Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010

The Estate and Gift Tax Committee of the Real Property Trust & Estate Law Section of the American Bar Association prepared this background paper on the transfer tax provisions (i.e., the gift, estate and GST taxes) of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010. The members of the Committee responsible for this paper are: Gale Allison, William Burke, Staci Criswell, Richard Franklin, Erica Hickey, Gregg Killoren, Sharon Klein, Lester Law, James Roberts, Martin Shenkman, Javier Tapia, Lenny Thebarge, Brain Tsu, and Timothy Vitollo.

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Following the passage of the new Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, this paper provides a historical perspective on the federal estate tax, summarizes the changes to the gift, estate and generation-skipping transfer taxes, explores the implications of these changes, and finally offers insight on estate planning going forward.

I. Historical Perspective on Estate Tax

On December 17, 2010, President Barack Obama signed into law the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (TRA)[1], which among many significant tax-related provisions modifies the estate and generation skipping-taxes. The TRA:

- Implements an estate tax regime for decedents whose death occurs after Dec. 31, 2009, but still allows estates for decedents who die between Dec. 31, 2009, and Jan. 1, 2011 to elect to apply the rules under the Economic Growth and Tax Relief Reconciliation Act of 2001[2] (EGTRRA);
- Establishes a top rate of 35% with an exclusion amount of $5,000,000, which sunset Dec. 31, 2012;
- Allows for portability between spouses of the maximum exclusion after Dec. 31, 2010;
- Extends the state death tax deduction created by EGTRRA through 2012;
- Provides that the gift tax for 2010 is calculated using a rate schedule with a top tax rate of 35% and a maximum exclusion of $1,000,000; after 2010, the top gift tax rate will also be 35%, but with a maximum exclusion of $5,000,000; and
- Provides a generation-skipping transfer (GST) tax exemption of $5,000,000 for transfers made during 2010, with a GST tax rate of 0%; after 2010, the GST tax rate will be 35% (GST tax is equal to the highest estate and gift tax rate in effect for the particular tax year).

To place the effect of the TRA in proper perspective, a brief review of the history of the estate tax is beneficial. The concept of the estate tax is as old as the pyramids. For example, there is evidence of a 10% tax on the transfer of property at death in Egypt around 700 B.C.E.[3] The origins of the TRA are much closer in time, thankfully.

The EGTRRA provisions, particularly the temporary repeal of the estate tax in 2010, followed by a resumption of the pre-EGTRRA estate tax rules, are what prompted Congress to act this year. However, before examining EGTRRA in more detail, it is useful to understand how estate tax rules operated before EGTRRA to appreciate how dramatically EGTRRA changed the estate tax landscape.

One of the most significant events leading to EGTRRA was an estate tax overhaul by Congress in 1976[4] that “unified” the estate and gift taxes by establishing a unified tax rate schedule and a unified

[1] H.R. 4853
[2] Pub. L. No. 107-16, 115 Stat. 38 (2001)
[3] Luckey, John R., “A History of Federal Estate, Gift and Generation-skipping Taxes,” Congressional Research Service, March 16, 1995
[4] Tax Reform Act of 1976, Pub. L. No. 94-455, 200-210, 90 Stat. 1520, 1846-48

credit that applied both to transfers during life and transfers at death. The Tax Reform Act of 1976 also added a tax on generation-skipping transfers.

The Economic Recovery Tax Act of 1981 (ERTA)[5] made substantial modifications to the state and gift tax system, bringing some relief from the Tax Reform Act of 1976. The changes included:

- A reduction in estate and gift tax rates for large estates from a top rate of 70% to 50%;
- An increase in the unified credit to $600,000;
- Unlimited tax free transfers between spouses;
- An increase in the gift tax exclusion;
- An increase in the maximum amount by which special use valuation can reduce the value of an estate for tax purposes; and
- A liberalization of the eligibility rules for installment payment of the tax.

These changes reduced the estate tax liability for many estates and removed the tax burden for smaller estates. Over the ensuing years, Congress enacted many increases to the estate tax as it became a priority to raise revenue in order to close budget deficits.

Congress provided relief again under the Taxpayer Relief Act of 1997 (1997 Act), which increased the effective unified exemption from gift and estate tax from the $600,000 previously allowed to a maximum of $1,000,000 in years 2006 through 2009.

Among other changes, the 1997 Act provided for inflation adjustments to the annual gift tax exclusion and the GST tax exclusion. The 1997 Act also brought relief to some taxpayers through the Qualified Family-Owned Business Interest (QFOBI) exclusion. An estate could enjoy substantial savings along in addition to the unified credit by qualifying for and electing QFOBI status. Initially, the QFOBI exclusion provided an additional $700,000 tax savings besides the unified credit. The QFOBI exclusion was amended to a Qualified Family Owned Business Interest Deduction, but could never exceed $1.3 million when the unified credit was applied to the estate. However, the exclusion is subject to recapture under certain conditions.

In 2001, EGTRRA was signed into law by President Bush. EGTRRA phased in a repeal of the estate and GST taxes. Before full repeal in 2010, the estate tax was reduced as follows: in 2002, the 55% and 53% tax rates and the 5% surtax were repealed; in 2003, the maximum rate was 49%. Each year thereafter, the maximum rates were reduced by 1% per year from 2004 through 2006, and in 2007 the highest rate was 45%.

In addition, EGTRRA increased the unified credit to $1 million for tax years 2002 and 2003, $1.5 million in 2004-2005, $2 million in 2006 through 2008, and $3.5 million in 2009. However, the lifetime gift exclusion remained at $1 million. After repeal of the estate tax in 2010, heirs would inherit assets with the decedent’s basis (and not in excess of fair market value), except that up to $3 million of basis could be added to assets left to a surviving spouse, and $1.3 million of basis could be added to assets

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[5] Pub. L. No. 97-34, 95 Stat. 172.

left to any heirs, resulting in a continuation of date of death value basis for the vast majority of estates. Certain restrictions applied to the "step up" in basis rules to prevent taxpayers from engaging in dubious transactions to avoid income taxes.

Among other modifications, EGTRRA phased out GST taxes within ten years, and simplified portions of the GST tax rules before repeal.

EGTRRA also repealed the state death tax credit for decedents dying after 2004 and replaced the credit with a deduction. Under EGTRRA's sunset provisions, the credit, as it existed before 2002, would be revived for decedents dying after 2010.

EGTRRA further expanded the definition of "closely-held business" for purposes of estate tax installment payment rules. The change allowed larger family businesses (e.g., those with up to 45 shareholders or partners) to defer estate tax payments over a fourteen year period. Additional expansion of the estate installment payment rules were made for holding companies and qualified lending and finance businesses.

Over the intervening years, numerous pieces of legislation have been introduced to change the outcome of EGTRRA. Many bills sought to make the repeal of the estate tax permanent. Others sought to keep the estate tax but in a modified form. With the success of the Democratic Party in the Congressional elections in 2006, most hopes for repeal faded away. And during the 2008 presidential campaign, then candidate, and now President, Barack Obama promised to work toward freezing the estate tax applicable exclusion amount at $3.5 million.

Starting in 2009, a host of bills were introduced dealing with estate tax. The usual complete repeal bills were introduced.[6] All were dead on arrival in the House Ways and Means Committee. Facing a similar fate was the "Fair Tax Act of 2009."[7] Three bills[8] were aimed at helping the family farmer by creating very substantial estate tax benefits, but with draconian conditions if the family farm did not stay in the family, including retroactive imposition of the estate tax back to the decedent's death and a deemed sale of the farm triggering additional taxable income or capital gains.

When it came to more normal estate tax changes, one bill[9] would have placed the applicable exclusion amount at $3,500,000, stepped it up over time to $5 million, and indexed it to inflation,

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[6] H.R. 99 introduced on January 6, 2009, by Rep. David Dreier [R-CA] titled the "Fair and Simple Tax Act of 2009," H.R. 205 introduced January 6, 2009 by Rep. William Thornberry [R-TX] titled the "Death Tax Repeal Act," H.R. 533 introduced January 14, 2009, by Rep. Randy Neugebauer [R-TX] titled "Opportunity for Family Farms and Small Businesses Act of 2009," H.R. 1763 introduced March 26, 2009 by Rep. Robert Latta [R-OH] titled "Responsible Reinvestment Act of 2009," and H.R. 1960 introduced April 2, 2009, by Rep. Joseph Pitts [R-PA] titled "Permanent Death Tax Repeal Act of 2009."

[7] S. 296 introduced January 22, 2009 by Sen. Saxby Chambliss [R-GA] and H.R. 25 introduced January 6, 2009 by Rep. John Linder [R-GA].

[8] H.R. 96 introduced January 6, 2009, by Rep. Michael Conaway [R-TX] titled the "Save Family-Owned Farms and Small Businesses Act of 2009", H.R. 173 introduced January 6, 2009 by Rep. John Salazar [D-CO] (bearing no title) H.R. 1328 was introduced March 5, 2009 by Rep. Timothy Bishop [D-New York] titled the "Farmland Preservation and Land Conservation Act of 2009."

[9] H.R. 498 introduced January 14, 2009 by Rep. Harry Mitchell [D-AZ] titled "Capital Gains and Estate Tax Relief Act of 2009."

among other changes. H.R. 2658[10] would reunify the estate and gift tax credit at an exclusion amount of $5,000,000, and index that to inflation in $10,000 increments. Yet another[11] would increase the unified credit to cover an applicable exclusion amount of $4,000,000. The lowest exclusion amount was in H.R. 2023,[12] which provided for a unified credit equal to an exclusion of $2,000,000 indexed to inflation. Senator Max Baucus along with other influential Senators introduced a bill on March 26, 2009,[13] which would have restored the unified credit for estate and gift taxes at $3,500,000 and indexed it to inflation.

A real attention getter was H.R. 436[14], introduced by Representative Pomeroy that would have added new valuation rules aimed at eliminating valuation discounts for family limited partnerships. However, the definitions were so broad that other businesses would be caught within the net, and a host of thorny questions would arise from the unartful language used.

Finally, in the closing days of 2009, the House approved H.R. 4853 which would have kept the 2009 estate, gift, and GST tax rules in effect.

During 2010, most efforts at estate tax changes focused on attempts to eliminate short term grantor retained annuity trusts or GRATs. Six pieces of legislation had provisions in the bills that would have provided for a minimum ten year GRAT term, five times longer than popular two year GRATs. None of those provisions made it through any final piece of legislation.

