



**2010 YEAR-END ESTATE PLANNING:
TAKING ADVANTAGE OF LEGISLATIVE CHAOS**

**A White Paper
from the
Private Wealth Services Group
of
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INTRODUCTION*

The current uncertainty regarding all federal taxes presents both opportunities and challenges for individuals and families in their estate and financial planning. The failure of Congress to act to date has resulted in massive confusion in the federal transfer (estate, gift, and generation-skipping transfer) tax system. Even now, as Congress works in the “lame-duck” session to reach a compromise on extending the tax cuts created in the 2001 Tax Act, it is impossible to predict the final results. This uncertain environment, however, also provides families with possible opportunities to take advantage of the provisions of current law before any changes enacted by Congress become effective. This paper discusses the current legislative situation, the estate planning opportunities for individuals and families, and the need for individuals and families to respond quickly to make the best use of those opportunities before they are eliminated by Congress.

Under current law, the federal estate tax does not apply to an estate of an individual who dies in 2010, the generation-skipping transfer (“GST”) tax (a tax on transfers to grandchildren or more remote descendants) does not apply to 2010 gifts, and the gift tax rate applicable to 2010 transfers has been reduced to 35%, the lowest gift tax rate in more than 50 years. Without Congressional action, the 2001 federal estate, gift, and GST taxes will be reinstated as of January 1, 2011, under the same statutes that applied in 2001. This means that the federal estate and gift tax exemptions will become \$1.0 million with a maximum tax rate of 55% (plus a possible 5% surcharge on certain transfers), and the GST exemption will be reduced to \$1.36 million with a tax rate of 55%.

Although most observers expected that Congress would have acted by now to clear up the transfer tax confusion, Congress has failed to enact any legislation as of the date of this paper. Congress has had recent significant discussions about extending the provisions of the 2001 Tax Act,

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including the transfer tax provisions. On December 2, 2010, Senator Max Baucus (Democrat-Montana), Chairman of the Senate Finance Committee, introduced the "Middle Class Tax Cut Act of 2010" which contained significant transfer tax provisions. Senator Charles Schumer (Democrat-New York) introduced an almost identical proposal on the same date. But, under the Baucus Bill, the income tax benefits would have been limited to individuals earning \$200,000 or less annually and families earning \$250,000 or less annually, while under the Schumer Bill the income tax benefits would have been limited to individuals or families earning \$1,000,000 or less annually.

On December 4, 2010, neither proposal garnered the sixty votes necessary to be considered by the Senate. Because Senator Baucus is Chairman of the Senate Finance Committee and is one of the six members of a working group formed by the President and congressional leaders in an attempt to reach a compromise on tax reductions this year, it is possible that some form of the Baucus Bill could be enacted before the end of 2010, bringing more certainty to the transfer tax area while severely curtailing a popular planning estate planning technique (the short-term GRAT). But Congress has disappointed many families and their advisors with its inaction during the last decade. It is possible that Congress could fail to reach agreement in the lame-duck session, delay action until 2011, or be unable to act at all.

Despite this legislative uncertainty, individuals may have a once in a lifetime opportunity to transfer wealth before January 1, 2011 at a gift tax rate and under a favorable transfer tax system that may never exist again. The factors favoring lifetime transfers before January 1, 2011, include:

- No GST tax on transfers to grandchildren in 2010;
- A current gift tax rate of 35% which is the lowest gift tax rate in the last 50 years (the top marginal gift tax rate has ranged from 45% to 70%);
- Low asset valuations resulting from the economic downturn;
- Favorable law for valuation discounts on carefully planned transfers of closely held business interests (which may be eliminated in the future);
- Interest rates at an all-time low (for example, a 1.53% interest rate is allowed for a nine-year loan made in December 2010; and
- Favorable law and low rate of 1.8% for valuing retained interests in a grantor retained annuity trusts (but the Baucus Bill would require a less advantageous 10-year minimum term for GRATs created after the effective date of legislation).

Despite these favorable factors, gifts before January 1, 2011 are not without risk. For example, Congress may enact retroactive legislation that will apply to transfers made this December. Also, a transfer made in 2010 may escape GST tax when the initial transfer is made to a trust for grandchildren, but later transfers from the trust to grandchildren may be subject to GST tax.

In this paper, McGuireWoods' Private Wealth Services Group will review the legislative background and possible legislative action and the timing of that action, discuss the potential tax benefits to individuals who make gratuitous transfers before January 1, 2011, and the potential tax risks of these transfers, and address possible strategies to minimize the tax risks of 2010 transfers.

THE UNCERTAIN TRANSFER TAX ENVIRONMENT

The chart below shows the transfer tax exemptions and tax rates for 2009 and 2010 and the exemptions and rates that will be in effect when pre-2001 law returns in 2011 without legislation. Significant differences exist among the transfer tax provisions in each of the three years and the current law for 2010 presents a very favorable environment for lifetime transfers when compared to 2009 or 2011.

	2009	2010	2011
Gift Tax Exemption	\$1,000,000	\$1,000,000	\$1,000,000
Maximum Gift Tax Rate	45%	35%	55% (with 5% surcharge on gifts between \$10,000,000 and \$17,184,000)
Estate Tax Exemption	\$3,500,000	Unlimited	\$1,000,000
Maximum Estate Tax Rate	45%	None	55% (with 5% surcharge on estates between \$10,000,000 and \$17,184,000)
GST Exemption	\$3,500,000	Unlimited	\$1,360,000 (which reflects an inflation adjustment)
GST Tax Rate	45%	None	55%

The significant uncertainty at this point is whether and when Congress will enact transfer tax legislation and, more importantly, what may be in that legislation. Although no one can answer

these questions with certainty, it is helpful to review the legislative background to see what Congress *may* do in the future.

