts will be bound by a local court's construction of the instrument.¹⁷ The Service may take the position, even if a local court determines that the entire estate passes into a credit-shelter trust, that for tax purposes it has passed to the surviving spouse (if the marital deduction bequest is outright) and that the surviving spouse made a gift by permitting the property to go into the trust and/or that the credit-shelter trust is included in the gross estate of the surviving spouse.¹⁸

Gifts to Spouse Likely to Die Soon

It seems appropriate for one spouse to transfer virtually all of his or her wealth to his or her spouse (although not more than the gift tax annual exclusion if the donee spouse is not a U.S. citizen) if the donee spouse is expected to die this year and the donor spouse is expected to survive past the end of the year. If the donee spouse does die this year and there is no retroactive reinstatement of the federal estate tax that

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¹⁶ See, e.g., *Matter of Fabbri*, *supra* note 12.

¹⁷ *Estate of Bosch*, 387 U.S. 456, 19 AFTR2d 1891 (1967).

¹⁸ *Cf.*, e.g., Rev. Rul. 84-105, 1984-2 CB 197, but see *Harris*, 340 U.S. 106, 39 AFTR 1002 (1950); *Estate of DiMarco*, 87 TC 653 (1986), *acq.* in result only.

will apply to the estate of the spouse who dies this year, the couple will be able to protect their entire wealth from estate tax. If instead the federal estate tax is retroactively reinstated to apply to the estate of the spouse who dies this year, the property received by gift, as well as all other property of the donee spouse, may be transferred free of federal estate to the surviving spouse using a combination of the federal estate tax exemption and the federal estate tax marital deduction.

In fact, if the federal estate tax is reinstated, it is at least arguable that at least a portion of the assets given to the deceased spouse before death by his or her spouse will be entitled to the step-up in basis under Section 1014(a) notwithstanding Section 1014(e), which essentially provides that there is no step-up in basis with respect to any property received by the decedent within one year of death that is transferred back at the donee's death to the donor. Section 1014(e), by its terms, applies only to the extent the gift "property is acquired from the decedent by (or passes from the decedent to) the donor of such property." If the gift property is placed in trust for the donor, then the section may not apply.¹⁹

FURTHER COMPLICATIONS: CARRYOVER BASIS INCREASES

Under Section 1022, the income tax bases of assets acquired from someone who dies in 2010 will not equal their estate tax values; rather the bases of the decedent's appreciated assets will carry over to those who inherit the property.²⁰ This section, however, provides certain basis increases for carryover basis property, to relieve small- and moderate-sized

estates from the need to maintain detailed records of basis.

It is arguable that the potential step-up in basis after 2010 is not inconsistent with the purpose of the Byrd rule.

The executor may allocate up to \$1.3 million to increase the basis of property. This allocation, however, may not increase the basis of an asset above its FMV as of the decedent's date of death. This allocation does not increase the basis of property worth \$1.3 million to \$1.3 million, but rather increases its basis by \$1.3 million. Therefore, a relatively large estate may end up with a full date-of-death value basis, if the property held by the decedent has no significant appreciation. This is likely to be the case for many estates in light of recent stock market declines.

EXAMPLE: A child of the decedent inherits land worth \$5 million in which the decedent's basis at death was \$1.5 million. The executor may elect to increase the basis of the land to \$2.8 million. If instead the land was worth only \$2.3 million when the decedent died, the executor could increase the land's basis from \$1.5 million by \$800,000 to \$2.3 million (and no higher), and could allocate the remaining \$700,000 of basis increase to other appreciated property (limited, again, to the FMV of such property at the decedent's death). If instead the land was worth \$10 million and its basis was \$8.7 million, the executor could allocate all of the \$1.3 million basis adjustment to the land and bring its basis up to \$10 million.

A decedent's executor also can allocate up to \$3 million to increase the basis of assets (but, again, not to an amount greater than the FMV of the assets at death) that the surviving spouse receives outright or through a QTIP trust²¹ ("qualified spousal property"). This is in addition to the \$1.3 million general increase in basis.

A QTIP trust qualifies for the federal estate tax marital deduction, when there is an estate tax, only to the extent the executor elects under Section 2056(b)(7) for it to so qualify. No such election is necessary for a trust otherwise described in that section to be qualified spousal property, so that the executor may allocate all or part of the \$3 million basis increase to its assets. No qualified domestic trust (QDOT) election under Section 2056A is required either, and it does not seem that the basis increase provision is limited to a surviving spouse who is a U.S. citizen.

Married Persons: No Estate Tax Plus Carryover Basis

Before turning to other important matters relating to the carryover basis rules, it is appropriate to explain how they complicate the division of the estate of a married person who dies in 2010.

A married person, who had directed that his or her estate be divided into two shares if his or her spouse survives (that is, an amount equal to his or her unused estate tax exemption to pass to a nonmarital share gift or trust, and the balance to pass in a form that may qualify for the estate tax marital deduction), may want to have his or her estate pass entirely into the estate tax exemption equivalent share to be held in the form of a credit-shelter trust that benefits the surviving spouse and descendants. Such a person, who may have had his or her estate planning documents in effect for some time, would have provided for a constantly increasing amount passing into the credit-shelter trust: \$675,000 before EGTRRA and then \$1 million in 2001 and 2002, \$1.5 million in

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¹⁹ In Ltr. Ruls. 9321050 and 9026036, the IRS held that Section 1014(e) applied only to the extent of the actuarial (tax) value of the income interest of the donor spouse in a trust created for that spouse by the donee spouse of the gift property.

²⁰ Under TRA '76, a carryover basis regime was adopted with respect to property included in the gross estates of individuals dying after

1976. See Section 1023 before its repeal by the Crude Oil Windfall Profits Tax Act of 1980 (PL. 96-223, section 401). The regime was retroactively repealed, although estates of individuals who died before the repeal could elect to have the carryover basis rules apply.

²¹ Section 1022(c) contains a definition of QTIP almost identical to that in Section 2056(b)(7), without the requirement of an election.

2004 and 2005, \$2 million in 2006, 2007, and 2008, and \$3.5 million in 2009.²² This suggests that if the exemption were increased, for example, to \$5 million,²³ the decedent would have wanted the first \$5 million to pass to the credit-shelter trust. And now, of course, without any estate tax, his or her entire estate (whether \$5 million or \$500 million) may pass federal estate tax free to the credit-shelter trust. That may be how an instrument making the credit-shelter trust/optimum marital deduction division will be construed. Of course, if the surviving spouse cannot benefit from the credit-shelter share (e.g., it is exclusively for the benefit of the decedent's descendants from a prior marriage), the result no doubt would seem harsh from the viewpoint of the widow or widower.²⁴

Assuming that, if there is no federal estate tax applicable at death, the instrument explicitly directs or is construed so that the estate of the married person is to be transferred exclusively into a credit-shelter trust, there is another potentially important tax issue. Unless the credit-shelter trust is in the form of a QTIP type trust (e.g., all income paid at least annually to the surviving spouse with no ability to pay any part of the trust to anyone else during the survivor's lifetime),²⁵ there may be insufficient qualified spousal property against which the executor may allocate the \$3 million basis increase.²⁶

If, however, the instrument were construed so that the entire estate passes to a QTIP trust if there is no estate tax, or if the instrument so directs expressly, there could be the maximum amount of property to which the executor may allocate the \$3 million basis increase, because the QTIP trust is qualified spousal property. In addition, the \$1.3 million basis increase also could be allocated to the QTIP. Of course, using a QTIP trust limits some other planning opportunities, such as being able to transfer property to children without making a taxable gift or splitting income with the trust and/or descendants, which normally would be available if the trustee of

the credit-shelter trust has the discretion to accumulate or distribute all income and corpus among descendants and the spouse. An instrument might provide that any part of the QTIP trust disclaimed by the spouse under Section 2518 would pass over to such a discretionary credit-shelter trust, affording the surviving spouse the option of taking advantage of such additional tax planning opportunities. The gift tax remains in effect in 2010, and the spouse can make a qualified disclaimer under Section 2518 and remain a beneficiary of any trust to which the disclaimed property passes by reason of the renunciation without being deemed to have made a taxable gift.

Revising Existing Documents for Married Persons

In a more perfect world, existing wills and trusts would have taken into account the no-estate-tax and carryover-basis possibilities.²⁷ Most such documents, however, do not cover those possibilities, because almost everyone thought it was impossible that repeal of the estate and GST taxes for 2010 would happen. Practitioners, therefore, should contact married clients to discuss how they want their property disposed of if they die when there is no estate tax. Although there are many options, two seem most likely to be used, at least if the situation is not complicated by a state death tax, as discussed below.

First, the married property owner could leave his or her estate to a

QTIP trust that qualifies for the estate tax marital deduction to the extent the executor so elects. That seems to be of no importance if the property owner dies when there is no estate tax, but as explained above, such a QTIP trust is also qualified spousal property, and therefore the executor may allocate the \$3 million basis increase to it. Also as discussed above, if the instrument is structured to allow for it, the spouse may make a formula disclaimer of the entire QTIP trust above the amount needed to allocate that basis increase and have the disclaimed assets pass into a credit-shelter trust that may provide more flexibility with respect to distributions than a QTIP trust does. The surviving spouse also should be able to disclaim specific assets, which may enhance the after-tax benefits of the disclaimer.

Regardless of how much remains in the QTIP trust, no portion should be included in the gross estate of the surviving spouse even if the estate tax is back in effect when he or she dies. Section 2044 includes the assets of a QTIP trust in the gross estate of the surviving spouse, but applies only if an election is made to obtain a marital deduction for the trust so that the spouse who created the trust avoids estate or gift tax by reason of the deduction. For the married person who dies in 2010, there will be no election to deduct the QTIP trust and no estate tax on the trust, because there is no estate tax applicable. Of course, if the estate tax is retroactively reinstated, then presumably the executor of the first spouse to die may elect QTIP treat-

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²² See Section 2010.

²³ A level that was proposed several times in Congress in recent years; see, e.g., H.R. 498, 111th Cong., 1st Sess. (1/19/09); H.R. 2658, 111th Cong., 1st Sess. (6/2/09); H.R. 3841, 111th Cong., 1st Sess. (10/15/09); and H.R. 3905, 111th Cong., 1st Sess. (10/23/09).

²⁴ Some individuals, even though they are married and wish the optimum tax division of their estate, direct that the estate tax exemption (or credit-shelter) share pass exclusively to or for descendants to the exclusion of the surviving spouse, figuring that the exemption amount is such a small part of their total wealth that the surviving spouse will be well taken care of. Under an interpretation of their estate planning documents that passes the entire estate to or in trust for descendants,

this objective will be completely frustrated. It has been suggested that tax formula divisions should never be used if the shares do not pass essentially the same way. See, e.g., Blattmachr, "Don't Be Driven by Tax Driven Formula Clauses," 5 *Probate & Property* 34 (September/October 1991).

²⁵ In some instances, the credit-shelter trust will be in the form of a QTIP trust. See, e.g., Rev. Proc. 2001-38, *supra* note 10.

²⁶ See generally Blattmachr and Graham, "Thinking About the Impossible for 2010," 21 *Probate & Property* 12 (May/June 2007).

²⁷ See Zaritsky, *Waiting Out EGTRRA's Sunset Period: Practical Planning While Congress Debates Estate Tax Repeal* (Thomson Reuters/WG&L, 2004), ¶ 3.02.

ment under Section 2056(b)(7) and avoid estate tax. To the extent the executor so elects, the QTIP will be included in the gross estate of the surviving spouse when or she later dies.

Because of formula issues, and because there is no available GST exemption in 2010, the size of a reverse QTIP trust portion may not be clear if the decedent dies in 2010.

It is possible that Congress, even if it does not retroactively reinstate the estate tax, could decide to cause QTIP trusts created by the first spouse to die in 2010 to be included in the gross estate of the surviving spouse. It seems difficult to imagine that Congress would single out QTIP trusts for this treatment—as opposed, for example, to a credit-shelter trust created by a married person who dies in 2010, especially if the credit-shelter trust is in a form that could constitute a QTIP trust. Nevertheless, with political matters there is no certainty.²⁸

The second approach is to provide that, if there is no estate tax, then the entire estate (other than a separate formula bequest to take full advantage of the basis increase for qualified spousal property) should

pass into the credit-shelter trust.²⁹ Professor Jeffrey Pennell has observed that one of the three great lies is “of course I’ll disclaim if it will save taxes.”³⁰ This second approach avoids any concern about the ultimate execution of a disclaimer by the surviving spouse. But there may be another factor in favor of providing for the entire estate of an individual who may die in 2010 to use a QTIP rather than a credit-shelter trust.

Using a QTIP Trust in All Events?

There may be one additional factor in favor of a married person’s leaving his or her entire estate to a QTIP trust whether or not there is estate tax. If there is no estate tax applicable at the individual’s death but there is a possibility of the retroactive reenactment of the tax, then the executor can wait until 15 months (assuming an extension to file is obtained) after death to determine to what degree a QTIP election should be made.³¹ Or, instead, the surviving spouse could make a qualified disclaimer of all or a portion of the QTIP trust and have it pass over to a credit-shelter trust (or other alternative disposition). Whether there is an estate tax at the individual’s death, whether one is retroactively reenacted, or whether there is no estate tax that applies to the estate, the disposition in favor of the spouse does not change (other than by the

execution of a disclaimer by the surviving spouse).

The spouse’s interest will vary if the will (or trust used as a will substitute) provides for the entire estate to pass into a credit-shelter trust if there is no estate tax or substantially into a QTIP trust (or other form of marital deduction) if there is an estate tax. Although that would not seem to affect the allowance of the marital deduction if there were an estate tax applicable when the individual dies, as it is not changed by any post-death event (other than a disclaimer by the surviving spouse), it could vary by post-death events if the disposition of the estate to the credit-shelter trust or to the marital deduction disposition does not just depend on there being an estate tax applicable when the individual died but on the retroactive reinstatement of the estate tax.

For example, suppose there is no estate tax when the individual dies in 2010, so the entire estate is to pass into a credit-shelter trust. But if the estate tax is retroactively reenacted so that it does apply to the individual’s estate, the estate does not pass to the credit-shelter trust as would occur as of the moment of death when no estate tax existed, the disposition is “switched” to pass substantially to the surviving spouse in some form that qualifies for the federal estate tax marital deduction. That raises the question of whether such a post-death transfer to the surviving spouse will qualify for the marital deduction. Although, as of the reenactment of the tax, the estate would pass in a form that would qualify for the estate tax marital deduction, it is not absolutely certain that the IRS would not contend that, because the marital deduction disposition was not actually in effect when the decedent died, the marital deduction should not be allowed. It does seem that result is unlikely to occur but there is no guarantee it will not happen.³²

Thus, a case can be made that providing for the entire estate to be transferred to a QTIP trust is a “safer” choice, at least until the law is

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²⁸ Exhibit 1 for this proposition is the repeal of the estate and GST taxes for 2010.

²⁹ Conditioning the disposition of property on “if I die when there is no federal estate tax applicable to my estate” may not be clear as to whether that condition applies if there is no federal estate tax applicable at the time of death but is retroactively reenacted to apply to the decedent’s estate. Therefore, some consideration also may be given to conditioning the disposition on “and no retroactive reinstatement of that tax.” Of course, in theory, that could occur decades from now. Therefore, it also may make sense to state the condition as only being for the current year, such as “if I die in 2010 when there is no federal estate tax applicable to my estate (including any retroactive reinstatement of such tax in 2010).”

³⁰ Pennell, 843-2nd T.M. (BNA), *Estate Tax Marital Deduction*, fn. 85.

³¹ If there is no estate tax in effect when the individual dies, there is no duty to file a Form 706. If the tax is retroactively reinstated, it

seems very likely estates of decedents who died before such legislation was enacted would have at least nine months from that time to file the return. Even if the return is required to be filed nine months after death, an extension for an additional six months can be obtained, so the executor would have at least into 2011 to file the return and make the QTIP election to the extent the executor determines appropriate. It seems unlikely that the 112th Congress, which will be sworn in at the beginning of 2011, would retroactively reimpose the estate tax on those who died in 2010.

³² The IRS might make its argument under the doctrine set forth in *Procter*, 142 F.2d 824, 32 AFTR 750 (CA-4, 1944), *cert. den.*, discussed in more detail below. Nevertheless, the predicate in the Fourth Circuit’s application of the doctrine was that the taxpayer was “trifling” with the audit and judicial processes. That would not seem to apply where the result is based on the action of Congress and the President.

clarified as to whether the estate tax might be retroactively reinstated.

Some Other Drafting Considerations

Regardless of whether a client is married, there are other revisions to documents that should be considered to address the no estate or GST tax/carryover basis regime of 2010.

First, the client's will (and it should be the will because it is the executor who gets to allocate the basis increases) should include express authority for the executor to allocate the basis increases, in the executor's sole and absolute discretion. Under Section 7701(a)(47), the executor is the person who is the executor or administrator of the decedent's estate. If there is no executor or administrator appointed, qualified and acting within the U.S., any person in actual or constructive possession of any property of the decedent is the executor for tax purposes. There may be many such persons, however, and there may be disagreement among them concerning who may exercise options and elections, such as the allocation of the \$1.3 million and \$3 million basis increases under Section 1022. Such disputes would be resolved if the decedent has a will admitted to probate so that an executor (or administrator) is appointed.

Second, it may be appropriate to provide expressly in the will that only an executor who is not a beneficiary is authorized to allocate the basis increase. Otherwise, there may be conflicts of interest and a question may exist whether an executor who is a beneficiary may allocate basis increase to himself or herself under local law without incurring personal liability and surcharge. If the executor who is also a beneficiary may allocate basis increase to himself or herself under state law, there may be potential gift tax consequences for failing to do so.³³

Third, whether or not an individual is married, some thought should be given to the interpretation of an instrument that makes a bequest or gift equal to the individual's unused GST exemption at death, as discussed above, because the absence of

a GST tax for 2010 may render the meaning of such a bequest or gift uncertain.

STATES WITH AN INDEPENDENT ESTATE TAX

Prior the enactment of EGTRRA, the vast majority of states imposed an estate tax equal to the credit allowable under Section 2011 for state death taxes paid. EGTRRA repealed this credit and substituted a deduction under Section 2058. The repeal of the state death tax credit meant that many states no longer had an estate tax of any kind.

Certain basis increases for carryover basis property are provided, to relieve small- and moderate-sized estates from the need to maintain detailed records of basis.

Some jurisdictions, such as Connecticut, the District of Columbia, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, and Washington, have instituted stand-alone state estate taxes. It does not appear that all

of the independent state estate tax systems were eliminated by the repeal of the federal estate tax for 2010, although, no doubt, some may argue that at least some of them have been.³⁴ There still may be a state death tax and it may present a significant issue for individuals who die domiciled in or who own real or tangible personal property in such states.³⁵

EXAMPLE: A married New Yorker died in 2009 with an adjusted gross estate of \$25 million (the total estate, less expenses and debts deductible on the estate tax return). The decedent's estate planning documents provided for an amount equal to her unused federal estate tax exemption to pass to a credit-shelter trust for the benefit of her husband and descendants; the balance of her estate passes to her husband in a form that qualifies for the estate tax marital deduction. The decedent's federal estate tax exemption for 2009 was \$3.5 million,³⁶ which also would be the amount of her taxable estate for federal and New York estate tax purposes. The applicable credit under Section 2010 will protect the estate from any federal estate tax, but because the New York estate tax exemption is effectively limited to \$1 million, New York will impose an estate tax equal to the amount of credit that would have been allowable under Section 2011 on \$3.5 million, which would

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³³ See generally Gans, Blattmachr, and Heilborn, "Gifts by Fiduciaries by Tax Options and Elections," 18 *Probate & Property* 39 (Nov./Dec. 2004), republished in *Digest of Tax Articles* (March 2005).

³⁴ One of the more interesting series of events involving the repeal of the state death tax credit occurred in the state of Washington. When EGTRRA was enacted, Washington had an estate tax. A 1981 initiative had expressly limited the Washington estate tax to "an amount equal to the federal credit." Rev. Codes Wash. section 83.100.030(1). In 2001, the legislature enacted an amendment that stated that references to the Internal Revenue Code were to "the United States Internal Revenue Code of 1986, as amended or renumbered as of January 1, 2001." Rev. Codes Wash. section 83.100.020(15). Several executors sued to contest the validity of this provision, and the state supreme court held in *Estate of Hemphill v. Washington*, 153 Wash. 2d 544, 105 P3d 391 (Wash., 2005), that the repeal of the federal credit for state death taxes automatically repealed the state estate

tax, notwithstanding the actions of the legislature. The state then adopted an independent Washington estate tax. Rev. Codes Wash. sections 83.100.010-83.100.906. See Mumford, "Up and Down and Back Again: Troubled Childhood Notwithstanding, Washington's Stand Alone Estate Tax Deserves to be Defended," 29 *Seattle U.L. Rev.* 687 (Spring 2006).

³⁵ As a general rule, a decedent's state of domicile may impose a death tax on all of the decedent's property at death other than real or tangible personal property actually situated in another state; that other state may impose its death tax on the real or tangible personal property actually situated there. See *Blodgett v. Silberman*, 277 U.S. 1, 8 AFTR 10243 (1928). See also Hellerstein and Hellerstein, *State Taxation*, Third Edition (Thomson Reuters/WG&L, 2009), ¶ 21.03.

³⁶ Certain lifetime gifts reduce the amount of estate tax exemption that will be effectively available to the individual's estate for federal estate tax purposes. See, e.g., Section 2001(b).

be \$229,200.³⁷ This represents an effective New York estate tax rate of about 6.5% (\$229,200/\$3,500,000). A New Yorker might well decide that paying such a tax when he or she dies is worthwhile, because it removes an extra \$2.5 million from the federal gross estate of the surviving spouse.

In 2010, however, the result could be very different. If the married New Yorker died in 2010 and her will (or revocable trust) leaves her entire estate to a credit-shelter trust that does not qualify for the New York marital deduction, her New York taxable estate, on which a tax determined under the rates set forth in Section 2011 will be imposed, will be \$25 million. The New York estate tax would be \$3,466,800, which represents an effective New York estate tax rate of nearly 14%. Both the amount of tax due and the effective rate of tax are much higher for this decedent than for a decedent dying in 2009, because the latter would have a much smaller New York taxable estate. This arrangement should also mean that \$24 million (plus any growth or minus any decline in value and consumption) will be excluded from the federal gross estate of the surviving

spouse at his later death (assuming there is a federal estate tax applicable at that time). At a 45% estate tax bracket, this would avoid \$10.8 million in federal estate tax in the estate of the surviving spouse—more than three times the amount that had to be paid to New York to achieve that result. Some married New Yorkers might well decide, however, that it is just too high a price to be paid when they die.

This awkward situation may arise, even if the decedent's governing instrument leaves the entire estate to a QTIP trust (other than, perhaps, an amount equal to the state estate tax exemption that might pass, for example, into a credit-shelter trust), if the individual dies domiciled in (or owns real or tangible personal property situated in) one of the states that imposes an independent estate tax and does not allow a state-only QTIP election.³⁸ Some jurisdictions, such as New York,³⁹ New Jersey,⁴⁰ Minnesota, Vermont, Iowa, North Carolina, and the District of Columbia, appear not to permit state-only QTIP elections.⁴¹ A distinction may be made, however, in those states between disallowing state-only QTIP elections where an inconsistent election is

made for federal estate tax purposes and allowing or disallowing a state-only QTIP election when the federal estate tax is not applicable. It would appear to be improper for a state that bases its estate tax on the federal estate tax law to disallow a marital deduction allowed by the "old" federal estate tax regime that it is following. Nevertheless, there is a risk that a decedent who dies in 2010 will not be allowed a QTIP election for state death tax purposes.

In a more perfect world, existing wills and trusts would have taken into account the no-estate-tax and carryover-basis possibilities.

A married individual domiciled in or owning real or tangible personal property situated in a state⁴² that does not permit a state-only QTIP election may have to make sure that the marital share is left in a form other than a QTIP, such as an outright disposition, a general power of appointment trust described in Section 2056(b)(5), or an estate trust,⁴³ assuming that such forms qualify for the estate tax marital deduction under the state death tax system in question, to avoid a significant state death tax to be paid if he or she dies in 2010. The most significant potential downside of this approach is that if the federal estate tax is reinstated, as it is currently scheduled to be in 2011, the other forms of bequest will be subject to estate tax when the surviving spouse later dies. In all, potential payment of state estate tax may be a small price to pay to obtain federal estate tax exclusion.

This change in form, however, must be undertaken with consideration of the carryover basis rules. It is clear that the outright bequest to a spouse of nonterminable interest property constitutes qualified spousal property to which the \$3 million basis increase under Section 1022(c)

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³⁷ See New York Tax Law (McKinney's), sections 951-961. Actually, the calculation of the New York estate tax is more complicated. It is the lesser of (1) what the federal estate tax would be on the taxable estate if the federal exemption were only \$1 million (not \$3.5 million) and (2) what the state death tax credit would be under Section 2011. The state death tax credit was determined based on the decedent's federal taxable estate reduced by \$60,000. That is, in computing the state death tax credit, the amount is not reduced by \$1 million. There is some question as to whether there is any New York estate tax exemption in 2010, which is an issue beyond the scope of this article.

³⁸ Some states expressly prohibit state-only QTIP elections. See Iowa Code section 450.3; Minn. Regs., Revenue Notice 06-04 (5/8/06).

³⁹ It is possible that these jurisdictions will allow a state-only QTIP election while there is no federal estate tax. For example, New York has ruled that an estate that is not required to file a federal Form 706 may elect to use alternate valuation even though, under Section 2032, no election is permitted for federal estate tax purposes because the amount of federal estate tax will not decline by reason of the election. See N.Y. Comm'r of Tax'n and Finance Advisory Opinion TSB-A-09(2)M, Pet. No. M090420A (9/22/09), 2009

WL 3253934. This opinion could indicate that New York will permit the alternate valuation for New York estate tax purposes during 2010 and will permit the equivalent of a state-only QTIP election.

⁴⁰ See N.J. Admin. Code sections 18:26-3A.8(d); 18:26-11.13 (7/21/08). This regulation has been reported as having been repealed, but the effect of repeal seems to be uncertain. See Practical Drafting at 9464 (October 2008). It is, therefore, possible that a New Jersey state-only QTIP election will be allowed.

