THE 2010 TAX ACT'S IMPACT ON ESTATE PLANNING AND ADMINISTRATION:

MAKING SENSE OUT OF THE CONFUSION

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A White Paper for Clients and Their Advisors
Prepared by the Private Wealth Services Group of McGuireWoods LLP

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[1] *2010 Year-End Estate Planning: Taking Advantage of Legislative Chaos* (December 6, 2010)
http://www.mcguirewoods.com/news-resources/publications/taxation/2010_Year-End_Estate_Planning.pdf
Estate Planning In Uncertain Times: The Impact of the Repeal of the Estate Tax and What You Need to Consider (January 1, 2010)
http://www.mcguirewoods.com/news-resources/publications/taxation/The%20Possible%20Impacts%20of%20Estate%20Tax%20Repeal.pdf

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I. INTRODUCTION AND OVERVIEW OF THE 2010 TAX ACT

On Friday, December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act"), which the Senate passed on December 15 and the House of Representatives passed late on December 16. This legislation to extend the so-called "Bush tax cuts" enacted in May 2001 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act"), and which otherwise would have "sunsetted" as of January 1, 2011, was the result of a compromise reached between President Obama and certain Congressional leaders. Under the 2010 Tax Act, the Bush tax cuts are extended for two years and modifications are made to the estate, gift, and generation-skipping transfer taxes. While a review of all of the provisions of the 2010 Tax Act are beyond the scope of this paper, for individuals the 2010 Tax Act:

- Retains the 2010 individual income tax rates for 2011 and 2012 starting at 10% with brackets of 15%, 25%, 28%, 33%, and 35%.

- Retains the 15% maximum tax rate for capital gains and qualified dividends.

- Allows taxpayers to continue to receive the full benefits of itemized deductions and personal exemptions, which otherwise would have been limited or phased out for taxpayers with higher incomes.

- Extends the marriage penalty relief.

- Patches the alternative minimum tax to prevent its application to an additional 21 million households in 2011.

- Modifies the estate, gift, and generation-skipping transfer taxes as discussed in more detail below.

- Extends to 2010 and 2011 the IRA charitable rollover provision of the Pension Protection Act of 2006, which permits an individual taxpayer who has attained age 70½ to make distributions of up to $100,000 per year from an individual retirement account to one or more qualified charities and exclude such distributions from gross income.

The 2010 Tax Act made significant and unexpected changes to the federal estate, gift, and generation-skipping transfer taxes. The federal estate tax applies to transfers at death, the gift tax applies to transfers during life, and the generation-skipping transfer tax ("GST tax") applies to transfers (during life or at death) to grandchildren or more remote descendants. Under the 2001 Tax Act, the estate and GST taxes were gradually reduced from 2002 through 2009 by increases in the amount that could be sheltered from tax (from $1 million to $3.5 million) and reductions in the rates (from 55% to 45%). The gift tax was retained with a limit of $1 million on the amount that could be sheltered from gift tax. In 2010, the estate and GST taxes, but not the gift tax, were repealed for one year. But in 2010, an appreciated asset no longer received a "step-up" in basis to the asset's fair market value as of the date of death (or alternate valuation date) upon the owner's death. Instead, the recipients of appreciated property upon a decedent's death in 2010 received property with a basis equal to the decedent's basis in the property (a "carryover basis"). Special rules allowed estates a special basis adjustment that could be allocated to increase the basis of property passing to anyone by $1.3 million and a spousal basis adjustment that could be allocated to increase the basis of property passing to a surviving spouse by $3 million. The gift tax rate was reduced to 35% for 2010.

If Congress had failed to take action, the estate, gift, and GST tax laws as in existence before the 2001 Tax Act would have returned in 2011 with a $1 million exemption for estate and gift tax purposes, a 55% maximum rate, and a $1.36 million GST exemption.

With the 2010 Tax Act, Congress made significant changes to the estate, gift, and GST tax laws for 2010, 2011, and 2012. These changes present both challenges and opportunities for individuals and fiduciaries and their advisors. This white paper will equip individuals and fiduciaries and their advisors with the information needed to better understand the changed environment and the obstacles and opportunities it presents.

The significant changes to the estate, gift, and GST taxes for 2010, 2011, and 2012 are:

- A reduction of the estate, gift, and GST tax rates to 35%.
- An increase of the estate tax and GST tax exemptions to $5 million.
- An increase in the gift tax exemption to $5 million for 2011 and 2012.
- Indexing of the estate tax, gift tax, and GST exemptions for 2012.
- A reunification of the estate and gift tax exemptions so that an individual can give away during life or at death up to $5 million for 2011 and 2012.
- An introduction of the concept of portability, which permits the estate of the second spouse to die to take advantage of the unused $5 million tax exemption of the first spouse to die for 2011 and 2012.
- A reintroduction of the estate tax for all of 2010 with the $5 million exemption and a 35% tax rate accompanied by an election for estates of 2010 decedents to opt out of the estate tax and into a modified carryover basis regime for appreciated assets.
- A reintroduction of the GST for all of 2010 with a $5 million exemption but a zero tax rate.

The 2010 Tax Act provision increasing the gift tax exemption from $1 million to $5 million will allow many to make far larger lifetime gifts in 2011 and 2012. The estates of 2010 decedents will now have to make a choice between the estate tax and a modified carryover basis. This will involve comparing the costs of paying the estate tax coupled with a step-up in basis for appreciated assets against analyzing the costs of electing out of the estate tax and taking a carryover basis for assets so that the recipients of appreciated property from the decedent's estate may pay higher capital gains tax. The application of the rules governing the GST tax can be complicated.

This white paper will help individuals and fiduciaries and their advisors to understand the impact of the 2010 Tax Act by examining:

- How the estate, gift, and GST tax provisions of the 2010 Tax Act came to be enacted.
- The provisions of the 2010 Tax Act that affect the estate, gift, and GST taxes.
- The impact of the 2010 Tax Act on the estates of decedents who died in 2010 and the factors that the executors of those estates must take into account in deciding whether to opt out of the estate tax into the modified carryover basis regime for appreciated assets.

- Steps that can be taken with respect to lifetime gifts made in 2010 before the enactment of the 2010 Tax Act, which gifts may have unintended consequences as a result of the changes made by the 2010 Tax Act.

- How individuals can take advantage of the favorable environment in 2011 and 2012 to make lifetime gifts using all of the techniques available to them, such as annual exclusion gifts, qualified tuition and medical expense payments, gifts either outright or in trust using the $5 million gift tax exemption available in 2011 and 2012, and techniques that can leverage the $5 million gift tax exemption or avoid a gift altogether, such as grantor retained annuity trusts and sales to intentionally defective grantor trusts.

- Changes to estate plans to make the best use of the favorable 35% estate tax rate, $5 million estate tax and GST exemptions, and portability of the $5 million exemption between spouses.

- How to preserve flexibility in estate planning documents in anticipation of the sunsetting of the current law at the end of 2012 or possible future congressional action to extend, modify, or repeal the transfer tax laws.

- The impact of the provisions of the 2010 Tax Act on planning for individuals who live in states with separate state death taxes.

- The provisions of the 2010 Tax Act that extend certain charitable giving incentives, as well as charitable giving opportunities in the current low interest rate environment.

- The impact of the 2010 Tax Act on planning for non-U.S. citizens.

Many commentators have observed that the estate tax (as well as the gift tax and GST tax) is a voluntary tax. Those who plan do not pay the tax. Those who fail to plan pay the tax. While planning cannot always completely eliminate exposure to the estate, gift, and GST taxes, appropriate planning can minimize these taxes. This white paper will explain how individuals and their advisors can take advantage of the changes brought about by the 2010 Tax Act to minimize these taxes and maximize the amounts passing to family members, charity, or other beneficiaries.

II. THE PATH TO THE 2010 TAX ACT

The 2001 Tax Act

December 2010 saw a great drama unfold in Washington, D.C. in the federal estate tax law arena, toward which Congress had been building for a decade. It started with the 2001 Tax Act, enacted only a few months into the administration of President George W. Bush. Addressing a campaign promise of President Bush, it attempted to repeal the estate and GST taxes by making those taxes inapplicable after 2009. In the meantime, the estate tax exemption was increased from 2002 through 2009, when it reached a high of $3.5 million, more than five times its level of $675,000 in 2001. The top tax rate of 55% was phased down to 45%. And the federal credit for state death taxes was phased out, leading to considerable differences in the tax burdens imposed on decedents' estates from state to state.

This repeal of the estate tax scheduled for 2010 focused attention on a couple of income tax issues. The first income tax issue was a concern that, without the accountability enforced by the gift and estate tax system, taxpayers would be free to transfer property that would produce income or increase in value to taxpayers for whom the income tax consequences of the income or gain would be less severe. For example, income might be transferred to someone in a lower income tax bracket. Or property that had increased in value might be transferred to someone with capital losses available to reduce the taxable capital gain upon sale of the property. To address these concerns, Congress left the gift tax in place for 2010,

with a lifetime exemption of only $1 million, a level thought appropriate to police and minimize these kinds of income-shifting transfers. To avoid a drop in the gift tax exemption to $1 million in 2010 when the estate tax expired, Congress kept the gift tax exemption at $1 million throughout the decade. As a result, the gift tax and estate tax "unified credits," which are the technical means for providing the exemptions, were "deunified," although they continued to be unified in the sense that the use of the credit for a gift affected the credit that was available both for future gifts and for transfers at death.

The second income tax issue involved the basis of property acquired from a decedent. Historically that basis has been equal to the value of that property on the date of the decedent's death (or alternate valuation date). This was typically called a "stepped-up basis," because the basis of appreciated property was "stepped up" to its date-of-death value, but it was also a stepped-*down* basis for property with a value less than its basis in the hands of the decedent. The estate tax has never been the "price" paid for a stepped-up basis in the usual sense. No effort is made to match estate tax revenue to the revenue lost from stepped-up bases, and the estate tax is paid by only a few people while stepped-up basis at death is available to everyone. Nevertheless, stepped-up basis is inevitably linked to the estate tax, and in 2001, without much explanation, Congress repealed stepped-up basis (but not stepped-down basis) for 2010 when the estate tax would be repealed. Exemptions were provided to replace the estate tax exemption, to reduce the possibility that many taxpayers who would not have paid estate tax would now be subject to additional income tax. These exemptions included a $1.3 million basis increase that the executor could allocate to any assets and an additional $3 million basis increase that the executor could allocate to assets that passed to the decedent's surviving spouse.

The 2011 Sunset

To expedite its consideration, the 2001 Tax Act was taken up under the streamlined process of "budget reconciliation." A rule for budget reconciliation drafted and sponsored by the late Senator Robert Byrd (D-WV) (and hence known as the "Byrd Rule") makes "extraneous" provisions in budget reconciliation subject to a point of order in the Senate. "Extraneous" is defined to include the reduction of net revenues in years beyond the period provided for in the budget resolution. Because the 2001 budget resolution generally covered 10 years, a net reduction of tax revenue beyond the 10th year would have been ruled out of order. A point of order under the Byrd Rule can be waived by a vote of 60 Senators, but the conference report that became the 2001 Tax Act received only 58 votes. To avoid a potentially deal-stopping point of order in the Senate, the 2001 Tax Act avoided any effect on tax revenue beyond 10 years by completely "sunsetting," or ceasing to apply, after December 31, 2010. That is why the so-called "Bush tax cuts," the income tax cuts enacted in the 2001 Tax Act, were set to expire after 2010.

Thus, with respect to the estate tax, the 2001 Tax Act created a framework in which the estate tax would be reduced over time through 2009, eliminated altogether in 2010, but then restored in 2011 to the 55% rate and $1 million exemption that it was scheduled to become before the 2001 Tax Act was passed, with a credit for state death taxes, a stepped-up basis for appreciated assets, and all the other features of pre-2001 Tax Act law.

Efforts to Stabilize the Estate Tax

There were efforts in Congress throughout the decade to address the estate tax permanently, including efforts to make total repeal permanent. Under Republican leadership, a key vote in the Senate was scheduled for just after the August recess in 2005, but Hurricane Katrina intervened. When the Senate renewed its effort in 2006, the effort had lost some momentum but still fell only a couple votes short.

Under Democratic leadership in the last four years, efforts focused on extending 2009 law, although separate budget resolution amendments in 2007, 2008, and 2009 to authorize (but not direct) an increase in the estate tax exemption to $5 million with a top rate no higher than 35% received significant support, including 51 votes for a single such amendment in

April 2009. In December 2009, the House of Representatives approved a permanent extension of 2009 law in a partisan vote (no Republican voted for it), but the Senate leadership was unable to obtain unanimous consent to interrupt work on healthcare reform and take up the House-passed measure. As a result, we entered 2010 with no estate tax and considerable uncertainty.

With time running out in the "lame duck" session on December 2, 2010, Senator Max Baucus (D-MT), the chairman of the Senate Finance Committee, introduced an amendment to pending tax legislation entitled the "Middle Class Tax Cut Act of 2010" and widely known as the "Baucus Bill." As with previous Democratic proposals, the amendment would have permanently reinstated 2009 estate tax law, with a 45% rate and $3.5 million exemption, effective January 1, 2010, except that the $3.5 million exemption would be indexed for inflation beginning in 2011. Executors of estates of decedents who had died in 2010 would be able to elect out of the estate tax into the carryover basis regime that had been 2010 law. The Baucus Bill also revived a 2006 idea for "portability" of the unified credit, or "exclusion amount" or "exemption," by making the portion of the exemption not used by a predeceased spouse available to the surviving spouse. It would have also provided substantial estate tax relief targeted to farmland.

The Deal Between the President and Some Congressional Leaders

On December 6, 2010, President Obama announced on national television that he and certain congressional leaders had agreed on "the framework of a deal" to permit the "Bush tax cuts" to be extended for two years. The President reported that the agreement included a one-year 2% payroll tax reduction, a 13-month extension of employment benefits desired by many Democrats, and an extension of the estate tax for two years with the $5 million exemption and 35% rate Republicans had been seeking for many years. It appears that the congressional leaders with whom the President reached this agreement were mostly Republicans, and the initial reactions of Republicans were supportive, even if not enthusiastic, while surprised Democrats originally reacted with skepticism or even hostility. As the days passed, Republican criticisms also emerged while more Democratic support began to be heard. In the House of Representatives in particular, the Democratic objections were directed largely at the estate tax proposal, believed by many to be both overly generous and unrelated to the core elements of the compromise.

On December 9, 2010, the Senate released the text of an amendment offered by the Senate leaders, Senators Harry Reid (D-NV) and Mitch McConnell (R-KY). Unlike the Baucus Bill and presumably to implement the agreement announced by President Obama, the Reid-McConnell Amendment not only raised the estate tax and GST exemptions to $5 million, it surprisingly made those changes retroactive to the beginning of 2010 and "reunified" the gift tax exemption by raising it to $5 million beginning in 2011. The Reid-McConnell Amendment passed the Senate by a vote of 81-19 on December 15.

In the House of Representatives, Democratic resistance continued to single out the estate tax cuts as too generous, and scaling them down to 2009 levels ($3.5 million exemption and 45% rate) was the point of the single substantive amendment that the House considered. On December 16, the House defeated that amendment by a vote of 194-233 and by midnight had approved the 2010 Tax Act by a vote of 277-148.

On December 17, 2010, President Obama signed the 2010 Tax Act, which became Public Law 111-312.

Comment and Forecast

On December 16, 2009, when Senator Baucus asked for unanimous consent that the Senate pause from its consideration of healthcare reform and approve an extension of 2009 transfer tax law for just two or three months, Senator McConnell asked Senator Baucus to agree to consideration of an amendment reflecting, as Senator McConnell described it, "a permanent, portable, and unified $5 million exemption that is indexed for inflation, and a 35-percent top rate" (similar to

what 51 Senators had voted for in April 2009). Senator Baucus objected to Senator McConnell's request, whereupon Senator McConnell objected to Senator Baucus's request, and all hopes of transfer tax legislation in 2009 died.

Now, except for permanence, the 2010 Tax Act has fulfilled Senator McConnell's request. But lack of permanence is important. It means that we may have to endure similar suspense in two years.

Meanwhile, the manner in which the estate tax provisions of the 2010 Tax Act evolved has troubled some observers. Many have long thought that any true congressional consensus about the estate tax would have to be more generous than 2009 law and would probably end up close to the $5 million exemption and 35% rate that have attracted support in the Senate votes in recent years. But it was also assumed that a consensus solution might phase in such cuts over several years or take other action to control the immediate cost, including revenue raisers related to the estate tax. Instead, the deal with the President was to do it all at once, without a phase-in, and, indeed, to do it retroactively to January 1, 2010, for estate and GST tax purposes. Moreover, there is not even an effort to pay for it. At the same time, tying the estate tax provisions to the *income* tax cuts, which also are now scheduled to expire in two years, and tying the income tax cuts in turn to a bad economy, just tees up another contentious tax debate, already beginning to be shaped by the way the estate tax provisions were singled out for debate in December 2010.

In the end, the fate of the estate tax in two years might again be affected by the perceived condition of the economy, as well as by the all-important ability of the Republican House leadership to influence the timing and packaging of such proposals. And if it is not addressed before another lame-duck session, then it will also undoubtedly be affected by the outcome of the 2012 presidential and congressional elections.

At this point, it is possible that the conditions that permitted the December 2010 deal with the President will not be repeated. In that case, there may be no legislation before the end of 2012. Perhaps, however, it is just as likely that Congress will grow weary of a tax that collects so little revenue, affects so few people, and absorbs so much debate time, and will simply repeal the estate tax after all. The only thing that is certain is the need for continued flexibility for at least two more years.

III. TRANSFER TAXES UNDER THE 2010 TAX ACT

Estate Tax

While the sunsetting provisions of the 2001 Tax Act repealed the federal estate tax for decedents dying in 2010 in favor of a modified carryover basis regime, the 2010 Tax Act retroactively reinstated the estate tax for 2010 decedents. The estate tax exemption amount for 2010 is $5 million and the estate tax rate is 35%.

However, an executor[2] of an estate of a decedent who died in 2010 ("a 2010 decedent") may elect out of the estate tax regime and instead choose to subject the estate to the modified carryover basis rules imposed in 2010 under the 2001 Tax Act. This election must be an affirmative election made by the executor in an appropriate manner to be determined by the Internal Revenue Service. Once the election is made, it is revocable only with the consent of the Secretary of the Treasury. Whether or not the election out of the estate tax would be appropriate for a particular estate is an involved question based on a myriad of disparate factors and a consideration of fiduciary duties as discussed in more detail below.

For decedents dying in 2011 and 2012, the estate tax exemption is $5 million and the estate tax rate is 35%. Significantly, the 2010 Tax Act reunifies the estate and gift tax regimes. Thus, the gift tax exemption and the estate tax exemption are no

[2] The term "executor" is defined in Internal Revenue Code section 2203.

longer disconnected, but instead the $5 million exemption applies for determining the transfer taxation of an individual's lifetime gifts and transfers at death.

Additionally, the 2010 Tax Act codified the concept of estate tax exemption "portability." Under the 2001 Tax Act and prior law, an individual's estate tax exemption amount was personal and nontransferable. Now, any remaining unused $5 million exemption of a decedent who dies in 2011 or 2012 (referred to as the "decedent's unused exemption") may, under certain circumstances, be used by the decedent's surviving spouse during lifetime or upon the surviving spouse's subsequent death. So with portability, a surviving spouse's gift or estate tax exemption is equal to his or her remaining $5 million exemption plus the decedent's unused exemption. Because of the reunification of the estate and gift tax, the surviving spouse's exemption may be applied to any transfer during life or at death. In order for the surviving spouse to use the decedent's unused exemption, the executor of the decedent's estate must make an affirmative election on a timely filed estate tax return, even if an estate tax return would not otherwise need to be filed.

A surviving spouse may use only the unused exemption of his or her most recently deceased spouse. In other words, if a surviving spouse who has the use of the unused exemption of his or her predeceased spouse remarries and the second spouse also predeceases, the surviving spouse now may use only the unused exemption amount of his or her second spouse, if any, and the unused exemption of the first spouse to die is lost. The 2010 Tax Act directs the Internal Revenue Service to promulgate appropriate regulations regarding the new portability rules.