LEGISLATIVE BACKGROUND

The Sunset Provision of the 2001 Tax Act Created the Chaos. The 2001 Tax Act created the extremely unusual transfer tax situation in 2010, which includes the one-year repeal of the estate tax, the one-year repeal of stepped-up basis and imposition of a modified carryover basis regime for inherited assets, and the one-year repeal of the GST tax.¹ Almost everyone expected that Congress would act before the suspension of the estate and GST taxes in 2010. Unfortunately Congress failed to enact legislation despite several efforts to do so. As a result, on January 1, 2010, the estate tax and GST tax disappeared for one year and the gift tax rate was lowered to 35%. During 2010, while some of the Congressional leaders recognized that action should be taken with respect to finding a permanent solution, no real action was undertaken.

When Will Congress Act? On November 15, after the mid-term elections, Congress returned to a lame-duck session planned to conclude by December 17. The Republican leadership vowed to take up action on the 2001 Tax Act as one of the first legislative priorities. Although the transfer tax provisions are a part of the 2001 Tax Act, most of the debate has centered on the income tax provisions of the Act rather than the transfer tax provisions.

If Congress is able to work a transfer tax fix into a tax bill in this lame-duck session, it is possible that Congress would do no more than revive 2009 law effective as of January 1, 2010 and extend that law for two or three years, giving the executors of decedents who have died since

¹ The one-year 2010 legislative situation was caused by section 901(a) (Sunset of Provisions of Act) of the 2001 Tax Act, which states:

In General.—All provisions of, and amendments made by, this Act shall not apply— . . .
. . . in the case of title V, to estates of decedents dying, gifts made, or generation-skipping transfers,
after December 31, 2010.

(b) Application of Certain Laws.—The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to . . . estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

December 31, 2009, the opportunity to elect out of the estate tax and back into the 2010 carryover basis law.

The Baucus Bill. On December 2, 2010, Senator Max Baucus (Democrat-Montana), Chairman of the Senate Finance Committee, introduced an amendment to the pending legislation, entitled the “Middle Class Tax Cut Act of 2010” (S.A. 4727) and widely known as the “Baucus Bill.” The Baucus Bill would have made the income tax provisions of the 2001 Tax Act permanent for individuals making under \$250,000 per year. The Baucus Bill also contained the following transfer tax provisions described in general terms:

- Reinstatement of the 2009 law for estate, gift and GST transfer taxes permanently effective January 1, 2010;
- Election for the executors of 2010 estates to apply either estate tax with stepped-up basis or no estate tax with a carryover basis regime;
- Portability of a deceased spouse’s unused estate tax exemption;
- Special provisions for farmers and ranchers;
- 10-year minimum term for GRATs; and
- Requirement that beneficiaries use the same income tax basis for inherited property as the values as finally determined for estate tax purposes.

The Baucus Bill had different effective dates for the above provisions.

- The effective date for the estate tax provisions was January 1, 2010 subject to the ability of the executor to elect 2010 treatment;
- The effective date for the gift and GST provisions was the date of introduction, December 2, 2010; and
- The effective date for the portability and GRAT provisions was the date of enactment.

Despite the fact that the Senate refused to take up consideration of the Baucus Bill on December 4, 2010 by a vote of 53-36 (60 votes being required to take up the bill), some or all of these provisions may find their way into future legislation. Although it would be painful and add to the confusion, it is also possible that Congress could delay action on the 2001 Tax Act until 2011.

Can Congress Enact Legislation with a Retroactive Effective Date of January 1, 2010? The most significant tax risk facing individuals who make gifts or other gratuitous transfers in 2010 is that

Congress will enact legislation retroactive to January 1, 2010, or some subsequent date that predates a 2010 transfer. Questions have been raised whether retroactive tax legislation would pass muster under the United States Constitution. Instinctively, retroactive legislation is unfair and inappropriate and, therefore, must be unconstitutional. Courts, however, have been more tolerant, leaving the constitutional issues very much in doubt.

The most likely basis for a constitutional challenge is the Due Process Clause of the Fifth Amendment. Over the years, courts have recognized that taxpayers have a substantive economic right under this provision that may be violated if the retroactivity is not a “rational means” of furthering “a legitimate legislative purpose.” In *United States v. Carlton*,² the United States Supreme Court approved the retroactive application of a 1987 amendment to the federal estate tax that denied a deduction then allowed with respect to sales of stock to an ESOP unless the stock was owned by the decedent before death. In approving the retroactive legislation, the Court observed that the amendment had a reasonable and legitimate purpose (preventing abuse of a loophole in previous legislation), and was only retroactive for “a modest period” of “only slightly greater than one year.” Although the taxpayer had relied on the previous law and had no notice that the law on which he relied would later be changed, the Court rejected his due process argument and deemed the retroactive application permissible.

The *Carlton* analysis is not without its critics. Some judges may find retroactivity to be so harsh that “the gap between law and justice is too stark to be ignored.”³ Nevertheless, *Carlton* appears to establish a fairly low due-process threshold for the constitutionality of retroactive tax laws – as long as the retroactivity is justified by a legitimate legislative purpose and is not excessive in length, it will not be held to violate the Due Process Clause. In the case of 2010 retroactive transfer tax legislation, both of these elements would appear to be satisfied. It is arguably a legitimate legislative purpose to raise revenue and to do so in a manner that provides continuity,

² *United States v. Carlton*, 512 U.S. 26, 30-31 (1994), quoting *Pension Benefit Guaranty Corporation v. R. A. Gray & Co.*, 467 U.S. 717, 729-30 (1984).