If Congress did not act before the end of 2010, the estate tax and GST tax would have been reinstated in 2011 at their 2001 rate levels. The federal transfer tax system would thus catch gratuitous conveyances from 2011 on, as though EGTRRA never existed. Therefore, the following would have occurred in 2011:

- The estate tax applicable exclusion amount would have been $1,000,000;
- The GST tax exemption amount would have been an indexed amount (at least $1,340,000, which would have been the indexed amount in 2010);
- The maximum estate and gift tax rate would have been 55%, with an additional 5% rate applied to transfers by gift or at death between $10,000,000 and $17,184,000; and
- Heirs would inherit assets at the adjusted basis under Section 1014 of the Code.[15]

The November 2010 elections changed the landscape. On December 6, 2010, Senator Baucus proposed a Senate Amendment to H.R. 4853 titled the “Middle Class Tax Cut Act of 2010,” which would have: (i) provided permanent estate tax relief by reinstating the estate tax retroactively to January of 2010 but allowing decedents’ estates to elect out; (ii) setting the applicable exclusion amount at $3,500,000, indexing that to inflation; (iii) setting a tax rate at forty-five percent (45%); (iv) keeping the

[10] H.R. 2658 introduced June 2, 2008, by Rep. Michael Capuano [D-MA] (no title).
[11] H.R. 1986 introduced April 21, 2009 by Rep. Travis Childress [D-MS] (no title).
[12] H.R. 2023 introduced April 22, 2009 by Rep. James McDermott [D-WA] (no co-sponsors) titled the “Sensible Estate Tax Act of 2009.”
[13] S. 722 introduced March 26, 2009 by Sen., Max Baucus [D-MT], Sen. Charles Schumer [D-NY] and Sen. John Rockefeller [D-WV] titled the “Taxpayer Certainty and Relief Act of 2009.”
[14] H.R. 436 was introduced January 9, 2009 by Rep. Earl Pomeroy [D-ND].
[15] References herein to Sections of the Code are to the Internal Revenue Code of 1986, as amended.

gift tax applicable exclusion at $1 million, but like the estate tax exclusion, indexing that as well; (v) adding portability; (vi) adding a farmland provision with exclusion and deduction provisions as well as a draconian recapture and deemed sale provision seen in earlier bills while increasing the special valuation cap; (vii) imposing a minimum ten year life on GRATs; and (viii) providing for basis consistency between reporting by the decedent's estate and the heirs.

Then on Friday, December 10, 2010, President Obama and the Republican leadership negotiated a compromise plan that took the form of the "Senate Amendment to the House Amendment to the Senate Amendment to H.R. 4853." That "Senate Amendment" is what is summarized here.

Key provisions that were left out of the Senate Amendment include the following:

- All provisions directly related to relief for the family farm, whether in the form of exclusion and/or deferment of taxation, or an increased special use valuation ceiling;
- Separate valuation rules for passive asset laden and family-owned entities;
- Any language related to GRATs; and
- Basis consistency rules.

The EGTRRA phased-out the estate and generation-skipping transfer taxes so that they were fully repealed in 2010, and lowered the gift tax rate to 35% and increased the gift tax exemption to $1 million for 2010. In 2011 the estate, gift and GST tax exclusion was scheduled to decline to $1 million and the estate, gift and GST tax rate to rise to 55%.

When reading this paper, it is important to remember that all the changes discussed herein will sunset at the end of 2012. The sunset provisions are discussed in section VII below. With the TRA, the Congress and the President have extended the instability of the transfer tax system for another two years, while also kicking in numerous changes to cope with during the ensuing period.

II. Terminology of TRA

One key to understanding the changes made by the TRA are the definitions to the terms below.

(a) Applicable Credit Amount

The applicable credit amount is the amount of tentative tax equal to the applicable exclusion amount.[16] When the applicable exclusion amount is equal to $5 million, the applicable credit amount is

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[16] These terms are defined in Section 2010(c) of the Code. Section 2505(a) of the Code refers to the applicable credit amount under Section 2010(c) to define the credit allowed against the gift tax. As discussed below, for 2010 the applicable credit amount for gift tax purposes is limited to the tax on an applicable exclusion amount of $1 million. For 2010, Section 2631(c) of the Code refers to the applicable exclusion amount under Section 2010(c) to define the GST exemption amount. For 2011 and thereafter it refers to the basic exclusion amount to eliminate the portability feature for GST exemption purposes that is built into the term applicable exclusion amount starting in 2011.

$1,730,800. For 2012, applicable exclusion amount is subject to being indexed for inflation and the applicable credit amount would be increased by 35% of the adjustment amount for inflation.

(b) Applicable Exclusion Amount

Prior to January 1, 2011, the applicable exclusion amount is $5 million.

Beginning January 1, 2011, the applicable exclusion amount is the sum of the basic exclusion amount and the deceased spousal unused exclusion amount.

(c) Basic Exclusion Amount

The basic exclusion amount is $5 million. For 2012, this amount is indexed for inflation, rounded to the nearest multiple of $10,000.

(d) Deceased Spousal Unused Exclusion Amount

With respect to the surviving spouse of a deceased spouse dying after December 31, 2010, the term deceased spousal unused exclusion amount (DSUEA) means the lesser of (A) the basic exclusion amount, or (B) the excess of (i) the basic exclusion amount the last deceased spouse of the such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under Section 2001(b)(1) on the estate of such deceased spouse. The following example may be helpful:

> Mikkey and Minney are married. Mikkey has $3.5 million in his personal name, Minney has $6.0 million in her name and they have no joint assets. Mikkey dies in 2011, never having made any taxable gifts in his lifetime. Mikkey leaves all of his assets in a QTIP trust for Minney. Minney's DSUEA is the lesser of (a) $5.0 million (i.e., the basic exclusion with regard to Mikkey); or (b) $1.5 million. In this case it will be $1.5 million.

III. Gift Tax under TRA

In 2010, the gift tax was the only transfer tax that remained in effect under the repeal of the EGTRAA. Its exemption amount was $1 million with a 35% tax rate on gifts totaling over the $1 million exemption.

Under the TRA, for the balance of 2010, the gift tax exemption amount is maintained at $1 million. The way this works is that Section 2505(a) provides a credit against gift taxes equal to the applicable credit amount allowed under Section 2010(c). Special for 2010, however, the TRA left in the EGTRAA language of Section 2505(a)(1) that read "(determined as if the applicable exclusion amount were $1,000,000)."[17]

Beginning in 2011, the gift tax exemption amount is raised from $1 million to $5 million. This is done by removing the "(determined as if the applicable exclusion amount were $1,000,000)" language

[17] Section 302(b)(1)(A) of the TRA.

from 2505(a)(1). With this language removed, Section 2505(a)(1) refers to the full applicable credit amount allowed under Section 2010(c), which is subject to being indexed for inflation in 2012.

Prior to the introduction of EGTRRA, the gift and estate tax were unified -- giving taxpayers a 'unified credit' for transfers made during taxpayers' life and after death. With the change to Section 2505(a)(1) described above and beginning in 2011, the gift tax is once again unified with the estate tax (i.e., both providing the same level of credit and exemption). For 2011, the 'unified' applicable exemption amount is $5 million per person, and in 2012 this amount is subject to being indexed for inflation.

The tax rate remains essentially flat at 35% for 2010 through 2012. Under the TRA, Section 2502(a) is reinstated in its pre-EGTRRA form, which essentially means that for purposes of computing the gift tax the table set forth in Section 2001(c) is used.[18] For 2010, the EGTRRA table created for years after 2009 and set forth in Section 2502(a)(2) is used. Both of these tables are exactly the same.

New language is added to the end of Section 2502(a) setting forth the method by which the applicable credit amount with respect to prior years' gifts will be determined. Section 2502(a) provides that the gift tax is determined by computing a tentative tax on the sum of the current year's taxable gifts and the prior years' taxable gifts, and subtracting from this amount the tentative tax on the prior years' taxable gifts. As changed by the TRA, the rates of tax in effect for the year of new gift (i.e., the one being reported) are used in lieu of the rates of tax in effect at the times of the prior years' taxable gifts to determine the amounts of the applicable credit amount used by such prior years' taxable gifts.[19] This new method is favorable to the taxpayer and preserves more applicable credit amount for future use.

(a) Implications

As a result of reunification of the gift and estate tax applicable credit amounts, taxpayers once again have the option to exhaust their entire exemption through lifetime giving without incurring a gift tax liability.

All taxpayers regardless of whether they made taxable gifts in their lifetimes may give at least $4 million, and some taxpayers may give up to $10 million (with the new portability provision) with no gift tax liability in 2011. The new method of accounting for the use of applicable credit amounts for prior years' taxable gifts means that a taxpayer who made gifts prior to 2010, using the entire applicable credit amount for the prior $1 million applicable exclusion amount (or actually paid gift taxes) will be able to transfer $4 million in 2011 with no gift tax liability. The following example illustrates this:

> Assume that Mary, having made no prior taxable gifts, gave $2 million in 2008 to her daughter, Sue. Accordingly, in 2008, Mary would have used her entire applicable credit amount of $345,800 and paid a

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[18] Section 302(b)(2) of the TRA.

[19] Section 302(d)(2) of the TRA.

gift tax of $435,800. Mary wishes to give Sue another $4 million in 2011. The following illustrates the gift tax computation with the modification of Section 2502(a) to the method of accounting for the use of the applicable credit amount for prior periods:

2011 gifts	4,000,000
Prior years' gifts	2,000,000
Total	6,000,000
Tentative tax on total	2,080,800
Tentative tax on prior years gifts	680,800
Balance	1,400,000
Maximum unified credit	1,730,800
Credit used for prior periods	330,800
	1,400,000
Total credits	1,400,000
Balance (credits minus balance of tax)	-

In this example, the actual credit used for the $2 million gift was $345,800 or $15,000 more than required to be recovered using the rates applicable in 2011. This $15,000 difference represents the tax for the excess of the rate brackets between $500,000 and $1 million, applicable in 2008, over the 35% rate applicable in 2011 to amounts over $500,000 ($250,000 x (37% – 35%) + 250,000 x (39% – 35%)). The key to applying this new provision in TRA is to determine the tax (at the new rates) that would be applicable to the same amount of taxable gift that related to the portion of the applicable credit amount previously used ($1 million in the example).

Another implication is that, because the TRA only extends the sunset provisions of EGTRRA until December 31, 2012, we find ourselves facing the same dilemma we have faced for most of the last ten years. That is, we are not able to predict what will happen in 2013. Without further changes, beginning in 2013 we will return to the $1 million gift tax exemption, the rates will return to being graduated with a top rate of 55%. Taxpayers will once again have to focus on the opportunity and advantages of making gifts at the 35% rate applicable through 2012 in light of the potential for higher gift and estate tax rates thereafter.

See section VIII(a), below, regarding what happens if a donor makes a $5.0 million gift and dies in 2013 or thereafter when the estate tax applicable exclusion amount is scheduled to return to the $1 million level.

IV. Estate Tax under TRA

Under the TRA, the estate tax is retroactively reinstated for persons dying after December 31, 2009, with certain modifications. The retroactive reinstatement is accomplished by Section 301(a) of the TRA changing each provision of the law amended by subtitle A (the provision repealing the estate

tax after 2009) or E (the carryover basis provisions) of EGTRRA to read as if such subtitles had not been enacted. The estate tax law is then modified in the following ways:

(a) Applicable Exclusion Amount

Section 2010(c) is rewritten to provide that the applicable credit amount is the amount of tax with respect to an applicable exclusion amount of $5 million.[20] Beginning in 2012, the applicable exclusion amount is subject to being indexed for inflation, with adjustments rounded to the nearest $10,000 amount.

(b) Rate of Estate Tax

The maximum estate tax rate is 35%. This is accomplished by amending Section 2001(c) to eliminate the brackets and rates for over $500,000 and replace the $500,000 bracket with a new and final bracket that indicates a tax of $155,800 on $500,000 plus 35% for the excess over $500,000. Subparagraph (2) of Section 2001(c) is deleted and subparagraph (1) becomes Paragraph (c).

(c) 2010 Election Out of Estate Tax into Carryover Basis

When the 2010 year passes, the concept of making the estate tax retroactive began to appear more unfair and unlikely. Eventually, sometime past mid-2010 the buzz about making the estate tax retroactive, but giving executors of 2010 decedents the choice as to whether to choose carryover basis or estate tax began. The TRA provided this structure, with the bonus that the estate tax now has a $5 million exclusion instead of the anticipated $3.5 million retroactive exclusion and portability could possibly apply.

