

Holy Cow! The Impossible Has Happened: 2010 Will Start As A Year Without Estate Tax and With Carryover Basis

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Jonathan G. Blattmachr is the author of five books and hundreds of articles. Jonathan's first book, written with Tom McGrath, "Carryover Basis Under the 1976 Tax Reform Act" was published in 1977 by the Journal of Taxation. Although the 1976 version of carryover basis has been repealed, the book contains several insights about such a regime which will be appropriate to consider next year. Carlyn S. McCaffrey, a partner at Weil, Gotshal & Manges in New York, is a past president of the American College of Trust & Estate Counsel (ACTEC), a prolific author, frequent lecturer and is regarded as one of the outstanding lawyers of her generation. In this article, Carlyn and Jonathan tell us about a most extraordinary event about to occur: the repeal of estate and generation-skipping taxes and the adoption of carryover basis for inherited property for people who die in 2010. Jonathan and Mike Graham of Dallas, Texas, wrote about this in an article published in the May/June 2007 issue of *Probate & Property*, entitled "Thinking About the Impossible for 2010: A Year Without Estate Tax and Carryover Basis." You probably will want to get a copy because, as Jonathan and Carlyn explain, for most people it is still not too late to take this extraordinary event into account. They also tell us about some of the planning opportunities and potential pitfalls that will arise next year.

EXECUTIVE SUMMARY:

In the 2001 Tax Act (known as EGTRRA), many changes were made to the estate tax system including increasing the exemption for this year to \$3.5 million, lowering the top rate to 45%, eliminating the state death tax credit and culminating in 2010 in the repeal of the estate and generation-skipping transfer or GST taxes (but not the gift tax) and the elimination of the "step up" in basis under section 1014(a) of the Internal Revenue Code so the decedent's basis will "carryover" to those who inherit his or her property. However, the "sunset" provision of the 2001 Act means that all of the changes the Act made (including income tax changes such as reducing the top income tax bracket from 39.6% to 35% and the reduction in the top bracket for long-term capital gains and dividends to 20%) will expire at the end of 2010. Hence, unless the law is changed in the future, the estate tax exemption will drop to \$1 million, the top estate, gift and GST tax rate will

become 55% as it was before the 2001 Act (and it can be 60% for some estate and gift tax transfers), the estate and gift tax system will again be “unified,” the state death tax credit under section 2011 will be restored and several other important provisions will again be as they were before EGTRRA, such as the qualified family owned business (QFOBI) provision under section 2057, all as of January 1, 2011.

This presents an extraordinary opportunity for estate planners and their clients. But there are also potential dangers for some. On account of the possibility of retroactive legislation, there is risk in taking any action at all on the premise that the estate and GST taxes are gone for the year and that the gift tax rate will be only 35%.

COMMENTARY:

Complications for Word Formula Dispositions. As is well known, many dispositions under wills and trusts are phrased in terms of tax concepts. For example, many married people divide their estates into two broad portions: one portion equal to the unused estate tax exemption (typically passing into a non-marital deduction trust often called the “credit shelter trust” for the benefit of the surviving spouse and descendants) and the other portion equal to the “optimum” marital deduction amount, typically expressed as the “minimum amount necessary as the Federal estate tax marital deduction to reduce my Federal estate tax to zero.”

Sometimes, an individual, whether or not married, will have a portion of his or her estate equal to his or her “unused GST exemption” pass in a way different from the balance of his or her estate (such as to a trust for the benefit of his or her grandchildren and more remote descendants).

These word formula are used because they produce what appears to be the optimal division or disposition of a decedent’s property. But they have no meaning if the concepts used to define them are not in the law. For example, what is the “minimum amount necessary as the Federal estate tax marital deduction to reduce my Federal estate tax to zero” if there is no Federal estate tax or Federal estate tax marital deduction? Similarly, if the estate tax exemption is defined as “applicable credit amount within the meaning of section 2010 of the Internal Revenue Code,” how much is that if there is no such applicable credit in effect in 2010? And, if the estate tax exemption is defined as “the largest taxable estate I can have for Federal

estate tax purposes without my estate paying any Federal estate tax,” how large in that amount if there is no concept of a taxable estate in the law?