³ *NationsBank of Texas, N.A., v. United States*, 269 F.3d 1332, 1338 (Fed. Cir. 2001) (Plager, J., dissenting).

and the maximum potential period of retroactivity, 12 months, is less than the 14 months the Court approved in *Carlton*.⁴

Notwithstanding that the outcome of a constitutional challenge is hard to predict, it seems virtually certain that someone would challenge almost any period of retroactivity, calling the tax law into question while litigation and appeals, possibly all the way to the Supreme Court, are ongoing. Because lawmakers are undoubtedly aware of that possibility, perhaps all that can be said is that since it has been almost a year with no legislation, it should be less likely that Congress will invite the constitutional fight by making any change retroactive. But who knows what Congress will do?

LEGISLATIVE PREDICTIONS

A premise of this paper is that individuals who are in a position to do so should consider making taxable gifts before the end of 2010. The advantages of making significant year-end transfers are obvious but the risks are less so. One risk is a legislative risk – what will Congress do and when will Congress act? It is impossible to predict what action Congress will take and when Congress will act.

Legislative Predictions. If Congress acts, our experience, recent Congressional floor debates and Finance Committee hearings, and the budget and legislative proposals in the current Congress teach us to look for the following features in the permanent estate tax fix, if and when it comes.

- Although possible, it is unlikely that the legislation will be **retroactive** to January 1, 2010. But the legislation could be effective as of the date of enactment or as of the date of introduction.
- **Transfer tax rates** may range from 45% to 35% with tax decreases (if any) phased in over a number of years – in order to contain the cost by pushing the revenue losses out as far as possible in the 10-year “budget window” under which Congress operates.
- The **estate tax exemption** may range from \$3.5 million to \$5.0 million with any increase above \$3.5 million phased in over a number of years.
- The **GST exemption and rate** will remain tied to the estate tax exemption and rate.

⁴ Five of the Justices who decided *Carlton* (Justices Stevens, Scalia, Kennedy, Thomas, and Ginsburg) are still on the Court. Justices Scalia and Thomas question the fundamental premise of an economic substantive-due-process right. But other Justices may find *Carlton* distinguishable if a retroactive reinstatement of the estate and GST taxes came before them.

- The **gift tax exemption and rates** may be recoupled with the estate tax and GST exemptions and rates, although this is an expensive feature that is much less likely (it was not part of the Baucus Bill).
- The **credit for state death taxes** is not coming back, and even retention of the deduction for state death taxes is doubtful.
- There may be a limited **portability** between spouses of the estate and gift tax exemptions but not the GST exemption.
- A **stepped-up basis at death** (for appreciated assets) will continue to be the general rule.
- There may be significant **relief targeted to family farms**, ranches, and other businesses.
- Executors of 2010 estates may be able to elect either the 2009 system with an estate and GST tax and a stepped-up basis or the 2010 system with no estate or GST tax system but a carryover basis.
- It is a time-honored tactic to combine rate relief with **“base-broadeners,”** which will probably include a 10-year minimum term for grantor retained annuity trusts and possibly, but less likely, adjustments to valuation discounts in the family setting.

2010 TRANSFER TAX PLANNING

Although there is significant legislative uncertainty, individuals may have a once in a lifetime opportunity to transfer wealth before January 1, 2011, under gift tax rates and favorable transfer tax laws that we may never see again. An individual willing to make taxable gifts in 2010 may:

- Pay less transfer tax than will be paid in the future because of the 35% gift tax rate; and
- Transfer assets to grandchildren at less transfer tax than will be paid in the future because the GST tax is not applicable to 2010 transfers.

The following discussion reviews the advantages and risks of making large taxable gifts in 2010 and the issues associated with GST transfers.

ADVANTAGES OF 2010 TAXABLE GIFTS

If an individual makes a taxable gift before January 1, 2011, and Congress does not act or enacts legislation with an effective date after the date of the gift, the gift tax rate would be 35% (as opposed to 45% in 2009 and possibly 55% or 60% in 2011). Because the 35% gift tax rate is the

lowest gift tax rate in recent memory and may be higher in the future, 2010 may be a very attractive time to make taxable gifts.

A 35% gift tax rate is an historic bargain. The top marginal gift tax rate has ranged from 45% to 70% since 1977. From 1977 to 1981, the top marginal gift tax rate was 70%. From 1984 to 2001, the top marginal gift tax rate was 55% with a 5% surcharge intended to eliminate the benefit of the lower marginal rates and lifetime gift tax exemption. The 2001 Tax Act reduced the top marginal gift tax rate to 50% in 2002 with a 1% annual decrease until the top tax rate was reduced to 45% in 2007.

A way of reviewing the impact of a transfer tax rate is to review the amount of assets necessary to transfer a set amount to a beneficiary. The following chart shows the amount of assets required (i.e., the gift amount plus the gift taxes) to transfer various amounts to a beneficiary assuming the donor makes a lifetime transfer, the transfer is subject to the highest gift tax bracket, the transfer is not subject to a state gift tax, and the donor lives three years following the gift.

Taxable Gift	35% Gift Tax Rate	40% Gift Tax Rate	45% Gift Tax Rate	50% Gift Tax Rate	55% Gift Tax Rate
\$1,000,000	\$1,350,000	\$1,400,000	\$1,450,000	\$1,500,000	\$1,550,000
\$2,500,000	\$3,375,000	\$3,500,000	\$3,625,000	\$3,750,000	\$3,875,000
\$5,000,000	\$6,750,000	\$7,000,000	\$7,250,000	\$7,500,000	\$7,750,000

Assuming there is an estate tax, it is always more expensive to transfer assets at death as opposed to a transfer during lifetime regardless of the transfer tax rate. The technical reason for this is that estate taxes are computed on a tax inclusive basis and gift taxes are computed on a tax exclusive basis. The following chart shows the amount of assets required to transfer various amounts to a beneficiary assuming the donor makes the transfer at the donor's death and the donor's assets are subject to the highest estate tax bracket in a state with no state estate tax.