⁴¹ It appears that a dozen states do permit state-only QTIP elections: Conn. Gen. Stat. section 12-391; 45 Ind. Admin. Code, rule 4.1-3-5(c); Ky. Rev. Stat. section 140.080(1)(a); 36 Me. Rev. Stat. section 4062 (2-B); Md. Code, Tax-General, section 7-309(b)(5)(iii); 830 Mass. Admin. Code section 65C.1.1; Ohio Stat. section 5731.15(B); Ore. Admin. Regs. section 150-118.010(7); 72 Pa. Stat. Ann. section 9113(a); R.I. Tax Division Ruling Request No. 2003-03; Tenn. Code section 67-8-315(a)(6); Rev. Codes Wash. section 11.108.025(4); Wash. Excise Tax Advisory No. 2013.57015 (5/19/03).

⁴² See note 35, *supra*.

⁴³ An estate trust is one that is transferred on the surviving spouse's death to his or her probate estate. Rev. Rul. 68-554, 1968-2 CB 412.

may be allocated.⁴⁴ A general power of appointment marital deduction trust⁴⁵ would constitute qualified spousal property provided that the spouse has a qualifying income interest for life and no person has a power to appoint the assets to anyone other than the spouse. It seems highly unlikely, however, that an estate trust would qualify.⁴⁶ A married person who decides to use a general power of appointment marital deduction trust that includes an inter vivos power or an estate trust, therefore, should consider making a formula bequest outright to the surviving spouse to ensure full use of the \$3 million additional basis increase for qualified spousal property.

A case can be made that transferring the entire estate to a QTIP trust is 'safer,' at least until clarification as to whether reinstatement might be retroactive.

The best course of action for a married person domiciled in a state that has a state death tax but that does not permit a state-only QTIP election and who is likely to die in 2010 may be to change domicile to a state without an estate tax, or at least a state that permits state-only QTIP elections. That, of course, may be life altering in many ways, but the additional price of dying in a state that has an independent estate tax and that does not permit state-only QTIP elections may be more than the individual (particularly if he or she is highly tax-adverse) is willing to undertake.⁴⁷

An unusual situation in New Jersey brings to light one more point worth discussing with respect to dispositions to a surviving spouse in 2010. New Jersey revoked its regulation that had provided that it would not recognize an unnecessary federal QTIP election. It has been suggested that this revocation reflects a concern that the state would lose the

ability to impose its estate tax when the surviving spouse died, if the surviving spouse's executor, relying on Rev. Proc. 2001-38, 2001-1 CB 1335, treated the election as not having been made. Regardless of the purpose of the revocation, it reinforces the important point that many states impose their state death taxes on the amount of the decedent's taxable estate as determined for federal estate tax purposes. A QTIP created by a decedent who dies in 2010 would not be included in the gross estate of the surviving spouse for federal estate tax purposes when he or she later dies and would not be subject to state death taxation when the survivor dies if the state imposes its death tax based solely on the decedent's federal gross estate. Therefore, any such state may be reluctant to permit a state-only QTIP election because it would not be able to tax the QTIP property when the surviving spouse dies (as it would not be in the survivor's gross estate for either federal or state death tax purposes) and would have the opportunity to tax the property only when the first spouse dies.

More Complications for States With Death Taxes

There may be additional hurdles for those who die in 2010 domiciled (or owning real or tangible person property situated) in a state with an independent state death tax, especially if that state tax does not permit a state-only QTIP election. That complication arises where property is already in an irrevocable trust, such as a

grantor retained annuity trust (GRAT) or qualified personal residence trust (QPRT), which provides for the creation of a QTIP trust for the surviving spouse to the extent the trust otherwise is included in the grantor's gross estate for federal estate tax purposes.

EXAMPLE: A grantor created a GRAT in October 2008 which is to terminate in October 2010. If she dies before the annuity term ends, all or a portion of the trust may be included in her gross estate under Section 2036(a).⁴⁸ On account of that possibility, the trust agreement provides that, if the grantor dies before the annuity term ends, the trust property (other than any annuity due the grantor or the grantor's estate) passes to a QTIP trust for the grantor's spouse, if then living. If the grantor dies in 2010 and before the GRAT term ends, there would have been estate tax inclusion that will cause a state death tax to be imposed, if the grantor was domiciled in a state with a state death tax and no state-only QTIP is permitted. There is no state estate tax if a state-only QTIP is permitted, assuming the grantor's estate can and does make the state-only QTIP election and avoids the state death tax. In those states that impose a state estate tax but that do not permit a state-only QTIP election, a state death tax may be imposed.

There might be a state death tax even in a state that permits a state-only QTIP election with respect to such an irrevocable trust, because of the way the disposition in favor of

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⁴⁴ The statute makes it clear that a usufruct interest qualifies, but does not say whether the analogous and more typical legal life estate also qualifies.

⁴⁵ A QTIP trust described in Section 2056(b)(7) is similar to a general power of appointment trust described in Section 2056(b)(5). But a trust granting the spouse the power to withdraw all property from the trust for his or her own benefit and also to appoint it during his or her lifetime to someone else likely would not be qualified spousal property.

⁴⁶ An estate trust described in Rev. Rul. 68-554, *supra* note 43, is not required to pay all of its income at least annually to the surviving spouse, although a trust that has such direction and otherwise meets the requirements of the Regulations would seem to be

described in Section 2056(b)(7), and therefore would be a QTIP trust.

⁴⁷ One changing domicile should be careful to make the change completely, or not at all. States can reach inconsistent conclusions regarding residency and the U.S. Constitution affords no protection against the same decedent being subjected to estate or inheritance taxes as a resident of more than one state. See *Dorrance v. Martin*, 12 F. Supp. 746 (DC N.J., 1935), *aff'd sub nom. Hill v. Martin*, 296 U.S. 393 (1935); *Texas v. Florida*, 306 U.S. 398 (1938); and the discussion in Hellerstein and Hellerstein, *supra* note 35, ¶ 21.09.

⁴⁸ Reg. 20.2036-1(c). See generally Blattmachr, Zeydel, and Gans, "Final Regulations on Estate Tax Inclusion for GRATs and Similar Arrangements Leave Open Issues," 109 JTAX 217 (October 2008).

the QTIP trust is designed. In fact, there also could be a state death tax, even if the grantor provides for the trust to be paid outright to his or her surviving spouse, which would qualify for the marital deduction because the property passes outright (unless the surviving spouse is not a U.S. citizen and the state allows a marital deduction only if the transfer is to a QDOT). The marital deduction may be lost because, sometimes, the GRAT will provide that the amount passing into the QTIP is limited to the portion of the trust included in the grantor's gross estate for federal estate tax purposes. In 2010 there is no federal estate tax, and there would be nothing included in the grantor's gross estate for federal estate tax purposes. Nothing would, therefore, pass into the QTIP or to a surviving spouse.

It may be appropriate to provide expressly in the will that only an executor who is not a beneficiary is authorized to allocate the basis increase.

A similar result could arise with respect to irrevocable life insurance trusts, which often have such contingent marital deduction provisions in the event part or all of the proceeds under policies owned by the trust are included in the insured's gross

estate.⁴⁹ Such inclusion is common if the insured transfers an existing policy to the trust and dies within three years of the date of the transfer.⁵⁰

The same result may also arise if one spouse has created a lifetime QTIP trust for the other. Such a QTIP will not be included in the donee spouse's gross estate if he or she dies in 2010, because there is no estate tax, but a state death tax could apply. The QTIP trust would be included under Section 2044 in the gross estate of the donee spouse for whom it was created, but many lifetime QTIP trusts automatically provide that, if the donor spouse survives the donee spouse, the trust property will be held in a QTIP trust for the donor spouse. A state-only QTIP election, if permitted, could be made to avoid state death tax on the assets in such a trust, but if a state-only QTIP election is not permitted the property presumably would be subject to state death tax. If the spouse who is the beneficiary of the inter vivos QTIP trust has a power of appointment, perhaps consideration should be given to exercising the power if such exercise may correct the problem.

Alternatively, the best course of action where property is held in an irrevocable trust with a contingent QTIP provision is to have the trust reformed by a court or by action of the beneficiaries and the grantor, if permitted by state law, prior to the death of the donee spouse.⁵¹ Another option is to reform the trust by

decanting, which is the act of paying the trust assets to a new trust.⁵²

About a dozen states have statutes that permit decanting of the assets of one trust to another trust to be held on terms different from those of the transferring trust. Many states that have independent state death tax systems do not permit decanting. One option is to use the Alaska decanting statute, which provides, in part, that if an Alaska resident or Alaska bank or trust company is appointed as co-trustee, and if the trustees agree that Alaska will be the primary place of trust administration, the trustees will have decanting powers under Alaska law.⁵³ In any event, the decanted trust would provide the appropriate provision such as an outright payment to the surviving spouse if the deceased spouse dies domiciled in a state with an independent state death tax and it would not otherwise qualify for the state death tax marital deduction.

SUGGESTED ACTION STEPS

Looking forward, the first step for practitioners who do not wish to continue to put faith exclusively in Congress's ability to solve these complex issues—which it has been unable to do for eight years—is to contact clients about the 2010 law changes. A generic memorandum or an individually addressed letter or memo to each client might be used.

A practitioner may wish to consider inviting clients to contact his or her firm to make an appointment to determine what, if any, steps should be taken.⁵⁴ As mentioned above, it seems appropriate to determine explicitly how clients whose documents contain word formulas actually wish to dispose of their property if they die when there is no federal estate tax and no GST tax, but there is carryover basis. For those living in state death tax states, other factors probably also should be discussed, including the possibility of changing domicile.

Lawyers will almost certainly be preparing many documents in 2010 to cover this situation. For example,

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⁴⁹ See Zaritsky and Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, Second Edition (Thomson Reuters/WG&L, 2009), ¶ 5.03[5][b]; Zeydel, "A Complete Tax Guide for Irrevocable Life Insurance Trusts," 34 Estate Planning No. 7 (July 2007), page 13.

⁵⁰ Section 2035(a).

⁵¹ Uniform Trust Code section 411 permits the grantor and all beneficiaries of a trust to modify or terminate the trust "even if the modification or termination is inconsistent with a material purpose of the trust." Court approval would not be required under the U.T.C. generally, but a variation in Alabama, Maine, Nebraska, New Mexico, Ohio, and Virginia requires that the modification agreement be submitted to a court to assure that the grantor and the beneficiaries did all agree to the proposed modification. These versions of the U.T.C. do not, however, require that the

court determine the appropriateness or desirability of the proposed modification. See Ala. Code section 19-3B-411; 18-B Me. Rev. Stat. section 411; Neb. Rev. Stat. section 30-3837; N.M. Stat. Ann. section 46A-4-411; Ohio Rev. Code section 5804-11; Va. Code section 55-544.11.

⁵² See Zeydel and Blattmachr, "Tax Effects of Decanting—Obtaining and Preserving the Benefits," 111 JTAX 288 (November 2009).

⁵³ Alaska Stat. section 13.36.157. The Alaska statute is consistent with the legal principle that a trustee derives its fiduciary powers from the place of administration. See U.T.C. section 108 (principal place of administration); 5A Scott on Trusts (4th ed., W. Fratcher 1987), § 615.

⁵⁴ Practitioners can find a sample letter to clients about this at the home page of www.interactivelegal.com.

married clients could explicitly state how their estates are to pass if they die when there is no estate tax. As mentioned above, this might be a direction for the entire estate (other than, perhaps, small pre-residuary bequests) to pass into a credit-shelter trust if there is no federal estate tax applicable when the married person dies, except for a bequest to take full advantage of the \$3 million increase in basis permitted for qualified spousal property. Alternatively, the documents might provide for the entire estate (other than, perhaps, small pre-residuary bequests) to pass into a QTIP trust.

It does not appear that all of the independent state estate tax systems were eliminated by the repeal of the federal estate tax for 2010.

Furthermore, a client who wishes to allocate to a spouse that amount of property sufficient to take advantage of the \$3 million spousal basis adjustment will need to decide whether this gift should involve selecting assets whose value is the smallest possible amount that will absorb the entire \$3 million adjustment, the largest possible amount that will absorb this adjustment, or an amount that fairly reflects the appreciation and depreciation in the estate assets generally.

Moreover, any married client living in a state with an independent estate tax likely should consider whether he or she wishes (1) to have state death tax paid at his or her death and avoid both federal and state estate tax when the surviving spouse dies, or (2) to avoid both federal and state death tax when the first spouse dies even if it means considerably more tax when the surviving spouse dies. That decision likely will be easier to make if the state permits a state-only QTIP election and the "optimum" state marital deduction share passes into a QTIP trust.

If the state permits a state-only QTIP election and the "optimum" state marital deduction passes to a QTIP trust, the decision of whether to pay state death tax if the first spouse dies when there is no federal estate tax may be postponed until the state death tax return is filed and the election to elect or not elect QTIP trust treatment must be made. Alternatively, if the married person lives in a state with a state death tax that does not permit a state-only QTIP trust, the document might provide for the entire estate (other than, perhaps, pre-residuary bequests and one equal to the state death tax exemption) to pass into a general power of appointment marital deduction trust (assuming such a trust would qualify for the state marital deduction or exemption). That, of course, will mean that the trust automatically will qualify for the state death tax marital deduction and could be included in the gross estate of the surviving spouse for federal estate tax purposes under Section 2041. The surviving spouse would have the option of making a qualified disclaimer pursuant to Section 2518 of the general power of appointment, converting that trust into a QTIP trust and thereby preventing the trust from being included in his or her gross estate for federal estate tax purposes, thereby also potentially forgoing the state law marital deduction.

Another consideration, as mentioned above, for any person residing in a jurisdiction with an independent state death tax, is the possibility of changing domicile to a state that has none. For those who own real or tangible personal property actually situated in a state with an independent state death tax, some consideration should be given to eliminating that property from tax. That, of course, is a matter that individuals have had to consider since EGTRRA eliminated the state death tax credit, which resulted in eliminating state death tax systems in a majority of states. Such action may include selling such assets, giving them away prior to death (although that could produce a gift tax liability), and converting such property

into an intangible. It might be appropriate, for example, for someone who is likely to die in 2010 to give such property to his or her spouse under the protection of the gift tax marital deduction if the spouse is expected to survive this year.⁵⁵

A decision likely should be made now as to whether state death tax will or will not be paid if the first spouse to die passes when there is no estate tax, for clients living in a state with an independent state death tax. This decision also can be postponed until after the first spouse dies, however, if the client's estate planning documents provide for the amount passing to the credit-shelter trust to be equal to the state death tax exemption and for the marital deduction share to pass either outright to the surviving spouse or to a general power of appointment marital deduction trust. In such a situation, there will be no state death tax due, and the surviving spouse may change that outcome by making a qualified disclaimer within nine months of the death of the first spouse to die.

The following language might be used in the will or revocable trust of a married person who prefers for the marital deduction share to pass into a QTIP trust but who lives in a state with an independent state death tax and no state-only QTIP:

If there is no federal estate tax applicable to my estate at my death (including no retroactive reenactment of such tax enacted by the end of the calendar year of my death making it applicable to my estate) and if the state of my domicile imposes a state death tax at my death but does not permit my estate to make an election to treat any property that would be described in Section 2056(b)(7) of the Internal Revenue Code of 1986, as amended (the "Code"), to qualify for the marital deduction or exemption for purposes of the state death tax, I hereby grant my husband/wife a power to appoint at his/her death by his/her Will by specific reference to this general power of appointment

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⁵⁵ The gift tax marital deduction is not allowed for transfer to or for a spouse who is not a U.S. citizen. See Section 2523(f). Nevertheless, the annual exclusion for 2010 for transfers to a non-U.S. citizen spouse is \$130,000.

the property in any trust that is so described to his/her estate so that the trust will be described in Section 2056(b)(5) of the Code.

In some respects, a plan that forces all property into a QTIP trust in the event the federal estate tax is not applicable at the decedent's death (at least in states with a state-only QTIP) might be safest for the following reasons. At the present time, no one can predict whether the federal estate and GST taxes will be retroactively reinstated, and whether any such retroactive reinstatement will ultimately be upheld against possible constitutional challenge. It is not entirely certain whether formulas providing for property to pass to a trust that qualifies for the marital deduction only if the tax is applicable or if the tax is retroactively reinstated would qualify for a marital deduction.

Will a state that bases its estate tax on the federal estate tax law disallow a marital deduction allowed by the 'old' federal estate tax regime that it is following?

The problem is that qualification for a marital deduction generally requires property to pass to or for the benefit of the surviving spouse at the date of the decedent's death. If at the date of death the tax is repealed, and

thus the formula causes nothing to pass to or for the benefit of the surviving spouse (except possibly sufficient property to absorb the \$3 million basis adjustment for qualified spousal property), would the shift in the estate plan after the fact, on a possible retroactive reinstatement of the tax, be effective to obtain a marital deduction? No one can predict the answer. It may seem obvious to some what the "fair" answer would be, but as we all know life under the tax law is not always fair. Should taxpayers take that risk vs. the risk that a spouse who receives the entire estate in a QTIP would not disclaim if the tax is in fact not in effect? These are, of course, client calls.

In fact, perhaps, the simplest plan of all for a married person is to have his or her entire estate (other than small pre-residuary bequests) pass into a QTIP trust and take advantage of any federal or state death tax exemption by a disclaimer made by the surviving spouse of his or her interest in the QTIP trust or by a partial QTIP election by the executor. That is, the bequest of the entire estate to the QTIP trust (and none to the "bypass" trust) would not be conditioned on there being a federal or state death tax (retroactive or otherwise) in effect at the decedent's death. It would instead provide for the entire residuary estate to pass to a QTIP trust in all events, with an express provision that if the surviving spouse disclaims any portion of his or her interest in the QTIP trust, the disclaimed portion would pass to a bypass trust.

If the decedent is domiciled in a state that may not permit a state-only QTIP election, the QTIP trust also should grant the surviving spouse a general power to appoint the trust to his or her estate at death so that the trust will qualify for the state estate tax marital deduction. The surviving spouse could disclaim the general power to avoid inclusion in his or her gross estate for federal estate tax purposes if the first decedent dies when there is no federal estate tax in effect (including no retroactive reenactment of the tax). The only limitation is that any disclaimer by the surviv-

ing spouse (unless he or she is under the age of 21 years) must be made within nine months of the death of the first spouse to die in order for the disclaimer to be qualified under Section 2518.

MORE ON CARRYOVER BASIS

As indicated above, the basis of an asset acquired from a decedent or from whom the property passed by reason of death in 2010 generally will not be equal to the asset's value on the decedent's date of death under Section 1014(a).⁵⁶ Instead, the decedent's adjusted basis will carry over to those who acquire the property.

There will be no income-tax-free step-up in basis at death, but there may be a "step down" in basis if the decedent's adjusted basis is greater than the asset's FMV. Section 1022(a) states that the income tax basis of carryover basis property is the lesser of (1) the decedent's adjusted basis in the property or (2) the FMV of the property at the date of the decedent's death.

As the country's prior experience with a carryover basis regime demonstrated, it is a complicated tax system. Some practitioners will bemoan the fact that there will be no federal estate tax return prepared for any individual dying in 2010, but returns and reports are still required for carryover basis property. The number of decedents' estates affected by carryover basis will, in fact, be many times the number that were affected by the federal estate tax last year.⁵⁷ Individuals will need significant professional advice and guidance, as occurs in all circumstances involving a new tax system. As a result, it should be a good year for those who administer decedents' estates and those who advise them.

An entire book could be written about the current carryover basis regime, as was done under the prior carryover basis rules.⁵⁸ This regime is virtually certain to be short term, however, so that may not occur again. Nonetheless, professionals need to become familiar with the

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⁵⁶ There are exceptions to the rule under Section 1014(a) that the basis of an asset acquired from or passing from a decedent is equal to its date of death value. If alternate valuation is elected pursuant to Section 2032, the basis is the value on such alternate valuation date. There are other exceptions as well.

⁵⁷ According to a New York Times editorial entitled "An Estate Tax Mess" (12/27/09), the number of estates affected by carryover basis will be 70,000, compared to 5,500 that would have been affected had the estate tax been retained with the 2009 parameters.

⁵⁸ See McGrath and Blattmachr, *Carryover Basis under the 1976 Tax Reform Act* (Journal of Taxation, 1977). Although there are many technical distinctions between the 1976 and 2010 carryover basis rules, a great many of the planning implications and solutions are the same.

rules, including filing requirements, and the planning opportunities and dangers they present. The impact of the carryover basis regime will be felt for quite some time and well beyond 2010, as property is sold, exchanged, depreciated, or otherwise dealt with for income tax purposes.⁵⁹ This article will not attempt to discuss these rules in complete detail, but it will highlight certain critical parts of these rules and also discuss how basis information of a decedent's property may be obtained.

Section 1022: A Synopsis

Significant aspects of the carryover basis rules are as follows.

No automatic long-term holding period. Basis will not be determined pursuant to Section 1014(a), so the automatic long-term capital gains holding period provided under Section 1223(9) will no longer apply. The decedent's holding period may be added (or tacked) to that of the estate or inheritor, but only if the basis is determined, in whole or in part, from the decedent's basis. An estate's or inheritor's basis would not be determined even in part by the decedent's basis if the decedent's basis was greater than the property's FMV at death, and these assets will not immediately after death be treated as long-term capital gain property.⁶⁰ This may suggest that these assets should be sold immediately prior to death if the decedent is likely to die this year.

Increases in basis. As noted above, under Section 1022(b) the executor may increase the bases of property "owned by the decedent" and "acquired from a decedent" by \$1.3 million. Additional increases are allowed for the sum of capital loss carryovers of the decedent under Section 1212(b) and NOL carryovers under Section 172, plus the sum of any losses that would have been allowable under Section 165 if the property had been sold before death for its FMV. Such increases cannot exceed an asset's FMV at death. For property acquired by a decedent who was at death a

non-U.S.-domiciliary alien,⁶¹ the basis increase under Section 1022(b) is limited to \$60,000.

As mentioned above, the decedent's executor may increase the basis of qualified spousal property (but not above the FMV of any asset at death) by an additional \$3 million. Qualified spousal property does not include any terminable interest.⁶² The estate tax marital deduction under Section 2056(a) is allowed for a transfer to a non-U.S.-citizen surviving spouse only if it is in the form of a QDOT described in Section 2056A, but qualified spousal property need not be transferred to a QDOT even if the surviving spouse is not a U.S. citizen. Therefore, a QDOT is not required with respect to a decedent dying in 2010 when leaving property to a surviving spouse who is not a U.S. citizen. This too represents an additional challenge in drafting a will (or a revocable trust used as a will substitute) for a married person whose spouse is not a U.S. citizen.

Property to which the basis increases apply. The basis increase rules apply only to property owned by and acquired from the decedent ("basis adjustment property"), which includes property in a revocable trust with respect to which the election to treat it as part of the decedent's probate estate for post-death income tax purposes under Section 645 could be made (a "qualified revocable trust").⁶³ One-half of property owned jointly with rights

of survivorship between the decedent and his or her spouse is treated as basis adjustment property.⁶⁴

Only that portion of property jointly owned by the decedent and someone other than his or her surviving spouse that would have been included in the decedent's gross estate under the estate tax rules is treated as basis adjustment property. Thus, for property owned jointly with a right of survivorship between the decedent and someone other than his or her spouse, and in which the decedent furnished consideration for the acquisition of the property, the decedent will be treated as the owner to the extent of the part of the property that is proportionate to such consideration; that portion of the property will be basis adjustment property.⁶⁵

Furthermore, property owned jointly with a right of survivorship between the decedent and someone other than his or her spouse in which the property has been acquired by gift, bequest, devise, or inheritance by the decedent and such other person and in which their interests are not otherwise specified or fixed by law, the decedent will be treated as the owner to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants with right of survivorship; that portion will be basis adjustment property.⁶⁶

The surviving spouse's half of community property owned together with the decedent, as well as the

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⁵⁹ See Berall, Harrison, Blattmachr, and Detzel, "Planning for Carryover Basis That Can Be/Should Be/Must Be Done Now," 29 Estate Planning 99 (March 2002)—in all likelihood, the most comprehensive discussion of the carryover basis rules applicable in 2010. This article should be studied by every professional who intends to be involved in the administration of estates of individuals who die this year.

⁶⁰ It has been suggested that if the property is sold after Section 1014(a) becomes effective again, it may be that basis is restored. See Berall et al., *supra* note 59, pages 99-100.

⁶¹ Section 1022(b)(3) uses the phrase "nonresident not a citizen," which appears to have been taken from Section 2101. For estate tax purposes, "resident" means an individual who has his or her "domicile" in the U.S. (a subjective intent test); see Reg. 20.0-1(b).

That phrase should be distinguished from "nonresident alien" defined in Section 7701(b), used for income tax purposes, which relates to physical presence in the U.S.

⁶² See Section 1022(c)(4)(B). The rules for not applying the basis adjustment for qualified spousal property seem to be nearly identical to those for not allowing the estate tax marital deduction under Section 2056(b).

⁶³ A QTIP trust that had been created by the decedent's spouse and which would have been included in the gross estate of the decedent under Section 2044 if the decedent had died when the federal estate tax was in effect will not be basis adjustment property because it will not be "owned by the decedent."

⁶⁴ Section 1022(d)(1)(B)(i)(I).

⁶⁵ Section 1022(d)(1)(B)(i)(II).

⁶⁶ Section 1022(d)(1)(B)(i)(III).

decedent's half of such property, is treated as basis adjustment property.⁶⁷ Property over which the decedent held any power of appointment, however, is not basis adjustment property.⁶⁸ The statute does not distinguish between a general or a limited power of appointment for this purpose.⁶⁹

A plan that forces all property into a QTIP trust if the federal estate tax does not apply (at least in states with a state-only QTIP) might be safest for several reasons.

An individual who holds a power to withdraw appreciated property from a trust (that is, to appoint such property to himself or herself) should consider exercising the power in favor of himself or herself, if the individual is very likely to die in 2010. This would be appropriate, of course, only to the extent that the property will not pass to charity at the individual's death, and that the individual's executor could allocate some of the individual's \$1.3 million aggregate basis increase or, if the individual is married and the property would pass to his or her spouse or a QTIP trust, some of the individual's \$3 million spousal basis adjustment, to these assets.