Gift and GST Taxes

The 2010 Tax Act did not change the gift tax exemption for 2010, which remained at $1 million. The gift tax rate applicable to taxable gifts in 2010 also remained at 35%. However, as noted above, starting on January 1, 2011, the gift tax exemption was unified with the estate tax exemption and is $5 million. So for gifts made in 2010, the lifetime exemption amount was $1 million, but the lifetime exemption amount for gifts in 2011 and 2012 is $5 million. The gift tax rate for gifts made in 2011 and 2012 remained at 35%.

While the 2001 Tax Act eliminated the GST tax for transfers made in 2010, the 2010 Tax Act retroactively reinstated the GST tax with a $5 million GST exemption, but confirmed that 2010 would indeed be a GST tax "holiday" by providing that the applicable rate for generation-skipping transfers would be zero in 2010. So in 2010, no GST taxes were imposed on direct skips or otherwise taxable distributions and terminations. In addition, the 2010 Tax Act made clear that certain subsequent distributions from trusts for the benefit of skip persons would not later be subject to GST tax pursuant to the "move-down" rule of Internal Revenue Code section 2653(a).

For generation-skipping transfers made in 2011 and 2012, the GST exemption is $5 million with a 35% tax rate. The $5 million amount will be indexed for inflation beginning in 2012. Unlike the estate tax exemption, the GST exemption is not portable to surviving spouses.

What is Not in the 2010 Tax Act

What is not in the 2010 Tax Act is as surprising as what actually appears in the legislation. Several of the transfer tax-related "revenue-raisers" were not included in the 2010 Tax Act. This cannot be taken as a statement on the legislative priority of raising revenue; no revenue offsets are included in the 2010 Tax Act. While the absence of these revenue-raisers in the 2010 Tax Act is generally considered favorable to taxpayers, many believe that some or all of the following may be taken up by a future Congress seeking to offset increasing budget deficits, permanent extensions of this or new tax regimes, or further spending.

Minimum GRAT Term. A grantor retained annuity trust ("GRAT") is a trust that has two components: an annuity interest that the grantor will retain and an interest that passes to selected beneficiaries (the "remainder"). The value of the gift or the remainder interest in the GRAT is measured when the trust is created, and it is calculated by subtracting the present value of the retained annuity interest from the value of the property transferred to the trust. If the value of the annuity interest is very high, the value of the gift (that is, the value of the remainder transferred to the remainder beneficiaries) is very low. The key to success of a GRAT is the assumption that the assets transferred into the GRAT will grow faster than the assumed growth rate that is prescribed by the Internal Revenue Service for calculating the value of the retained annuity (the "section 7520 rate").

If the grantor dies during the term of the GRAT, the assets transferred to the GRAT will be included in the grantor's estate and subject to estate tax. To avoid this mortality risk, many individuals create a short-term GRAT (or a series of short-term GRATs), where the annuity interest is paid for two or three years. If the grantor survives the term and the assets outperform the section 7520 rate, the appreciation in the assets of the GRAT passes to the remainder beneficiaries at a nominal gift tax cost.

An early attack on this technique took the form of rumors of congressional plans to limit the attractiveness of GRATs by imposing a minimum gift tax value for the remainder, such as 10%. This effort coalesced in the Obama Administration's revenue proposals for fiscal year 2010 and the Treasury Department's "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (the so-called "2009 Greenbook") and was repeated in the 2010 Greenbook for fiscal year 2011.

The 2009 and 2010 Greenbook proposals focused on the term of the GRAT rather than the value of the gift and would have required the GRAT to have a minimum 10-year term. The proposal was estimated to raise $3.25 billion in revenue over 10 years in the 2009 Greenbook and $2.959 billion over 10 years in the 2010 Greenbook. Throughout 2010, various forms of the Greenbook proposal were included in incarnations of transfer tax reform legislation before enactment of the 2010 Tax Act (H.R. 4849, H.R. 5486, H.R. 4899, S. 3533, and H.R. 5764). The estimated revenue would have been used to offset the permanent or temporary extension of estate tax relief.

The Greenbook proposals attempt to introduce a heightened downside risk – the grantor's mortality – into a technique with little downside risk. Simply put, a longer-term GRAT increases the likelihood that assets will be included in the grantor's estate and subject to the estate tax.

A short-term GRAT has been a successful technique for capturing the upside of asset volatility. If the proposal to introduce a minimum term for a GRAT is resurrected, the ability to transfer appreciation to future generations with a GRAT still exists. Planners, however, will have to customize GRAT terms to reflect traits of the assets transferred into the trusts by using, for example, a level term GRAT or a GRAT in which the annuity increases in some years but not others (or increases at different rates in different years).

Attack on Discounts. Beginning with proposals during the Reagan Administration and then late in the Clinton Administration, limits on valuation discounts for interests in family-owned entities have been considered as a means of raising revenue. A 1999 proposal would have eliminated valuation discounts for interests in any entity that was not an active business. Under the 1999 proposal, entities that held "readily marketable assets" or "non-business assets" could not have been valued at a discount for transfer tax purposes.

In a 2005 report entitled "Options to Improve Tax Compliance and Reform Tax Expenditures," the Joint Committee on Taxation (the "JCT") continued the attack on valuation discounts, responding to "the frequent use of family limited partnerships ('FLPs') and LLCs to create minority and marketability discounts," claiming in essence that families were

manufacturing discounts for transfer tax purposes.[3] The JCT proposed reducing the effectiveness of these discounts by applying aggregation rules (for the transferor and the transferee) to limit the discount in certain intra-family transfers.

The 2009 and 2010 Greenbooks picked up where these efforts left off and proposed raising revenue by curbing techniques designed to reduce the transfer tax value of assets, but not the economic benefit of the assets in the hands of the owners. Under Internal Revenue Code section 2704(b), certain "applicable restrictions" that would otherwise justify valuation discounts (such as limitations on the ability to liquidate the entity) are ignored for transfer tax purposes in intra-family transfers. The Obama Administration's proposal would have created a more durable category of disregarded restrictions under Internal Revenue Code section 2704(b) and may have included limitations on liquidation, management, distributions, access to information, and transferability. The disregarded restrictions under this proposal would significantly limit the marketability discounts that are commonly used in valuing interests in family-owned entities.

The proposal was estimated to increase tax revenue by $19.038 billion over 10 years in the 2009 Greenbook and $18.667 billion over 10 years in the 2010 Greenbook. Of all the pay-for proposals, limitations on valuation discounts would generate the most revenue for the Treasury. Moreover, the limitations would adversely affect many common "estate freeze" techniques, including gifts and sales to trusts of interests in family-owned entities.

The proposal to limit valuation discounts made only one serious appearance in the tax debate during 2010. The Pomeroy Bill (H.R. 436) called for a separate valuation of business and non-business assets in an intra-family transfer (returning to the Clinton Administration era), causing many taxpayers, advisors, and business valuation experts to fear the end of the valuation discount era was near.

Despite these fears, the 2010 Tax Act contains no provisions regarding valuation discounts. But, because of the amount of revenue estimated to be raised by limiting valuation discounts, a budget-conscious Congress may likely again consider some form of limitation on valuation discounts for intra-family transfers. Individuals and their advisors should consider using techniques to take advantage of valuation discounts for transfers of interests in family entities while still viable.

Consistency in Basis. The 2010 Tax Act has reinstated the estate tax, and with it, the "step-up" in basis for assets included in the estate. This has also resurrected the debate over consistency in basis reporting.

The basis of property acquired from a decedent is "the fair market value of the property at the date of the decedent's death," with appropriate adjustments if the alternate valuation date is used. It is possible for the beneficiary of property acquired from a decedent to claim, for income tax purposes, that the value of the asset reported by the decedent's estate was too low, and that the beneficiary's basis is therefore greater than the estate tax value. These claims are often made after the statute of limitations has run on the estate tax return, and thus the beneficiary would recognize less gain and pay lower capital gains tax upon sale of the property.

The 2005 JCT report first addressed the issue of consistency in basis reporting in a systematic way, proposing that a beneficiary would be required to use an income tax basis equal to the estate tax value. The proposal called for a basis report to be filed with the Internal Revenue Service and delivered to the beneficiary setting forth the basis of property received by the beneficiary.

The 2009 and 2010 Greenbooks addressed the consistency in basis as a potential source of revenue to offset some temporary or permanent tax relief. It was expected to increase tax revenue by $1.87 billion over 10 years in the 2009 Greenbook and $2.103 billion over 10 years in the 2010 Greenbook. In subsequent comments, the JCT approved the

[3] Available at http://www.house.gov/jct/s-2-05.pdf.

Greenbook proposal and addressed the general need for consistency in reporting across the tax system and the specific need for more realistic determinations of value on estate tax returns.[4]

Consistency in basis reporting appeared in the estate tax reform debate in 2010, most notably in the Responsible Estate Tax Act (S. 3533 and H.R. 5764) but was not included in the 2010 Tax Act. Because of the policy reasons behind the proposal (that is, consistency) and the need for revenue offsets, this proposal may resurface in future debates and legislative proposals. All proposals supporting consistency in basis have included broad authority for Treasury to issue regulations to implement the rules and would have broad impact on estate and income tax reporting.

Benefits to Farmers. Throughout the estate tax reform debate over the last decade, legislators looked to provide political context, and garner political support, for estate tax reform proposals. The Senate Finance Committee, most notably Senators Baucus and Conrad, tried to couch the estate tax reform debate in terms of middle class tax relief, singling out America's family farmers and ranchers as deserving of relief.

The many incarnations of estate tax reform legislation have set forth targeted relief for family farms, including an estate tax exemption for the value of farmland so long as it was held by a qualified heir (S. 3664), and an increase in the reduction of value under the special use valuation provisions of Internal Revenue Code section 2032A (currently limited to $1 million) to the applicable exclusion amount (S.722 and S. 3533, H.R. 5764).

Because the estate tax exemption has been increased to $5 million, some will conclude that the "middle class tax relief" objectives of estate tax reform for family farmers and ranchers have been met. Therefore, further action on these farm exemptions will not be as urgent and may not occur.

Sunsetting

The uncertainty surrounding the estate tax during the last decade has largely been driven by section 901 of the 2001 Tax Act – the sunset provisions. That section provides: "All provisions of, and amendments made by, this Act shall not apply (1) to taxable, plan, or limitation years beginning after December 31, 2010, or (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010."

The 2010 Tax Act does nothing to solve the concerns with these sunset provisions. It simply replaces the date "December 31, 2010" with "December 31, 2012," and invites continued speculation and confusion. Absent meaningful reform or legislation in the next two years, individuals and fiduciaries and their advisors will be in the same position in 2012 as they were in 2010: all of the tax changes will expire on December 31, 2012, and after that date the tax law "shall be applied … as if the provisions and amendments [of the 2001 Tax Act and the 2010 Tax Act] had never been enacted." The estate tax exemptions, rates, and other provisions are scheduled to return to pre-2001 Tax Act levels, confirming the need for flexibility in estate planning documents as discussed more fully below.

IV. IMPACT OF THE 2010 TAX ACT ON ESTATES OF DECEDENTS DYING IN 2010

The 2010 Tax Act provides the estates of 2010 decedents with an unprecedented election to allow the estate tax regime as reinstated effective as of January 1, 2010 to apply to the estate or to elect out of the estate tax and be subject instead to the modified carryover basis regime established by the 2001 Tax Act. Being provided with a choice to use a taxing system that produces the best result for an estate and its beneficiaries is initially very appealing. However, given the complexity and potential for conflicts of interest for any estate that has more than one beneficiary, it may be very difficult to determine

[4] "Description of Revenue Provisions in President's Fiscal Year 2010 Budget Proposal, Part One: Individual Income Tax, Estate and Gift Tax Provisions," Joint Committee on Taxation (Sept. 9, 2009).

which tax regime produces the best result. Furthermore, even if it can be determined which regime produces the best overall result for the estate and its beneficiaries collectively, it is possible that one regime will not produce the best result for every beneficiary individually. Therefore, the administration of the estate of a 2010 decedent has the potential for even more friction and conflict not only between the executor and the beneficiaries but also among the beneficiaries.

Uncertainty Surrounding Tax Provisions and Formula Clauses

Interpreting the 2010 Decedent's Estate Plan. The estate plans of many 2010 decedents contain provisions that are dependent on federal tax concepts, such as the amount of the estate tax exemption or the GST exemption, the most typical being a formula division of the decedent's assets between a family share or trust (in the amount that can pass free of federal estate tax by virtue of the estate tax exemption), and the marital share or trust (the balance of the decedent's assets). The estate plans of 2010 decedents may also include gifts that rely on tax concepts, such as the adjusted gross estate or values as determined for federal estate tax purposes, or have savings clauses that force assets not subject to the federal estate tax into non-marital shares or trusts.

When the federal estate tax was "repealed" for 2010, the interpretation of these provisions became uncertain, and the literal language of the provisions could at times produce results that were detrimental to the estate beneficiaries or contrary to the decedent's intent. As a result of the changes made by the 2010 Tax Act, tax-dependent provisions, especially formula clauses, must be carefully reviewed.

The Challenge for Fiduciaries. The 2010 Tax Act presents uniquely difficult challenges in interpreting the estate plans of 2010 decedents. Beneficiaries may argue that applying the 2010 Tax Act's higher exemptions in interpreting documents are contrary to the decedent's intent. Also, although the GST tax has been imposed on 2010 estates with a $5 million exemption, the GST tax rate for 2010 is zero. A gift made by reference to the GST tax exemption may arguably be limited to $5 million, whereas a gift referring to the burden of the tax itself may be unlimited as a consequence of the rate. Perhaps most significantly, the election into carryover basis could affect the operation of formula clauses and other tax-dependent provisions and give rise to objections by disadvantaged or disinherited beneficiaries, who will point out (rightly, in many cases) that the testator never anticipated the possibility of such an election and its effect on the disposition of the estate.

Fiduciaries must exercise extreme caution when interpreting tax-dependent provisions, as their actions could, for example, result in extreme situations such as the total disinheritance of the surviving spouse (and loss of property to which basis may be allocated), or just the opposite, in ways that are contrary to the testator's intent. Unfortunately, the 2010 Tax Act may place some fiduciaries in the position of picking inheritance "winners" and "losers," and disappointed heirs may seek to punish fiduciaries on the ground that the fiduciary improperly distributed assets in breach of a fiduciary duty (such as the duty of loyalty and the duty to treat beneficiaries impartially). Complex family situations (such as second marriages) will increase the fiduciary risk in interpreting tax-dependent provisions and determining whether to make the carryover basis election.

Fiduciaries may need to seek the guidance of the court in dealing with formula clauses, tax-dependent provisions, and the carryover basis election or seek agreement among all the beneficiaries. Judicial relief, however, may be affected by limitations on admission of extrinsic evidence of the testator's intent (only a handful of states have passed statutes to alleviate this concern). Furthermore, the Internal Revenue Service may not be bound by a state court decision.

State Corrective Statutes. In response to the problem with formula clauses, 20 jurisdictions passed legislation that provided default rules of construction to clarify the meaning of formula clauses with reference to 2009 law (and a $3.5 million exemption) or provide other relief from uncertainty. The following states passed corrective statutes:

Delaware *12 Del. C. 3335*	Indiana *Ind. Code 30-4-2.1-13*	New York *NY CLS EPTL 2-1.13*	Tennessee *Tenn. Code 32-3-113*
District of Columbia *DC Code 20-1108*	**Maryland** *Md. Estates and Trusts Code 11-110*	**North Carolina** *N.C. Gen. Stat. 36C-1-113*	**Utah** *Utah Code Ann. 75-3-917*
Florida *Fla. Stat. 736.04114; 733.1051*	**Michigan** *House Bill 619 2010 Mi. P.A. 224*	**Pennsylvania** *Pa. C.S., Section 3, Title 20, Chapter 28 (Sec. 2801-2803)*	**Virginia** *Va. Code 64.1-62.4*
Georgia *O.C.G.A. 53-4-75*	**Minnesota** *Minn. Stat. 524.2-712*	**South Carolina** *S.C. Code 62-2-612*	**Washington** *Rev. Code Wash. 11.108.080; 090*
Idaho *Idaho Code 15-1-501*	**Nebraska** *R.R.S. Neb. 30-2342.02*	**South Dakota** *S.D. Cod. Laws 10-40A-11*	**Wisconsin** *Wis. Stat. 854.30*

For states with a corrective statute imposing a default rule of construction, the statute must be carefully reviewed to determine whether it will have any effect on the interpretation of formula clauses. Now that the 2010 Tax Act has imposed estate and GST taxes on all estates of 2010 decedents, some beneficiaries will take the position that the corrective statute has no further application because the estate and GST tax laws have "become effective," and the $5 million estate tax and GST exemptions should govern the interpretation of formula clauses.

Particular attention must be paid to whether the election into carryover basis, if made, will affect the operation of the corrective statutes. It is doubtful that the possibility of such an election was considered in the drafting or enactment of state corrective statutes. If the carryover basis election is made, is the federal estate tax law still "effective" so that the corrective statute will not apply? Also, some beneficiaries may understandably ask whether the GST tax has "become effective" for purposes of the corrective statute and interpreting documents when the 2010 GST tax rate is zero.

An additional concern is that some of the corrective statutes include a statute of limitations for seeking judicial relief from the statute (usually requiring the suit to be filed within one year from the date of death). For the estates of decedents who died in early 2010 and where there is the possibility of disagreement among the beneficiaries, it may be necessary to initiate a suit very early in 2011. Many executors will not have completed the analysis of the carryover basis election by the date the suit must be filed under these statutes. Nevertheless, the courts generally welcome fiduciaries facing uncertainty, and it should be sufficient to plead the basis for needing guidance without full development of any recommendations to present to the court. States should consider, at a minimum, amending their corrective statutes to allow adequate time to seek guidance from the courts on these very difficult issues.

Filing Requirements

Absent any state law deadlines, the 2010 Tax Act has, for federal tax purposes, provided the estates of 2010 decedents with sufficient time to prepare the necessary analysis to determine which taxing regime is the most favorable. The filing requirements and due dates for the estates of 2010 decedents are as follows:

- For the estates of 2010 decedents dying after 2009 and before December 17, 2010, the due date for filing the federal estate tax return and the due date for the payment of any federal estate tax due is September 19, 2011

(September 17 is a Saturday). Presumably, the six-month extension for filing the estate tax return may be requested as well, although this is not completely clear at this time.

- For the estates of those 2010 decedents dying after December 16, 2010, the federal estate tax return and the due date for the payment of any federal estate tax due will be the date that is nine (9) months after the decedent's date of death (that is, the traditional estate tax return due date).

- The filing requirements and due dates for state estate tax returns are unknown at this point, but presumably will conform to the federal rules.

- The time and manner of filing the election for those estates of 2010 decedents who desire to elect out of the estate tax regime and into the modified carryover basis regime has been delegated to the Treasury. Treasury has made no pronouncements as yet, but presumably this election will not be due before April 18, 2011.

- Those estates of 2010 decedents who desire to elect out of the estate tax regime and into the modified carryover basis regime must file a Form 8939 along with the 2010 decedent's final individual income tax return, which will be due on April 18, 2011. The Form 8939 has been issued by the Internal Revenue Service in draft form at this point. Form 8939 will require the estate to list and describe each asset in the estate and report the fair market value of each asset on the date of the 2010 decedent's death, the basis of each asset in the hands of the 2010 decedent, and the amount of the general basis adjustment or spousal basis adjustment allocated to each asset by the executor of the estate. Compiling the 2010 decedent's basis information will probably be a major undertaking for the executor.

Election to Avoid Estate Tax and Use the 2001 Tax Act Carryover Basis Rules

For many estates of 2010 decedents the election to use the estate tax regime or the carryover basis regime will not be an easy one to make. While projecting the estate taxes that would be due for a particular estate may be relatively straightforward, forecasting the total income tax liability under a carryover basis regime, which is dependent on a number of independent factors and future changes in the income tax rates, could present a significant challenge for the executor. The following factors are among those that should be considered in making the election between the estate tax regime and the carryover basis regime:

- Calculation and apportionment of estate tax burden.
- Impact of state death taxes, particularly in states with an exemption below $5 million.
- Anticipated date of sale of each asset.
- Ability to allocate basis.
- Decedent's basis in each asset.
- Date of death value of each asset.
- Projected future value of each asset.
- Projected earnings from each asset.
- Tax character of any future gains or earnings on assets.
- Identity of the beneficiaries.
- Revenue needs of the beneficiaries.
- Future tax rates.
- Domicile of beneficiaries and personal income tax information.
- Availability of asset-specific tax deductions and credits.
- Impact of election on formula clauses.