Taxable Bequest	35% Estate Tax Rate	40% Estate Tax Rate	45% Estate Tax Rate	50% Estate Tax Rate	55% Estate Tax Rate
\$1,000,000	\$1,538,462	\$1,666,667	\$1,818,182	\$2,000,000	\$2,222,222
\$2,500,000	\$3,846,154	\$4,166,667	\$4,545,455	\$5,000,000	\$5,555,556
\$5,000,000	\$7,692,308	\$8,333,333	\$9,090,909	\$10,000,000	\$11,111,111

These charts illustrate that it is advantageous from a gift tax standpoint for a donor to consider a taxable gift in 2010 unless the donor believes that either the estate or gift tax rate will be lower in the future. But gift taxes are not the only consideration in transferring wealth. A donor must also consider other factors, including whether the donor will have sufficient liquid assets to meet the needs of the donor and the donor's dependents, whether the property given away may depreciate in value after the gift, whether there are any income tax consequences to the transfer, and what will be the impact of the gift on the donee.

In addition to a 35% gift tax rate, a 2010 taxable gift will offer the advantages that have normally been connected with taxable gifts. Among these advantages are:

- Freezing the value of the gifted property for transfer tax purposes at the time of the gift;
- Shifting income from the gifted property to the donee; and
- Taking advantage of discounts that may not be available for transfers at death.

RISKS ASSOCIATED WITH 2010 TAXABLE GIFTS

Tax Risks Associated with All Taxable Gifts. Taxable gifts are subject to the following potential tax risks:

- The property may depreciate from the date of the gift to the date of the donor's death, in which case the estate taxes payable at the donor's death may have been lower than the gift taxes paid by the donor; and
- The income tax payable upon a sale of the gift property by the donee may be greater than the transfer tax savings because the donee assumes the donor's income tax basis whereas the donee would receive a stepped-up basis if the property were inherited (assuming no carryover basis regime is in effect).

Tax Risks Peculiar to 2010 Gifts. In addition to the risks associated with any taxable gift, 2010 gifts have unique risks. The most significant risk arises because there is no estate tax applicable to 2010 decedents under current law. There is no transfer tax advantage to a donor or

the donor's beneficiaries for the donor to pay gift tax if the donor dies when there is no estate tax (which could happen if the donor dies in December 2010) applicable to the donor's estate. Another risk peculiar to 2010 gifts is that Congress could enact legislation retroactive to January 1, 2010 (or some other date that predates the gift) increasing the gift tax rate, possibly to 45%. Congress could also enact prospective legislation that would apply after the date of introduction. Both Senators Baucus (Democrat-Montana) and Schumer (Democrat-New York) introduced legislation on December 2, 2010 that would have applied a 45% rate to gifts after December 2. The Senate refused to consider each of these bills in a rare Saturday session on December 4. The provisions of these bills could provide some guidance as to provisions that might appear in any tax legislation enacted as part of a compromise between the Republicans and Democrats in the current lame-duck session or in 2011 if Congress fails to act this year. Fortunately there are planning techniques available to minimize these peculiar risks.

Planning Techniques to Minimize 2010 Transfer Tax Risks. There are several planning techniques to minimize the 2010 transfer tax risks, including:

- Delaying the effective date of the gift (which minimizes the risk of a retroactive increase in the gift tax rate and the donor's death in 2010 when there is no estate tax but increases the risk of prospective legislation increasing the gift tax rate);
- Using a formula gift (which avoids a possible retroactive increase in the applicable gift tax rate); and
- Transferring the property to a trust for the benefit of the donor's spouse structured as a qualified terminable interest property trust (which avoids both a retroactive increase in the gift tax rate and a donor's death in 2010 when there is no estate tax).

Two events could occur between the time a donor decides to make a gift and January 1, 2011, that would eliminate or minimize the transfer tax advantages of a 2010 taxable gift:

- The donor could make a gift and then die during 2010 when there is no estate tax, or
- The donor could make a gift and then Congress could enact retroactive legislation.

Delayed Delivery to Reduce Risk of Donor's Death When There Is No Estate Tax. A donor who is concerned about making a gift and then dying during 2010 when there is no estate tax could execute gift documents that delay the effective date of the gift as long as possible, possibly to 11:59 p.m. December 31, 2010. If the donor dies before the effective date of the gift, the gift is not

complete at the donor's death, and no gift tax is payable. The problem with delaying the effective date of the gift is that Congress could enact legislation in December 2010 that increases the gift tax rate with an effective date as of the date of introduction or enactment, which would be before the effective date of the gift.

A donor must weigh the risk of the donor's death before January 1, 2011 against the risk that Congress may enact legislation increasing the gift tax rate with an effective date before January 1, 2011. The Baucus Bill, which was introduced on December 2 and failed to garner sufficient votes to be considered by the Senate on December 4 would have increased the gift tax rate to 45% with an effective date as of the date of introduction.

The simplest approach for a delayed delivery gift is for the donor to state in the gift instrument that the effective date of the gift is 11:59 p.m. December 31, 2010. It is important that the donor deliver the deed of gift to the donee, and the donee should acknowledge receipt of the deed of gift so as to establish delivery and acceptance. By using this technique, a donor does take the risk that Congress will enact legislation changing the gift tax rate with an effective date before December 31, 2010.

