

Estate Tax Issues in 2010: Still Crazy after all these Years

By Henry G. Will

Our saga began in 2001 when EGTRRA¹ was passed by Congress and signed by President George W. Bush. Everyone knew the federal estate and generation-skipping transfer (GST) taxes expired on Dec. 31, 2009, so everyone thought Congress would enact a permanent fix effective in 2010. Over the past 10 years under EGTRRA, the federal estate tax went through a series of changes so that in 2009 the exemption amount (unified credit) for each decedent was \$3.5 million and the top estate tax rate was 45 percent. Most practitioners felt confident that this tax regime would be made permanent by Congress for 2010 and the following years, with a few tweaks, of course. However, the extremely partisan Congress did not pass legislation in 2009 to stabilize the estate tax. On Jan. 1, 2010, the "impossible"² happened: The federal estate and GST taxes expired and the estate tax world became crazier than ever.

Well into the fourth quarter of 2010 there is no clarity on federal estate and GST tax law from Congress. While estate planners have become familiar with the law now in effect in 2010 and that which is on the books for 2011, much interpretation of existing law and speculation about proposed legislation has left us very uncertain about how to guide our clients. It is still crazy after all these years.

This article will review the estate tax and related laws in 2010, some of the issues raised by the status of the law in 2010 and the sunset of EGTRRA at the end of 2010, the prospect of pre-EGTRRA (*i.e.*, 2001) law returning

in 2011, practitioner responses to the current situation and prospects for legislation.

ESTATE TAX LAW IN 2010

In 2010, no federal estate tax applies to estates of decedents dying after Dec. 31, 2009³ (although a retroactive estate tax could be passed), no GST tax applies to generation-skipping transfers made after Dec. 31, 2009⁴ (although a retroactive GST tax could be passed), and a modified carryover basis (instead of a stepped up basis) applies to assets of decedents dying in 2010.⁵ The federal gift tax continues to apply to lifetime transfers made during 2010, subject to a lifetime exemption of \$1 million and a per

donee exclusion of \$13,000. Importantly, the gift tax rate in 2010 is 35 percent,⁶ but this rate will change to a top rate of 55 percent in 2011.⁷ Will Congress in 2010 enact estate and GST taxes retroactive to the beginning of 2010, or will any tax adopted be prospective only? If estate and GST taxes are adopted (whether effective in 2010 or 2011), will they be similar to what was in effect at the end of 2009 with a \$3.5 million applicable credit amount and a top tax rate of 45 percent, or will there be significant modifications? Will Congress eliminate the federal estate and GST taxes altogether? Will Congress let the 2001 estate tax regime scheduled to become applicable in 2011 as is now provided by the sunset rules of EGTRRA?⁸

Publicity about recent deaths of wealthy Americans in 2010 keeps speculation alive about the estate tax.⁹ However, most planners have stopped guessing what Congress will do because they were surprised (if not shocked) when the 2009 estate and GST tax laws were allowed to expire with no successor estate or GST tax for 2010.¹⁰ Many professionals in the estate planning field have called for Congress to act, including some who appeared before Congress urging action to provide clarity in this area. For example, the Iowa Bar Association wrote a letter with over 1,000 lawyers' signatures to Sen. Grassby urging legislation and the American College of Trust and Estate Counsel (ACTEC) detailed the many issues that have surfaced and how they could be corrected¹¹ and circulated the list to congressional staff members.

ISSUES IN 2010 CAUSED BY ONE YEAR ESTATE AND GST TAX SUSPENSION AND THE SUNSET PROVISIONS OF EGTRRA

Estate planners have struggled throughout 2010 to identify and answer many questions raised by EGTRRA's provisions for suspension of estate and GST tax laws, the sunseting of EGTRRA on Dec. 31, 2010, and the uncertainty about future laws that may replace those now on the books. Early in 2010, ACTEC identified many important issues raised by the one-year suspension of federal estate and GST taxes. See Exhibit A hereto for a complete list of the issues summarized by the Washington Affairs Committee of ACTEC for congressional staff members on Feb. 22, 2010.¹² Of particular importance are problems with the GST tax (assuming it is reinstated) because events occurring in 2010 that are not taxable can have a dramatically adverse

GST tax impact years later.¹³ Some counsel have suggested that gifts to grandchildren in trust be avoided in 2010, or that gifts be made to donor's children, who in turn would fund a trust for their own children in order to avoid the donor's "transfer" to a GST trust. Other anomalies possibly resulting from the sunset provision of EGTRRA include the following:

- (a) Gifts deemed to have been completed in 2010 because of Code Section 2511(c) under the law as written must be disregarded if EGTRRA is treated as if it had never been enacted: Will future gift tax calculations need to take the 2010 transfers into account under Section 2502(a)?
- (b) If carryover basis applies in 2010 but is to be treated as if it had never been enacted due to the sunset provisions of EGTRRA Section 901, will a sale of the property after 2010 use carryover basis or stepped-up basis to determine gain or loss for income tax purposes?