- Potential for disagreement among beneficiaries concerning the allocation of basis.
- Conflicts of interest in making the election and allocating basis.
- Aggressiveness of positions that will be taken if the estate tax return is filed.
- Aggressiveness of positions taken and valuation discounts claimed on the decedent's previously filed gift tax returns and those gift tax returns of the decedent that will be filed contemporaneously with the estate tax return.
- Whether "adequate disclosures" were made on the decedent's previously filed gift tax returns.
- Magnitude of the expense and aggravation factor associated with filing the estate tax return versus filing the Form 8939.
- The availability of binding consents or court approval.
- Whether a compensating equitable adjustment is appropriate, and whether it should be approved by a court.

Each estate of a 2010 decedent must examine its own unique facts to determine if it should elect to avoid the estate tax and have the modified carryover basis rules apply (the "Carryover Basis Election"). Nevertheless, it may be helpful to consider some broad-brush "rules of thumb" that can be considered as starting points for such an analysis by the executor of the estate of a 2010 decedent.

1. If the 2010 decedent had no surviving spouse and the estate would be required to pay estate tax (that is, the taxable estate is in excess of $5 million), the executor should elect to have the 2001 Tax Act rules apply (carryover basis and no estate tax) unless the estate tax that would be paid would be less than the projected income tax that could be saved by obtaining the step-up in basis in excess of the step-up provided by the $1.3 million general basis adjustment.

Example: Father died a widower in March 2010 with an estate valued at $42 million on the date of his death. Most of the assets in his estate consisted of undeveloped pasture land for which his basis was at best $100,000 in total. His entire estate was left to his three sons who have no interest in continuing Father's ranching operations. The executor of Father's estate calculated the estate tax to be approximately $12.95 million (ignoring state estate taxes for purposes of this illustration). In comparison, if the estate elected out of the estate tax and relinquished the right to the full step-up in basis for the estate assets, the sons would be foregoing $8.12 million of potential income tax savings calculated as follows:

Fair market value on date of death	$42,000,000
Father's basis	(100,000)
General basis adjustment	(1,300,000)
Foregone basis adjustment	$40,600,000
Potential foregone income tax savings, assuming an effective capital gains rate of 20%	$ 8,120,000

The executor of Father's estate will make the Carryover Basis Election because the $12.95 million of estate taxes avoided far exceeds the potential income tax savings.

Example: Mother, a widow, died in June 2010 with a net estate valued at $5.1 million. Her largest asset was stock in her closely held corporation that was valued at $4 million at the date of her death and had a basis in her hands of $200,000. Mother had never made taxable gifts. The executor of Mother's estate calculated the estate tax for her estate to be $35,000 (35% of $100,000 ($5,100,000-$5,000,000) and ignoring state estate taxes for purposes of this illustration). As a result, the beneficiaries of Mother's estate would obtain a full step-up in basis to $4

million for the stock. Obtaining the full step-up should save the beneficiaries, who are highly likely to sell the stock, at least $500,000 in income taxes calculated as follows:

Fair market value on date of death	$4,000,000
Mother's basis	(200,000)
General basis adjustment	(1,300,000)
Foregone basis adjustment	$2,500,000
Potential foregone income tax savings, assuming an effective capital gains rate of 20%	$ 500,000

The executor of Mother's estate will not make the Carryover Basis Election because the estate taxes of $35,000 are far less than the potential income tax savings.

2. If the 2010 decedent had no surviving spouse and the 2010 decedent's estate would not be required to pay estate tax (for example, gross estate less than $5 million), the executor should not make the Carryover Basis Election. There are two major advantages to not making the Carryover Basis Election. The first advantage is simplicity as no estate tax return will be required to be filed because the estate will fall below the $5 million filing threshold. Secondly, the appreciated assets in the estate will obtain the full step-up in basis, which is important if the collective appreciation for these assets is in excess of the $1.3 million general basis adjustment.

3. If the 2010 decedent had a surviving spouse, most of the decedent's assets passed other than outright to the surviving spouse (for example, to a credit shelter trust and a "QTIPable" marital trust), and the surviving spouse's estate is likely to be subject to estate tax upon the surviving spouse's death, then the executor should make the Carryover Basis Election. As a result of making the Carryover Basis Election, the property in the trusts for the benefit of the surviving spouse will not be included in the surviving spouse's future taxable estate. The Carryover Basis Election should not be made, however, if the projected estate tax in the surviving spouse's estate is small as compared to the income tax to be saved from obtaining the full step-up in basis for all of the 2010 decedent's assets.

Example: Husband died in September 2010 with a net estate valued at $9 million. The estate consisted of cash, certificates of deposit, and low basis marketable securities. Husband's will provided for a credit shelter trust for the benefit of Wife and children equal to the amount of his available applicable exclusion amount with the balance being transferred to a marital trust for the benefit of Wife. (For purposes of this illustration, we are ignoring the possible effect that making the Carryover Basis Election might have on the interpretation of the formula in the will. See the discussion below in this section under Formulas.)

Wife has a net worth of approximately $7 million exclusive of any property to be received directly or indirectly from Husband's estate. If the executor of Husband's estate were to make the Carryover Basis Election, the value of the marital trust assets ($4 million at the date of Husband's death) will avoid estate taxation upon Wife's subsequent death, thus saving the remainder beneficiaries of the marital trust at least $1.4 million of estate taxes. The price to pay for making the Carryover Basis Election is the failure to obtain a stepped-up basis for the assets in Husband's estate of any more than that which is provided by the general basis adjustment of $1.3 million and the spousal basis adjustment of $3 million for the assets allocated to the marital trust.

The executor of Husband's estate will make the Carryover Basis Election.

4. If the 2010 decedent had a surviving spouse and most of the 2010 decedent's assets pass outright to the surviving spouse, the executor should not make the Carryover Basis Election in order to obtain the full step-up in basis, regardless of whether the surviving spouse's estate is required to pay estate tax.

> **Example:** Wife died in July 2010. Her primary assets were (i) a $2.1 million balance in her 401(k) plan that was payable to Husband, (ii) $3 million of marketable securities in a joint-with-right-of-survivorship brokerage account with Husband, and (iii) their principal residence valued at $1 million, net of a small mortgage, which was owned as tenants by the entirety. Husband has substantial assets in his own name. The executor of Wife's estate will not make the Carryover Basis Election because her assets will be included in Husband's gross estate for estate tax purposes regardless of whether the election is made or not, assuming no disclaimer by Husband. As a result, Wife's estate will file an estate tax return but pay no estate tax because her assets are passing to the surviving spouse, but her assets obtain the full step-up in basis to the extent otherwise available. (Note that the 401(k) account is not eligible for a basis step-up.)

5. If the 2010 decedent had taken aggressive positions in the past on federal gift tax returns for gifts made to family members or if the executor is likely to take aggressive positions on the estate tax return for the estate of the 2010 decedent, the prudent approach may be to make the Carryover Basis Election to avoid or minimize audit risks.

> **Example:** Father died in 2010, a widower, with an estate valued conservatively at $5.5 million. Father's hobbies had consisted of golf, yacht racing, and using all techniques available to beat the Internal Revenue Service out of tax revenues. In the past Father had formed several family limited partnerships, transferred numerous properties to such partnerships, made gifts of the limited partnership units, and claimed substantial discounts for lack of marketability and minority interests on those gifts which he reported on federal gift tax returns, although he rarely obtained an appraisal of the value of such partnership interests. Even though the assets in Father's estate have built-in gain far in excess of the $1.3 million general basis adjustment, the executor of Father's estate, which is a corporate fiduciary, has made a strong recommendation to Father's children, who are the beneficiaries of Father's estate, to make the Carryover Basis Election to avoid filing an estate tax return.

6. If the expense and aggravation factor for obtaining the basis of the assets in the hands of the 2010 decedent are so significant, it may actually be less expensive, simpler, and less time-consuming to pay estate taxes and not make the Carryover Basis Election.

> **Example:** Mother died in 2010 survived by her two sons. Mother's grandfather had made a fortune creating and developing a chain of auto parts stores throughout the Midwest. One of the reasons that Mother's grandfather and father had often cited for the success of the business was that each one of the company's 327 store locations was owned by a separate corporation, thus allowing the local manager of the store to obtain an equity interest in that store. As a result of this business strategy, at the time of her death, Mother held at least a few shares of stock in each of the 327 separate corporations. Such shares had been received by Mother either as gifts from her grandfather, her grandmother, or her father or as inheritances from her grandfather, her grandmother, her father, or two maiden aunts. The executor has been unable to find any sufficient information to establish the basis of Mother's shares.
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> Mother's estate appears to be valued at approximately $5.2 million. The executor will not make the Carryover Basis Election which could cause the estate to pay federal estate taxes of about $70,000 plus state estate taxes. The $70,000 tax bill is not an insubstantial amount, but it was determined that it would cost the estate more than $125,000 to engage a law firm or accounting firm to reconstruct any semblance of the basis of the shares in the various auto parts stores in Mother's hands.

Managing Risks in Making the Carryover Basis Election

There is little historical guidance for executors faced with the Carryover Basis Election in terms of implementing a process that will fulfill their fiduciary obligations and avoid liability. Some historical guidance may be found in a prior carryover basis election, enacted with the federal Crude Oil Windfall Profit Tax Act of 1980, Public Law 96-223, that permitted executors of certain estates to elect to have the basis of property received from the estate determined for federal income tax purposes according to the decedent's basis, rather than according to the value for estate tax purposes (fair market value at date of death or an alternate valuation date). Other tax elections typically made by executors, such as the QTIP election, the alternate valuation date election, and the election to deduct estate expenses against income, offer little procedural direction to serve as a bright line limit on a fiduciary's liability when making the Carryover Basis Election. Those other elections simply do not implicate the executor's duties to the same degree as the Carryover Basis Election or present comparable risks. State law offers little comfort and merely charges the executor with making elections in the best interests of the estate and its beneficiaries.

The Carryover Basis Election is unique in the degree of discretion afforded executors, and there is no prescribed one-size-fits-all process that will shield a fiduciary from liability when determining whether to pay estate tax or to opt-out in favor of the 2010 carryover basis rules. General state law principles of fiduciary duty in estate administration should guide executors; however, these flexible guides offer little certainty or solace to the fiduciary charged with deciding whether to make the election.

Generally, the executor has a duty to preserve assets, defend against claims, and use reasonable care and skill in administering the estate. Fiduciary duties include the duties of loyalty and impartiality, and fiduciary actions are evaluated within the confines of the discretion granted the executor under the provisions of the testator's will and based on the testator's intent. With these principles in mind, fiduciaries must develop a systematic approach to the Carryover Basis Election that includes extensive information gathering, detailed calculations, and the involvement of beneficiaries and, where necessary or appropriate, the courts to minimize or eliminate fiduciary liability.

Potential problems may arise with basis allocation if the appreciation in assets at the decedent's death is greater than the amount of basis adjustments available. In this situation, executors may have to choose between a 35% tax on the entire estate (in excess of the $5 million exemption), a burden that may be more easily divisible among beneficiaries, and no estate tax, but a basis allocation that may fall more or less favorably on certain beneficiaries. Difficulty will arise when the decedent has made specific bequests of appreciated assets and has not provided for pro rata distribution among residual beneficiaries. These tough decisions may lead to unhappy beneficiaries and potential claims against the executor.

Executor discretion in allocating basis will also depend on whether the decedent's estate planning documents grant the executor specific authority to allocate basis and exonerate the executor from liability for any basis allocation decisions. Even if broad discretionary authority is given to the executor and the optimal allocations are made to minimize tax paid, perceived unfairness may lead certain beneficiaries to claim a breach of the executor's duty of impartiality.

Adding to this challenge for executors is the fact that many decedents' wills contain provisions that provide for different dispositions of certain assets depending upon the applicability of the estate tax. In these cases, the Carryover Basis Election could affect the decedent's dispositive scheme and should be made with utmost caution. The executor will need to be mindful of the allocation issues discussed above and aware of both the decedent's goals when formulating the estate plan and the impartiality due each of the beneficiaries.

Because of the complicated problem the Carryover Basis Election presents and the many factors that must be taken into account to make an informed decision, the fiduciary should use financial and legal advisors as necessary to evaluate each of these factors and arrive at a proposed course of action.

Beneficiary Consents. After the executor has conducted a thorough analysis, calculations, and a comparison of the tax consequences to the estate under each approach, the executor should involve the beneficiaries in the ultimate decision over whether or not to make the Carryover Basis Election if possible. Further, the executor should work with the beneficiaries to develop a proposal for division of the estate assets. If the estate opts for carryover basis, the executor should obtain beneficiary consents to any basis allocations if possible, because of the potential for huge shifts in economic value resulting from the allocation of basis.

Court Approval. Regardless of whether the Carryover Basis Election is made, the executor may want the protection of court approval of the decision. If the executor chooses to seek court approval, the executor should determine the tax and other consequences to the estate and the beneficiaries of each scenario and present recommendations to the court. Interested parties should be provided notice and an opportunity to contest the recommendations.

Conflicts of Interest. Because of the conflicts that could arise as a result of the Carryover Basis Election, an executor who is also a beneficiary of the estate should consider resigning as executor in favor of an independent or corporate fiduciary to avoid self-dealing concerns. However, professional fiduciaries may balk at being appointed under such circumstances. It is recommended that executors seek not only advice of counsel regarding the Carryover Basis Election, but also court approval for any decisions made.

Conflicts Between Executors and Trustees. Fiduciaries who are acting as trustees but not executors should request information regarding the decedent's basis and the executor's proposed basis allocations. If proposed allocations do not meet the standards of fairness and loyalty owed to the trust beneficiaries, the trustee must consider how to proceed in order to protect the interests of the trust beneficiaries.

> **Example:** Mother died in January 2010, survived by her sister and three children. Her estate totaled $30 million. Mother's will gave several warehouses that are fully leased (valued at a collective $3 million) to her sister and gave the residue of her estate outright to her children. Mother's will also provided that any estate taxes were to be paid from the residue of her estate. Mother's adjusted basis in the warehouses was $100,000. The remainder of Mother's estate consists of cash and marketable securities with bases fairly close to the fair market value of such securities on the date of her death.
>
> Mother's sister would undoubtedly advocate for the executor not to make the Carryover Basis Election so that the estate tax will apply and the warehouses will obtain the full $2.9 million step-up in basis. If the combined federal and state income tax rates are 40%, this step-up will save Mother's sister an additional $640,000 in income taxes through larger depreciation deductions (40% of the excess of $2.9 million full step-up in basis over the $1.3 million general basis adjustment that would be available if the Carryover Basis Election were made).
>
> Mother's children, however, clearly will object to paying federal estate taxes of $8.75 million (35% of excess of $30 million taxable estate over the $5 million exemption) plus state estate taxes. The children will strongly advocate that the executor make the Carryover Basis Election so that no estate taxes will be due.
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> There appears to be no opportunity for an executor to make any type of partial Carryover Basis Election. Therefore, presumably, the executor of Mother's estate will make the Carryover Basis Election, as it produces the lowest overall tax cost for the beneficiaries collectively. However, the question will arise as to whether the executor has been impartial with respect to all of the beneficiaries.
>
> Making the Carryover Basis Election clearly saves the most taxes, but all such tax savings inure to the benefit of Mother's children and none inure to the benefit of Mother's sister. Stated another way, the tax "cost" to Mother's

sister of the Carryover Basis Election is $640,000, which is the income taxes that will not be saved because there will be no larger depreciation deductions. Is the executor being impartial by allowing all of the tax cost of the Carryover Basis Election to be borne solely by Mother's sister? Similarly, is it fair for such tax cost to be shifted completely to Mother's children? Because Mother's sister is receiving 10% of Mother's estate and Mother's children are receiving 90% of her estate, a reasonable equitable adjustment may be to distribute $576,000 (90% of $640,000 tax cost) of marketable securities to Mother's sister in addition to the warehouses. As a result, Mother's children will receive distributions totaling only $26,424,000, instead of $27 million, and thus the children will be bearing 90% of the collective tax cost of the Carryover Basis Election. Mother's sister will then be bearing only 10% of the tax cost.

Disclaimers

Regardless of whether the estate of a 2010 decedent elects to be subject to the estate tax regime or opts out in favor of the carryover basis regime, each beneficiary of an estate of a 2010 decedent who died before December 17, 2010, has been granted additional time to make a qualified disclaimer within the meaning of Internal Revenue Code section 2518(b). This extension of time is until September 19, 2011 (again, not September 17 because the Treasury Regulations permit an extension when the due date falls on a weekend or holiday). Unfortunately, however, disclaimers are also governed by state law, and at this point, it is unknown as to whether state legislatures will modify the state law disclaimer requirements to conform to the federal extension of time. For example, many states also require that the disclaimer be executed and filed within nine months of the date of the decedent's death.

If the state law is not modified and the disclaimer is made in compliance with the 2010 Tax Act extension of time, but beyond the state law deadline, the transfer may still be effective to transfer the disclaimed property to the successor in interest, but it may be treated as if the disclaimant were making the transfer. For federal tax purposes, the disclaimant would not be treated as the transferor or treated as making a gift as long as the disclaimer satisfies the requirements of Internal Revenue Code section 2518, notably that the disclaimant has not accepted the bequest or any of its benefits before making the disclaimer. But it is unclear what the consequences of such a delinquent disclaimer will be under state law.

Another issue that will undoubtedly be raised by some beneficiaries is whether an otherwise valid disclaimer that was filed within nine months of the date of death of a 2010 decedent could be rescinded in light of the taxpayer-favorable provisions added by the 2010 Tax Act.

Example: Husband died on January 27, 2010 leaving most of his assets outright to Wife, who survived him, including a farm valued at $1.2 million. Based on the recommendation of her advisors, Wife disclaimed the farm with a qualified disclaimer that was executed and filed with the appropriate authorities before October 27, 2010. Wife's advisors made this recommendation because Wife already owned about $1 million of assets in her own name and would be receiving about $1.8 million of property from Husband's estate exclusive of the farm and her future estate tax exemption appeared to be only $1 million.

Generation-Skipping Transfers by 2010 Decedents

Regardless of whether the executor of the estate of a 2010 decedent makes the Carryover Basis Election to avoid the estate tax and accept the modified carryover basis provisions, the GST tax will apply. Fortunately, however, even though the GST tax may apply and cannot be avoided through a Carryover Basis Election, there is no adverse tax consequence because the GST tax rate is zero for generation-skipping transfers occurring in 2010.

It is highly unlikely that the estate planning documents of a 2010 decedent intentionally provided for generation-skipping transfers in excess of the GST exemption for 2010. Similarly, if a 2010 decedent had died intestate, it is highly improbable

that the intestacy laws of the 2010 decedent's jurisdiction would have produced a result that would have otherwise caused GST tax to be incurred. In other words, individuals and their advisors did not plan on incurring GST tax in the hopes that Congress would avoid a catastrophe by slashing the rate to zero. Thus, if there is any GST planning to be undertaken by the estate of a 2010 decedent and the beneficiaries of such estate, it will likely occur through the use of disclaimers.

> **Example:** Father died on August 15, 2010, leaving his entire estate valued at $40 million equally among his five children. Most of the assets in Father's estate consisted of marketable securities which Father had actively traded himself, resulting in very little appreciation. As a result of the lack of built-in gain with respect to the estate assets, it is clear that the executor of Father's estate will make the Carryover Basis Election to avoid the federal estate tax and forego the full step-up in basis. Father's oldest child, Son, has been an extremely successful entrepreneur and would like to disclaim the 20% of Father's estate that he is entitled to receive. If Son disclaims, Father's will provides that his share will pass outright in equal shares to Son's daughter. Even though Son does not execute and file the disclaimer until April 2011, the disclaimer relates back to the date of Father's death on August 15, 2010 when the GST tax was zero.
>
> The effect of the disclaimer was a direct skip to Son's daughter who is Father's grandchild. However, this would not be the case if Father's will had provided that if Son had predeceased Father, then the share that would have otherwise been distributed outright to Son would instead be held in a trust for the benefit of Son's daughter. This is certainly a common approach for non-tax reasons as grandparents and parents often want to provide for professional management of the assets and protection of such assets from creditors and failed marriages and the beneficiaries themselves. If Father's will had established a trust for his granddaughter, however, and a distribution from that trust were made after 2010 to that granddaughter or the trust were to terminate after 2010 and all of the trust property distributed to the granddaughter or her descendants, the GST tax will apply to such distribution. An allocation of Father's GST exemption to the granddaughter's trust would avoid the incurrence of GST tax upon a distribution from the trust to the granddaughter after 2010.
>
> The maximum GST exemption available to Father's estate is only $5 million, however, and, if Son disclaims his entire $8 million share, the disclaimed amount would exceed Father's GST exemption. Under the circumstances, Son could instead disclaim only $5 million of his inheritance from Father, thus retaining $3 million.
>
> A better approach, however, would be available if the trust for Father's granddaughter were structured in a certain manner. If the granddaughter's trust were exclusively for the benefit of that granddaughter, that trust would qualify as a "direct skip trust" and the trust would avoid GST tax not only in 2010 when it is established ("deemed" established on August 15, 2010) because the GST tax rate is zero, but also in subsequent years when distributions are made to the granddaughter from the trust because of its "direct skip trust" status.