Although the delayed deed of gift approach may be suitable for gifts of closely held business interests and other property, this approach may not be acceptable for gifts of marketable securities, real estate, and private equity investments. An approach that should be successful with marketable securities is for the donor to transfer the gift property to a specially designed trust. The trust would be designed so that the donor has the right to revoke the trust up to 11:59 p.m. December 31, 2010.

Options to Minimize Risk of Congress Enacting Retroactive Legislation. A donor who is concerned that Congress may enact legislation after the donor has made a gift can use several different techniques to minimize this risk. These techniques include:

- A delayed gift;
- A formula gift; and
- A QTIP disclaimer trust.

Delayed Gift. A donor could use the delayed gift technique described above whereby the donor executes gift documents that delay the effective date of the gift as long as possible, possibly to 11:59 p.m. December 31, 2010. If Congress enacts retroactive legislation and the donor does not want to pay the increased gift tax, the donor fails to complete the gift, the gift is not effective, and no gift tax is payable. Similar to the risk described above, the problem with delaying the effective date of the gift is that Congress could enact legislation in December 2010 that increases the gift tax rate with an effective date as of the date of introduction or enactment, which would be before the effective date of the gift.

Formula Gifts. Another approach to avoid adverse tax consequences from legislation enacted in December 2010 that increases the gift tax rate is for the donor to use a formula to determine the amount of the donor's gift. Although formula gifts are common in estate planning documents, the Internal Revenue Service has attacked the validity of certain formula clauses. Taxpayers have had success in several recent court cases with carefully drafted formula gifts that resulted in the allocation of property among individual beneficiaries and charities. For example, two recent cases permitted formula gifts where the property was split between private individuals and charities with the amount passing to each determined by the final determination of the value of the gifts for estate or gift tax purposes.⁵ Following these cases, a donor may be able to craft a formula gift that will protect the donor from future events.

The following sample language that could be used in a gift instrument to make a formula gift:

I give 100 shares of stock of Closely Held, Inc. to be divided between my son Able and my donor advised fund at the Community Foundation. I give to my son Able that portion of the 100 shares of Closely Held, Inc. that is subject to a 35% or lower federal gift tax rate under Chapter 12 of the Internal Revenue Code. I give the remaining portion of the 100 shares, if any, to my donor advised fund at the Community Foundation.]

Under this formula, the donor's son would receive the entire gift if the gift tax rate remained at 35% or Congress retroactively imposed a lower rate (which is highly unlikely). If Congress enacted

⁵ *Estate of Christiansen v. United States*, 586 F.3d. 1061 (8th Cir. 2009); *Petter v. Commissioner*, T. C. Memo. 2009-280.

retroactive legislation and increased the gift tax rate above 35%, the entire gift would be distributed to the donor's spouse, and the donor would not have to pay any gift tax.

Tax advisors may be able to design other types of formula gifts to protect the donor from the tax risk inherent in a 2010 taxable gift. Properly structured formula gifts may allow a donor to accomplish the donor's planning objectives while avoiding adverse gift tax consequences due to subsequent events.

Gift to QTIP Disclaimer Trust. Some individuals may wish to make gifts in 2010 to take advantage of the 35% gift tax rate and the repeal of the GST tax but may be concerned about the possibility of a retroactive imposition of an increased gift tax rate and the GST tax. One technique available for married individuals that can protect against possible retroactive legislation is a gift to a qualified terminable interest trust (QTIP) for the benefit of a spouse followed by the possibility of the spouse's disclaimer depending upon what happens in Congress.

With this technique, the donor creates an irrevocable trust for the benefit of the donor's spouse with the donor's grandchildren as the remainder beneficiaries. The trust would be structured to qualify as a QTIP trust, which means that the spouse must receive all trust income and no beneficiary other than the spouse can have an interest in the trust during the spouse's lifetime. Because a QTIP trust is eligible for the gift tax marital deduction, there would be no gift tax payable on the transfer from the donor to the QTIP trust assuming the donor makes an election to qualify the trust for the federal gift tax marital deduction on a timely-filed gift tax return.

Under the terms of the trust, the spouse will have the right to disclaim the spouse's interest in the trust, in which case, the trust assets would pass to the donor's grandchildren. Under current law, if the spouse makes a qualified disclaimer within nine months of the gift without having received any benefits from the trust, the gift will be treated as coming directly from the donor to the grandchildren and the gift to them should be deemed made on the original date of the transfer to the trust in 2010. This allows the spouse to make the decision whether to transfer the assets to the grandchildren up to nine months after the date of the gift. If Congress passes retroactive legislation and either increases the gift tax rate or reinstates the GST tax, the spouse will not disclaim the gift in

favor of the grandchildren. Because the trust will be a QTIP trust, there will be no gift taxes imposed on the donor assuming a QTIP election is made on a timely-filed gift tax return. The property can continue to be held in the QTIP trust for the spouse or distributed to the spouse outright.

If Congress does not pass any retroactive legislation, the spouse can disclaim the gift made to the QTIP trust. As a result of the spouse's disclaimer, the trust property will be deemed to pass directly from the donor to the donor's grandchildren as of the date of the original gift. In this case, the gift to the QTIP trust will be subject to a gift tax rate of 35% and because there is no GST tax in 2010, the gift should not be subject to GST tax.

A variation on this approach involves using the QTIP election to qualify the trust for the federal gift tax marital deduction. A donor must make the QTIP election on a timely filed gift tax return which would be due on April 15, 2011, or later if the donor obtains an extension. If Congress passes retroactive legislation, the donor would make the QTIP election, no gift tax would be owed, and the property would remain in trust for the benefit of the spouse. If Congress does not pass retroactive legislation, the donor would not make the QTIP election and the property would pass pursuant to the terms of the trust upon the spouse's death to children or other beneficiaries or held in trust for their benefit. This second approach allows the donor to retain more control over the decision whether to qualify the trust for lifetime QTIP treatment.

