2010 Estate Tax Repeal –
Is it Real? What's the Deal?

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Caution: These are preliminary thoughts on the current status of the estate tax as of January 1, 2010 and have not been thoroughly analyzed and proofread in an effort to disseminate this information quickly. Therefore, this information should not be relied upon to make any estate planning or related decision without first verifying the sources and accuracy of the discussion.

Introduction

Cabbage PATCH Kids 'n Congress

Welcome to the Theater of the Absurd! Congress, by failing to do what everyone assumed they would, has created one of the biggest tax messes in history. That's quite a statement in light of a tax law that gives new meaning to the term "complexity". Everyone expected Congress to "patch" the estate tax so that in 2010 we'd have the same $3.5 million exclusion and 45% tax rate as in 2009 until they decided what to do for the long term. But alas, Congress, opted to do nada and left us all holding the cabbage waiting for the patch! The potential damage to families from failed bequests, the toll of potentially ugly litigation, and more, is simply inexcusable.

Probably 100% of the tax experts all believe that some time in 2010, Congress will put that same proposed patch into law, and if legally permissible (the pundits differ a bit on this one) make that patch retroactive back to January 1. There are arguments on all three sides:

- Retroactive reinstatement should be viable under the concepts of U.S. v. Hemme, 58 AFTR 2d 86-6320 (106 S.Ct. 2071) and Estate of Allgood, 52 TCM 576 (1986). The court held that it was reasonable for Congress to reduce the unified estate tax credit to prevent taxpayers from deliberately taking double tax benefits. The court, however, reasoned that since the estate paid *less* tax under the *new* law, it wasn't deprived of anything to which it could properly take constitutional exception. This rationale may not apply in the current situation.
- Retroactive reinstatement should not be permitted under the concepts of Untermyer v. Anderson, 6 AFTR 7789, 276 US 440, 1 USTC ¶297 (US) Citator 2nd (RIA) which refused to sanction retroactive reinstatement of the gift tax. This

position is that it is not a retroactive change in existing rules, but a retroactive enactment of a law that presently doesn't exist. An important point in this issue might be that there has been so much discussion on retroactivity in even the general media that it can be argued that taxpayers have had notice of this possibility, lots of notice.

- Repeal carry over basis rules retroactively and make estate and GST reinstatement effective prospectively. If this occurs, there may be a golden window of planning available prior to Congress acting. It would also mean that the detailed analysis of the carryover basis rules below will be so much wallpaper.

If the estate tax reinstatement is not retroactive, or Congress doesn't act, 2010 will be an even bigger tax mess. This article will summarize some of the issues, but the bottom line is that at least some of your clients may need to update their wills, revocable trusts, and estate plans NOW! Depending on the language in the will, revocable trust and other documents, the entire plan may be in jeopardy. Unfortunately, even if clients heed this important advice, should Congress retroactively change the law, the revisions themselves may have to be revisited!

President Bush's Smoke and Mirrors Come Home to Roost

The Bush tax breaks enacted in 2001 as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act" although it was also affectionately known by the acronym "ERGTRRA") played the oft used political games to make government budget numbers "work" (outside Washington folks call it smoke and mirrors). In 2010 the estate tax was repealed, but it roars back with a vengeance in 2011. That way President Bush could tell all that he repealed the evil death tax. But he never really did because 2011 assured its return at a costly level in order to make the budget numbers "work." With budget deficits multiplying like ***Tribbles*** (if you don't know how Tribbles multiply then you missed a classic Star Trek episode), few authorities believe that the estate tax will ever be repealed.

Overview of the Estate Tax System 2009, 2010 and 2011

2009 Estate Tax Rules

The estate and generation skipping transfer (GST) tax apply with a $3.5 million exclusion and maximum 45% rate. The gift tax has a $1 million lifetime exclusion and maximum 45% rate.

2010 Estate Tax Rules (as of January 11, 2010)

2010 with Repeal Real

No estate or generation skipping transfer (GST) tax will exist in 2010 -- unless Congress acts. The gift tax remains with a 35% rate, and the same $1M exclusion, as a backstop to the income tax. Thus, estate tax repeal was effective January 1, 2010.

Should you plan on this or is it just a tempest in a teapot? If you immediately revise all of your estate planning documents to conform to the estate tax repeal landscape, and then Congress reinstates the estate tax, will you have to revise all your planning and documents yet again? Is it worth the effort and cost to revise your documents to endeavor to anticipate all the following scenarios?

There are four potential scenarios:

- Repeal stays effective for 2010 and thereafter.
- Repeal stays effective for 2010 and, thereafter, the laws presently scheduled to take effect in 2011 actually do take effect ($1 million exclusion and 55% tax rate).
- Repeal stays effective for a short initial portion of 2010, but then Congress reinstates the estate tax using the 2009 rules of a $3.5 million exclusion and 45% rate pending further Congressional action.
- The estate tax is reinstated retroactive to January 1, 2010, using the 2009 rules.

Throw Momma from the Train – Redux

Hey, it was only a movie title now, but will people push mom from the train in 2010? Will kids who too often ignore mom’s wishes not to have heroic measures dust off those old living wills and pull the plug on mom? Will suddenly caring children take mom home from the nursing home to provide a “different” level of care at home?

Probably some will. Ugly but true.

State Estate Tax Rules Post-2010 Repeal

Many states “decoupled” from the federal estate tax system and enacted their own estate tax laws, often with a lower exclusion than the federal estate tax exclusion (e.g., 2009 - $3.5 million). It does not appear that such state estate tax systems are repealed to track the federal estate tax repeal in 2010 - absent express action by those states. However, depending on the wording of the various state laws, this conclusion may prove incorrect.

If state estate taxes will remain, which is likely in light of the significant deficits many states face, a host of issues are raised. The state estate tax systems still generally track the federal estate tax. If the federal estate tax really is repealed, then the interpretation and application of state estate tax systems will become increasingly difficult and outdated as time progresses. Most significantly, as explained in discussions below, the presence or absence of a state estate tax will create substantial issues with the application of the new federal rules, and widely different results could occur as a result of the different state estate tax laws (or absence of them).

Carry Over Basis Rules

Yeah, But They Also Said We'd Never Have Repeal Limbo!

Why bother discussing carry over basis rules? Most pundits are convinced that Congress will reinstate the estate tax, and most likely *retroactively*. But the same experts never imagined American taxpayers in the bizarre wormhole (for those of you who aren't Trekkies a wormhole is a tunnel connecting two different points in space-tax-time). So, knowing full well that the following discussion is likely to be as useful as a buggy whip on the new electronic cars, we plow onward. If carry over basis has fallen to the status of the buggy whip (as every accountant and estate planner hopes) skip the next section and move onward.

New 2010 Income Tax Basis Rules - Overview

The general rule is that the heir's basis will be the lower of (a) the fair market value of the asset or (b) the decedent's tax basis.

For those dying in 2010 there will be a limited basis step up. Congress effectively created an income tax cost to replace the estate tax. If you die owning a stock you paid $1 for and it is worth $1M under 2009 law, you would pay an estate tax (if your estate exceeded $3.5M) but then the "investment" or "tax basis" in that stock would be increased to $1M value at your death. IRC Sec. 1014. If your kids sold it for $1M they would not pay capital gains tax.

Under the new 2010 law the basis step up is limited under an arcane set of new rules that even tax geeks hope will never have to be learned. These rules are called "carryover basis". Every estate will get to increase the tax basis in assets owned at death by $1.3M (only $60,000 for non-resident aliens, sorry Sigourney). $3M more can be allocated to increase basis of property received from a deceased spouse. These rules will require substantial recordkeeping by everyone, regardless of the size of your estate, because everyone is potentially subject to income and capital gains taxes. The rules are arcane, even for tax laws!

These new rules are similar to what a donee of property received as a gift during the donor's lifetime, must do -- determine the donor's income tax basis and then make certain adjustments. IRC Sec. 1015. More specifically, the basis of property received as a gift is the adjusted basis of the donor, subject to a few special rules. If the donor's tax basis is greater than the fair value of the property at the date of the gift, the basis for determining a loss is limited to the fair value of the property on the date of the gift. This is to prevent the donee from recognizing a tax loss for income tax purposes on property received as a gift.

The second special rule is that if the donor giving you the property had to pay gift tax on the gift, the adjusted basis of the property is increased by the amount of gift tax paid, so long as the increase is not to an amount more than the fair value of the property.

Application of Carryover Basis Rules

Example of Carry Over Basis

Carry over basis is simple in concept to explain (although very tough to implement). Consider the example above used to explain step up in basis.

Example: You own a building which has an adjusted tax basis (investment, less depreciation, plus improvements) of $200,000 and a fair market value on the date of your death of $1,000,000. Had you sold the building just prior to death you would have realized a taxable gain of $800,000 [$1,000,000 - $200,000] and paid an approximate federal and state income tax of about $200,000.

If you die in 2010 or later owning the building your heirs will inherit it with the same $200,000 tax basis you had, not a tax basis of the $1,000,000 fair value at death (subject to the optional basis adjustment rules). If your heirs sell the building the next day, they will have a taxable gain of $800,000, the same gain you would have had. The real difficulty for your heirs will be to locate the records you have of improvements to the building, depreciation deductions, closing costs, etc., to demonstrate your tax basis.

While a pure carry over basis rule would have met the objective of replacing an estate tax with a capital gains tax, Congress sought to minimize the impact of these rules on "smaller" estates. Thus, Congress enacted a "modified" carry over basis rule which permits some amount of basis adjustment. For "smaller" estates, some 98% of decedents, this means that the net tax effect will be similar under the new law (if, in fact, carryover basis remains the law which is unlikely according to most), as it had been under prior (i.e., the current rules which existed until 2010) -- no federal estate tax and a step up in income tax basis.

As will be explained below, every estate will be allowed to step up $1.3 million in assets. Thus, if the appreciation of assets in an estate is under $1.3 million at the owner’s death, all assets will receive a step-up in basis. This means that every executor should create records showing the basis of all assets held by the estate. These records should show a description of the asset, decedent's adjusted tax basis, the fair value at death, and then finally the tax basis to the heirs. This is almost akin in many instances to the work necessary to file an estate tax return.

Rules Similar To Gift Assets Under Prior Law

Property acquired from any decedents who die after December 31, 2009 is to be treated as if transferred by the decedent to the heir as a gift. Assets received as gift transfers will have the same tax basis to the donee (heir) as they did to the donor (decedent), namely carry over basis (subject to several exceptions). This gift rule is the same under the post 2010 law as under old law. This means that not only will the tax basis of the decedent generally carry over to the heirs, but the character of the property, as ordinary income or capital gain property, will also carry over to the heirs. This is important since the characterization of property as capital gains property can have substantial income tax benefits on sale. Similarly, if the property inherited was depreciated, and hence subject to depreciation recapture on sale (i.e., some portion of the gain that would otherwise be treated as capital gains must be characterized as ordinary income and taxed at a higher rate) that taint will also carry over to the heirs.

Character of Property

The carry over basis rules enacted as part of the 2001 Tax Act also provide that the character of property in the hands of the decedent carries over to the hands of the heir. There are exceptions.

Example: If land was inventory, and hence ordinary income property to the decedent who subdivided land and sold building lots as a livelihood, then the land inherited by his heirs would have not only the same tax basis as it did to him, but it would also be characterized as ordinary income property.

Property Must Be "Acquired From" The Decedent To Be Subject to New Basis Rules

The general rule noted in the preceding paragraph applies to property "acquired from" the decedent. This term must be defined to understand when the new rules will apply. Property acquired by devise (real property received from a decedent), bequest (personal property received from a decedent), or inheritance, or by the decedent's estate, will be deemed "acquired from". Property transferred by the decedent as a gift during his lifetime is deemed "acquired from" the decedent for purposes of the new rules. Any other property which passes from the decedent by reason of the decedent's death if passed without consideration (i.e., not paid for by the recipient). This includes property the decedent owned as a joint tenant with the right of survivorship or as a tenant by the entirety. For jointly held property between spouses the property is deemed 1/2 owned by each spouse. This means only 1/2 the value of jointly held property can be stepped up in value.

Property transferred by the decedent to certain trusts, will similarly be subject to the new basis rules. Property transferred to a "qualified revocable trust" or "QRT will be subject to the new carry over basis rules. Finally any other trust with respect to which the decedent reserved a right to change the beneficial enjoyment of the trust property by exercising a right reserved to the decedent to alter, amend or revoke the trust, will be treated as property "acquired from" the decedent and subject to the new rules.

Exceptions to the General Carry Over Basis Rules

The decedent's basis will not always be the exact tax basis to the heir. The basis will actually be the lesser of the adjusted basis of the decedent in the property, or the fair market value of the property at the date of the decedent's death. This means the lesser of basis or fair value, not a pure carry over basis. Executors will thus have to create records more complex than those under prior (i.e., pre-2010) law. The executor will have to determine your adjusted tax basis in each asset and still identify current fair market value information for each asset as of the date of your death (although the complexity of a second calculation at the alternate valuation date won't be necessary). But this is not the entire picture, more complexity is yet to come in the form of two modified increases to basis, explained below.

Example: Decedent dies on January 21, 2010 (and Congress has not retroactively reinstated the estate tax under a 2009 structure). Decedent owned a rental property with a basis of $575,000, and worth $650,000. Assume neither of the special basis adjustments explained below are allocated to the property. The adjusted tax basis in the hands of the heirs, on which they will determine their capital gain when they sell it, is $575,000.

Example: Decedent dies on March 1, 2010, (and Congress has not retroactively reinstated the estate tax under a 2009 structure), owning a rental property with a basis of $575,000, and worth $450,000. The adjusted tax basis in the hands of the heirs, on which they will determine their capital gain when they sell it, is the lesser of Decedent's adjusted tax basis or the fair value at his death, or $450,000.

The implications of the above is that the executor will have to determine the fair value of every asset in the estate, just as under prior law. This may require an appraisal for non-marketable assets such as real estate and closely held business interests.

General Increase $1.3 Million in Tax Basis

One of the major exceptions the new law provides to the general carry over basis concept is that every decedent can increase the basis of assets to eliminate $1.3 million of taxable appreciation.

Example: Your estate consists of a house worth $600,000 for which you paid only $300,000 (your tax basis) and stocks worth $2.5 million which you only paid $1.5 million (your tax basis). You can allocate $300,000 of special basis adjustment to increase the basis in your house to its $600,000 fair value, effectively eliminating any gain. You can allocate $1 million of special basis adjustment to your securities, thus effectively eliminating any gain. When your estate utilizes this special "modified" carry over basis rule, your heirs will not have to pay capital gains tax on the pre-death appreciation when they sell the assets. Without this special tax break the $1.3 million in appreciation could have ultimately cost your heirs $260,000 in capital gains tax (depending on future increases in capital gains rates).

The purpose of the above rule is to prevent the majority of estates from bearing the burden of passing on capital gains tax to their heirs. Just as the applicable exclusion amount under prior law kept estates of under $3.5 million from paying estate tax, the $1.3 million basis step up, modifies the carry over basis rules to enable *most* estates to avoid the cost of capital gains on later sales of inherited assets. When this is combined with the $3 million special basis adjustment on transfers of assets to a spouse, only a very tiny percentage of estates' heirs will face an income tax. Unfortunately however, it does not permit smaller estates to avoid significant paperwork and complexity.