V. IMPACT OF THE 2010 TAX ACT ON 2010 GIFTS

The year 2010 was a roller coaster experience for individuals and their advisors with respect to the federal gift tax laws. Under the 2001 Tax Act, the maximum gift tax rate decreased from 45% in 2009 to 35% in 2010. Until President Obama signed the 2010 Tax Act into law on December 17, there was significant uncertainty as to what the gift tax rate would be for taxable gifts made in 2010 and 2011. Advisors were also concerned that Congress would retroactively increase the 2010 35% gift tax rate or would pass no legislation and the gift tax rate would increase as scheduled to 55% in 2011. In addition to the uncertainty concerning the gift tax rate for 2010 and 2011 gifts, there was also uncertainty regarding the treatment of 2010 gifts to generation-skipping trusts.

In early December 2010, Senator Max Baucus (D-MT), the Chairman of the Senate Finance Committee, introduced the amendment to pending tax legislation discussed previously, which was widely known as the "Baucus Bill," and which would have reinstated the 45% gift tax rate effective for all gifts made after the date of the introduction. While the Baucus Bill did not get the requisite votes for passage, its effective date provision caused many to fear the worst – that Congress could at any time enact legislation that would eliminate the favorable 35% gift tax rate applicable to 2010 gifts. The fear of potentially adverse legislation caused some taxpayers to accelerate gifts before any new legislation that could increase the 35% gift tax rate. Then, Congress enacted the 2010 Tax Act, which extended the 35% tax rate to 2011 and 2012 and increased the gift tax exemption from $1 million to $5 million for 2011 and 2012, causing some individuals to regret making large taxable gifts in 2010.

Rescission of 2010 Gifts

Those taxpayers regretting a taxable gift made in 2010 may wish that they could turn back the clock and unwind the transfer. In some states and under the right circumstances, it may be possible to rescind the gift for federal gift tax purposes. Under the equitable principles of most state laws, the donor and donee may rescind a gift by agreement if the gift was made because of a mistake which was material to the gift transaction.[5] In the majority of jurisdictions, the mistake must be mutual between the parties, although some states allow a unilateral mistake to void a gift. Some states may not allow rescission if the donee has accepted benefits from the gift, such as dividends or other income, or otherwise exercised indicia of ownership with respect to the transferred property.

Where a donor made a gift in 2010 under the mistaken belief that the gift would be a tax-efficient transfer that would result in a lower amount of gift taxes due from the gift, the donor's strongest argument for a rescission of the gift is that the gift was a result of a material mutual mistake of fact. A mistake of fact is an instance where one or more parties fail to have sufficient knowledge of the existence of a certain fact, or believe the facts to be other than what they actually are, and such misunderstanding is not a result of a lack of due care by any party. Because the gift resulted in unanticipated adverse gift tax consequences because of the extension of the 35% tax rate and the increase of the gift tax exemption to $5 million, the donor and the donee suffered from a mutual mistake of fact.

In some jurisdictions, a gift may be revoked by reason of a mistake of law. A mistake of law differs from a mistake of fact in that it occurs when the parties have full knowledge of the facts but do not understand the legal effect of such facts. While a mistake of law may be applicable in this instance because the parties could not have fully comprehended the legal effect of the gift, the mistake is more likely a mistake of fact regarding the future of the federal transfer tax regime.

If a gift is effectively rescinded under applicable state law, the gift should not be subject to the gift tax because there is no completed gift. Some courts have held that a gift made based on a material mistake of fact that may be revoked under state law is an incomplete gift because the donor did not relinquish all of the donor's rights over the transferred property.[6] Other courts have held that, if the mistake was merely based on the tax consequences of the transaction, the rescission of the gift would not alter the federal tax consequences of the transaction.[7] The latter courts focus on the rescission of a completed gift, while the former courts note that the gift could not be complete because of the donor's ability to revoke it. The better view, based upon the gift tax regulations, appears to be that if the donor, as a matter of law, has a right to rescind the gift, the gift is not complete and therefore should not be taxable.

If in fact the gift was incomplete because of the mistake, and no gift tax is due for this reason, the donor may nevertheless be required to report the transaction on a gift tax return. The regulations regarding the reporting of a gift are broad in their

[5] Because the law of rescission is based on state law principles, the results will vary from state to state and jurisdiction to jurisdiction. This analysis is meant to provide an overview of the governing principles but not a prediction of the outcome of any matter.
[6] *See, e.g., Berger v. United States*, 487 F. Supp. 49 (W.D. Pa. 1980).
[7] *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7th Cir.1968).

scope and require that a return be filed for all gifts made during the taxable year, with the exception of a few delineated transfers (such as annual exclusion gifts), even if no tax is due as a result of the gift.[8] Because no completed gift occurred for state law purposes, the reporting regulations may not be applicable to a rescinded transfer.

It is possible that individuals will not receive any benefit for reporting the rescinded gift as an incomplete gift on a gift tax return. Pursuant to the gift tax regulations, even adequate disclosure of an incomplete gift on a gift tax return does not begin the statute of limitations period for the Internal Revenue Service to challenge the transaction.[9] The period for assessment remains open indefinitely until the gift is determined to be complete.

Can a 2010 gift be rescinded after December 31, 2010? It is clear that a transaction cannot be rescinded in a later tax year for income tax purposes. Revenue Ruling 80-58, which is an income tax ruling, holds that a rescission that occurs in the same tax year as the original transfer is effective and the transaction is disregarded for income tax purposes if the parties are returned to their original positions before the rescinded transfer. Based on annual accounting principals, if the rescission occurs in a subsequent tax year, the transfer may not be disregarded.

The income tax rule may not be applicable for gift tax purposes. *Breakiron v. Gudonis*, a recent case from Massachusetts, involved the rescission of a gratuitous transfer where the rescission occurred in a tax year after the original transfer and yet the court held the transfer to be nontaxable.[10] Similar cases involving gifts also have not followed the annual accounting rules, which are primarily based upon the principle that the government should receive a regular flow of revenue from the income tax system. It is possible that the annual accounting principle would not apply in the gift tax area, where a regular flow of receipts is not anticipated or required, and a rescission of a 2010 gift in 2011 may be sufficient to disregard the gift for gift tax purposes.

Disclaimer of 2010 Gifts

It may be possible in certain circumstances for the donee of the gift to disclaim the gift to avoid a taxable gift in 2010. A disclaimer must be effective for both state law and federal gift tax purposes. A donee cannot validly disclaim a gift if the donee has accepted the benefits of the gift. If the donee has asserted rights or control over the transferred property, or otherwise indicated ownership of the property, the donee will generally be deemed to have accepted the gift.[11] If the donee has not accepted the benefits of the gift, the donee may disclaim it, causing the gift to lapse. As a result of the disclaimer, the lapsed gift may result in a reversion of the property to the donor depending upon applicable state law.

GST Consequences of 2010 Gifts

Before the passage of the 2010 Tax Act, there was significant uncertainty about the tax treatment of 2010 transfers to generation-skipping trusts. First, individuals and their advisors were uncertain whether Congress would enact legislation that would be retroactive. The temporary suspension of the GST tax in 2010 might have provided a window in which to make transfers free from GST tax (that would otherwise be subject to GST tax if made at other times). But if the GST tax was later retroactively imposed by legislation, and transfers that otherwise would not have been were in fact made in 2010 to obtain that GST tax savings, the very action intended to produce a tax savings could attract, aggravate, or accelerate a GST tax that otherwise could have been avoided or deferred.

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[8] Reg. § 25.6019-1.
[9] Reg. § 301.6501(c)-1(f)(5).
[10] *Breakiron v. Gudonis*, 2010 U.S. Dist. LEXIS 80888 (D. Mass. 2010). The unusual procedural posture of the *Breakiron* case may be difficult to replicate in another case, and there is no reason to assume that the Internal Revenue Service accepts the *Breakiron* result.
[11] Reg. § 25.2518-2(d)(1).

And unlike the general application of the estate and gift taxes, planning undertaken for GST tax purposes can have long-term effects because the GST tax typically arises in the context of a long-term trust with potential generation-skipping events spanning many years. Concerns arose that, with few exceptions, generation-skipping transfers made in 2010 would have GST tax implications in future years. That risk was amplified by the statutory mandate under the 2001 Tax Act that the GST tax was to be applied in those future years as if the temporary suspension in 2010 "had never been enacted."

Because the 2010 Tax Act retroactively reinstated the GST tax for 2010 transfers (but with a tax rate of zero), these concerns were alleviated. 2010 did prove to be a GST tax "holiday." With the reinstatement of the GST tax came the reinstatement of the GST exemption amount, and donors could appropriately allocate GST exemption, if necessary, to transfers made in 2010. In addition, as noted above, the 2010 Tax Act made clear that certain subsequent distributions from trusts for the benefit of skip persons would not later be subject to GST tax pursuant to the "move-down" rule. Even in light of this favorable rule, generation-skipping transfers were limited in 2010 after enactment of the 2010 Tax Act by the gift tax exemption for 2010. While the 2010 Tax Act increased the GST exemption to $5 million, the gift tax exemption for 2010 remained at $1 million for 2010 before increasing to $5 million in 2011. More significant generation-skipping transfers are undoubtedly planned using the $5 million exemptions in 2011 and 2012.

Additionally, the 2010 Tax Act assuaged apprehension in the gift tax area regarding the treatment of irrevocable grantor trusts during 2010. Under a narrow reading of Internal Revenue Code section 2511(c), there were concerns that transfers to grantor trusts would be incomplete gifts, and the assets of the trust would be includable in the transferor's estate. The 2010 Tax Act simply revoked Internal Revenue Code section 2511(c), removing speculation as to the interpretation of the section.

Extension of Time to File Returns

The 2010 Tax Act extends the due date for a return to report a generation-skipping transfer in 2010 made before December 17 at least nine months from the date of enactment or September 19, 2011 (September 17 being a Saturday). This extension applies also to the filing of a return to report any late allocation of GST exemption. The 2010 Tax Act did not extend the due date for filing of a gift tax return, so gift tax returns reporting 2010 gifts are due on April 18, 2011. Nevertheless, income tax return filing extensions will automatically extend the time for filing the gift tax return and an automatic six-month extension for filing a gift tax return continues to be available.

VI. PLANNING FOR GIFTS IN 2011[12]

The 2010 Tax Act, by reunifying the estate tax and the gift tax and increasing the amount of the gift tax exemption from $1 million to $5 million for 2011 and 2012, has greatly expanded the ability of individuals to make large gifts and thereby remove significant amounts of property and post-gift appreciation on that property from their estates. Over the next two years, individuals who have the resources to do so should carefully consider taking advantage of this favorable environment for lifetime gifts.

Reducing estate tax through lifetime gifts is one of the most effective methods of decreasing transfer taxes. An individual can give away substantial amounts of property without incurring gift tax. For wealthy individuals, making large taxable gifts almost always is advantageous from a tax standpoint. The challenges in planning for lifetime giving often are the non-tax ones and include factors such as:

- Impact of the gift on the beneficiary.

[12] This section is based in part on "Effective Strategies for Making Gifts," by Thomas W. Abendroth and Charles D. Fox IV, American Bankers Association Teleconference (Nov. 4, 2010).

- Concerns about the adequacy of the donor's remaining resources after the gift.
- Perceptions about the inflexibility of irrevocable transfers, such as the inability to significantly change the future trust terms when gifts are made in trust.

The sophisticated and well-advised donor will follow a particular sequence in making gifts, starting with those that have the least tax impact and are the easiest to implement, and then moving to gifts that have permanent tax consequences or involve more complex planning. That sequence typically is:

- Annual exclusion and education and medical exclusion gifts;
- Lifetime exclusion gifts;
- Leveraged and split-interest gifts (such as grantor retained annuity trusts; qualified personal residence trusts; gifts with sales for a promissory note; loans; charitable remainder and lead trusts); and
- Gifts that require payment of gift tax.

Annual Exclusion Gifts

The Internal Revenue Code currently provides an exclusion from gift tax for the first $10,000 (indexed for inflation) given to any donee in any year. The annual exclusion amount is indexed in $1,000 increments. Because of indexing, the annual exclusion since 2009 has been $13,000. Thus, an individual currently can make annual gifts of up to $13,000 to any number of people, without any gift tax on the transfers or use of gift tax exemption. As will be discussed in more detail, a married individual can double the annual exclusion by gift-splitting — using one spouse's funds and having the non-donor spouse consent to treat gifts made as being made one-half by each of the spouses.

The benefits that can be derived from making $13,000 annual exclusion gifts should not be underestimated. In substantial estates, simple cash gifts of $13,000 can generate a federal estate tax savings of at least $4,550 for every transferee involved, assuming a 35% estate tax rate.

> **Example:** Father has extensive assets and three children (two of whom are married) and five grandchildren. If Father has an estate that would be taxed at a 35% rate, gifts of $13,000 to each of the three children, to the spouses of the two married children, and to each of the five grandchildren would entail transfers of $130,000. These transfers would result in a federal estate tax savings of $45,500. If Father continues this gift program for 10 years, his taxable estate will be reduced by $1,300,000, saving $455,000.

In some families, it is not unusual for an elderly family member to have 20 or more living descendants. A donor with 25 descendants could transfer $325,000 per year, entirely tax-free. And, by giving away property which is likely to grow in value, all the future appreciation on that property is also removed from the donor's estate.

> **Example:** Father gives Son $13,000 worth of stock in the XYZ Widget Company. At Father's death, the $13,000 of XYZ Widget Company stock has increased in value to $100,000. If the federal estate tax rate at Father's death is 35%, the lifetime gift of the stock to Son saved $35,000 in federal estate tax.

The annual exclusion is available for gifts to an unlimited number of donees who do not need to be related to the donor. The exclusion is not cumulative. A donor cannot carry over the exclusion from one year to another. If a parent fails to give $13,000 to one child in 2011, he cannot give the child $26,000 in 2012. A donor can give a single asset to multiple donees and qualify for multiple annual exclusions.

Example: Grandfather transfers a parcel of real estate worth $65,000 to his five grandchildren, as tenants-in-common. The gift would qualify for five annual exclusions.

A donor also can give away partial interests in property as annual exclusion gifts. For example, an individual can make gifts of fractional interests in real estate over several years in order to fit each gift within the annual exclusion.

Transfer for Educational or Medical Expenses

Tuition payments made directly to an educational organization on behalf of a person and payments for a person's medical care made directly to the provider also are not treated as taxable gifts. This can be an important exclusion for planning purposes. For example, grandparents who already take full advantage of the annual exclusion for gifts to grandchildren can make additional tax-free transfers by paying their grandchildren's tuition for private school or college.

Education Expenses. The education expense exclusion is limited to tuition. Tuition means the amount of money required for enrollment. It includes tuition for part-time students. It does not cover books, supplies, room and board, or similar expenses.

Medical Expenses. The medical expense exclusion applies to payments for (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, (2) the purpose of affecting any structure or function of the body, or (3) transportation primary for and essential to medical care. Payments for medical insurance are also included.

Lifetime Planning To Make Full Use of the $5 Million Gift Tax Exemption

The shelter provided by the gift tax exemption, which is technically called the applicable exclusion amount, does not actually exclude the property transferred from the transfer tax system. Because the unified estate and gift tax system adds adjusted taxable gifts back to an individual's estate at death, the value of the property transferred by taxable gift at the time of the transfer does not escape tax.

Annual exclusion gifts and the direct payment of education or medical expenses are true excluded transfers. The property given away is never subject to gift tax or estate tax in the estate of the donor. Therefore, an individual first should take advantage of these exclusions to the fullest extent possible, on an annual basis. It rarely makes sense to make a taxable gift instead of making annual exclusion gifts or paying medical and education expenses.

But the gift tax laws in 2011 and 2012 present one possible exception to this general conclusion. With the gift tax exemption increased to $5 million for 2011 and 2012 and the possible return to a $1 million exemption in 2013 because of sunsetting, over the next two years wealthier individuals who can afford to make larger gifts have a wonderful opportunity to remove a larger amount of assets from their estates without tax than might be possible after 2012.[13]

Even if the current estate and gift tax law is extended beyond 2012, making large gifts now to take advantage of the $5 million gift tax exemption can be beneficial. The sooner the gifts are made, the sooner the assets are removed from taxation, and the sooner the appreciation on the assets after the date of the gift is removed from taxation in the donor's estate. And a husband and wife have a combined gift tax exemption of $10 million.

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[13] Some commentators have expressed some concern that, if the exemption reverts to $1 million in 2013, the unified gift and estate tax system may subject gifts made in 2011 and 2012 to estate tax at the donor's death when adjusted taxable gifts are added back to the donor's estate. Most commentators agree that Congress did not intend this result and do not expect such an interpretation to prevail.

The best assets to use for taxable gifts are ones with a high return and a high basis. Because the value of the taxable gift itself is usually not excluded from the estate tax calculation, the primary benefit of a taxable gift is removing the future appreciation of and earnings from the gifted property from one's estate.

> **Example:** Mother transfers $1 million of stock to an irrevocable trust. Over 10 years, the stock provides an average total return of 6% annually after tax. When Mother dies in year 10, the trust holds $1,790,848. A total of $790,848 escaped tax in Mother's estate, saving $276,797 (35% of $790,848).

With the gift tax applicable exclusion amount set at $5 million rather than $1 million for 2011 and 2012, even greater amounts of appreciation and possibly the gifts themselves can be sheltered from gift tax by the gift tax exemption.

One thing to consider when making a gift is that any property transferred by gift retains the donor's tax basis. On the other hand, property included in a decedent's estate receives a step-up in basis. These rules lead to the common advice that higher basis assets are generally more suited for lifetime gifts.

Given the capital gains tax rate, compared to the estate tax rate (35% in 2011 and 2012 and perhaps beyond), the lack of a basis step-up should not stop someone from making a taxable gift. However, it is a relevant factor for an older donor or one in poor health. In either case, the asset may not appreciate much between the date of the gift and the donor's death. If the donee is likely to sell the asset, it may be better to have it pass through the donor's estate and receive a stepped-up basis.

> **Example:** Mother, age 90, makes a taxable gift to Daughter of $500,000 of stock with a $50,000 basis. Mother dies two years later. The stock has appreciated to $570,000. The $70,000 escaped tax in Mother's estate saving $24,500. Daughter sells the stock shortly after her mother's death. She realizes a $520,000 gain and pays $104,000 of income tax as a result of the sale (assuming an effective capital gains rate of 20%).

If the property transferred is an asset the donee will retain for a long time, such as a vacation property, the basis should be much less of a factor. Other factors include the ability of the donee to defer any gain (for example through a tax-deferral technique such as a like-kind exchange) or offset gain with accumulated capital loss carryforwards.

There is no doubt that this is a time of great uncertainty regarding future transfer tax laws. No one can predict whether the current law will be in place in 2013 and beyond or whether there will be estate tax reform. There is no benefit in waiting. An individual who is otherwise in a position to make a $5 million gift should do so to allow the appreciation and earnings to accumulate outside his or her estate. In fact, if the pre-2001 Tax Act law returns in 2013 with its $1 million gift tax exemption, the donor should benefit from transferring up to $5 million in 2011 or 2012.

This principle is nothing more than a current expression of the fundamental principle that the sooner one uses the exemption the better. Obviously, many individuals cannot afford to give away up to $5 million during life. For those that can, the advantages of using the exemption early can be substantial.

> **Example:** A and B are twins and partners in a family partnership. Each of their interests is currently worth $10 million. A transfers one-half of his interest ($5 million) to an irrevocable trust for his children. B decides not to make a similar gift. Ten years later, B reconsiders and decides to make a taxable gift to use his $5 million gift tax exemption. The partnership assets have grown an average of 7% annually during the 10-year period. The trust A created now holds $9,835,758. By using his exemption when he did, A moved an additional $4,835,758 out of his estate. Put another way, because he waited, B can transfer only about one-half of his partnership interest out of his estate with a $5 million gift.

