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What Estate Planners and Their Clients Should Know About The Tax Relief Act of 2010

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On December 17, 2010, President Obama signed into law "The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" ("TRA 2010"). The new tax law caught most estate planners by surprise with its sweeping changes to the federal estate, gift and generation-skipping transfer tax systems. Among other things, TRA 2010 retroactively restored the estate and generation-skipping transfer (GST) tax systems as of January 1, 2010 (although subject to an "opt out" for 2010 decedents for purposes of the estate tax). It also unified the estate, gift and GST lifetime exemption amounts at $5 million (with this amount to be indexed from 2010 beginning in 2012), although the lifetime gift tax exemption amount was maintained at $1 million in 2010 before being raised to $5 million in 2011. TRA 2010 also establishes a maximum tax rate of 35%, with the notable exception that GSTs occurring during 2010 are instead subject to a *zero percent* tax rate. It moreover ushers in the portability of lifetime exemption amounts between spouses for estate and gift tax (but not GST tax) purposes. TRA 2010 is scheduled to expire on December 31, 2012, so it may effectively be regarded as a temporary patch.

I. Estate Tax Including Portability

Default Rule – Estate Tax Applies in 2010

The default rule under TRA 2010 is that the estate tax applies to estates of decedents dying in 2010, with a $5 million exemption and a 35% tax rate. This reenactment of the estate tax is accomplished via § 301(a) of TRA 2010, which sunsets certain provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") as if they had never been enacted. This provision retroactively applies to decedents dying after, and generation-skipping transfers occurring after, December 31, 2009.[1]

Carryover Basis Election for 2010 Decedents

Executors of estates of decedents who died during 2010 may elect to opt into the prior EGTRRA posture of temporary estate tax repeal for 2010 and have the modified carryover basis rules of IRC § 1022 apply with respect to property acquired or passing from the decedent.[2] Large estates in excess of the $5 million exemption amount that would otherwise have to pay substantial estate taxes will likely make this election. However, the executor will have to consider a number of factors in determining whether to make this election. These factors include (1) the amount of estate tax currently payable compared to the amount of gain that would be subject to income tax on a subsequent sale of property taking into account the anticipated dates of such sale, and (2) whether depreciation can be used to generate current income tax benefits even without selling such property.

If the carryover basis election is made, then TRA 2010's repeal of EGTRRA's repeal of the estate tax does not apply with respect to Chapter 11 of the Internal Revenue Code (yes, there is indeed a triple negative here). Importantly, however, the carryover basis election does not affect the GST tax for 2010, as the GST provisions are contained in Chapter 13 of the Internal Revenue Code (as opposed to Chapter 11 for the estate tax).

Extension of Time to File and Pay Estate Tax and GST Tax and To Make Qualified Disclaimers

Estate Tax Return

The federal estate tax return and the payment date of federal estate tax are extended to no earlier than nine months after TRA 2010's date of enactment of December 17, 2010. The extension applies to estates of decedents dying from January 1, 2010 to the day before the date of enactment.[3] Because the date that is 9 months after the date of enactment (September 17, 2011) falls on a Saturday, the due date for filing federal estate tax returns and paying federal estate tax for 2010 decedents is therefore no earlier than September 19, 2011.

Carryover Basis Report

Under current law, the carryover basis report is required to be filed with the decedent's final income tax return.[4] In contrast to the estate tax return, the due date for this report has not been extended by TRA 2010 for executors who make the carryover basis election.

Qualified Disclaimers

The time for making any disclaimer under IRC § 2518(b) for property passing by reason of the death of a decedent who dies after 2009 is extended to 9 months after the date of enactment (until September 17, 2011).[5] This creates additional planning flexibility well into 2011, provided that the beneficiaries have not already accepted the benefits of the property. In this regard, state law requirements for disclaimers often require that they be made within nine months after the transfer, so disclaimers during the extended time period may not comply with local law to be effective against the disclaimant's creditors. Fortunately, state law requirements will often be alleviated for federal tax purposes by IRC § 2518(c)(3), which provides that transfers that do not qualify as disclaimers under state law may still constitute a qualified disclaimer for federal tax purposes, provided that the disclaimer operates as a valid transfer under local law to the persons who would have received the property had it been a qualified disclaimer under local law.