Note: It is not merely estates of $1.3 million and under that will be able to avoid the impact of the carry over basis rules, rather, it's estates of any value that do not have more than $1.3 million in pre-death appreciation that will receive this benefit. Thus, even an estate of $10 million or more may avoid the tax consequences of carry over basis if the appreciation on its assets is less than the permissible basis adjustments.

The actual mechanics of this special basis adjustment are somewhat more complicated and involve a bit of jargon. The basis increase allocated to a particular asset is the "aggregate basis increase" allocated under the new allocation rules, to that asset. IRC §1022(b)(2)(A). The aggregate basis increase in 2010 is:

a. $1.3 million, as explained above.

b. Plus, any increase in the $1.3 million (adjusted for inflation).

c. Plus, any capital loss carryovers.

d. Plus, any net operating loss carryovers under Code §172. These are taken into account to the extent that these losses would have been permitted to be carried over from the decedent's last income tax return to the next year's income tax return had the decedent lived.

e. Plus, any loss deductions for built in losses which would have

> been permitted as deductions under Code §165 as if the property inherited from the decedent had instead been sold for its fair value prior to the decedent's death.

The rules apply to all property "acquired from the decedent". Thus, joint assets, assets held in qualifying revocable trusts ("QRTs"), etc. will all be subject to these new allocation rules. However, the executor of an estate only has the legal right to make decisions concerning *probate* assets. Non-probate assets will thus present a particular challenge.

Special $3 Million Increase for Property Passing to a Spouse - Overview

If the property in question passes to the decedent's spouse, it may qualify for an additional (unrelated to the $1.3 million basis increase) $3 million basis adjustment. Similar to the $1.3 million basis step, this is another major modification of the general carry over basis rules. This rule would effectively makes the carry over basis rule (other than the allocation of basis) irrelevant for most married taxpayers.

Example: The amount of pre-death appreciation that can receive a step up in basis if everything is left to a surviving spouse is $4.3 million ($1.3 million and $3 million). This amount can be increased further if the special home sale exclusion rules discussed below are also considered.

This increase is only available, of course, only if there is a surviving spouse. Thus, the estate tax laws will continue the substantial favoritism historically shown to married couples.

If the entire estate is funded to a family trust, similar to a bypass trust used under prior law, then the trust may not meet the requirements of Qualified Spousal Property ("QSP") if there are other beneficiaries and the spouse is not receiving the appropriate income interest.

Consideration should be given to funding a family trust not to exceed $1.3 million in appreciation and the balance to a QTIP that qualifies as a QSP. Another approach is to bequeath all to a QTIP and permit a portion to be disclaimed into a bypass or family trust, but that disclaimer would have to have a similar limitation.

Requirements to Qualify for $3 Million Spousal Basis Adjustment

In order for assets to qualify for the basis step up, they must be "qualified spousal property" ("QSP"). Congress knew instinctively that taxpayers needed more estate tax acronyms to keep the rules confusing! QSPs include QTIPs or out right transfers of property to a surviving spouse.

Qualified terminable interest property ("QTIP") qualifies as a QSP, and thus for the $3 million spousal basis adjustment. This is a trust from which the surviving spouse will receive income for life and which is funded with property which passes from the decedent. This requires that the surviving spouse be entitled to receive all of the income from the assets in this trust, payable to her at least annually. Alternatively, the surviving spouse may have an interest for life in the property. No person can be given a power to appoint any part of the QTIP assets to anyone other than the surviving spouse during the surviving spouse's lifetime. This means giving a power to someone to appoint the QTIP property after the death of the surviving spouse will not disqualify those assets from the $3 million basis step up.

Example: Husband wishes to bequeath $5 million of assets with a $2 million tax basis, and hence $3 million of pre-death appreciation, to a QTIP trust for his third wife. Husband wants, on her later death, the assets to be distributed to the children from his first marriage, but he is not certain in what proportions or how (i.e., in trust or not). He gives his brother a limited power of appointment to designate the proportions and when the class of persons consisting of his children from is first marriage may receive these assets. If this power is exercisable during his third wife's lifetime, the assets bequeathed to the QTIP will *not* qualify for the $3 million basis step up. On the other hand, if this power is only exercisable *after* the third wife dies, the assets so bequeathed should qualify. The definitions of different types of powers of appointment will no longer appear in the tax laws once the estate tax is eliminated.

In determining whether payments to the surviving spouse will qualify as constituting all the income payable at least annually, the new law directs the IRS to issue regulations governing how an annuity will qualify as the appropriate type of income interest. In determining whether a transfer of property qualifies for QTIP treatment an interest in property, such as a fractional or percentage share, will qualify.

Out Right Transfer Property to Surviving Spouse Qualifies for Basis Step Up

An out right transfer property to the surviving spouse qualifies as QSP. This is basically property which is transferred outright to the surviving spouse. More technically, this is any property "acquired from" the decedent as that term was defined in the preceding discussions. Property will not qualify for the $3 million basis adjustment as "out right transfer property" if the interests passing to the surviving spouse will lapse on the occurrence of an event or contingency, the failure of an event or contingency to occur, or the lapse of time.

Example: Husband dies leaving assets with $1.3 million of pre-death appreciation to his son, and a house worth $4 million, with $3 million of pre-death appreciation, to his surviving wife. However, because Husband was concerned about his surviving wife's remarrying, he had the bequest to her limited to a life estate. She had full use of the residence for her life, but upon her death the house would be transferred to his son. The surviving wife's ownership interest in the house will lapse on the occurrence of an event, her death, so it will *not* qualify for any of the $3 million basis adjustment under these rules.

If the termination is because of the death of the surviving spouse under a simultaneous death clause (a provision which states which spouse should be presumed to have died first in the event both spouse's die from a common disaster or at approximately the same time), or if the surviving spouse dies within six months of the date of the first spouse's death, the asset is passed elsewhere, this condition will not prevent the benefit of the $3 million basis adjustment.

Property Must be Owned by Decedent to Qualify for Basis Increase

To qualify for the spousal basis increase the assets involved had to be owned by the deceased spouse on his death. If property was owned jointly by the deceased spouse and the surviving spouse, the decedent will be presumed to have owned one-half of the property. If the property is owned by the decedent and a joint tenant who is not the decedent's spouse then the property will be treated as owned by the decedent based on the proportion of the value contributed to the property's acquisition by the decedent.

Example: Husband and Friend purchased land for $500,000, with Husband contributing $300,000 and Friend contributing $200,000. Husband will be treated as owning 3/5ths of the property.

The decedent will be treated as owning property held in a qualified revocable trust ("QRT") which decedent funded during his lifetime with assets. This is in general terms the popular revocable living trust.

The decedent will not be deemed the owner of assets because of his possessing a power of appointment over those assets.

The actual mechanics of this spousal basis adjustment are that a portion of the "aggregate spousal basis increase" is to be allocated under the new allocation rules, to each qualifying asset. The aggregate spousal basis increase in 2010 is $3 million, plus, any increase in the $3 million for inflation.

Maximum Basis Increase

The maximum basis increase, when the $1.3 million general increase and the $3 million spousal increase are both used in full is still limited to the fair market value of the property involved.

Example: Husband dies with an $8 million estate consisting of an interest in a closely held business. His tax basis (investment) in the family limited partnership ("FLP") operating the business is $4.5 million. The theoretical maximum basis increase on his bequest of the FLP interests to his surviving wife is $5.3 million [$1.3 million + $4 million], but the FLP interests cannot be increased by more than their fair value of $8 million so the maximum basis increase permitted is only $3.5 million [$8 million - $4.5 million].

Planning For the New Spousal Basis Adjustment

Since no one can know who will be the surviving spouse, a planning objective under the new post-estate tax system, similar to the objective under the old law, will be to divide assets between spouses. This is meant to assure the greatest likelihood of maximizing the basis increase regardless of who is the first to die. But the task of dividing assets is actually somewhat different, and more complex, than planning under prior law (i.e., the estate tax system in place through 2009). Under pre-2010 law the planning is based on dividing the value of assets between spouses. Under the post 2009 modified carry over basis system you will need to divide assets based on appreciation. This is not only more complex but will require more careful monitoring. Thus, taxpayers who divided assets to maximize funding of bypass trusts under prior law will have to re-evaluate that planning.

Example: Husband and Wife have a combined estate of $6.5 million consisting of a house valued at $2 million, purchased for $500,000, stock purchased at $1,000,000 valued at $1,000,000, and real estate worth $3.5 million, purchased for $500,000. The total estate has appreciation of $4.5 million [$1.5 million on the house and $3,000,000 on the real estate]. Under 2009 law Husband and Wife could divide assets by giving the Husband the house and stock, and Wife the real estate so each owns sufficient value of assets to take maximum advantage of the applicable exclusion and the graduated estate tax rates. Under the new system, however, this approach won't suffice. The assets will have to be divided so that the appreciation on assets is equally divided. The stock could be owned by either and would not be relevant since there is no appreciation (this could obviously change as time goes on and the stock appreciates or depreciates in value). The house and real estate would have to be divided equally, or alternatively the house owned by one spouse and the real estate divided in a manner that equalizes the appreciation between spouses.

Inflation Adjustment Increases $1.3/$3 Million Figures

The basis adjustment or increases for $1.3 million general, and $3 million spousal, are subject to increases for inflation. The inflation increase will be based on the increase in the cost of living adjustment for a particular calendar year, using 2009 (the last year before the modified basis adjustment rules become operative) as the base year. The amounts of inflation increases will be rounded down as follows:

a. $100,000 for the $1.3 million adjustment applicable to all taxpayers.

b. $250,000 for the $3 million spousal basis adjustment.

c. $5,000 for the $60,000 adjustment for non-resident aliens.

Community Property Law and the New Carry Over Basis Rules

Generally all property acquired by a husband and wife during their marriage, while they are domiciled in one of the community property states belongs to each of the marriage partners, share and share alike. They share not only in the physical property acquired but also in the income from the property and their salaries, wages, and other compensation for services. At the same time, each may have separate property. They may also hold property between them in joint tenancy and generally may adjust between themselves their community and separate property (i.e. use a transmutation agreement). Couples can state prior to marriage via a prenuptial agreement that they will not be bound by the community property laws of their state of domicile.

Generally, community property assets retain that character even after the parties have moved to a non community property state, unless the parties themselves are able to adjust their rights between themselves. This is important with respect to your actions with respect to the assets held. For example, your restructuring of title to any assets presently owned individually or in joint name could affect this characteristic.

Property acquired before marriage retains the form of ownership it had when acquired - separate, joint or other. Property acquired during the marriage by gift or inheritance by one of the parties retains the character in which it was acquired. Property purchased with community property is community property, and property purchased with separate property is separate property. Property purchased with commingled community and separate property, so that the two cannot be separated, is community property.

For community property a special rule applies which may provide for a full basis step up. This is a significant benefit for community property. A surviving spouse's one-half share of community property assets will be treated as if "acquired from" the decedent and subject to the carry over basis rules. To obtain this benefit at least one-half of the interests in the asset, under the decedent's state's community property law, must be treated as if owned by the decedent.

3 Year Rule - Restricting Death Bed Planning Techniques

The purpose of this rule is to protect income tax revenues. Since there is no estate tax after 2009, unless or until Congress changes the law, and there will still be a $1 million gift tax exclusion, what will stop taxpayers from shifting assets between high and low income tax bracket taxpayers to obtain basis step up?

Example: A terminally ill patient, Tom, has an estate consisting of modest assets. The patient, however, has a close friend, Ida, who owns a particular internet stock she purchased for $1 that is now worth $1 million. The friend, Ida, sees the benefits of obtaining a basis step up so his heirs can avoid capital gains tax. Ida transfers the stock to the close friend who is terminally ill, Tom. When Tom dies, he can bequeath the stock, with basis step up, back to Ida. Ida can now sell the stock and avoid capital gains tax because the tax basis in the internet stock received a free basis step from Tom. This is an obvious abuse which has to be controlled to protect the integrity of the new tax system.

Congress sought to limit this abuse by preventing basis step up on transfers within three years of death. This rule provides that the basis of assets transferred within three years of death cannot be increased under the modified carry over basis rules for the $1.3 million adjustment if acquired by the decedent within the three year period ending on the date of death. This restriction applies to property acquired by gift. A spouse can transfer property within three years of death to obtain a basis step up under the $3 million spousal basis step up unless the transferor spouse received the assets as a gift.

If the above interpretation is correct then clients should consider inter-spousal transfers prior to death. There is a 3 year rule but it provides for an exception for intra-spousal transfers. Thus, if one spouse is on his or her death bed, consider transfers to the healthy spouse before death to obtain a full basis step up. Durable powers of attorney should be amended to address this. See sample clauses below.

Allocating the Basis Adjustment

The basis adjustment, for the $1.3 million and $3 million are to be made by the executor appointed under the decedent's will. The executor's determination will be governed by state law unless and except as changed by the decedent's will, revocable living trust, or other governing instruments. The executor will report the allocations as made on a tax return. Once made, the allocations will be binding except as the IRS may indicate in future regulations.

Many taxpayers assumed that if the estate tax is eliminated, the requirements to file an estate tax return will be eliminated. But filing requirements will continue, and in many respects will be more complex and difficult to make, and will likely affect more, not fewer, taxpayers. Further, since the rules will be new and different, for larger estates the cost and time involved under the new post-estate tax repeal law, may actually be *greater* than before. Even for smaller estates that do not need to file a return, equivalent records will have to be maintained to establish the tax basis for property.

The allocation of basis adjustments may be made on an asset by asset basis. The template used in the past for a Code Section 754 basis adjustment for a partnership may present a useful template for this analysis.

The basis allocation will be quite simple for most estates in that the amount of basis increase permitted will exceed the pre-death appreciation in the assets.

<u>Example</u>: You die with $2 million in assets, which have a tax basis of $1 million. The $1.3 million basis adjustment alone (i.e., without consideration of the spousal $3 million adjustment) enables your executor to step up the basis of every assets so that no pre-death appreciation will ever be taxed. This is relatively simply in that there is no conflict, as illustrated in the next example, below.

Although there is no conflicts between heirs in the above example, “simple” may still not be an appropriate description of what the executor will face. The executor will have to obtain the tax basis and fair market value of all assets, including joint assets and revocable living trust assets over which the executor may have no control. Also, for decedents domiciled in states with no estate tax (or when they are under the state estate tax thresholds) heirs won’t pressure executors to undervalue assets, but rather to value them as *high* as feasible to maximize the basis step up to minimize future capital gains.

The real issue under the new modified basis adjustment rules will arise when the aggregate basis increase is not sufficient to assure every heir of the elimination of capital gains tax.

<u>Example</u>: You die, unmarried, with $3 million in assets, which have a tax basis of $1 million. The $1.3 million basis adjustment cannot enable your executor to step up the basis of every asset so that no pre-death appreciation will ever be taxed. Some assets will have a built in tax cost, others may not. The decisions as to how the executor should make such an allocation are quite complicated, and could create considerable disputes and conflicts of interest between beneficiaries.