It is important to recognize that the estate tax system, with the increased applicable exclusion amount and lower maximum rate, is retroactively applicable for deaths after December 31, 2009. That is the default system in place. As indicated, however, the TRA grants executors of 2010 decedents the option to elect out of the retroactive estate tax system and to use the carry over basis system of Section 1022, under which executors of 2010 estates have the authority to allocate $1.3 million in increased basis to estate assets, as well as an additional $3.0 million in increased basis to assets transferred in a qualifying manner to a surviving spouse.[21] Hereinafter we refer to this election as the “2010 carryover basis election.”

The 2010 carryover basis election is to be made in the manner the Secretary of the Treasury shall designate and once made may be revoke only with the consent of the Secretary of the Treasury.[22]

(d) Gift Tax “Payable” Credit

Prior to the TRA changes, Section 2001(b) set forth the method by which the estate tax is to be calculated. Under this method, estate tax is calculated on the total of the amount of the taxable estate

[20] Section 302(a) of the TRA.
[21] Section 301(c) of the TRA.
[22] *Id.*

plus prior taxable gifts. This total is then reduced by the tax on the prior taxable gifts. The purpose of this structure is to prevent taxpayers from the ability to obtain two runs of the lower rate brackets by making both lifetime and testamentary transfers. The effect of these steps is to push the taxable estate up into its proper place on the rate table.[23] Under this method, the reduction for gift taxes previously paid is based upon the estate tax rates in effect upon death, even though the gift tax imposed at the time of the gift may have been less than this amount.

Under the TRA, Section 2001(b)(2) is modified to refer to a new subsection (g) of Section 2001. New subsection (g) continues to use the estate tax rates in effect upon death for purposes of calculating the tax payable on prior taxable gifts. New subsection (g), however, also sets forth the method for calculating the use of the amounts of the applicable credit amount relating to the prior taxable gifts. This methodology follows that described above in section II(a) for gift tax purposes. As changed by the TRA, the rates of tax in effect for the year of death are used in lieu of the rates of tax in effect at the times of the prior taxable gifts to determine the amounts of the applicable credit amount used by such prior taxable gifts.[24] This new method is favorable to the taxpayer and preserves more applicable credit amount for use against the estate tax.

(e) Implications

(i) Inflation adjustment

A significant concern has been whether the applicable exclusion amount would be inflation indexed. Without inflation indexing the economic value of the applicable exclusion would be eroded, perhaps severely, over time. The recent enactment of the Medicare tax on passive investment income, is an example. Starting in 2013 the 3.8% Medicare tax will apply to net investment income if adjusted gross income (AGI) is over the $200,000 (single) or $250,000 (joint) threshold amounts.[25] This provision raised the specter that other non-inflation adjustment tax hurdles may follow. Fortunately, unlike the Medicare tax provision, TRA provides for inflation adjustments to the applicable exclusion amount, thus securing, in real terms, the value of the elevated exclusion, at least through 2012. Beyond 2012 is an open question.

(ii) Estate Tax v. Income Tax Election for 2010 estates

The estates of 2010 decedents must decide whether to make the 2010 carryover basis election. The default structure is to accept the retroactive estate tax with a $5 million applicable exclusion amount and a basis step. This is a costly retroactive tax benefit for the government to provide. It will, however, provide considerable simplification for many 2010 estates. It will also enable practitioners to address compliance issues with a known body of law.

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[23] *See e.g.*, Smith v. Comm'r, 94 T.C. 872 (1990).
[24] Section 302(d)(1) of the TRA.
[25] Section 1411 of the Code.

For any estate under $5 million in net worth, the choice of the retroactive estate tax regime, with which clients and practitioners are familiar, appears to be obvious. There will be no federal estate tax and the income tax basis of all qualifying assets will be stepped up without limit. For an estate of a single decedent (i.e., no surviving spouse) valued at $5 million under the carryover basis regime, less than a full basis step up would ensue if the appreciation were greater than $1.3 million (ignoring for simplicity the other adjustments that might affect this figure).

For an estate in excess of $5 million it would appear that the carryover basis regime might be better to avoid estate tax. But the estate tax at a 35% rate would have to be compared to the potential income tax cost differential under the carryover basis regime. The estate tax will be generally due nine months from death if the estate tax regime is applied. But if the carryover basis regime is elected, the income tax that might eventually be triggered as a result of the limited basis adjustment can be deferred almost indefinitely utilizing a range of income tax planning techniques (harvesting gains and losses, charitable remainder trusts, tax deferral using Section 1031 exchanges, etc.). Therefore, it would seem that in most if not all instances the carryover basis regime will be preferable for all estates over $5 million. Consider modeling to demonstrate that the carryover basis regime is better.

V. Portability

The newly enacted system of portability is perhaps the most interesting aspect of the TRA. This new system is rife with planning possibilities and pitfalls for the unwary.

Essentially, the new structure will allow a decedent's estate or a donor to take advantage of the applicable exclusion amount of the decedent's or donor's previously deceased spouse.[26] This "portability" concept is intended to prevent families from incurring gift and estate tax that could have been avoided through planning prior to the death of the predeceased spouse.

(a) Mechanics of the Provision

Formerly, an estate could take advantage of a certain amount that could pass free of estate tax – the "applicable exclusion amount." As set forth above, the portability introduces two new definitions -- the basic exclusion amount (BEA) and the deceased spousal unused exclusion amount (DSUEA) starting in 2011. Recall that the TRA has increased the applicable exclusion amount to $5 million for estates effective as of January 1, 2010 (for 2010).

Under the new portability provision, when computing the applicable exclusion amount for a donor's or a decedent's estate, the DSUEA is added to the donor's or decedent's BEA. Essentially, the DSUEA is equal to the BEA applicable to the deceased spouse's estate (not indexed for inflation)[27] less the amount of the predeceased spouse's taxable estate plus adjusted taxable gifts.

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[26] Section 303 of the TRA.

[27] Note that upon the death of the deceased spouse, his or her basic exclusion amount becomes fixed and is not allowed to be indexed for inflation for the time period between the deceased spouse's death and the surviving spouse's death. However, the basic exclusion amount would be indexed, starting in 2012, up to the time of the deceased spouse's death (i.e., the first spouse's death).

> Jill, who dies in 2011, had made $1 million of adjusted taxable gifts and had a taxable estate of $3 million. Her DSUEA available for her surviving spouse, Jack, would be $1 million ($5 million – ($1 million + $3 million)). The DSUEA would be added to the Jack's BEA amount ($5 million) to obtain Jack's applicable exclusion amount of $6 million for 2011. In 2012, Jack's applicable exclusion amount will be increased as a result of the inflation adjustment to his 2012 BEA.

We must re-emphasize that this new provision is only available with respect to gifts made or decedents dying on or after January 1, 2011, and only with respect to previously deceased spouses who die on or after January 1, 2011. And, that the provisions are scheduled to expire after December 31, 2012.

In order for the DSUEA to be available, the executor for the deceased spouse must do the following three steps: (i) file an estate tax return on a timely basis, including extensions (a late filed return will not suffice), (ii) on that return compute the DSUEA, and (iii) make an irrevocable election that the DSUEA may be taken into account. Also, the statute of limitations does not bar the re-examination of the deceased spouse's estate tax return for purposes of determining the DSUEA available to the surviving spouse.

As Section 2010(c) is revised by the TRA, new subsection (4)(B)(i) limits the surviving spouse's estate to using the DSUEA of the "last such deceased spouse." According to the Technical Explanation of the TRA prepared by the Joint Committee on Taxation, if a surviving spouse had more than one previously deceased spouse, then the survivor's estate may only use the last deceased spouse's DSUEA.

Importantly, TRA changes the definition of the applicable credit amount under the gift tax (Section 2505 of the Code) to incorporate the definition of the applicable credit amount under the estate tax, as newly amended to include the portability provisions. This allows surviving spouses to use the DSUEA when making lifetime gifts. The statute does not make clear how the DSUEA will be used. For instance, does the DSUEA get consumed first and then the surviving spouse's BEA (i.e., a "first-in-first-out" or "FIFO" approach? As discussed below, the Joint Committee's example appears to allow this but this was not incorporated into the new statute.

The portability provisions do not apply to a person's GST exemption. This is because Section 2631(c) is revised beginning 2011 to refer to the basic exclusion amount, not the applicable credit amount.

The Secretary of the Treasury is directed to adopt regulations to implement the portability provisions.

(b) Joint Committee Examples

The Joint Committee on Taxation provided three examples in its explanation of TRA to show how the portability provisions operate:

> Example 1. − Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax

return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use *for lifetime gifts* or for transfers at death (emphasis added).

Example 2. – Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Example 3. – Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

The Joint Committee's Example 2 illustrates the danger posed by remarriage. The example assumes that the executor of Husband 2's estate makes an election to permit Wife to use Husband 2's DSUEA. This begs the question of what happens if Husband 2's executor does not make the election. Would Wife continue to retain the benefit of Husband 1's DSUEA? Or, would Wife be left with no DSUEA at all? The new statute and the Joint Committee's reasoning imply that the only DSUEA available would be that of the *last* deceased spouse of the surviving spouse.

By contrast, example 3 raises the intriguing possibility that the estate of Husband 2 may gain the benefit of the DSUEA of Husband 1 if Wife dies first. Under this interpretation, when calculating the applicable credit amount for a donor's or decedent's estate, one must first absorb the DSUEA before calculating the donor's or decedent's applicable credit amount. This "first-in, first-out" interpretation is neither mandated by the terms of the new statute nor clearly prohibited by it.

(c) Implications

- The DSUEA is not indexed for inflation, which favors credit shelter trust planning.
- Relying on the DSUEA does not guard against the estate tax on appreciation of assets received by the surviving spouse. This favors using credit shelter trust planning.
- One benefit of relying upon the DSUEA is to take advantage of basis step-up on assets received by the surviving spouse. This is an advantage compared to a credit shelter trust.
- Surviving spouses who remarry will have to plan carefully to determine the impact of remarriage on the available DSUEA. The surviving spouse has an incentive to make taxable gifts of the DSUEA of the first spouse, to assure its use. For example, if the second spouse turns out to be the surviving spouse and the Joint Committee's Example 3 is wrong, or if the second spouse predeceases and has used or is likely to use all of his or her DSUEA, then the first spouse's DSUEA will have been squandered.
- More pointedly, a surviving spouse who inherits a large DSUEA may prefer not to remarry if the new spouse has used or is likely to use all of his or her exclusion amount. A way out of this dilemma is for the spouse to use the first spouse's DSUEA by making gifts (taking into consideration whether the Joint Committee's Example 3 is correct, or alternatively consuming all of the surviving spouses BEA and DSUEA, to assure usage).
- Conversely, a widow or widower whose previous spouse used the entire DSUEA can gain a tax advantage by marrying a second spouse who has not used his or her DSUEA, provided the new spouse dies first.
- The sunset provision of TRA provides that portability will disappear as an option after 2012. For decedents dying in 2011 and 2012, using a credit shelter trust will be a far more certain device to lock in the benefit of the new $5 million applicable exclusion amount. The costs of portability may not be sustainable.
- The inability to preserve the first spouse's unused GST exemption favors the use of credit shelter trust planning (applying the decedent spouse's GST exemption to that trust (assuming that it is structured to benefit skip persons)).
- The portability concept strongly encourages the filing of federal estate tax returns for all married decedents dying on or after January 1, 2011, in order to preserve the availability of the DSUEA. In fact, there appears to be no reason (other than costs) not to do so, even if the surviving spouse is less wealthy – i.e., the surviving spouse might win the lottery. Also, the surviving spouse could marry a wealthy (or wealthier) new spouse (Spouse 2). Spouse 2 could give the surviving spouse assets with which to make lifetime gifts using the DSUEA.
- The DSUEA has an economic value, perhaps even for a surviving spouse without sufficient assets to use the exemption at the time of the deceased spouse's death. As the song says "Match maker, match maker, make me a match …" I have deceased spousal unused exclusion available.
- The IRS is charged with issuing regulations to implement the portability feature. Given the history relating to the complexity of making QTIP elections, the number of failed QTIP elections, and the IRS revising the estate and gift tax return forms several times in an effort to assist taxpayers (and their advisors) in safeguarding QTIP elections, it would appear by analogy that the portability election will be a feast for the litigators. Remember that pursuant to the statute, the executor must (i) file an estate tax return on a timely basis, including extensions (a late filed

return will not suffice), (ii) on that return compute the DSUEA, and (iii) make an irrevocable *election* that such amount may be taken into account. That's right, timely file a return, calculate a specific number, and make an election! There's lots of room for error! Perhaps the IRS will be helpful and safeguard (i.e., dummy proof) the process.

