Now You See It, Now You Don't, Then You Do...
Federal Transfer Tax And Related Income Tax Changes In 2010 And Beyond

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Federal estate and generation skipping transfer taxes have been "repealed" — or, more accurately, made not applicable to transfers during 2010. Congress' failure to extend application of the law as it existed prior to 2010 or take other action was quite a surprise to most practitioners. As a result, there has been little attention paid to appropriate planning for 2010.

Major changes, in addition to the "repeal" of estate and generation skipping transfer taxes, apply to transfers occurring during 2010. These include substitution of a carry over basis regime for transfers at death instead of a step-up in basis, with complex allocation rules, and changes to reporting requirements. These changes affect all tax-motivated planning under non-2010 law. Ignore at your and your clients' peril!

This article provides a high-level summary of the major changes in estate, generation-skipping transfer, and related income tax law for 2010, and planning recommendations for those trying to decide whether further inquiry and action are appropriate.[1] These recommendations address:

- Remedial actions to assure that documents prepared under prior law accomplish the intended goals
- Optimizing planning given the current law
- Dealing with the uncertainty surrounding whether changes may be enacted that would affect planning implemented in response to the current law

The gift tax remains applicable to gratuitous transfers, but with a rate reduced to 35%.[2] The available exclusion during 2010 is $1 million.[3]

Unless new legislation is enacted, as of the beginning of 2011 we will return to the law effective in 2001 that provided for an estate, generation skipping transfer, and gift tax exemption equivalent of $1 million per transferor. There is on-going discussion of what form permanent (permanent? — ha! — or, more likely, interim) changes, if any, might take. Given other legislative agenda items, it appears that such action is unlikely to occur quickly enough to make it unnecessary to at least consider whether changes to previous planning are needed, and whether new planning possibilities under 2010 law should be implemented. There have been suggestions that any extension of 2009 law or changes in this area will be retroactive to the beginning of 2010; it is uncertain whether an attempt to do so would be effective, adding uncertainty to planning actions that rely on 2010 law.[4] In addition, the language of the 2001 Tax Act creates uncertainty regarding the effect of actions taken in 2010, should we reach 2011 without Congressional action.[5]

Summary of Recommendations

The following is a list of recommendations for planning during 2010, with each discussed in more detail in following sections:

- If the estate of the client and spouse is valued at less than $1.3 million, no tax related changes to prior planning are required.
- If the estate of the client and spouse is valued between $1.3 million and $4.3 million, documents should be reviewed to assure that property will pass in a way that qualifies for full allocation of basis adjustment, if desired.
- For estates valued in excess of $4.3 million, a careful analysis of the basis and unrealized gain is required for assets owned, with appropriate amendments to prior planning.
- Consider changes to provide for taking basis into account when determining distributable interests, and make express provision for allocation of basis adjustment in the executor's discretion, by formula, or to direct benefits as desired.
- All documents — particularly those with tax based formula provisions — should be reviewed to assure that the language is unambiguous, and that the disposition resulting from governing language is the disposition desired.
- Avoid formula gifts for transfers in 2010.
- For large estates, consider whether aggressive planning is appropriate.

In reviewing the changes in the law and the recommendations made in this article, keep these changes in mind: during 2010 there will be no automatic step-up in basis at death, there will be carry over basis, and while the estate and generation skipping transfer taxes do not apply, the gift tax does.

Law Prior to 2010

Under prior law, assets received a step-up in basis for income tax purposes to the date of death value.[6] Thus, if land was purchased in 1960 for $100 per acre, and the owner died in 2009 when the land was valued at $5,000 per acre, there would be no income tax payable on the gain of $4,900 per acre. Only if the total value of all property owned by the decedent passing to someone other than a surviving spouse — not just the land — exceeded the estate tax exemption available ($3.5 million in 2009[7]) would any tax — either estate or income — be paid.

Example, death in 2009:

400 acres purchased in 1960 at $100 per acre	$40,000
Value at date of death (400 acres times $5,000)	2,000,000
Unrealized gain	1,960,000
Step up in basis at death	1,960,000
Taxable gain	$-0-
Income taxes payable if land sold immediately after death	$-0-

Since the value of the decedent's estate was less than $3.5 million, no estate taxes would be paid.