<u>Example</u>: Assume the same facts as in the preceding example, and that there are three children. The $3 million estate consists of the following assets:

o House - value $1 million, basis $250,000.
o Business - value $1 million, basis -0-.
o Stock - value $1 million, basis $750,000.

How should the basis increase of $1.3 million be allocated? It could be done proportionately to relative appreciation. The house has $750,000 of the total $2 million of appreciation so that $487,500 [$1.3 million x $750,000/$2,000,000] of the basis adjustment could be allocated to the house.

But what if your son plans on living in the house indefinitely so that it won't be sold? What if the home qualifies for the home sale exclusion rule on a portion of the gain?

What if your son is the executor? What if you left each child 1/3 of each assets versus giving the house to child 1, the business to child 2 and the stock to child 3? The factors to consider, and the risks and issues that can arise are almost endless.

Income In Respect of a Decedent ("IRD") and The New Modified Carry Over Basis Rules

You cannot use basis increase on property which is income in respect of a decedent ("IRD") property (this is sometimes called Code §691 property). For example, the assets in your IRA accounts cannot be allocated any portion of the basis step up under the modified carryover basis system.

Liabilities and the New Modified Carry Over Basis Rules

If you sell property that is subject to a liability, that liability is treated as part of the amount you realize on the sale, and can thus contribute to the determination of the taxable gain. These rules are not changed by the 2001 Tax Act. However, with the repeal of the step up in basis rules which gave property a tax basis equal to its fair value on death, there is a greater opportunity for taxpayers to unexpectedly face a tax cost.

Liabilities in excess of your adjusted tax basis will not be considered for determining whether gain is recognized on acquisition of property from a decedent by the decedent's estate or any beneficiary which is not a tax exempt entity. The purpose of this rule is to prevent the repeal of the estate tax stepped up basis from triggering gain on assets held with liabilities in excess of basis.

Example: You purchased real estate for $100,000. It appreciated to $2,000,000 and you mortgaged the property for $1,500,000. The mortgage liability exceeds your basis in the real estate by $1,400,000. On your death, your estate will not recognize gain on the property. Further, when your estate distributes the real estate to your heirs (assuming that the $1.3 million or $3 million basis adjustments are not applied to this property) your heirs will also not recognize gain on the receipt of the property.

Example: Assume that your executor applies the $1.3 million and a portion of the $3 million basis adjustments to the real estate. The basis of the real estate can thus be increased by $1.9 million to its $2 million fair value which exceeds the $1.5 million mortgage.

The new carry over basis rules could have provide an opportunity for taxpayers to circumvent the tax consequences of carry over basis using charity. Congress wanted to prevent taxpayers from financing a property, giving the money received from the financing to their heirs, and then donating the property subject to the mortgage (or other financing arrangement), If permitted, this would enable you to circumvent the carry over basis rules. Your heirs would have cash with a basis equal to its value (i.e., the cash from the financing) and the encumbered property would be donated to a charity and "disappear" from your balance sheet, including the financing. The charity could then sell the property and not report any gain. This is because a charity, under the general rules would not have to report gain on such a transaction. If permitted this would enable you to avoid the income tax consequences of the new Code §1022(g). To prevent this type of planning ,your heirs will end up inheriting the property with the liability. Gain won't be recognized as a result of the heir receiving an asset with a liability in excess of your tax basis in the asset. But, the heir will inherit the same tax problem you had. Namely, if the heir disposes of this encumbered asset, he will have to recognize taxable gain.

Gain on Distributions from Estates and Trusts

A common drafting technique for wills has been to state that a specific dollar amount rather than a percentage (in tax jargon a pecuniary bequest) would be given to fund (transfer the requisite assets to) a state level bypass trust to preserve the maximum state estate tax exclusion (e.g., $675,000 in New Jersey, or $1 million in New York), or simply to give a desired dollar amount to a specified heir. Generally, no gain or loss results from a transfer of property from an estate to a trust or from a trust to a beneficiary under the terms of the governing instrument.

There are several exceptions. When the distribution is of appreciated property distributed in satisfaction of a right to receive a specific dollar (pecuniary) amount, gain may be recognized for income tax purposes.

Example: On your death you have a particular mutual fund worth $250,000. When your estate is settled eight months later and your state bypass trust is funded in the amount of $675,000, the mutual fund is worth $600,000. Your will bequeaths an amount up to $600,000 to the bypass trust for the benefit of your surviving children. The executor funds this bypass trust with the mutual fund. The tax basis to the estate in the mutual fund is $250,000. Gain of $350,000 [$600,000 - $250,000] must be recognized.

Example: Grandparent transfers various assets to a trust for the benefit of several grandchildren. When each grandchild reaches age 35 he or she is to receive $35,000. When the first grandchild reaches age 35 the trustee transfers stock with a tax basis of $24,000 and a fair market value of $35,000. The trust must report a gain of $11,000 [$35,000 - $24,000].

If the estate can allocate a portion of the $1.3 million or $3 million spousal basis adjustment to the property some portion or all of the gain could be eliminated. It is not clear whether post-death appreciation can be so eliminated. But in many cases the valuation of a non-marketable assets is not precise so that the effect may be to eliminate all gain.

Special Use Valuation Rules and Income Recognition

To minimize the estate tax burden on estates including certain interests in closely held business or real estate assets Code §2032A provide special valuation rules. These rules are an exception from the general valuation rules of valuing assets at their fair market value under the standard of a hypothetical willing buyer and a willing seller. For example, if you use land as a parking lot for your business, but a developer could build an office building on the land, the price a developer would pay for the best use of the property, not a price a purchaser would pay for parking lot land, is used. This general valuation rule can create a tremendous hardship for farm or family businesses where assets are used in the business at a lesser value than fair value. The special valuation provisions of Code Section 2032A are intended to mitigate this hardship. A major drawback of taking advantage of the special use valuation is that the basis step-up which assets receive on death is limited to the special use valuation amount (increased by any gain recognized, as explained below). This lower basis could trigger an unintended future income tax cost, so a special income tax rule was provided for.

The special rule provides that if an estate had to recognize taxable income as a result of a distribution of special use valuation property to a qualified heir the amount would be limited to the excess of the fair value (not the special use value) of the property on the date it was transferred exceeds the value of the property on the date of death. This rule eliminated any taxable gain to the extent that the value of the property on the date of death exceeded the special use valuation of the property.

If your executor distributes appreciated assets to satisfy a beneficiary's right to a pecuniary bequest your estate will recognize gain only to the extent that the fair value of the property on the date of distribution exceed the value of the property on the date of the decedent's death. This new rule is necessary after 2009 when the modified carry over basis rules come into play. Prior to 2010 this special rule for determining gain only applied to distributions of special use valuation property, not any other property, because it was only in that context that the unfairness would arise.

Example: Reconsider the example above. On your death you have a particular mutual fund worth $250,000. You purchased the mutual fund for $50,000 years earlier. When your estate is settled eight months after your death, the mutual fund is worth $600,000. Your will bequeaths an amount up to $600,000 to a trust (it is no longer a bypass trust since there is no longer, after 2009, an estate tax assuming you were domiciled in a state without an estate tax) for the benefit of your surviving spouse and children. The executor funds this by pass trust with the mutual fund. The tax basis to the estate in the mutual fund is $50,000, carry over basis, not the $250,000 fair value at death, as it would have been under the old law. Note, that if your executor allocated some portion of the $1.3 million or $3 million spousal, basis step-ups permitted under the post-2009 laws, the $250,000 basis could be achieved under the new law. However, for this example, assume that no such allocation is made (i.e., the basis adjustments are allocated to other assets). Gain of $550,000 [$600,000 - $50,000] must be recognized if no special rule is provided for. This new special rule states that the gain cannot exceed the amount of appreciation from the date of death value, or the $250,000. Thus the gain under the post-2009 law should be the same as under prior law of $350,000.

The result of the special rule is that even if your executor doesn't make an allocation of basis to an asset with pre-death appreciation, the gain the estate will realize for income tax purposes will not be greater under the post-2001 Tax Act than it was under prior law. Similar rules will be provided by the IRS to address the comparable income tax problem by trusts. IRC §1040(b).

This special rule is yet another instance where an estate will have to determine and document the fair market value of assets at death, the decedent tax basis in assets, and other data. Record keeping under the new rules will continue.

What happens to your estate's tax basis in the property if this special rule applies? The basis of property to an heir (i.e., what the heir will use to calculate income tax when later selling the property) is the basis before the exchange, which is your tax basis on purchasing the property during your lifetime, increased by the amount of gain your estate must report.

Example: Your heirs (the trust's) tax basis should be your tax basis of $50,000 increased by the $350,000 gain recognized, or $400,000. The difference between the $400,000 basis and the $600,000 date of death value, or $200,000 is exactly the amount of gain not recognized by your estate because of this special rule. The result is that if your heir (trust) sells the mutual fund it will then realize the gain. Thus, this special rule defers the timing of recognizing gain, it does not eliminate it.

It appears that losses will continue, as under prior law, to be deducted when an estate distributes property with post-death depreciation to satisfy a pecuniary obligation.

Example: Your will states that $50,000 should be distributed to your favorite college friend. Your executor distributes stock that you paid $80,000 to purchase. Your estate should be entitled to a $30,000 loss deduction.

Special Rules for Inherited Art and Creative Property After 2009

The general rule under the 2001 Tax Act is that, not only will your tax basis in property carry over to (i.e., become the tax basis for) your heirs, but the character of property as a capital asset (the gain on which would be taxed at more favorable capital gains rates) and the holding period (the time of ownership which can affect the capital gains tax rates affecting assets on sale) also carry forward and apply to your heirs.

Prior law provided that creative property, such as music, art, copyrights, etc.) which you received as a gift (more technically, art when your tax basis was determined in part or whole by reference to the tax basis of an earlier holder, such as the donor who created and gave you a sculpture) would not be characterized as a capital asset. Such property will no longer be characterized as not constituting a capital asset. This new rule is a special exception to the general modified carry over basis rules.

<u>Example</u>: Craftsman buys clay for $10 and makes a sculpture worth $20,000 and bequeaths it to you. Under prior and current law your tax basis is $10. Under prior law the sculpture would be an ordinary (non-capital) asset to you because it was not a capital asset to Craftsman. Under this new special rule it can be characterized as a capital asset to you (unless another exception applies).

Special Rules for Donations of Certain Capital Assets

The amount which can be deducted for a charitable contribution purposes is limited. Specifically, the new law reduces the contribution deduction by two items. The first is the gain which would not qualify as long term capital gain. This is determined as if the property were sold for its fair value on the date it was donated. The second reduction applies if either a gift is made to certain private foundations, or a donation is made of tangible personal property the use of which is not related to the charitable purpose of the charity (e.g., art donated to a hospital). In these two situations, the amount of the gain which would have been characterized as long term capital gain is applied to reduce the charitable contribution deduction.

The special rule characterizing certain inherited art, copyrights and other property as capital gain property will not apply to charitable contributions of such property.
The new carry over basis rules change the character of inherited art and other property for purposes of determining your income tax on the sale or exchange of that property. It does not change the rules for purposes of determining the deduction available if you donate that type of property to a charity.

Personal Residence Interplay of Home Sale Exclusion and Carry Over Basis Rules

The new 2010 carry over basis rules liberalize the home sale exclusion rules for estates and heirs. To understand the changes, an overview of the home sale exclusion rules is necessary.

The house sold must have qualified as your principal residence for at least two of the five years prior to the sale. To add some flexibility, if your client doesn't meet the full two year test, your client may qualify to benefit from a portion of the $250,000 maximum exclusion if you had to move because of a job change, health problem or other qualifying excuse.

If the residence was partially used for personal purposes as a principal residence and partially used as for business purposes (rental or house office) the full exclusion may not be available. To the extent that depreciation was claimed on the property after May 6, 1997, the exclusion will not be available. This means that depreciation prior to such date will not have an adverse impact. Depreciation from a home office or rental use after that date will.

The maximum gain which can be excluded is $250,000 for a single client, or $500,000 for a couple filing a joint tax return. To use the higher $500,000 exclusion, one of the spouses had to have owned the house for at least two of the preceding five years. Both spouses had to have used the house as a principal residence during at least two of five years preceding the sale. There was some leniency in the event you fail some of the above requirements for reasons beyond your control. If you fail the “two of five year” ownership and use rule, or the “once every two year” sale rule, as a result of a change in your employment, health, or certain circumstances to be specified in future regulations, you may qualify for a *partial* exclusion.

However, the home sale exclusion rules did not provide for any leniency on the death of a taxpayer. This is even more problematic when the step up in basis rules are eliminated, such leniency might be necessary. Under 2009 law (i.e., the law which existed through 2009 when the modified carry over basis rules became) if you purchased a house that appreciated prior to your death, the appreciation would qualify for a basis step up on your death and the capital gains would disappear.

Example: You purchased a home for $40,000. It appreciated to $290,000, a $250,000 increase. If you sold the home prior to your death, the gain could be excluded from taxation under the home sale exclusion rules. If however, you died owning the home, the exclusion would not apply but your heirs would obtain a step-up in basis in the home they inherited from you. Thus the basis would be increased from $40,000 to the fair value of the home on your death, or $290,000. Thus, if your heirs sold the home, no capital gains tax would be due.

Post 2009, the modified carry over basis rules will not always guarantee a step up in the tax basis of your home. Thus, unless this issue were specifically addressed, your heirs could face a capital gains tax they may have avoided under prior law.

Example: You purchased a home for $40,000. It appreciated to $290,000, a $250,000 increase. If you died owning the home, and the $1.3 million/$3 million spousal basis adjustments were not allocated by your executor to the home, your heirs would obtain a carry over in basis in the home they inherited from you, or $40,000. Thus, if your heirs sold the home for $290,000, a $250,000 capital gains tax would be due. The new rule described below seeks to address this.

An estate or trust may qualify to exclude the gain realized on the sale of the decedent's personal residence. Your estate could qualify for this benefit, an heir who inherited the property from you (e.g., your child) could qualify, and a special trust referred to as a Qualified Revocable Trust ("QRT") can qualify. The QRT is explained more fully, below.

Example: You purchased a home on July 1, 1997 for $100,000 and lived in it until you died June 30, 2003 when the home was worth $500,000, an appreciation of $400,000. Assume that your executor did not elect to allocate any of the $1.3 million/$3 million spousal basis adjustments to the home. Your estate sold the home after your death for $500,000. Your executor could use the $250,000 home sale exclusion to eliminate $250,000 of the $400,000 capital gain.

When an executor considers which assets should receive an allocation of the $1.3 million/$3 million spousal basis adjustments consideration should be given to maximizing the use of the home sale exclusion available to estates. This can increase the maximum capital gains which can be avoided under the post-2009 laws to $4,550,000 [$1.3 million general basis step up + $3 million spousal basis step up + $250,000 home sale exclusion]. Remember, this is not value of assets which can be increased, but rather appreciation.

A QRT, Qualified Revocable Trust is not the same as a QPRT, or Qualified Personal Residence Trust. Confusion will abound. Good for accountants and lawyers, but not easy for regular folk. A QRT is a trust which is a grantor trust which is treated as owned by you. The income earned by a grantor trust is taxable to you as the grantor (i.e., the person who set up the trust) during your lifetime. The common revocable living trust is a QRT. A trust will not qualify as a QRT if it is a foreign trust. If you could only exercise power over the trust with the consent of another person, the trust will not qualify as a QRT. IRC Sec. 684.