GST Tax Returns

The due date for filing any return under IRC § 2662 to report a "generation-skipping transfer" made in 2010 before the date of enactment (December 17, 2010) is extended to no earlier than 9 months after the date of enactment. Because September 17, 2011 falls on a Saturday, the extended due date is therefore no earlier than September 19, 2011.

Portability

TRA 2010 ushers in a portability concept to combine the applicable exclusion amounts of both spouses to prevent their waste if a poorer spouse predeceases a richer spouse without fully utilizing his or her $5 million applicable exclusion amount.

Under TRA 2010, the executor of a deceased spouse's estate may transfer any unused estate tax exemption to the surviving spouse.[6] This is accomplished through the Act's amendment of IRC § 2010(c) to provide that the estate tax applicable exclusion amount shall equal (1) the "basic exclusion amount" ($5 million indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount."[7]

The "deceased spousal unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted tax gifts. The first item limits the unused exclusion to the amount of the basic exclusion amount -- therefore, if the estate tax exclusion amount has decreased by the time of the surviving spouse's death, the lower basic exclusion amount would provide the limit on the unused exclusion of the predeceased spouse that could be used by the surviving spouse. The second item is the last deceased spouse's remaining unused exclusion amount.

The following additional considerations apply to portability:

1. As an exception to the statute of limitations, the IRS may examine the return of a predeceased spouse at any time for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse.[8]

2. The executor of the first spouse's estate must file an estate tax return on a timely basis to elect to permit the surviving spouse to use the unused applicable exclusion amount.

3. Only the last deceased spouse's unused exclusion amount applies. So remarriage to a wealthier spouse who has made adjusted taxable gifts could cause a reduction in the amount that can be sheltered from estate tax due to portability.

4. Portability also applies for purposes of the gift tax exemption.[9]

5. Portability does <u>not</u> apply to the GST exemption.

6. Portability applies to estates of decedents dying, and gifts made after 2010, but like the rest of the estate and gift tax provisions of TRA 2010, expires after 2012.

Portability will ensure a step-up in basis of the subject assets at the surviving spouse's death and may appeal to clients as a reason to avoid having to plan their estates. Portability, however, does not dispense with the need to use credit shelter or bypass trusts in estate planning. The following considerations continue to support the use of credit shelter or bypass trusts, in lieu of relying on portability:

- There are substantial non-tax benefits from using trusts, including asset protection, asset management, and restricting transfers of assets by a surviving spouse;

- The deceased spousal unused exclusion amount is not indexed;

- The unused exclusion amount from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse;

- With portability, growth in assets is not excluded from the gross estate of the surviving spouse -- in contrast, growth in the assets of a credit shelter or bypass trust is excluded from the gross estate of the surviving spouse; and
- There is no portability of the GST exemption.

II. Gift Tax

TRA 2010 maintained the lifetime gift tax exemption at $1 million in 2010, but increased it (beginning in 2011) to be "unified" with the amount of the estate tax applicable exclusion amount (*i.e.,* $5 million), with such amount to be indexed from 2010 beginning in 2012. This means that married couples, with gift-splitting, can make transfers of up to $10 million per couple without having to pay any gift taxes.[10] It therefore paves the way for leveraging strategies that can transfer vast amounts of wealth outside of the gross estate. For example, a couple could gift $10 million to a grantor trust as a "10% seed capital gift" and thereafter sell $90 million of assets to such trust in a nontaxable transaction in exchange for a promissory note bearing interest at the applicable federal rate.[11] The couple would continue to pay all of the income taxes on the grantor trust, further depleting their estates and allowing the property in the trust to compound tax-free.[12]

III. GST Tax

TRA 2010 also brought about massive changes to the GST tax system, as summarized below.[13]

GST Tax Applicable Rate of Zero in 2010

As a result of TRA 2010, the GST tax system applies for all of 2010, but with a tax rate of *zero* on generation-skipping transfers occurring during 2010.[14] This applies to outright transfers, distributions or terminations in favor of individuals who are "skip persons,"[15] as well as to direct skips in further trust.[16] Because of the ability of non-skip persons to make qualified disclaimers during 2011 that relate back to 2010, the zero percent GST tax rate in 2010 still presents itself as an effective planning strategy throughout much of 2011.