Ideally, wills and trusts will have taken the possibility of there being no estate tax into account. But it is known that most such documents do not cover that possibility because almost all thought it was impossible that it could happen.

A further complication arises for people who die with estates that are subject to a state death tax. Approximately a dozen states have “independent” death tax systems. These will not be automatically repealed simply because there is no Federal estate tax. Again, perhaps, in an ideal situation, wills and trusts will have made an explicit provision for the disposition of someone’s estate if there were no Federal estate tax but there were a state death tax. But virtually none has.

Carryover Basis Considerations. Under Section 1022, the income tax bases of assets acquired from someone who dies in 2010 will not equal their estate tax values; rather the bases of his or her assets will “carryover” to those who inherit the property. Thankfully, the Internal Revenue Code has provided two “exceptions” to the carryover basis rule, which will provide some relief to the beneficiaries who receive these assets. The first exception permits the decedent’s executor (or personal representative) to allocate up to \$1,300,000 to increase the basis of assets under the instrument. This increase, however, may not increase the basis above the fair market value of the asset on the date of death. In addition to the \$1,300,000 step-up in basis, the decedent’s executor (or personal representative) can also allocate up to \$3,000,000 to increase the basis of assets that the surviving spouse receives outright or through a QTIP trust (called “qualified spousal property”).

First, the client’s will (and it must be the will because it is the executor who gets to allocate the basis increases) should have language to authorize the executor (or personal representative) to allocate the basis increase, in his or her sole and absolute discretion. Second, the will or will substitute (such as a revocable trust) should make a special bequest to the spouse or a QTIP trust in order to be able to use the \$3 million basis increase for qualified spouse property. For example, if the married person’s will or trust is construed as transferring everything to the credit shelter trust, there may be no qualified spousal property. And making this special bequest is complicated because it is not \$3 million worth of property that need to pass

outright to the surviving spouse or a QTIP type trust but property having inherent gain of \$3 million. Sample language and advice is contained in the Blattmachr/Graham article, mentioned above, on "*Thinking About the Impossible.*"

Don't Forget About Section 2511(c). Also effective next year (if there is no estate tax), section 2511(c) will provide that, except as provided in regulations, a transfer in trust will not be treated as a gift unless the trust is a grantor trust in its entirety with respect to the grantor. There is no such regulation and usually they may be effective only on a prospective basis. Hence, it seems that to have a completed gift, any transfer in trust must be to a grantor trust (that is, one that under section 671 will have all its income, deductions and credits against tax attributed to the grantor). That should not be problematic as a general rule. A QTIP for one's spouse, for example, likely will be such as trust. See sections 676 and 677. And grantor trust status usually is very beneficial. *See, generally*, Akers, Blattmachr & Boyle, "Creating Intentional Grantor Trusts," 44 Real Property, Trust and Estate Law Journal 207 (Summer 2009). Nonetheless, in some cases, individuals create non-grantor trust so, for example, the income will not be attributed to the grantor who may live in a high tax jurisdiction such as New York but to the trust which may not be subject to any (or at least lower) state and local taxes. Also note that it must be a grantor trust with respect to the trust's "real" grantor, not a beneficiary who is treated as the owner of the trust for income tax purposes under section 678.

Year End Action or Inaction? Many estate planners have been urging their clients to take action before the end of this year in light of the possibility of enactment of adverse changes to the estate and gift tax system, such as the elimination of grantor retained annuity trusts (GRATs), qualified personal residence trusts (QPRTs) and discounts in valuation. But now it may be better to wait until early next year because those adverse changes were not enacted.

Any gift a taxpayer might make in creating a GRAT in 2011 would be exposed to a potentially lower gift tax (maximum 35%) than if created in 2010 (45%). The same is for a QPRT. In fact, that is true for any potential gift which might occur, such as by an installment sale to a grantor trust.