Example: A trust can be characterized as a grantor trust if a related non-adverse trustee can be given the right to distribute income and principal among a class of trust beneficiaries without an ascertainable standard in order to achieve grantor trust status. See PLR 8103074 and Carson v. Comr., 92 TC 1134 (1989). Such a trust would not appear to qualify as a QRT under the new law.

Your heir, say your child inheriting your home, can count the time periods for which you owned the house, or used it as your residence, in determining if the heir qualifies for the home sale exclusion. Specifically, a home has to be used, as explained above, for two of the five years before sale, as a principal residence. Your use and ownership can be combined with that of your heir.

Example: You purchased a home on January 1, 2003 for $100,000 and lived in it until you died December 31, 2003 when the home was worth $340,000. You only lived in and owned the home for one year and thus do not meet the requirements for the home sale exclusion. You bequeath your home to your life partner who is in need of additional cash. If he sales the home immediately he will have a capital gains tax to pay. Your partner resides in the home as his principal residence for one year and then sells it for $360,000. Your partner can add your ownership and use of the home to his and thus qualify to exclude up to $250,000 of the gain when he sells the home. He need not wait to qualify for the two year use period based solely on his use.

It appears that the heir can count his use of the property *and* the decedent's ownership. Thus, if the decedent owned the house but the heir used it, the exclusion may be available. Under pre-2010 law a surviving spouse can add the deceased spouse's use and ownership to determine if the exclusion is available. Thus, the post-2009 modified carry over basis law appears to extend this benefit.

Special Rules Applicable To Foreign Taxpayers and Transactions

The basis adjustment available to most estates which permits assets' basis to be increased by up to $1.3 million is reduced to a nominal $60,000 for non-resident aliens. Further, the adjustment for capital loss carryovers, net operating loss carryovers under Code §172 and any loss deductions for built in losses which would have been permitted as deductions under Code §165 to a resident taxpayer, will not be permitted to a non-resident alien. You will have to evaluate any estate tax treaty between the United States and the country in which the particular non-resident taxpayer is a citizen. There may be benefits to offset this harsh limitation.

No basis increase is permitted on stock in a: foreign personal holding company ("FPHC"), a domestic international sales corporation ("DISC"), a foreign investment company ("FSC"), or a passive foreign investment company.

Testamentary transfers starting from 2010 by a U.S. estate to a nonresident alien will be treated as a sale or exchange of those assets at their fair value.

Gain from the sale or exchange of a foreign mutual fund or investment company stock is treated as ordinary income, and not capital gain, under special rules. The basis of such stock becomes its fair market value on death. This special rule is repealed after 2009 when the estate tax is repealed and the new modified carry over basis regimen begins.

Reporting Requirements Under the New Modified Carry Over Basis Rules

The new modified carry over basis rules require substantial compliance. The new reporting requirements must address the complexity of advising heirs of their tax basis in inherited assets. IRC Sec. 6018.

Your executor must file a tax return with the IRS reporting specified information - although the new reporting requirements will only apply to estates over $1.3 million. This is the amount below which no appreciation will be taxed under the modified carry over basis rules. For estates of $1.3 million or less the tax basis of all assets will be stepped up so the IRS need not worry about reporting. The above rule is limited to the $1.3 million figure, as inflation indexed. It is not increased by the amounts for losses and loss carryovers.

For estates with under $1.3 million in assets (not appreciation) even if an IRS tax filing is not necessary, executors should compile the same information since this information will be necessary for heirs to determine the tax basis if assets they sell. Further, if an heir, say your child, has a large estate, it is possible that the heir's executor will have to file a tax return on his death. The information from your estate will be necessary for your heir's executor to file a tax return.

These rules are a bit confusing in that the modified carry over basis rules refer to $1.3 million of appreciation, not $1.3 million of assets. However, the reporting requirements are based on $1.3 million of assets. The rationale for the difference is simple. The IRS will assume that for assets of estates under $1.3 million in total value all assets will have a tax basis equal to their value at the date of the decedent's death (similar to the step-up in basis rules under current law). The issue of whether the $1.3 million in basis step up protects all assets cannot apply for estates with less than $1.3 million even if all assets have a zero tax basis. Over this amount, taxpayers will have to prove tax basis.

Estates of under $1.3 million will presumably not be required to file any type of tax return. As noted above, executors of such estates should still collect and organize similar information since each heir will still have to have documentation of the tax basis in assets inherited. What this also means, which is the same as under current law, for estates not required to file, the incentive will be do justify the highest value possible for any assets in the estate since these assets will become the tax basis of the assets to the heirs.

Example: Father died and his entire estate is valued at $850,000. His estate is left to his only heir, his son. The estate consists of a house which the son, as executor, believes to be worth about $350,000 and $500,000 of mutual funds. The value of the mutual funds is fixed and clear, but what about the house? Under prior law in say 2001 with a $675,000 exclusion, the son would make every effort to have the house appraised at the lowest value possible in order to minimize the value of the estate and hence minimize estate taxes on the value in excess of $675,000. After 2009, under the new modified carry over basis rules, son would endeavor to do just the opposite, up to a point. The higher the son could have the house appraised, but not in excess of $800,000 (the amount which when combined with the $500,000 of mutual funds would trigger the requirement for the estate to file with the IRS), the better. Why? So long as the estate is under $1.3 million in value there is no reporting requirement. Under this threshold the incentive will be to value any asset with an uncertain value (real estate, closely held business, art, etc.) as high as possible since that value will be the value to the heir and determine the income tax the heir will have to pay on selling the property.

For non-resident aliens (non-citizens) estates over $60,000 will be subject to reporting requirements. The only assets considered are those potentially subject to U.S. taxation, generally tangible property located in the U.S. Tax treaties may affect this. These are bi-lateral conventions (agreements) between the U.S. and the non-resident alien's country of citizenship.

In many instances the executor may not have complete information to file the required tax return with the IRS. For example, a trust may own assets included in your “taxable” estate, you may have owned assets jointly with someone so that they assets pass by operation of law outside your estate, etc. In these instances the new reporting rules direct your executor to describe the property and list anyone who has a beneficial interest in the property, such as a joint owner, trustee, etc. These rules could be extremely burdensome and difficult to implement. For many estates several different people will have to collaborate to complete the return. For example, if before you died to transferred some but not all of your assets to a revocable living trust, the trustee and you executor would each have information necessary to the completion of this return. For most taxpayers this should not be an issue because the trustees and executors are often the same people. Where they are not, coordination will be necessary. For some taxpayer's this could prove problematic. In addition, co-owners of any joint assets will presumably have information and be required to cooperate as well.

The information which will have to be reported is similar, but more comprehensive than, what had to be reported on an estate tax return under pre-2010 law. The reason for the detailed reporting requirements is that heirs must know the tax basis they have in assets they inherit so that they can determine their income tax consequences when they sell property. You must advise the IRS of:

- The name and tax identification number (e.g., Social Security number for an individual) of each beneficiary (recipient).
- An accurate description of the property involved. For publicly traded stock this will be quite simple. Likely, more complex requirements and details will be required of a closely held business or other harder to value assets.
- The adjusted income tax basis of the property to the decedent. This requirement was not relevant under prior law when most assets (except IRD, etc., an IRA account as an example) received a step up in tax basis to the fair value at death (or at the alternate valuation date six months following death).
- The fair market value of each asset to the decedent. This is similar to the current law. Although the new law post 2009 is based on a carry over basis concept, the existence of the "modified" carry over basis approach actually adapted (i.e., which permits you to adjust basis for the $1.3 million general and the $3 million spousal amounts) requires both tax basis and fair market value data. When this is compounded by the issue of how to allocate these adjustments, the complexity is truly remarkable.
- The decedent's holding period for the property. As explained above, the time the decedent held the property, which is necessary for determining the capital gains consequences on the sale of property, carries from the decedent to the heirs.
- Any information necessary to determine if any of the gain an heir would realize on the sale of the property would be taxed as ordinary income (i.e., at the maximum individual income tax rates) rather than as capital gain income (potentially taxed at the lower capital gains tax rates) must be provided. This

could include information as to dealer status. For example, if the decedent purchased land, subdivided, and sold many lots as inventory, any remaining lots could generate ordinary income and not capital gains to the heirs. Similarly, depreciation deductions claimed on a property could cause the recharacterization of some portion of the gain as ordinary income instead of more favorable capital gains.

- If carry over basis remains law, which is unlikely, but hey, who knows, the IRS will define the phrase "sufficient information" which your executor will have to provide, in a broad, complex and difficult to comply with manner. But when they do, forgive them, for it was Congress that came up with this mess. The IRS will only be trying to implement it.
- Any other information that the IRS may require in regulations. Hey, if they are requiring all "sufficient" information in the preceding paragraph, what else might they want?

Once your executor makes the determinations above, he will then have to report to your heirs the information necessary for them to determine their tax basis, holding period,, etc. in the property. Specifically, the new law will require that for decedent's dying after 2009 the following information will have to be provided to heirs:

- Name, address, telephone number of the person filing the return. This will generally, but not always, be your executor.
- All of the information required to be furnished to the IRS, as explained in the preceding section, for the assets bequeathed to the particular heir.

Your executor will have to provide this information to each heir within 30 days of filing with the IRS. Perhaps the typical receipt and release used for probate and estate administration will include an acknowledgement of the data attached as an exhibit so that the executor has proof of meeting these requirements.

To assure that your executor complies with these rules, substantial penalties are provided for in the event that the reporting requirements to the IRS and heirs are not met. The penalty is generally $10,000 for failing to furnish the required information to the IRS. However, for failing to provide the IRS the information required concerning appreciated assets which the decedent received as a gift within three years of death is only $500. If an executor fails to provide beneficiaries with the information required under the Code then the penalty is $50 for each failure.

Impact of Repeal on your Existing Estate Planning Documents

Your Will Could be Really Wrong

If your will leaves an amount to a trust or children based on the amount that doesn't create a federal estate tax (a common way to write will language because of the many changes the law has taken over the years) what happens if there is no estate tax? Your dispositive scheme may just go haywire! You need to revise your will to contemplate a world without an estate tax. Tax advisers never had this scenario in mind on their radar screen.

In some instances the manner in which assets are owned or a will or trust is structured it might be feasible to correct the problem after death through post-mortem planning. For example, it might be feasible for a surviving spouse or children to disclaim assets they receive, even in trust, and have those assets then pass to the beneficiary who was really intended to receive them. If a will or revocable trusts establishes a trust for many beneficiaries (called a "sprinkle" or "pot" trust). If some assets pass to persons that were not intended but sufficient assets remain in a pot trust it might be feasible with appropriately directed distributions from that trust to equalize or offset unintended consequences created by the repeal of the estate tax.

Unfortunately, in many situations the consequences of estate tax repeal, possibly even if the estate tax is reinstated retroactively, litigation may ensue. Many courts would adopt a construction that would minimize taxes which has historically been significant, but if this impacts the actual beneficiaries inheriting will they?

Word formulas that leave a specified calculated amount based on tax law to a particular beneficiary or trust may no longer be effective or worse may completely contradict the testator's intent. These have been used to fund bypass trusts, state bypass trusts, to divide bequests as between bypass and QTIP, funding the marital or bypass, funding trusts for grandchildren or other exempt persons, etc. The elimination of the estate and GST tax can result in all or nothing passing to one of the intended recipients of a formula clause.

Example of Bypass Funding

Your will was written when the estate tax exclusion was $600,000 and bequeathed the largest amount that would not trigger a federal estate tax to your children from a prior marriage. The balance, which was the bulk of your estate, was to pass to your new spouse.

Sample Pre-2010 Will Clause Funding Federal Bypass

"I give, devise and bequeath the pecuniary sum which is the largest dollar amount which will not create a federal estate tax on my death, to the Trustee of my Applicable Exclusion Trust, in trust, ("Applicable Exclusion Trust") to be disposed of in accordance with the provision below "Application of Applicable Exclusion Trust."

Note that similar issues are raised by a martial (QTIP) trust funding clause approach that states that "I give, devise and bequeath the pecuniary sum which is necessary to avoid the creation of a federal estate tax on my death, to the Trustee of my Qualified Terminable Interest Property Trust, in trust, ("QTIP Trust") to be disposed of in accordance with the provision below "QTIP Trust."

This common scenario raises a myriad of issues:

- How will the language in your will "the largest amount that will not trigger federal estate tax" be interpreted if there is no estate tax? Will the simplistic literal interpretation apply? If there is no federal estate tax than an infinite amount can pass free of estate tax.
- Does the application of the literal interpretation of the provision result in your entire estate pass to your children and nothing to your surviving spouse? Does it matter if that was clearly not the intent of the testator?
- Will courts recognize the intent at the time the will was drafted to pass a portion of the estate to the spouse and only a portion not all to the children? This would be a strained interpretation if the will had been in place for many years. As the federal estate tax exclusion has increased from $600,000 to $3.5 million everyone has had plenty of time and notice to revise their documents to readjust the amount passing to the children under a will similar to that above. So why on this final step of repeal would the courts recognize something different? At which point of the spectrum from $600,000 to $3.5 million to the entire estate was the testator's "intent?" The counter argument is that if no change was made to the will language as the exclusion increased, that perhaps that was the intent. What if there were projections prepared by the estate or financial planner or CPA that reflected what would occur under the formula and those projections clearly illustrated that a limited dollar figure would pass to the children? If the presumption of the testator when the will was signed was that there would be an estate tax, how should that presumption be factored into the analysis?
- If Congress retroactively reinstates the estate tax to January 1, 2010 but you die before the reinstatement is passed what happens? Will a retroactive estate tax change survive a constitutional challenge? It is pretty likely that someone with substantial wealth will die between January 1, 2010 and the date Congress eventually reinstates the estate tax (if Congress in fact does so) whose heirs will have a tremendous incentive to challenge any reinstatement. But even if such a challenge was successful as to the estate tax what will the implications be for state law interpretations of the will as to how property will be distributed? Will a state court be bound to the new retroactive definition of the estate tax exclusion?

State Estate Tax Roulette

The state in which you are domiciled on death can make the planning implications more obtuse to figure out. Variations in state estate tax can result in a vastly different scenario.

Consider the same sample will clause illustrated above with a twist (additional phrase ***highlighted***):

Sample Pre-2010 Alternative Will Clause Funding Bypass Trust

"I give, devise and bequeath the pecuniary sum which is the largest dollar amount which will not create a federal ***or state estate tax*** on my death, to the Trustee of my Applicable Exclusion Trust, in trust, ("Applicable Exclusion Trust") to be disposed of in accordance with the provision below "Application of Applicable Exclusion Trust."

Well, if you were domiciled in the Garden State (that's New Jersey for you non-Springsteen fans) if those magic words "or state estate tax" appear in your will, New Jersey has only a $675,000 exclusion so the initial dispositive scheme of more than a decade ago in the old will would still be carried out.