Law during 2010

The law for 2010, however, implements a different taxation system. There is no automatic step-up in basis for income tax purposes to date of death value. Instead a system of "carry over basis" is applied, in the same treatment applied to gifts under prior law, but subject to a limitation: the starting basis of each particular asset is the *lower* of the basis while owned by the decedent, or value at the date of death.[8]

Carry over basis is subject to adjustments that may be allocated by the executor of the decedent[9] to property acquired from the decedent[10]: $1.3 million[11] in additional basis may be allocated to property passing to anyone, and an additional $3 million in basis may be allocated to property passing in a qualified manner to a surviving spouse.[12] To qualify, the gift to the spouse may be outright or as a qualified terminable interest.[13] The interest passing to the spouse may be made conditional on surviving for a period not exceeding six months without being a disqualified terminable interest.[14] In community property states, spousal basis adjustment may be allocated both to the decedent's interest in the community and to the surviving spouse's interest in the community in a manner similar to, but more limited than, the step-up in basis provided under prior law.[15] Property including certain gifts received within three years of death and certain stock of foreign investment companies are not eligible for allocation of basis adjustment.[16] Allocation of basis adjustment cannot increase the basis of property to more than fair market value as of the date of death.[17]

On the same facts as described above, the outcome under current law may be very different, and will depend on who is receiving the property.

Example, death in 2010:

Gift to someone other than surviving spouse	
400 acres purchased in 1960 at $100 per acre	$40,000
Value at date of death (400 acres times $5,000)	2,000,000
Unrealized gain	1,960,000
Adjustment to basis allocated by executor	1,300,000
Taxable gain	660,000
Income taxes payable if land sold immediately after death[18]	$99,000

Gift to surviving spouse

400 acres purchased in 1960 at $100 per acre	$40,000
Value at date of death (400 acres times $5,000)	2,000,000
Unrealized gain	1,960,000
Adjustment to basis allocated by executor	1,960,000
Unrecognized gain	-0-
Income taxes payable if land sold immediately after death	$-0-

Since the estate tax is not applicable, no estate taxes will be paid in either case.

Thus, if the estate of the client and spouse is valued at less than $1.3 million, no tax related changes to prior planning are required, since there logically cannot be more than $1.3 million unrecognized gain in the property.

- **Recommendation:** If the estate of the client and spouse is valued between $1.3 million and $4.3 million, documents should be reviewed to assure that property will pass in a way that qualifies for full allocation of basis adjustment, if desired.
- **Recommendation:** For estates valued in excess of $4.3 million, a careful analysis of the basis and unrealized gain is required for assets owned, with appropriate amendments to prior planning.

Note that it is unrealized gain that is important, not total value of the property passing, unlike the applicable law before and after 2010. Thus formula language based on value and application of estate and generation skipping transfer taxes (such as marital deduction formula clauses or formula transfers referring to the available generation skipping transfer tax exemption) may not provide an optimal outcome, even if drafted to avoid definitional and interpretational difficulties. If a standard pre-2010 marital deduction formula clause determines disposition and the bypass trust is funded with substantially all assets, as is shown in the first case, income taxes will be incurred that would not be incurred if the bypass trust were not so funded.[19] Thus, the planning choice presented is whether to fully utilize the spousal step-up in basis, and, if so, whether the disposition should be outright, in which case the property will be taxable in the surviving spouse's estate should the estate tax be applicable but the other one-half of the community may have basis adjustment allocated to it, or whether the disposition should be in a trust satisfying the qualifying terminable interest property requirements but structured so as not to cause inclusion in the surviving spouse's estate upon reapplication of the estate and generation skipping transfer tax, but potentially foregoing the allocation of basis adjustment to the surviving spouse's one-half of the community.[20]

The executor is required to file an informational return if the fair market value of non-cash assets to be received by beneficiaries exceeds $1.3M, subject to a lower limit for non-resident decedents who are not U.S. citizens.[21] The allocation of increased basis is made on this return.[22] *The allocation of basis is not automatic*; thus failure to allocate available increase in basis will result in loss of the available additional basis.

The governing documents will determine whether the executor has discretion to allocate basis among assets. Absent a provision granting such discretion, the executor is required to treat all beneficiaries fairly. Since rarely do documents provide for consideration of basis when determining distributive interests (unlike consideration of indebtedness secured by assets), simple exercise of discretion provided may substantially affect the beneficial interest received.