An individual who holds a testamentary power of appointment over property that may be appointed to

his or her estate might choose to exercise it pursuant to a word formula that would appoint only the amount to which available basis adjustment could be allocated. Such a formula would be particularly complicated, for three reasons:

1. It may be uncertain how much inherent gain will be present in the assets when the individual dies, as the assets may increase or decrease in value between the date on which the exercising instrument is executed and the date of death.

2. The individual (and his or her advisors) must determine whether to minimize the amount over which the power should be exercised or maximize the potential tax savings, as discussed in greater detail below.

3. It is not certain that property appointed at death to the individual's estate will be treated as "owned by the decedent" and "passing from the decedent," which are general prerequisites for the basis adjustments under Section 1022 to apply.

There are other potential problems that can arise when exercising a power of appointment over appreciated property. Assets so appointed, to the extent that the power of appointment is exercised in favor of the individual's estate, or if held by the decedent's estate to the extent withdrawn prior to death, will become subject to the claims of the decedent's creditors and may be taken into account in determining the assets on which the executor's commissions (or attorneys' fees) are based. Moreover, property subject to a general power of appointment created before 10/22/42 is included in the powerholder's gross estate for federal estate tax purposes only to the extent it is exercised; it is not included merely because it lapses.⁷⁰

It may, therefore, be best to provide that a general power is exercised only if no federal estate tax (including no retroactive reenactment of the tax) would be imposed on account of the exercise, and if no state estate tax based on the federal gross or taxable estate is thereby increased. The IRS might argue that providing for an exercise of a power

of appointment to be effective only if there is no retroactive reenactment of the federal estate tax somehow violates public policy and should be ignored so the power should be treated as exercised, which would result in the inclusion of the property subject to the power (to the extent of the deemed exercise) in the powerholder's gross estate.⁷¹ Such an argument, however, should be rejected, because the condition has been made necessary by an unusual state of the law, and is required to address the inequities inherent in retroactive tax law.

A trustee also might consider distributing appreciated property to a distributee who is expected to die in 2010, if that distributee lacks sufficient appreciated property to take full advantage of both the \$1.3 million aggregate basis adjustment and, if applicable, the \$3 million spousal basis adjustment. Such a distribution, however, is somewhat of a risk, because Congress could retroactively reinstate the estate tax and cause the distributee's estate to become liable for a higher estate tax than otherwise. Thus, consideration also might be given to the size of the distributee's estate, so that the ideal distributee would have both unused aggregate basis adjustment and unused estate tax exemption, or would plan to leave property to a surviving spouse (or a QTIP for such a spouse) and have both unused spousal basis adjustment and have a spouse with unused estate tax exemption.

A gift of appreciated property to a donee (other than a spouse) who is expected to die in 2010 will not be effective; property acquired by the decedent by gift for less than adequate and full consideration within the three-year period ending with the date of death is not basis adjustment property.⁷² An exception to this three-year rule is made for property acquired by the decedent as a gift from his or her spouse, and such property still is not basis adjustment property if the donor spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration.⁷³ Thus, a client should

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⁶⁷ Section 1022(d)(1)(B)(iv). This rule is similar to the concept used in Section 1014(b)(6), which provides for the bases of both spouses' halves of community property to be stepped up when the first spouse dies, in most instances.

⁶⁸ Section 1022(d)(1)(B)(iii).

⁶⁹ *Id.*

⁷⁰ Section 2041(a).

⁷¹ See, by analogy, Procter, *supra* note 32, in which the court held that a clause that returned property to a transferor if it was determined to be a taxable gift was not effective because it interfered with the proper administration of the tax law.

⁷² Section 1022(d)(1)(C)(i).

⁷³ Section 1022(d)(1)(C)(ii).

consider giving property to his or her spouse, if the donee is significantly more likely to die this year than the donor, to the extent that the donee spouse does not already hold assets with sufficient appreciation to take advantage of both the \$1.3 million aggregate basis adjustment and the \$3 million spousal basis adjustment.

Property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent, property transferred by the decedent during life to a qualified revocable trust or any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust, and any property passing from the decedent by reason of death to the extent that such property passed without consideration, is basis adjustment property unless otherwise expressly excluded.⁷⁴ Expressly excluded are stock or securities of a foreign personal holding company, stock of a DISC or former DISC, stock of a passive foreign investment company unless such company is a qualified electing fund (as defined in Section 1295) with respect to the decedent, and the right to income in respect of a decedent.⁷⁵

Other rules. Gain will be recognized in satisfying a pecuniary bequest (a fixed sum of money) with carryover basis property, but only to the extent the property on the date of such satisfaction exceeds the asset's value on the decedent's date of death.⁷⁶ The recipient's basis is the asset's carryover basis determined under Section 1022, increased by any gain recognized by such distribution.⁷⁷

One who acquires the decedent's principal residence as carryover basis property also can use the decedent's unused \$250,000 gain exclusion under Section 121. The inheritor's use of the property as his or her principal residence may be combined with that of the decedent for purposes of satisfying the two-of-five-year occupancy test for the exclusion under that section to apply.⁷⁸

Negative basis property. Many individuals own commercial real estate or other property with liabilities in excess of the property's adjusted income tax basis. Gain is recognized on any lifetime transfer of such "negative basis property," at least to the extent such liability exceeds the basis, even if transferred without consideration.⁷⁹

No such gain is recognized, however, by a transfer occurring at death. That rule is respected under the carryover basis rules, unless the property is transferred at death to a "tax-exempt beneficiary." Section 1022(g) (2) defines a tax-exempt beneficiary as "(A) the United States, any State or political subdivision thereof, any possession of the United States, any Indian tribal government (within the meaning of section 7871), or any agency or instrumentality of any of the foregoing, (B) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter 1, (C) any foreign person or entity (within the meaning of section 168(h)(2)), and (D) to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance."

It is not entirely clear what entities are included as tax exempt under this rule. A charitable remainder trust is exempt from tax under Section 664(c), but it may not clearly fall within the definition of a "tax-exempt beneficiary" under Section 1022(g)(2). Moreover, a charitable remainder trust funded from an estate that was not subject to estate tax appears not to satisfy the definition of a charitable remainder trust that would be tax exempt. Regulations provide that a trust is not exempt unless a tax deduction was allowed for transfers to the trust, and no estate tax deduction would apply when the trust was funded from a decedent's estate if the estate tax was not then in effect.⁸⁰

A potential way to defeat the carryover basis rule with respect to negative basis property is to borrow heavily against a highly appreciated asset and bequeath the asset (which would then have a negative basis) to

an individual or non-exempt entity for whom the decedent wishes to create a tax problem. There would presumably be no gain when the individual dies and the negative basis property would be inherited by the named individual or non-exempt entity.⁸¹ This is why Treasury has regulatory authority to impose gain on the estate—see "D" above—but of course there are no Regulations at this time. The cash so borrowed would be bequeathed to the chosen objects of the borrower's bounty and the income tax basis of the cash, of course, would equal its face amount.

As the country's prior experience with a carryover basis regime demonstrated, it is a complicated tax system. Returns and reports are still required for such property.

An inheritor should be able to disclaim a negative basis asset, but it is uncertain if that would prevent the disclaimant from being treated as transferring the negative basis asset and recognizing the inherent gain. The disclaimer rules of Section 2518 generally apply for gift, estate and GST tax purposes, but not for income tax purposes.⁸² Moreover, the disclaimer under Section 2518 must usually be made within nine months

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⁷⁴ Section 1022(e).

⁷⁵ Sections 1022(d)(1)(D) and 1022(f).

⁷⁶ Sections 1040(a) and (b).

⁷⁷ Section 1040(c).

⁷⁸ Section 121(d)(11).

⁷⁹ See, generally, Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 JTAX 149 (September 2002).

⁸⁰ Reg. 1.664-1(a)(1)(iii)(a).

⁸¹ The purpose of leaving a negative basis asset to one's enemy, for example, would not seem to be for a tax-avoidance purpose but rather to cause distress to an individual by having the tax imposed on him or her.

⁸² See GCM 39858, 9/23/91 (applying Section 2518 disclaimer rules to income tax treatment with respect to a disclaimer of retirement plan benefits). See also Rev. Rul. 66-167, 1966-1 CB 20.

of the decedent's death, and the inheritor may not even be aware of the bequest of the negative basis property until after that time.⁸³

More generally, Treasury also is given authority to issue Regulations "as may be necessary to carry out the purposes of" the carryover basis rules.⁸⁴ As noted above, no such Regulations have been issued.

In any event, practitioners probably need to reconsider the estate plan of any individual who holds significant negative basis property.

Certain transfers to foreign trusts.

Section 684 treats a transfer to a foreign trust or estate as a sale or exchange. Before 2010, Section 684 applied only to transfers to a foreign trust or estate, but for 2010 it also applies to a transfer to a nonresident alien individual.⁸⁵

This deemed sale or exchange treatment does not apply to a transfer to a foreign trust that is a grantor trust, to the extent that the trust is deemed owned by a U.S. person.⁸⁶ Grantor trust status ceases on the death of the grantor, which causes the transferor to then be treated as having sold or exchanged the transferred assets to the trust.⁸⁷ The general rule of gain recognition does not apply by reason of the death of the U.S. transferor, if the basis of the property in the hands of the foreign trust is adjusted to the date-of-death value under Section 1014(a).⁸⁸

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⁸³ For other ways in which the carryover basis rules might be defeated, see Sheppard, "News Analysis—Debt in Contemplation of Death," 2001 TNT 136-6 (7/16/01).

⁸⁴ Section 1022(h).

⁸⁵ Section 684(a).

⁸⁶ Section 684(b)(1).

⁸⁷ Reg. 1.684-2(e).

⁸⁸ Reg. 1.684-3(c).

⁸⁹ See Section 7701(a)(30)(E).

⁹⁰ See Berall et al., *supra* note 59, page 100.

⁹¹ Section 6018(a). If the decedent is a nonresident alien, Section 6018(b)(3) makes the filing requirements applicable if the value of tangible property in the U.S. and any other property acquired from the decedent by a U.S. person exceeds \$60,000.

⁹² Section 6018(b)(2).

⁹³ Section 6075.

⁹⁴ See Section 6018 as in effect before 2010, and Section 2002.

To the extent the assets are included in the grantor's gross estate for federal estate tax purposes, therefore, no deemed sale or exchange would occur under this rule, but if basis is not so determined (e.g., for life insurance proceeds, stock in a DISC defined in Section 992(a), and the right to income in respect of a decedent primarily dealt with under Section 691), there would be no exception when the transferor dies and the trust loses its grantor trust status.

If the transferor to a foreign grantor trust owned by a U.S. person dies in 2010, of course, no trust assets can take a basis under Section 1014(a), and therefore a sale or exchange would be deemed to occur on the grantor's death. This suggests that some consideration be given to converting a foreign grantor trust into a domestic trust, at least until the end of 2010, which can often be accomplished by removing foreign trustees.⁸⁹ Moreover, it is not at all certain that the increases in basis permitted under the carryover basis rules will apply to the assets in such a foreign trust.⁹⁰

Carryover basis reporting requirements.

The executor, if a decedent dies in 2010 with carryover basis property (other than cash) in excess of the \$1.3 million aggregate basis adjustment under Section 1022(b), must file a return with the IRS to facilitate enforcement of these rules.⁹¹ No such return form has yet been published.

It seems likely that the \$1.3 million threshold of Section 1022(b) is used to establish the filing obligation under Section 6018 because, regardless of what the carryover basis of the property is, it will be increased to at least \$1.3 million (or the FMV of the property on the date of death, if lower), under Section 1022(b). The executor, apparently, need not make an affirmative allocation if the FMV at death for carryover basis property does not exceed \$1.3 million, and no return would be required.

The executor also must report any property acquired by the decedent within three years of death that

is not treated as carryover basis property (e.g., was not acquired by his or her surviving spouse), and which was not reported on a Form 709 gift and GST tax return.⁹²

The form is to be filed with the decedent's income tax return for the year of death.⁹³ If a person dies at or near the end of a calendar year, this does not provide much time to collect the required information.

The duty to file a decedent's U.S. estate tax return, including reporting and paying estate tax on all property included in the decedent's gross estate, falls on the decedent's executor even with respect to assets not under the fiduciary's control.⁹⁴ Section 6018(b)(4), however, now provides that an executor who is unable to make a complete carryover basis return still must file a return that includes a description of such property and the name of every person holding a legal or beneficial interest therein. On notice from the IRS, each such person must submit a return to the Service. The executor logically can report only property of which the executor has knowledge, as was required of an executor filing an estate tax return under Section 6018 before 2010.

Section 6018(c) specifies the information that must be included in the return, including:

1. The name and TIN of the recipient of such property.
2. An accurate description of such property.
3. The adjusted basis of such property in the hands of the decedent and its FMV at the time of death.
4. The decedent's holding period for such property.
5. Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income.
6. The amount of aggregate or spousal basis increase allocated to the property.
7. Such other information as may be required by Regulations.

Instructions for the form will likely enumerate all of the information required to be included.

The executor also is required to furnish to each person whose name is required to be set forth on the carryover basis return (other than the executor) a written statement showing both:

- The name, address, and phone number of the person required to make such return.
- The information provided to the IRS with respect to property acquired from, or passing from, the decedent to the person required to receive such statement.⁹⁵

The impact of the carryover basis regime will be felt for quite some time and well beyond 2010, as property is sold, exchanged, depreciated, or otherwise dealt with.

A \$10,000 penalty is imposed on an executor who fails to file the carryover basis return on time.⁹⁶ This return is due when the decedent's final income tax return is due to be filed, including extensions.⁹⁷ Additional penalties are imposed for an intentional failure to supply the required information and for failure to supply the information to those who have acquired the property that is required to be disclosed on the return.⁹⁸

How to acquire basis information. The following sources of information may prove useful:

- The decedent's own personal records.
- The decedent's U.S., state, or local income tax returns (which may be obtainable from his or her return preparer, or from the IRS or other taxing authority).
- The decedent's family members, friends, and business associates.
- The decedent's brokerage account statements.
- The decedent's investment advisors.
- Death tax returns of family members who have predeceased

the decedent and from whom the decedent may have acquired property.

- Personal property tax returns.
- Trust accounts.
- Those who have acted as a guardian or conservator for the decedent and their (or court) records.
- Insurance companies.
- Deeds and other public records.
- The decedent's professionals (such as his or her accountant or business lawyer).
- Government records.

The best source of information, of course, is likely to be the individual. Asking clients to put records together "just in case" is more than merely appropriate. Clients who live past 2010 will not be disadvantaged from having assembled this information.⁹⁹

Planning—overview. Clearly, trying to have property owners make records of their bases in assets is extremely important. This likely will be especially important for individuals owning collections, such as works of art.¹⁰⁰

A review of the client's assets and testamentary instruments should be undertaken to determine the consequences of bequests (including formula bequests) that will be made at death if there is no step-up in basis permitted. This may be somewhat similar to considerations for a person whose estate will include significant rights to income in respect of a decedent.

As indicated at the beginning of this article, some consideration must be given to ensuring that the \$3 million basis increase for qualified spousal property will be available to its maximum extent, assuming it is otherwise compatible with the client's goals.

GST transfers at death. Under Section 2654(b), the basis of property transferred in a taxable termination at death is to be adjusted in a manner similar to the manner provided under Section 1014(a). Section 2654(b) does not apply in 2010 with re-

spect to generation-skipping transfers that occur in 2010.¹⁰¹

The lack of a GST tax in 2010 suggests that trusts that are not exempt from GST tax should be restructured so that a taxable termination or distribution occurs in 2010, rather than thereafter, as long as the trustee and beneficiaries are willing to assume the risk of the retroactive reenactment of the GST tax.

NEW LIMITED GIFT TAX RULE

New Section 2511(c), effective 1/1/10, states that "[n]otwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part 1 of subchapter 1 of chapter 1."

The legislative history makes it clear that the purpose of the subsection is to provide that a transfer to a trust will be treated as a completed gift, regardless of the dominion and control that the donor retains, to the extent property is transferred to a trust that is not a grantor trust in its entirety.¹⁰² This should be of little concern as it is virtually impossible to make a transfer to a U.S. (domestic) trust that is not a grantor trust and prevent the gift from being complete.

The powers that the grantor would have to retain to prevent the transfer from being complete for federal gift tax purposes are set forth

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⁹⁵ Section 6018(e).

⁹⁶ Section 6716. Section 6019, which imposes the duty to file Form 709, is changed for 2010 as well. The donor must not only file the return but supply certain information about the gifts to the donees. Penalties under Section 6716 now apply to such gift tax reporting information.

⁹⁷ Sections 6075(a) and 6075(b)(3).

⁹⁸ Sections 6716(b) and 6716(d).

⁹⁹ For extensive advice about how to attempt to acquire information about the decedent's basis in assets, see McGrath and Blattmachr, *supra* note 58.

¹⁰⁰ *Id.*

¹⁰¹ Section 2664.

¹⁰² See the Blue Book, *supra* note 4, pages 249-250.

in Reg. 25.2511-2. Virtually all of the powers that render the gift incomplete would cause the trust to be a grantor trust. The IRS has, however, issued several private letter rulings holding that the transfer to a specifically designed trust was incomplete but the trust is not a grantor trust.¹⁰³ A transfer to such a trust would, therefore, be a completed gift under Section 2511(c).

An IRS argument that conditioning exercise of a power on no retroactive reenactment of the estate tax somehow violates public policy should be rejected.

There have been discussions among practitioners, based on suspicions and concerns, rather than legislative history or Treasury declarations, that Section 2511(c) means that any transfer to a trust that is a wholly grantor trust is not subject to gift tax because transfers to it would be treated as incomplete by reason of Section 2511(c). That is not what Section 2511(c) provides, and is completely inconsistent with the legislative history. Some practitioners incorrectly contend that, because Section 2511(c) states that any gift to a trust other than a wholly grantor trust is a completed gift, then any gift to a wholly grantor trust must not be a completed gift. This appears to be an incorrect reading of the section. It is preposterous to think that the Congress wanted to repeal the gift tax on all transfers to grantor trusts (even where the trust would

not be included in the grantor's gross estate should the grantor die after 2010).

Asserting that a transfer to a grantor trust is not a completed gift could have consequences more adverse to the taxpayer than treating the initial transfer as a completed gift. The IRS could contend with some confidence, for example, that because the gift to the trust was incomplete, it must be included in the grantor's gross estate when he or she dies,¹⁰⁴ or that it becomes a completed gift when transfers from the trust are made to others during the grantor's lifetime.

Practitioners are cautioned not to take action on the premise that Section 2511(c) prevents any lifetime transfer to a wholly grantor trust from being a completed gift.

GST TAX MATTERS FOR 2010

Although EGTRRA is described as repealing the GST tax for 2010, the method by which that has occurred may produce a result far different than if Chapter 13 (comprising all the GST tax provisions) had in fact been repealed. The provision of the law that effects the GST tax "repeal" is Section 2664, which states: "This chapter shall not apply to generation-skipping transfers after December 31, 2009." That is, no GST tax is imposed on any generation-skipping transfer that occurs in 2010. To interpret Section 2664, however, at least the provisions defining a "generation-skipping transfer" must remain in effect. And other provisions may remain in effect as well, which will have implications for the application of the GST tax in 2011, in-

cluding to GST transfers made in 2010.

The meaning of Section 2664. Absent Section 2664, Section 2601 imposes a tax "on every generation-skipping transfer." Section 2611(a) states that "the term 'generation-skipping transfer' means—(1) a taxable distribution, (2) a taxable termination, and (3) a direct skip." Those terms are defined in Section 2612 and generally turn on whether a transfer is being made to or for a "skip person" as defined in Section 2613.

Section 2664 results in no tax being imposed in 2010 on a generation-skipping transfer that occurs in 2010. But Section 2664 is broader—it says Chapter 13 does not apply to any generation-skipping transfer that occurs in 2010. Accordingly, it seems, although it is not certain, that in addition to the tax being inapplicable, none of the collateral provisions in Chapter 13 (other than apparently Section 2664 itself) apply to a generation-skipping transfer that occurs in 2010.

Consequently, any rule in Chapter 13 that is directed to or involved with a generation-skipping transfer also does not apply in 2010. If that is correct, then some of the provisions that avoid double GST tax may not apply, as described more fully below, reducing the potential to avoid GST tax over the long term by making generation-skipping transfers in 2010 (except perhaps some outright GSTs), although there still may be opportunities for planning this year.

GST-tax-free taxable distributions and terminations. Unless the federal government retroactively reinstates the GST tax, any taxable distribution, taxable termination, or direct skip made in 2010 is not subject to GST tax. As a result, it may be appropriate to consider making such a transfer this year.

For example, the trustee of a trust that is not exempt from the tax by reason of "grandparenting" or prior allocation of GST exemption (a "GST non-exempt trust") might make a taxable distribution or tax-

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¹⁰³ See, e.g., Ltr. Ruls. 200502014, 200612002, 200637025, 200647001, 200715005, 200729005, and 200731009. See also IR-2007-123, 7/9/07, stating that the Service was considering withdrawing these rulings because of inconsistency with Rev. Rul. 76-503, 1976-2 CB 275, and Rev. Rul. 77-158, 1977-1 CB 285. In Rev. Rul. 76-503, a trust was created by three siblings, each of whom named an adult child as one of the three trustees who, acting unanimously, had complete discretionary power over the assets of the trust, and who individually had the right to name a relative as successor. A trustee would be replaced on death or res-

ignation by a successor trustee. The Service stated that the surviving trustees were in no better position to exercise the power after a decedent-trustee's death than before the death, and that the interests of the co-trustees were not adverse to exercise of the power in favor of the decedent-trustee. The IRS stated that one third of the trust fund was includable in a decedent-trustee's estate as property subject to a general power of appointment under Section 2041.

¹⁰⁴ Such a contention would, however, be inconsistent with *Estate of DiMarco*, *supra* note 18.

able termination this year without any GST tax being imposed. Thus, the trustee could make a distribution to the transferor's grandchild from a GST non-exempt trust without GST tax this year. The problem is the specter of retroactive reinstatement of the tax.

What about distributions to skip-person trusts? Similarly, the trustee, if authorized under local law or the terms of the governing instrument, might make a distribution to another trust, transfers to which constitute a taxable distribution from or taxable termination of the original trust.

For instance, the trustee of a GST non-exempt trust created for a child that permits distributions to more remote descendants might make a distribution in 2010 to a trust exclusively for grandchildren. Such a trust would be treated as a skip-person trust under Section 2613. Unless the tax is retroactively reinstated, that distribution would seem not to be subject to GST tax.

What about future GSTs from the same trust? Prior to 2010, under Section 2653(a), someone in the generation of the grantor's children would be treated as the transferor of the trust for GST tax purposes under the "change-transferor rule." That rule provides that subsequent distributions to grandchildren would not be subject to GST tax because the transferor to the trust is deemed to have moved down to the generation immediately above the highest generation of any person who has an interest in the trust.

Section 2653(a) applies, however, only "if ... there is a generation-skipping transfer of any property." Certainly, the distribution from the non-GST-exempt trust to the trust for grandchildren is a generation-skipping transfer (a taxable distribution if less than all of the trust property is distributed, or a taxable termination if it all is distributed). The question is then whether Section 2664 forecloses the application of Section 2653(a), which provides the beneficial rule of moving the generation of the transferor down

one or more generations, because Section 2653(a) applies only when there is a generation-skipping transfer and Section 2664, by its terms, forecloses the application of any part of the GST tax chapter (presumably including Section 2653(a)) to any generation-skipping transfer.

Arguably, it does foreclose the application of Section 2653(a), at least during 2010. Conversely, one might maintain that the rule of Section 2664 was meant only to capture taxable events and nothing else, or, alternatively, that in 2011 Section 2653(a) applies as if Section 2664 had never been enacted.

What difference does it make? Suppose a grandmother creates a trust in 2010 for her ten-year-old grandson, to be paid to him when he reaches age 25. The transfer of property by her to that trust is, of course, a direct skip defined in Section 2613, and therefore a generation-skipping transfer under Section 2612. Because Chapter 13 does not apply to any generation-skipping transfer in 2010, there is no GST tax imposed. And distributions from the trust to the grandson in 2010 also would not be subject to GST tax even if the rule of Section 2653(a) does not apply, because they would then be taxable distributions, another type of generation-skipping transfer with respect to which, in 2010, no tax is imposed.

But unless the change-transferor rule applies in the future, the distribution from the trust to the grandson at 25, when under current law the GST tax will have been restored, would be a taxable termination and subject to GST tax. Such a construction would make taxpayers who make GSTs in trust in 2010 worse off than they were in 2009, except for the one year without GST tax. This then raises the question of the meaning of the EGTRRA section 901(b) sunset provision, which states that the Code is to be applied after 2010 as if the provisions of EGTRRA "had never been enacted." That language can possibly be construed to mean that the change-transferor rule applies in 2011 and going forward, because it certainly would have applied to a di-

rect skip in trust if EGTRRA had never been enacted.

So, in addition to the risk of a retroactive reinstatement of the GST tax, there is a risk if a taxable distribution or taxable termination is made in a later year. If, however, one believes that Section 2653(a) would apply in 2011 and thereafter, then it would be preferable to make the distribution to a trust for the most remote generation of living descendants, such as great-grandchildren. In fact, if the only beneficiaries of the trust to which the distribution may be made are great-grandchildren for at least some period, then potentially children and grandchildren could later become trust beneficiaries without changing the fact that someone in the grandchildren's generation is treated as the transferor.

The executor, apparently, need not make an affirmative allocation or file a return if the FMV at death for carryover basis property does not exceed \$1.3 million.

The reason that appears to occur is the definition of skip person under Section 2613, which includes a trust if all interests in the trust are held by skip persons, and under Section 2652(c) an interest in a trust generally requires a present interest, even though discretionary. By definition, only great-grandchildren would have an "interest" in the trust at the time of creation, causing the "transferor" of the trust to move down to the level of a grandchild. Subsequent reintroduction of higher-generation beneficiaries would not seem to change that result, with the consequence that distributions to great-grandchildren and any more senior skip generation would never become subject to GST tax.