If, however, you headed South to the sunny climes of the land of Miami Vice where there is no state estate tax, then the issue is identical to that of the federal exclusion amount. Since the federal estate tax does not exist then your entire estate would arguably pass in Florida by the above bequest. The remainder provision in your will would be academic. This could result in your designated bypass trust heirs, perhaps children from a prior marriage, receiving your entire estate and your surviving spouse nothing (or vice versa depending on the structure of your will).

Two different states, two completely different results.

Now the fun can really begin. Let's play 2010's estate tax version of ***Where's Waldo***?

Example Bypass Funding and State Estate Tax Formula

You were domiciled in a high tax state, New Jersey. Worried over the substantial estate tax you began filing income tax returns as a Florida resident and used your Florida beach condominium as your address. Since you know the best tax advice is obtained on the golf course, you heeded the recommendations of your gold buddies and took out a library card in Florida, registered to vote in Florida, and opened a bank account in Florida. Following your death, the State of New Jersey audits your estate and aggressively argues that you never severed your ties sufficiently to shift your domicile from New Jersey to Florida. You still retained the bulk of your financial contacts, investment accounts and accountant in New Jersey and a large and primary home. Were you domiciled in New Jersey or in Florida on death. This argument has heretofore taken the form of executor and heirs versus the high tax state. But alas, in the Alice in Wonderland world of estate tax repeal, the executor, or perhaps the beneficiaries, might actually encourage the New Jersey Division of Taxation to pursue the domicile claim. How so?

Example Encouraging State Estate Tax Audit

The will contains the following clause: ""I give, devise and bequeath the pecuniary sum which is the largest dollar amount which will not create a federal ***or state estate tax*** on my death, to the Trustee of my Applicable Exclusion Trust, in trust, ("Applicable Exclusion Trust") to be disposed of in accordance with the provision below "Application of Applicable Exclusion Trust. The remainder of my estate shall be distributed out right and free of trust to my surviving spouse." The children from the first marriage are the sole beneficiaries of the bypass trust. The recently wed 3rd spouse is the beneficiary of the remainder. The children might advocate for Florida domicile so that the entire estate inures to their benefit. The new spouse will advocate for New Jersey domicile so that the bulk of the estate inures to his benefit. The executor will probably hire independent counsel and pray not to be shot in the cross-fire. If Congress reinstates the estate tax the children and new spouse may each continue their battles in separate state courts.

More Issues For Existing Will Bypass Funding Clauses and State Estate Tax

Alas, there are yet more issues, complications and confusion relating to the interplay of federal estate tax repeal and state estate taxes and the funding of bypass trusts. Consider the following:

- The calculus prior to 2010 for a testator living in a high estate tax state was whether it was worth funding a bypass trust for the difference between the state estate tax exclusion and the federal exclusion amount. Example: Decedent resided in a state with a $1 million exclusion. In 2009 depending on the age and health of the surviving spouse it might be advantageous to fully fund the bypass trust up to the larger federal exclusion of $3.5 Million even at the cost of incurring a state estate tax. The avoidable state estate tax on the incremental $2.5 million funding to a bypass trust for a New York domiciliary in 2009 would have been approximately $230,000. This might well have been worthwhile to avoid a later and more substantial federal estate tax. But if repeal is real then why incur any state estate tax on the first death if there cannot be a future greater federal estate tax savings. Wills and revocable living trusts containing maximum federal funding clauses need to be re-examined. As with the discussions above the impact on the dispositive scheme, not just the tax costs, must be evaluated.
- Under pre-2010 law clients might have funded a family trust in the form of a bypass trust that would benefit the surviving spouse and all children, with an independent trustee, perhaps an institution, having a sprinkle power to allocate income and principal. The only constraint on this dispositive scheme would have been estate tax considerations. But if under 2010 estate tax repeal, while repeal is in effect (if not retroactively reinstated) the full funding of a bypass family sprinkle trust might be exactly what the testator desired. If the testator resided in a state with no estate tax if repeal is real then there is no negative tax consequence (other than possibly loosing out on the $3 million spousal basis adjustment) to

funding this trust with the entire estate. However, if the testator lived in a state that had a state level estate tax, then there could e a substantial state estate tax cost on funding a family trust in lieu of a marital trust.

- But way make planning reasonable? Even if repeal is the real deal for 2010, if in 2011 the federal estate tax roar's back with a measly $1 million exclusion and a 55% marginal rate, then it might be well worthwhile to incur a substantial state estate tax if the surviving spouse dies after 2010.
- State estate filing requirements might be affected. For example, A New Jersey estate tax return must be filed if the decedent's gross estate plus adjusted taxable gifts as determined in accordance with the provisions of the Internal Revenue Code in effect on December 31, 2001 exceeds $675,000. It must be filed within nine months of the decedent's death (nine months plus 30 days if the Form 706 method is used). For decedents dying after 12/31/01, as an alternative to filing a completed 2001 Form 706, an estate may in many cases use the simplified tax system to compute the New Jersey estate tax. This method is based upon the net estate as determined for the New Jersey inheritance tax with certain adjustments. The simplified method is not intended for use in all estates and it may not be used if an estate files or is required to file a federal estate tax return (Form 706) with the IRS, or if its use does not produce a tax liability similar to that produced. So if there is no estate tax then under New Jersey law the only approach to filing a New Jersey estate tax will be to use the so called "simplified method." But if the federal estate tax is repealed a bequest to a QTIP marital trust cannot currently meet the requirements to qualify for the federal estate tax marital deduction. Does that then vitiate the marital deduction for New Jersey estate tax purposes? Must an outright bequest or alternative marital deduction approach be used? If this interpretation is upheld then wills would have to be revised to assure qualification for state estate tax marital deductions, but in a manner that does not vitiate the qualification for the $3.0 million spousal basis step up.
- If a state that has a state estate tax might refuse to recognize a federal marital savings clause, or other marital bequest as illustrated above, then any client with an inter-vivos trust that has a situs in that state should evaluate the options to shift that trust to another state via appointing a new trustee and having the local trustees resign, decanting, having a trust protector who is empowered to change situs do so, etc. The practical problem with this is that what client would incur the cost to proactively fend off a theoretical state estate tax issue when, so far, most tax practitioners anticipate a retroactive reinstatement of the estate tax. By the time such taxpayers change their mind, or die, it may be too late to address the issue.

Sample Pre-2010 GST Funding Clause

Similar to the bypass funding issues raised above, many wills contain formula generation skipping transfer ("GST") tax funding clauses. How will these be interpreted if there is no estate tax?

Sample Pre-2010 GST Funding Clause

“The term "GST Exempt Amount" shall mean an amount equal to my unused generation-skipping transfer tax exemption (as defined in Code Section 2631) remaining after all allocations of such exemption before or after my death. It is my intention that my Executor maximize the use of my generation skipping transfer tax exemption. If any of my issue survive me, my Executor shall pay the GST Exempt Amount, as defined above, in accordance with the provision below entitled "Distribution for Grandchildren". If none of my issue survive me, this bequest shall lapse. The Trustee shall hold the GST Exempt Amount, in trust, for the use and benefit of my Grandchildren, as provided below. The remainder of my estate shall be paid to the trust for my daughter, as provided below.”

This sample provision raises a host of issues. Since there is no GST tax in 2010, pending a reinstatement, then there cannot be a GST exempt amount so perhaps the likely conclusion of this provision is that the trust contemplated for grandchildren will not be funded. In the confusion of estate and GST tax repeal, the child and grandchild may each argue vastly different facts and that the testatrix had opposite objectives to that claimed by the other.

Example Intent for Minimum GST Funding

The daughter will argue that her mother only intended to benefit her and since the GST tax has been repealed the entire estate should be distributed to the daughter’s trust.

Decedent had an estate of $5 million and was very close to her only child, Daughter. Decedent therefore wanted to fund the maximum bequest to her daughter for her benefit. The intent of the dispositive scheme was to primarily benefit Daughter, but preserve some GST tax benefits by funding what at the time was a $1 million trust for Daughter’s children which would relieve the financial worries daughter had. Thus, the intent when the will was executed was to fund the then maximum $1 million to a grandchildren’s trust without incurring the confiscatory GST tax. The remaining asset were bequeathed to a trust for the benefit of Decedent’s beloved daughter. However, as a result of the repeal of the estate tax is that the entire estate passes to the trust for the grandchildren bypassing the beloved daughter.

Example Intent for Maximum GST Funding

The grandchildren will advocate that their grandmother really only intended to benefit them and that the courts should interpret the will as intending to benefit solely them since the GST tax has been repealed. Their argument is supported by the fact that as the GST exemption rose over many years from $1 million to $3.5 million their grandmother did not modify her dispositive scheme.

Decedent had an estate of $5 million and was estranged from her only child, Daughter. Decedent therefore wanted to fund the maximum bequest to her grandchildren for their benefit. The intent of the dispositive scheme was to fund the maximum feasible to a grandchildren’s trust without incurring the confiscatory GST tax. The remaining asset were bequeathed to a trust for the benefit of Decedent’s estranged daughter, a non-skip person and the grandchildren. Thus the trust for Daughter is not a skip person so the plan would have avoided incurring GST tax on Decedent’s death. The trustees of the Daughter’s trust understood Decedent’s objectives and intended to maximize distributions to or for the benefit of the grandchildren’s education and medical costs that would not trigger GST tax with the objective of depleting the trust over time. However, as a result of the repeal of the estate tax is that the entire estate pay pass to the trust for the estranged daughter.

Salvaging Existing Plans for an Incompetent Client

Assume that you determine that your client’s last will and testament will have an incorrect and unintended result, but the client was diagnosed years ago with Alzheimer’s and is not competent to modify the will. What can be done? Perhaps the agent under a durable power of attorney can revise the title to various assets, and modify certain beneficiary designations, to bypass the will thereby restoring the intended dispositive scheme. However, what risks does an agent face in doing so? Are such acts really contemplated by the durable power of attorney? Even if arguably supported by the power, if title to assets is changed shortly before death, and particularly if it benefits the agent effecting the changes, what impact will that have on the likelihood and success of a challenge by the adversely effected beneficiaries under the will?

If the testator is incompetent is it feasible while the testator is alive to bring an action to clarify the dispositive provision under the will, beneficiary designations and perhaps other documents?

Assume that a proceeding is brought in state court to reinterpret a will of a testator who is alive but incompetent in January to avoid the risk of death with an uncertain property distribution right and because of the uncertainty of what Congress might or might no do.. If a determination is made by the state court and then Congress later reinstates the estate tax how will that state court determination impact the tax status of the distributions?

The U.S. Supreme Court has held that where estate tax liability turns on the nature of a property interest held and transferred by the decedent under state law, IRS is not bound by a state trial court's determination of the property interest. In determining what the property interest is, the federal courts can make their own determination of the state law, unless the highest court of the state has decided the point. If the highest court of the state has not decided the point, the federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the state. 8 Bosch (footnote 8). Com. v. Bosch, Herman Est, (1967, S Ct) 19 AFTR 2d 1891 , 387 US 456 , 18 L Ed 2d 886 , on remand (1967, CA2) 20 AFTR 2d 5987 , 382 F2d 295 , 67-2 USTC 12491 , revg (1966, CA2) 18 AFTR 2d 6217 , 363 F2d 1009 , 66-2 USTC 12412 .

Bosch (footnote 8) is distinguishable where a state court decree extinguishes the decedent's rights in the property so that they do not exist at the time of his death. Thus, IRS ruled that trust corpus was not includible in the estate of the decedent- grantor. IRS so ruled even though the decedent's interest was extinguished in a nonadversarial action brought by him, which was not appealed but which the highest court of that state may well have decided otherwise. Rev Rul 73-142, 1973-1 CB 405. This ruling provided as follows: "Unlike the situation in Bosch, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death)." Would this rationale suggest that a state court holding as to how assets should be distributed prior to death of the testator would then be binding on the IRS?

The Bosch principle does not apply, however, to a determination of rights and interests settled by local adjudication and res judicata at a time before events that raise a federal tax question occur. Rev. Rul. 73-142, 1973-1 CB 405. See Priv. Ltr. Rul. 200543037 (July 12, 2005) (state court order regarding payment of estate taxes given effect because the state court had jurisdiction over the parties and the subject matter, the time for appeal had passed, and the order was issued before the time of the event giving rise to federal estate taxes). See Ufford, "Bosch and Beyond," 60 ABAJ 334 (1974), discussing procedures instituted by some states to broaden access to the highest court of the state in an effort to comply with Bosch. In addition, retroactive changes of legal effects of a transaction through judicial nullification of a transfer or a document do not have retroactive effect for federal tax purposes and thus do not alter results under Section 2033. PLR 9609018 (Nov. 27, 1995). Cf. Estate of Hill v. Comm'r, 64 TC 867 (1975) aff'd without opinion, 568 F2d 1365 (5th Cir. 1978) ; American Nurseryman Publishing Co. v. Comm'r, 75 TC 271, 276-277 (1980) , aff'd without opin., 673 F2d 1333 (7th Cir. 1982) .

2011 Estate Tax Rules (as of December 31, 2009) - He's Back - The Return of Freddy Krueger

In 2011 the exemption will be only $1M and the rate 55% (plus state estate tax) unless Congress acts. Ouch!

Everyone is confident Congress will bring back the estate and GST tax. If Congress reinstates the estate and GST taxes but does not make them retroactive what happens during that interim window when there is no estate or GST tax? You may not be able to set up a dynasty trust and make it GST exempt because you may not be able to allocate GST exemption to protect a trust if there is no GST tax. Does that put the freeze on that type of planning until Congress acts? What if you set up a GST exempt trust and Congress retroactively reinstates the GST tax? Will that result in a retroactive allocation of GST exemption to that trust?

Gift, Estate and GST (?) Planning Under the 2010 Repeal Regime

Certain Gifts under 2511(c)

The 2001 Act added Code Section 2511(c) as follows:

"Treatment of certain transfers in trust. Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1."

This rule is effective for gifts made after December 31, 2009. If the emphasis is on the first part of the provision then perhaps the intent is that a sale, which would be a transfer, to a non-grantor trust (e.g., of non appreciated property that might appreciate in the future), would not be respected as a sale, but rather would be treated as a gift. This could be a landmine for those consummating sales of non-appreciated property to an irrevocable trust. The initial portion of this provision could also be interpreted to imply that a gift to a non-grantor trust would be deemed a completed gift to trigger gift tax rather than an incomplete gift. So a transfer to a non-grantor trust will be treated as a gift. Remember that under the carryover basis regime the gift tax was retained as a backstop to protect the income tax. This provision is intended to prevent an end run around the income tax without triggering gift tax.

If the emphasis is on the latter portion of the provision it might possibly be interpreted to mean that the transfer of assets to a grantor trust might not be respected as a gift according to some commentators.

GST gifts

If a GST transfer occurs in 2010 the GST tax is not assessed. Some wealthy folks may have used up their GST exemption. Does a temporary repeal of the GST tax provide a window of opportunity to make a gift to a trust so only gift, but not GST tax, will be due?

- What happens if you make such a gift but the estate and GST taxes are reinstated retroactively?
- Consider using a formula clause in the documents creating the gift transfer (e.g., bill of sale, LLC Membership Interest Purchase or Sale Agreement). Also, the recipient trust agreement could provide that any portion of the gift that is greater than your GST exemption available at the date of the gift will be allocated to a sub-trust (a trust formed under the trust you establish) for children. This would arguably eliminate any GST tax that would inadvertently be triggered by the

transfer. The amount of GST exemption available should be adjusted in any such formula to reflect the consequences of any retroactivity.