Again, using the facts described above:

Example, death in 2010, gifts to two children "equal shares":

400 acres purchased in 1960 at $100 per acre	$40,000
Value at date of death (400 acres times $5,000)	2,000,000
Unrealized gain	1,960,000

Gift to Child 1

One-half of unrealized gain	980,000
Adjustment to basis allocated by executor	980,000
Unrecognized gain	-0-
Gross value of share	1,000,000
Less unrecognized income taxes	0,000
Net value of share	1,000,000

Gift to Child 2	
One-half of unrealized gain	980,000
Adjustment to basis allocated by executor	320,000
Unrecognized gain	660,000
Income taxes payable if land sold immediately after death	99,000
Gross value of share	1,000,000
Less unrecognized income taxes	99,000
Net value of share	901,000

Of course, life is never so simple. In most cases the client will have assets acquired at various time, having varied bases, with some held long term and some held short term.

- **Recommendation:** Consider changes to provide for taking basis into account when determining distributable interests, and make express provision for allocation of basis adjustment in the executor's discretion, by formula, or to direct benefits as desired.

Drafting considerations

Documents incorporating transfer tax planning under prior law frequently use formula clauses to allocate assets between a surviving spouse and other beneficiaries, and between generation skipping gifts and those that are not generation skipping. This creates potential problems of interpretation for such documents if the testator dies in 2010. What is the meaning of the phrase "maximum marital deduction allowable to my estate" when there is no estate tax applicable, and therefore no deductions allowable? How should a gift based upon that phrase be construed? Previously unambiguous provisions may during 2010 have become ambiguous.

Documents should be reviewed to assure that terms such as "maximum marital deduction," "available generation skipping transfer tax exemption," and other terms predicated on the estate or generation skipping transfer tax have alternate definitions, or the documents contain alternative provisions not relying on the meaning of those terms, so that the disposition desired will be unambiguously expressed.

- **Recommendation**: All documents should be reviewed to assure that the language found in the document has an unambiguous meaning, and that the disposition resulting from governing language is the disposition desired.

Crafting formula gifts under prior law was a relatively straightforward problem, with solutions refined over more than 60 years. Crafting language for tax motivated formula gifts under 2010 law is much more complex. Instead of an evaluation based on one variable — date of death value — within the context of applicable estate or gift tax, gifts must be determined with respect to two independent variables: date of death value and unrealized gain. Since unrealized gain is not dependent upon the value of the asset, and tax-motivated dispositions during 2010 are based upon the ability to optimally allocate the available basis adjustment, it is much more difficult to draft a formula gift that is predictable both in tax and dispositive effect.

While some commentators have made an attempt to draft such formula provisions,[23] unless Congress extends the 2010 regime it may be advisable to simply forgo formula gifts for transfers occurring in 2010 and use other approaches to the problem. Given the (apparently) short-term nature of the problem, the simplest solution may be a careful analysis of assets and related unrealized gain, combined with a disposition designed to obtain available tax benefits while directing assets to desired beneficiaries. Where such analysis is not feasible, planning for the disclaimer of an intentionally over-funded marital gift (whether outright or in a qualified terminable interest) can provide post-mortem flexibility so that tax and dispositive results can be optimized.

- **Recommendation:** Avoid formula gifts for transfers in 2010.

Gift Planning

For large estates, an aggressive gift program may potentially be extremely beneficial even in the face of a high degree of uncertainty. The combination of temporarily reduced gift tax rates, the tax exclusive nature of the gift tax, the absence of a generation skipping transfer tax, and the high probability of reapplication of the estate and generation skipping transfer tax provide a strong motivation for current transfers by those with substantial wealth. For simplicity, consider an unmarried client with an estate having $20 million in assets available for transfer to desired beneficiaries, who has not used any unified credit in prior transfers, ignoring deductions:

Gift in 2010	
Available assets for gift and tax	20,000,000
Applicable exclusion amount	1,000,000
Total available for transfers and tax after exclusion	19,000,000
Amount transferred to beneficiaries subject to gift tax[24]	14,074,000
Gift tax at 35%[25]	4,926,000
Total amount to beneficiaries[26]	15,074,000
(less income taxes on unrealized gain)	

Transfer at death in 2011	
Available assets	20,000,000
Applicable exemption equivalent	1,000,000
Taxable estate	19,000,000
Estate tax at 55%	10,450,000
Total amount to beneficiaries	9,550,000
(with step up in basis to date of death value)	

Thus, ignoring income taxes, beneficiaries receive $5.52 million more, or more than 50% more than by later transfer at death. Even if the entire amount received by gift had a zero basis (unlikely), and the gain was taxed at 20%, beneficiaries would receive $2.51 million more. In addition, however, the generation skipping component of the transfer by death would be limited to $1 million, meaning that the balance of $8.5 million would be subject to tax in the next generation. In contrast, the entire amount of the 2010 gift could be made generation skipping and avoid taxation for two or more generations, yielding substantial additional benefits.