GST Exemption of $5 million for 2010 and in Subsequent Years (With indexing beginning in 2012)

IRC § 2631(c) provides that the GST exemption amount equals the estate tax applicable exclusion amount under IRC § 2010(c) for such calendar year. Accordingly, the GST exemption amount under TRA 2010 is $5 million for 2010 and 2011, and this $5 million GST exemption will be indexed from 2010, beginning in 2012.[17] Absent subsequent legislation, after TRA 2010 sunsets following 2012, the GST exemption will be $1 million, indexed from 1997.

35% GST Rate for 2011 and 2012

The "applicable rate" for determining the GST tax is the maximum estate tax rate multiplied by the inclusion ratio of the trust.[18] Because the maximum estate tax rate under TRA 2010 is 35%, the GST tax rate under TRA 2010 is also 35% (except that the GST tax rate is zero for generation-skipping transfers in 2010).

GST Planning Issues and the Need to Elect Out of Automatic Allocation of GST Exemption for Direct Skips

TRA 2010 had an absolutely enormous impact on GST planning.

First, TRA 2010 removed many of the uncertainties concerning the GST tax for 2010 and confirmed that the GST tax relief provisions contained in EGTRRA (including increased GST exemptions, automatic allocation of GST exemption, qualified severances, IRC Section 9100 relief for late allocations, etc.) will apply in 2010 and afterwards. Although TRA 2010 itself sunsets after December 31, 2012, it provides an example of how the helpful GST provisions of EGTRRA could be extended after December 31, 2012 through subsequent legislation.

TRA 2010 also clarified that "direct skip" gifts for grandchildren to trusts that were made in 2010 will *not* result in having the GST tax apply when distributions are made from the trust to the grandchildren in later years. Moreover, under TRA 2010, the transferor "move down rule" of Chapter 13[19] applies to generation-skipping transfers in 2010, thereby resolving the potential uncertainties under EGTRRA with respect to direct skip gifts to trusts concerning the treatment of subsequent distributions.

Taxpayers will generally need to elect out of the automatic allocation of GST exemption for 2010 GST transfers on a timely-filed gift tax return to prevent GST exemption from being wasted on a transaction occurring during 2010 for which a 0% GST tax rate applies.[20] If, however, it is possible that further distributions may be made to *great-grandchildren or their descendants* from a trust to which a direct skip has been made in 2010, then -- notwithstanding the 0% GST tax rate in 2010 – circumstances could still render advisable the allocation of GST exemption to such trust. This is because the application of the move-down rule will place the transferor one generation above the grandchildren (i.e., the children's generation), and thereby expose subsequent distributions or terminations in favor of great-grandchildren or their descendants to GST tax. If, however, the possibility of that occurring is remote, then the client should be advised to elect out of the automatic allocation of GST exemption on 2010 GST transfers.

Late Allocation of 2010 GST Exemption to Transfers in Prior Years

Clients sometimes wish to allocate more GST exemption to prior trust transfers. Having an additional $1.5 million of GST exemption available to allocate (the difference between the $5 million GST exemption amount in 2010 and the $3.5 million GST exemption available in 2009) can enable the client to allocate substantial additional GST exemption to prior trust transfers at current trust values.

IV. Other Transfer Tax Aspects of TRA 2010

The following additional transfer tax aspects of TRA 2010 should be noted:

IRC § 2511(c) Has Been Deleted

IRC § 2511(c) -- which was added by EGTRRA – had provided that transfers to non-grantor trusts during 2010 are to be treated as gifts. TRA 2010 retroactively repealed that section of the Internal Revenue Code.[21]

TRA 2010 Sunsets after December 31, 2012

TRA 2010 is perhaps best regarded as a "two-year patch," as § 101(a) of TRA 2010 states that the sunset provisions contained in Section 901 of EGTRRA are applied by replacing "December 31, 2010" with "December 31, 2012." That means that unless Congress takes further action, then come January 1, 2013 the tax laws that existed prior to EGTRRA – including the $1 million estate, gift and GST tax exemptions, and the 55% top estate, gift and GST tax rates -- come roaring back into effect.