- How can the IRS apply a Proctor type argument if the public policy has created the problem in this instance? Further, unlike Proctor the taxpayer would not be “toying” with the audit process in this instance since it is Congressionally created uncertainty, not taxpayer machinations, that have created the uncertainty. Proctor v. Comm'r, 142 F2d 824 (4th Cir. 1944).

> Donor hereby gives and assigns all of donor’s rights and interest in the property set forth on Schedule A attached hereto (“Gift Property”) irrevocably as a completed gift to the Trust. The value of such Gift Property that does not exceed the Seventy Five Percent (75%) of the maximum generation skipping transfer tax exemption available to Donor at the time of this transfer, based on the values finally determined for federal gift tax purposes, with consideration given to any retroactive reinstatement of the generation skipping transfer (“GST”) tax shall be transferred to the Dynasty Sub-Trust formed under the Trust. The value of any remaining portion of the Gift Property in excess of that, if any, transferred to the Dynasty Sub-Trust above shall be transferred to the Children Sub-Trust formed under the Trust. The transfers hereunder shall be complete and final as of the date of the initial transfer to the Trust. Had the GST tax not been eliminated the Grantor would have had at the date of this transfer One Million Dollars ($1,000,000) of remaining GST exemption.

- Any amount that does not exceed the GST exemption available to you when the gift was made, or the amount that could pass free of GST tax if greater, would be allocated to the grandchildren and future generation’s sub-trust. The trustee or trust protector should be given broad powers to divide trusts, allocate GST exemption, etc.
- Funding a transfer to a trust that is intended to be GST exempt when there is no GST tax to exempt the transfer from is theoretically problematic. How can you allocate a GST exemption if there is no exemption and no GST tax?
- If you take the position of allocating GST exemption if and when it is enacted should you file a 2010 gift tax return and affirmatively apprise the IRS of such an election while there is no tax?
- The dilemma this creates is substantial. Taxpayers fearing the formerly unthinkable return of the estate and GST tax in 2011 at 55% with a mere $1 million exemption may be anxious to transfer assets that remain at depressed recession values to trusts that will be removed from their estates and exempt for GST purposes, but can this be done? Waiting for Congress to act may result in the asset values recovering and undermining the planning to then be faced by the 2011 rules which could be even more costly.
- If you affirmatively elect to allocate a GST exemption that does not exist what becomes of that “allocation” if GST is retroactively enacted? Will the retroactive

enactment retroactively permit allocation of GST exemption? If it does is it the value at the date of the transfer or the date of the post-reinstatement allocation (akin to a late allocation of GST)?

More GST Planning

The GST exemption drops for the $3.5 million in 2009 to only $1 million in 2011 if Congress doesn't change the rules. For those who missed using up GST exemption in 2009 (e.g., a QTIP with reverse GST allocation), there may be a 2010 spin, depending what our fearless leaders in Washington decide upon. Fund a QTIP and make a reverse QTIP election. Example: Wife sets up a marital or QTIP trust for Husband and gifts $5M to the trust. No gift tax because of unlimited marital deduction. If there is a gap in GST tax because Congress does not retroactively reinstate it, then the amount give to the QTIP can continue on after Husband's death in perpetuity for future descendants. If Congress reinstates the GST retroactively, the assets in the QTIP trust can be funneled by a formula clause into a more standard sequence of trusts, bypass/QTIP back to Wife then to kiddies on her later death.

Gifts to GST Exempt Grandchild's Trust

A gift can be made to a trust for a single grandchild and if other criteria are met: one beneficiary, included in grandchild's estate, at the end of the trust term the trust will be distributed to the grandchild (skip person). IRC Sec. 2642(c) (2). It is not clear that in 2010, unless the GST is reinstated, that these gifts can be made and continue the GST exemption of such trusts.

GST Trust Distribution Planning

The GST is inapplicable, can what would otherwise be a taxable distribution in 2009, be made without incurring GST Tax since there is no GST tax? This could be an affirmative planning opportunity and there may be a window of opportunity. If Congress retroactively reinstates the GST tax will they tax such distributions?

Gift Planning at 35% Rate

Make taxable gifts! Yes, you read right! If you're loaded and on in years or not well, if you make large taxable gifts at the 2010 35% maximum gift tax rate, that could be a whopping savings from incurring the 55% marginal estate tax rate that comes into play in 2011 and later years if Congress does nothing. Also, if you survive 3 years after making the taxable gift, the gift tax you paid is removed from your estate as well as the asset (in tax jargon that's a net gift). That's a winner. Just make conforming updates to your living will since you'll need to survive 3 years after making the taxable gifts to get the gift tax out of your estate.

If the gift tax is reinstated at the 45% rate retroactively will Congress provide an opportunity to reclaim the gifts to avoid the higher rate?

Grantor Retained Annuity Trusts (GRATs) Planning Under Repeal

GRATs remain a favored planning tool to reduce gift taxes. In light of the Green Book proposal of a 10 year minimum term or the much talked about minimum 10% taxable gift requirement on the funding of a GRAT (although it appears more rumor than real) many clients might benefit from continuing to fund GRATs now. GRATs have never been a vehicle for transferring wealth to grandchildren or later generations (skip persons) because GST exemption cannot be allocated to the end of the GRAT term as a result of the estate tax inclusion period rules ("ETIP").

- Since the GST has been repealed in 2010 can GRATs be established that allocate the remainder interests following the GRAT term to a perpetual dynastic trust for skip persons?
- If the GST tax is reinstated what would happen to such a GRAT?
- Is this a brief window of opportunity to fund a dynastic GRAT before Congress retroactively reinstates the estate tax?
- If the GST tax is retroactively reinstated could the GRAT provide for a distribution to a post-GRAT term trust for children and if it is not reinstated to grandchildren? Would this provide a practical means of continuing planning until Congress decides?
- Some commentators have suggested structuring the GRAT remainder interest to a grandchildren, and if they are not then living to the grantor's children. If the grandchildren can disclaim within nine months of the funding of the GRAT the estate and GST tax status will be known. If the GST tax is not retroactively reinstated the grandchildren can retain the assets. If it is reinstated retroactively, then the grandchildren can disclaim their interests to avoid the GST. While this might be a concept worth exploring, issues abound. Will grandchildren disclaim? Are the grandchildren of sufficient age to legally disclaim? Will the constitutionality of retroactivity be finally determined in time?

Charitable Lead Trust (CLT) Planning Under Repeal

Charitable Lead Trusts (CLTs) could present an interesting opportunity. Maybe! With a CLT you can gift a large sum of money to your children and reserve a periodic payment to a charity for an intervening period. This charitable interest reduces the value of the gift to your children dramatically. Under 2009 law you cannot set up a CLT for grandchildren unless it is structured as a unitrust. This means the charity gets a percentage of the value of the CLT assets each year, instead of a fixed amount. That squeezes some of the "vig" out of the plan. The reason for this had been that you cannot allocate GST exemption to a CLT using annuity payments (called a CLAT). Well, if there is no GST tax can you now do CLATs for grandchildren since there is no GST tax? Some practitioners suggest formula clauses to divide the CLT assets depending on the outcome of future tax legislation. Other advisers suggest using a disclaimer so that if the law becomes clear within 9 months of funding the children can disclaim and the CLT remainder can go to grandchildren if the GST tax is not re-enacted, or if re-enacted is not retroactive. Other advisers are looking for Advil.

Probate and Estate Administration Complicated By Repeal

Making 754 Elections and Partnership Agreements and Operating Agreements

Partnership agreements and limited liability company operating agreements frequently include provisions governing a basis adjustment under partnership tax law section 754 of the Internal Revenue Code. If the estate tax is in fact repealed and a carry over basis in place the implementation of a Code Section 754 election may change. The basis of an LLC or partnership interest may not be the same as under prior law. The executor making the allocation of the basis adjustment under the new carry over basis regime, in contrast to prior law, might be held liable for allocating basis adjustment to a partnership or LLC if the general partner, manager, or members have to approve the adjustment. In the past, since the step up in basis was automatic, there was no issue for the executor other than pursuing the adjustment, However, under the new paradigm, since the basis adjustment is limited, if an executor allocates the limited $1.3 or $3 million basis adjustment to a partnership interest and the 754 election is not automatic, the executor might be sued by the beneficiaries for wasting the limited benefit of the basis adjustment. On the other hand, if the partnership or LLC interest is highly appreciated, and the executor does not allocate basis adjustment to this interest, the executor could be held liable for not maximizing the tax benefits.

Disclaimers Face New Issues

A disclaimer (renunciation) is the formal legal refusal by an heir to accept a gift, bequest or devise. A common use of disclaimers in drafting estate planning documents prior to 2010 was to leave a bequest outright to a surviving spouse and provide the right to disclaim the desired portion of that bequest to a bypass or credit shelter trust. Apart of the issue as to how few surviving spouses exercised the right to disclaim, the new 2010 estate tax repeal landscape disclaimers take on a new dimension.

- Disclaimers may take on increased importance post-estate tax repeal. If there is no estate tax it might prove advantageous for surviving spouse’s to renounce bequests that would flow to them and let the assets pass to children or other heirs without estate tax. If the disclaimer is not used, a gift tax might be incurred in the future in making transfers. So a new perspective in a no-estate tax environment is to utilize disclaimers to avoid future gift taxes.

- If the carry forward basis rules remain law then disclaimers will be useful to shift assets in the most advantageous manner to maximize basis step up. For example, if excessive assets are bequeathed to a non-spouse or non-QTIP trust (i.e., a trust that will not qualify as "spousal property") then perhaps disclaimers can be used to shift assets to a spouse or qualifying spousal trust (e.g., a QTIP under IRC Sec. 2056(b) (7)) to obtain maximum benefit of the $3 million spousal basis step up under new IRC Sec. 1022.
- Disclaimers, if heirs generally cooperate, may be vital to achieving testamentary objectives in the event that the estate tax is not reinstated retroactively, or if it is there are gaps and challenges to how dispositive provisions should be interpreted during that period.

To Distribute or Not To Distribute, That is the Question

With so much uncertainty, executors for estates of those who die after January 1, 2010 have to be extremely cautious. Perhaps the only safe approach would be to withhold sufficient funds to cover a potential federal and state estate tax at the 2009 rates. However, this too presents issues. Beneficiaries may be in need of funds and press the executor to make distributions. But until the issues are resolved how can an executor make a distribution? But resolution may be quite a while in coming. If the estate tax is retroactively reinstated and that reinstatement is litigated all the way to the Supreme Court how long will that take before an executor can make a distribution of withheld funds? However that potential Supreme Court case is resolved, will that resolve the manner in which state law will interpret the will for purposes of determining how asset will be distributed under the terms of the governing document? How many years will that add to the period for which distributions might warrant being delayed? Will cash hungry beneficiaries accept such delays?

Being Prudent Under the Prudent Investor Act

Distribution decisions will be quite difficult for personal administrator to make. But, just like those great Sham Wow infomercials, "there's more!" How should the executor invest the funds withheld pending estate tax and state property law clarification? What is an appropriate time frame? Most executors opt to be conservative and liquid. That is usually not an issue since the time period for most estates is relatively short. But if a substantial portion of the estate will have to be held for what might be an undetermined number of years, how should those funds be prudently invested?

Alternate Valuation Date Issues

If an estate has declined in value by the alternate valuation date ("AVD") six months following death, and the estate or GST tax have been reduced, the executor can elect to use the alternate valuation date method to value estate assets. IRC Sec. 2032. If an asset is distributed or sold prior to the alternate valuation date the value is normally fixed on that date. When an executor considers the potential benefits of the alternate valuation date consideration must be given to when assets should be distributed. But with estate tax repealed, what happens if an executor succumbs to beneficiary pressure and distributes an asset say in mid-January and then in February Congress reinstates the estate tax. What valuation date should be used for that distributed asset? While under the general AVD rules the date of distribution should be used, there was no estate tax on the day of distribution. If the estate tax is made retroactive will that reinstatement permit executors to recapture interim distributions? That is no small matter as a distribution of a business or non-business asset could also affect whether a closely held business interest in the estate will qualify for the estate tax deferral.

Appraisals

The new carry over basis tax regime provides that the executor can allocate an increase in income tax basis increases for property passing under the estate up to a maximum of $1.3 million (not counting the $3 million special spousal adjustment). This allocation of basis increase, not surprisingly, cannot increase the basis of an asset above its fair market value as of the decedent's date of death. Although every asset is appraised at its fair market value there is no question that for most assets excluding marketable securities that there is a range in which the fair market value can be. The situation is complicated by the uncertainty over how estate tax repeal will be resolved. Most if not all practitioners anticipate that something will be done to avoid the confusion of carry over basis tax rules.

Example $1.3 Million Basis Step up Versus Estate Tax

Decedent died January 2, 2010 with an estate consisting of a single asset, a shopping center, with a tax basis of $9 million. Depending on the valuation assumptions concerning retail sales forecasts and overages rent and their impact on cap rates a range of $8.6 to $10.2 million is supportable as the fair value of the shopping center. If the appraised value of the shopping center was $10.2 million the tax basis could be stepped up to the full $10.2 million since it is less than the $1.3 million permissible basis step up. There would be no tax cost in achieving this basis step up and it will minimize future capital gains if the shopping center is ever sold. Executor obtains an appraisal and distributes interests in the shopping center to Decedent's heirs on February 10, 2010, after each heir has signed a receipt, release and refunding bond expressly agreeing to pay any estate tax if the tax were reinstated. In March Congress acts and reinstates the estate tax effective back to January 1, 2010. The valuation of the shopping center at $10.2 million results in a substantial estate tax. Had an $8.6 million appraisal been obtained the estate tax cost would have been substantially less. Thus, depending on whether carry over basis or estate tax applies the personal representative could face significantly different pressures as to how to handle the appraisal of estate assets. Even if the correct value were clearly determinable an executor obtaining an appraisal before the uncertainty as to what estate tax laws apply may face questions from beneficiaries.

Document Revisions Pending Congressional Action to Reinstate the Estate Tax

Clients Should Review and Act (But Few if any Will)

The bottom line for all clients is that they really need to have every estate plan and every document comprising that plan, reviewed to determine what steps if any should be taken. Few if any clients are likely to be willing to undertake such cost and time investment (meetings, etc.) especially with the law in limbo.

Revisions to Powers of Attorney

Gift provisions under all durable powers should be revised. If there will no longer be an estate tax, then the purpose of gift clauses needs to be re-evaluated. Since there is uncertainty the gift provision for some clients could be keyed into whether or not there is a federal or state estate tax. Clients should also evaluate whether they wish to have the risks of authorizing an agent to make gifts if the only potential tax benefit is a state estate tax savings. Consider the possible following clauses for a power of attorney:

Comment: Since in 2010 the estate tax has been repealed you may not wish to permit gifts. However, since the status of the estate tax is uncertain, the following has been drafted so that if the estate tax is reinstated, so too will be the right to make gifts. Unless there is a federal estate tax in force at the time that the Agent intends to consummate a gift transfer, then no gifts shall be permitted.