It seems the "risk" with respect to the retroactive reintroduction of GST tax is no greater if the distribution is made to a trust for great-

grandchildren rather than grandchildren. In either event, only one GST tax would be imposed if the pre-2010 GST tax system were retroactively adopted.

GST-tax-free gifts to skip persons. Another possibility is for an individual to make gifts in 2010 to descendants more remote than children. Under Section 2664, these direct skips are not subject to GST tax although they would be subject to gift tax. These transfers may perhaps suffer less from the prospect of potential retroactive reinstatement of the tax. But that risk is likely too much for most clients to accept—especially because if transfer taxes were retroactively applied, the total tax could exceed 110% of the transfer, i.e., a 45% GST tax and a 45% gift tax on both the gift and the GST tax under Section 2515.

Lifetime “reverse” QTIP trusts. A “relatively safe” step for an individual who is married may be to create a lifetime QTIP trust in 2010 for his or her spouse who is a U.S. citizen. By making the election under Section 2523(f), transfers to the trust will qualify for the gift tax marital deduction and not be subject to gift tax. Of course, such a trust, if the beneficiary spouse dies when the estate tax is back in effect, will be included in his or her gross estate for federal estate tax purposes under Section 2044. Because the trust would be included in his or her estate, the beneficiary spouse would be treated as the transferor of the trust property for GST tax purposes, which could result in a GST tax if the GST tax is back in effect when the beneficiary spouse dies.¹⁰⁵

But the beneficiary spouse will not be treated as the transferor for GST tax purposes if the grantor spouse makes the reverse QTIP election for GST tax purposes pursuant

to Section 2652(a)(3).¹⁰⁶ It seems that such a reverse election may be made in 2010 because, as mentioned above, Chapter 13 is not repealed for 2010—it is just made inapplicable to any generation-skipping transfer this year, and neither the transfer to the QTIP trust nor the making of the reverse QTIP election constitutes or involves a generation-skipping transfer as defined in Section 2612.

Practitioners are cautioned not to take action on the premise that Section 2511(c) prevents any lifetime transfer to a wholly grantor trust from being a completed gift.

If it develops that the reverse QTIP election may not be made or that, even if made, the QTIP trust is not exempt from the GST tax, there seems to be little downside as long as the spouse creating the lifetime QTIP trust is “comfortable” in creating such a trust for his or her spouse. And if the election is permitted and Chapter 13 is restored, it seems the grantor spouse would be able to make a late allocation of GST exemption, which may restore some of the GST benefits.¹⁰⁷

Is there any GST exemption this year? It is not clear whether a trust created in 2010, such as a QTIP trust even if the transferor makes the reverse QTIP election, would be exempt from GST tax. Although the ability to create a lifetime QTIP trust for one’s spouse and make the reverse QTIP election has been available since 1986 when the current Chapter 13 became effective, it avoided GST tax only if the grantor spouse also allocated GST exemption to the trust. And, it seems that in 2010 the grantor spouse has no GST exemption to allocate because Section 2631(a) cross-references Section 2010(c) and there is no amount for the year 2010 in Section 2010(c).

This, in turn, raises the question of whether an individual could create a generation-skipping trust this year for his or her family and make it exempt from GST tax. For example, an individual might create a long-term trust for his or her spouse and/or for more remote descendants. Such a trust might be subject to gift tax but arguably would be exempt from GST tax. Prior to 2010, an individual could create such a GST-tax-exempt trust by allocating sufficient GST exemption to it (up to \$3.5 million in 2009).¹⁰⁸ No one would appear to have any GST exemption in 2010, however. Under Section 2631(c), the GST exemption amount for any year is equal to the applicable exclusion amount for estate tax purposes under Section 2010(c). And there is no applicable exclusion amount for the year 2010 under Section 2010(c), so it seems the GST exemption for 2010 has fallen to zero. It seems unfair to prevent individuals from creating GST-tax-exempt trusts in 2010 when they could be created in prior years and presumably in 2011 and thereafter.

Substantial uncertainty. Unfortunately, and especially taking into account that the GST tax might be reinstated retroactive to the beginning of 2010, it appears that there is significant uncertainty as to whether or how the GST tax rules will apply, especially for years after 2010. It may be “safer” to wait until Congress adjourns in 2010 and see what (if anything) has been done. If Congress has not reinstated the GST tax, action might be taken—such as making taxable distributions or taxable terminations—with the expectation that a new Congress would not likely enact a law after 2010 that would reinstate the tax for transfers in 2010. That possibly still could happen, however. In addition, it may be that Congress will reintroduce the tax in 2010 retroactive to the date a bill to do so was introduced, rather than to January 1. If clients delay taking action while waiting to see what Congress would do, the opportunity to make tax-free transfers might disappear.

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¹⁰⁵ See Section 2652.

¹⁰⁶ See generally Blattmachr, “Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation,” *The Chase Review* (Spring 1996).

¹⁰⁷ See Reg. 26.2632-1(b)(4)(ii)(A).

¹⁰⁸ See Sections 2631 and 2642.

Conditional or formula distributions? Perhaps a trustee making a taxable distribution or taxable termination could make it "conditional" so it would be "recalled" if it would be subject to tax by a retroactive reenactment of the GST tax. The IRS, however, might contend that the effect of the condition (e.g., having the distributed property returned to the trust if the distribution would be subject to GST tax) should be ignored as a condition subsequent under the doctrine of *Procter*, 142 F.2d 824, 32 AFTR 750 (CA-4, 1944), *cert. den.*, thereby rendering the condition void as against public policy. Although the Tax Court in *Estate of Petter*, TCM 2009-280, seems to have limited the application of *Procter*, it is uncertain whether *Procter* would apply with respect to a retroactive reenactment of the GST tax. Nevertheless, in the circumstance where formulas are necessitated by the uncertain state of the tax law, the use of a formula would not appear to constitute "trifling with the judicial process" as proscribed by *Procter*.

Alternatively, the trustee or an individual could make a "formula" distribution or gift such as the following:

The trustee/I hereby distribute from this trust/give to [the skip-person beneficiary] the lesser of (1) [amount desired to be distributed] or (2) that fractional share of the trust estate/my interest in XYZ the numerator of which is the largest amount that can be distributed/given to the beneficiary without the imposition of any federal generation-skipping transfer tax (including without the imposition of any federal generation-skipping transfer tax that is retroactively reinstated to apply to this distribution/gift), and the denominator of which is equal to the fair market value as finally determined for federal tax purposes of the trust estate/my interest in XYZ.

Nevertheless, it seems likely the IRS might contend nothing was distributed or, alternatively, the *Procter* doctrine has been violated.

Do ETIPs end? Under Section 2642 (f), known as the "estate tax inclusion period" (ETIP) rules, an allocation of GST exemption is "suspended" during any period that the value of the property transferred during lifetime

would be included in the transferor's federal gross estate (other than by reason of Section 2035). Because the federal estate tax is not applicable to decedents dying in 2010, it is possible that the ETIP period for any lifetime transfer before 2010 has now closed and any previous allocation of the exemption is effective.

It would seem, however, that no automatic allocation could take effect in 2010 because no GST exemption appears to be available in 2010. Therefore, since it is unlikely that an individual would have affirmatively allocated GST exemption to a trust with an ETIP, perhaps the close of the ETIP period in 2010 has no practical consequence. Nevertheless, that result is uncertain, as many matters with respect to the GST tax currently are.

What about transfers to Section 2642(c) trusts? Under the law before 2010, Section 2642(c) permitted certain transfers of property that qualified for the gift tax annual exclusion under Section 2503(b) to satisfy the definition of a nontaxable gift, with the result that the transfer has a zero inclusion ratio for GST tax purposes. If certain additional requirements were met, transfers in trust could qualify for this special treatment.

The problem now is that to qualify, the transfer must be a direct skip, which is a type of generation-skipping transfer. It would appear that because Section 2642(c) applies to a generation-skipping transfer, and Section 2664 says that Chapter 13 does not apply to generation-skipping transfers after 2009, the zero-inclusion-ratio rule also does not apply. This could be problematic even for transfers to existing Section 2642(c) trusts, not because the transfer would be taxable (because in 2010 the GST tax does not apply) but because in 2011 and thereafter it is not clear that the change-transferor rule of Section 2653(a) would apply.

The consequence, if Section 2653 (a) does not apply, is that distributions to the skip-person beneficiary of the trust would be taxable. The transfer is in effect caught in the

Practice Notes

The first step for practitioners who do not wish to continue to put faith exclusively in Congress's ability to solve the complex issues arising from the EGTRRA sunset provisions—which it has been unable to do for eight years—is to contact clients about the 2010 law changes. A generic memorandum or an individually addressed letter or memo to each client might be used.

A practitioner may wish to consider inviting clients to contact his or her firm to make an appointment to determine what, if any, steps should be taken. It seems appropriate to determine explicitly how clients whose documents contain word formulas actually wish to dispose of their property if they die when there is no federal estate tax and no GST tax, but there is carryover basis. For those living in state death tax states, other factors probably also should be discussed, including the possibility of changing domicile.

middle—no zero-inclusion-ratio rule, and possibly no change-transferor rule. This would appear to be an unduly harsh result, and perhaps future legislation or interpretation of Section 2664 and the sunset provisions will clarify the result. It is a trap for the unwary, as many clients may continue to make transfers to such trusts that were created in prior years. The safer route would be to make an outright annual exclusion gift to the grandchild if that were appropriate under the facts.

What happens in 2011? Several provisions in Chapter 13 were added by EGTRRA. As things now stand, in 2011 the provisions under Section 2631(c) dealing with increasing amounts of GST exemption, Section 2632(c) dealing with deemed alloca-

tions of GST exemption, Section 2631 (d) dealing with retroactive allocations of GST exemption, Section 2642 (a)(3) dealing with qualified severances, and Section 2642(g) providing relief from late allocations, will sunset as if never enacted. If no legislative fix is forthcoming, taxpayers will have to pay close attention to the need to make affirmative allocations of GST exemption in order to obtain the benefits of any restoration of the GST exemption in 2011.

If the sunset takes place and is interpreted to mean that benefits conferred while EGTRRA was in effect are ignored after 2010, then generation-skipping trusts created prior to 2010 would have different inclusion ratios in 2011 than in the years during which EGTRRA was in effect by virtue of the provisions of EGTRRA providing for (1) deemed allocations to GST trusts, (2) affirmative allocations of GST exemption in excess of \$1 million indexed for inflation, (3) qualified severances, (4) relief under Section 2642(g), and (5) retroactive allocations under Section 2632(d).

Potential Planning Opportunities

Notwithstanding the uncertainties, the possibility that a transfer in trust in 2010 may avoid the application of GST tax for all time is enticing.

The best way to take advantage of that opportunity would appear to be through the use of formula transfers. For example, a donor might make a formula gift to an irrevocable trust that provides that the amount that will not be subject to GST tax, currently or at any time in the future, will pass to a dynasty trust for descendants and the balance will pass

to the donor's spouse, a general power of appointment trust for the spouse (which will not require an election as a QTIP would), or charity. Of course, to the extent the transfer exceeds the donor's gift tax exemption, the transfer may attract gift tax, but perhaps only at a 35% rate.

Another alternative would be to establish a GRAT that provides a similar formula at the end of the GRAT term between a dynasty trust and a distribution outright to the donor's children. A "zeroed-out" charitable lead trust with a similar formula at the end of the lead term also might be considered. Of course, any transfer that does not involve a GST in 2010 is potentially less effective than one that does.

One also might consider a gift to an irrevocable trust that explicitly permits the trustees or certain adult beneficiaries to disclaim with the result that the gift property returns to the transferor.¹⁰⁹ Unfortunately, a qualified disclaimer under Section 2518 must be made within nine months of the gift, and we may not have clarification of the law by that time.

OTHER CHANGES AND RULES FOR 2010

The legislative history states that EGTRRA distinguishes between the imposition of the estate tax on a decedent dying after 2009 and the imposition of a special recapture tax after that date with respect to the estate of a decedent who dies before 2010. The Conference Report states that the disposition after 2009 of property for which the estate of a decedent who died before 2010 was

allowed the tax benefits of special-use valuation (Section 2032A), the deduction for interests in qualified family-owned businesses (Section 2057), or deferral of estate taxes attributable to a business interest (Section 6166), still will result in the recapture of the previous estate tax benefits, to the extent provided under pre-EGTRRA law.¹¹⁰ The repeal of the estate tax will not prevent the imposition of these recapture taxes.

It seems the 'risk' of the retroactive return of GST tax is no greater if the distribution is made to a trust for great-grandchildren rather than grandchildren.

For example, assume that a decedent died on 1/2/07 and that an interest in real estate she owned and used as part of her farm was valued by her estate under the special-use valuation rules of Section 2032A. Under that section, if the property ceases to be used as a family farm or business within ten years after the decedent's death, an additional estate tax will be imposed, to recapture the estate taxes saved by the special-use valuation election. The decedent's family ceases to use the farm as a family farm in 2010, three years after the decedent's death. The recapture tax is imposed with respect to the decedent's estate, even though the cessation of the use of the property as a family farm or business occurred in 2010.

The estate tax also will continue to be imposed after 2009 in certain instances with respect to QDOTs created for the benefit of a noncitizen surviving spouse, where the spouse whose will or trust created the QDOT died before 2010.¹¹¹ The estate tax will be imposed with respect to an estate of a decedent dying after 2009 in the following two situations:

1. On any distribution after 2009 and before 2021, from a QDOT, be-

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¹⁰⁹ See Rev. Rul. 90-110, 1990-2 CB 209 (holding a disclaimer by trustees ineffective only because it was ineffective under state law). See also Estate of Christiansen, 130 TC 1 (2008), *aff'd* 586 F.3d 1061, 104 AFTR2d 2009-7352 (CA-8, 2009) (holding a formula disclaimer by the beneficiary under a will to be effective to obtain a charitable deduction for property devised to charity as a result of express provisions in the will setting forth the disposition in the event of a disclaimer).

¹¹⁰ See H. Rep't No. 107-84, 107th Cong., 1st Sess., (2001), 147 Cong. Rec. H2773-H2774 (5/25/01).

¹¹¹ Section 2210(b); EGTRRA section 501(a). On the rules for QDOTs, see generally Bittker

and Lokken, *Federal Taxation of Income, Estates, & Gifts* (Thomson Reuters/VWG&L, 2009), ¶ 129.2.5; Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* (Thomson Reuters/VWG&L, 2009), ¶ 52.11; Peschel and Spurgeon, *Federal Taxation of Trusts, Grantors and Beneficiaries* (Thomson Reuters/VWG&L, 2009), ¶ 7.10; Stephens, Maxfield, Lind, Calfee, and Smith, *Federal Estate and Gift Taxation*, Eighth Edition (Thomson Reuters/VWG&L, 2009), ¶ 5.08A; Spielman, *U.S. International Estate Planning* (Thomson Reuters/VWG&L, 2009), ¶ 10.04; Westfall and Mair, *Estate Planning Law and Taxation*, Fourth Edition (Thomson Reuters/VWG&L, 2009), ¶ 16.01.

fore the date of the death of the noncitizen surviving spouse.

2. On the value of the property remaining in a QDOT on the date of death of the noncitizen surviving spouse if such surviving spouse dies before 2010.

ESTATE ADMINISTRATION FOR 2010 DECEDENTS

The regime of no estate or GST tax and carryover basis presents new challenges in administering the estates of those who die in 2010. It may involve construction of instruments and certainly will mean new challenges in finding information about the adjusted basis of the decedent's assets.

The threat that the estate tax might be retroactively reinstated also complicates the administration. For example, under the 2009 rules, the executor or trustee might have decided to sell assets soon after death to ensure adequate cash to pay estate tax, debts, and expenses—especially if the estate or trust held highly volatile assets. Now, an executor or trustee who needs or desires to liquidate some or all of the decedent's low-basis assets soon after the decedent's death, in order to effect a diversification of the estate or trust investments or to raise cash to pay expenses and state or foreign death taxes or to facilitate distribution, will need to consider the recognition of capital gains because of a low carryover basis. Some fiduciaries may decide to buy a collar to protect the value of significant blocks of stock, while they wait to see if the estate tax is going to be reinstated. Other assets, such as works of art and real estate, cannot be so easily protected.

In almost all estates, consideration of disclaimers may make good sense in 2010. For example, if the will or revocable trust is construed to mean the entire estate passes to the surviving spouse, it may be best for the spouse to disclaim all or a portion of the property, particularly if the disclaimed assets will pass to a credit-shelter trust of which he or she is a beneficiary. Such a dis-

claimer will not cause the credit-shelter trust to be included in the spouse's gross estate when the federal estate tax is back in effect. Such a disclaimer would likely also make good sense even if there is no federal estate tax in effect, as long as the spouse continues to receive enough assets to take full advantage of the spousal basis adjustment in the decedent's estate. Because Congress may retroactively reinstate the estate tax, however, the disclaimer should not be of so large an amount that it would cause the estate to be subject to tax.

Any transfer that does not involve a GST in 2010 is potentially less effective than one that does.

The need for and utility of any disclaimer by a spouse or by other beneficiaries will depend on the proper construction of the formula clauses in the decedent's will or trust. The fiduciary should bring a suit to construe the will or trust promptly after the decedent's death, if there is any question whatsoever regarding the meaning of the formula clause in light of the absence of the estate or GST tax. A local court's determination of the meaning of the instrument will not be binding on the IRS or the federal courts, as noted earlier, unless it is the highest court of the state, but such lower court holdings are given due regard. Thus, if the opinions of the trial court are consistent with (or at least not inconsistent with) applicable state law, they generally should be followed by the Service.¹¹²

A disclaimer also could be drafted to disclaim "the largest amount that would pass free of federal estate tax with respect to the decedent's estate (whether applicable on the date of death or enacted after the date of death and applying retroactively to the decedent's estate)." Such a disclaimer should be qualified, although it raises a problem for the fiduciary who needs to distribute the

assets, because the application of any retroactive statute may be uncertain for several years while the issues are litigated.

RETROACTIVE REINSTATEMENT

The Democratic leadership in both the House and the Senate have expressed a desire to reinstate the estate and GST taxes early in 2010, and to do so retroactively, to eliminate a period of effective repeal. Retroactive reimposition of these taxes will face legal challenges based on claims of unconstitutionality, but ultimately retroactivity should be permitted.

The Supreme Court has repeatedly upheld retroactive changes in the tax laws, where such retroactivity is "confined to short and limited periods required by the practicalities of producing national legislation."¹¹³ Generally, due process permits retroactive tax legislation if the retroactivity serves a "rational legislative purpose."¹¹⁴

In *Carlton*, 512 U.S. 26, 73 AFTR2d 94-2198 (1994), *rev'g* 972 F.2d 1051, 70 AFTR2d 92-6199 (CA-9, 1992), the Supreme Court rejected a due process challenge to a retroactive elimination of an unintended loophole. TRA '86, enacted 10/22/86, included an estate tax deduction for one-half the proceeds of "any sale of employer securities by the executor of an estate" to an ESOP. On 12/10/86,

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¹¹² Some state legislatures are likely to pass laws stating how to construe a will or trust formula clause in 2010, and such laws almost always will be binding on the IRS and the federal courts. Not many states are likely to accomplish that this year, however.

¹¹³ *Carlton*, 512 U.S. 26, 73 AFTR2d 94-2198 (1994); see also *Hemme*, 476 U.S. 558, 58 AFTR2d 86-6320 (1986); *Darusmont*, 449 U.S. 292, 47 AFTR2d 81-519 (1981); *Welch v. Henry*, 305 U.S. 134, 21 AFTR 973 (1938); *Hudson*, 299 U.S. 498, 18 AFTR 628 (1937); *Milliken*, 283 U.S. 15, 9 AFTR 993 (1931); and *Cooper*, 280 U.S. 409, 8 AFTR 10270 (1930). See also similar opinions from lower courts in *NationsBank of Texas*, 84 AFTR2d 99-5001 (Fed. Cl. Ct., 1999); *Kane*, 942 F. Supp. 233, 78 AFTR2d 96-6400 (DC Pa., 1996), *aff'd* 118 F.3d 1576, 80 AFTR2d 97-5141 (CA-3, 1997); *Quarty*, 170 F.3d 961, 83 AFTR2d 99-1562 (CA-9, 1999). See also discussions in *Stephens*, *Maxfield*, *Lind*, *Calfee* and *Smith*, *supra* note 111, ¶ 2.01[3]; *Westfall* and *Mair*, *supra* note 111, ¶ 9.02.

¹¹⁴ *Carlton*, *supra* note 113.

Carlton, as executor, bought for the estate 1.5 million shares of MCI Communications for \$11,206,000, and two days later sold the stock (at a loss of 42¢ per share) to the MCI ESOP, deducting \$5,287,000 (one-half of the sales price) on the decedent's estate tax return.

On 12/22/87, Congress retroactively amended the Code to limit the deduction to securities that were "directly owned" by the decedent "immediately before death." The amendment applied retroactively, as if it were incorporated in the original TRA '86 provision.

Carlton challenged the amendment on the grounds that its retroactivity violated the Due Process Clause. The district court granted summary judgment for the IRS, but a divided Ninth Circuit reversed, holding that such application was rendered unduly harsh and oppressive, and therefore unconstitutional. The Ninth Circuit stressed Carlton's lack of notice that the rule would be retroactively amended and his reasonable and detrimental reliance on the pre-amendment law.

The Supreme Court reversed and upheld the statute, without dissent (although with two concurring opinions reflecting the views of three justices). The Court stated that a retroactive law is constitutionally valid if (a) the government shows that the statute has a rational legislative purpose and is not arbitrary and irrational, and (b) the period of retroactivity is "modest."

The Court held that the amendment's retroactive application was rationally related to the legitimate legislative purpose of closing an unintended loophole that would result in revenue losses, and that the period of retroactivity (14 months) was modest and consistent with the time requirements inherent in enacting national tax legislation.

Justice Scalia wrote a concurring opinion, in which Justice Thomas joined, agreeing that the statute

should be sustained, notwithstanding its retroactivity, but strongly criticizing the analysis that the majority had used. Justice Scalia started strongly, stating:

"If I thought that 'substantive due process' were a constitutional right rather than an oxymoron, I would think it violated by bait-and-switch taxation. Although there is not much precision in the concept 'harsh and oppressive,'" which is what the Court has adopted as its test of substantive due process unconstitutionality in the field of retroactive tax legislation, ... surely it would cover a retroactive amendment that cost a taxpayer who relied on the original statute's clear meaning over \$600,000.... [H]ere the amendment "without notice, ... gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute." (Citations omitted.)

Justice Scalia was not impressed (at least not favorably) by the majority's characterization of the estate tax amendment as merely "a curative measure," nor was he inclined to accept the "post-legislation legislative history (another oxymoron) to show that, despite the uncontested plain meaning of the statute, Congress never meant it to apply to stock that was not owned by the decedent at the time of death." He believed that, whether Congress had treated a citizen oppressively should not depend on whether the oppression was, after all, only a "curing" of an earlier error.

More important, Justice Scalia rejected the majority's distinguishing of the earlier cases on retroactivity based on the fact that they involved the imposition of new taxes, rather than a change in tax rates. He characterized the elimination of a specifically promised tax break that was to have been a reward for costly action, after the action has been taken, as being more harsh and oppressive than merely imposing a new tax on past actions. He then stated that:

"The reasoning the Court applies to uphold the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid. To pass constitutional muster the retroactive aspects of the statute need only be

'rationally related to a legitimate legislative purpose.' ... Revenue raising is certainly a legitimate legislative purpose, see U.S. Const., Art. I, section 8, cl. 1, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal. I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees *no* substantive rights, but only (as it says) process...." (Citations omitted; emphasis in original.)

Carlton, even considering Justice Scalia's scathing concurring opinion, strongly suggests that any challenge to a 2010 retroactive reinstatement of the estate and GST taxes would be unsuccessful, but there is one area in which the reinstatement of the estate and GST taxes differs from the curative provision at issue in *Carlton*. The Ninth Circuit's decision in *Carlton* relied in part on two older Supreme Court decisions—*Blodgett v. Holden*, 275 U.S. 142, 6 AFTR 8003 (1927), and *Untermeyer v. Anderson*, 276 U.S. 440, 6 AFTR 7789 (1928)—which had rejected retroactive imposition of the first federal gift tax. The Supreme Court rejected the relevance of these cases, stating that they "were decided during an era characterized by exacting review of economic legislation under an approach that 'has long since been discarded.'"

More important, the Court in *Carlton* also stated that "Blodgett and Untermeyer, which involved the Nation's first gift tax, essentially have been limited to situations involving 'the creation of a wholly new tax,' and their 'authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws.'" (Citations omitted.)

As the Ninth Circuit stated in a later case, the law distinguishes between the imposition of a wholly new tax and changes in an extant tax, because the Constitution does not approve of the imposition of a new tax when the taxpayer has "no reason to suppose that any transactions of the sort will be taxed at all."¹¹⁵

NOTES

¹¹⁵ Quarty, *supra* note 113, quoting Darusmont, *supra* note 113 (itself quoting Cohan, 39 F.2d 540, 8 AFTR 10552 (CA-2, 1930) (Learned Hand, J.)).

Reasonable minds may differ on whether the re-adoption of the estate and GST taxes constitutes the "creation of a wholly new tax." The government would certainly argue that reenacting an estate tax that dates to the First World War and a GST tax that has been in place for over 30 years should be distinguished from enacting the nation's first tax on lifetime donative transfers. Nonetheless, a reasonable argument can be made that the critical issue is the imposition of a new tax on a closed transaction, and that there are few ways to close a transaction more firmly than death.¹¹⁶

There are, however, serious questions of fairness in such a retroactive reinstatement, which could temper the legislative desire to avoid having any period in which there was no estate or GST tax. For example, the trustee of a trust that is not exempt from GST tax might make a distribution to a skip person in 2010 when Section 2664 states that there will be no such tax in effect. That affirmative action in reliance on the law as it existed when the distribution was made makes a retroactive reintroduction of the GST tax seem unfair and harsh. Congress, to eliminate such a politically unfavorable appearance of unfairness, might permit the trustee to reacquire the distributed property and thereby avoid the retroactively imposed tax. A similar relief was afforded under Section 2055(e)(3)(J), where the grantor of a charitable remainder trust may declare it null and void *ab initio* if it fails to provide for the value of the remainder to be at least 10% of the value of the property contributed to the trust, even though such a declaration presumably would cause the charity to lose what would be a vested property interest in the remainder in the trust.