(d) Interaction with State Death Taxes.

The lower federal estate tax rate, increased federal estate and gift tax applicable exclusion amount, and portability feature create both complexities and opportunities in relation to state death taxes. For purposes of discussion, this section will refer to the District of Columbia (DC), Maryland and Virginia, the local jurisdictions in the national capital area. These jurisdictions provide a good diversity of state death tax systems for discussion, as DC has a separate estate tax but no DC only QTIP election, Maryland has a separate estate tax and does allow a Maryland only QTIP election, and Virginia has no separate estate tax.

(i) Implications

1) Aggregate Effective Maximum Rate Still Near 50%.

Following the TRA, in a state that imposes a state estate tax, the aggregate effective maximum rate of taxation will be 45.40%. Currently 21 states and the District of Columbia[28] impose a separate estate tax in addition to the federal estate tax. Most of these states impose their tax by reference to the table under Section 2011(b) of the Code that had been in effect prior to 2005 to determine the credit for state death taxes allowed on the federal estate tax return. This table starts at a rate of 8/10th of 1% for amounts under $90,000 and goes to a maximum rate of 16% for amounts over $10,040,000, with 20 different brackets. The maximum 16% tax rate would be deductible against the federal estate tax at 35%. At the maximum rates, the effective rate of taxation is 45.40% (16% x (1-.35) + 35%). This combined rate of taxation is still considerably high, constitutes more than a nuisance tax, and clients will still be motivated to engage in planning to reduce their tax bill.

2) Effective Tax Reduction of 8.4%, not 10%.

While the maximum federal estate tax rate has been reduced by 10%, the maximum aggregate state and federal rate, for estates over $10,040,000 in a state imposing a state death tax by reference to Section 2011(b) of the Code, has been reduced by only 8.4%. This is because the state rate is unchanged but it is now deductible against a lower federal rate, thereby proportionately increasing the impact of the state estate tax. In 2009, the maximum combined state and federal estate tax rate was 53.80% (maximum state rate of 16%, deductible against a 45% maximum federal rate, plus the maximum federal rate (16% x (1-.45) + 45%)). Now the maximum combined state and federal estate tax rate is 45.40% (maximum state rate of 16%, deductible against a 35% maximum federal rate, plus the maximum federal rate (16% x (1-.35) + 35%)). Therefore, the reduction in the aggregate rate of taxation

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[28] For simplicity of discussion and unless otherwise indicated, references to state estate taxes includes the District of Columbia.

is 8.4% (53.80% - 45.40%). In the national capital region, a Virginia resident realizes 100% of the federal reduction in estate tax rates, while a DC or Maryland resident only realizes 84% of the reduction. The upshot is that this is more reason for a wealthy client to move to a state like Virginia, which has no separate estate tax.

3) Higher Costs to Use Larger Federal Applicable Exclusion Amount.

One complexity results from the now greater difference between the state estate tax exemptions and the federal estate tax exemption. Therefore, upon the first spouse's death, taking advantage of the full federal estate tax applicable exclusion amount will in some cases require a greater payment of state estate taxes. If the state has a $1 million estate tax exemption, funding the credit shelter trust with $5 million upon the first spouse's death would require a payment of $391,600 in state death taxes, if the state death tax is charged to the credit shelter trust (i.e., resulting in a net funding of $4,608,400).[29] It is also possible to fund the credit shelter trust with a net of $5 million. To do this, the taxable estate would need to be $5,444,091, whereupon the state death tax would be $444,091. The federal estate tax would still be zero, but state death taxes would increase by $52,491 ($444,091 - $391,600).

(ii) Planning Considerations

1) States with State Only QTIP Election.

States such as Maryland that allow a state only QTIP election are better positioned to allow their residents flexibility to use the increased federal estate tax applicable exclusion amount while deferring the state death tax until the surviving spouse's death. The state only QTIP allows for the following planning: the credit shelter trust could be funded with $1 million (i.e., the state death tax exemption amount) and a QTIPable marital trust could be funded with the remaining $4 million of the federal applicable exclusion amount. The QTIP trust would not be qualified for the federal estate tax marital deduction, but could be qualified for the Maryland estate tax marital deduction by making the Maryland only QTIP election. Therefore, the full federal estate tax applicable exclusion amount is used without triggering any federal or Maryland estate tax upon the death of the first spouse. Upon the surviving spouse's death the Maryland only QTIP would be subject to Maryland estate tax, if the surviving spouse died a Maryland resident.[30] Residents of states where a state only QTIP election is available should review their plans and consider this approach. A QTIPable credit shelter trust is another option, but this approach costs the flexibility that a credit shelter trust could offer in allowing

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[29] This assumes the state death tax is computed by reference to the table under Section 2011 of the Code and that there is no deduction of the state exemption amount in the computation process (i.e., tax is paid on the whole $5 million).

[30] Note that the federal estate tax deduction for death taxes paid to a state is not applicable to estate taxes with respect to property not included within the federal gross estate. Therefore, when the surviving spouse dies, no state death tax deduction is available with respect to state death taxes paid on the state only QTIP. Therefore, it would be necessary to compute the amount allowable as a deduction under Section 2058 of the Code without regard to the state only QTIP and compute the amount actually payable to the state including the state only QTIP.

for the accumulation of income and including others such as descendants as discretionary beneficiaries during the surviving spouse's lifetime.

2) States without State Only QTIP Election.

Unlike Maryland, some states do not allow a state only QTIP election. For example, in DC, which does not provide for a DC only QTIP election, a resident is faced with a few imperfect options in using the full federal estate tax applicable exclusion amount upon the first spouse's death:

a) Pay State Death Tax on Full Federal Applicable Exclusion Amount.

The DC resident could plan to fund the credit shelter trust with $5 million and pay $391,600 to $444,091 (depending on the apportionment of the state death tax to the credit shelter trust or not). One pitfall with this approach is that if the surviving spouse changes residency to a state without a state estate tax, the DC estate tax on this $5 million will have already been paid. If the surviving spouse would definitely remain a resident of DC, paying the DC estate tax on this $5 million upon the first spouse's death may actually result in a lower total estate tax liability on the aggregate estates.

b) Rely on Portability.

Under the TRA, the credit shelter trust could be funded with just an amount equal to the DC estate tax exemption ($1 million). The balance of the estate of the first spouse to die could pass to the surviving spouse in an outright transfer or GPOA marital trust or by joint property. The portability election would be made on the estate tax return of the first spouse to die. In addition to the concerns with portability as outlined above in section V(c), there is a cost of not using the lower brackets under the state death tax table between the first $1 million and $5 million. The rates from $1 million to $5 million are 5.6% to 11.2%. Relying on portability puts an extra $4 million in the estate of the surviving spouse to be taxed at higher rates under the state death tax table, though perhaps deductible against a 35% federal estate tax. The examples below illustrate that not utilizing the lower brackets of the state death tax table may increase the aggregate tax paid by both spouse's estates.

$10 Million Estate - Married Couple	Pay State Estate on Each Spouse's Death	Pay State Estate on 2nd Spouse's Death
1st Spouse's Death		
Gross Estate Value	5,000,000	5,000,000
Marital Deduction	-	(4,000,000)
Taxable Estate	5,000,000	1,000,000
Maryland Estate Tax	391,600	-
Federal Estate Tax	-	-
Total Estate Tax	391,600	-
2nd Spouse's Death		
Gross Estate Value	5,000,000	5,000,000
Additional Marital from 1st Spouse	-	4,000,000
Taxable Estate	5,000,000	9,000,000
Maryland Estate Tax	391,600	916,400
Federal Estate Tax	-	- *
Total Estate Tax	391,600	916,400
Total Estate Tax for both Spouses	783,200	916,400
Increase(decrease)		133,200

*Assumes portability of $4 million of exclusion from 1st Spouse to die.

$100 Million Estate - Married Couple	Pay State Estate on Each Spouse's Death	Pay State Estate on 2nd Spouse's Death
1st Spouse's Death		
Gross Estate Value	50,000,000	50,000,000
Marital Deduction	(45,000,000)	(49,000,000)
Taxable Estate	5,000,000	1,000,000
Maryland Estate Tax	391,600	-
Federal Estate Tax	-	-
Total Estate Tax	391,600	-
2nd Spouse's Death		
Gross Estate Value	50,000,000	50,000,000
Additional Marital from 1st Spouse	45,000,000	49,000,000
Taxable Estate	95,000,000	99,000,000
Maryland Estate Tax	14,666,800	15,306,800
Federal Estate Tax	26,366,620	26,142,620 *
Total Estate Tax	41,033,420	41,449,420
Total Estate Tax for both Spouses	41,425,020	41,449,420
Increase(decrease)		24,400

*Assumes portability of $4 million of exclusion from 1st Spouse to die.

c) Consider Using Gift Tax Portability to Save State Estate Taxes.

If upon the first spouse's death, portability is used as outlined in subsection 2 above for the amount in excess of the state death tax exemption amount, the surviving spouse could make a gift of the amount by which the federal estate tax applicable exclusion amount of the first spouse to die exceeds the state death tax exemption amount transferred to the credit shelter trust. State death taxes on this part of the estate subject to the gift are completely avoided as most states do not have a separate gift tax. This is better than simply taking advantage of the bracket run in both estates under the state death tax table. Since the portability of the first spouse to die's applicable exclusion amount applies to both estate and gift taxes, there would be no federal gift tax on this part either. The pitfall with this approach is that the surviving spouse would likely be parting permanently with the property to avoid Section 2036 inclusion.

d) Consider Using Portability and Changing Domicile to Save State Estate Taxes.

If upon the first spouse's death, portability is used as outlined in subsection 2 above for the amount in excess of the state death tax exemption amount, the surviving spouse could change to domicile to a state without a separate estate tax. For example, the DC or Maryland resident could move across the Potomac River to Virginia. As such, state death taxes on this ported part of the estate, as well as the surviving spouse's estate, is completely avoided. This is better tax wise than all the other solutions.