GUIDANCE IN 2010

In 2010, estate planners have been guided by numerous estate planning articles, books and seminars that focus on the current unique situation. Two seminal documents published early in 2010 have provided excellent guidance for estate planners this year.¹⁴ Using this guidance, we now are notifying clients of the uncertain state of affairs, reviewing documents for hidden traps such as tax-based formula clauses for funding marital and by-pass trusts and other provisions in wills and trusts that might have unintended consequences depending on how the tax law applies upon a client's death, and counseling against transfers to GST trusts. In 2010, estate planners are trying to more clearly specify in wills and trusts how distributions are to occur if no estate or GST tax applies to the decedent's estate and to draft flexible provisions that allow an estate plan to work for a client whose death occurs in 2010 or later in spite of the current uncertainty of the tax laws. Other popular techniques include making lifetime gifts to QTIP trusts and postponing the QTIP election until there is more clarity, making lifetime gifts at lower gift tax rates in 2010, using QTIP trust marital deduction provisions in testamentary documents so that elections can be made after death if an estate or gift tax continues and an election is needed to qualify for the marital deduction, disclaimer arrange-

ments in testamentary documents, and trust protectors with powers to amend. In addition, sophisticated lifetime transfers are very popular, such as those to charitable foundations and to younger generation beneficiaries, including transfers by way of GRATs, CLATs, CRUTs and sales to defective grantor trusts, when these seem appropriate for the client. Past midyear 2010, we continue to use valuation discounts for minority interests and lack of marketability.

To aid the interpretation of documents prepared before 2010 by decedents whose death occurs in 2010, several states (but not Oklahoma) have adopted special statutes that establish presumptions for interpretation.¹⁵

NO OKLAHOMA STATE DEATH TAX

Oklahoma decedents who die in 2010 (and later) are spared tax and complications because the Oklahoma Estate Tax was repealed effective Jan. 1, 2010.¹⁶ However, other state death taxes may apply depending on the situs of the decedent's property, thereby giving rise to questions about computation of the estate tax in such other jurisdictions when no QTIP election for federal purposes is allowed due to the absence of a federal estate tax.¹⁷

LAW TO BECOME APPLICABLE IN 2011

If EGTRRA "sunsets" as now written, in 2011, the following taxes will be in effect:¹⁸

- 1) A federal estate tax will apply to decedents' estates subject to a \$1 million unified credit and a top tax rate of 55 percent (60 percent for transactions between \$10 million and \$17,184,000);
- 2) Generation-skipping transfers made during lifetime or by a decedent at death will be taxed at a rate of 55 percent (60 percent for transfers between \$10 million and \$17,184,000) with an exemption of \$1 million adjusted for inflation;
- 3) The federal gift tax will apply to lifetime transfers as it does in 2010 but with a top tax rate of 55 percent (60 percent for transfers between \$10 million and \$17,184,000) and the \$1 million lifetime exemption and the \$13,000 per donee exclusion will continue to apply;
- 4) The estate and gift tax systems will be unified as they were in 2001; and

- 5) Carryover basis will expire and stepped-up basis will apply again as before 2010.

Although law to this effect has been enacted by Congress, it is anyone's guess whether such law will remain in effect.

THE BIG QUESTION: WHAT WILL HAPPEN TO THE FEDERAL ESTATE AND GST TAXES?