Often, when Congress plans to retroactively change the tax law, the chairs of the tax-writing committees issue a statement warning taxpayers not to rely on the current state of the law. Congressional staff members from the House Ways and Means Committee and the Senate Finance Committee confirmed on 12/31/09

that no joint letter of this nature was forthcoming, because the lawmakers could not agree on how best to proceed with the estate and GST taxes.¹¹⁷

Practitioners should caution their clients about the chance of retroactive reimposition of an estate and GST taxes, but they also should consider taking advantage of planning opportunities that may exist during the hiatus, particularly where there would be limited downside risk from doing so.

Some practitioners recognized the possibility that a client might die in a year without federal estate tax and addressed this in the client's documents, but it is unlikely that anyone anticipated a year both without estate tax and with the possibility that the federal government might retroactively reinstate the tax. A will or revocable trust of a married individual, who otherwise would have divided his or her residuary estate into credit-shelter and optimum marital deduction portions, might have stated, "If I die when there is no federal estate tax applicable to my estate, I give my residuary estate to the Trustee of Credit-Shelter Trust hereunder." If he or she died today, there would be no federal estate tax applicable and so the residuary estate would pass to the credit-shelter trust. It is unclear, however, what will happen if Congress retroactively reinstates the tax so the estate is subject to estate tax.

The correct construction of such a will or revocable trust may be that the residuary estate passes into the credit-shelter trust, and the entire estate will be subject to federal estate tax unless that trust is in a form that qualifies for the marital deduction. The better construction is that the phrase "if I die when there is no federal estate tax applicable" means "if I die when there is no federal estate tax applicable including no retroactive reenactment of such tax." In preparing new or amending existing wills and trusts, that probably should be expressly stated.

Alternatively, the will or revocable trust could state that if the federal estate tax is not applicable at

death, all property passes to a QTIP trust for the surviving spouse with an express provision that a disclaimer by the surviving spouse will fund the credit-shelter trust (but eliminating any power of appointment over the credit-shelter trust as to the disclaimed property). The risk of this approach is that the most efficient tax disposition, if repeal remains in effect, will require a spousal disclaimer. If the estate tax is retroactively reinstated, however, then either the formula would fund the credit-shelter trust retroactively in the usual fashion, or it could be funded by disclaimer, but there is no risk that the disposition would produce an inadvertent estate tax on a retroactive reinstatement of the estate tax due to a failed qualification for a marital deduction.

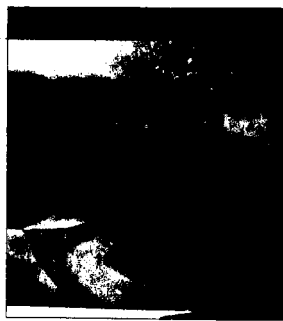
CONCLUSION

It is amazing to think that we can remain certain only about death but not taxes. Still, the public perception of a windfall is widely overstated. Instead, we seem to have many more pitfalls for taxpayers and practitioners than planning opportunities. This result occurs primarily because of the hasty penning of the sunset provisions of EGTRRA that appear to say "as you were" but not quite. The married taxpayer may have the greatest flexibility to plan for the uncertainty created by a year of transfer tax law with which no one ever expected to contend. The ability to put in place a spousal QTIP trust that may qualify for a marital deduction by an election that will not need to be made until 2011 permits a married taxpayer to put off the need to determine whether the trust will or will not produce a gift or estate tax until such time that taxpayers should know what the state of the law in fact is. Estate planners are living in a most interesting time. ■

NOTES

¹¹⁶ For further discussion of this issue see Gans, "Retroactive Estate Tax: Can it Be Made Constitutional?," 2010 TNT 7-8 (1/11/10).

¹¹⁷ BNA Daily Tax Report, 1/5/09, page G-1.



IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate

A significant new letter ruling, Ltr. Rul. 200944002, enables planners to provide clients with a strategy that offers not only asset protection, but significant potential estate tax savings and other advantages.

GIDEON ROTHSCHILD, DOUGLAS J. BLATTMACHR,
MITCHELL M. GANS, AND JONATHAN G. BLATTMACHR

Until 1997, it appeared that, under the law of all American states, any trust an individual created or "settled" for himself or herself (a so-called self-settled trust) was permanently subject to the claims of creditors of the grantor regardless of the motivation for creating the trust and even if the grantor was merely eligible and not entitled to receive distributions from the trust in the discretion of an independent trustee.¹ For example, section 58 of the Restatement (Third) of Trusts provides that a self-settled trust is permanently subject to the claims of the grantor's creditors.² On 4/1/1997, Alaska adopted a statute (AS 34.40.110) which provides that, if a trust contains a transfer restriction, it is not subject to the claims of the grantor's creditors unless (1) the grantor may revoke or terminate the trust, (2) the grantor intends when the transfer of property is made to the trust to defraud a creditor, (3) the grantor is in

default of child support payments by 30 or more days, or (4) the trust requires that income or corpus be distributed to the grantor.

IRC Section 2036(a)(1) has provided since 1931 that a decedent's gross estate includes property he or she has transferred in trust or otherwise during lifetime other than for full and adequate consideration in money or money's worth if the

decedent retained the right to the income from that property. The right to the income need not be express but may be implied and need not be legally enforceable.³ For example, if there is an implied understanding between the grantor and the trustee that the trustee will distribute property to the grantor, the trust will be included in the grantor's estate.⁴

The tax law follows creditors' rights with respect to the gift and estate taxation of a self-settled trust. In other words, if an individual creates a self-settled trust in a jurisdiction where his or her creditors may attach the trust assets, the transfer to the trust is an incomplete gift (and, therefore, not subject to gift tax) and the trust is included in his or her estate, even if the settlor did not retain the right to the income and did not have an understanding that he or she would receive distributions from the trust.⁵ Thus, the mere fact that the grantor's creditors may attach the trust assets is

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sufficient to cause the trust to be included in his or her estate.⁶

A transfer is incomplete for federal gift tax purposes if the grantor retains sufficient "dominion and control" over the property within the meaning of Reg. 25.2511-2(b).⁷ As discussed in more detail below, the power conferred under local law upon the grantor to be able to relegate his or her creditors to the assets of the trust prevents the transfer to the trust from being complete because the grantor has retained sufficient dominion and control over the transferred property.

Among other IRC provisions, property transferred during life may also be included in the transferor's estate if the grantor at death holds the power (i.e., a legally enforceable right) to control the beneficial enjoyment of the trust property.⁸ Both Sections 2038(a) and 2036(a) have been used to cause a self-settled trust whose assets are subject to the claims of the grantor's creditors to be included in the grantor's estate.⁹

Creditors' claims

Aren't all transfers potentially subject to creditors' claims? Any transfer made by an individual with actual intent to delay, hinder or defraud creditors (a so-called fraudulent transfer) is subject to the claims of his or her existing or reasonably foreseeable future creditors, whether the transfer is in trust or outright.¹⁰ Hence, if an individual transfers property directly to his or her spouse or child with such an intent, the transferor's creditors may attach the property to pay their claims.

Whenever an individual transfers property, it may subsequently be determined to be a fraudulent transfer. Because the property so fraudulently transferred is subject to the claims of the transferor's creditors, it might be argued that it is not sub-

ject to gift tax. Indeed, whenever a transfer during life is made, it is possible that some creditor will be able to prove in some court having jurisdiction over the property and/or the transferor that it was a fraudulent transfer. In some cases, the statute of limitations against a claim of a fraudulent transfer does not begin to run until the transfer is discovered by the creditor.¹¹ That means that any lifetime transfer is potentially subject to the claims of the transferor's creditors at any time. But that mere possibility is insufficient to render the transfer incomplete for gift tax purposes or to cause the property to be included in the transferor's estate.

**Ltr. Rul.
200944002
seems completely
consistent with
the official
position of the IRS.**

IRS test: Ability to relegate creditors to the trust assets. The IRS appears to have developed a test to determine if a transfer is incomplete for federal estate and gift tax purposes. With respect to transfers to trusts, the IRS has officially ruled that the transfer is incomplete (and, therefore, not subject to gift tax) if the law governing the trust provides that the creditors of the grantor may

attach the trust property. For example, in Rev. Rul. 76-103,¹² the IRS stated with respect to a self-settled trust under which the trustee could, but was not required to, distribute income and principal to the grantor:

The trust was created in State X and has been administered under the laws of that State from the date of the transfer.*** Under the law of State X, the trust is a "discretionary trust" and the entire property of the trust may be subjected to the claims of the grantor's creditors, whenever such claims may arise.*** in the instant case, the grantor's transfer of property to the trust does not constitute a completed gift for Federal gift tax purposes.*** If and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in section 25.2511-2 of the regulations....Furthermore, if the grantor dies before the gift becomes complete, the date of death value of the trust corpus will be includible in the grantor's gross estate, for Federal estate tax purposes, under section 2038 of the Code because of the grantor's retained power to, in effect, terminate the trust by *relegating* the grantor's creditors to the entire property of the trust. The reason the transfer is regarded as incomplete is because the grantor, in such a case, may "*relegate*" his or her creditors to the assets of the trust. (Emphasis added.)

because the grantor's creditors could reach the income and corpus of the trust).

⁷ This Reg. states, "As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete."

⁸ See Section 2036(a)(2); Section 2038.

⁹ See, e.g., Rev. Rul. 76-103, *supra* note 5 (last sentence); Estate of Paxton, 86 TC at 818.

¹⁰ See, e.g., Uniform Fraudulent Transfer Act § 4(a)(1).

¹¹ See, e.g., Fla. Stat. 726.110, providing that a creditor can challenge as fraudulent an asset transfer to avoid pre-existing creditors for one year after the transfer was or could reasonably have been discovered by the creditor under certain conditions.

¹² 1976-1 CB 293.

¹ Almost all states contain exceptions. For instance, under the law of almost all but not all states, individual retirement accounts ("IRAs") are exempt from claims of creditors of the owner even if in the form of a trust. See, e.g., New York Estates, Powers & Trusts Law 7-3.1 (complete protection); cf. Cal. Civ. Proc. Code § 704.115 (protection limited to the extent reasonably necessary for support).

² Virtually the identical rule was contained in the Restatement (Second) of Trusts § 156.

³ See, e.g., Reg. 20.2036-1(c)(1)(i).

⁴ See, e.g., Estate of Skinner, 316 F.2d 517, 11 AFTR2d 1855 (CA-3, 1963).

⁵ Rev. Rul. 76-103, 1976-1 CB 293.

⁶ See, e.g., Paolozzi, 23 TC 182 (1954), *acq.* 1962-1 CB 4 (transfer to the trust incomplete because grantor's creditors could attach the trust property), and Estate of Paxton, 86 TC 785, 818 (1986) (value of corpus of self-settled trust included in grantor's estate

However, if the grantor has a mere expectancy that he or she might receive distributions from the trust, then the gift is complete. In Rev. Rul. 77-378,¹³ the IRS stated, again with respect to a self-settled trust:

[U]nder the applicable state law the trustee's decision whether to distribute trust assets to the grantor is entirely voluntary. The grantor cannot require that any of the trust's assets be distributed to the grantor *nor can the creditors of the grantor reach any of the trust's assets.* *** [I]f the grantor retains...a mere expectancy that the trustee will distribute trust assets to the grantor rather than an enforceable interest in the trust, the expectancy does not prevent the completion or reduce the value of the gift. *** Although the trustee has an unrestricted power to pay trust assets to the grantor, the grantor cannot require that any of the trust's assets be distributed to the grantor nor can the grantor utilize the assets by going into debt and relegating the grantor's creditors to the trust. *** Whether the grantor would enjoy any of the trust's assets is dependent entire-

ly on the uncontrolled discretion of the trustee. Such a hope or passive expectancy does not lessen the value of the property transferred. Accordingly, the Federal gift tax is applicable to the entire value of the property transferred to the trust by the grantor. (Emphasis added.)

Hence, it seems virtually certain that whether a transfer to a self-settled trust, under which the grantor is not entitled but only eligible in the discretion of the trustee (other than the grantor) to receive distributions from the trust, is a completed gift turns on whether, under the local law that governs the trust and under which it is administered, the grantor's creditors can attach the assets of the trust. In other words, if under the local law that governs the trust and under which it is administered, the grantor can relegate his or her creditors to the trust assets, the gift is incomplete. If the grantor cannot so relegate the creditors, the gift is complete.

Does it follow the trust is not in the gross estate?

Estate and gift tax provisions are to be construed *in pari materia* or, in other words, consistently.¹⁴ Does it, therefore, follow that if a self-

settled trust is governed by and administered in a state where the grantor's creditors cannot attach the trust assets that the trust is excluded from the grantor's estate (assuming it is not included for some other reason, such as the grantor's retention of a power to change the timing of when beneficiaries of the trust, other than himself or herself, will receive trust property)?

In most cases, a transfer that is a completed gift in its entirety is not in the transferor's estate. But there are circumstances where estate tax inclusion will occur even with respect to property that has been the subject of a gift completed during lifetime. For example, a transferor almost certainly would not retain sufficient dominion and control over property to render the gift incomplete if the grantor transferred it to another with an implied understanding that the transferor could continue to use the property unless the creditors of the grantor could attach the transferred asset by reason of that understanding. Yet, that implied understanding is sufficient to cause the transferred property to be included in the grantor's estate.¹⁵

¹³ 1977-2 CB 347.

¹⁴ See *Estate of Sanford*, 308 U.S. 39, 44, 23 AFTR 756 (1939).

¹⁵ See Reg. 20.2036-1(a); *Estate of Skinner*, *supra* note 4.

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There is at least one other circumstance where a transfer of property during life is a completed gift but nonetheless will be in the transferor's estate. Reg. 25.2511-2(d) states:

A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.

Yet, a power to determine the timing of distributions from a trust causes the property to be included in the grantor's estate. Reg. 20.2038-1(a) provides, in part:

[S]ection 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust.

Despite the fact that, in some cases, property that has been the subject of a completed gift during lifetime may also be included in the transferor's estate, there is no law to suggest it would occur with respect to a self-settled trust governed by the laws of, and administered in, a state where the grantor's creditors cannot reach the trust assets and the grantor retained no other interest or power that would render the gift incomplete or cause it to be included in the grantor's estate. In fact, the law seems virtually certain that there is no estate tax inclusion.

Case law and private letter rulings

In *Estate of Uhl*,¹⁶ the Seventh Circuit Court of Appeals held that the

portion of the trust the decedent created during lifetime and from which he had not retained the right to the income but from which the trustee could pay him the income was not included in his estate because, under Indiana law, which governed the trust, his creditors could not attach the trust assets because the Seventh Circuit concluded that he had not retained the benefit of the property within the meaning of Indiana's fraudulent conveyance statute.

Perhaps, the case that deals most explicitly with the issue of creditors' rights and estate tax inclusion of a self-settled trust is *Estate of German*.¹⁷ In that case, Mrs. German, a Florida domiciliary, created a trust under Maryland law. Mrs. German was not a trustee, but her son was one of the trustees and lived in Maryland. The trustees were authorized, in their discretion, to distribute income and corpus of the trust to her, although only with the consent of an adverse party (that is, another beneficiary). In holding that the trust was not included in her estate, the court stated in part:

The question presented is whether the decedent divested herself of her interest in property in 1969 when she transferred such property to a trust with a proviso that the trustees might, in their absolute discretion, pay any or all of the income or principal to decedent at any time during her lifetime, if they received the written consent of the person who was entitled to receive the principal and accumulated income of the trust after her death, or whether she continued to enjoy the right to the income or principal of the trust up to date of her death, because under Maryland law if she chose to incur any debts her creditors could still attach or levy upon the trust assets to collect them. ***

[T]he narrow issue to be decided herein is as to the extent of decedent's creditors' rights with respect to the trust income and

assets under Maryland law. *** Defendant [IRS] has not established that under Maryland law creditors of the settlor could have reached the trust income or principal of her discretionary trusts up to the time of her death. (Emphasis added.)

It seems apparent that the fact that the trustees could make distributions to Mrs. German only with the consent of an adverse party had no impact on the court's test that inclusion turned on whether her creditors could attach the trust assets under Maryland law. It seems to have had something to do with the court's conclusion that the IRS had "not established that under Maryland law creditors of the settlor could have reached the trust income or principal of her discretionary trusts up to the time of her death." But, again, it seems to have nothing to do with the tax issue which the court phrased as "the narrow issue to be decided herein is as to the extent of decedent's creditors' rights with respect to the trust income and assets under Maryland law."

The IRS has previously issued two private letter rulings (which under IRC Section 6110(k)(3) may not be cited or used as precedent) in which it concluded that a self-settled trust, created under the law of a jurisdiction where the grantor's creditors could not attach the trust assets, was not included in the estate of the grantor.

In Ltr. Rul. 9332006 (not precedent), two siblings, who were U.S. citizens, created an irrevocable trust in a foreign country, which provided that interests in self-settled trusts were not subject to the claims of the grantor's creditors. The beneficiaries of the trust in the ruling included the siblings, a living parent, and their future heirs.

¹⁶ 241 F.2d 867, 50 AFTR 1746 (CA-7, 1957).

¹⁷ 7 Ct. Cl. 641, 55 AFTR2d 85-1577 (Ct. Cl., 1985).

The laws of the country allowed a protector of the trust who held certain powers over the trust, including the power to appoint new or additional trustees. The protector also was a U.S. citizen, and the trust provided that neither the protector nor his estate could be a beneficiary. The trust further provided that the protector was neither a person nor entity related to or under the control of the grantors. The beneficiaries could not compel distributions from the trust. The trust was determined to be a foreign trust for purposes of Section 7701(a)(31).¹⁸ The siblings funded the trust with fractions of directly held partnership interests.

The IRS ruled that the partnership interests transferred to the trust were completed gifts and, therefore subject to gift tax, finding that the grantors had parted with dominion and control of the property on the transfer. The Service further ruled that the partnership interests would not be includable in the grantors' estates, finding that the trustee's discretion to make distributions to the grantors was not a retained interest or power.

Ltr. Rul. 8037116 (not precedent) involved a self-settled trust governed by the law of New York. The ruling relies on *Herzog*,¹⁹ a decision by the judicial panel of Judges Learned Hand, Augustus Hand and Chase of the Second Circuit Court of Appeals, which concluded that the self-settled trust was not subject to the claims of the grantor's creditors and, therefore, the transfer to it constituted a completed gift for federal gift tax purpose. Ltr. Rul. 8037116 states, in part:

In this case, the decedent did not retain the right to possess, enjoy, or receive income from the property, but he did retain the opportunity to enjoy it. However, in the same jurisdiction, the [Second Circuit] Circuit Court of Appeals has characterized such a beneficiary status as a hope or passive expectancy rather than a right to enjoyment of the property, *with the result that the property was not includible in the gross estate.* *Herzog v. Comm.*, 116 F.2d 591, 593 (2d Cir. 1941). We conclude that the ability of this decedent to receive income and principal under the terms of the trust he created is not sufficient to require inclusion of the property under section 2036(a)(1) of the Code. (Emphasis added.)

It may be of interest to note that the decision of the Second Circuit in *Herzog* that the self-settled trust was not subject to the grantor's creditors under New York law may have been incorrect. In *Vanderbilt Credit Corp. v. Chase Manhattan Bank*,²⁰ an intermediate court of New York state held that a self-settled trust is subject to the claims of the grantor's creditors. Indeed, in two separate statutes, New York law provides that a self-settled trust is void with respect to the grantor's creditors.²¹

But the Second Circuit did not explicitly hold that under New York law, the creditors of the grantor could not attach the trust assets but rather New York law was not sufficiently certain that they could attach the trust property to render the gift incomplete. Nevertheless, the fact that the Second Circuit may have incorrectly construed New York law does not change the fact that it developed the test that whether a self-settled trust is included in the grantor's estate turns on whether creditors of the grantor may attach the trust assets. And, in any case, it appears the IRS has fully adopted that test.

Perhaps, of greater interest is the characterization by the IRS in Ltr. Rul. 8037116 of the Second Circuit's

holding. The ruling, as quoted above, says, in part, "has characterized such a beneficiary status as a hope or passive expectancy rather than a right to enjoyment of the property, *with the result that the property was not includible in the gross estate.*" (Emphasis added.) In fact, the court did not, as the letter ruling incorrectly states, hold the property was not included in the grantor's estate but rather that the grantor's lifetime transfer to the trust was complete for gift tax purposes. But, it seems that the IRS has concluded that it means also that the trust property would not be included in the grantor's estate if creditors could not attach it.

IRS official position on estate tax inclusion of self-settled trusts

Of course, private letter rulings, such as Ltr. Ruls. 9332006 and 8037116, may not be cited or used as precedent, although they may be used to establish substantial authority in some cases to avoid the imposition of the penalty under IRC Section 6662 for the substantial underpayment of income tax.²² In any event, the letter rulings are consistent in holding that a self-settled trust is not included in the grantor's estate if the grantor's creditors cannot attach the trust assets (unless some other factor, such as the retention of the right to income, is present).

More important is that the official position of the IRS is also consistent with that holding. In Rev. Rul. 76-103, the IRS stated, "Furthermore, if the grantor dies before the gift becomes complete, the date of death value of the trust corpus will be includible in the grantor's gross estate, for Federal estate tax purposes, under section 2038 of the Code because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust." Because inclusion in the grantor's estate was premised

¹⁸ The definition of "foreign trust" has since been revised. See IRC Sections 7701(a)(30) and 7701(a)(31).

¹⁹ 116 F.2d 591, 26 AFTR 169 (CA-2, 1941).

²⁰ 473 N.Y.S. 2d 242 (N.Y. App. Div., 1984).

²¹ EPTL 7-3.1; CPLR 5205.

²² See Reg. 1.6662-4(d)(3)(iii).

on the grantor's power to relegate his or her creditors to the assets of the trust, it seems to follow logically that if the grantor dies after the gift becomes complete, the trust corpus will not be includable in the grantor's estate, for federal estate tax purposes, because the grantor would not have retained a power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust.

Nonetheless, the culmination of the IRS acceptance of the test that inclusion of a self-settled trust in the grantor's estate turns on whether the grantor's creditors can attach the assets of the trust seems to be set forth in Rev. Rul. 2004-64.²³ The trust involved in that Ruling was a grantor trust—that is, one that under IRC Section 671 had its income attributed to the grantor so the grantor had to include the trust's income in his or her gross income. The Ruling is best known for its holding that the grantor would not be treated as making a gift by paying the income tax on the trust's income that was attributed to the grantor under Section 671.²⁴

But Rev. Rul. 2004-64 also deals with an aspect of the tax effects of a self-settled trust. The Ruling states, "If, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under § 2036(a)(1). If, however, the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, *the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate.*" (Emphasis added.)

Nonetheless, the Ruling also states, "However, such discretion [to reimburse the grantor for such income tax] combined with other facts (including but not limited to: an understanding or pre-existing arrangement between A and the trustee regarding the trustee's exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; *or applicable local law subjecting the trust assets to the claims of A's creditors*) may cause inclusion of Trust's assets in A's gross estate for federal estate tax purposes." (Emphasis added.)

New letter ruling involving Alaska law

Before discussing the new letter ruling, it seems appropriate to discuss Ltr. Rul. 9837007. In that ruling, an Alaska resident proposed to create a self-settled trust for the benefit of herself and her descendants under which the trustee (which was other than herself) could, but was not required to, accumulate all income or pay income and/or corpus to one or more of the beneficiaries. The ruling recites that, under the law of the state (which clearly was Alaska) that governs the trust, because the trust contains certain language specified in the statute, a creditor of the grantor will be precluded from satisfying claims out of the grantor's interest in the trust.

The letter ruling relies primarily on Rev. Rul. 77-378 and holds, "Based on the representation that there is no express or implied agreement between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries, we conclude that the proposed transfer by Donor of property to Trustee to be held under the Trust agreement will be a completed gift for federal gift tax purposes." However, Ltr. Rul. 9837007 also states, "We are

expressly not ruling on whether the assets held under the Trust agreement at the time of Donor's death will be includible in Donor's gross estate for federal estate tax purposes." Ltr. Rul. 200944002 expressly answers the issue not addressed in Ltr. Rul. 9837007.

In the new letter ruling (Ltr. Rul. 200944002), the grantor proposed to create a trust for the benefit of himself, his wife, and his descendants. Under the terms of the trust, the trustee could, but was not required to, accumulate all income or pay income and/or corpus to one or more of the beneficiaries. Upon the grantor's death, the trust would be divided into per stirpital shares for his descendants and held in further trust for them or, if no descendant is then living, to charity. The trustee was neither a related nor subordinate party within the meaning of IRC Section 672(c) with respect to the grantor. The grantor and certain others are prohibited from being a trustee.

The ruling recites the grantor is a resident of the state under which the trust is created. From the facts recited about local law, the state is Alaska. The ruling correctly recites that, under state law, if the trust contains a transfer restriction (which the trust does), it is not subject to the claims of the grantor's creditors unless (1) the grantor may revoke or terminate the trust, (2) the grantor is intending when the transfer of property is made to the trust to defraud a creditor, (3) the grantor is in default of child support payments by 30 days, or (4) the trust requires that income or corpus be distributed to the grantor. Representations were made that none of those four conditions existed. In addition, the trustee

²³ 2004-2 CB 7.

²⁴ See, e.g., Gans, Heilborn, and Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," 31 ETPL 467 (Oct. 2004).

would be prohibited, under the terms of the trust, from reimbursing the grantor for income tax imposed on the grantor on trust income attributed to the grantor under IRC Section 671.

Based primarily on Rev. Rul. 2004-64, the IRS concluded, "because the trustee is prohibited from reimbursing Grantor for taxes Grantor paid, the Grantor has not retained a reimbursement right that would cause Trust corpus to be includible in Grantor's gross estate under § 2036. *See* Rev. Rul. 2004-64. *In addition, the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause Trust corpus to be includible in Grantor's gross estate under § 2036.*" (Emphasis added.) But the IRS added, "We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036."

Ltr. Rul. 200944002 seems completely consistent with the official position of the IRS. Although this letter ruling cannot be cited or used as precedent, taxpayers may rely on Revenue Rulings.²⁵ And the result reached in Ltr. Rul. 200944002 is essentially the same as that reached in Rev. Rul. 2004-64.