GST TAX PLANNING

The GST tax has prevented many donors from transferring wealth to grandchildren or more remote descendants or to trusts for their ultimate benefit since 1986 when it was enacted. Although the 2001 Tax Act increased the GST exemption to \$3.5 million in 2009, the double taxation resulting from the GST tax (because transfers are subject first to a gift or estate tax and then to the GST tax) generally makes it prohibitively expensive to transfer significant wealth to grandchildren. In the absence of legislation, the GST tax, similar to the estate tax, "shall not apply to generation-skipping transfers after December 31, 2009" but the GST tax, also similar to the estate tax, is resurrected on January 1, 2011. Because the only tax applicable to lifetime gifts to grandchildren in

2010 is the gift tax, individuals may have a once in a lifetime opportunity in 2010 to make transfers to grandchildren at the historically low gift tax rate of 35% and without the imposition of any GST tax.

The following chart shows the tax consequences of an outright gift to a grandchild assuming the donor has used all of the donor's lifetime gift tax exemption and GST exemption, the gift is subject to the highest gift tax rate in a state with no state gift tax and Congress does not change the law. The chart shows the significant advantages of 2010 gifts to grandchildren.

Year	Gift to Grandchildren	Gift Tax	GST Tax	Total Tax	Net Gift to Grandchildren
2009	\$10,000,000	\$4,500,000	\$2,475,000	\$6,975,000	\$3,025,000
2010	\$10,000,000	\$3,500,000	-0-	\$3,500,000	\$6,500,000
2011	\$10,000,000	\$5,500,000	\$2,475,000	\$7,975,000	\$2,025,000

Although the one-year repeal of the GST tax creates a significant opportunity for grandparents who want to make gifts to grandchildren, a grandparent faces several tax risks peculiar to 2010 transfers to grandchildren. The first risk is similar to the gift tax risk with 2010 gifts. The grandparent could die in 2010 when there is no estate or GST tax but still have to pay gift taxes. The second risk is that Congress could increase the gift tax rate and reinstate the GST tax retroactively to January 1, 2010 or to another date that predates the gift to the grandchildren. The third risk involves gifts by a grandparent in trust for the benefit of a grandchild rather than outright to a grandchild and the possibility that the GST tax could apply to transfers made from that trust to the grandchild after 2010.

Risk of Donor's Death When There Is No Estate Tax. A donor who is concerned about making gifts to grandchildren and then dying during 2010 when there is no estate could use the technique discussed above to delay the effective date of the gift as long as possible, possibly to 11:59 p.m. December 31, 2010. A donor must weigh the risk of the donor's death before January 1, 2011 against the risk of Congress enacting legislation increasing the gift tax rate with an effective date before January 1, 2011.

Planning Techniques to Minimize Risks of Retroactive GST Legislation. A donor can use several planning techniques to minimize the risk that Congress enacts legislation retroactively reinstating the GST tax to January 1, 2010 or some other date that predates the gift to the grandchild. These techniques are similar to the techniques discussed above for minimizing the tax risks associated with 2010 gifts and include:

- Delaying the effective date of the gift to 11:59 p.m. December 31, 2010 (which avoids both a retroactive application of the GST tax and a donor's death in 2010 when there is no estate or GST tax); and
- Using a formula gift (which avoids a possible retroactive application of the GST tax); and
- Transferring the property to a trust for the benefit of the donor's spouse structured as a QTIP trust (which avoids both a retroactive application of the GST tax and a donor's death in 2010 when there is no estate tax).

There are two events that could occur between the time a donor decides to make a gift to grandchildren and December 31, 2010 that would create significant transfer tax issues:

- The donor could die, or
- Congress could enact legislation that retroactively applies the GST tax to the gift.

Similar to planning to minimize the risk associated with 2010 taxable gifts, a donor who is concerned about events that may occur before January 1, 2011, can use several different techniques to execute gift documents that delay the effective date of the gift until December 31, 2010. These techniques are described above and include the following:

- Delaying the effective date of the gift so the donor can unwind or fail to complete the gift before its effective date if it becomes prudent to do so using a gift instrument or a specially designed trust.
- A formula gift under a document using language such as –

I give 100 shares of stock of Closely Held, Inc. to be divided between my grandson Baker and my donor advised fund at the Community Foundation. I give to my grandson Baker that portion of the 100 shares of Closely Held, Inc. that is not subject to the generation-skipping transfer tax under Chapter 13 of the Internal Revenue Code. I give the remaining portion of the 100 shares, if any, to my donor advised fund at the Community Foundation.

- A gift to a QTIP trust structured so the remainder passes outright to a grandchild upon the spouse's death with the spouse's possible disclaimer depending upon what happens in Congress.

2010 Gifts in Trust for the Benefit of Grandchildren. Direct gifts in 2010 to grandchildren, as opposed to gifts in trust, are not subject to a GST tax but are subject to a gift tax. In many instances, however, it is not appropriate or advisable for a grandparent to make direct gifts to grandchildren. The grandchild may not be able to manage the gift property properly because of age or immaturity, or the grandparent may worry about potential predators (such as a spouse or creditors) preying on the grandchild's assets. Unfortunately, the GST tax consequences are more complicated and not clear if a grandparent transfers assets to a trust in 2010 for the benefit of a grandchild. The GST analysis is more complex for 2010 gifts placed in trust for the benefit of grandchildren because there is no GST tax applicable to the transfers which leaves the transfers in "no-man's land."