Implementation of such a plan would not be for the faint of heart. Offsetting these large potential benefits is the uncertainty attached to the treatment of such gifts, and the associated risk of litigation. Chief among these risks is the possibility that Congress may attempt to make any legislation retroactive to the beginning of 2010, raising the unsettled question as to whether such action could affect the treatment of completed transfers. In addition, due to the particular language of the Sunset Provisions of the 2001 Tax Act, there are substantial questions as the effect of any provision of the Act should the Sunset Provisions be allowed to become effective at the end of 2010.

- **Recommendation**: For large estates, consider whether aggressive planning is appropriate.

Practical Considerations for Lawyers

What to do?

Most practitioners end their representation when documents are executed by the client. If there is no continued representation, there is no obligation to inform a former client of changes in the law affecting the planning implemented. It is the author's experience, however, that very few lawyers, much less non-lawyers, have even a surface understanding of the very different law applicable during 2010. Although temporary, the 2010 environment can substantially affect the benefits passing from decedents dying in 2010, particularly those having implemented marital deduction planning.

In addition, given the large increase in exemption equivalent through 2009, many clients who might benefit by tax planning if the 2001 Tax Act sunsets without further legislation have not implemented such planning. If the year draws to a close without enactment of legislation, these former clients would benefit from knowing that changes may be appropriate.

While failure to inform former clients of these changes may be neither a breach of an ethical obligation or actionable[27], it would be preferable to inform clients, particularly those for whom work was done after the 2001 Tax Act, of the changes which might affect their decisions. They then can make an informed choice whether to make changes to accommodate the law applicable in 2010, or defer action until the situation resolves.

Conclusion

2010 provides a challenging estate planning environment. Although only temporary, the changes imposed can significantly change the outcomes of planning decided upon and implemented while the estate and generation skipping transfer tax was applicable. Information should be provided to clients, and documents reviewed to assure that clients' goals continue to be accomplished. Documents drafted during the year should incorporate provisions optimizing outcomes both under current law and the law should current Code provisions be allowed to sunset.

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[1] 2010 changes not discussed include treatment of transfers in trust as gifts, unless made to a wholly-owned grantor trust as to the donor or donor's spouse, IRC Sec. 2511(c), and questions and changes associated with the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act). For an in-depth discussion of these and other items discussed in this article, see "Estate Planning in Light of One-Year 'Repeal' of Estate and GST Tax in 2010" by Steve R. Akers, available from the author at akers@bessemer.com.

[2] IRC Sec. 2502 During 2010, a new subsection 6019(b) is effective, requiring notice to each donee of the content of the gift tax return within thirty days after the required due

date of the return. The due date of the return remains April 15 of the year following the gift. IRC Sec. 6075

[3] IRC Sec. 2505

[4] See Akers, above

[5] For transfers after 2010, Section 901(b) of the 2001 Tax Act provides that "The Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts, and transferees described in subsection (a) [the 2001 Tax Act] *as if the provisions and amendments described in subsection (a) had never been enacted*." [Emphasis added] The "had never been enacted" language is very broad, and if construed literally will present problems related to actions taken after the 2001 Tax Act and before 2011, and for beneficiaries of those dying in 2010. These potential problems include a number of issues associated with allocation of generation skipping transfer tax exemption and application of carry over basis with respect to those dying in 2010.

[6] IRC Sec. 1014 (for years other than 2010)

[7] IRC Sec. 2010

[8] IRC Sec. 1022(a)

[9] IRC Sec. 1022(d)(3)

[10] IRC Sec. 1022(d)(1)(A) provides that the basis adjustment is available "only if the property was owned by the decedent at the time of death." Special rules are provided in IRC Sec. 1022(d)(1)(B) for jointly held property, certain revocable trusts (essentially those in which the decedent retained the right to revoke in himself or a non-adverse party, see IRC Sec. 645, 672 and 676), and community property. A decedent is not treated as the owner of property by reason of holding a power of appointment, thus property passing by reason of exercise of a general power of appointment is not eligible for allocation of basis adjustment. IRC Sec. 1022(e) provides a laundry list of property that will be considered to have been acquired from the decedent.