VI. Generation-Skipping Transfer Tax

(a) Exemptions and Rates

The TRA retroactively reinstates the estate tax and generation skipping transfer tax ("GST tax") in 2010 with a $5,000,000 exemption.[31] However, the potentially inequitable consequences of a retroactive reinstatement of the estate tax and GST tax are mitigated by two key provisions under the TRA. First, a decedent's executor may elect out of the estate tax regime in 2010. The GST tax planning implications of this election are discussed further below. Second, for those who rely on the default rule of estate taxation in 2010 the GST tax applicable rate is zero.

(b) Compliance

For those making 2010 generation skipping transfers prior to the enactment date of the TRA, the TRA extends the filing deadline for GST tax reporting until nine months after the date of enactment. For direct skips occurring at death, taxable distributions and terminations, it seems clear that the TRA extends the filing deadline for the Forms 706, 706GS(D) and 706GS(T). However, less clear is the reporting of intervivos direct skips, which are reported on the Form 709. The TRA does not expressly extend the filing deadline of a Form 709. If the TRA is read to extend the filing of the Form 709, would this effectively extend the gift tax filing deadline? Even with a 0% applicable rate, intervivos direct skips are presumably reportable in 2010 given their potential impact on GST tax exemption.

(c) Postponement of EGTRRA Sunset

Section 901 of the EGTRRA, provided that the Internal Revenue Code would apply as if the EGTRRA amendments had "never been enacted" after December 31, 2009. Section 101(a)(2) of the TRA amends section 901 of the EGTRRA to apply after December 31, 2012. Thus, the allocation of increased GST tax exemption (up from $1,000,000 in 2003) during 2004 through 2009 and other measures taken under the EGTRRA amendments including, among others the:

- Deemed allocations of GST tax exemption under Section 2632(c) of the Code;
- Late allocations of GST tax exemptions under Section 2632(d) of the Code; and
- Qualified severances under Section 2642(a)(3) of the Code;

will be respected in 2010 through 2012. Additionally, section 301(a) of the TRA should resolve any issues raised by the application of Section 2664 of the Code, formerly providing that the GST tax, and consequently any generation skipping transfers, shall not apply after December 31, 2009.

[31] Sections 301(a) and 301(c)(2) of the TRA.

(d) Changes in 2011-2012

(i) Exemptions and Rates

A GST tax with a $5,000,000 exemption and maximum rate of 35% will apply in 2011.[32] Beginning in 2012, TRA will index, in increments of $10,000, the $5,000,000 GST tax exemption for inflation.[33] However, the TRA amendments are not permanent and it appears that Congress, for the time being, intends that the benefits sunset after 2012.[34]

(ii) Exemption Portability

The TRA also introduces exemption portability provisions, beginning in 2011.[35] These provisions do not apply to the GST tax. Section 303(b)(2) of the TRA makes this clear by amending Section 2631(c) of the Code to reference the new "basic exclusion amount" term instead of the "applicable exclusion", thus limiting the GST tax exemption to $5,000,000.[36] Under the exemption portability provisions, the "applicable exclusion" is the sum of the "basic exclusion amount" and the "deceased spouse's unused exclusion amount".

(e) Implications and Planning Considerations

(i) Election and GST Tax Exemption

As mentioned above, an executor of a decedent may elect out of the estate and GST tax regimes in 2010.[37] The TRA provisions regarding the election do not carry many GST tax implications on their face, other than to provide that regardless of the executor's election out of the estate and GST tax regime, the decedent will still be considered the transferor for purposes of Section 2652(a)(1) of the Code.[38]

However, the election out of estate tax, and consequently the GST tax, would at first seem to prevent a trustee from making a testamentary allocation of GST tax exemption (or the automatic allocation rules from applying to generation skipping transfers in the year of the decedent's death). Although the language of the TRA does not seem to expressly permit an executor to elect out of the estate tax while applying the default rule of GST taxation, the Joint Committee makes clear in its Technical Explanation of the TRA that it intends the GST tax exemption to be available even if the

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[32] Section 302(c) of the TRA.
[33] Section 302(b) and (c).
[34] Section 304 of the TRA provides that section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (as amended by section 101(a)(1) of the TRA to extend the expiration to the end of 2012) shall apply to amendments made by "this section" (that is, section 304). However, section 304 makes no such amendments.
[35] Section 303 of the TRA.
[36] Section 303(a) and (b)(2) of the TRA.
[37] Section 301(c) of the TRA.
[38] *Id.*

executor elects out of estate taxation in 2010.[39] Because a decedent will still be considered the transferor for GST tax purposes regardless of an executor's election, an allocation of GST tax exemption may be desirable at death to avoid a taxable distribution or termination in the future. If the election rules are applied as the Joint Committee intends, this should not be a problem even if the executor elects out of the estate tax regime in 2010. It remains to be seen whether this issue will be clarified in the statute or through the issuance of Treasury Regulations.

(ii) Allocation of Exemption

Assuming the grantor did not die in 2010 and settled trusts with GST tax provisions in 2010, some uncertainty existed as to how GST tax exemption would be allocated to those trusts in a year where the GST tax did not exist. Prior to the TRA, some commentators speculated that a late allocation of GST tax exemption in 2011 to such a trust might resolve the issue. By retroactively reinstating the GST tax, and consequently its exemption and allocation rules, it appears that an allocation of GST tax exemption can be made for those trusts (or any other generation skipping transfer for that matter) in 2010.

(iii) Decanting

Alternatively, if a non-exempt trust was settled in 2010 due to the uncertainty surrounding the GST tax and the effects of the EGTRRA sunset provisions, the practitioner may consider decanting the trust to make it GST tax exempt if permitted under state law. Decanting to achieve GST tax exempt status may be preferable to outright distributions to skip persons given the benefits of maintaining property in trust. It may also be the only alternative if the trust instrument does not permit distributions to skip persons. By decanting the non-exempt trust, the non-skip beneficiaries (the children, for example) may be granted a presently exercisable limited power of appointment in the new recipient trust to add grandchildren as beneficiaries and/or to permit the trustee to make distributions in trust for the benefit of the grantor's grandchildren. However, since non-exempt trusts typically grant beneficiaries a general power of appointment, whether intervivos or testamentary, the practitioner must take care in avoiding a taxable lapse of such power under Sections 2041 or 2514 during the decanting process. In fact, some commentators believe it difficult to avoid such a lapse during the decanting process if the children hold a presently exercisable general power of appointment under the original trust terms; as the transfer of trust corpus to a new recipient trust in which the children no longer hold a general power of appointment (granted under the original trust terms) presumably causes a lapse of that power. To the extent that the original trust terms provide the children a testamentary general power of appointment, a lapse of such power may arguably be avoided in the decanting process as such power is not presently exercisable.

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[39] Footnote 53, JCX-55-10, "The $5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules."

(iv) Gifts to Skip Persons

Although the zero percent GST tax applicable rate might encourage larger direct skips in 2010, a 2010 gift tax applicable exclusion of $1,000,000 would effectively limit the (gift tax-free) amount of such transfers to a client's unused gift tax exclusion.[40] In 2011 and 2012, donors will have the benefit of a gift tax applicable exclusion of $5,000,000, but a 35% GST tax applicable rate.

Further, while gifts into trusts for the benefit of skip persons (grandchildren, for example) and their descendants will not be treated as generation skipping transfers pursuant to the "move down rule", these trusts will continue to maintain their inclusion ratio.[41] Thus, the practitioner should consider allocating GST tax exemption to those trusts to avoid a taxable distribution upon the distribution of trust property to the grandchildren's descendants or a tax termination upon the death of all grandchildren who are beneficiaries of the trust.

(v) Trust Distributions

Trust distributions, unlike direct skips, need not be subject to the gift tax. Accordingly, the TRA may provide an opportunity for non-exempt trusts to make GST tax-free distributions to skip persons in 2010. Further, as alluded to above, to the extent that such distributions can be made in trust for the benefit of those skip persons, and GST tax exemption is be allocated to the trusts receiving the distributions, a non-exempt trust may effectively be converted into a GST tax exempt trust.[42]

VII. Sunset Provisions

The TRA is inextricably connected with the EGTRRA.[43] Section 304 of TRA provides that the sunset provisions in section 901 of EGTRRA apply to all of the amended estate and gift tax provisions in TRA. TRA lowers both estate and GST taxes for 2011 through December 31, 2012, increases the applicable exclusion amount (from $1 million to $5 million[44]) and reduces the top tax rate from 55% to 35%. However, when contemplating the sunset provisions of EGTRRA presented in TRA, practitioners encounter significant uncertainties that have implications for prospective estate planning. The ambiguities inherent in the sunset provisions of EGRRRA are not resolved with any finality and are merely postponed for two additional years. Section 101(a) of TRA pronounces that section 901 of EGTRRA is applied only until December 31, 2012.

TRA did nothing to add perspicuity to the pre-existing ambiguities addressing the short-term nature of the sunset provisions of EGTRRA and how these provisions will be resolved in the long-term.

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[40] This of course ignores the application of sections 2503(b) and 2642(c).
[41] Section 2653(a) and (b).
[42] Assuming that distributions in trust by the non-exempt trust would be held in a trust containing GST tax provisions.
[43] The author is aware that TRA modifies the sunset provisions of § 901 of EGTRRA, §303 of JGTRRA, ARRA (as it relates to the AOTC) and the EITC by extending them for two (2) years (only one year in case of the adoption rules); however, the scope of this section addresses only those sunset provisions explicitly referenced by the estate tax provisions of TRA.
[44] Based upon an applicable exclusion amount calculation that is both indexed and rounded to next $10,000 increment after 2011.

It remains to be seen what long-term treatment will be given to the taxpayer-favorable provisions in EGTRRA set to expire December 31, 2012 by virtue of TRA or by what manner these provisions will be revived if they are permitted to expire. TRA § 301(a) states that a provision modified by sections ". . . A or E of title V of the [EGTRRA] is amended to read as such provision would read if such subtitle had never been enacted." As most readers are aware, subtitle A of part V of EGTRRA addresses Chapters 11 and 13 of the Code and subtitle E addresses carryover basis. Subtitle A of EGTRRA (Section 2210 of the Code) specifies Chapter 11 of the Code does not apply to decedents who die after 2009 (however Qualified Domestic Trusts receive distinct treatment in this section). Subtitle A (Section 2664 of the Code) specifies Chapter 13 of the Code doesn't apply to post-2009 GST transfers.

All of the other estate planning provisions within EGTRRA would be effective prospectively for two additional years (2011 and 2012). This includes the following estate planning provisions: reduction of both the estate and the gift tax rates, increasing the GST exemption amount, setting the gift tax applicable exclusion amount at one million dollars ($1 million), increasing the exemption equivalent for the unified credit, modifying the deferred estate tax payment requirements of Section 6166 of the Code, using the state tax deduction in lieu of the state death tax credit and altering some of the substantial GST sections.[45]

(a) TRA's Effective Dates

TRA contains both prospective and retroactive effective dates. The revision of the estate tax provision, the removal of GST tax on direct-skip transfers made in 2010 (in situations where the transfer is made in trust at present and a subsequent distribution is made to a beneficiary) and the increase in GST exemption to five million dollars ($5 million) are all applied in retroactive fashion. The estate tax and GST provisions generally are made effective for decedents dying and gifts made on or after January 1, 2010. The sections with proactive effective dates are the re-coupling of the estate and gift tax annual exclusion amounts and the portability of an unused exclusion amount by a surviving spouse provision. Both of these sections are effective January 1, 2011.