There is a very important exemption to the GST tax in 2011 and 2012. Every individual has a $5 million GST exemption that can be used in 2011 and 2012 to shield transfers from GST tax. A husband and wife have a combined GST exemption of $10 million. The ability to apply this GST exemption to property and have that property and all future appreciation insulated from transfer tax can provide substantial benefits to future generations.

Individuals with significant wealth should try to take advantage of the GST exemption during life by setting aside property in an irrevocable trust for children and grandchildren. The sooner the GST exemption is used, the greater the amount of property that will be sheltered from transfer tax. An individual who makes a lifetime transfer of $5 million in 2011 can remove substantial amounts of property from his or her estate even if no annual exclusions are available.

> **Example:** Husband and Wife give $10 million to an irrevocable trust for the benefit of their descendants and allocate their GST exemptions to the trust. If the trust assets grow on average at a 6% after tax rate (accumulated income plus appreciation) and Husband and Wife live for another 25 years, there will be approximately $43 million in the trust at their deaths. By creating the trust during life, the couple has transferred an additional $33 million to grandchildren free of any transfer tax.

Another way to maximize the use of the GST exemption is to create a so-called "dynasty trust" that is intended to last for the maximum period permitted by law. Under many states' laws, a dynasty trust can last for up to 21 years after the death of the last surviving family member who was living when the trust was created (this period of time is called the "perpetuities period"). Assuming normal life expectancies, such a trust created by an individual today could be expected to last nearly 100 years. A number of states now permit perpetual trust terms, and one can take advantage of this by choosing which state's law will govern the trust. During the existence of the trust, trust property will be available to the grantor's descendants for such purposes as the grantor designates. There will be no gift, estate, or GST tax assessed on the trust property during the term of the trust. So the property can be insulated from transfer tax for two and sometimes three generations.

> **Example:** Husband and Wife place $10 million in a dynasty trust for the benefit of their descendants, and allocate their GST exemptions to the trust. The trust is to last until the end of the perpetuities period, assumed to occur in 100 years. Assuming the trust assets grow on average at a compounded 6% after tax rate and 2% is paid out annually to the beneficiaries, the assets will be worth around $485 million when the trust ends in 100 years. This property will pass to their grandchildren or great-grandchildren free of transfer tax at that time.

Assume that the assets grow at the same rate but the trust is not exempt from the GST tax because no GST exemption was allocated to it. Assume that a 35% GST tax is imposed in 80 years when the grantor's last child dies. At the child's death, the assets will have grown in value to approximately $230 million. However, a GST tax of about $80 million will be due, leaving about $150 million after tax. At the end of an additional 20 years, the trust will be worth around $329 million, or $156 million less than if it had initially been exempted from GST tax.

A number of states have no rule against perpetuities and therefore no limit on the duration of trusts. These trusts are commonly referred to as dynasty or perpetuities trusts. Other states allow an option to have the rule against perpetuities not apply and have passed legislation that encourages the use of their jurisdictions to create perpetuities trusts. Alaska, Idaho, New Jersey, Pennsylvania, Rhode Island, South Dakota, Wisconsin, and Idaho all have eliminated the rule against perpetuities. Delaware also has abolished the rule with respect to interests in personal property. North Carolina repealed the rule against perpetuities effective August 9, 2007.[14]

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[14] A state constitutional problem has arisen because of the provision of Section 34 of Article I of the North Carolina Constitution that provides "[p]erpetuities and monopolies are against the genius of a free state and shall not be allowed." The North Carolina Bar believes that the repeal is constitutional and is examining ways to resolve the potential conflict.

In addition, Arizona, Colorado, Illinois, Maine, Maryland, Missouri, Ohio, Nebraska, New Hampshire, Virginia, Wyoming (up to 1,000 years), and the District of Columbia all permit a trust settlor to opt out of the rule in varying degrees. Finally, Nevada (365 years), Tennessee (360 years), Utah (1,000 years), Florida (360 years), and Washington (150 years) have modified the rule to allow trusts potentially to last longer then would be permitted under the common law rule against perpetuities.

It is not necessary to be a resident of one of these states to take advantage of their laws. However, it is necessary to establish some nexus to the state. This is usually done by creating a trust governed by the law of that state, using a trustee domiciled in the state, and having some of the trust administration take place there.

Alaska, Delaware, Missouri, Nevada, Rhode Island, South Dakota, Tennessee, Utah, Wyoming, New Hampshire, and Hawaii currently permit individuals to establish trusts of which they can be the beneficiaries but which, unlike trusts in the other states, protect the assets of the trust from the claims of the creditors of the creators of the trusts if certain requirements are met. They are sometimes referred to as "domestic asset protection trusts."

Several commentators have taken the position that if creditors cannot reach the trust property, as will be the case if the Alaska, Delaware, Missouri, Nevada, Rhode Island, South Dakota, Tennessee, Utah, Wyoming, and New Hampshire laws prove effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust. Instead, a completed gift will occur upon the transfer of the property to the domestic asset protection trust. The result is a freeze transaction. By using this technique, the creator of the trust removes the appreciation from his or her estate but continues to enjoy the benefits. With the gift tax exemption increased to $5 million for 2011 and 2012, one can transfer up to $5 million to one of these trusts. The asset protection trust states also permit trusts that can run forever or for long periods of time and benefit several generations.

> **Example:** Father creates a domestic asset protection trust in Delaware in 2011 and funds it with $5 million. This gift escapes gift tax because it is sheltered from gift tax by Father's $5 million gift tax exemption. Father and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete. Father dies in 2020 when the assets in the trust are worth $15 million. Up until the time of his death, Father has been a discretionary beneficiary and received distributions from the trust. By using a domestic asset protection trust, according to its proponents, the $10 million of appreciation after the funding of the trust will escape estate taxation.

We cannot count on the $5 million exemption being increased or even lasting beyond 2012 or the transfer tax being eliminated. Careful estate planning therefore requires thoughtful use of this limited exclusion. In addition to identifying high basis assets and trying to identify assets with good growth potential, the exclusion will be most effective if used with techniques that reduce the current taxable value of transfers in one or more ways. This includes all the techniques used in sophisticated planning.

The exemption amount is a limited resource. It pays to use it with techniques that maximize its benefit. For the wealthiest individuals, it is not enough just to transfer $5 million of property and start it growing outside the estate. Instead, these individuals should consider one of the following techniques:

- Valuation discounts for closely held business interests.
- Limited partnerships and limited liability companies.
- Gifts of fractional interests, with fractional interest discounts.
- Grantor retained annuity trusts.
- Sales to an intentionally "defective" grantor trust.

- Qualified personal residence trusts.
- Augmenting gifts with loans at the applicable federal rate or sales in exchange for a note.

Using Discounts in Valuing Closely Held Business Interests. The valuation for estate and gift purposes of transfers of interests in a closely held business or partnership offers significant opportunities for transfer tax savings. The courts have held that a majority interest has more value than a proportionate share of a business's total value, while a minority interest has less value than a proportionate share. A business owner, therefore, should look to fractionalization and dispersal of such interests, both as a defensive measure to eliminate the control premium which the Internal Revenue Service will try to attribute to a majority holding, and as an offensive measure to obtain a minority discount on a minority holding. The business owner also should be sure to take advantage of discounts for lack of marketability, which should apply to all closely held assets, whether the person holds a majority interest or a minority interest.

A lack of marketability discount is available for closely held stock because there is no ready market for the stock. It is not traded on an exchange. This illiquidity renders the stock less attractive than publicly traded stock and justifies a reduction in value. The discount for lack of marketability in reported cases and rulings ranges from 15% to as high as 50% or 60% in exceptional situations.

A discount for lack of control, commonly called a "minority interest discount," is appropriate when the stock being valued does not carry control of the company and the owner of the stock is unable to dictate the company's management or distribution decisions. A discount is applicable because the buyer is unable to influence his return on investment. A willing buyer would take this lack of control into account in making an offer to purchase a minority block of stock. The "control premium" is the flip side of the minority discount. It is the value added to a block of stock to reflect the fact that the owner controls the company. Market studies and cases indicate that the minority interest discount (or control premium) often is in the range of 15% to 40%. Thus, the combined effect of marketability and minority interest discounts in valuing closely held stock could be very significant.

Limited Partnerships and Limited Liability Companies. Over the past 15 years, many individuals have been using a family-owned partnership or limited liability company ("LLC") as a vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. Usually, the parents act as general partners of the partnership or own a controlling interest in a corporate general partner. As general partners, the parents manage the partnership and make all investment and business decisions relating to the partnership assets. The general partnership interest usually is given nominal value, with the bulk of the partnership equity being limited partnership interests. Initially, the parents receive both general partnership interests and limited partnership interests. Thereafter, the parents can transfer their limited partnership interests to the children.

> **Example:** Parent transfers $10,000 of his $1 million of real estate, cash, and securities to his children. Parent contributes the remaining $990,000 to a newly formed limited partnership, to which the children contribute their $10,000. Parent receives a general partnership (GP) interest worth $10,000 and limited partnership (LP) interests with a net asset value of $980,000. The children receive $10,000 of LP interests. Parent makes gifts of the $980,000 of LP interests to children.

An LLC can be structured in much the same way as a limited partnership. The parents or one of them, often act as manager of the LLC and thereby control the decision-making. Initially, the parents receive the bulk of the LLC membership interests. Over time, they can transfer most or all of those interests to their children. The LLC can provide an attractive alternative to the use of a partnership, especially where there is a desire to limit the personal liability of all the participants in the entity without creating a separate entity to serve as the general partner.

Family partnerships and LLCs can be used in many cases to obtain additional valuation discounts. It should be possible to discount the value of the limited partnership or LLC membership interests for gift and estate tax purposes below the value of the underlying partnership or LLC assets because the interests lack marketability and control. As with interests in a closely held corporation, there is no ready market for closely held limited partnership or LLC interests. By their very nature, limited partnership interests do not participate in management of the partnership and therefore lack control. A non-manager member of an LLC also does not participate in management of the LLC. These characteristics of a limited partnership or LLC interest make it less valuable than the assets transferred upon formation of the partnership or LLC. In effect, one can transfer assets to a partnership or LLC in order to create a closely held business and take advantage of discounts where they otherwise would not be available. The benefit of these discounts, of course, is that they enable an individual to give away more property.

> **Example:** After creating a partnership with $1 million of real estate, cash and securities, Parent gifts $980,000 of LP interests to his children. The appraiser discounts those interests by 35% to reflect their lack of marketability and control. This enables Parent to transfer the LP interests for $637,000 and possibly shelter the entire gift with applicable exclusion amount and annual exclusions.

A family partnership or LLC can be particularly beneficial with assets such as real estate (held directly or through other partnerships) and business assets because it permits ownership to remain consolidated while economic interests in the assets are given away in the form of partnership or LLC membership interests. The partnership or LLC also can hold other investment assets, such as marketable securities. (A family partnership or LLC cannot hold stock in an S corporation because a partnership or LLC is not a permissible S corporation shareholder.)

Fractional Interest Discounts. A donor also can give away partial interests in property for any type of gift. This may reduce the overall cost of the gift because valuation discounts may be available for these partial interest gifts. These fractional interest discounts are most often applied to gifts of real estate. The Internal Revenue Service has been reluctant to grant fractional interest discounts of any significance for gifts of real estate. The Internal Revenue Service often takes the position with fractional interests of real estate that the only discount that should be allowed is one that reflects the cost of partitioning the real estate. In most situations, this cost represents only a small portion of the value. However, courts generally have recognized that such discounts should apply, and should reflect not only the cost of a partition, but the risk and delay inherent in the partition process.[15]

Grantor Retained Annuity Trusts. A GRAT is an irrevocable trust in which the grantor retains the right to receive a fixed dollar amount annually for a set term of years. The amount paid out to the grantor can be increased by up to 20% each year. At the end of that period, any remaining property passes as provided in the trust, either outright to designated beneficiaries or in further trust for their benefit. For a GRAT to be successful, the grantor must survive the annuity term. If the granter dies during the term, all or a substantial portion of the value of the GRAT will be included in the grantor's estate.

The transfer of property to a GRAT constitutes a gift equal to the total value of the property transferred to the GRAT, less the value of the retained annuity interest. The value of the annuity interest is determined using the valuation tables under Internal Revenue Code section 7520 and the section 7520 rate for the month of the transfer. The grantor of a GRAT is treated as making an immediate gift when the GRAT is funded, but the value of the gift is a fraction of the total value of the property because it represents a future benefit. Therefore, if the grantor survives the annuity term, there is an opportunity for property to pass to the designated remaindermen at a reduced transfer tax value.

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[15] *See, e.g., LaFrak v. Commissioner*, 66 T.C. Memo 1297 (1993); *Estate of Baird v. Commissioner*, T.C. Memo 2001-258; *Estate of Busch v. Commissioner*, T.C. Memo 2000-3; *Ludwick v. Commissioner*, T.C. Memo 2010-40.

Example: In January 2011, Mother, age 55, transfers $500,000 of assets to a GRAT and retains the right to receive an annual annuity of $40,000 payable annually for 15 years. The interest rate assumption underlying the valuation tables is 2.4%. Under the Internal Revenue Service tables, the value of Mother's retained annuity interest is $464,440, so the amount of the gift upon creation of the GRAT is $35,560. If the trust assets provide an average return of at least 7% annually, the assets of the trust will be worth $374,355 at the end of 15 years. If the trust assets provide an average return of at least 8% annually, there will be at least $500,000 in the GRAT at the end of the term.

The annuity does not have to be an equal amount each year. It can be defined as a fixed initial amount, increased by up to 20% in each subsequent year.

Most GRATs provide that the annual annuity must be satisfied from trust principal to the extent trust income in a given year is insufficient. The Internal Revenue Service has ruled privately that the grantor trust rules apply where the annuity may be satisfied out of trust income or principal. Therefore, virtually every GRAT should be treated as a grantor trust with respect to all trust income. This is an important additional benefit. It means that a GRAT can be funded with stock, partnership interests, or real estate, and that asset can be distributed back to the grantor to satisfy the annuity without the distribution being treated as a sale.

The GRAT is particularly attractive for individuals who have used their applicable exclusion amount but still want to transfer wealth to others. A "zeroed-out GRAT" can be used so that there are no gift tax consequences upon the creation of the trust. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using gift tax exemption or paying gift tax. If the transferred assets increase significantly in value during the term of the GRAT, some of that appreciation is transferred out of the grantor's estate free of tax.

A zeroed-out GRAT often works best when the annuity term is short (such as two years) and the GRAT is funded with one stock. A single stock that performs well during a two-year period easily can grow at an annual rate of 20% or more over that time frame. During 2010, the U.S. House of Representatives passed bills several times that would have mandated a minimum 10-year term for GRATs. This provision was not included in the 2010 Tax Act. Thus, short-term GRATs are still a viable planning technique.

Example: In January 2011 when the interest rate assumption underlying the section 7520 rate is 2.4%, Father creates a two-year GRAT and funds it with $500,000 of stock that has a current price of $25 per share. He retains the right to receive an annuity of 52.5% each year for the two years. The value of the annuity is $500,000, and the value of gift to the remaindermen is zero. If the stock increases to $30 per share after one year, and $36 per share at the end of two years (a 20% increase each year), there will be $142,500 left in the GRAT at the end of the two years to pass to children tax-free:

Initial Value of Stock	$500,000
Year 1 Ending Value	$600,000
Annuity to Grantor	($262,500)
Year 2 Beginning Value	$337,500
Year 2 Ending Value	$405,000
Annuity to Grantor	($262,500)
Property Remaining for Children	$142,500

The property transferred to a two-year GRAT needs to sustain a high growth rate for only a short period of time for the GRAT to be successful. If the property does not appreciate as anticipated, it all is returned to the grantor in the form of

annuity payments. The grantor then can create a new GRAT. If a short-term GRAT is used, it is better to isolate separate stocks in separate trusts so that the losers do not pull down the winners.

Sales to "Intentionally Defective" Grantor Trusts. The sale to an "intentionally defective" grantor trust (that is, a trust purposefully set up to be a grantor trust for income tax purposes) combines the long-recognized advantages of a sale in exchange for a promissory note with the benefits of a grantor trust.

An installment sale involves the sale of a business interest or other assets by an individual to the business, a family member, or a third party in exchange for an installment obligation (e.g., a promissory note). The sale limits the value of the individual's retained interest to the amount of any down payment plus the face value of the note (or other evidence of indebtedness) received, reduced by the income tax liability on the payments made to him. A market rate of interest normally must be paid on the installment obligation in order to avoid having the face value of the note discounted for tax purposes and a gift imputed. However, the courts have concluded that interest at the applicable federal rate ("AFR") will avoid an imputed gift. This is advantageous to the taxpayer because the AFR is usually lower than commercial lending rates.

Any gain from an installment sale of an asset is generally reportable on a proportionate basis over the time period in which the payments are actually received, unless the seller elects otherwise. Thus, income tax resulting from the gain can be deferred and spread over more than one year. Exceptions exist, such as if the property is sold within a certain period (generally two years) or if the repayment obligation is forgiven. If the seller dies before the obligation is paid in full, any unpaid principal balance is included in the seller's estate, and the deferred gain is taxed as payments under the note and received by the seller's beneficiaries. Finally, if the installment obligation is transferred by bequest or inheritance to the obligor or is canceled by the deceased seller's executor, the seller's estate will recognize any unreported gain.

An interest charge is imposed on the capital gains tax deferred under such installment obligations to the extent the amount of such obligations held by the taxpayer resulting from sales in a single year have an aggregate face value that exceeds $5 million. The interest rate is the rate charged by the Internal Revenue Service for underpayment of tax. The income tax detriment of the capital gain and this interest charge are often acceptable costs, and an installment sale directly to children or to a non-grantor trust still makes sense. However, in most estate planning motivated transactions, the installment sale is made to an irrevocable grantor trust. The trust is not treated as a separate taxpayer for income tax purposes. As a result, the transaction is not treated as a sale for tax purposes and the resulting capital gain from the sale, and the interest charges, are eliminated.

> **Example:** A creates an irrevocable trust and funds it with a gift of $100,000 of stock in his S corporation. The trust is structured as a grantor trust. A then sells $1.9 million of the stock to the trust for a 13-year installment note, bearing an interest rate of 5.2% (the assumed long-term AFR). The company distributes cash to the trust of $240,000 per year, and the stock and other assets of the trust are appreciating at 5% per year. The amortized payments to A under the note are about $204,710 per year. At the end of 13 years, the trust will own all the stock, debt-free, and the stock and other investments from the accumulated distributions in excess of the note payments will have a value of $4,396,390.

Qualified Personal Residence Trusts. A qualified personal residence trust ("QPRT") is a form of grantor retained income trust – a type of split interest trust where someone receives an income interest and someone else receives the remainder interest. To create such a trust funded with a personal residence, the trust must be in a form prescribed by Internal Revenue Service regulations. To create a QPRT, the grantor transfers a residence to an irrevocable trust which gives the grantor the right to use the property and receive whatever income it produces for a specified term. At the end of the term, the property will be distributed to the grantor's beneficiaries (spouse, descendants, or others) or held in trusts for their

benefit. The grantor has the option of leaving the residence in trust for his or her spouse, which would permit the couple to continue to reside there after the term.

When the trust is established, the grantor makes a gift of the present value of the remainder interest. This gift equals the value of the transferred property less the present value of the retained income interest. The gift tax savings occur because the Internal Revenue Service valuation tables assume a return based on the "treasury bond" model – that is, that a person invests in a treasury bond that pays interest over the life of the bond and pays face value at maturity. Other assets which have a significant appreciation element, such as stocks and real estate, do not fit the model but are subject to the same rules.

If the grantor dies during the income term, all of the property will be included in the grantor's estate. This negates the transfer tax benefit but puts the grantor in no worse a position than had the grantor not created the trust because the property would have been included in the grantor's estate anyway.