[11] IRC Sec. 1022(b)(2)(B). This basic available basis adjustment may be increased by unused built-in losses and loss carryovers. IRC Sec. 1022(b)(2)(C). The basis adjustment is limited to $60,000 for a nonresident not a citizen of the United States, IRC Sec. 1022(b)(3), and is adjusted for inflation after 2010 (when, of course, the law will no longer be in effect!), 1022(d)(4)

[12] IRC Sec. 1022(c)(2)

[13] IRC Sec. 1022(c)(3)

[14] IRC Sec. 1022(c)(4)(C). Although not identical, the source of this subsection appears to be Sec. 2056(b) applicable to the marital deduction allowable under the estate tax, thus interpretation should be in *pari materia* with that subsection.

[15] IRC Sec. 1022(d)(1)(B)(iv) provides that "Property which represents the surviving spouse's one-half share of community property ... shall be treated for purposes of this section as owned by, and acquired from, the decedent if at least one-half of the whole of the community interest in such property is treated as owned by, *and acquired from*, the decedent without regard to this clause." [emphasis added] The emphasized language

suggests that the amount of basis adjustment allocable to the surviving spouse's one-half of the community may be limited to the amount of community passing to the surviving spouse, unlike prior treatment of the step-up in basis provided for the entire community property.

[16] IRC Sec. 1022(d)(1)(C) and (D)

[17] IRC Sec. 1022(d)(2)

[18] The applicable tax rate is 15%. IRC Sec. 1(i) The capital gains rate will return to 20% if the 2001 Tax Act is allowed to sunset.

[19] Typically, such clauses provide that the maximum amount possible without payment of estate taxes be sheltered from inclusion in the surviving spouse's estate by passing to a credit shelter trust structured to avoid that outcome. Most such credit shelter trusts provide only for discretionary distributions, although typically the surviving spouse is a permissible beneficiary. Such a disposition does not qualify for the spousal property basis increase under IRC Sec. 1022(c)(2). While a credit shelter trust could be constructed to be qualified terminable interest property under IRC Sec. 1022(c)(5), the requirement that the spouse be the sole beneficiary for life and mandatory income distribution requirement would limit flexibility during the surviving spouse's lifetime. Such a trade-off might be justified, however, since it would both allow allocation of the spousal property basis increase, and protect the disposition from the estate and generation skipping transfer taxes, should they become applicable after 2010.

[20] See note 15, *supra*

[21] IRC Sec. 6018 Subsection (c) of this section describes the information to be included in the return. In addition to the return, this section requires that a written statement reflecting the information found on the return be provided to each recipient within thirty days after the due date of the return. The due date of the return is the due date of the decedent's final income tax return. IRC Sec. 6075

[22] IRC Sec. 1022(d)(3) Query: does the mandatory language found in this subsection — "shall allocate the adjustments ... on the return required by section 6018" — read in conjunction with the filing requirements of 6018 preclude allocation by the executor in an estate for which no return is required? (Note that this particular provision is not parallel to the automatic step-up in basis provided under section 1014 under non-2010 law.) If so, then no basis adjustment is available for estates not having non-cash assets with a value of at least $1.3M. While it seems unlikely this was the legislative intent, it would seem within a fair reading of the provisions and might be asserted by the Internal Revenue Service.

[23] A number of samples of such attempts are provided by Akers, supra.

[24] $19M = (taxable amount transferred) + .35(taxable amount transferred), or $19M ÷ 1.35 = taxable amount transferred

[25] $ 14,074,000 (taxable amount transferred, rounded) times .35 = 4,926,000 (rounded)

[26] $14,074,000 (taxable amount transferred) + $1,000,000 (exclusion amount)

[27] Note, however, that documents prepared after the 2001 Tax Act not drafted to avoid definitional problems related to references to the estate and generation skipping transfer tax, or provide alternate dispositions related to allocation of increased basis, might well be negligent. If a surviving spouse jointly represented with the decedent were deprived of an increase in basis, and subject to an additional income taxes, there may be no privity bar to a malpractice action. While providing information and choice to such clients might not preclude such an action, it would seem to reduce the likelihood of such an action.