What we don't know is how long the federal estate, GST and gift tax regimes scheduled to become effective in 2011 will remain in place or whether such taxes will be applicable at all in 2010 and thereafter. Another very serious question is whether Congress will "fix" the issues created by EGTRRA.¹⁹

The Obama Administration Proposals

President Obama's 2010 budget assumes that a federal estate tax will be in effect similar to that which existed in 2009. In addition, the Obama Administration announced in the Greenbook for 2009 three proposals that would affect federal estate and gift taxation. These appear in H.R. 436 as proposed by Rep. Pomeroy in 2009 and in S. 3533 as proposed by Sen. Bernie Sanders in 2010 and may be expected in regulations under Code Section 2704(b) and other proposed legislation. The proposals are stated as follows in the 2009 Greenbook:²⁰

- 1) **Require Consistency in Value for Transfer and Income Tax Purposes.** "This proposal would require both consistency and a reporting requirement. The basis of property received by reason of death under section 1014 would have to equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor would have to equal the donor's basis determined under section 1015. This proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary information to both the recipient and the IRS. A grant of regulatory authority would be included to provide details about the implementa-

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tion and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return. The proposal would be effective as of the date of enactment.”

2) **Modify Rules for Valuation Discounts.**

“This proposal would create an additional category of restrictions (disregarded restrictions) that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transfer’s family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard identified in regulations. A disregarded restriction also would include any limitation on a transferee’s ability to be admitted as a full partner or holder of an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to

permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions. This proposal would apply to transfers after the date of enactment of property subject to restrictions created after Oct. 8, 1990 (the effective date of section 2704).”²¹

3) **Require Minimum Term for Grantor Retained Annuity Trusts (GRATs).**

“This proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of 10 years. Although a minimum term would not prevent “zeroing-out” the gift tax value of the remainder interest, it would increase the risk of the grantor’s death during the GRAT term and the resulting loss of any anticipated transfer tax benefit. This proposal would apply to trusts created after the date of enactment.”

Proposed Legislation Regarding the Estate Tax

In January 2009, Sen. Pomeroy started the process of legislation that would “fix” the estate tax by introducing H.R. 436, the “Certain Estate Tax Relief Act of 2009.” H.R. 436 would continue the federal estate and GST taxes in 2010 as they were at the end of 2009 and would repeal the carryover basis rules. Subsequently, many estate, gift and GST tax bills have been introduced in Congress and it is likely that many more bills affecting the federal estate, gift or GST taxes will be introduced for consideration in 2010. Bills and resolutions in the U.S. Congress can be found on the Internet at www.govtrack.us Following are the principal bills proposed as of the date of preparation of this article that would affect estate planning.

A. **H.R. 4154** “Permanent Estate Tax Relief for Families, Farmers and Small Businesses Act of 2009.” This bill was passed by the House of Representatives on Dec. 31, 2009 and sent to the Senate on Jan. 20, 2010. H.R. 4154 would:

1) Repeal carryover basis (by repealing Subtitles A and E of title V of EGTRRA);

- 2) Retain the estate tax (by repealing the Sunset provision in Section 901 of EGTRRA);
- 3) Establish a \$3.5 million applicable exclusion amount (by amending section 2010(c) of the Code); and
- 4) Establish a 45 percent maximum estate tax rate (by amending section 2001(c) of the Code).

H.R. 4154 also would establish the "Statutory Pay-As-You-Go Act of 2009." However, on Feb. 12, 2010, President Obama signed H.J. Res. 45 which increased the federal debt ceiling to \$14.3 trillion and contains Pay-As-You-Go rules. Accordingly, the Pay-As-You-Go issue has been separated from proposed estate tax legislation.

B. S. 3533 "Responsible Estate Tax Act." This bill was introduced by Sen. Bernie Sanders (I-VT) on June 24, 2010. If adopted, it would:

- 1) Repeal carryover basis (by repealing subtitles A and E of title V of EGTRRA);
- 2) Reinstate estate and generation-skipping taxes (by repealing the Sunset provisions in section 901(a) of EGTRRA)
- 3) Establish a \$3.5 million unified credit against the estate tax;
- 4) Establish the following estate tax rates on estates over \$3.5 million:
 - 45 percent on assets over \$3.5 million up to \$10 million;
 - 50 percent on assets over \$10 million up to \$50 million; and
 - 55 percent on assets over \$50 million.
- 5) Impose a 10 percent surtax on assets in excess of \$500 million;
- 6) Retroactively reinstate the estate tax back to Jan. 1, 2010;
- 7) Disallow minority interest discounts for "non-business" assets; and
- 8) Provide additional relief for farmers, allowing them to reduce the value of their farmland by \$3 million.

In addition, S. 3533 contains the following provisions to enact the Obama Administration proposals:

1) Grantor Retained Annuity Trusts: S. 3533 would require GRATs to (a) have at least a 10-year term, (b) prevent annuity payment amounts from decreasing during the first 10 years and (c) include remainder interests with a value greater than zero determined at the time of transfer.