The Internal Revenue Service regulations define a personal residence to include appurtenant structures used for residential purposes and a reasonable amount of adjacent land. The Internal Revenue Service has been quite liberal in its interpretation of "appurtenant structures" and "adjacent land." The key test is whether the property size is unusual for the area. The Internal Revenue Service has permitted QPRTs for large properties where the size was not unusual compared to other local properties.[16] Similarly, the Internal Revenue Service has approved QPRTs with ancillary buildings related to the residence.[17]

> **Example:** Assume that Father is 67 when he transfers a Michigan vacation home, worth $1.5 million, to a QPRT for 10 years in January 2011. At the end of that 10-year period, the vacation home will pass to his children (or, if Father dies before the end of the 10-year term, will revert to his estate). Under the Internal Revenue Service tables, which assume an interest rate of 2.4 percent, the value of Father's retained income interest is $615,000, and the amount of the gift of the remainder is $885,000. Thus, this $1.5 million property is transferred out of John's estate at a gift tax value of $885,000. Father can use $885,000 of his $5 million gift tax exemption to shelter the gift from gift tax. If the home doubled in value before the end of the 10-year term, the $1.5 million of appreciation will escape transfer tax as well.

Low-Interest Loans. A simple way for an individual to take advantage of the current low interest rate environment is to lend funds at the minimum AFR necessary to avoid adverse gift and income tax consequences to a child, grandchild, or trust for the benefit of one or more descendants, to enable the recipient to take advantage of investment opportunities with a potential for high returns.

The annual AFRs for January 2011 are:

Short-Term	0.43%
Mid-Term	1.95%
Long-Term	3.88%

> **Example:** Father lends Daughter $1 million in January 2011 for three years when the minimum short-term interest rate is 0.43%. The loan is for simple interest with annual payments of interest and payment of the principal at the end of the three-year term. Daughter invests the $1 million in assets earning 5% over the three-year term. At the

[16] See P.L.R. 9639064 (residence on 43 acres); P.L.R. 9544018 (vacation home on 18 acres).
[17] See P.L.R. 9606003 (residence with apartment over garage).

> end of the three-year term, Daughter, after paying $4,300 in interest each year and then paying the loan back, clears $144,069.

Taxable Gifts

The 2011 tax rate on gifts over $5 million is 35%. The rate will revert to the 2001 tax rate schedule beginning in 2013 if Congress does not act to alter current law. That means gifts will be taxed at rates beginning at 41% and increasing to 55% for gifts over $3 million in 2013 and beyond.

Even without a lower gift tax rate, the payment of gift tax has always been "cheaper" than the payment of estate tax. This is because of the difference in the ways that the gift tax and estate tax are computed. As long as the donor lives three years after making the gift (so the gift tax is not brought back into the estate), the gift tax is calculated on a tax-exclusive basis. The estate tax calculation is a tax-inclusive calculation.

> **Example:** Mother is in the top marginal gift and estate tax bracket of 35%, has already used up her $5 million gift tax exemption and wants to transfer $1 million to Son after tax. If she makes that gift during 2011, she would need $1.35 million to complete the gift: $1 million to give to Son and $350,000 to pay the resulting gift tax. On the other hand, if Mother waited until her death to give him the $1 million, she dies in 2016, and Congress fails to act and the maximum estate and gift tax rate returns to 55% in 2013, she would need approximately $2,222,222 to complete the transfer: $1 million to give to Son and $1,222,222 to pay the estate tax. This result occurs because the money used to pay the estate tax will be part of Mother's estate at death, and estate tax will be due on that money as well as on the $1 million passing to Son. Thus, transferring the $1 million to Son during life requires about $872,200 less than making the same transfer at death. If Congress acts and retains the 35% rate for 2013 and later years, Mother would need $1,538,461 to transfer $1 million to Son at her death in 2016.

There are of course disadvantages to making large taxable gifts. The primary disadvantage is that the donor no longer has the property transferred, as well as the cash used to pay the gift tax. This is less of a problem for very wealthy individuals. To achieve the maximum advantage, the donor would have to live for three years after making the gift.

Another disadvantage of lifetime gifts is that whenever a decision is made to transfer property during life (as opposed to at death), a potential step-up in income tax basis will be lost. As discussed above, if a donor transfers property by gift during life, the donee's basis for purposes of computing any gain realized on a subsequent sale is the donor's basis, increased by any gift tax paid that is attributable to the asset's appreciation. If the property is transferred at death, the beneficiary would generally receive a step-up in basis to fair market value at date of death or alternate valuation date. Thus, the decision to transfer property by gift may have a significant income tax cost if the property is subsequently sold by the beneficiary.

VII. ESTATE AND GST PLANNING IN 2011 AND 2012

The Estate Tax Exemption

In popular terms, the estate tax exemption that is available at death is reduced by the gift tax exemption that is used during life. Because what is popularly referred to as an "exemption" is actually administered as a "unified credit" against the tax, the mechanics are not that simple, but that is generally the outcome. That is how the gift tax and estate tax are "unified." Since World War II, the estate tax exemption has only gone up, sometimes on a phased basis, from $60,000 to about $175,000, to $600,000, to $1 million, to $3.5 million, and now to $5 million. (Correspondingly, the top rates have gone down, from 77% to 70%, to 55%, to 45%, and now to 35%.) Now the $5 million exemption is "scheduled" to drop to $1 million in 2013. Many assume that Congress will make the current exemptions permanent or just repeal the estate tax completely, but Congress has surprised us, as in December 2009. So there has been a lot of speculation about the

consequences of a drop in the exemption for the calculation of the estate tax where large gifts have been sheltered by the larger exemption.

The 2010 Tax Act includes a provision that apparently is intended to address this issue, at least in part. Neither the statutory language nor the accompanying explanation prepared by congressional staffs satisfactorily explains how the provision will work or is intended to work, although it is clear that it is intended to apply to both changes in the exemption and changes in rates, whereas previous provisions had addressed only changes in rates. The amendment appears to be well-meaning and likely intended to avoid any untoward "recapture" or "clawback" of a gift tax exemption in the form of an increased estate tax. But until there are forms, instructions, or other published guidance from the Internal Revenue Service on this subject, there will always be a certain risk in making gifts in 2011 and 2012. Of course, if the exemptions and rates in the 2010 Tax Act are made permanent, this issue will be moot.

In all events, however, the substantially larger, indexed, and possibly sunsetting estate tax exemption suggests that closely monitored formulas will continue to be important in estate planning documents, as will specific definitions of the intended outcome in certain contingencies such as a return to older law or even repeal of some or all of the estate, gift, and GST taxes.

The GST Tax

The GST tax was once thought to be the most disrupted by the "repeal" for 2010 and revival in 2011, because so much of the application of the GST tax depends on a continuously maintained tax profile that the 2010 repeal interrupted or depends on special rules enacted in the 2001 Tax Act and of questionable validity after the "sunset" of the 2001 Tax Act. Because of the 2010 Tax Act, that interruption disappears, the suspension of necessary rules is avoided for two years, and the GST tax is now the same as it was before 2010. Its exemption and rate are tied to the estate tax exemption and rate, and now are tied to the gift tax exemption and rate as well.

The GST exemption at unprecedented levels, coupled with the number of jurisdictions that permit the rule against perpetuities to be waived and trusts, in effect, to last forever, suggests that many gifts made in 2011 and 2012, including leveraged gifts, will be made to very long-term trusts. This in turn will increase the need for careful consideration of trust terms, attention to provisions for trustee succession, and provisions for maximum built-in flexibility consistent with the donor's objectives.

Portability

The 2010 Tax Act permits a surviving spouse to use the unused portion of the predeceased spouse's exemption for estate and gift tax purposes, but not for GST tax purposes. Again, because what is popularly referred to as an "exemption" is actually administered as a "unified credit" against the tax, the mechanics are not that simple, but that is the effect.

Portability was not in effect until 2011. It applies to a surviving spouse only if the predeceased spouse died after December 31, 2010. As enacted, it applies only until December 31, 2012. Because portability for only two years is not very meaningful, this is an indication that at least some in Congress contemplated that it would be extended or made permanent. Again there are no guarantees.

The *predeceased* spouse's executor must affirmatively elect portability. The election must be made on a *timely* filed estate tax return. It is not clear why an election is required on the predeceased spouse's timely estate tax return for the surviving spouse to use the unused exemption of the predeceased spouse. But such an election has been in every legislative version of portability since 2006, despite criticisms. If that election is made, there is no statute of limitations on Internal Revenue Service examination of the predeceased spouse's return, but only for the limited purpose of determining the amount of

unused exemption available to the surviving spouse. (The regular statute of limitations will prevent any adjustments to the predeceased spouse's return as such.) It is possible that Congress thought an election by the predeceased spouse's executor was necessary in order to keep the return open even for that limited purpose.

Portability can no more than double a surviving spouse's own exemption and is limited to the unused exemption of the survivor's *last* deceased spouse. Someone who has been widowed more than once can only use the exemption of the most recent deceased spouse. And no one can use exemption of a deceased spouse which that deceased spouse in turn received by surviving a predeceased spouse.

These rules and limitations are perhaps best illustrated by the following examples from the technical explanation of the Senate amendment that became the 2010 Tax Act, prepared by the staff of the Joint Committee on Taxation:

> **Example 1:** Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount or unused exemption. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's exemption is $7 million (her $5 million basic exemption plus $2 million of Husband 1's unused exemption), which she may use for lifetime gifts or for transfers at death.
>
> **Example 2:** Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's unused exemption. Although the combined amount of unused exemption of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exemption is available for use by Wife because the unused exemption is limited to the lesser of the basic exemption ($5 million) or the unused exemption of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exemption). Thereafter, Wife's exemption amount is $6 million (her $5 million basic exemption plus $1 million of Husband 2's unused exemption), which she may use for lifetime gifts or for transfers at death.
>
> **Example 3:** Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's exemption is $7 million (her $5 million exemption plus $2 million unused exemption from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's unused exemption, which is $4 million (Wife's $7 million exemption less her $3 million taxable estate). Under the provision, Husband 2's exemption is increased by $4 million, the amount of Wife's unused exemption.

There may be a technical problem with Example 3 under the wording of the statute, but it is likely that it will be clarified if and before portability is made permanent.

Portability of a predeceased spouse's exemption to the surviving spouse would simplify estate planning for some married couples, especially those with combined estates in excess of the exemption but not larger than twice the exemption. It would eliminate the need for those spouses to have a complicated will with a "credit shelter trust" that escapes estate tax at the survivor's death. And it would reduce the need for married couples to keep an eye on how much property each spouse owns, because portability of the exemption will be available whether or not the predeceased spouse owned enough property to have used any exemption (or owned any property at all). For example, portability will work just fine if a married couple holds all their assets as joint tenants with right of survivorship.

But a credit shelter trust will still offer advantages over portability, especially in larger estates. These advantages include:

- Providing professional management and asset protection during the surviving spouse's life;
- Protecting the expectancy of children from diversion by the surviving spouse, especially in cases of second marriages and blended families;
- Sheltering intervening growth in value and accumulated income from estate tax; and
- Permitting use of the predeceased spouse's GST exemption, because portability applies only to the gift and estate tax exemption.

The decision to rely upon the portability regime or continue with the traditional "credit shelter" trust regime must be made by considering the relationship between the top estate tax rate, the top capital gains tax rate, the rate of inflation, and the rate of return on assets. Currently, the top estate and capital gains tax rates are separated by only 15% (20% top capital gains tax rate and 35% top estate tax rate). This is the closest together these rates have been in 90 years. Only in the initial years of the tax system (1917 – 1921) did the capital gains tax rate ever exceed the estate tax rate. Throughout the rest of the history of the transfer tax system, the top estate tax rate has been double, and at times triple, the top capitals gains tax rate.

If a decedent gives assets outright to the surviving spouse and the decedent's executor elects to allow the surviving spouse to use the decedent's unused exemption, all of the appreciation in these assets may be exposed to estate taxation at the surviving spouse's death. However, if a decedent instead funds a credit shelter trust with the maximum amount that can pass free of estate tax and transfers the remaining assets to the surviving spouse, only the assets transferred to the spouse and the appreciation on those assets will be exposed to estate taxation. The assets in the credit shelter trust, and the appreciation in those assets, will be sheltered from estate tax at the death of the spouse. Upon liquidation after the spouse's death, those assets will be subject to capital gains tax though, because they will not receive a stepped-up basis at the surviving spouse's death.

When the top rates are so close, as they are now, the tax savings afforded by a credit shelter trust are limited – basically to the spread between the rates. If that spread grows in the coming years, and returns to the historical trend of a top estate tax rate nearly double that of the top capital gains rate, the tax savings associated with the use of a credit shelter trust will grow with it.

The differences between portability and the use of a credit shelter trust under the 2010 Tax Act are illustrated by the following examples.

> **Example – Portability**: Husband dies in 2011 with $10 million in assets, and his estate tax exemption is $5 million. Husband transfers all assets to Wife (free of estate tax by reason of the marital deduction). Husband's executor elects to allow Wife to use Husband's unused exemption. Wife dies in 2019. Assuming a 2% rate of inflation and 5% return on assets, Wife's estate will include $14,774,554 in assets. Wife's estate tax exemption after indexing is $5,860,000, and Husband's unused exemption is still $5,000,000. Wife's estate owes $1,370,094 in estate tax assuming a 35% estate tax rate. If the assets are liquidated at Wife's death, there will be no capital gains tax because all of the assets received a step-up in basis.
>
> **Example – Credit Shelter Trust:** Husband dies in 2011 and funds a credit shelter trust with $5 million. The balance of his assets ($5 million) is transferred to Wife. Wife dies in 2019. The value of the assets in Wife's estate is $7,387,277. Wife's estate owes $534,547 in estate tax (assuming a 35% estate tax rate). The assets in Wife's estate receive a step-up in basis at Wife's death and when liquidated are not subject to capital gains tax. The value of the assets in the credit shelter trust at Wife's death is $7,387,277. The credit shelter trust assets are not subject to estate tax at Wife's death. Assuming those assets are liquidated and because they received no step-up in basis at

Wife's death, the credit shelter trust will have a capital gains tax of $477,455 (assuming an effective 20% capital gains tax rate). The total estate and income taxes following Wife's death is $1,012,002, or $358,092 less than would have been paid under portability.

	Portability	**Credit Shelter Trust**
Husband's Assets	$10,000,000	$10,000,000
Husband's Exemption	$5,000,000	$5,000,000
Assets Transferred to Wife	$10,000,000	$5,000,000
Assets Transferred to Credit Shelter Trust	-0-	$5,000,000
Wife's Exemption	$5,860,000	$5,860,000
Value of Wife's Assets at Wife's Death	$14,774,554	$7,387,277
Value of Assets in Credit Shelter Trust at Wife's Death	-0-	$7,387,277
Assets Subject to Estate Tax at Wife's Death	$14,774,554	$7,387,277
Estate Tax Rate	35%	35%
Estate Tax	$1,370,094	$534,547
Assets Subject to Capital Gains Tax on Liquidation at Wife's Death	-0-	$7,387,277
Capital Gains Tax Rate	20%	20%
Capital Gains Tax	-0-	$477,455
Total Tax	$1,370,094	$1,012,002
Tax Savings	-0-	$358,092

On the other hand, for many couples, the simplicity of portability, the second step-up in basis for appreciated assets (which a credit shelter trust does not receive), and the avoidance of state estate tax at the death of the first spouse to die in states with an estate tax and no state-only QTIP election will be more dominant considerations.

In any event, until we know whether portability will be made permanent, it is prudent to assume that it will be and therefore to consider an election every time a married person dies (unless that person uses the entire exemption or it is very unlikely that the surviving spouse's total estate will exceed the surviving spouse's exemption). To the extent that the smallest estates may have the most unused exemption to pass on and therefore need the election the most, it might be hard

to see portability as a simplification. But, again, if the couple's combined estate is well under the exemption, there may be no reason to get involved with portability at all.

VIII. PRESERVING FLEXIBILITY IN ESTATE PLANNING DOCUMENTS

If estate planners can take any lesson from 2010, it is that one cannot predict when and how the transfer tax landscape may change. In light of this general unpredictability and the looming uncertainty of 2013 and beyond, maintaining flexibility in estate planning documents is imperative. Estate planners should use drafting techniques that allow maximum flexibility to react to future changes in the law and changes in family circumstances. Beneficiaries, executors, trustees, and advisors will always need to evaluate the tax and other effects of exercising the powers or options that provide this flexibility, but the following techniques may allow the most flexibility in order to carry out the intention of a grantor or decedent or maximize available tax benefits in an uncertain transfer tax landscape.

Powers of Appointment

The inclusion of powers of appointment in irrevocable trust agreements allows beneficiaries to take a "second look" at a trust after its creation. A testamentary power of appointment permits a current beneficiary who holds the powers to make prospective changes that may affect future beneficiaries, effective upon the death of the current beneficiary. In contrast, an *inter vivos* power of appointment permits a current beneficiary to transfer property to other beneficiaries during the beneficiary's lifetime. An *inter vivos* power of appointment may initially appear less favorable because of possible adverse tax consequences, but *inter vivos* powers allow a beneficiary to provide an immediate benefit for the permissible appointees if appropriate to do so. The holder of an *inter vivos* power of appointment does not need to wait until his or her death to implement the flexibility provided by the grantor.

Estate planners must also be mindful of the tax treatment of general and limited powers of appointment. The holder of a general power of appointment is treated as owning the appointive property for estate tax purposes. If the holder dies holding a general power of appointment, the appointive property will be included in the holder's estate. Likewise, the exercise of a general power of appointment during the holder's life may trigger gift tax liability for the holder. In contrast, the holder of a limited power of appointment (that is, one that is not exercisable in favor of the holder, the holder's estate, the holder's creditors, or creditors of the holder's estate) is not treated as owning the appointive property for estate tax purposes. However, adverse GST tax consequences may still apply.

Testamentary Powers of Appointment. A testamentary power of appointment allows an estate plan to react to changes in the law or in family circumstances without locking in any such changes until the death or incapacity of the holder of the power. Such powers of appointment may allow (1) the distribution of trust principal to a trust designed to better address new tax laws, (2) the retention of more property for future generations if permitted by changes to the GST tax, and (3) the distribution of property outright to beneficiaries if neither tax nor non-tax reasons justify the continued existence of a trust.

In drafting testamentary powers of appointment, individuals and their advisors should consider the permissible appointees of the power of appointment (for example, whether permissible appointees should be limited to the spouse or descendants) and whether the donee of a limited power of appointment may appoint trust assets outright or in further trust. The ability to appoint trust assets in further trust requires consideration of restrictions on the duration of the new trust, the distribution of trust assets at trust termination, the ability of the donee to create separate trusts, or other aspects of the future disposition of the trust assets.

***Inter Vivos* Powers of Appointment.** The exercise of an *inter vivos* general power of appointment will be treated as a gift by the holder, equal to the value of the trust interest transferred by the holder. Further, an *inter vivos* power of appointment may cause otherwise excludable trust property to be taxed in the holder's estate. The adverse tax

consequences of *inter vivos* powers of appointment may be lessened through the use of the holder's annual exclusion amount. The 35% gift tax rate, at least through 2012, also may lessen the tax sting. In some cases, the resulting gift by the holder (that is, the value of the trust interest surrendered by the holder) may be zero or have a nominal value. For example, if a trustee has discretion to make distributions to a surviving spouse for health and support needs that are not adequately provided for out of the surviving spouse's other assets and income, and the surviving spouse has significant independent assets, the value of the trust interest surrendered by the surviving spouse will have little value because of the unlikelihood that the surviving spouse could receive trust distributions.

Discretionary Distributions

The dispositive provisions of a trust provide guidance to the trustee on how and when trust assets may be distributed to trust beneficiaries. Permitting a trustee to make discretionary distributions to beneficiaries is a simple way to grant a trustee the flexibility to adapt to changing circumstances. Some individuals may not feel comfortable granting a trustee what may seem like unfettered discretion. Such concerns may be alleviated by carefully selecting the initial trustee, naming a successor trustee, and directing when and under what conditions a trustee may be removed. The following is a list of drafting pointers and considerations with respect to discretionary distributions:

- Be specific and clearly define the distribution standard.
- Consider the combination of ascertainable and non-ascertainable standards.
- Consider the use of an independent trustee or trust protector to make discretionary distributions under a non-ascertainable standard.
- Permit the trustee to distribute trust principal to a qualified trust for the benefit of the beneficiary, such as a new trust better designed to address current tax law.
- Permit a surviving spouse who is the beneficiary of a marital trust to make annual exclusion gifts to children.
- Permit the trustee to make unequal distributions to beneficiaries with no requirement of later equalization.
- Allow the trustee to consider a beneficiary's changing needs and circumstances, including other assets that may be available to the beneficiary, the beneficiary's maturity level, the beneficiary's need for asset protection, and whether the beneficiary would be motivated by the creation of an incentive system.
- Limit the discretionary power of a trustee to distribute trust property to himself or herself as a trust beneficiary to an ascertainable standard in order to prevent such power from being treated as a general power of appointment.
- Even if limited to an ascertainable standard, deny or further restrict the discretionary power of a trustee to distribute trust property to or for his or her dependents as trust beneficiaries.