Consequently, it seems that if a taxpayer creates a self-settled spendthrift Alaska trust, the trust will not be included in the grantor's estate unless the grantor retains

some power or interest (such as the right to the income or the power to control where the property will pass when the grantor dies) to cause it to be included. Nevertheless, there are four important issues that should be addressed:

1. Although the IRS ruled in both Ltr. Rul. 200944002 and Rev. Rul. 2004-64 that the trust would not be included in the grantor's estate under Section 2036, could a self-settled trust be included under Section 2038 even if the grantor's creditor could not attach the trust assets?
2. Does the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("2005 Bankruptcy Act") affect the question of whether a self-settled trust is included in the grantor's estate?
3. Would the result reached in the letter ruling be the same if the grantor were not an Alaskan?
4. Would the result reached in the letter ruling be the same if the law governing the trust was not that of Alaska but of some other state which provides creditor protection for self-settled trusts?

Section 2038 and self-settled trusts.

Rev. Rul. 76-103 held that, if the grantor died before the gift to the self-settled trust became complete by changing the situs of the trust from one state where it was subject to the claims of the grantor's creditors to another state where it was not subject to such claims, the trust would be includable in the grantor's estate, for federal estate tax purposes, under IRC Section 2038 because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust. But, if the grantor could

not so relegate his or her creditors to the trust, it should not be included in the grantor's estate. Because under the new letter ruling the grantor's creditors may not attach the assets of the self-settled trust, Section 2038 should not apply.

2005 Bankruptcy Act and estate tax inclusion. The 2005 Bankruptcy Act made many changes to the bankruptcy laws of the United States. One may have a direct impact on the efficacy of self-settled trusts with respect to asset protection. Section 548 of the Bankruptcy Code²⁶ (which was adopted by the 2005 Bankruptcy Act) provides that the trustee in bankruptcy may avoid any transfer of an interest of the debtor that was made on or within ten years before the filing of the bankruptcy petition if, among other conditions, the transfer is made to a "self-settled trust or similar device" and the debtor made the transfer with the "actual" intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date the transfer was made, indebted.

The scope of the new section is uncertain.²⁷ Nevertheless, even if it means that the trustee in bankruptcy can attach the assets in a self-settled trust, it does not give the grantor the power to simply relegate his or her creditors to the assets of the trust. At the time of the transfer, presumably, the grantor will not be in bankruptcy, which is a necessary condition for the new bankruptcy rule to apply. Moreover, a finding by the bankruptcy court of the actual intent to defraud, etc. would have to be made. Those events are so remote that it seems quite certain that the Act has no impact on whether the transfer is complete or the property involved is included in the grantor's estate.

Importance of the grantor's domicile. In both Ltr. Ruls. 9837007 and 200944002, the grantor was an

²⁵ Rauenhorst, 119 TC 157 (2002).

²⁶ 11 U.S.C. § 548.

²⁷ See, generally, Rothschild, "Did Bankruptcy Reform Act Close the 'Loophole' for the Wealthy?," Tax Notes (Apr. 2005).

Alaskan. However, it does not seem that the conclusions reached would be different if the grantor were domiciled in another state. In fact, in Ltr. Rul. 9332006, the grantors were Americans who created the self-settled trusts under a foreign country's laws which protected the trusts from claims of the grantors' creditors. Yet the IRS concluded that the trusts would not be included in the grantors' estates without discussing the rights of creditors under the law of the domicile of the grantors.

Estate of German seems on point. The grantor in that case was a Floridian, but the trust was created and administered under the laws of Maryland, where one of the trustees resided. The court makes it clear that the question of whether the trust would be included in Mrs. German's estate turned on "the extent of decedent's creditors' rights with respect to the trust income and assets under *Maryland law*," not Florida law. (Emphasis added.)

There are some cases which suggest that courts may attempt to apply the laws of the grantor's domicile to determine whether a self-settled trust created and administered under the laws of a jurisdiction other than that domicile is subject to the claims of the grantor's creditors. Examples include *In re Portnoy*²⁸ and *In re Brooks*.²⁹ The correctness of those decisions has been questioned.³⁰ But, perhaps, the cases are correct. Both *Portnoy* and *Brooks* involved foreign self-settled trusts, and the courts refused to grant the grantor a discharge in bankruptcy by holding that the trusts were part of the bankruptcy estate of the grantor but were not available to the grantor's creditors. Nevertheless, it seems certain that the grantor could not, under the foreign laws under which the trusts were formed and were administered, relegate his or her creditors to the assets of the trust.

The key in determining whether a transfer to a self-settled trust is a completed gift and whether it is in the grantor's estate turns on whether the grantor may relegate his or her creditors to the trust assets. Certainly, if an individual not domiciled in Alaska creates a self-settled trust which is governed by the laws of and is administered in Alaska, the individual may not simply relegate his or her creditors to the trust assets.

The fact that someday some court might somehow conclude that the grantor's creditors could attach the trust assets certainly seems insufficient to render the gift incomplete or to cause the trust to be included in his or her estate. Indeed, under the law of Florida, it seems nearly certain that Mrs. German's creditors could have attached the assets in the self-settled trust she created.³¹ As impliedly recognized by the definition of spendthrift trusts set forth in *Croom*,³² Florida law will not protect assets contained in a spendthrift trust to the extent the settlor creates the trust for his or her benefit, rather than for the benefit of another.

Moreover, the grantor of the trust in Ltr. Rul. 200944002 might move to another state which allows a grantor's creditors access to the assets of a self-settled trust. Perhaps, a court in the grantor's new domicile would conclude that under its law, the assets in the Alaska trust are subject to his creditors. Nothing in the law seems to absolutely preclude such a conclusion. And, of course, courts make mistakes in applying the law but, even if they do, the parties will be bound by their erroneous decisions unless they successfully are able to overturn them by some appeal or other process. But, any lifetime transfer, whether in a self-settled trust or otherwise, is potentially subject to the claims of a transferor's cred-

itors, as reflected by the 2005 Bankruptcy Act. However, it seems virtually certain that such a mere possibility of creditor attachment someday alone is insufficient to prevent the transfer from being a completed gift or to cause it to be included in the grantor's estate.

It is also appropriate to mention that, in any case where the grantor's ability to extract a benefit from the trust is dependent upon a court's willingness to apply the law of the grantor's domicile instead of the law of the state designated in the trust instrument, it is difficult to view the grantor as having retained the right to relegate his/her creditors to the assets of the trust. The concept of relegation, the touchstone of the analysis in Rev. Rul. 76-103, is not an insignificant aspect of Section 2036. It contemplates that one or more of the grantor's creditors must have unfettered access to the trust's assets.

Nor is the concept without foundation in the Section 2036 jurisprudence. Indeed, it can be traced back to the notion in *Byrum*³³ that Section 2036(a)(1) does not apply where the grantor retains something that is merely speculative and/or contingent. This seems similar to the phrase in Rev. Rul. 77-378 of "a hope or passive expectancy" where the grantor is a mere discretionary beneficiary and the trust is governed by the law of a state where his or her creditors cannot attach the trust assets to pay the grantor's debts, and

²⁸ 201 BR 685 (Bankr. S.D. N.Y., 1996).

²⁹ 217 BR 98 (Bankr. D. Ct., 1998).

³⁰ See, e.g., Rothschild, Rubin, and Blattmachr, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?," 9 J. Bankr. L. & Prac. 59 (Nov./Dec. 1999).

³¹ In Florida, at the time of the *German* decision, trusts containing valid spendthrift provisions were "those trusts that are created with a view of providing a fund for the maintenance of another." *Croom v. Ocala Plumbing & Elec. Co.*, 62 Fla. 460, 57 So. 243, 244-45 (1911). (Emphasis added.)

³² *Croom v. Ocala Plumbing & Elec. Co.*, 62 Fla. 460, 57 So. 243, 244-45 (1911).

³³ 408 U.S. 125, 150, 30 AFTR2d 72-5811 (1972).

that phrase is in turn derived from *Herzog*,³⁴ which seems to be the first case involving the gift tax effects of transferring property to a self-settled trust, where the court stated that "a hope or passive expectancy is not a right." Thus, if the grantor cannot unqualifiedly assure his/her creditors at inception that they can reach the trust's assets to satisfy their claims, Section 2036 should not apply. (Based on this reasoning, any creditor's right to set aside the trust on fraudulent conveyance grounds should similarly be irrelevant to the Section 2036 analysis.)

Laws of other self-settled trust states. The culmination of the reasoning of the IRS as to its official position with respect to the gift completeness and estate tax inclusion of a self-settled spendthrift trust seems to be reflected most recently in Rev. Rul. 2004-64 upon which Ltr. Rul. 200944002 is based. The conclusion, as stated in the letter ruling, is "[T]he trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036," although the letter ruling adds that it is specifically not ruling on whether the trustee's discretion to distribute income and principal of the trust to the grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between grantor and trustee regarding the exercise of this discretion)

may cause inclusion of the trust's assets in the grantor's estate for federal estate tax purposes.

Rev. Rul. 2004-64, in dealing with "Situation 3," where the trustee may but is not required to reimburse the grantor for the income taxes the grantor owes on the income imputed to the grantor under IRC Section 671, states, in part:

[A]ssuming there is no understanding, express or implied, between [the grantor] and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy [the grantor's] obligation [to pay the income tax] would not alone cause the inclusion of the trust in [the grantor's] gross estate for federal estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses [the grantor] from Trust assets for the amount of income tax [the grantor] pays that is attributable to Trust's income.***However, such discretion combined with other facts (*including...applicable local law subjecting the trust assets to the claims of [the grantor's] creditors*) may cause inclusion of Trust's assets in [the grantor's] gross estate for federal estate tax purposes."³⁵ (Emphasis added.)

Rev. Rul. 2004-64 seems to indicate that, if any creditor of the grantor may reach the trust assets, the trust will be included in the grantor's estate. By way of example, the Utah self-settled spendthrift trust statute allows the State of Utah to attach the trust assets if the grantor ever becomes indebted to the state, such as it seems for income tax on income attributed to the grantor from a grantor trust.³⁶ Therefore, it seems likely that a Utah self-settled trust would be included in the grantor's estate under the reasoning of Rev. Rul. 2004-64.

In the trust described in Situation 3 of the Revenue Ruling, the only interest the grantor had was the eligibility to receive distributions from the trust to reimburse the grantor

for income tax the grantor had to pay on the trust income imputed to the grantor under Section 671. Although Rev. Rul. 2004-64 does not state that estate tax inclusion would occur even if only a tax authority could attach the trust assets by reason of the eligibility of the grantor to be reimbursed for income tax, the Ruling would seem to require inclusion in that situation. Under Reg. 20.2036-1(b), inclusion occurs "to the extent that the use, possession, right to the income or other enjoyment [from the trust] is to be applied toward the discharge of a legal obligation of the decedent or otherwise for his pecuniary benefit." Under this Regulation, if any creditor of the grantor is able to reach trust assets to satisfy that creditor's claim, it seems inclusion is required.

For example, if the decedent's spouse or minor child could reach the assets in satisfaction of the decedent's duty of support, Section 2036 would apply.³⁷ The last sentence of Reg. 20.2036-1(b)(2) explicitly contemplates this result: "The term 'legal obligation' includes a legal obligation to support a dependent during the decedent's lifetime." Thus, even if no other creditor of the grantor could reach the trust assets, inclusion in the estate is required if only one creditor (e.g., the grantor's spouse or minor child) can reach the trust assets. In other words, because the grantor remains able to extract pecuniary benefit from the trust, by having the trust discharge his or her obligation to his or her dependent, the corpus of the trust is included in the estate even if no other creditor has access.

It seems that all other states that have self-settled trust legislation, other than Alaska or Nevada, allow certain creditors access to the trust. In fact, in Utah, among other types of claimants who may attach assets in a Utah self-settled spendthrift

³⁴ 41 BTA 509, 510 (1940), *aff'd* 116 F.2d 591, 26 AFTR 169 (CA-2, 1941).

³⁵ The creditor claims issue is not mentioned in Ltr. Rul. 200944002 because the trust instrument prohibited the trustee from reimbursing the grantor for the income tax due on the trust income attributed to the grantor.

³⁶ Utah Code Ann. § 25-6-14(1)(c)(viii).

³⁷ See, e.g., *Estate of Lee*, 33 TC 1064 (1960); *Dwight's Estate*, 205 F.2d 298, 44 AFTR 48 (CA-2, 1953); *Richards*, 375 F.2d 997, 19 AFTR2d 1856 (CA-10, 1967).

³⁸ Utah Code Ann. § 25-6-14(1)(c)(viii).

trust, is a claimant of "a tax or other amount owed by the settlor to any governmental entity."³⁸

Many other self-settled spendthrift trust states have exceptions for certain "family" claims.³⁹ Is it, therefore, certain that a self-settled trust created under the law of a state that permits attachment for family claims will be included, with certainty, in the grantor's estate? It does not seem so. It may well be that such family claims are too remote to be considered as causing the grantor to have retained a power to relegate such creditors to the trust. Perhaps, the answer will turn on whether the grantor at the time the trust is created is under some type of family obligation (such as to pay alimony or child support).

But, in any case, it does seem that it would be more prudent, until the law with respect to other states is clarified, to use self-settled trusts created only in Alaska or Nevada if the goal is to prevent the trust property from being included in the grantor's estate. It might be appropriate to create the trust initially under Alaska or Nevada law and to have the initial trust situs be there but to allow the trustee to change the situs and governing law. When and if the law of another state is clarified so its creditors' rights provisions will not cause estate tax inclusion, the trust could be relocated (as occurred in Rev. Rul. 76-103) and the governing law changed to such other state.

Structuring and administering the trust

Trust property may be included in the estate of a transferor if there was an express or implied understanding the transferor will benefit from the property. In virtually all cases where there was no express retention of an interest, the courts have found an implied one only if the transferor has received benefits

from the property (such as receiving distributions from the trust or other entity to which the property was transferred.⁴⁰) However, in *Estate of Bongard*,⁴¹ the court found an understanding, even though the transferor had not benefited from the property after its lifetime transfer, that he had retained "the enjoyment of the property held by" the partnership because he could control when certain partnership property would be redeemed. Therefore, the court concluded that partnership property was included in his estate under Section 2036(a)(1).

Hence, it seems that it may be best if the grantor of the self-settled trust retains no power over the trust or its assets.

The trust should be structured to be one from which no person has any entitlement to distributions during the grantor's lifetime but only eligibility. That is, the trustee should be given express authority to accumulate all income and not to make any distributions (at least until the grantor dies). Nevertheless, it would not seem harmful to the goal of preventing the trust from being included in the grantor's estate to give some other trust beneficiary (perhaps, the grantor's spouse or one or more descendants) the power to withdraw property from the trust under

an ascertainable standard relating to health, education, maintenance, and support. Such a withdrawal power does not constitute a general (that is, estate and gift taxable) power of appointment under IRC Section 2041(b). Accordingly, the power would not cause the trust to be included in the powerholder's gross estate.

Such a power, however, could make the trust assets subject to the claims of the powerholder's creditors under the law of some states.⁴² However, if the law governing the trust would not permit the powerholder's creditors to attach the property by reason of the power, the trust should not be subject to the powerholder's creditors even if the law of the powerholder's domicile would permit such attachment.⁴³ Under Alaska law, for example, a power to withdraw property from a trust for the powerholder's health, education, maintenance, and support does not subject the trust to claims of the powerholder's creditors.⁴⁴

Even though the IRS acknowledges in Rev. Rul. 2004-64 that "assuming there is no understanding, express or implied, between A and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy A's obligation would not alone cause the inclusion of the trust in A's gross estate for federal estate tax purposes" * * and

financial statement used to obtain or maintain credit other than for the benefit of the trust).

⁴⁰ See, e.g., *Estate of Skinner*, *supra* note 4, and *Rosen*, TCM 2006-115.

⁴¹ 124 TC 8 (2005).

⁴² See, e.g., *In re Marcia Flood*, N.Y. L. J. (3/11/1998) (New York law but overruled by statute).

⁴³ See Restatement (Second) of Conflict of Laws, § 273. Restatement (Second) of Conflict of Laws, § 273(b) states, in part, "Whether the interest of a beneficiary of a trust of movables is assignable by him and can be reached by his creditors is determined...in the case of an inter vivos trust, by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered and otherwise by the local law of the state to which the administration of the trust is most substantially related."

⁴⁴ See AS 34.40.110(b)(3)(F).

³⁹ See, e.g., 12 Del. Code § 3573 ("on account of an agreement or order of court for payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt"); § 456.5-503.2 R.S. Mo. (child and spousal claims and "a claim of this state or the United States to the extent a statute of this state or federal law so provides"); N. H. RSA 564-D:15 (similar to Delaware); R.I. Gen. Laws § 18-9.2-5 (similar to Delaware); S.D. Codified Laws § 55-16-15 (similar to Delaware); § 456.5-503.1 R.S. Mo. (similar to Delaware); Tenn. Code Ann. § 35-16-104(i)(D) (allowing claims based upon "A written agreement, judgment or order of a court for division of marital property of a spouse or a former spouse, but only to the extent of such debt, legally mandated interests and the reasonable cost of collection"); Wyo. Stat. § 4-10-520(a) (similar to Delaware as well as a creditor where the trust property is listed on an application or

that [t]his is the case regardless of whether or not the trustee actually reimburses [the grantor] from Trust assets," it also seems appropriate for the grantor not to seek any distribution from the trust except as a financial "last resort." If the grantor never receives a distribution and has no power over the trust assets (unlike the individual in *Bongard*), the risk of the IRS successfully arguing there was an implied understanding that the grantor would benefit from the trust seems remote.

In addition, it may be preferable to have an independent trustee who controls distributions and who has not advised the grantor about the "benefits" of creating a trust from which he or she could receive distributions. It may be best to use a corporate fiduciary with whom the grantor has no significant relationship. The attorney to the grantor may wish to have an express agreement with the trustee that there is no agreement as to how the trust will be administered or if or when distributions will be made to any beneficiary. It may be appropriate to document that the trustee was expressly advised that it is solely its responsibility and liability for the administration of the trust and that there is no understanding that distributions will, in fact, be made to the grantor or any other beneficiary.

Although the law now seems virtually certain that a self-settled trust governed under the laws of and administered in a state that prevents all creditors of the grantor from attaching the trust assets will not be included in the grantor's estate (assuming the grantor has no other interest or power in the trust), there are additional steps that may be taken to more greatly ensure that

result. One is to permit distributions to the grantor's spouse (defined, perhaps, as the person to whom the grantor is married and living with from time to time) and to permit distributions to the grantor only at such time or times, if any, that the grantor is not married to and living with another as husband and wife. As long as the grantor is happily married, any distribution to his or her spouse likely may be about as satisfactory in benefiting the grantor as would distributions to him or her.

If and when the grantor and his or her spouse separate or the spouse dies, the spouse would no longer be eligible to receive distributions but the grantor would then be eligible but not entitled to receive them. If the grantor is married at death, it seems creditors would be foreclosed at that time from attaching the trust assets under the law of all states, thereby preventing the inclusion of the trust in the grantor's gross estate under the reasoning of Rev. Rul. 76-103 and *Estate of Paxton*.⁴⁵ As discussed below, even if the grantor married within three years of his or her death, there should be no estate tax inclusion under any transfer-within-three-years-of-death rule by reason of the grantor having become not married within three years of death. Also, the grantor's ability to eliminate his or her spouse as a beneficiary and to become one himself or herself would not seem to cause the trust to be included in the grantor's estate.⁴⁶

A further step would be to permit someone other than the grantor to eliminate the grantor as a beneficiary of the trust. Both IRC Sections 2036(a) and 2038 apply as of the moment of the transferor's death, not before, unless the grantor has made a transfer with respect to that retained interest or power or relinquished it within three years of death.⁴⁷ Even if the grantor is expunged as a beneficiary within three years of death by

Practice Notes

It seems that if a taxpayer creates a self-settled spendthrift Alaska trust, the trust will not be included in the grantor's estate unless the grantor retains some power or interest to cause it to be included.

the action of another, it seems that the transfer-within-three-years-of-death rules cannot apply because the grantor will not have made a transfer or relinquishment with respect to the trust by reason of being eliminated as a beneficiary, which are prerequisites for Section 2035(a) or 2038(a)(1) to apply. But see TAM 199935003.

Conclusions

Though many, if not most, self-settled trusts are intended to be incomplete gift transfers (and thus includable in the settlor's estate), Ltr. Rul. 200944002 provides planners with the opportunity to provide clients who have been hesitant to make large gifts (for fear of future needs) with a strategy that offers not only asset protection, but significant potential estate tax savings while at the same time the comfort of knowing that if the settlor requires some portion of the funds transferred, a trustee can provide for them.

It has been 12 years since Alaska adopted the first self-settled spendthrift trust legislation. Based on the law as it existed at that time, it seemed that a self-settled Alaska trust, under which the trustee other than the grantor could but was not required to distribute trust property to the grantor, would not be included in the grantor's estate for federal estate tax purposes unless the grantor held some other interest or power over the trust. Developments since that time, such as Rev. Rul. 2004-64, have reinforced that conclusion. And Ltr. Rul. 200944002 seems now to be directly on point. ■

⁴⁵ 86 TC 785, 818 (1986).

⁴⁶ See Rev. Rul. 80-255, 1980-2 CB 272, and *Estate of Tully*, 528 F.2d 1401, 37 AFTR2d 76-1529 (Cl. Ct., 1976).

⁴⁷ See Sections 2035(a) and 2038(a)(1).

CARRYOVER BASIS: A “DISCREDITED” CONCEPT

By

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The 1976 Tax Reform Act¹ introduced the controversial concept of carryover basis. This replaced “stepping up” or down the adjusted basis of property to its date of death or alternate valuation date value. A fresh start rule exempted prior appreciation, “changing” the basis of inherited property to its December 31, 1976 value. The concept was so complicated that Jonathan Blattmachr, a co-author of this article, wrote a book about it.²

A. The 1976-1980 Carryover Basis Controversy

Tax professionals soon realized that carryover basis created new complexity to estate administration. A storm of protest arose by many professional groups. The Carter Administration and various “liberal” organizations tried to defend this significant change, proposing a 1978 moratorium and a “fix up.” But the rapidly strengthening opposition’s refusal to compromise and insistence on repeal was overwhelming.

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¹ P.L. 94-455.

² McGrath & Blattmachr, *Carryover Basis Under the 1976 Tax Reform Act* (Journal of Taxation 1977).

During a dialogue between panelists³ and committee members at a 1979 House Ways and Means Committee hearing, it was apparent that those strongly favoring repeal; namely, Republicans led by senior minority member, Barber Conable, and conservative Democrats, including Sam Gibbons, were far more articulate and convincing than Committee Chair, Al Ullman, and the handful of liberal Democrats favoring fix up. Retroactive repeal was enacted, but the President threatened a veto. However, an oil supply crisis, causing skyrocketing gasoline prices, made a crude oil windfall profits tax a very important Administration priority. Carryover basis opponents attached its retroactive repeal to this veto-proof bill.

B. A Resurrected Carryover Basis Applies to 2010 Decedents

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)⁴ enacted a modified carryover basis provisions for 2010 deaths, while gradually phasing out the estate and GST taxes, repealing them for 2010 deaths. In 2011, all prior tax law provisions⁵ will apply as if EGTRRA had never been enacted.⁶

Unlike the 1976 carryover basis legislation, EGTRRA does not have a fresh start basis rule. Appreciation that accrued prior to enactment of EGTRRA will be exposed to tax. The absence of a fresh start basis rule makes the determination of basis more difficult.

³ Among proponents were former Commissioner of Internal Revenue, Donald C. Alexander, former Deputy Assistant Secretary of the Treasury, John Nolan, and distinguished tax attorney, James Lewis, who had previously served as a somewhat lower level in the Treasury. All three were former chairs of the American Bar Association's Tax Section. Among opponents, representing the American College of Probate Counsel (now the American College of Trust and Estate Counsel) as a Regent and its Estate and Gift Tax Committee Chair, was Frank S. Berall (a co-author of this article).

⁴ Enacted June 7, 2001.

⁵ Section 901(a)(2) of EGTRRA.

⁶ Section 902(b) of EGTRRA.

Section 1014(f)⁷ makes section 1014(a)'s adjustment to basis, to the value at death or alternate valuation date, inapplicable to 2010 decedents' estates. However, persons who die after 2010, when EGTRRA will have expired, will be entitled to the basis adjustment previously allowed by section 1014 as though EGTRRA had never been enacted.

Section 1022 treats property acquired from a 2010 decedent as if transferred by gift, thus carrying over its basis. Although the legislative history of the EGTRRA indicates that the nature of any gain or loss that would have been realized by the decedent's sale of inherited property also carries over to the decedent's estate, it is not clear that the statute supports this conclusion. The fact that the property is treated as received by gift does not determine the character of the donee's property or the character of the donee's gain. For example, property that was inventory in the hands of the donor may be a capital asset in the hands of the donee. Section 1221 does address the question of whether a work of art or literary composition acquired upon the death of the artist or author in 2010 is a capital asset in the hands of the transferee. Subsection (a)(3)(C) of section 1221 provides that if the basis of the property is the same in whole or in part, as the transferor's basis, determined without regard to section 1022, then the asset is not a capital asset. Section 6018 (c)(5) requires that executors of decedents who die in 2010 file a return disclosing whether the gain on the sale of the property would be treated as ordinary income. However, except for these provisions, the statute does not support the carryover of the character of property to the decedent's estate or beneficiaries.

⁷ Added by EGTRRA, § 542.

Section 1221(11) treats gain on the sale of assets that acquired a new basis under section 1014 as long-term gain. During 2010, since section 1014 is not in effect, gains realized within 12 months of a decedent's death will be short term unless a decedent's holding period is "tacked" to the holding period of his estate or other recipient and is treated as being held for at least a year. Tacking is allowed when a person's basis is the same (in whole or in part) as the basis of the person from whom the asset was acquired. If the limited basis adjustments allowed by EGTRRA are not allocated to an asset or not allocated in an amount sufficient to increase the basis of an asset to fair market value on the date of the decedent's death, tacking should be allowed because the basis will be the same (in whole or in part) as the decedent's basis. If the limited basis adjustments are allocated to increase the basis of an inherited asset to full fair market value, it is not clear whether tacking will be allowed.