2) Basis Information: S. 3533 would enact new Code section 6035 that would require (a) the executor of each estate to furnish each person acquiring property from the decedent a statement of the value of the property, and (b) the person who gifts property and is required to file a gift tax return to furnish the donee a statement of the adjusted basis of the property, the fair market value of the gift, the amount of gain or loss recognized by the grantor on a transfer to a trust and the amount of gift tax paid by the transferor. In addition, (c) Section 1014 would be amended to require the basis to be used by the acquirer of the property consistently with the information reported to such person under section 6035.

3) Valuation Rules for Certain Transfers of "Non-business Assets": S. 3533 would not allow valuation discounts with respect to "non-business assets," which are defined generally as any asset not used in the active conduct of a trade or business. Passive assets are defined to include several classes of property, including cash, debt instruments, commodities, collectibles and assets which produce royalty income (other than a patent, trademark or copyright). Exceptions are made for certain passive assets including real property used in the active conduct of a real property trade or business in which the transferor materially participates.

Other Notable Legislative Proposals affecting Estate, Gift or GST Taxes

C. Tax Extenders: H.R. 4213, the "American Jobs and Closing Tax Loopholes Act of 2010," included several tax extenders including one for IRA charitable rollovers, but it failed to pass the Senate.

D. GRAT Limitations. Several bills include provisions similar to those in S. 3533 to amend Code §2702's definition of "qualified interests" and provide that a retained annuity interest will only be a qualified interest if the term of the interest is "not less than 10 years," the annuity payments don't decrease from one year to the next, and the remainder interest in the GRAT is greater than zero.

E. Possible Vehicle for an Estate Tax Bill: H.R. 5486, the "Small Business Jobs Tax Relief Act of 2010" was passed by the House on June 15, 2010. The bill was combined with H.R. 5297, the "Small Business Lending Fund Act of 2010" and has been approved by the House. The combined bill has been sent to the Senate as H.R. 5297, the "Small Business and Infrastructure Jobs Tax Act of 2010." It may become a vehicle for estate tax legislation.

F. Discount Limitations. Minority interest and lack of marketability discounts are targeted in the provisions of H.R. 436 and S. 3533 and may indicate what is to come.

G. In July, Sens. Kyl (R-AZ) and Lincoln (D-AR) indicated they might introduce a bill in the Senate to establish an estate tax with a \$3.5 million exemption that will increase over time to \$5 million, and a top tax rate of 45 percent. Commentators did not expect it to succeed.

PREDICTION

In the fourth quarter of 2010, it is dangerous to make predictions, but the political situation in Washington, D.C. leads to a logical one: After the 2010 elections in November, the "lame-duck" Congress may have the fortitude to continue the major provisions that were in the 2009 law by enacting something like the Sanders bill (S. 3533) for a temporary period of two or three years. That would enable Congress to avoid "raising taxes" by the return of pre-EGTRRA law when EGTRRA sunsets and to delay final decisions about a highly emotional topic until after the presidential election in 2012.

While 2010 has been challenging, the uncertainty and multiple legislative possibilities have caused us to focus on facets of federal estate, GST and gift tax law we have not closely reviewed before. In order to serve our clients

well, it is absolutely essential that we remain alert. Stay tuned for interesting developments the rest of this year.

1. EGTRRA means Pub. L. No. 107-16, 107th Cong. 1st Session (June 7, 2001), known as the "Economic Growth and Tax Relief Reconciliation Act of 2001."

2. Some of the country's leading lawyers and commentators wrote a comprehensive article in February 2010 entitled, "The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010," Jonathan G. Blattmachr, Mitchell M. Ganns, Howard M. Zaritsky and Diana S.C. Zeydel in *Journal of Taxation*, February 2010, at 68ff (hereinafter cited as Blattmachr, et al 2010 *JT* article").

3. EGTRRA in Section 501(a) added §2210 to the Internal Revenue Code of 1986, as amended (the Code) that provides "(a) in general...this chapter (Chapter 11) shall not apply to estates of decedents dying after Dec. 31, 2009."

4. Code Section 2664, added by EGTRRA, states that the GST tax rules do not apply to "generation-skipping transfers made after Dec. 31, 2009."

5. Under EGTRRA, Code Sections 1014(f) and 1022(a) give a person who receives property from a decedent who dies during 2010 an adjusted basis equal to the lessor of the fair market value of such property on the decedent's death or the adjusted basis of the property in the hands of the decedent, subject to two basis adjustments: a \$1.3 million aggregate basis increase and the \$3 million "spousal property basis increase."