Comment: Under the carry over basis system there will be a $3 million spousal basis adjustment at death so that you may wish to consider unlimited gifts to take advantage of this. If at the time the agent intends to make transfers to my spouse, there is no estate tax but rather a carry over basis tax system is in place, and if under that system it is permissible and possible by a gift to transfer assets to my spouse so that there is a reasonable likelihood of those transferred assets achieving a step up in income tax basis, then the Agent hereunder shall be permitted to make unlimited transfers of appreciated property.

Revisions to Wills

If there is no federal estate tax applicable to your estate because repeal remains in effect (giving consideration to a reinstatement), then a common dispositive structure for someone residing in a state with no estate tax might be to bequeath the maximum amount to a marital trust that qualifies for the special $3 million spousal basis adjustment, with the remainder to a bypass trust. If the testator resides in a state which has an estate tax the preceding dispositive scheme may result in an increase in the state estate tax on the first death. In such instances it might be preferable to bequeath the entire estate to the marital trust with only an amount not in excess of the state estate tax exclusion being bequeathed to the bypass trust. Given the uncertainty as to whether or when Congress might modify the estate tax, it might be prudent to consider a time limit on the above criteria.

"If there is no estate tax on the date of my demise, and no estate tax is reinstated within Six (6) months of the date of my death, then…."

Wills should also have express language authorizing the executor to allocate the $1.3 million general basis adjustment and the additional $3 million spousal basis adjustment. This power perhaps should be exercised by an independent person, not a beneficiary who would benefit. This is far from a simple matter to address as the possibilities are endless. For example:

- What is the expected holding period for the property? If property, such as a family cottage, is intended to remain for generations in the family it is less in need of an allocation to increase basis than are other assets which are more likely to be sold.
- Are other avenues to avoid, defer or minimize the potential future capital gains tax available and how does their availability compare to other assets in the estate if the maximum basis adjustment has to be rationed to the various assets?
  - o **<u>CRT Example</u>**: I the estate holds raw land that is likely to be donated to the local church for an expansion project the basis adjustment is less important as compared to other assets if a charitable remainder trust could be used.
  - o **<u>1031 Exchange Example</u>**: If the estate owns a shopping center and rather than sell it a tax deferred Code Section 1031 exchange is a likely possibility, then the allocation of basis to the shopping center may be less advantageous than an allocation to other assets.
  - o **<u>Exchange Funds</u>**: If highly appreciated securities could be contributed to an exchange fund to diversify without incurring capital gains then these assets would be less in need of an allocation.
  - o **<u>Principal Residence</u>**: If the decedent's principal residence can be sold and exclude gain under the home sale exclusion rules then to the extent that that exclusion will avoid taxable gain, basis adjustment should not favor the residence.
- What will the capital gains tax rates be?
- What will the tax bracket and status of the beneficiaries receiving the property be?

The myriad of factors and competing interests of different beneficiaries will also make it difficult for advisers to evaluate and weigh the many options. How will counsel to the executor advise on the allocations? If there are no directives in the will (and how should those be drafted?) as to how the basis adjustment should be allocated, what framework can be used to make a determination? Clients might consider carving out specific assets that should or should not receive an allocation. This might include a direction not to favor a family business in the basis adjustment allocation because the testator's intent is that it not be sold.

Wills should be revised for those domiciled in states with estate tax systems to assure qualification for state estate tax marital deductions, but in a manner that does not vitiate the qualification for the $3.0 million spousal basis step up. "It is Testator's express intent that the above bequest and devise to a trust for Testator's spouse shall qualify for the state estate tax marital deduction if any portion or all of Testator's estate shall be subject to state estate tax. Further, said marital trust to the extent feasible shall conform with the requirements of a Qualified Spousal Property under Code Section 1022(c) if the carryover basis rules apply to decedent's estate for the purpose of the maximizing the assets in decedent's estate that qualify for basis adjustment. The basis adjustment applies to property which is qualified spousal property which includes an outright transfer property to the spouse, or qualified terminable interest property."

Testator directs the Estate Protector to take any necessary steps to modify this Last Will and Testament to achieve these objectives." Perhaps, a new function of an independent "estate protector," analogous to a trust protector, should be empowered to make any modifications to deal with the uncertainty.

Consider adding an independent fiduciary to every will and empowering that fiduciary to make certain changes and interpretations to carry out the testator's wishes in light of the substantial uncertainty. While a novel concept unsupported by case law or other authority, the "pickle" Congressional inaction has created is too unprecedented.

Bypass Funding – New Formula for New Paradigm

Prior to 2009 a bypass or applicable exclusion trust was valued based on a dollar amount of assets, e.g., $3.5 million in value if there was no state estate tax. The paradigm under a carryover basis regime has changed. Since the maximum basis step up that can be allocated to non-spouse property assets with appreciation of more than $1.3 million should not be allocated to a family trust in most situations. In effect it would be a three tier allocation:

1. $1.3 million of appreciation (assets valued from $1.3 million to infinite) to the family trust.
2. $3 million of appreciation (assets valued from $3 million to infinite) to the QTIP that qualifies as a QSP.
3. The balance wherever the client wishes which must be stated.

The first two tier allocation could be accomplished with a formula similar to that below, quite different from formulas under prior law.

If there is no federal or state estate tax on my death, and there is a carry over basis regime, then I give, devise and bequeath the assets selected by my Executor, or my Special Tax Executor if one is appointed and acting hereunder, that have in aggregate not more than $1.3 million in appreciation as of the date of my death (“Family Trust”) to be disposed of in accordance with the provision below "Family Trust". The balance of my estate shall be bequeathed to a QTIP the property of which qualifies as a Qualified Spousal Property (“QSP”), in the provision “QTIP Trust,” below, up to a maximum of $3 million of appreciation. Any assets remaining after the above two allocations shall be allocated to SPECIFY.

Sample Will Clause – Executor Broad Discretion to Deal with Uncertain Tax Environment and Avoid Tax Formula Clauses

Upon my death, if my spouse survives me, my Executor shall distribute my residuary estate, after the payment of debts, administration expenses, specific bequests and tangible property distributions provided for in the preceding articles, in trust for the benefit of my spouse and descendants (“Residuary Trust”). My Executor shall in the Executor’s discretion divide the assets distributed to the Residuary Trust into two or more separate trusts based on the Executor’s consideration of the criteria below and the Executor shall determine the status of each of such separate trusts. I recognize that the Executor will have to exercise broad discretion and make significant assumptions as to a range of factors including but not limited to the interpretation of current and future state and federal income, gift, estate and generation skipping transfer (“GST”) taxes, as well as possible tax status of current and perhaps future beneficiaries, holding periods for assets, and other factors. These considerations and decisions may include by way of example and not limitation:

- Qualify any one or more of such separate trusts for a state and/or federal estate tax marital deduction. I recognize that there may not be a federal or state estate tax marital deduction depending on the status of the tax laws, the state in which I am domiciled at death, and the date of my death.
- Allocate any portion or all of my remaining GST tax exemption if any and if applicable, to any one or more of such separate trusts. I recognize that there may not be a federal or state GST tax or GST exemption depending on the status of the tax laws, the state in which I am domiciled at death, and the date of my death.
- Allocate any portion or all of any basis adjustment, such as that provided for under Internal Revenue Code Section 1022, if any and if applicable, to any one or more of the assets held in my estate, or comprising part of the assets of my estate for tax purposes such that such allocations can be made. I recognize that there may not be a federal or state carry over basis rule depending on the status of the tax laws, the state in which I am domiciled at death, and the date of my death.
- If at the time of my death the tax laws provide for a bypass or applicable exclusion trust, or an analogous concept, I would direct my Executor to fund such trust for the benefit of my NAME-HEIRS, with the maximum amount that will not trigger federal or state estate tax on my death. However, I recognize that this approach may not necessarily be optimal for planning or funding of such trust MODIFY-ACCORDINGLY.

It is my general direction to my Executor that my Executor shall endeavor to divide the assets subject to their control in such manner and to such one or more trusts, as should, in their discretion, is potentially likely to minimize the aggregate state and Federal income, estate, gift and GST taxes payable by my estate, my heirs and the aforesaid trusts over the anticipated life expectancy of the current beneficiaries of said trusts ALTERNATE over the foreseeable future.

By way of general guidance to my Executor, had there been no estate tax, it would be my intent to divide my estate in the following manner and in the following order:

1. SOME-PERCENTAGE (%) of the value of my estate to a lifetime trust for my spouse, but hopefully not less than #MINIMUM DOLLARS ($.00).
2. SOME-PERCENTAGE (%) of the value of my estate to a lifetime trust for my spouse and children OTHER-HEIRS, but hopefully not less than MINIMUM-DOLLARS ($.00), nor more than MAXIMUM-DOLLARS ($.00).
3. The balance to the trust for my spouse my spouse and children other disposition.

It is my general intent in qualitative and not quantitative terms that STATE-OBJECTIVE.

Notwithstanding anything herein to the contrary, if the value of the trust created hereunder would be less then Fifty Thousand Dollars ($50,000.00) when funded, or at any later date shall become less than Twenty Five Thousand Dollars ($25,000.00) on any subsequent date when the Trust Estate is valued for purposes of computing Fiduciary commissions, the Fiduciary may, in the Fiduciary's discretion, terminate the Trust, or determine not to fund such Trust initially, and distribute the principal thereof to #my spouse. the income beneficiaries of such Trust in equal shares.

Sample Will Clause – Possible Pecuniary Bypass Trust Language

If at the date of my death there is a federal estate tax, or I am domiciled in a state that has an estate tax, then. I give, devise and bequeath the pecuniary sum which is the largest dollar amount which will not create a federal or state estate tax on my death, to the Trustee of my Applicable Exclusion Trust, in trust, (“Applicable Exclusion Trust”) to be disposed of in accordance with the provision below "Application of Applicable Exclusion Trust". I recognizes at the time of the execution of this will that there is no federal estate tax, and that the state exclusion for the state in which I presently am domiciled is New York is $1 million New Jersey is $675,000 and that such amount shall serve as the cap or maximum amount of funding to this trust in all circumstances. I recognize that if I become domiciled in a different state prior to my death and without changing this Will that the impact of this distribution scheme may be changed and this bequest may be eliminated. OPTIONAL I therefore state that the minimum distribution to and funding of this trust shall be not less than MINIMUM FUNDING ($.00).

Sample Will Clause – Possible QTIP Trust Language

If at the time of my death, my spouse survives me, and there is no federal estate tax, then the following trust shall be established for my surviving spouse ("QTIP Trust").

1. If there is no federal estate tax on my death and none is retroactively made applicable to the time of my death within Nine (9) months of the date of my death:
    a. I direct that a marital trust be funded even if there is no spousal marital deduction.
    b. I direct and I expressly authorize my Executor, or a Special Tax Executor if one is appointed and serving hereunder, to modify this QTIP to qualify for a state estate tax marital deduction if I am domiciled in a state that has an estate tax on my death, or if I own property taxable in such a state and the qualification of this trust for state estate tax for a marital deduction would materially reduce such state estate tax.
    c. If carryover basis rules apply I expressly authorize my Executor, or a Special Tax Executor if one is appointed and serving hereunder, to modify this QTIP trust in any manner necessary to qualify assets held by this QTIP trust as Qualified Spousal Property as such term is defined in Code Section 1022 or any similar or successor statute.
2. My Trustee shall hold, manage, and invest the amounts held in the QTIP Trust for the benefit of my spouse. My Trustee shall pay or apply all of the net income thereof to or for the benefit of my spouse in annual or more frequent installments.
3. My Trustee shall/may distribute to my spouse, so much or all of the principal of such Trust, OTHERSTANDARD: in accordance with the Standard for Payment defined below as shall be determined by my Trustee.
4. My Special Tax Executor shall, in his her or its discretion, determine whether or not to elect to qualify all, any part, or none of this trust for the marital deduction provided in Code Section 2056, for federal and/or state estate tax purpose if such an election is feasible. If there is no federal estate tax but my estate is subject to a state estate tax my Special Tax Executor shall take any actions necessary, including modification of the terms of this QTIP Trust to endeavor to qualify this bequest for the state estate tax marital deduction if feasible. #However, in no event may such modification entail the termination of or non-funding of this QTIP Trust. My Executor is hereby indemnified and held harmless for any decision regarding this election.
5. If all, or any part, of the QTIP Trust has been qualified for the marital deduction, then the following provisions shall apply to that portion, or all of such trust intended to qualify for the marital deduction:
    a. If required by applicable tax law or regulation to qualify this trust for the unlimited marital deduction, then in the year of my spouse's death, I direct my Trustee to distribute all of the remaining net income earned by the trust, through and including the date of my spouse's death, to the estate of my spouse.

b. I direct that my spouse shall have the right and power to compel my Trustee of this Trust to convert any non-productive property held in this trust into income producing property and that any provision of this Will which would prevent the allowance of the marital deduction for Federal estate tax purposes shall not apply to this trust. However, if the production and/or payment of income is not at some future date required by applicable tax law, and if this QTIP trust thereafter is invested and distributed using total return unitrust concepts, this right shall not be exercised in a manner that conflicts with total return investing and/or unitrust distribution concepts…….

Sample Will Clause – Executor To Allocate Basis Adjustment

If at the time of my death the tax laws provide for a basis adjustment, similar to that provided under Code Section 1022, then I give my Executor the authority to allocate such basis adjustment to assets over which my Executor has authority under applicable tax laws to make such allocation, wherever such property is located, to and among such assets as my Executor may direct and appoint by a written instrument delivered to each beneficiary or heir with respect to the specific article or articles to which an allocation is or is not made. The provision of such a written instrument to any beneficiary, heir or other appointee if adult, or if a minor of his or her parent or the person with whom he or she resides, shall be a full and sufficient discharge to the Executor from all liabilities with respect to the allocations so made. I request, but do not direct, that the Executor consider the following factors in making such an allocation:

- Possible future income tax rates.
- Anticipated holding periods for assets.
- Tax incentives that could minimize or defer the income tax consequences on selling assets.
- My intent that a particular asset be held for a short or long time period.
- Any wishes as I may have expressed to such Executor.

Sample Clause Appointing a Special Tax Executor

1. **Special Tax Executor Provisions**.

a. **Comment: Consider the possibility of designating an independent person as a "special" executor to make certain tax determinations. That person, if a fiduciary and "executor" would have to obtain letters testamentary or administration. It is not clear whether instead such a person could not be an executor, and in some other fiduciary or quasi-fiduciary capacity be granted the limited powers to make specified tax decisions. A significant issue is that these "limited" tax decisions, considering the combination of income, gift, estate and GST taxes, affect a substantial portion of the value of many estates. How can the decisions made be coordinated with that of the surviving spouse and how far can the role of some type of protector be carried? What would state law say in regards to such a new and novel "executor" type function?**

b. Purpose of Appointment; Statement of Intent.

i. Testator appoints a Special Tax Executor as a special Executor specifically intended to qualify under Code Section 1022(d) (3) if applicable, to make decisions that are directly or indirectly affected by subsequent tax developments (whether legislative, regulatory, or otherwise). These may include state or federal tax laws and may relate to income, capital gains, estate tax, gift tax, generation skipping transfer tax, inheritance tax and other taxes.

ii. The purpose of this appointment is to empower an independent fiduciary to facilitate carrying out Testator's wishes as embodied in this Will in the event that subsequent tax developments change the assumptions upon which this Will and the dispositive scheme hereunder were prepared, including but not limited to the funding of trusts, provisions for which bequests and devises shall bear which tax costs, and to which assets, exemptions, and other tax attributes shall be allocated or applied.

iii. In the event of any conflict in the exercise of powers by the Special Tax Executor and the Executor or any other fiduciary appointed under this Will, the powers of the Special Tax Executor shall control.