Problems with 2010 GST Transfers in Trust. GST planning typically involves transfers to a long-term trust. Long-term trusts have potential generation-skipping transfers (for example, distributions to grandchildren) that will span many years. Accordingly, transfers to a GST trust in 2010 will have GST tax implications after 2010. The analysis of the GST tax consequences of post-2010 transfers from a 2010 GST trust is complicated by the statutory mandate that the GST tax will be applied in future years as if the temporary suspension in 2010 "had never been enacted."

As a general rule, the creation and funding of a generation-skipping trust is not subject to GST tax. The trust simply becomes subject to the rules governing taxable distributions and taxable terminations in the future, to the extent its inclusion ratio is greater than zero. There may not be a significant GST tax benefit in creating a GST trust in 2010 because the definitions and other provisions of the GST tax law that are suspended in 2010 may be back in 2011. Arguably it is impossible to tell who the transferor is, but it is likely that all such issues will be resolved in 2011 (or earlier, if Congress acts) when the GST tax law is revived. Taxable distributions and taxable terminations with respect to the trust will presumably then be taxed just as in the case of any trust created in any other year.

Avoiding the 2010 GST Trust Problem: Power to Grant General Powers of Appointment to Children. One possible way of addressing this is to give the trustee or a trust protector the ability

to grant lifetime or testamentary general powers of appointment to the children in a dynasty trust created for the benefit of children and more remote descendants. If the termination of the trust after 2010 is subject to GST tax, the trustee would create a general power of appointment which would cause the trust to be subject to estate tax in the holder's estate but would avoid GST tax. This would make the holder of the power the transferor for GST tax purposes. The holder could also possibly allocate his or her GST exemption to the trust at that point to exempt all or a portion of the trust assets from the GST tax.

Minimizing the 2010 GST Trust Problem: Use of Skip Trust. Another possible means to avoid the problem discussed above is to create and fund a trust which itself is a "skip person" because no non-skip person has an interest in the trust. An example is a trust that skips the donor's children and is to be administered solely for the benefit of the donor's grandchildren and younger generations. In ordinary times, the creation and funding of such a trust would be a "direct skip" subject to GST tax. In 2010 (unless Congress changes the law), there is no GST tax on that direct skip. Thus, a donor may create a trust exclusively for present and future grandchildren, or exclusively for present and future great-grandchildren, and the like, and there is no GST tax on that action. There will be a gift tax, but the lower gift tax rate in 2010 is another benefit of creating the trust this year (assuming that the grandparent does not die in 2010).

In the future administration of the "skip person" trust, there is uncertainty, but possibly also some opportunities. In the first place, distributions to beneficiaries during the remainder of 2010, unless Congress changes the law, will be exempt from GST tax. In addition, as discussed previously in the context of an existing trust, payments by a trust to an educational institution for a beneficiary's tuition or to a provider of health care or medical insurance for a beneficiary will never be subject to GST tax, regardless of the status of the trust or the generation of the beneficiary. Thus, one long-term benefit of creating such a trust in 2010 is to provide, at a reduced gift-tax cost, a fund for the education (and health care) of the designated generation or generations.

It is possible, though not free from doubt, that the trust could provide even more long-term benefits. Ordinarily, a "direct skip" transfer to a trust for, say, the grantor's grandchildren would be

a “generation-skipping transfer” and, under a special rule (called the “move-down rule”), the transferor would be treated as if the transferor were one generation above the generation of the trust’s beneficiaries. In other words, the trust would be treated as if a child of the grantor was the transferor, and the grandchildren (the beneficiaries of the trust) would be nonskip persons. Because the creation and funding of the trust would not be a “direct skip” in 2010, it may seem as if this special rule would not apply, the grandchildren would remain skip persons, and distributions to the grandchildren would be subject to GST tax.

All provisions of the 2001 Tax Act, including the suspension of the GST tax in 2010, are treated after 2010 as if they “had never been enacted.” In 2011, if the suspension of the GST tax is treated as if it “had never been enacted,” that would mean that the transfer to the trust is treated as a “direct skip” after all, not so as to impose a GST tax in 2010, but so as to trigger the “move-down” rule for purposes of defining taxable distributions in 2011 and beyond. If so, the grandchildren would be treated as nonskip persons, and distributions to them after 2010 would not be subject to GST tax. Distributions after 2010 to descendants of grandchildren could still be taxable distributions, and the death of the last surviving grandchild could still be a taxable termination.

In addition, it is possible – although it does not seem likely – that legislation enacted in 2010 would prospectively reinstate 2009 law or some variation of it and, following the pattern of the Tax Reform Act of 1986 which originally enacted the present GST tax, would “grandfather” any irrevocable trusts created before the effective date of the legislation. In that case, all distributions from the trust would be exempt from GST tax.

Again, there is no guarantee that such a have-it-both-ways result would be secured, but the wording of the 2001 Tax Act arguably supports this result. The downside, apart from the possibility of retroactive legislation in 2010 or later, is that general distributions to the trust beneficiaries would be subject to GST tax. Even in that case, the trust would still be available for the tax-free payment of tuition and health care costs for those beneficiaries.