Unless EGTRRA is extended after 2010, a basis adjustment may be available, even for property acquired from a 2010 decedent's estate, if the asset is sold after 2010. Section 902(b) of EGTRRA provides that the Internal Revenue Code shall be applied and administered to years, estates, gifts and transfers described in subsection (a) of Section 902 as if the provisions and amendments described in subsection (a) had never been enacted. Subsection (a) of section 902 provides that EGTRRA shall not apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2010. If the Code is applied to "years after 2010" as if EGTRRA had never been enacted, then assets acquired from the estate of a decedent who died in 2010 would have acquired a date of death basis under section 1014. On the other hand, if the Code is applied to "estates of decedents dying after 2010" as if EGTRRA had never been enacted, the basis

of assets inherited in 2010 would continue to be determined under the carryover basis rules of EGTRRA.

C. The \$1.3 Million Basis Increase

To ease the application of the modified carryover basis system to small and medium-size estates, a “basic” basis increase of \$1.3 million is allowed for the estate of any U.S. citizen or resident, up to fair market value.⁸ This adjustment is augmented by the sum of section 1212(b) capital losses and section 172 net operating loss carryovers. The net operating loss carryforward is the same amount that would have been carried over from the decedent’s last taxable year to a later one, had he lived. The section 165 “built in” losses are calculated as if the decedent had sold the property at fair market value immediately before death. The additional adjustment for the decedent’s “built-in losses” makes it unnecessary in most cases actually to sell assets to realize losses (in order to preserve them for the modified carryover basis system) prior to death.

Non-resident alien decedents are not treated as generously. Their initial basis increase will be limited to \$60,000 and no additional adjustment will be allowed for unused built-in losses or loss carryovers.⁹ Hence, American taxpayers (and others) who inherit property from a foreign decedent will face more income tax, on average, on the disposition of that property than for inheritances from American decedents. Under prior law, the basis of property acquired from a foreign decedent, even though not subject to United States estate tax, was equal to its estate tax valuation date fair market value, as a general rule.

⁸ Section 1022(b)(2)(B).

⁹ Section 1022(b)(3).

These basis adjustments cannot cause an inherited asset's basis to exceed its date of death fair market value.

The rule treating transfers by a U.S. person to a foreign trust or estate as a sale or exchange is expanded to include transfers by a U.S. person or U.S. estate to a non-resident alien individual. The transferor's gain to be recognized is the excess of the transferred property's fair market value over its adjusted basis in his hands. The deemed sale does not apply to lifetime transfers to nonresident alien individuals.

Clarification is needed as to whether section's 1022 basis adjustments will be allowed to reduce gain, particularly where a sale or other taxable transfer occurs before allocations to basis adjustments have been made.

D. The \$3 Million Spousal Basis Increase

Qualified spousal property receives a \$3 million basis increase (but not above date of death fair market value).¹⁰ Qualified spousal property includes an outright transfer to a surviving spouse unless it is a terminable interest. However, interests terminating because the spouses may die in a common disaster are not considered to be terminable interests if the spouses in fact do not die in a common disaster.

Qualified spousal property also includes qualified terminable interest property (QTIP).¹¹ This is defined identically to section 2056(b)(7)'s QTIP definition; namely, property "which passes from the decedent, and . . . in which the surviving spouse has a qualifying income interest for life . . . [being] entitled to all the income . . . [at least]

¹⁰ Section 1022(c).

¹¹ Section 1022(c)(5).

annually . . . and no person has a power to appoint any part of the property to any person other than the surviving spouse.”¹² For Louisiana, Puerto Rico and other decedents in civil law jurisdictions, a usufruct for life will qualify.¹³ However, unlike the federal estate tax requirement, no QTIP election is required for property to become qualified spousal property.

Nor does the latter include a charitable remainder trust, of which the spouse is the only non-charitable beneficiary, because she is not entitled to all its income. The I.R.S.’s regulatory authority could treat both an annuity and such a trust as qualified spousal property.

Certain interests for which an estate tax marital deduction was available under prior law are not considered qualified spousal property eligible for a section 1022(c) \$3 million spousal basis step up. For example, a section 2056(b)(5) general testamentary power of appointment marital deduction trust will not qualify if the spouse has a lifetime general power of appointment which may be exercised in favor of anyone other than the surviving spouse. Similarly, an “estate trust,” whose remainder goes to the spouse’s estate, without requiring any income payment to her would not be qualified spousal property.

Other than QTIPs, terminable interests such as life estates, term of year legacies, annuities (except as provided in regulations), patents and copyrights will probably not

¹² Section 1022(c)(5)(D) treats a specific portion as separate property, limiting that former term to a portion determined on a fractional or percentage basis.

¹³ Section 1022(c)(5)(B)(i).

qualify for the \$3 million spousal property basis increase.¹⁴ But, a bond, note or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or term of years, will qualify.¹⁵

E. QTIP Trusts

While allocation of the \$3 million basis increase can be made to property received by a surviving spouse or QTIP trust, how can these assets be identified if the estate is still open and not all assets that could be distributed to the surviving spouse or QTIP trust have been distributed? For example, if the executor allocates the basis increase to \$4 million in stock with a \$1 million basis and the QTIP's share is at least equal to \$4 million, if the executor allocates the \$3 million basis adjustment to the stock and sells the stock before funding the QTIP, must the sales proceeds be allocated to the QTIP? Suppose there is cash that could be distributed in satisfaction of the QTIP instead of the assets that have been sold and with respect to which all or part of the \$3 million basis increase has been or it is claimed will be allocated? A similar problem was discovered in the 1976 version of carryover basis by Jonathan Blattmachr (one of this article's authors). He could never figure out a perfect way to solve the issue. Repeal of the 1976 carryover basis made it unnecessary for the I.R.S. to address it. However, it may be necessary now.

While there can be a total \$4.3 million (plus unused losses) increase in the basis of the property transferred to a surviving spouse, neither the \$1.3 million aggregate basis increase (including unused losses) nor the \$3 million spousal basis increase can raise the

¹⁴ Section 1022(c)(4)(B).

¹⁵ *Id.*

basis of any property above its fair market value at death. Thus, the executor must determine which assets to use and to what extent to give each a basis increase. With insufficient appreciation to use these adjustments, the excess is lost.

F. Jointly Held Property

Property owned by a decedent includes jointly owned property, 50% of that held in joint tenancy if the surviving spouse is the only other joint tenant.¹⁶ Where there are additional tenants and the decedent furnished consideration, he will be treated as owner to the extent of his proportion in it.¹⁷ Where the decedent and someone not his spouse acquired property by gift, bequest, devise or inheritance as joint tenants with right of survivorship, the decedent will be treated as owner to the extent of his fractional interest's value.¹⁸ Where the decedent's interest in jointly held property was received by him as a gift, while the surviving joint tenant purchased his interest, there may be difficulties in proving contribution of the purchased property, as well as determining the contribution ratio for the joint property.¹⁹

G. Effects on Foreign Spouses

The \$3 million spousal basis increase applies to non-resident aliens and non-U.S. citizen surviving spouses' estates, regardless of the surviving spouse's citizenship or

¹⁶ Section 1022(d)(1)(B)(i)(I).

¹⁷ Section 1022(d)(1)(B)(i)(II).

¹⁸ Section 1022(d)(1)(B)(i)(III).

¹⁹ *Id.*

residency.²⁰ Unlike the estate tax law, where the estate tax marital deduction is permitted only for property passing to a qualified domestic trust or QDOT described in section 2056A, a non-U.S. citizen surviving spouse may enjoy the basis increases under the modified carryover basis rules that a U.S. surviving spouse may enjoy.

H. Inflation Adjustments While EGTRRA expires on December 31, 2010, there is a remote possibility that Congress might extend its carryover basis provisions. If so, and the latter do not expire as scheduled, there will be post-2010 inflation adjustments for the \$1.3 million basic basis step up, the \$3 million spousal basis increase and the \$60,000 non-resident alien decedent's step up.²¹ But, inflation adjustments to the \$1.3 aggregate increase from the 2009 base year will only be in \$100,000 multiples. However, aggregate spousal basis increases of \$3 million will be increased for inflation in \$250,000 multiples. The \$60,000 non-resident aliens' aggregate basis increase will be increased for inflation in \$5,000 multiples, but cannot be increased by unused loss carryovers or built-in losses.²²

I. Other Problems

(1) The "Owned by" Requirement

For property to receive a basis adjustment, it must be both owned by and acquired from the decedent. The "acquired from" requirement is broadly construed. It includes

²⁰ Kaufman, *The Estate and Gift Tax: Implications of the 2001 Tax Act*, Tax Analysts Special Report, Tax Notes, P. 949, 952, August 13, 2001.

²¹ H.R. 107-37. *See also* §§ 1022(b)(3) and (d)(4). This adjustment for inflation seems irrelevant, since carryover basis expires December 31, 2010.

²² Sections 1022(b)(3) and (d)(4).

acquisitions by bequest, devise and inheritance, as well as property passing to his estate, from his revocable trust or any other trust he had the power to alter, amend or terminate and any other property passing from him because of his death, to the extent it passed without consideration.²³ However, the “owned by” requirement is given a narrower meaning. Assets held by a trust will satisfy the “owned by” requirement only if the trust is a qualified trust under section 645(b)(1) so it may, by election, be treated as part of the decedent’s probate estate for income tax purposes. Property over which a decedent had a general power of appointment is not treated as his; thus if he has the right to withdraw assets from a trust established by someone else, he will not be treated as owning them for section 1022 purposes. It is at least arguable that assets owned in a trust that is treated as a grantor trust for income tax purpose of which the decedent was the grantor will qualify for a basis adjustment because it is the official position of the I.R.S. that such a trust does not exist for income tax purposes but it is treated as owned by the grantor.²⁴ But the specific reference to section 645 trusts as meeting the “owned by” requirement implies that other grantor trusts do not meet the “owned by” requirement. This uncertainty may create some pressure for trustees to make distributions to terminally ill beneficiaries, or to exercise withdrawal rights.

The surviving spouse’s half share of community property is considered as having been owned by and acquired from the decedent if at least half of the community interest is treated as owned by and acquired from the decedent, without regard to this provision.

²³ H.R. 107-37 and §§ 1041(b)(2) and (3).

²⁴ Rev. Rul. 85-13, 1985-1 C.B. 142.

This rule is consistent with the benefit community property has enjoyed over jointly held property in determining the basis of assets acquired from a decedent under section 1014.

(2) Negative Basis Property.

Liabilities exceeding basis will be disregarded in determining a transferee's adjusted basis and whether gain is realized at death by the decedent or in a transfer to his estate or to any beneficiary other than a "tax exempt" one.²⁵ A beneficiary inheriting carryover basis property subject to a liability exceeding basis may incur tax on its subsequent disposition in an amount that could exceed its value. Thus, he should consider disclaiming it.²⁶

If property subject to liabilities in excess of basis is left to a charity, a foreigner or, to the extent provided by regulations, to any other person for a tax avoidance purpose, gain is realized by either the decedent at death or by the estate when it distributes the property. A deduction for the distribution would only shield the tax liability to the extent of the value of the property distributed. However, if such property passes to a domestic trust that has no other assets, the collectability of the tax on the eventual sale of the asset subject to liabilities in excess of basis is doubtful.

(3) Property Received Within Three Years of Death

In general, property given to a decedent within three years of death will not qualify for a basis adjustment. However, transfers within three years of death from a

²⁵ Section 1022(g).

²⁶ As a general rule, disclaimed property passes to alternate takers, which may eventually mean those who take under the intestate laws of the decedent's domicile and, if all individual takers disclaim, to the state of the decedent's domicile which would be a tax exempt entity which would cause the decedent to recognize the gain as of time of his death.

spouse do qualify for a basis adjustment unless the donor spouse acquired the property by gift from another person within the 3 year period.

(4) Income in Respect of a Decedent

As under section 1014, no adjustment to basis is allowed for income in respect of a decedent (“IRD”) principally dealt with under section 691 including traditional IRAs, section 401(k)s and similar tax deferred retirement plans.

(5) Satisfying Pecuniary Bequests with Carryover Basis Assets

Section 1040 provides that only post-death appreciation is recognized by an estate if a pecuniary bequest is satisfied with appreciated carryover basis property. To the extent provided in regulations, a similar rule will apply to trusts. Until then, revocable trusts should make a section 645 election to be treated and taxed as an estate, which will permit the trust to avoid gain recognition pursuant to section 1040 while the election is effect. Section 1040 seems to exempt IRD from being recognized when satisfying a pecuniary bequest, unless there has been an increase in value since death. This is based on a literal reading and may have been unintentional. A beneficiary’s basis will be the transferor’s basis immediately prior to transfer, plus the gain recognized by the estate or trust on the transfer. Thus, selection of assets to fund pecuniary bequests will significantly affect the beneficiary’s future income tax liability, potentially resulting in a significant gain at a later sale or other taxable disposition. A “boilerplate” provision allowing pecuniary bequests to be paid in cash or in kind and without regard to basis in the discretion of the executor could, under a carryover basis regime, distort a decedent’s

estate plan, such as where the decedent bequeathed a specific sum to an individual and intended the legatee to receive that amount without any inherent income tax liability.

(6) Principal Residences

The \$250,000 exclusion under section 121 on the sale of a principal residence will be extended to estates and heirs, if the residence was used by the decedent as such for two or more years during the five years before its sale. There can be tacking of the decedent's occupancy period to that of the individual beneficiary's in determining if the two-year rule is fulfilled, even if the residence was owned by a trust during the decedent's occupancy.²⁷ However, this exclusion is allowed only to an estate or an individual beneficiary and not to a trust. Therefore, sales should be made before funding a testamentary trust. A revocable trust making a section 645 election to be taxed as an estate should also be able to use this exclusion while the election is in effect.

(7) No basis adjustment or credit is allowed for state and foreign death taxes.

This is a particularly harsh consequence for U.S. citizens residing abroad. Not only may assets have to be sold to pay foreign death taxes without an income tax "credit" for the foreign death tax, but state death taxes may present the same problem.

J. Information Returns, Other Estate Administration Problems and Risks to Executors

²⁷ Conference Committee Report (H.R. CONF. REP. No. 107-84), hereafter H.R. 107-84. The report refers to the beneficiary as an "heir," which could be limited to an intestate beneficiary, but this was probably not the intent.

An as yet not designed information return, in lieu of a United States estate tax return, is required to report large transfers at death.²⁸ All property (other than cash) acquired from a decedent with a fair market value at death exceeding the \$1.3 aggregate basis increase (without increase for unused built-in losses and loss carryovers) will require the executor to file such a return reporting large transfers at death.²⁹ This filing requirement also applies to appreciated property acquired by the decedent within three years of death, for which the donor was required to file a gift tax return.³⁰ Basis increase allocations must be made by the executor on an asset by asset basis, on that return, for 2010 deaths. Allocation can be made to one or more shares or to an entire block of stock, but an asset's basis cannot be adjusted above its fair market value on date of death.

The return must report, to both the I.R.S. and the beneficiaries, the recipient's name and tax identification number (TIN), the property's accurate description, its adjusted basis in the decedent's hands, its fair market value at his death, his holding period, sufficient information to determine whether any gain on its sale is ordinary income, the amount of basis increase allocated to the property and any other information prescribed by not yet proposed regulations.

The return must be filed if the aggregate value of these assets (excluding cash) exceeds \$1,300,000. If the executor cannot make a complete return, then every person holding any legal or beneficial interest in the property must file one.³¹ For non-resident

²⁸ See section 6018.

²⁹ As specified in § 6018(c).

³⁰ Section 6018(b)(2).

³¹ Section 6018(b)(4).

aliens' estates, the return requirement applies only to tangibles situated in the United States and other property acquired from that decedent by a U.S. person.

All return preparers must furnish a written statement to each beneficiary with the name, address and phone number of the person required to make the return and the information called for about the decedent's property passing to that person, no later than 30 days after the return is filed.³² These returns are required when the federal income tax return for the decedent's last taxable year is due to be filed. This would be April 15, 2011 or as late as October 15, 2011, if extensions to file are requested. (Thus, the I.R.S. has a long time before it must release form return.) There is a \$10,000 late filing penalty against the executor and a \$500 penalty for each failure to furnish the section 6018(b)(2) information concerning certain gifts received by a decedent within three years of death. Furthermore, a \$50 penalty will be imposed for failure to furnish statements to the recipients.³³ A reasonable cause exception exists for failure to comply with these requirements.

Administration of 2010 decedents' estates will be complicated by allocation of basis adjustments. Determining optimum allocation may not be the fairest way of doing that under general fiduciary principles. The fairness of an allocation will probably be disputed and possibly litigated between beneficiaries. Even relatively small estates will have to appraise hard-to-value and not readily marketable assets.

The lack of a decedent's records will require extra time to reconstruct basis, particularly for jewelry, collectibles and similar items of tangible personal property

³² Section 6018(e).

³³ Sections 6716(b) and 6019(b).

purchased in small quantities over a lifetime. The reporting requirements and dealing with disputes between beneficiaries over exemption allocations may increase the risk of surcharge actions, malpractice suits against attorneys for alleged mishandling of allocations or violations of fiduciary duties in making them. An executor who is also a beneficiary will have conflicts of interests in allocating potential basis increases and may be accused of violating his duty of loyalty to the estate.

It is likely that the I.R.S. will have enforcement problems. It is unclear if and when the as yet to be designed return, upon which basis allocations and other information must be reported, will be audited or what penalties will apply in the event of a valuation dispute. If sales occur decades after a 2010 death, can the seller rely on the return's data? Until statutes of limitations run on income tax returns on which beneficiaries report the sale or other taxable disposition of property acquired from a decedent, the disclosures on the executor's information return can apparently be questioned by the I.R.S., even many years after the estate was closed and the executor discharged or died or if a bank that was executor is no longer in business.

K. Planning

While carryover basis will only have an impact on decedents dying in 2010, unless Congress extends it, the impact of it on estate planning must nonetheless be considered.

One solution for clients with assets without a readily ascertainable basis would be to estimate basis and sell them while alive. Then, in a possible audit, it might be easier for the taxpayer than for his executor to negotiate a favorable settlement. Another

advantage of selling assets while alive would be to eliminate costly difficulties for the executor and the accompanying uncertainty beneficiaries may experience while the basis issue is disputed with the I.R.S. Another solution for a client concerned about dying during 2010 with an asset without basis records would be to give it to a charity for its charitable purposes.

Provisions to protect executors should be drafted into the instruments to exonerate them from liability for asset allocation. Naming a corporate executor, or even co-executor, if the latter is solely responsible for the allocations, should reduce accusations of conflicts of interest.

Engagement and advice letters should alert clients to carryover basis problems that their estates will face if they die this year or if carryover basis is extended beyond 2010. They should be advised to determine the basis of existing property to the extent possible and urge maintenance of proper records of all future acquisitions and additions, as well as request the client's permission to review instruments to deal with possible his death in 2010. Some attorneys may wish to ask the client to sign and return the letter to establish that the attorney gave this advice.

L. Unresolved Questions

1. Will the basis of assets inherited in 2010 be adjusted to date of death fair market value when EGTRRA expires and the Code is applied to years after 2010 as if EGTRRA had never been enacted, i.e., as if section 1014 had never ceased to apply? If so, where possible, sales of assets in these estates should be delayed until after 2010. s.

2. Is the nature of a decedent's gain (e.g., ordinary income or capital gain) carried over? If the decedent was a dealer, will the estate have to treat the property as inventory rather than a capital asset? There is no definitive rule contained in section 1022 that says that the nature of the gain will remain the same in the hands of the inheritor as it was in the decedent's hands.

3. It should be noted that the legislative history of EGTRRA indicates that the character of the income to the decedent determines the character of the income to the estate or beneficiary who inherits the asset from the decedent. Specifically, "[t]he character of any gain or loss on the sale of an asset is also carried over with its basis. For example, depreciated real estate, which would have been subject to 'recapture' tax had it been sold by the decedent, will be subject to such recapture if sold by his estate."³⁴ The statute, however, as mentioned, does not appear to include language that requires this result. For example, if the decedent was a dealer, is the inventory later sold by the decedent's estate ordinary income to the estate, as it would be to the decedent? Nothing in the statute mandates that result.

4. While it does not appear to have been intended, it seems that section 1040 excuses recognition of income as IRD, if used to satisfy a pecuniary bequest. Will this be allowed?

M. Possible Congressional Action

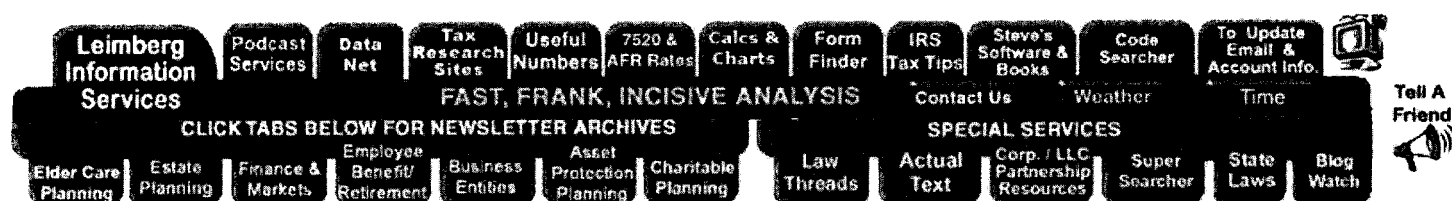
Senate Majority Leader Harry Reed and Minority Leader Mitch McConnell have discussed trading Republican votes for a jobs bill for Democratic votes to restore the

³⁴ H.R. 107.37.

2009 estate tax rates of 45% on estates over \$3.5 million along with reinstating the estate tax retroactive to January 1, 2010. Retroactive legislation may lead to litigation by estates challenging the constitutionality of apply the reinstated tax to the estates of decedents who died prior to enactment. Unfortunately, however, there is yet no indication whether carryover basis will also be retroactively repealed.

N. Conclusion

However Congress deals with the absence of estate and GST taxes for 2010 decedents, it may once again consider the retroactive repeal of carryover basis. The cost of administering the carryover basis rules both to the I.R.S. and taxpayers may exceed its revenues. Because many more people will be affected by the carryover basis provisions than would be affected by an estate tax with a \$3.5 million exemption, Congress might be able to curry political favor by retroactively reenacting the estate tax with such an exemption and repealing the carryover basis provisions.



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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1559

Date: 10-Dec-09
From: Steve Leimberg's Estate Planning Newsletter
Subject: PLR 200949012 - Beneficiary Defective Trust(sm) Private Letter Ruling

"Private letter ruling 200949012 sets forth what appears to be a certain and correct way to allow one person (such as a parent) to create a trust for another (such as a child) in a manner to make the trust a grantor trust with respect to such other (such as the child), even after the power to withdraw all property without restriction lapses because the beneficiary's power to withdraw for health, education, maintenance and support does not lapse. That will permit this Beneficiary Defective TrustSM to grow free of income tax and without causing the beneficiary to be deemed to be making a gift by paying the income tax on the income imputed to him or her under Code Sec. 671 and 678. It also permits the beneficiary to sell assets to the trust without gain, under Rev. Rul. 85-13, while being able to benefit from and to maintain control over the assets sold without gross estate inclusion, if the sale is for full and adequate consideration in money or money's worth."

Trusts that are defective with respect to their grantors have long been popular with clients and their advisors. Trusts that are defective with respect to their beneficiaries are a relatively new development, and have become quite popular because of their creditor protection and estate exclusion features. As they draft these specialized trusts, a question some advisors have wrestled with is the extent to which a "lapse" will be treated as a "release" for section 678 purposes.

In their commentary, **Jonathan G. Blattmachr** and **Diana S. C. Zeydel** inform **LISI** members about a recent development that illustrates how to more assuredly create a trust that remains a section 678 trust, or a Beneficiary Defective TrustSM, even after the power to withdraw all property from the trust lapses. They also explain why this produces an important planning option for clients.

Jonathan G. Blattmachr is the author of five books and hundreds of articles and co-developer with **Michael L. Graham, Esq.**, of Dallas, Texas, of **Wealth Transfer PlanningSM** a software system for lawyers. Jonathan also was the principal drafter of the request for ruling that resulted in the issuance of PLR 200949012 which is the subject of this important **LISI** commentary.

Diana S. C. Zeydel is a shareholder of **Greenberg Traurig, P.A.** in Miami, and is a frequent lecturer and author.

Here is their commentary:

EXECUTIVE SUMMARY:

The IRS has just issued Private Letter Ruling 200949012. Although it may not, under section 6110(k)(3) of the Code, be cited or used as precedent, it appears correctly to conclude that a trust that is not a grantor trust with respect to its creator will be a grantor trust with respect to its beneficiary if the beneficiary is granted unilateral right to withdraw all trust corpus for any reason (or no reason at all) which lapses.

In the ruling, following the lapse, the beneficiary continues to have the right to withdraw all the trust property for his or her health, education, maintenance and support (HEMS). The HEMS power is used in the ruling to ensure that the power to withdraw is not treated as having been entirely released but only partially released consistent with the precise wording of Code Sec. 678(a)(2). The ruling was not predicated on the power to withdraw for HEMS being a Code Sec. 678(a)(1) power.

It is the authors' view that this represents the first such private letter ruling dealing with this issue.

FACTS:

Background

A grantor trust is one whose income, deductions and credits against tax are attributed under Code Sec. 671 to the grantor. The attribution of income, deductions and credits will occur with respect to the grantor if any of the conditions described in Code Sec. 673 to 677 or Code Sec. 679 is present.

Where those provisions apply, the grantor is treated as the "owner," in the parlance used in the Code and regulations, of the trust, for income tax purposes. In fact, such trusts are sometimes called "substantial owner trusts." Grantor trusts (also known as "defective trusts") are often the estate planner's best friend.

For example, one of the most powerful factors in financial planning, of which estate planning is a subset, is the income tax free compounding of wealth. Because the income of a grantor trust is received by the trust but is taxed for income tax purposes to the grantor, the trust grows on an income tax free basis.