1. **Comment**: **Considering the tremendous uncertainty as to what the estate tax law is and will be consider creating an independent fiduciary position to take certain actions to ameliorate unforeseeable situations.**

c. Designation of Person To Serve as Special Tax Executor.

i. My estate, and any trust formed under this, my Last Will and Testament ("Will"), may be funded, and administered without restriction if no person is serving as Special Tax Executor.

ii. The Special Tax Executor shall be the first of the following who is able and willing to serve, so long as such individual is not serving as a Executor:

1. NAME1

2. NAME2

3. A person designated in writing by a majority vote of the INIDICATE NAMES OF BENEFICIARIES Current Beneficiaries Children [define] who are then living.

iii. The person so selected to serve as Special Tax Executor may not be:

1. Any current beneficiary of any trust formed under this Will, or a beneficiary of any bequest or devise under this Will.

2. Related to or subordinate to any #Current Beneficiary.

3. An executor of this Will, or a Trustee of any trust formed hereunder. However, if such person is named as a successor Executor of my Will, or

as a successor Trustee of any trust formed under this Will, then said person may serve as the Special Tax Executor.

d. Powers of Special Tax Executor.

i. The Special Tax Executor shall only have the powers set forth herein below.

1. **Comment: With the tremendous uncertainty presently existing giving broad powers to adapt and reinterpret provisions of a will may provide a safety valve pending resolution of final tax legislation. Once final tax legislation is enacted so that there is some degree of certainty as to the tax laws, the concept of an Special Tax Executor may remain useful, e.g., allocation of tax basis if the carry over basis rules survive, but the powers should be revised to reflect the then current tax environment.**

2. **Comment: Some of the powers indicated are analogous to those given to a trust protector in many trusts, but they may have important tax consequences, e.g. lessening or enhancing nexus to a particular state for a testamentary trust for income tax purposes, etc**.

ii. Sign in such capacity any income, estate or other tax return as to the decisions made by such Special Tax Executor.

iii. Allocate the basis adjustment provided for under Internal Revenue Code Section 1022 or any successor statute among the assets in Testator's estate such that the authority to allocate the basis adjustment maybe exercised. This authority may be exercised over such assets whether or not subject to probate or distribution under this Will, or whether non-probate assets passing outside of the Estate. The Special Tax Executor shall consider the anticipated holding period for assets, any indication in this Will or otherwise by Testator that certain assets should be held or not held, the investment directions in this Will and any trust formed hereunder, the possible needs of beneficiaries and any other matters the Special Tax Executor deems appropriate.

iv. Conforming any marital trust so that it meets the requirements of constituting a Qualified Spousal Property ("QSP") under IRC Section 1022, if such law applies to the Estate.

v. The interpretation and application of any formula provided for under this Will for the funding or non funding of a bypass (applicable exclusion or similar type of trust), marital (QTIP or otherwise) trust formed under this Will in a manner that in the Special Tax Executor's reasonable discretion carries out Testator's wishes hereunder. This power shall only be recognized in the event that there have been changes in the federal and/or state tax laws that could reasonably change the interpretations, calculations, and consequences of such formula clauses, and which in the Special Tax Executors determination, Testator did not factor into the determination of such clauses.

vi. The determination as to which assets to allocate to which trusts or bequests if no specific direction as to such asset or trust is contained elsewhere in this Will.

vii. Remove and replace any institution serving as Executor, or Co-Executor, or named as Trustee or co-Trustee of any trust formed or to be formed under this Will even if not yet appointed. If the Special Tax Executor removes any institutional Executor, the Special Tax Executor shall appoint another institutional Executor. If an institutional fiduciary is removed a successor institutional fiduciary shall be named. The successor institution may be located in any jurisdiction selected in the discretion of the Special Tax Executor.

viii. Select a person or institution to serve as investment counsel, money manager or in such similar role directing investments ("Investment Advisor"). To remove an Investment Advisor and select another Investment Advisor.

ix. Determine state income, estate, inheritance or other tax filing status, and tax filing positions, relevant thereto on Testator's final income tax returns.

x. Determine the tax positions to be taken by the Estate as to Testator's residency and domicile for state tax purposes on any estate, inheritance or other filings.

xi. Change situs and/or governing law of any trust formed under the Will.

xii. The Special Tax Executor may reasonably interpret the terms of the Will in order to:

1. Take advantage of opportunities to minimize income, gift, estate and other tax costs for Testator's estate and/or the trusts formed under this Will, and or the estate and/or trust beneficiaries. Testator recognizes the possibility of competing interests in regards to these decisions, the difficulty of weighing the myriad of potential current, and possible future tax laws, and gives wide latitude to the Special Tax Executor in this regards.

2. Respond to changes in state or federal tax law, including case law and regulations that the Special Tax Executor determines adversely affect the administration of this Will or that may possibly adversely affect the funding or administration of any of the trusts formed under this Will.

3. Respond to changes in circumstances that adversely affect the tax status of Testator's estate for income, estate, generation skipping transfer and other taxes, and/or of the trusts formed under this Will, or the beneficiaries, in a manner which the Special Tax Executor reasonably would not have believed the Testator to have anticipated.

e. <u>Application of Special Tax Executor's Powers</u>.

i. The Special Tax Executor's powers are granted in a fiduciary capacity.

ii. The Special Tax Executor shall not be liable for any action taken in good faith # in the absence of bad faith, intentional misconduct or gross negligence, shall not be held liable for any action or omission #SET STANDARDS#.

iii. No bond or security of any kind shall be required of any Special Tax Executor acting hereunder or appointed pursuant to the provisions hereof.

iv. The Special Tax Executor is not responsible to monitor the administration or actual tax filings of the Testator's estate or of any trust formed under the Will to determine whether powers or rights exercised hereunder have been carried out as directed.

f. Limitations on Powers and Responsibilities of the Special Tax Executor.

i. No Special Tax Executor may exercise any power in a manner to benefit such Special Tax Executor, or such persons spouse or descendants of either.

ii. No Special Tax Executor may posses or exercise any power that would constitute a general power of appointment as such term is defined under Code Section 2041 and 2514 and the Regulations thereunder or that would cause the Special Tax Executor to become an owner of any portion of the Estate or trust created hereunder.

g. Special Tax Executor Resignation.

i. Any Special Tax Executor hereunder may resign at any time without obtaining prior judicial approval.

ii. Such resignation shall be effective upon the delivery of an instrument in writing declaring such resignation to the Executor, Trustees #and the Current Beneficiaries, as defined above.

iii. The resignation shall not be deemed complete until the delivery of all copies of all documents and records (whether physical or electronic) which have come been transmitted to the resigning Special Tax Executor to the successor Special Tax Executor, named above, or if none, the Executor.

h. Compensation of Special Tax Executor.

i. Any person serving as Special Tax Executor shall be entitled to reasonable compensation for services rendered in such capacity and the Executor is directed to pay same at reasonable intervals. Such compensation shall consider, but not be limited to a reasonable hourly wage for services rendered, as well as consideration of the level of responsibility and effort involved, and the risk and liability assumed. ALTERNATIVE COMPENSATION ARRANGEMENT

ii. The Special Tax Executor shall be entitled to reimbursement by the Executor for any expenses incurred by the Special Tax Executor in the execution of the duties powers and responsibilities as Special Tax Executor. These expenses may include by way of example and not limitation the costs of consulting with independent counsel, tax advisers, accountants and investment advisers, the preparation of projections of net of tax investment returns and other relevant matters. The listing of permissible expenses for reimbursement shall not create any obligation on the Special Tax Executor to undertake any such steps.

Actions on Irrevocable Trusts

Many irrevocable trusts, such as irrevocable life insurance trusts (“ILITs”) include a marital savings clause that provides that if the insured/grantor dies within three (3) years of the transfer of insurance to the trust the insurance will be held in a marital savings trust that qualifies for the estate tax marital deduction. But what will be the impact of that provision if there is no federal estate tax in force on the decedent’s death?

Sample ILIT Clause

“Notwithstanding anything herein to the contrary, if the amounts payable under insurance policies on the life of the Grantor held in this Trust or the amounts payable under insurance on the life of the Grantor for which the Trustee has been designated beneficiary (collectively, the "Proceeds") are included in the Grantor's gross estate for the federal estate tax, and Grantor's spouse is then living, then the Trustee shall hold such proceeds, in trust, and shall manage, invest, and reinvest the same, to collect the income thereof, and to pay over the net income to Grantor's spouse, or to apply the same for the benefit of such spouse, in convenient installments, but at least annually, and so much of the principal as may be necessary or appropriate in accordance with the Standard for Payment, during such spouse's life.”

If the federal estate tax is not in force on death then the above clause would not operate to create a marital savings clause and it could result in a substantial and otherwise deferrable state estate tax on the death of the first spouse to die who established an ILIT.

Actions to Address Failure of Savings Clause

It may be feasible under such a trust to have a court reform the trust prior to death to have the clause reinterpreted to mandate a marital trust for state estate tax purposes. But prior to the issue becoming a real dispute with the state tax authorities it is unlikely that anyone would be willing to take such action. However, if the testator/grantor were in ill health and the insurance in issue substantial, pursuing every avenue might be worthwhile. If the ILIT includes a clause to modify the trust to achieve certain tax objectives, or if the ILIT appoints a trust protector given those powers, an action may be feasible by the fiduciaries to attempt to rectify the situation but it is not clear how state tax authorities, desperate for tax revenues, may view such an action. For example, if the ILIT trust protector powers included language similar to the following: “Respond to changes in circumstances that adversely affect the Trust or the beneficiaries in a manner which the Trust Protector reasonably would not have believed the Grantor to have anticipated,” it might support an action by the protector to ameliorate the issue.

EDITOR'S NOTE: An ILIT may not be able to buy an asset from the estate as was a normal procedure in the past to infuse cash into the estate to make bequests and pay taxes because there may be gain triggered on what was always assumed to be a tax free transaction. So, if carry over basis actually sticks, loans by ILITs may be the only viable route to provide an illiquid estate with the cash it needs.

Professional Advisers Should Act

Is There A Duty to Inform Clients

Advisers should consider reaching out to clients, and perhaps former clients, and informing them of the magnitude of the issues and encourage them to address planning. Far too many clients never return to review their planning and routinely ignore newsletters and other information given them. It certainly seems appropriate and reasonable to assume that the substantial media coverage given to the Congressional guffaw on the estate tax should suffice to put every client on notice of the issues. For example, on December 18, 2009 The New York Times featured an article "Estate Tax Is Expiring But Death Won't Last," and there were many more.

It is also important to note that almost all clients are adverse to complexity and costs. So even practitioners that may have endeavored to discuss post-2001 Tax Act the implications of estate tax repeal likely did not receive a favorable reaction from clients, let alone the willingness to discuss the possibilities, how to plan for them or a willingness to pay for the time involved.

Professional advisers are probably safer if they endeavor to notify clients of the magnitude of the issues. A likely problem is that too many clients/testators might assume that the repeal of the estate tax is a good deal. While it may be vis-à-vis a tax bill, it remains in many cases a potential family and personal calamity from a property distribution perspective.

How To Handle Drafting and Planning

The situation created by Congress is really not a lot of fun. Practitioners really should incur the time and cost to inform clients of the potentially issues and the needs to update their planning and documents. Practitioners should also bear in mind that many former clients might just claim they continue to remain clients if they need someone to sue because a testamentary plan goes awry. The complexities of determining who the client was, and whether or which heirs have the position to sue the practitioner, and so on, are daunting. Even those viewed as non-clients might have in some instances standing to sue. The court in the landmark decision of Ultramares Corp. v. Touche held that the non-client must have a relationship to the professional so close that it approaches privity of contract.255 N.Y. 170 (1931). See also Credit Alliance Corp. v. Arthur Andersen & Co., 65N.Y.2d 550.

The downside is that the cost and effort may be for naught if Congress reinstates estate tax. Also, as many of these issues become clearer and are hopefully resolved by some future legislation, nuances of that legislation may require clients that have only just revised estate planning documents to revise it again.

Restrictions on Disclosure of Tax Return Information Code Section 7216

CPAs should consider the rules governing the use of tax return information Treas. Reg. 301.7216. And this no jaunt down the yellow brick road. Tax return information is defined to mean “any information, including, but not limited to, a taxpayer’s name, address, or identifying number, which is furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer. Treas. Reg. Sec. 301.7216-1(b)(3)(i).

As a tax return preparer you may compile and maintain a separate list containing certain information regarding taxpayers whose tax returns the tax return preparer has prepared or processed. This list may be used by the compiler solely to contact the taxpayers on the list for the purpose of providing tax information and general business or economic information or analysis for educational purposes, or soliciting additional tax return preparation services to such taxpayers. The list may not be used to solicit non-tax return preparation services to these taxpayers. Treas. Reg. Sec. 301.7216-2(n).

A tax return preparer will not be liable for penalties under IRC Sec. 7216 and 6713 when the tax return preparer discloses tax return information contained in the list permitted to be maintained by the tax return preparer under Treas. Reg. Sec. 301.7216-2(n) to a third-party service provider that creates, publishes, or distributes, by mail or e-mail, newsletters, bulletins, or similar communications to taxpayers whose tax returns the tax return preparers have prepared or processed containing tax information and general business and economic information or analysis for educational purposes or for purposes of soliciting additional tax return preparation services for the tax return preparer. Rev. Rul. 2010-4.

But alas, this is not an automatic “Pass Go, Collect $200.” You have to assure that the publisher has procedures in place that are consistent with good business practices and designed to maintain the confidentiality of the disclosed tax return information and, that by the publisher following these procedures, which you apparently must have some idea of what they are, you can conclude that the publisher has sufficient data confidentiality procedures in place to assure the confidentiality of your tax return data. Further, the publisher/fulfillment house must acknowledge to you that it is prohibited from the further use or disclosure of the tax return information (names and addresses) provided to it by you for purposes other than those related to the provision of the printing and mailing of your newsletter, or other mailings. Wow, not only is the estate tax gap complex to understand, but then you have to figure out how to explain it to your clients, and even if you figure that out, you then have to jump through hoops of 7216 and Rev. Rule. 2010-4, to even be able to communicate it.

Attorney Client Privilege Issues

Attorneys should consider rules governing attorney advertising. Other considerations might apply.

Conclusion

There has never in history been such confusion and disarray in the tax system. It is likely that significant portions of this memorandum will be outdated before you are able to read or apply them. Even portions not outdated may be rendered moot by future developments, or better planning options. But while caution is in order, inaction and indecision, as Congress has so aptly proved, is itself a decision.