Hence, it may be preferable to wait until early next year to take such planning steps.

Other Planning Action for Next Year. Similarly, it maybe better to wait until next year to avoid GST tax. For example, almost any transfer to a so-called “skip person,” such as grandchild or a trust for grandchildren or more remote descendants, is subject to GST tax this year if in excess of the GST exemption (limited to \$3.5 million). Next year, there is to be no GST tax so taxpayers need not limit such transfers to \$3.5 million (or whatever their remaining GST exemption is) to avoid the tax.

Moreover, it may be possible for a married person to completely avoid the GST tax forever (even after 2010) on transfers made next year. For example, a married woman might transfer her entire wealth to a so-called “qualified terminable interest property” or “QTIP” trust for her husband, if he is a US citizen. No gift tax will be due. Although the trust will be included in his estate when he dies under section 2044, it may be that this QTIP will be “grandparented” from the GST tax when it is reinstated in 2011. That planning option was available for QTIP trusts created before the effective date of the 1986 version of the GST tax. In any event, there seems to be little risk in trying that (as long as the spouse creating the QTIP for his or her husband and wife is comfortable in doing so).

Another GST tax planning option is to create a “dynasty” type \$3.5 million trust for grandchildren or more remote descendants. Under the law that will be in effect in the beginning of 2010, there will be no GST tax even though the transfer to such a trust (considered a “skip person” even if the grantor’s children and/or spouse become beneficiaries at a later time). Even if the Congress retroactively reinstates the GST tax back to the beginning of 2010, the taxpayer likely could apply her GST exemption to prevent any GST tax—it seems unlikely, although it is not impossible, that the Congress would not grant at least a \$3.5 million GST exemption on any reinstated retroactive GST tax system.

It also may be appropriate to have trusts make what otherwise would be “taxable terminations” and “taxable distributions” in early 2010. Although under current law, these transfers would be subject to GST tax, there will be no such tax next year. The risk of course is that Congress will reinstate that tax retroactively. It seems, however, politically unlikely that it would not grant some relief to those who took action based on the law at the time of the transfer—that is, that there was no GST tax. Perhaps, someone will figure out a way to “recall” the transfer if the tax is reinstated retroactively.

Carryover Basis Records. As Jonathan and Tom McGrath detailed in their book on carryover basis, there are ways to run down what the decedent's basis was in his or her assets at death. (Jonathan, by the way, reports that the bids on Ebay for copies of that monograph are soaring.) Yet the best solution is to get the information from clients now. So contact your clients soon to gather that important information.

Other Matters. As mentioned above, the entire pre-EGTRRA estate tax system, including the special exclusion rule for certain conservation easements under section 2031(c) and the QFOBI provisions under section 2057 will come back into the law in 2011. Also, the rules for extension of estate tax payments with respect to closely held business interests will change and some are adverse (e.g., reducing the number of owners to make it closely held from 45 to 15). *See, generally,* Jonathan Blattmachr & Elisabeth (Lisi) Madden (now Mullen), *Untangling Installment Payments of Estate Tax under Section 6166*, 36 Estate Planning 3 (July 2009)

Planners need to focus on these changes well before the end of next year.

SUMMARY AND CONCLUSION:

The elimination of the estate and GST taxes and introduction of carryover basis for those dying in 2010 represents an extraordinary event for estate planners and their clients. In many ways, it opens tremendous but temporary planning opportunities. But, as explained, it also poses dangers. Practitioners can find a sample letter to clients about this at the home page of www.interactivelegal.com which can be downloaded in word and modified. But action needs to be taken. The real dangers are inaction by practitioners and political risk. Will Congress retroactively reintroduce these taxes? What will happen in 2011? While it is impossible to be at all certain about these matters, advice and counsel to clients now is extremely important. And most important of all, estate planners need to counsel their clients right away.



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