6. The 35 percent gift tax top rate was imposed by EGTRRA.

7. Fifty-five percent was the top gift estate and GST tax rate before EGTRRA was enacted. The sunset provisions of EGTRRA Section 901 have the effect of restoring the tax rates in effect before EGTRRA was enacted in 2001.

8. Section 901 of EGTRRA is referred to as the "sunset provisions of EGTRRA."

9. Some interesting cases have been noted in the press. The estate of Donald Duncan, a Texas billionaire who died in 2010 with an estate estimated to be \$9 billion might escape estate taxes altogether because of the "fortuitous" timing of his death, although (absent a retroactive tax) assets in his estate will be subject to the modified carryover basis which could result in large income taxes when his property is sold by his heirs. George Steinbrenner's death in July 2010 raised some similar observations.

10. "No one can predict accurately what Congress will do in 2010 regarding the estate and GST taxes...Anyone who claims to know what Congress will do should be considered a dangerously unreliable source of information." Howard M. Zaritsky, *Practical Estate Planning in 2010*, Thomson Reuters/WG&L, published in March 2010 (hereinafter cited as Zaritsky, *Practical Estate Planning*).

11. ACTEC prepared a list of specific proposals to correct questions left open and confusing in the current law. See "Addressing Technical Issues Relating to the Estate and GST Taxes," June 18, 2010, at the ACTEC public website, ACTEC.org under "Legislative and Regulatory Analysis." Also, see Howard M. Zaritsky, "Practice Alert: GST Planning in 2010 - Another Fine Mess They've Gotten Us Into." *RIA Planners Alert*, July, 2010, pp 2-3.

12. "Issues Raised by the One-Year Suspension of the Estate and GST Taxes," Feb. 22, 2010. Exhibit A hereto is a reproduction of the ACTEC summary of issues which can be found on the ACTEC public website at ACTEC.org.

13. Zaritsky notes that direct-skip transfers in trust in 2010 could lose the benefit of the move-down rule of Code Section 2653(a) that ordinarily would protect subsequent transfers from GST tax. The risk is that since Code Section 2664 states that the GST tax rules do not apply to generation-skipping transfers after 2009 may eliminate the move-down rule. Even though the EGTRRA "sunset" rule states that tax laws apply to transfers after 2010 as if EGTRRA (including Code Section 2664) "had not been enacted," one cannot be certain how IRS and the courts will interpret the "never been enacted" language. See Zaritsky, op cit at p.2. Similar risks of interpretation of the sunset rules apply to annual exclusion gifts in trust and discretionary distributions to possible skip persons from testamentary generation-skipping trusts created by estates of decedents who die in 2010.

14. See Blattmachr, et al 2010 *JT* article, and Zaritsky, *Practical Estate Planning*.

15. An attempt was made to amend Title 84 of the Oklahoma statutes by adding new Section 187 that would have provided a will, trust or other instrument of a decedent who died in 2010 that contained a formula referring to various provisions of the federal estate or GST tax laws (such as unified credit or estate tax exemption) or that measured a share of a trust or a gift based on the amount that can pass free of federal estate

or GST taxes, "shall be deemed to refer to the federal estate tax and generation-skipping transfer tax laws as they applied with respect to estates of decedents dying on Dec. 31, 2009." However, this law was not passed.

16. Repealed by Laws 2006, 2nd Ex. Sess., C. 42 §6, eff. Jan. 1, 2010.

17. See Zaritsky, *Practical Estate Planning*, at ¶2.06[3][b].

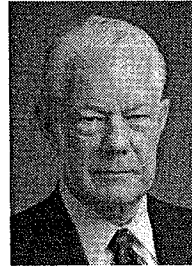
18. See Blattmachr, et al 2010 *JT* article, at pp 68-69.

19. See ACTEC materials published June 18, 2010, cited at footnote 11.

20. *The Greenbook* can be found at <http://www.ustreas.gov/offices/tax-policy/library/grmbk09.pdf>.

21. Note that this proposal could be enacted by Treasury Regulations for Code Section 2704 instead of through the legislative process.

ABOUT THE AUTHOR



Henry G. Will practices law in Tulsa as a shareholder and director of Conner & Winters LLP specializing in estate planning and exempt organizations. He is a graduate of Yale University (magna cum laude, 1962) and Yale Law School (1965) and is a Fellow of ACTEC.

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