(b) Deadlines for 2010 Estate and GST Returns

In addition to employing both prospective and retroactive effective dates, TRA also modifies statutory compliance dates for certain classes of estates and beneficiaries. The estates of decedents who died between January 1, 2010 and December 16, 2010 (the day prior to the date of enactment of TRA) may delay filing the estate tax return and paying estate tax until nine (9) months after December 17, 2010.[46] Similarly, any beneficiaries of GST transfers made during the same time period are permitted to delay the filing and paying of taxes until nine (9) months after December 17, 2010.[47]

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[45] Some of the altered GST sections address changes to some of the valuation rules, allocations of automatic exemption provisions and retroactive allocations.
[46] Section 301(d)(1) of the TRA.
[47] Section 301(d)(2) of the TRA.

(c) Disclaimers

Will the extension of the time to make disclaimers still have hurdles to face under the language of governing documents or state law? Will states have to create disclaimer extension patches similar to the formula clause patches to enable executors to take advantage of this leniency?

The increased $5 million estate tax applicable exclusion amount and 35% rate are effective January 1, 2010; however, TRA section 301(c) provides an alternative election for decedents dying within a certain period of time. Qualifying estates are provided with the option of making a special election that is available to estates with decedents who will have died within a specified time in the future (from the present until January 1, 2011) and estates with decedents who died within a pre-determined period in the past (December 31, 2009 to present). TRA section 301(c) permits the executor of the estate of a decedent dying within that time frame to make a special election and choose 0% estate tax (with a modified carryover basis). [Regardless of whether or not the executor makes such an election under TRA, the GST framework remains the same and any testamentary generation-skipping transfer would be considered to have a "transferor." Section 2653(a) of the Code would still apply and the transferor of the generation-skipping transfer would be considered one generation above that of the testamentary beneficiaries.]

The estate and GST provisions generally are effective for decedents dying, gifts made and GSTs made after December 31, 2009. The increased gift tax applicable exclusion amount takes effect on January 1, 2011. The new rules providing for portability of an unused exclusion amount between spouses under TRA section 303 generally are effective for decedents dying and gifts made after December 31, 2010.

VIII. Planning Implications of the TRA

(a) Timing of Gifts

Timing of making a gift may be as important as making the gift itself. In 2010, the gift tax applicable exclusion amount is $1 million; in 2011, it is $5 million; in 2012, it is $5 million, adjusted for inflation; and, currently, from 2013 onward, it is slated to be $1 million (i.e., EGTRRA rates).

With the gift tax applicable exclusion amount increasing dramatically in 2011 (and 2012) it may make sense to make large taxable gifts (using at least the gift tax applicable exclusion amount) in 2011 and 2012.

What happens if a donor makes a $5 million gift and dies when estate tax applicable exclusion amount is $1 million in 2013 or thereafter? Will the donor's estate be taxed on the excess of the used applicable exclusion amount used during lifetime over the applicable exclusion amount available upon death (hereinafter referred to as the "clawback")? And, if so, why would one want to use the current higher gift tax applicable exclusion amount?

While there are good arguments against a clawback[48] and it is likely not what Congress intended,[49] most commentators agree that the possibility of a clawback cannot be ignored and donors should be advised of the concern. It is also possible that Congress or the IRS will cure this concern as 2013 approaches. In the interim, donors should consider the merits of structuring the gifts as net gifts and review state law apportionment statutes to determine liability for the increased taxes upon death that are attributable to the lifetime gifts. Even with these concerns, pursuing these large gift plans may be beneficial.

In our example the donor's estate may be taxed on $4 million given during life (i.e., the excess of the gift tax applicable exclusion amount over the estate tax applicable exclusion amount in 2013). The donor may still desire to make the gift because any post-gift appreciation in value escapes estate taxation at death. The following examples illustrate this point.

> *Example 1*: Bill, a single person, is worth $15 million. Bill has a daughter, Mary, who is his only beneficiary. Let's assume that in 2011 and 2012 the estate and gift tax applicable exclusion amount is $5.0 million, and that tax rates are 35%. Let's also assume that from 2013 forward the gift and estate tax applicable exclusion amount will be $1.0 million and that the tax rate will be 35%. If Bill dies in 2012 with a gross estate of $15 million, then his estate tax liability will be $3.5 million (i.e., $15 million - $5 million X 35%).

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[48] *See Smith v. Comm'r*, 94 TC 872 (1990), in which the Tax Court reviewed the legislative history to Section 2001(b) of the Code and found that its purpose is to consider taxable gifts in computing estate taxes to push the taxable estate up in the proper brackets. "The purpose of adding post-1976 gifts to the taxable estate and then subtracting the gift tax payable on those gifts is to 'push the taxable estate up to its 'proper' place on the unified cumulative rate schedule.' " (Judge Well's dissent). This structure prevents a taxpayer from gaining two bracket runs by making both gifts during lifetime and transfers upon death. In the *Smith* case, the court refused to allow a valuation adjustment of a gift for purposes of the estate tax computation (after the gift tax statute of limitations had run) to work in a fashion that essentially allowed the IRS to "collect the barred gift taxes through the imposition of a higher estate tax…" [except to the extent of pushing up into the brackets]. (majority opinion). There is discussion in the case that the legislative history of 2001(b) supports the idea that the gift tax "payable" credit could be higher than actual gift taxes paid. The same rationale should apply equally to changing rates or credits. The computation process should limited to its purpose of preventing two bracket runs. To do otherwise essentially allows the IRS to use this computational process to collect unauthorized gift taxes. Perhaps Congress will clarify that Section 2001(b)(2) of the Code to use the rates in effect upon death and the lower of the credit in effect at the time of the gift or death for this part of the computation. Note that historically since the unification of the gift and estate tax rates and credits in 1976, the gift tax applicable exclusion amount was never contemplated to be in excess of the estate tax applicable exclusion and therefore it is not surprising that neither the Congress nor the IRS contemplated this concern.

[49] After all, Congress revised 2001(b)(2) by adding subsection (g) and revised 2502(a) to ensure in both contexts that the computations relating to the use of applicable credit amount for prior taxable gifts were done using the lower rates in effect upon death or later gift, with the effect that donors would have more available for use upon death or later gifts. This demonstrates that Congress intended donors to have the benefit of the new lower rates and increased applicable exclusion amounts. It seems inapposite to suppose Congress also contradictorily intended the clawback scenario.

Example 2: Same as *Example 1*, except that the assets increase by 10% to $16.5 million at the time of his death. The estate tax liability will be $4.025 million (i.e., $16.5 million - $5 million X 35%).

Example 3: Same as *Example 1*, except that he gives away $5 million to Mary during life and dies with $10 million at his death. In this case, the estate tax liability will be the same as in *Example 1*. The gross estate would be comprised of the assets remaining at death (of $10 million) and the amount of the gift at the time of the gift (of $5 million). The resulting tax liability will be the same as *Example 1 (i.e.,* $3.5 million).

Example 4: Same as *Example 3*, except that the assets grew by 10% (i.e., the assets in his name grew to $11 million and the assets in his daughter's name grew to $5.5 million). In this case, the gross estate would be $16 million (i.e., the $0.5 million of appreciation in Mary's hands would escape taxation, because only the amount of the gift of $5 million is added back for estate tax calculation purposes). The resulting estate tax liability would be $3.85 million. Note, the difference in tax liability between *Example 2* and *Example 4*, is $175,000 (i.e., 35% of the $500,000 of appreciation)

Example 5: Same as *Example 1*, except Bill dies in 2013 (when the exemption is $1 million). In this case, the gross estate is the same $15 million (as it was in *Example1*). But the taxable amount would be $14 million at 35%, resulting in a $4.9 million liability.

Example 6: Same as *Example 2*, except Bill dies in 2013. In this case the gross estate would be the same, but the taxed amount would be $15.5 million. The estate tax liability would be $5.425 million.

Example 7: Same as *Example 4*, except Bill dies in 2013. In this case, like in *Example 4*, the gross estate is $16 million (i.e., $500,000 of growth of assets in Mary's name escapes taxation); however, with a $1 million exemption, the taxable amount is $15 million, which results in a tax liability of $5.25 million. Note the difference between *Example 6* and *Example 7* is the same $175,000 (i.e., the estate tax on the appreciation) is the same difference between *Example 2* and *Example 4*.

In reviewing these examples, the benefit of lifetime giving (regardless of the exemption amount) is the avoidance of estate tax on any appreciation. The benefit can be defined algebraically as follows:

$$B = A \times ETR$$

Where:

B = benefit

A = appreciation

ETR = estate tax rate

Thus, if estate tax rates increase from 35% to 55%, the benefit would increase accordingly. Let's review Examples 6 and 7 to see if this formula holds true. In Example 6, if the tax rate was 55% instead of 35%, the estate tax liability would be $8.525 million (i.e., 55% of $15.5 million), and in Example 7, the estate tax liability would be $8.25 million (i.e., 55% of $15 million). The difference of $275,000 would be the estate tax of 55% of the $500,000 that escaped taxation.

So, what makes giving the maximum lifetime applicable exclusion amounts in 2011 and 2012 so appealing? It is the ability to move assets out of one's estate without paying any tax on the gift so that appreciation on those assets could avoid any taxation at death.

If the taxpayer wishes to pay a gift tax in those years, it would also be appealing, because if the donor survives three years from the date of the gift, any gift tax paid would also avoid being taxed in the donor's estate (i.e., because of the tax exclusive nature of gift tax). And, if estate tax rates rise in future years, then the benefit of paying gift taxes at lower rates is even more beneficial.

Thus, with a larger lifetime applicable exclusion amount of $5 million in 2011 and 2012 (indexed for inflation), some of the lowest estate tax rates we've seen in 50 years, and the tax exclusive nature of gift taxes, using one's lifetime applicable exclusion amount (and perhaps even making taxable gifts) in 2011 and 2012 would appear to be the appropriate time to make gifts.

Which is better, 2011 or 2012? It depends on many factors, which include, but are not limited to the following: (1) potential appreciation of the gift; (2) interest rates; (3) whether one pays gift tax (or not); (4) donor's reticence to paying tax; (5) donor's need for the assets; and (6) view of the future of estate taxes. By example, for those persons who have assets that they believe will increase in value dramatically in 2011 (as opposed to 2012), then all else being equal, one would make the gift in 2011. If the donor believes that the asset would increase steadily over the next couple of years, then one would look at the benefit of making a non-taxable gift in 2011 and any use the benefit of the additional exclusion (from the cost of living adjustment) in 2012, and consider making a taxable gift in 2012. However, if the donor is in his or her 80s, perhaps making a taxable gift in 2011 may make some sense to take advantage of the 3-year rule for avoidance of including the gift tax in one's estate. Suffice to say, there are so many different factors that are to be taken into consideration, that one must look at the individual donor and do the math to see what makes sense, and then have the donor determine if they want to do it.

With a $1 million applicable exclusion amount large estate planning transactions were limited, and the debate over the need for and use of seed gifts and/or guarantees, has been important. A client who restricted the size of assets subjected to a note sale to a grantor trust transaction in 2010 or prior years as a result of his or her advisers beliefs about seed gifts (e.g., insistence on seed gifts using the 9:1

ratio) can revisit that transaction and replicate it fourfold in 2011 by making up to $4 million of incremental seed gifts to the trust.