Trust Protectors

"Trust protectors," "special trustees," "independent trustees," and persons with similar titles and roles can serve as the custodians of the paramount purposes of an irrevocable trust. Such persons can be granted, among other important powers, the authority within certain limits to fine-tune an individual's estate plan. For example, a trust protector can be granted the power to make administrative changes to a trust, such as changes to the procedures for the removal and appointment of trustees or changes to trustee investment provisions. A grantor may also allow a trust protector to make substantive changes to trust terms to address changes in family circumstances, financial conditions, trust or tax laws, or other legal environments that may affect the trust. Some grantors may also choose to give a trust protector the authority to make changes affecting the beneficiaries of the trust, such as adding or removing beneficiaries, directing discretionary distributions, or altering a beneficiary's interest in the trust. The authority of a trust protector can also be limited to specific transfer tax conditions, such as permitting a trust protector to act if the estate tax is permanently repealed or if it no longer applies to the grantor's estate.

The selection of a trust protector requires care. Grantors may wish to appoint a trusted individual or advisor or a committee to serve as trust protector. Often, if the grantor is unable to name a trust protector in the trust agreement, a provision may be included permitting one or more beneficiaries, trustees, or third parties to appoint a trust protector if one is needed in the future. Grantors should also consider how and when a successor trust protector should be appointed. The grantor of the trust should typically not serve as trust protector because of potential adverse tax consequences. From a non-tax perspective, a current or future beneficiary should not be named as trust protector without very careful consideration, because of the risk of potential abuse of the power and potential criticism or legal challenge from other beneficiaries. Exoneration and indemnification provisions in the trust document may shield the trust protector (whether a beneficiary or otherwise) from liability and encourage an appointee to accept the role as watchdog over the trust. The nature and extent of the duties and liabilities of trust protectors is not well developed in American law, increasing the need for careful attention to the drafting of trust protector provisions to avoid both abused by and placing unreasonable risk on trust protectors.

Powers of Attorney

Most individuals with comprehensive estate plans have a power of attorney giving one or more agents the power to act on his or her behalf during life, and most commonly during incapacity. Powers of attorney may be used to add flexibility to an existing estate plan, but their effectiveness ceases at the individual's death when the power of attorney expires. Some examples of how a power of attorney may be used with respect to estate planning include granting the agent the power to make gifts to individuals and charities (sometimes limited to smaller gifts such as annual exclusion gifts) or the power to exercise the individual's right to create, modify, or revoke a trust.

In order to be effective and induce reliance by third parties, estate planning related powers should be expressly granted and well-defined. For example, the Uniform Power of Attorney Act, which has been adopted so far in nine jurisdictions,[18] requires powers over trusts and to make gifts, and the power to disclaim or refuse an interest in property (including a power of appointment) must be specifically authorized in the power of attorney. Even with a specific grant of power, some powers such as the power to make gifts may still be limited by state law, such as being limited to gifts that are consistent with the individual's established pattern of gifting. The reason for these and other conditions and limitations on sensitive powers related to estate planning is the reality that, while these powers offer useful flexibility, they can also be abused in a way that can cause great harm to the individual and the estate plan. Individuals and their advisors should carefully review applicable state laws to see if similar requirements and limitations apply. With respect to the power to make gifts, the individual may wish to name permissible beneficiaries specifically or categorically, or clearly define the extent to which larger gifts are permitted. With respect to the power to deal with a trust, the individual may wish to limit the agent's power to transferring assets to a revocable trust or condition certain powers on the individual's incapacity. In any event, powers of attorney for estate planning purposes should be durable to survive the principal's incapacity. Most importantly, individuals should give very careful consideration to the selection of the agent who will hold the significant powers granted under a power of attorney.

Decanting

A number of states[19] have enacted decanting statutes that allow a trustee, without court approval, to appoint trust assets in favor of another trust with new or modified terms that may better address changes in the tax law. Where available, decanting statutes can be useful tools for dealing with changes in beneficiary circumstances, consolidating trust assets for administrative purposes, modifying trustee provisions (such as removal powers, appointment of successor trustees, and

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[18]The UPOAA has been enacted in Colorado, Idaho, Maine, Maryland, Nevada, New Mexico, U.S. Virgin Islands, Virginia, and Wisconsin. The UPOAA is also pending in Minnesota, Ohio, and West Virginia.

[19] Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, New York, North Carolina, South Dakota, and Tennessee have enacted decanting statutes.

trustee compensation) or investment provisions, changing the situs or governing law of the trust, and correcting drafting errors. The state statutes vary in form with respect to the similarity required between the beneficiaries and their interests in the old and new trust, whether an interested trustee may decant a trust, and the notice and procedural requirements to decant.

Grantors living in jurisdictions that have not enacted decanting statutes may wish to consider including the following drafting alternatives:

- Broad distribution provisions that specifically permit the trustee to distribute assets to one or more new trusts for the benefit of some or all of the beneficiaries.
- An *inter vivos* power of appointment that permits a beneficiary to appoint trust property to a trust with different terms.
- A merger provision, taking into account any requirements under state law for the merger of trusts.

Grantors and their advisors may also wish to consider other state trust law provisions, including the Uniform Trust Code provisions adopted by many states and discussed below.

Uniform Trust Code

The Uniform Trust Code (the "UTC"), which has been adopted so far in 23 jurisdictions,[20] provides numerous statutory tools for dealing with common trust problems. These statutory provisions provide flexibility to grantors, trustees, and beneficiaries in dealing with irrevocable documents, both by allowing private agreements concerning trusts and by codifying the broad powers of the courts over trusts. Each state's version of the UTC has state specific variations that must be carefully reviewed. The discussion below is based on the UTC as approved by the National Conference of Commissioners on Uniform State Laws.

The UTC allows interested persons, usually the trustee and the beneficiaries, to enter into a private agreement called a "nonjudicial settlement agreement" that resolves almost any matter involving a trust, so long as the agreement does not violate a material purpose of the trust and could be approved by a court. Court approval of the agreement is not required, but is allowed. One of the most important and useful features of this provision is the ability to bind minor, incapacitated, and unborn persons to a nonjudicial settlement agreement by virtual representation. Under virtual representation, minor, unborn, or incapacitated persons may in many circumstances be bound to the agreement without the appointment of a guardian *ad litem* provided there is a qualified representative available, such as a parent or a person with a substantially identical interest in the trust, who does not have a conflict of interest. Nonjudicial settlement agreements can be one of the most useful and efficient ways of addressing and resolving a very wide range of trust issues.

The UTC also codifies the power of a court to modify a noncharitable irrevocable trust with the consent of all beneficiaries where not inconsistent with a material trust purpose, or on the consent of the settlor and all beneficiaries even if inconsistent with a material trust purpose and codifies the power of a court to modify a trust to react to unanticipated circumstances and further the trust purposes. A court may also modify the trust administrative provisions if the terms would be impracticable, wasteful, or impair the trust's administration after considering the settlor's probable intent.

The UTC also codifies the power of the court to reform a trust to correct mistakes and to conform the trust terms to the settlor's intent, on clear and convincing proof of a mistake, and empowers a court to modify a trust to achieve the settlor's tax objectives in a manner not contrary to the settlor's probable intention, which modification may be retroactive. This

[20] The following states have adopted the UTC: Alabama, Arizona, Arkansas, the District of Columbia, Florida, Kansas, Maine, Missouri, Michigan, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, and Wyoming. The UTC is pending in New Jersey.

may be very useful with respect to for trusts made by decedents who die in 2010, where the decedent may not have considered or understood the effect of an increased estate tax or GST exemption on the estate plan and the beneficiaries. This section is an important tool when the settlor's intentions are thrown off track by tax law changes.

Lastly, the UTC permits the merger and division of trusts. A trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts if the result does not impair the rights of any beneficiary or adversely affect the achievement of the purposes of the trust. The trustee must provide notice to all "qualified beneficiaries" of the trust (generally, the current beneficiaries and the presumptive remainder beneficiaries, but not contingent remainder beneficiaries) and will need to consider how tax attributes (for example, charitable deductions, capital loss carryforwards, and net operating losses) will be divided among the trusts. A trustee may also use a nonjudicial settlement agreement to obtain beneficiary consent to the merger or division and the tax and other aspects of the action.

In states that have not adopted the UTC, other trust laws may provide similar or alternative ways in which to maintain flexibility in irrevocable documents.

Conclusion on the Need for Flexibility

We may have the long-awaited answer to what transfer taxes look like in 2010 and 2011, but uncertainty remains. Estate planning must continue even in times of uncertainty, and irrevocable trusts will continue to play an important role in this planning. Trusts offer many non-tax benefits, including disability protection, asset protection, privacy protection, avoidance of probate, income tax planning, and greater protection against challenges to an estate plan.

The techniques addressed above allow individuals to defer decisions on how and when property will be distributed to beneficiaries. A grantor can place limits on how decisions will be made and what needs of beneficiaries or other matters should be considered. Although the techniques and other tools discussed above may not be appropriate in all circumstances, their inclusion in a comprehensive estate plan will provide flexibility in permitting grantors, trustees, and beneficiaries to adapt to changing circumstances. These techniques will permit continued planning while maintaining the flexibility necessary to react to what Congress may do in the future.

IX. THE INCREASED IMPORTANCE OF STATE TAXES UNDER THE 2010 TAX ACT

Before the 2001 Tax Act, almost every state imposed a state death tax equal to the federal state death tax credit available under Internal Revenue Code section 2011. In addition, several states had stand-alone inheritance taxes. The 2001 Tax Act reduced the federal state death tax credit in stages from 2002 through 2004 and eliminated it in 2005, replacing it with a deduction under Internal Revenue Code section 2058. The 2010 Tax Act retained the federal deduction for state death taxes. Thus, those states that tied (or "coupled") their state death tax to the amount of the current federal state death credit will continue to lack a state death tax in 2011 and 2012.

Several states did not lose their state death taxes because of the phase-out of the state death tax credit under the 2001 Tax Act because those states did not tie their state death taxes to the current federal state death tax credit. Instead, those states had tied their state death taxes to a prior year's state death tax credit. These were sometimes referred to as "decoupled" states. Other states that faced the loss of their state death taxes acted to retain their state death taxes by various means, such as decoupling the state tax from the federal credit, determining the state tax by reference to pre-2001 Tax Act law, or imposing a stand-alone state death tax regime. In addition, the states that retain a state death tax often have lower thresholds for the imposition of the state death tax than the federal threshold.

Planning for individuals who reside in one of these states or who have property subject to a state tax is more complicated than planning for individuals who are not subject to separate state death taxes. The states that currently have a separate state death tax (and their thresholds for tax) are:

State	Type of Tax	2011 Estate Tax Filing Threshold
Connecticut	Stand-Alone Estate	$3,500,000
Delaware	Estate	$3,500,000 or $5,000,000[21]
District of Columbia	Estate	$1,000,000
Hawaii	Stand-Alone Estate	$3,500,000
Indiana	Inheritance	
Iowa	Inheritance	
Kentucky	Inheritance	
Maine	Estate	$1,000,000
Maryland	Estate and Inheritance	$1,000,000
Massachusetts	Estate	$1,000,000
Minnesota	Estate	$1,000,000
Nebraska	County Inheritance	
New Jersey	Estate and Inheritance	$675,000
New York	Estate	$1,000,000
North Carolina	Estate	$5,000,000
Ohio	Stand-Alone Estate	$338,333
Oregon	Estate	$1,000,000
Pennsylvania	Inheritance	
Rhode Island	Estate	$859,350
Tennessee	Inheritance	
Vermont	Estate	$2,750,000
Washington	Stand-Alone Estate	$2,000,000

The effective combined federal and state tax rate for those states that are decoupled from the current federal state death tax varies depending upon whether the state permits the taxpayer to take into account the federal deduction in calculating the state tax. Internal Revenue Code section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. The federal estate tax return (Form 706) was redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

[21] Pending clarification by the Delaware Division of Revenue.

As the following table shows, the marginal federal rate in 2010 through 2012 is 30.2% or 29.4% depending on whether the state allows a deduction for the state tax itself.

Top Marginal Estate Tax Rates			
	Federal	**State**	**Total**
2009			
"Coupled" State	45%	0	45%
Ordinary "Decoupled" State	38.8%	13.8%	52.6%
"Decoupled" State/No Deduction	37.8%	16%	53.8%
2010-2012			
"Coupled" State	35%	0	35%
Ordinary "Decoupled" State	30.2%	13.8%	44.0%
"Decoupled" State/No Deduction	29.4%	16%	45.4%
2013			
All States (Under Current Law)	39%	16%	55%

The resulting loss of state revenue and state budgetary shortfalls may lead many of the states that lack a state death tax to enact new state death tax legislation. Two states have already done this. In 2009, Delaware, which had lacked a state death tax since 2005, reinstated its state death tax. Vermont lowered the threshold for its state death tax in 2009. However, it should be noted that some states actually phased out or eliminated their state death taxes at different points during the period from 2002 to 2010. These states included Virginia, Wisconsin, Illinois, Kansas, and Oklahoma.

Furthermore, existing post-2001 Tax Act difficulties continue. Not all states that have a state death tax, as noted above, set the same threshold for the imposition of the tax or enacted consistent provisions concerning whether it would be possible to make an election to qualify a QTIP trust for a state marital deduction distinct from the federal election. The variation in state laws since the enactment of the 2001 Tax Act resulted in a dramatic increase in estate planning complexity for individuals domiciled or owning real or tangible personal property in states with a state death tax. Individuals have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and movables, and use of lifetime gifts. The states with a separate state estate or inheritance tax that specifically permit a QTIP election are Indiana (for separate inheritance tax), Kentucky (for separate inheritance tax), Maine, Maryland, Massachusetts, New Jersey (only to the extent permitted to reduce federal death tax), Ohio (for its stand-alone estate tax), Oregon, Pennsylvania (for separate inheritance tax), Rhode Island, and Tennessee (for separate inheritance tax).

The use of a separate state QTIP election can prevent the imposition of a state tax at the death of the first spouse to die and perhaps provide benefits, but the possible advantages and disadvantages need to be analyzed carefully.

> **Example:** Husband dies in 2011 with an estate of $7 million in a state which has a separate state estate tax and a threshold of $1 million. Under standard credit shelter and marital trust estate planning, Husband's estate would fund the credit shelter trust with $5 million to take advantage of the current $5 million exemption from federal estate tax and the marital trust with the balance. If the state does not permit a separate state QTIP election, funding the credit shelter trust with $5 million will subject the assets in the credit shelter trust to state tax at the first death. The state tax could be as high as $396,080. The balance of $2 million would pass to a marital trust. Of course, the property in the credit shelter trust would escape future federal and state taxation at the surviving spouse's death.

One alternative is to simply fund the credit shelter trust with the $1 million that can escape both federal and state tax. The balance of $6 million would qualify for the marital deduction and escape both federal and state tax at the first death. However, at the second death, the marital trust worth $6 million would be subject to federal tax to the extent that it exceeded the threshold for federal tax at the surviving spouse's death (currently $5 million but decreasing to $1 million in 2013 with a 55% rate under current law) and to state tax if the surviving spouse lived in a state that had a state death tax. This might result in higher tax at the surviving spouse's death. For example, if the marital trust had $6 million in it and the federal estate tax exemption is $1 million and the rate is 55%, the federal tax would be $2,595,000. This needs to be compared to the first situation above in which state tax of $396,080 is paid at the first death, but only $2 million is included in the QTIP trust and subject to tax at the surviving spouse's death. The federal tax on the $2 million marital trust would only be $210,000. Thus, the state tax at the first death and the federal tax at the second death are far less than the federal tax at the second death in this alternative.

A second alternative, if the state permits a separate state QTIP election, is to allocate $1 million to the credit shelter trust, $4 million to a QTIP trust for which only a state QTIP election would be made, and $2 million to a QTIP trust for which both a federal and state QTIP election would be made. As a result, no federal or state tax is owed at the first death. At the second death, both QTIP trusts are subject to state tax, but only the $2 million QTIP trust is subject to federal tax. Depending upon the thresholds for state and federal tax at the time (or if there even is an estate tax), little tax may be owed. Essentially, the second alternative allows one to delay the imposition of tax until the second spouse's death while making maximum use of the federal exemption to protect assets from federal tax at the first and second deaths. There is the risk that this strategy could not produce the desired results if the tax rates go up or the exemption goes down, but it does allow one to shelter the entire federal exemption amount from federal tax at the first and second deaths.

In an era of a greater federal estate tax exemption, individuals in states with a state death tax still have plenty of opportunities to implement strategies that minimize the impact of state death taxes, through a combination of lifetime transfers, change in domicile, and deferral of payment of state taxes by use of state QTIP elections. But the planning is more difficult because of the separate rules often affecting state and federal taxation. Individuals in states with a state death tax still have plenty of opportunities to implement strategies that minimize the impact of state death taxes, through a combination of lifetime transfers, change in domicile, and deferral of payment of state taxes via state QTIP elections.

X. CHARITABLE GIVING IN 2011

Charitable Giving Incentives under the 2010 Tax Act

The Pension Protection Act of 2006 (the "PPA of 2006") included three provisions applicable to individuals that were labeled as charitable giving "incentives." These incentives were limited in duration and were generally available only in 2006 and 2007. These incentives were subsequently extended through 2009. The 2010 Tax Act extended these provisions again, making them effective for 2010 and 2011.

IRA Charitable Rollover. The 2010 Tax Act extended the IRA charitable rollover provision as originally enacted in 2006. This provision provides an exclusion from gross income for certain otherwise taxable IRA distributions from a traditional or Roth IRA in the case of "qualified charitable distributions." Qualified charitable distributions are any distributions up to $100,000 per year from an IRA made in 2010 or 2011 directly by the IRA trustee to a "qualified charitable organization" if the IRA owner has actually attained age 70½ at the time of the rollover. The 2010 Tax Act also allows a taxpayer to elect to treat a charitable rollover made in January 2011 as if made on December 31, 2010.

A distribution is to a qualified charitable organization if it is made to a public charity other than one classified as a supporting organization and is not to a donor-advised fund (even if maintained by an otherwise qualifying charity). Contributions to private foundations (other than private operating foundations or conduit foundations) do not qualify for the exclusion. The IRA owner is not entitled to an income tax charitable deduction for any amount excluded from gross income under this provision.

The exclusion is available only for distributions from traditional and Roth IRAs and not for distributions from employer-sponsored retirement plans, SEPs, Keoghs, 403(b) plans, 401(k) plans, SIMPLE IRAs, or profit sharing plans. Distributions must be made directly from the IRA trustee or administrator to the qualified charitable organization. To exclude the distribution from income, the donor must obtain written substantiation of receipt of an IRA distribution from the donee organization that includes a statement that no goods or services were provided.

The exclusion applies only if the entire amount distributed would have been allowable as a charitable deduction (without regard to any percentage limitations) if contributed by the donor. Thus, the donor cannot receive any benefits from the charity as a result of the transfer or the exclusion from gross income will not be available. As a result of this requirement, the exclusion is not available for a distribution to fund a charitable remainder trust, pooled income fund, or charitable gift annuity.

If the donor's IRA contains both deductible and nondeductible contributions, the charitable rollover will be deemed to have been made from the deductible (and therefore taxable) portion first. In addition, the charitable rollover will count towards the donor's required minimum distribution for the tax year.

Even though the donor does not actually obtain an income tax charitable deduction, the IRA charitable rollover can offer tax benefits to some taxpayers that might not be available for a traditional charitable gift. The charitable IRA rollover may be beneficial for taxpayers who do not itemize their deductions and therefore cannot claim an income tax charitable deduction or for taxpayers whose states do not allow an income tax charitable deduction. In addition, many taxpayers wish to minimize adjusted gross income to avoid certain phase-outs or other provisions dependent upon the amount of the taxpayer's adjusted gross income.

In Notice 2007-7, which was issued following the PPA of 2006, the Internal Revenue Service clarified several issues under the IRA charitable rollover rules. Specifically, the IRA charitable rollover may be used to pay a legally binding pledge. Also, the IRA owner can receive the check (made payable to the charity) and deliver the check to the charity. Also, if a husband and wife each have sufficient IRA assets in their own name, they can each give $100,000 to charity from their respective IRAs during 2010 and 2011.