FLPs and LLCs: Possible Alternatives to Using 2010 GST Trusts to Make Gifts to Grandchildren. In response to the concerns raised about the possible adverse GST tax

consequences of using trusts as a vehicle to make gifts to grandchildren, some commentators have suggested making gifts to a custodian under an applicable Uniform Transfers to Minors Act Statute or to a court-appointed guardian. Unfortunately, the regulations under the Internal Revenue Code treat transfers under the Uniform Transfers to Minors Act as a “trust equivalent.”⁶ Thus, gifts to a custodian under a Uniform Transfers to Minor Account for the benefit of a grandchild will be given the same treatment as a gift to a trust for the benefit of a grandchild. Also, the Internal Revenue Service has indicated informally that it will treat a guardianship the same as a trust equivalent for purposes of its analysis of the GST tax consequences of the transfer. While legitimate objections to the Service’s position exist, one would expect the Service to attempt to assess adverse GST tax consequences to gifts to grandchildren through a guardianship.

One possible alternative is for the donor to first create a limited partnership or limited liability company and then transfer assets to the limited partnership or limited liability company. Instead of transferring cash or marketable securities or other property to the grandchildren outright, the donor would transfer the limited partnership interests or membership interests in the limited liability company to the grandchildren.⁷ (This will be a question of state law, and a donor should consult applicable state law for guidance.) In this way, the general partner of the partnership or the manager of the limited liability company can exercise control over the underlying assets in the limited partnership or limited liability company. It is possible that the Service could characterize these transfers as a trust equivalent as well.

THE GRAT: A 2010 ESTATE PLANNING TECHNIQUE TO IMPLEMENT NOW

Because of the favorable interest rate environment, individuals who want to make tax-free gifts should consider using a grantor retained annuity trust (GRAT) to transmit wealth to the individual’s beneficiaries in a tax-efficient manner. A GRAT is an estate freeze technique that attempts to leverage the mismatch between interest rates dictated by the Internal Revenue Service to value transfers and the actual performance of the transferred assets over the life of the GRAT.

⁶ Treas. Reg. § 26.2652-1(b), Ex. 1.

⁷ Some commentators have questioned whether a completed gift can be made to a minor without the appointment of a legal guardian. Others believe that acceptance is presumed or a natural guardian (parent of the grandchild) can accept the gift on behalf of a minor grandchild.

A GRAT is an irrevocable trust that pays the grantor two or more annuity payments with any remainder interest in the GRAT being distributed tax-free to children or other beneficiaries. The annuity payments are structured so that the value of the annuity payments equals substantially all of the value of the trust assets so the gift of the remainder interest is a nominal value. The annuity payment stream is valued based on an interest rate assumption determined under Internal Revenue Code section 7520, which varies monthly and is fixed when the GRAT is created. If the trust assets outperform the interest rate assumption, the excess is distributed tax-free to the remainder beneficiaries, with only the initial nominal gift tax value being treated as a gift. The interest rate assumption or section 7520 rate for transfers to GRATs in December 2010 is 1.8%.

The valuation rates and tables prescribed by section 7520 often produce relative values of the annuity and remainder interests in a GRAT that are not consistent with actual returns on trust assets. As a result, under present law, individuals can use GRATs to make gifts of property with little or no transfer tax consequences, so long as the investment return on assets in the trust ends up being greater than the rate of return assumed under section 7520 for purposes of valuing the annuity and remainder interests.

GRATs are often structured with relatively short terms, such as two years, so as to capture short-term volatility and to minimize the risk that the grantor will die during the trust term, causing all or part of the trust assets to be included in the grantor's estate for estate tax purposes. Because GRATs carry little down-side risk, individuals frequently maintain multiple short-term, zeroed-out GRATs funded with different asset portfolios to improve the client's odds that at least one trust will outperform significantly the section 7520 rate assumptions and thereby allow the client to achieve a transfer to the remainder beneficiaries at little or no gift tax cost.

One of the "revenue raisers" that Congress has considered during 2010 and is contained in the Baucus Bill introduced on December 2, 2010 is to require a minimum 10-year term for a GRAT. This limitation on GRATs was included in several bills passed by the House of Representatives⁸ and

⁸ Section 307 of the "Small Business and Infrastructure Jobs Tax Act of 2010" (H.R. 4849), which passed by a vote of 246-178 on March 25, 2010 contained a minimum term of 10 years. A similar provision was in H.R. Rep. No. 111-447, 111th Cong., 2d Sess. 55-56. (2010). The same provisions appeared in section 531 of the

is designed to introduce additional downside risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. If Congress imposes a 10-year minimum term for a GRAT, it will be harder to realize one of the chief benefits of a GRAT, which is capturing upside volatility in the GRAT for the benefit of the next generation. In addition, the 10-year minimum term will increase the risk of the donor's death during the term of the GRAT, which would cause the trust assets to be included in the grantor's estate for estate tax purposes. A 10-year minimum term requirement will make a GRAT a much less valuable estate planning technique.

All of the congressional proposals, including the Baucus Bill, have an effective date as of the date of enactment. If individuals are interested in short-term GRATs, now is the time to act.

CONCLUSION

The remaining days of December offer individuals the opportunity to make significant gifts of property to family members and others at gift tax rates that will unlikely ever be as low as the current 35% rate. Congress may act to create obstacles preventing tax payers from taking advantage of the current low gift tax rate. Consequently, time may be of the essence in implementing the strategies discussed above. The lawyers in McGuireWoods' Private Wealth Services Group stand ready to help our clients and their advisors successfully obtain estate planning results that benefit themselves and their families from both a tax and non-tax perspective.

"Small Business Jobs Tax Relief Act of 2010" (H.R. 5486), which the House of Representatives passed by a vote of 247-170 (with five Republicans in favor and Eight Democrats against) on June 15, 2010. They were also added to the supplemental appropriations bill (H.R. 4899) that the House approved on July 1, 2010. And they appeared in section 8 of the "Responsible Estate Tax Act" (S. 3533 and H.R. 5764), introduced by Senator Sanders on June 24, 2010, and Rep. Linda Sanchez on July 15, 2010.