(i) Bolster Seed Gifts; Increased Exclusion and Note Sale Transactions

In 2010 (and prior years) the $1 million gift tax applicable exclusion amount limited some larger estate planning transactions, where the donor was reticent in paying gift taxes. The debate over the need for and use of seed gifts has been important in the so-called "Sale to an Intentionally Defective Grantor Trust" (or "Sale to Grantor Trust"). Thus, donors sometime restricted the size of the sale transactions as a result of his or her adviser's beliefs about seed gifts (e.g., insistence on seed gifts using the 9:1 ratio). In 2011 and 2010, for those who do not wish to make a taxable gift, and who have used their $1 million exclusion (in a prior transaction), they can revisit that transaction and replicate it fourfold in 2011 by making up to $4 million of incremental seed gifts to the trust.

The increased gift tax applicable exclusion amount in 2011 might afford clients who consummated leveraged note sale transactions in prior years the opportunity to gift additional assets to a buying grantor trust and perhaps negotiate the cancellation of the existing note guarantees and unwind some of the complexity of those transactions.

One theory espoused concerning seed gifts and guarantees that so long as a significant sum of capital was at risk in the transaction, regardless of the ratio of that risk capital (seed gift) to debt, the transaction should be respected. For adherents to this view, the ability to increase the amount of a trust's funding by perhaps an incremental $4 million of seed gifts in 2011 may support almost unlimited note purchases by such trusts.

(b) Discounts

In 2010 (and in earlier years) there were a number of estate tax bills (together with President Obama's version 2009 and 2010 Greenbooks) that called for significant restrictions on the use of discounts for closely-held family businesses in estate planning transactions. These provisions espoused in the earlier bills never made their way into TRA; therefore, their use in discount planning should remain viable. The use of discount planning is combined with the substantial $5 million gift tax applicable exclusion amount in 2011 could prove to be a way to shift tremendous wealth. Since there is only a two year time horizon (i.e., 2011 and 2012) assured for the $5 million applicable exclusion amount this may open a new and unprecedented opportunity for the wealthy to plan.

Recall that in our analysis above, we mentioned that even if the applicable exclusion amount is decreased in future years, what avoids estate tax is the appreciation. When one uses discounts, the amount of the discount is, in effect, a form of appreciation, thus, the discounted value also avoids taxation. The following examples illustrate the benefit.

> *Example 10*: Assume the same basic facts as Example 1, above. We will assume that Bill, a single person, is worth $15 million. Bill has a daughter, Mary, who is his only beneficiary. Let's assume that in 2011 and 2012 the estate and gift tax applicable exclusion amount is $5 million, and that tax rates are 35%. Let's also assume that from 2013

forward the gift and estate tax applicable exclusion amount will be $1.0 million and that the tax rate will be 35%. Further, we will assume that DCEs will be able to take discounts for all years. We will also assume that Bill properly forms a discounted family entity (DCE) using $5.0 million of his assets. We will assume that the entity discount is 40% (i.e., the resulting value being $3.0 million). In this case, if Bill were to die in 2012, the gross estate would be $13 million, of which $8 million would be subject to tax. The resulting estate tax liability would be $2.8 million.

Comparing this to *Example 1*, the difference in the tax liability of $700,000 (i.e., $3.5 million in *Example 1*, and $2.8 million in this *Example 10*), is equal to the product of the discount (i.e., 40% of $5 million) and the estate tax rate of 35%. Thus, entity discounts have a remarkable effect on estate planning.

Now, let's see what happens if the discount applies in the year of the gift, but it is unavailable in the year of death and the estate tax applicable exclusion amount decreases to $1 million (from $5 million). In this case, we will use *Example 5* as our base case. Recall in *Example 5*, Bill dies in 2013, where he has a gross estate of $15 million, of which $14 million will be taxed, resulting in an estate tax liability of $4.9 million.

Example 11: Let's assume the same basic facts as *Example 5*, above. We will assume that Bill, a single person, is worth $15 million. Bill has a daughter, Mary, who is his only beneficiary. Let's assume that in 2011 and 2012 the estate and gift tax applicable exclusion amount is $5 million, and that tax rates are 35%. Let's also assume that from 2013 forward the gift and estate tax applicable exclusion amount will be $1 million and that the tax rate will be 35%. Further, we will assume that DCEs will be able to take discounts in 2011 and 2012, but going forward (i.e., from 2013 onward), the discount will not be permitted. We will also assume that Bill properly forms a discounted family entity (DCE) using $5 million of his assets. We will assume that the entity discount is 40% (i.e., the resulting value being $3 million). Finally, we will assume that in 2011 Bill gives away $5 million comprising of his DCE to Mary (valued at $3 million for gift tax purposes) and $2 million of other assets. Thus, after making the gifts, Bill has $8 million remaining. Let's assume he dies in 2013 and that his $8 million estate (exclusive of the prior gifts) was valued at the same amount. In this case, Bill's gross estate would be $13 million, of which $12 million would be taxed, resulting in a tax liability of $4.2 million.

Comparing *Example 5* to this *Example 11*, one sees that the difference of tax liability of $700,000 (i.e., $4.9 million in *Example* 5 and $4.3 million in *Example* 11) results from not taxing the discount. Thus, the discounted value should be viewed as "appreciation". Thus, by giving away a

discounted asset at life, it is the equivalent of giving away an asset that appreciated at a rate equal to the discount. The result of which is that the discounted value is not taxed, and passes for the benefit of the decedent's loved ones.

Accordingly, even if the assets don't appreciate, if a discounted entity is formed in the next couple of years and is given away, and if the discount benefit goes away (and is not applied retroactively), then the family will still benefit from having formed the entity and given it away during lifetime. The increased applicable exclusion amount allows one to transfer a significant portion of a discounted entity without incurring gift tax over the next couple of years.

(c) Grantor Retained Annuity Trusts (GRATs)

Like the legislation that had been proposed to significantly limit the use of discounts for family-controlled entities, there were a number of proposals that would have required 10 year terms for GRATs. This 10-year term would have effectively repealed the technique for older clients (and perhaps for some younger ones, too). TRA does not include any restrictions on GRATs. Thus, GRAT planning should continue while interest rates and asset values are low.

However, with a $5 million gift and estate applicable exclusion amount and portability, will this planning be limited only to ultra high net worth clients? Perhaps not. If 2013 may bring the specter of a reduced estate tax applicable exclusion amount and a higher rate, perhaps other clients should too consider pursuing GRATs while they remain advantageous. An impediment for many clients with estates that would appear to be below the new estate tax thresholds will be the costs of GRATs. So who might the best candidates for GRATs be other than ultra high net worth clients? Perhaps wealthy clients who have already implemented GRATs so that the complexity and cost barriers to consummating additional GRATs are low.

> Example: Clients, with a combined net worth of $8 million implemented several two year GRATs in November 2010. While $8 million can readily avoid estate tax with a $5 million exclusion enhanced by portability, the clients understand GRATs, and the cost of funding more GRATs with nearly identical terms and using the same investment manager is quite modest. Such a client might opt to continue funding new GRATs, and to "roll" or cascade the existing GRATs into new GRATs when the payments come due, since for the relatively modest cost involved it provides a safeguard against asset growth or 2013 law changes pushing them into a taxable estate situation.

The typical rolling GRAT strategy might make sense for some clients to minimize state estate tax even if there is no federal tax likely.

(d) Qualified Personal Residence Trusts ("QPRTs")

If the higher $5 million applicable exclusion amount remains, it may make it unnecessary to consider QPRTs for modestly sized estates. Recall that QPRTs have been especially valuable to clients

who had moderately sized estates that were subject to the estate tax, where their homes were a significant asset, and where they did not have estates so large that cash gifts, GRATs, dynasty trusts and other planning techniques would have been palatable. Often QPRTs were agreeable because the client could retain their liquid assets intact to cover living expenses, while giving away a non-cash-flowing assets and retaining the use of the same for a period of time. If the higher applicable exclusion amount is applicable at death, for most of these clients, at least until 2012, there may be no use for QPRTS.

However, if the higher applicable exclusion amounts were to dissipate, QPRTs may make some sense. Recall that if the applicable exclusion amount is used during life and it decreases, the "appreciation" outside the estate is not taxed. Recall in the discount situation, the discounted value is effectively the same as appreciation (which is not taxed). In the same vein, if the donor survives the QPRT term the difference between the value of the home at the time of death and value of the gift, would be considered "appreciation" and would not be subject to estate tax. With QPRTs (like other assets), if the plan succeeded it would be at the expense of a more substantial capital gains tax to the heirs when the house is sold at some future date.

Suffice to say, for modestly wealthy clients with substantial value in their homes, and homes so valuable that the previous applicable exclusion amount levels may have made QPRTs impractical, re-evaluating the technique may be worthwhile.

> Example: Susan, a single person, has $10 million estate, consisting of a $6 million home and $4 million of marketable securities and cash. The state in which she resides has an estate tax with a $1 million exemption amount, but no gift tax. With a $1 million gift tax applicable exclusion amount a QPRT was impractical. With a $5 million gift applicable exclusion amount, she could create a QPRT (for a period of time that she anticipates to survive) and not trigger any gift tax. She would shift the discounted current value of the residence out of her estates (assuming she survives the QPRT term), not trigger any gift tax, remove future appreciation from her estates, and achieve substantial future estate tax savings (both from a state and federal level).

Thus, even if a taxpayer lives in a state not subject to estate tax (e.g., Florida), if he or she has real estate that would qualify as a residence for QPRT planning purposes in a state that has an estate tax, it may be worthwhile revisiting this, in light of the current federal gift tax applicable exclusion amount levels and the anticipated lower federal and state estate tax exemptions and tax rates.

(e) Formula Clauses and Bequests

As with the 2010 estate tax repeal's impact on formula clauses, a change in 2011 to a $5 million lifetime applicable exclusion amount makes it essential for all clients to review all formula clauses keyed to estate tax figures. This might include not only the obvious ones such as the amount bequeathed to a bypass trust, but prenuptial and buyout agreements as well. Clients should be wary of relying on state estate tax patches to fix these issues since the results could be further confounded by yet another unforeseen change.

As noted elsewhere, since the TRA's extension of expiring EGTRRA provisions is only a two year reprieve for taxpayers, should practitioners draft all formula clauses with explanatory provisions, caps and floors, and other safeguards to deal with the unknowns of 2013 and beyond? How much drafting complexity will clients who assume that their marital estates will never exceed $10 million tolerate?

(f) Generation Skipping Planning

With the GST tax rate at 0% in 2010, 35% in 2011 and 2012, and reverting to 55% in 2013 (and beyond), and with the GST exemption at $5 million through 2011 (increasing with inflation for 2012), and with the anticipation of its decrease to EGTRRA levels to an estimated amount of $1.4 million, planning today to effectively take advantage of the new changes and the anticipated reversion to EGTRRA rate and exemption amount is important.

TRA eliminated Section 2664 of the Code, and by so doing Chapter 13 is back in the Code and the rate is 0% for 2010. This eliminated lots of technical issues that arose earlier in 2010 (e.g., creation of a skip trust with the move down rule) that we need not worry about.