In Rev. Rul. 2004-64, 2004-2 CB 7, the Internal Revenue Service acknowledged that a grantor did not make a gift by paying income tax on the trust's income attributed to the grantor under the grantor trust rules. Some commentators have concluded, based upon "Monte Carlo" simulations, that such a tax free compounded for a grantor trust is a more significant wealth tax reduction strategy than a grantor retained annuity trust (GRAT), an installment sale for a grantor trust (ISGT) or even a 30% discount in value of assets being transferred out

[i]
of the property owner's estate is likely to be.

In fact, a GRAT is an effective strategy in significant measure, in many cases, because the trust is a grantor trust. The GRAT can distribute appreciated assets back to the grantor in satisfaction of the grantor's right to [ii]
the annuity payments without triggering gain for income tax purposes to the trust or to the grantor.

If the trust were not a grantor trust, the distribution of non-cash assets in satisfaction of the annuity (a pecuniary sum) would cause the trust potentially to recognize gain if the assets distributed in satisfaction of [iii]
the annuity have a basis less than their fair market value. In PLR 200846001 (not precedent), the IRS

ruled that the exercise of a power of substitution with respect to a GRAT does not have gift or income tax consequences.

An installment sale to a grantor trust also may be an especially effective wealth tax reduction strategy [iv]

The IRS has ruled that the existence of a grantor trust is ignored for Federal income tax purposes. [v]
Hence, the sale of appreciated assets to a grantor trust does not cause realization of gain or other income, nor does the payment of interest to the grantor by the trust cause the receipt of gross income if the assets were [vi]
sold to the trust for a note.

Estate Tax "Problems" with Traditional Grantor Trusts

Because a grantor trust permits its beneficiaries to experience tax free compounding of wealth a grantor trust should be considered for all wealth transfer strategies at least for as long as the grantor can endure paying tax on the wealth held in trust for the beneficiaries. This would include using a grantor trust to hold the remainder in a GRAT after the annuity term ends, after the retained use term in a qualified personal residence trust (QPRT) expires, and after indebtedness arising from an ISGT is paid in full.

Indeed, the grantor rarely will be a beneficiary of the grantor trust (other than, for example, during the annuity term of a GRAT but not thereafter). If the grantor remains a beneficiary of the trust, there may be a risk that the trust will be included in the grantor's gross estate for Federal estate tax purposes, thwarting the estate tax planning effectiveness of the arrangement. Such estate tax inclusion will occur if the grantor retains the right to the income of the trust or it is found that there was an implied understanding between the [vii]
trustee and the grantor that is would be distributed to the grantor.

Even if there is no implied understanding, estate tax inclusion nonetheless will occur if the grantor's creditors [viii]
can attach the assets in the trust. Under the law of most states, a trust an individual creates or "settles" and from which distributions may be made to himself or herself (a so-called "self-settled trust") is void with respect to his or her creditors and, therefore, is permanently subject to the claims of his or her creditors regardless of the motive for creating the trust and regardless of whether the claim arose before or after the [ix]
trust was formed.

Nonetheless, the trust could be created in a jurisdiction (such as Alaska or Nevada) where such a "self settled" trust is not subject to the claims of the grantor's creditors as long as, among other conditions, the grantor was not trying to defraud his or her creditors when creating the trust. Cf., e.g., *Estate of German v. United States*, 7 Cl. Ct. 641 (1985) (self-settled trust not included in the gross estate of the Florida decedent because the IRS could not establish that the trust was subject to the claims of her creditors under Maryland law which governed the trust). See, also, PLR 200944002 (not precedent), which held that a self-settled spendthrift trust created under Alaska law would not be included in the grantor's gross estate unless some other factor, such as an implied understanding between the trustee and the grantor that the grantor would benefit from the trust, were present.

Although creating the trust in a jurisdiction that does not permit the grantor's creditors access to the trust may prevent the property from being included in the grantor's gross estate, the grantor's access to the trust must be very limited as a practical matter. If, for example, the trustee makes regular distributions to the grantor, it is

almost certain it will be found there was an implied understanding, causing gross estate inclusion. ^[x] In addition, the grantor may neither retain nor hold at or within three years of death any control over the beneficial enjoyment of the trust property--otherwise the trust may be included in the grantor's gross estate under Code Sec. 2036(a)(2) and/or 2038.

What would be preferable is if the trust could be a grantor trust without concerns of creditor attachment or estate tax inclusion. For some, there is a way: a Beneficiary Defective TrustSM, which is a special trust described in Code Sec. 678 that was the subject of new private letter ruling (PLR) 200949012.

Beneficiary Defective TrustSM

Under Code Sec. 678, a beneficiary who is not the actual grantor nonetheless is treated as the trust's owner, causing the income deductions and credits against tax of the trust to be attributed to him or her, if the beneficiary holds the unilateral right to withdraw the property from the trust. In other words, such a trust is treated as substantially owned by the beneficiary so the grantor trust rule of attributing the income, deductions and creditors of the trust to beneficiary occurs under Code Sec. 671. Beneficiaries are often given such a right unilaterally to withdraw the trust assets in so-called Crummey trusts, named after the famous case of *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), in order to qualify transfers to the trust for the gift tax annual exclusion. ^[xi]

The beneficiary's power of withdrawal not only causes the beneficiary to be treated as the trust's owner for income tax purposes but it also causes him or her to be treated as holding a general power of appointment within the meaning of Code Sec. 2514 and 2041. And that, of course, means that the property over which the beneficiary holds the general power will be included in the beneficiary's gross estate.

In addition, the law provides that if the beneficiary releases or exercises the power, the beneficiary will be treated as making a gift (to the extent the power is exercised in favor or someone other than the beneficiary) and/or treated as a transfer for estate tax purposes (such as where the beneficiary exercises it in further trust from which the beneficiary is entitled to income for life). ^[xii] Hence, from an estate tax perspective, such a beneficiary seems no better off than the grantor who creates a self-settled trust: in each case, entitlement to income or a power of control causes estate tax inclusion.

But Code Sec. 2514(e) and 2041(b)(2) provide that if the power of withdrawal lapses, it is not a gift (or a transfer for estate tax purposes) except to the extent the power lapses in excess of the greater of \$5,000 or 5% of the value of the property over which the power is exercisable in a given calendar year. Hence, and as is well known, the power granted in a "Crummey trust" (which allows the property transferred to the trust to qualify for the gift tax annual exclusion under Code Sec. 2503) is made to lapse at a rate of the greater of \$5,000 or 5% a year.

Over time, the beneficiary gradually will lose the power of withdrawal by reason of the "5 and 5" lapse, except to the extent additional property is transferred to the trust which is subject to the withdrawal power. The question is whether that lapse causes the beneficiary to lose the status as the trust's owner—that is, does the trust stop being a defective trust with respect to the beneficiary?

Code Sec. 678(a)(2) provides that the beneficiary remains the owner where the power of withdraw is "partially released or otherwise modified" by the beneficiary and the trust would be a grantor trust if the

beneficiary had been the true grantor (e.g., the beneficiary is eligible to receive trust distributions from the trustee). Several private letter rulings (not precedent under Code Sec. 6110(k)(3)) indicate that the IRS may view a complete lapse (under the Code Sec. 2514(e) and 2041(b)(2) "5 and 5" limitation) as a partial release. [xiii]

However, such a conclusion does not seem to be able to be reconciled with the language of Code Sec. 678 or its regulations. It is hard if not impossible to see how a complete lapse is a "partial release" or "other modification" of the power of withdrawal. First, it is unclear whether a "lapse" (which apparently is the disappearance or elimination of the power without any action by the powerholder) is a "release". Code Sec. 2514(e) and 2041(b)(2) provide that a lapse is a release for purposes of those sections although only to the extent the lapse exceeds the "5 and 5" level mentioned above.

This begs the question of whether a lapse is a release for purposes of section 678. Even assuming it is, it is hard to see how the complete lapse is a "partial release of other modification" of the power of withdrawal. Nevertheless, the new private letter ruling suggests there is a way in which lapse is treated as a partial release and the trust could remain "defective" for income tax purposes with respect to its beneficiary.

Coupling a Unilateral Power of Withdrawal with a HEMS Power

In private letter ruling 200949012, a trust was created for a beneficiary by someone else. The trust granted the beneficiary (a) the unilateral right to withdraw all contributions made to the trust (1) for any reason (or no reason at all) and (2) for the beneficiary's health, education, maintenance and support (HEMS), and (b) a testamentary special (non-general) power of appointment. A unilateral power to withdraw the property for any reason is a general power of appointment but a power to withdraw under HEMS is not. [xiv]

The IRS expressly notes that "This power [to withdraw under the HEMS standard] will not lapse." But the IRS also expressly notes that the unilateral "power [to withdraw for any reason] will lapse each calendar year in an amount equal to the greater of \$z and y% of the value of the Trust." (it seems clear "\$z" means "\$5,000" and "y%" means "5%.")

Even if the grantor contributed \$1,000,000 to the trust, the power to withdraw for any reason would lapse at least after 20 years—as 5% of \$1 million is \$50,000. If the trust grew in value, the power would lapse even faster because it would lapse at an annual rate of 5% of a greater sum than \$1 million. But the power of withdraw would have disappeared only in part. That is, the lapse would have been partial only: the power to withdraw for HEMS would remain.

Indeed, private letter ruling 200949012, the IRS concludes the "Beneficiary will be treated as the owner of Trust for federal income tax purposes under §§ 671 and 678 before and after the lapse of Beneficiary's power of withdrawal with regard to any transfer to Trust." This statement suggests that the IRS does equal "lapse" with "release" for purposes of section 678 and that, on account of the continuous non-lapsing power to withdraw to HEMS, it is a partial release.

A Little More Analysis

As explained in detail in Gans, Blattmachr & Lo, "A Beneficiary as Trust Owner: Decoding Section 678," 35 ACTEC Journal 106 (Fall 2009), it appears that a trust will not be a section 678 trust if the beneficiary's power to withdraw is limited to a standard such as HEMS. In other words, for the trust to be a section 678 trust, the beneficiary must be given the unilateral right to withdraw all income or corpus from the trust.

Yes, a trust may be defective in part but our goal is to make the trust a section 678 trust in its entirety. And, yes, "income" under the grantor trust rules, unlike the "normal" rules relating to the income taxation of estates, trusts and their beneficiaries, means income for tax purposes (including capital gains), not fiduciary accounting income. See Reg. §1.671-2(b). And it is possible that if the beneficiary was given only a power to withdraw all tax income from the trust, and no power over corpus, and that power never lapsed, only the unwithdrawn tax income would be included in the powerholder's gross estate under section 2041.

But see Rev. Rul. 66-161, 1966-1 C.B. 164 dealing with a power to withdraw capital gains for grantor trust purposes which holds that capital gains lose their character as such after the year they are earned and become merged into corpus such that in the subsequent year a fraction of the trust appears to become a grantor trust relating to the amount of capital gains subject to withdrawal in the prior year divided by the fair market value of the trust at the beginning of the following year. But it would be preferable, in many cases, to prevent any portion of the trust to be included in the beneficiary's gross estate.

But giving the beneficiary a unilateral right to withdraw gives the beneficiary a general power of appointment for estate and gift tax purposes. So, to begin, granting the beneficiary a unilateral right to withdraw makes the trust a section 678 trust but it will cause estate and/or gift tax issues for the beneficiary. Now that power may be made to lapse at a calendar year annual rate of 5% or \$5,000 without, perhaps, adverse estate and gift tax purposes. But that seems to terminate section 678 status when the power has lapsed in its entirety.

In other words, once the power to withdraw lapses in full, it does not seem to be a "partial release or other modification" of the power. And Code Sec. 678(a)(2) states that a trust remains a section 678 trust if (1) the power is partially release or otherwise modified and (2) it would be a grantor trust with respect to the real grantor if the real grantor had retained an interest or power described in any of sections 673, 674, 675, 676, 677 or 679. So, by way of example, if the beneficiary has partially released or otherwise modified the power and if any of the conditions set forth in sections 673-677 or 679 are present (e.g., the trustee may distribute the corpus to the beneficiary), the trust remains a section 678 trust.

For example, let's suppose the trust gave the beneficiary a unilateral right to withdraw all trust corpus and it provided that the beneficiary could release the power in whole or in part. Let's assume the beneficiary released the power so he or she could only withdraw the property for his or her health, education, maintenance and support. That would certainly seem to be a "partial" release. Because a trust from which the real grantor could withdraw property for such reasons would be a grantor trust under Code Sec. 676, the trust for the beneficiary with respect to which he or she had made such a partial release would remain a section 678 trust.

But that affirmative release would not expunge the estate and gift tax general power of appointment problem the beneficiary had at the beginning. The only way "out" of a general power of appointment (other than by a disclaimer pursuant to section 2518) is to let it lapse under the 5%/\$5,000 rule mentioned above.

And, in the example above, it is a true release not a lapse. And that is true even though a power to withdraw for HEMS is not a general power of appointment for estate and gift tax purposes. The reason is that the beneficiary either made a gift by reason of partial release or is deemed to have retained sufficient power to

[xv]

continue to cause estate tax inclusion under section 2041.

The bottom line is that in PLR 200949012 the unilateral power is allowed to lapse, thereby avoiding section 2041, but for such lapse to be treated only as a partial release for purposes of section 678 so defective trust

status for the beneficiary continues. Again, the private letter ruling expressly states,

"Beneficiary will be treated as the owner of Trust for federal income tax purposes under §§ 671 and 678 before and after the lapse of Beneficiary's power of withdrawal with regard to any transfer to Trust."

Thus, the ruling, at least, seems to accept a "lapse" as a "release" so that the lapse to a HEMS standard falls within Code Sec. 678(a)(2) as a "partial release" even though as to the unilateral right to withdraw there is a lapse not a release.

A Comment about the Portion Rule

Howard Zaritsky has raised an additional issue not analyzed in the ruling. Reg. § 1.671-3(a)(3) deals with the issue of when only a portion of a trust is treated as owned by the grantor or another person. If a portion of a trust treated as owned by the grantor or another person consists of an undivided fractional interest in the trust, or a interest represented by a dollar amount, only a pro rata share of each time of income, deduction and credit is normally allocated to the portion.

Where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus such as capital gain) is attributed to the portion.

"The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question."

How would this regulation affect the analysis? If the beneficiary had a right to withdraw 100% of the trust corpus at the time the trust is funded (there being no income) and 100% lapsed, it would seem the beneficiary should be treated as owning 100% of the trust for income tax purposes.

But in the facts of the ruling only the greater of \$5,000 and 5% lapses and the balance would continue to be subject to withdrawal in the following year. In that case, it would seem that if 5% lapses, the beneficiary is the owner of 5% of the trust going forward.

But what about the *unlapsed* portion? It seems possible that the beneficiary would be treated as owning a fraction of the trust the numerator of which is the amount currently subject to withdrawal and denominator of which is the fair market value of the trust. That fraction would seem to be added to the 5% owned by reason of the lapse. If the trust estate appreciates, this means that in the second year less than the entire trust will be treated as owned by the beneficiary.

If the foregoing analysis is correct, the trust would be wholly grantor at least by the 20th year of administration ($5\% \times 20 = 100\%$).

Alternatively, if the power of withdrawal were as to a fraction, and were to hang as to a fraction, then the two fractions would always add up to 100%. So in year 1 the beneficiary may withdraw 100% which lapses as to 5% and continues as to 95%. In that way, if the trust appreciates, the entire trust would remain a wholly grantor trust as to the beneficiary.

A negative is that this could cause a greater portion of the trust to be included in the beneficiary's gross estate for a longer period of time, assuming appreciation, because as the trust appreciates, so would the power of

withdrawal or the unlapsed portion.

As previously indicated, the ruling does not analyze the cited regulation. The ruling appears to conclude that if at any time the beneficiary had the power to withdraw 100% of the trust, then the beneficiary owns 100% of the trust thereafter for income tax purposes.

Additionally, the power of withdrawal in the ruling was not limited to corpus, and a power limited to corpus is what literally invokes the fraction analysis under the regulation. However, grantor trust status is a year in year out determination. And by the second year the determination of grantor trust status appears to be a two part analysis: part one relates to the power of withdrawal that was partially released, which invokes at least a 5% fraction under Code Sec. 678(a)(2), and part two relates to the unlapsed power of withdrawal under Code Sec. 678(a)(1), possibly invoking the fraction analysis because the remaining amount subject to withdrawal is

[xvi]

pecuniary.

COMMENT:

Enhancing Estate Planning for the Powerholder Beneficiary

As mentioned above, grantor trust status provides significant opportunities for estate planning for the grantor such as by allowing the trust to grow on an income tax free basis and permitting the grantor to sell assets to the trust without gain and in exchange for low (Applicable Federal Rate) interest charge. By making the trust a grantor trust with respect to the trust beneficiary under Code Sec. 678 provides that beneficiary with similar and, to some degree, even enhanced estate planning opportunities.

For example, a grantor cannot be a beneficiary of the trust unless the trust is created in a jurisdiction (such as Alaska or Nevada) where the grantor's creditors are not given access to the trust property. Even if it is created and administered in such a jurisdiction, the grantor cannot retain the right to trust distributions or have any control over the beneficial enjoyment of the trust property or the trust will be included in his or her estate under Code Sec. 2036 and/or 2038.

But with a Beneficiary Grantor Trust(sm) or BGT(sm), the Beneficiary can hold both interests and powers without gross estate inclusion because the Beneficiary is not the person who transferred property to the trust. Of course, to the extent the Beneficiary's power of withdrawal has not lapse by his or her death, the trust property will be included in his or her gross estate under Code Sec. 2041.

Because the Beneficiary may be able to hold powers over the trust without causing estate tax inclusion, this provides an opportunity of the Beneficiary inadvertently making a gift when selling property to the trust (whether or not for a note). As explained in detail in the ILS Newsletter "Safety Nets for Installment Sales to Grantor Trusts," which can be downloaded on the Home Page at www.interactivelegal.com, if a beneficiary holds the power to veto distributions to trust property to others and holds a special power of appointment at death, any gift made to the trust (by sale for less than full and adequate consideration or otherwise) will be incomplete, thereby foreclosing the possibility of gift tax being imposed on it.

Although any gift element transferred to the trust by the beneficiary (such as a sale for less than full value) could result in a portion of the trust being included in the beneficiary's estate, the beneficiary may report the sale on his or her own gift tax return (Form 709) and take the position the sale was for full value. As long as full disclosure set forth in Reg. § 301.6501-1(f)(3) is made on the gift tax return, any transfer reported as a full value sale can only be challenged by the IRS within, as a general rule, within three years of the filing of

the return.

If the IRS does not make a successful challenge, it not only will be unable to later claim that the sale was, in whole or in part, a taxable gift, but also will be foreclosed from contending the property is included in the selling-beneficiary's gross estate (except to the extent the beneficiary holds a general power of appointment over the trust property) and from contending that the amount of the property exempted from generation-skipping transfer tax by allocation of GST exemption is incorrect.

More on Creditor Rights and Beneficiary Rights of Withdrawal

Whether or not a trust remains one that is treated as substantially owned by the beneficiary after the right to withdraw property from the trust lapses, it may remain subject to the claims of creditors of the beneficiary. Not only may that be adverse if a creditor holds a claim against the beneficiary that may be satisfied with trust assets, it also may cause the trust assets to be included in the beneficiary's gross estate under Code Sec. 2041. The reason is that a general power of appointment under that section includes one that the beneficiary can appoint to his or her creditors. Code Sec. 2041(b)(1).

To the extent the beneficiary has allowed his or her power of withdrawal to lapse, the beneficiary may be treated as the trust's grantor triggering the self-settled trust rules under state law. In other words, it may be that, under state law, the beneficiary who allows his or her withdrawal power to lapse may be treated as the trust's grantor because he or she has, in effect, turned his or her back to the property. And, if that is the case, the beneficiary is now treated as the "settlor" who has created (to the extent of the lapse) a "self-settled trust."

As mentioned above, a self-settled trust under the law of most states, is void with respect to the grantor's [xvii]

creditors—that is, the "settlor's" creditors can attach the trust property. Hence, the beneficiary would hold the power, under state law, to relegate his or her creditors to the assets of the trust, thereby making it a general power of appointment—because, as mentioned above, a general power of appointment for tax purposes includes one where the powerholder may appoint the property "in favor of the decedent[‘s] [xviii] creditors."

Even if one may conclude, which seems difficult, that the powerholder has not made a contribution to a self-settled trust by allowing his or her withdrawal power of the trust assets to lapse, the trust likely would be considered self-settled to the extent the powerholder makes a sale of property to the trust for less than fair value. As mentioned above, a beneficiary may sell an asset to the trust, for cash, for a low AFR interest note or for some other asset.

Even if the IRS does not successfully challenge that the sale was for less than full and adequate consideration in money or money's worth, a state court may conclude that the sale was for less than full value and, to that extent, the beneficiary has made a transfer to a self-settled trust. As mentioned above, that may cause estate tax inclusion under Code Sec. 2041 because the beneficiary may relegate his or her creditors to the trust.

The IRS may be foreclosed from attempting to include the property in the beneficiary's gross estate under Code Sec. 2036 or 2038 (because the IRS did not challenge that the sale was for full value) but it will not be foreclosed from arguing that the beneficiary holds a general power of appointment because he or she, under applicable local law, may relegate his or her creditors to the trust assets which, as explained above, will cause the beneficiary to hold a general power of appointment under Code Sec. 2041.

As explained in Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter TrustSM," Probate & Property, July/August 2007, pg. 52, there are two potential solutions to block that general power of appointment problem from arising. First, the trust could be created in a jurisdiction (again, such as Alaska or Nevada) which would foreclose the creditors of the selling-beneficiary from attaching the trust property even if it is sold to the trust for less than its full value. Second, distributions to the selling-beneficiary could be limited to an ascertainable standard relating to health, education, maintenance and support. Distributions pursuant to [xix] that standard, even if held by the beneficiary, are not a general power of appointment. In fact, it may be best to use a "belt and suspenders" approach by using both solutions.

Summary

Private letter ruling 200949012 sets forth what appears to be a certain and correct way to allow one person (such as a parent) to create a trust for another (such as a child) in a manner to make the trust a grantor trust with respect to such other (such as the child), even after the power to withdraw all property without restriction lapses because the beneficiary's power to withdraw for health, education, maintenance and support does not lapse.

That will permit this Beneficiary Defective TrustSM to grow free of income tax and without causing the beneficiary to be deemed to be making a gift by paying the income tax on the income imputed to him or her under Code Sec. 671 and 678.

It also permits the beneficiary to sell assets to the trust without gain, under Rev. Rul. 85-13; while being able to benefit from and to maintain control over the assets sold without gross estate inclusion (if the sale is for full and adequate consideration in money or money's worth).

In order to ensure the beneficiary will not be treated as having made a gift by such a sale, the beneficiary should hold a power to veto distributions to others and to appoint the property at death to persons other than himself or herself, his or her creditors or estate or creditors of his or her estate.

However, the trust likely should be created under the law of a state that denies creditors access to a self-settled trust and, perhaps, distributions, even in the discretion of a trustee other than the beneficiary, should be permitted to be made to the beneficiary only under an ascertainable standard relating to health, education, maintenance and support.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jonathan Blattmachr
Diana Zeydel

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CITES:

Sections 671, 673, 674, 675, 676, 677, 678, 679, 2036, 2038, 2041, 2514 and 6110(k)(3) of the Internal Revenue Code of 1986, as amended; Reg. § 1.661(a)-2(f), Reg. § 25.2511-2(c), Reg. § 20.2041-3(d), Reg. § 301.6501-1(f)(3); Private Letter Rulings 200747002, 9809005, 8342088, 200944002 and 200949012; Rev. Rul. 77-378, 1977-2 CB 347, Rev. Rul. 2004-64, 2004-2 CB 7; *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968); *Estate of Skinner v. United States*, 316 F. 2d 517 (3d Cir. 1963)., *Estate of German v. United States*, 7 Ct. Cl. 641 (1985); New York EPTL 7-3.1; Restatement (Third) of Trusts § 58.

CITATIONS:

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- [i] See, generally, Blattmachr, Hatcher, Weinreb, Weiss & Zeydel, "Selected Comparisons of Selected Estate Tax Reduction Strategies," published in the ACTEC Fall 2007 Proceedings in Greenbriar, West Virginia.
 - [ii] See Rev. Rul. 1985-13, 1985-1 CB 184.
 - [iii] See Reg. § 1.661(a)-2(f).
 - [iv] See, generally, Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 Estate Planning 3 (Jan. 1996).
 - [v] See Rev. Rul. 85-13, *supra*.
 - [vi] See Blattmachr & Zeydel, "GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?" 41st Annual Heckerling Institute on Estate Planning (2007).
 - [vii] See, e.g., Rev. Rul. 2004-64, 2004-2 CB 7.
 - [viii] Rev. Rul. 77-378, 1977-2 CB 347.
 - [ix] See, e.g., New York EPTL 7-3.1.
 - [x] See, e.g., *Estate of Skinner v. United States*, 316 F. 2d 517 (3d Cir. 1963).
 - [xi] See, generally, Gans, Blattmachr & Lo, "A Beneficiary as Trust Owner: Decoding Section 678," 35 ACTEC Journal 106 (Fall 2009); Zeydel, "A Complete Tax Guide for Irrevocable Life Insurance Trusts," 34 Estate Planning 6 (June 2007).
 - [xii] See Code Sec. 2514(b) and 2041(a)(2).
 - [xiii] See, e.g., 200747002, 200104005, 200147044, 200022035, 9809005, 8342088.
 - [xiv] See Code Sec. 2041(b).
 - [xv] . See Reg. § 25.2511-2(c) and Reg. 20.2041-3(d).

[xvi]

See generally, J. Blattmachr & L. Boyle "Income Taxation of Estates and Trusts," Chapter 4, PLI; J. Horn, "Flexible Trusts and Estates for Uncertain Times", Chapter 9 (3rd Edition); L. Schmolka, "Selected Aspects of the Grantor Trust Rules," Chapter 14, 9th Annual Heckerling Institute on Estate Planning (1975); and H. Zaritsky, "Grantor Trusts: Sections 671-679" 858 T.M. Portfolio.

[xvii]

See, e.g., Restatement (Third) of the Law of Trusts, § 58.

[xviii]

Cf. Rev. Rul. 76-103, 1976-1 CB 293.

[xix]

Code Sec. 2041(b).