Contributions for Conservation Purposes. Despite a number of congressional hearings and stories of abusive transactions, the PPA of 2006 actually increased the tax benefits associated with conservation easements made during 2006 and 2007, which benefits were previously extended through 2009. The 2010 Tax Act extends these benefits for conservation easements placed on property in 2010 and 2011. These provisions increase the percentage limitation for deductibility of certain gifts of qualified conservation contributions from 30% to 50% of adjusted gross income and increase the carryover of unused deduction from five to 15 years.

In the case of a farmer or rancher, a qualified conservation contribution deduction is allowable in 2010 and 2011 up to 100% of the taxpayer's contribution base as long as the property is restricted in such a manner that the property remains available for a farming or ranching purpose. The carryover is extended from five to 15 years. An eligible farmer or rancher means a taxpayer (other than a publicly traded C corporation) whose gross income from the trade or business of farming is greater than 50% of the taxpayer's gross income for the tax year.

S Corporation Stock Basis Adjustment. The 2010 Tax Act extends for 2010 and 2011 the PPA of 2006 provision that conforms the S corporation rules to the partnership rules by providing that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's *pro rata* share of the adjusted basis of the contributed property (rather than by the shareholder's *pro rata* share of the amount of the contribution).

Charitable Giving Opportunities in 2011

Statistics about charitable giving during the Great Recession confirm that individuals and corporations not only reined in their spending during 2008 and 2009, but also decreased their charitable giving. According to *Giving USA*, 2008 saw the largest drop in annual giving in more than 50 years at 5.7%.[22] But, donors continued to give with donations of $303.75 billion to charity in 2009 (as compared to $315.08 billion in 2008).[23] A recently released study by Bank of America Merrill Lynch and the Center on Philanthropy at Indiana University shows that gifts by wealthy donors declined by an average of nearly 35% from 2007 to 2009.[24] When viewed in the context of the significant losses of wealth during the Great Recession and the uncertainty over future tax rates and the 2010 one-year repeal of the federal estate tax, these declines may actually be less than expected. This indicates that, for many people in the United States, philanthropy is important and, while the amount of charitable giving may be affected by tax uncertainties and economic downturns, many people continue to give generously despite declines in their portfolios and uncertainty over future tax rates.

This continuing desire to fund charitable causes does, however, require advisors to work with donors to enable them to give "smarter." There are certain gift techniques that are particularly attractive in the current low interest rate environment and others that require the exercise of greater caution. The section 7520 rate used to value many types of planned charitable gifts hit an all time low of 1.8% in December 2010. Historically low section 7520 rates favor certain planned giving techniques, such as charitable lead annuity trusts and gifts of a remainder interest in a residence or farm. But, the low section 7520 rates may make certain gift techniques, such as charitable remainder trusts, inaccessible for certain younger donors and will reduce the donor's income tax charitable deduction for certain planned gifts.

Effect of Low Section 7520 Rates on Charitable Giving Techniques. Fluctuations in the section 7520 rate used to value many types of charitable gifts, including charitable lead trusts, charitable remainder trusts, charitable gift annuities, and remainder interests in personal residences or farms can have a dramatic effect in certain circumstances on the amount of a donor's income or transfer tax charitable deduction. The rates, which vary monthly, have ranged from a high of 11.6% in 1989 to a low of 1.8% in December 2010. These current low rates offer some opportunities and pitfalls when making a planned gift.

Charitable Lead Annuity Trusts Offer Unique Opportunities. While charitable lead unitrusts are not affected significantly by fluctuations in the section 7520 rate, charitable lead annuity trusts are affected by the section 7520 rate – lower rates generally increase the value of the charitable lead interest. With a charitable lead annuity trust, a fixed amount is paid to a charitable beneficiary for either a term of years or during someone's lifetime. Upon expiration of the term, the remaining assets of the trust pass to the donor's designated beneficiaries (usually children in the case of a charitable lead annuity trust because of GST tax considerations). Unlike charitable remainder trusts, there are no limits on the number of years of the charitable term and no minimum or maximum annuity amount.

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[22] Strom, "Charitable Giving Declines, a New Report Finds," *NY Times* (June 9, 2009) available at http://www.nytimes.com/2009/06/10/us/10charity.html.
[23] "U.S. Charitable Giving Falls 3.6 Percent in 2009 to $303.75 Billion," available at http://www.philanthropy.iupui.edu/news/2010/06/pr-GUSA2010.aspx.
[24] Blum, "Donations by the Wealthiest Americans Plunged 35% in Downturn," *Chronicle of Philanthropy* at 31 (Dec. 2, 2010). The study is available at http://mediaroom.bankofamerica.com under press releases.

While the donor is not entitled to an income tax charitable deduction upon the establishment of the charitable lead annuity trust unless it is structured as a grantor trust for federal income tax purposes, the donor is entitled to an estate or gift tax deduction for the value of the charitable lead interest. Assuming the charitable lead annuity trust is a nongrantor trust, the trust will be entitled to an income tax charitable deduction each year for amounts of its gross income paid to charity under the terms of the trust agreement. Because the present value of the remainder interest (that is, the transfer to the children) factors in the delay in the children's receipt of and control over the trust assets, these assets are valued at a discount, resulting in a smaller transfer or gift to the children.

Although the value of the charitable interest is limited to the value of the property transferred to the trust, it is possible for a donor to create a charitable lead annuity trust with a charitable interest equal (or nearly equal) to the value of the property transferred to the trust. With these so-called "zeroed-out" charitable lead annuity trusts, the remainder interest passing to the noncharitable beneficiaries would be equal to zero or of nominal value, and the donor would make no (or a nominal) transfer for gift or estate tax purposes as a result of the creation of the trust. With lower section 7520 rates, the remainder interest can be reduced to zero with shorter terms and lower payouts than would be the case at higher section 7520 rates. The following table shows payout rates and trust terms that "zero out" the remainder value in a charitable lead annuity trust assuming a 1.8% section 7520 rate and a 2.4% section 7520 rate and quarterly payments made at the end of each quarter to charity.

CHARITABLE LEAD ANNUITY TRUST FOR TERM OF YEARS
Payout Rates to Zero-Out or Produce Nominal Remainder Value

Term of Years	Annuity Payout at 1.8% 7520 Rate	Annuity Payout at 2.4% 7520 Rate
10	10.944%	11.266%
15	7.616%	7.946%
20	5.959%	6.297%
25	4.97%	5.318%
30	4.315%	4.672%

With a zeroed-out charitable lead annuity trust, if the trustee's investment of the transferred assets yields a higher return than the section 7520 rate during the trust term, the excess return passes to the children free from transfer tax.

> **Example:** Donor wishes to contribute $100,000 annually to her favorite charities for 20 years. She transfers $1,678,134 to a charitable lead annuity trust and directs annual charitable payments of $100,000. At the end of the 20-year term, the trust assets are to be distributed to her daughter. Assuming the section 7520 rate is 1.8%, Donor is entitled to a gift tax charitable deduction equal to the amount transferred to the trust and there is no gift to the daughter for gift tax purposes. During the 20-year term of the trust, the trust assets earn an annual return of 4%. At the end of the charitable term, the trustee will distribute the remaining assets, worth $654,523, to the Donor's daughter, free of transfer tax.

Gift Annuities Still Offer Benefits Despite Low Rates. In uncertain economic times, many donors favor the security of fixed payments offered by a charitable gift annuity, as well as the simplicity of establishing a gift annuity. With a gift annuity, the donor transfers assets to a qualified charitable organization in return for the charitable organization's agreement to pay the donor or another beneficiary an annual annuity for life. For income tax purposes, the donor is entitled to an income tax charitable deduction equal to the difference between the fair market value of the property

transferred and the value of the annuity contract. A portion of the income received by the donor will be taxable as ordinary income, while a portion may be exempt from federal income tax. If the gift consists of appreciated property, the transfer is treated as a "bargain sale" (that is, part gift, part sale). Assuming the donor is the annuitant, any capital gains attributable to the sale portion of the gift are reported ratably over the donor's lifetime.

Many donors like the certainty of receiving an annual fixed amount. Of course, because a charitable gift annuity is a contract with a particular charity, the financial viability of the charity can present a risk to the donor. Any donor entering into a gift annuity arrangement with a charity should undertake appropriate due diligence before making the transfer to determine the financial stability and longevity of the charity.

The current low section 7520 rates significantly reduce the available charitable deduction for the gift associated with a gift annuity. But, for a donor interested in tax-free income and not concerned with the amount of the charitable deduction, the low section 7520 rates have a significant and advantageous impact on the exclusion ratio, which is the amount of the annuity payments that will be excluded from income each year for federal tax purposes.

> **Example:** A 65-year old donor gives property in return for a 5.5% annuity, which is the current rate recommended by the American Council on Gift Annuities.[25] With a 7% section 7520 rate, the donor's charitable deduction is 49.288% and the exclusion ratio for the annuity payments is 46.3%. If the section 7520 rate is 1.8%, however, the donor's deduction decreases to 21.291%, while the exclusion ratio increases to 71.9%.

Other problems can arise with charitable gift annuities if the value of the charitable gift is not at least 10%. The debt-financed property provisions of the unrelated business income tax rules that apply to charities provide that the charity will not have debt-financed property as a result of entering into the gift annuity arrangement if, among other requirements, the value of the annuity payable to the donor or other annuitant is less than 90% of the value of the property transferred to the charity. Charitable gift annuities for younger annuitants can easily run afoul of these rules, even when using the American Council on Gift Annuities' recommended rates.

> **Example:** The recommended rate for an annuitant who is 38 years old is 4%. Using a section 7520 rate of 1.8%, the value of the donor's annuity interest exceeds 100%, and the donor is not entitled to a charitable deduction. This transaction would run afoul of the debt-financed property rules, and the charity would most likely be unwilling to enter into the arrangement under these terms.

Gifts of a Remainder Interest in a Personal Residence or Farm Offer Favorable Deduction Despite Retained Interest. Unlike most planned giving vehicles where the donor retains an interest and which are adversely affected for donor deduction purposes by low section 7520 rates, the charitable deduction for a gift of a remainder interest in a personal residence or farm is enhanced by a lower section 7520 rate. The federal tax laws allow a charitable deduction for income, estate, and gift tax purposes for a charitable gift (not in trust) of a donor's personal residence (including a vacation home or second residence) or farm, even though the donor retains an interest in the property for life or a term of years. The donor may either retain a life estate or give one to others, and the life estate may be for one or more lives.

Many donors have charitable commitments but have watched their liquid assets decline in value as a result of the economic downturn. Others continue to be wary about large transfers to charity as a result of tax and economic uncertainty. For a donor interested in satisfying a charitable commitment or obtaining an income tax charitable deduction currently, a gift of a remainder interest in a personal residence or farm may be appropriate as it will have little, if any, immediate impact on the donor's lifestyle and liquidity.

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[25] The rates recommended by the American Council on Gift Annuities can be found at http://www.acga-web.org/giftrates.html.

Existing Charitable Remainder Trusts Offer Opportunities. Many donors are unwilling to consider charitable remainder trusts currently, not only because of the depressed property values and economic uncertainty, but also because of the depressed values of the charitable remainder interests resulting from the low section 7520 rates. But for donors with existing charitable remainder trusts, the low section 7520 rate may offer an opportunity for additional income tax planning.

During the booming stock market of the 1990s, many people took advantage of the opportunity afforded by charitable remainder trusts to make tax-deductible contributions to charity while at the same time reserving what was expected to be substantial future income on the donated property. The expectations of these donors have not been realized in many cases as a result of the Great Recession. The disappointment has been particularly sharp for those who established charitable remainder unitrusts as donors have watched trust values, and correspondingly unitrust payments, decline. For those who established charitable remainder annuity trusts, many are faced with the uncertainty as to whether the trust will have sufficient assets to satisfy the annuity payments during the full term of the trust and whether the charitable beneficiary will ever reap any benefits from the trust. For a donor who may not need the income and still wishes to make a sizable contribution to the charitable remainderman, the time may be appropriate to consider a gift of the donor's unitrust or annuity interest to the charitable remainderman. The donor will be entitled to an income tax charitable deduction for the current value of the annuity or unitrust interest (which for some annuity trusts could be as much as 100% of the value of the trust assets), and the charitable remainderman will be able to use the assets in furtherance of its mission immediately.

Current Developments Affecting Substantiation of Charitable Gifts

In order to claim an income tax charitable deduction for a gift to charity, the federal tax laws impose a number of substantiation requirements. A donor who makes a gift of $250 or more must obtain a written acknowledgement of the gift from the charitable donee before claiming the deduction for the gift on a timely filed income tax return. A donor who makes a gift of property valued at more than $5,000 must obtain a qualified appraisal from a qualified appraiser to determine the value of the contributed property. Compliance with these substantiation rules is a prerequisite to entitlement to the income tax charitable deduction for the gift. That is, if the donor does not have the required written acknowledgement or the required qualified appraisal, the donor is not entitled to an income tax charitable deduction for the gift. For a donor making a substantial gift to charity, the loss of the entire deduction for the gift could be devastating.

The Internal Revenue Service, perhaps weary of valuation disputes with taxpayers, has recently changed tactics in connection with the income tax charitable deduction. There were a number of cases decided in 2010 where the Internal Revenue Service denied a taxpayer's income tax charitable deduction based on a lack of required substantiation. The courts have sided with the Internal Revenue Service in these cases and denied the deduction.

In *Friedman v. Commissioner*,[26] the taxpayers obtained an appraisal and attached the required Form 8283 to their return, but the appraisal did not indicate the valuation method used or the basis for the appraised values of diagnostic and laboratory equipment. The taxpayers also did not have the required contemporaneous written acknowledgement for the donation. The court found that the taxpayers failed to strictly or substantially comply with the qualified appraisal requirements and disallowed the claimed charitable deductions.

In *Scheidelman v. Commissioner*,[27] the taxpayers made a gift of a façade easement along with a cash gift. The court denied a deduction for the gift of the façade easement because the taxpayers did not have a qualified appraisal and denied a deduction for the cash gift because the taxpayers were unable to prove that the cash gift was not a *quid pro quo*. In *Lord v. Commissioner*,[28] the court disallowed the taxpayer's charitable deduction for a contribution of a conservation easement because the taxpayer's appraisal failed to include the date of contribution, the date the appraisal was performed, and the

[26] T.C. Memo 2010-45.
[27] T.C. Memo 2010-151.
[28] T.C. Memo 2010-196.

appraised fair market value of the easement on the date of contribution. Similarly, in *Hendrix v. United States*,[29] the taxpayers' charitable deduction was denied because the appraisal did not indicate the anticipated date of contribution, did not disclose the terms of the agreement between the taxpayers and the donee, did not include the required qualifications of the appraiser, and did not include the required statement that the return was prepared for income tax purposes. In addition, the taxpayers did not obtain the required contemporaneous written acknowledgement from the donee.

Any donor or advisor working with a donor must take steps to ensure that the Internal Revenue Service cannot deny a deduction for a legitimate charitable gift. This means ensuring that the donor obtains the required contemporaneous written acknowledgement and an appraisal, if required, that meets all of the requirements for a "qualified appraisal" from a qualified appraiser. The Internal Revenue Service republished its Publication 1771 – Charitable Contribution Substantiation and Disclosures in June 2010.[30] This publication can serve as a guide to ensure that the substantiation requirements are met. The Internal Revenue Code and the Treasury Regulations also provide details on the requirements for a qualified appraisal and the definition of a qualified appraiser.[31] All appraisals should be carefully reviewed to ensure that all requirements are satisfied as certain of the required provisions are not always customary to a routine appraisal.

Conclusion on Charitable Giving

As the high levels of charitable giving during the Great Recession indicate, Americans continue to find ways to fund charitable endeavors despite economic and tax uncertainties. For those individuals who want to continue to achieve their philanthropic goals, there are unique opportunities created by the current environment. For those willing to see the silver lining, favorable and tax-advantaged charitable giving opportunities are available. But care must be exercised to wade through the regulatory requirements and avoid certain pitfalls.

XI. IMPACT OF 2010 TAX ACT ON INTERNATIONAL ESTATE PLANNING

Gift Tax

As individuals contemplate engaging in the various estate planning techniques described in this white paper as a result of favorable tax law changes made under the 2010 Tax Act, it is important that the international implications of any cross-border transfers be considered. Particularly in the context of lifetime gifting, if assets located in the United States are to be transferred to other jurisdictions, or vice versa, the local and foreign tax consequences of the gift must considered.

As discussed above, with the increase of the gift tax exemption to $5 million and the retention of the 35% gift tax rate for transfers in 2011 and 2012 enacted by the 2010 Tax Act, the impetus to make substantial gifts has been amplified, including gifts to non-U.S. citizens and non-U.S. residents. Additionally, beginning in 2011, the annual exclusion amount for gifts made from a U.S. citizen to a non-citizen spouse will increase, as a result of an inflation adjustment, from $134,000 to $136,000. However, individuals must use caution in transferring U.S. assets to a foreign jurisdiction to ensure that the tax laws of the donee's jurisdiction do not unexpectedly burden the transfer. For instance, overseas tax laws may impose taxes in relation to any proposed gift of U.S. assets that might negate the benefit of any estate planning in the United States. Understanding the transfer tax system of the foreign jurisdiction is an important factor in determining the benefits and costs of a proposed transfer.

Similar caution must be used in making transfers of assets from non-U.S. residents to U.S. residents. Federal gift tax is imposed on non-resident foreign citizens only for gifts of real and tangible personal property situated in the United States.

[29] No. 2:09 cv. 00132 (S.D. Ohio 2010).
[30] This publication can be found on the Internal Revenue Service website at http://www.irs.gov/app/picklist/list/publicationsNoticesPdf.html?value=1771&criteria=formNumber.
[31] I.R.C. § 170(f)(11), Treas. Reg. § 1.170A-13, I.R.S. Notice 2006-46 available at http://www.irs.gov/irb/2006-46_IRB/ar13.html.

No gift tax is imposed on the transfer of intangible property by a non-resident foreign citizen. An exception applies to certain expatriated non-resident foreign citizens or certain individuals with dual citizenship. The non-resident foreign citizen can make gifts of all U.S. assets, other than real or tangible property located in the United States, without being subject to any federal gift tax. Gifts of cash should be made from bank accounts located outside the United States because the Internal Revenue Service considers gifts of cash from a U.S. bank account to be gifts of U.S. tangible property subject to U.S. gift tax. With careful planning though, a non-resident foreign citizen with substantial U.S. and foreign assets should be able to provide for family and friends in the United States without federal transfer tax.

Estate Tax

Many countries impose an estate tax on the value of local assets passing to beneficiaries upon the death of the owner, regardless of nationality or residence. Real estate and bank accounts are typical of the types of assets that will be subject to these local estate taxes. For example, in the United Kingdom, all local property (other than excluded property and other exemptions such as property passing to a surviving spouse) is subject to a 40% inheritance tax upon the death of the owner. Additionally, some nations, such as Portugal, apply real estate stamp taxes to real property transferred by devise or descent. Thus, U.S. citizens with property overseas, or those considering transferring assets overseas, must be aware that such property may be subject to local estate or inheritance taxes.

Similarly, nonresident aliens are subject to the U.S. estate tax only with respect to property situated in the United States, generally including real estate, government bonds, and stock of a domestic corporation. The 2010 Tax Act extended the so-called "estate tax look-through rule," which provides that stock of a regulated investment company would not be deemed property located within the U.S. to the extent that the assets held by the regulated investment company would not be treated as U.S. assets if they were owned directly by the decedent's estate.

To avoid estate taxation in both the United States and a foreign jurisdiction, Internal Revenue Code section 2014 provides a U.S. estate tax credit for estate or inheritance taxes paid in foreign jurisdictions. For the credit to be applicable, the foreign tax must be the substantial equivalent of the U.S. estate tax, meaning that the tax is imposed on the transfer of property from a decedent to a beneficiary. The rate of the foreign tax is also significant as the credit under Internal Revenue Code section 2014 is limited to the lesser of the foreign tax attributable to the property and the U.S. estate tax attributable to the property. Additionally, the United States has entered into estate tax treaties with certain countries, such as Australia, France, and Japan, which provide for specific and unique transfer tax rules. The language of these treaties is binding upon the citizens of each jurisdiction and should be consulted before engaging in any cross-border estate planning.

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about this white paper. Please feel free to contact any member of the Group.

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