It also allows for some planning suggestions for the balance of 2010. For instance, one may consider making outright gifts to grandchildren and/or more remote descendants. This gift would be a taxable gift (to the extent it exceeds the annual exclusion amount). Thus, except to the extent of the gift tax applicable exclusion amount, gift tax will be due (at a rate of 35%). This gift (in excess of the annual exclusion amount) would be considered a transfer subject to GST tax; it will be a direct skip. Since it is a direct skip, remember that the "automatic allocation rules" would apply. Thus, remember to "opt out" of those rules.

An alternative to the direct gifts to beneficiaries, is to make a gift to "skip trusts" to trigger GST tax. Since the rate is 0%, the tax liability will be $0. Recall that the gift will be a taxable gift and that a gift tax may be triggered. If you opt to use a skip trust, the beneficiaries of the trust should all be of one generation (e.g., a trust solely for "grandchildren" – don't mix generations). It should be noted that the gift tax is paid on the amount transferred to the trust and the GST tax associated with the transfer. In 2010, with no GST tax, the gift tax is only on the amount of the gift.

> Example: Robert, the father of Bill, and grandfather of Mary, has not used the gift tax applicable exclusion amount during his life. Robert makes a $10 million gift to trust for benefit of Mary (his only grandchild) in 2010. The GST tax is $0, and the gift tax will thus only be the tax on the value of the gift (less any gift tax exclusion). Thus, if Robert has his entire $5 million gift tax, the gift tax will be $1.75 million.

One should opt out of the automatic allocation of GST exemption. Recall that the "first generation above the highest generation" rule would apply; therefore, the skip trust would not be GST exempt forever. Therefore, even though transfers from the skip trust to the trust beneficiary (e.g., Mary) would not be subject to GST tax, when Mary dies, depending upon how the trust is structured, it may either be included in her estate or the trust termination would be a GST transfer (triggering GST tax at that time).

Since this is a skip trust, children should not be given an interest in the trust. However, a planning strategy proposed by some is to decant the trust years later and add the children. This should not affect the trust's GST status.

In some situations, clients may not have any grandchildren. A proposed solution by some planners is to consider a gift to a trust where the client may have "grandnieces" or "grandnephews" and have a class gift to "grandnieces, grandnephews and grandchildren". One should be careful of this planning suggestion, in that it is important that the interest given to grandnephews and grandnieces is not insignificant (see. §2652(c)(2)).

In some situations, clients may have great grandchildren. If this is the case, consider a skip trust only for grandchildren. Remember, it could be for those lives in being, as well as unborn great grandchildren. Again, it may be possible to include less junior generations (e.g., grandchildren and children) at a later point in time.

Clients may have non-exempt GST trusts. Consider making transfers out of the trust to the skip beneficiaries (if the trust's provisions allow). Even though the transfer to a skip person is a taxable transfer, when applied to a rate of 0% in 2010, there will be no tax due. If the entire trust is distributed, then there is a taxable termination. But again, there will be no tax due. With the elimination of some uncertainties that TRA eliminated, some planners suggest transferring the distributed assets into further separate trusts for the beneficiaries, keeping each level of generations separate, or simply transferring the assets outright to the beneficiaries.

For 2011 and 2012, one should consider utilizing the newly increased GST exemption amount of $5 million. If GST exemption is allocated to a trust, the trust is exempt for as long as state law allows (in some states like Delaware, the trust could last forever). The allocation of GST exemption is different than the application of a 0% GST tax to taxable transactions. Assets to which the GST exemption has been allocated are exempt (for so long as they may remain in trust under the governing state's laws (which may be forever in various states), or may be whatever the Rule Against Perpetuities permits (e.g., 360 year for certain Florida trusts)). Assets that one taxes at a 0% rate will be taxed again generally when the beneficiary dies. Thus, the exemption forever exempts assets.

Beginning in 2010, consider making a late allocation to a non-exempt or partially exempt trust, since there is an increase in the GST exemption amount.

(g) Same Sex Couple Planning

Same sex couples will face a less onerous tax burden, not because the negative tax stance towards same sex couples has changed, but because of the higher exclusion and lower tax that will effectively permit more same sex couples to shift wealth between partners at less cost. Under prior law as well as the TRA, same sex married couples could not benefit from the federal gift or estate tax marital deduction. To worsen the discriminatory treatment of same sex couples a corner stone of the TRA, the addition of the new and beneficial concept of portability will not be available to same sex couples. This will result in these couples using bypass trust planning rather than relying on portability. This, as discussed above might prove beneficial in many, but not all scenarios. The practical problem

with implementing this planning is dividing assets so that whichever partner dies first has adequate assets to fund the bypass trust. This too will require advance planning. Perhaps for some using discounts, the large gift tax exclusion and other planning will provide an opportunity to shift wealth to irrevocable trusts or the less wealthy partner. Since the increased exclusion is only scheduled to be law for two years, wealthy same sex couples, especially those with a significant skewing of wealth in the hands of one partner, should plan aggressively while that window of opportunity exists.

(h) Charitable Giving

The motivation that the estate tax provided to so many wealthy Americans to engage in charitable planning is over for the vast majority of Americans. The size and scope of the TRA changes may obviate forever many clients concerns or motivations for charitable giving to reduce estate tax.

Clients who might have considered or implemented testamentary charitable lead trusts as part of their estate plan to reduce the size of their taxable estates should review and revisit any such decisions, and the mechanisms for them.

> Example: Client had a $4 million estate and feared that the $1 million exclusion 55% estate tax rate might come to pass in 2011. Client incorporated a $1 million 15 year charitable lead trust in his or her will to reduce the estate tax. With the new exclusion this is no longer necessary and perhaps revision and removal would be desired.

(i) Probate and Executor Fees

In past years with a 45% or higher marginal estate tax rate (higher with state estate tax factored in) it was often quite advantageous to have an executor, even a family member disinterested in remuneration, be paid a full statutory executor fee. The estate tax savings could have significantly outweighed any income tax cost. However, far fewer estates are subject to a federal estate tax and a marginal estate tax rate that may not exceed state and federal combined income tax rates, that there may be no incentive in many more cases to pay executor commissions. While this may raise additional issues, the analysis has changed.

(j) Probate and the Prudent Investor Act

If the administration of a typical estate was rather quick in terms of calendar time it might have been reasonable for an executor to hold even significant estate funds as liquid assets. However, given the myriad of delays the estate tax conundrum has created, exacerbated by the filing and disclaimer extensions (and perhaps a need to await a state renunciation patch or certainty that one won't be enacted) might have lengthened the time frame for the administration of 2010 estates. Executors (as if they don't already have sufficient imponderables to juggle) should give consideration to formally preparing an investment policy statement and evaluating appropriate investment allocation options while they continue to hold funds.

(k) Those who died in 2010

There is a unique opportunity for fiduciaries of estates (and revocable trusts) of decedents who died in 2010. The law permits the executor, personal representative or trustee (which we simply refer to as "fiduciary") to default into an estate tax regime (which allows assets to be stepped-up (or down) to the fair market value at date of death), or an income tax regime (which allows for no estate tax and a modified adjusted basis scheme), as detailed above.

This election applies for the entire year (i.e., all decedents who die in 2010). In a prior version of a bill that failed, some of the provision (e.g., electing which paradigm to be taxed under) was effective through the date of the enactment of the bill, and not for the whole year.

For decedents with estates of less than $5 million, it would be preferable to be subject to the estate tax regime and have a full step-up in basis. The rationale for this is that there will be no estate tax and there will be a full step-up in basis. Thus, if assets are liquidated immediately at death, there would also be no income tax on the liquidation.

For estates that are more than $5 million, the selection of the tax regime would depend on a few factors, such as:

- Estate tax cost versus income tax cost. In the analysis, one must be mindful that some assets will be taxed as capital assets, whereas others may be subject to ordinary income tax;
- Complexity;
- Timing of sales of assets; and
- Ability for future tax planning.

For very large estates, it appears that the no-estate tax / modified income tax basis adjustment paradigm would be better. This would be true, even if the basis in the assets were very low. Paying an estate tax of 35% within the later of 9 months from the TRAs date of enactment or death, is generally going to be more costly than paying a capital gains tax at some later point in time.

There are no "hard and fast" rules that apply to married couples, one of whom dies in 2010. A non-exhaustive list of issues to consider before selecting the taxing paradigm includes:

- Examining the ownership of assets for the married couple unit, taking into consideration the overall estate plan.
- Determining the taxable estate of the decedent, and that of the surviving spouse. For instance, if the total estate (for the couple) is less than $5 million, it appears that the estate tax regime would be preferable. If the total estate (for the couple) is between $5 and $10 million, then it would depend upon the nature of the assets, the tax basis and the overall estate plan. If the total estate is more than $10 million, then it depends upon the assets in the hands of the decedent, and how and to whom the assets passed.
- Overall, one would have to look at the estate plan, determine where the assets would go and see what was most tax efficient.

Under the TRA, the fiduciary has up to 9 months after the date of the enactment to file the report for carryover basis. There appears to be a technical issue with whether the date is 9 months

after the date of enactment or whether it is the time for filing the decedent's final income tax return. It is believed that the 9 months after the date of enactment is the proper date.

Probably one of the most significant ramifications of the change is that it is unlikely that states will be following the federal rules and that decedents dying in states with an estate tax or with assets subject to state estate taxes, one must look carefully, to see the state death tax implications. Thus, one must run the numbers (looking at all of the applicable or potentially applicable taxes) to see whether it is more or less beneficial to be subject to the estate tax regime or opt into the income tax regime.

There are many states that enacted "estate glitch bills" to deal with the issue of how to fund certain types of trusts in the event that there was no estate tax in 2010. In light of the recent change in the law, one should look carefully at their state's particular law to see what, if anything, is affected by the enactment of TRA. The authors hope that the states can enact legislation to rectify any "glitches" to the states' estate glitch bills.

(l) Planning and Drafting for Years after 2012

What happens in 2013? Do the issues advisers pondered about before the onset of 2011 all resurface? A host of questions arise, for instance:

- Does Section 101 of the TRA mean that after 2012 again we will have to ask whether it will be as if the EGTRRA provisions that were law from 2001-2012 were never in effect?
- Will we again have to ponder the issue as to whether a GST exempt trust created in 2012 to which GST exemption was automatically allocated under the EGTRRA automatic allocation rules as extended by TRA really remains GST exempt in 2013?
- Will estate planners face a Freddy Krueger type character, as the series: "A Nightmare on Estate Street" continues, or will we see the serial movie akin to Friday 13th revive as "TRA 2013".
- Even if TRA, or something substantially equivalent, is enacted, what will happen after the two year period of the tax cut extensions?

If the economic recovery strengthens and the deficits remain, perhaps 2013 will bring with it increases in the gift, estate and GST tax. In contrast to the 2010 estate tax repeal which no adviser thought could actually happen, this potential has to be considered.

There may be increasing interest in what were affectionately referred to as "I love you" wills leaving bequests outright to surviving spouses. This simplification, however, will come at a potentially tremendous cost. If the surviving spouse remarries the assets will be at risk from the new spouse, and that new spouse's spousal right of election.

XI. Conclusion

Estate planning is constantly evolving and the TRA is now part of that evolution. We all know as estate planners that getting the most chips to the next generation is only a small part of the process, and little assurance that the heirs will be really benefited. Many clients will still be motivated to save federal estate taxes at 35%, but other objectives may take on increased importance, such as the benefits of saving state estate taxes, securing future portability, asset protection, business succession

planning, structural arrangements to improve asset management, addressing religious concerns and health issues, and a myriad of other issues.