Effective Dates

Changes Applicable for 2010

Many, but not all, of the changes brought about by TRA 2010 are effective retroactively for all of 2010. These retroactive changes include the reenactment of the estate tax with a $5 million applicable exclusion amount and a 35% tax rate (subject, however, to the election to have carryover basis apply instead of the estate tax), technical computational details for calculating estate and gift taxes, increasing the GST exemption to $5 million for 2010, and clarifying that direct skip transfers in trust in 2010 will not result in the application of GST taxes when distributions are later made to the beneficiaries (at least to the oldest generation of direct skip beneficiaries when the trust is created).

Changes Applicable Beginning in 2011

Other changes are effective beginning in 2011. These include the reunification of the gift and estate tax applicable exclusion amounts at $5 million, and the portability of the unused estate tax applicable exclusion amount.

Changes Effective for Decedents Dying Before Date of Enactment

Certain changes under TRA 2010 apply only to estates of decedents dying in 2010 prior to, and generation-skipping transfers made in 2010 prior to, the date of enactment. Into this camp fall the provision allowing a delay in filing and paying tax until not earlier than 9 months after the *date of enactment*, and the extended period for making disclaimers with respect to transfers resulting from a person's death.

Items Not Addressed by TRA 2010

TRA 2010 did *not* address several provisions contained in various bills that have been introduced in Congress from time to time during the past few years. These include proposals that would require grantor retained annuity trusts ("GRATs") to have a 10-year minimum term, prevent the annuity amount from decreasing in any year, and require the remainder interest to have a value greater than zero determined at the time of the transfer to the trust. It is anybody's guess whether Congress will revisit GRATs later this year or next year.

Finally, it should be noted that a whole category of individuals is generally *unaffected* by TRA 2010. Specifically, TRA 2010 does not affect the general estate and gift tax rules applicable to nonresident decedents and donors who are not citizens of the United States. Such persons remain subject to lifetime applicable exclusion amounts of $60,000 for estate tax,[22] and zero for gift tax,[23] respectively.

Endnotes

1 TRA 2010 § 301(e). In addition, § 301(c) of TRA 2010 clarifies that for GST tax purposes the decedent is deemed to be subject to the estate tax and is therefore the "transferor" even though Chapter 11 does not apply to the decedent due to the carryover basis election.

2 TRA 2010 § 301(c).

3 TRA 2010 § 301(d).

4 IRC § 6075(a).

5 TRA 2010 § 301(d)(1)(C).

6 TRA 2010 § 303.

7 TRA 2010 § 303(a).

8 TRA 2010 § 303(a).

9 TRA 2010 § 303(b)(1).

10 Although highly unlikely as a practical matter, there is a school of thought that this could potentially pose a risk of recapture or "clawback" if the estate tax applicable exclusion amount is subsequently reduced below $5 million in the case of a decedent who has gifted away $5 million or more during his or her lifetime.

11 *See* IRC § 1274(d); Rev. Rul. 85-13.

12 *See* Rev. Rul. 2004-64.

13 GST tax is imposed on three types of transfers:

i. Direct Skips: These are transfers to a skip person that are subject to the estate tax or the gift tax. *See* IRC § 2612(c).

ii. Taxable Terminations: These occur upon the termination (whether by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust (which generally requires that such person be a current beneficiary (whether mandatory, or discretionary with the trustee) of the income or corpus of the trust) unless (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from a trust to a skip person. *See* IRC § 2612(a).

iii. Taxable Distributions: These are distributions from a trust to a skip person that are neither a direct skip nor a taxable termination. *See* IRC § 2612(b).

14 TRA 2010 § 302(c).

15 A "skip person" includes family members more than one generation, and unrelated persons more than 37½ years, younger than the transferor.

16 A trust will be a skip person (and therefore trigger the move-down rule) if a second generation or more remote beneficiary has the right to receive current distributions or is a permissible current recipient of distributions and if there are no interests held by non-skip persons. If that is the case, it does not matter that non-skip persons may be contingent remaindermen or future beneficiaries.

17 TRA 2010 § 302(a)(1).

18 IRC § 2641(a).

19 The move-down rule of IRC § 2653 applies if there is a generation-skipping transfer of property (*i.e.*, a direct skip, taxable distribution or taxable termination) and the property is held in trust. The effect is that for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to one generation above the highest generation of any person who has an "interest" in the trust immediately after the transfer. Thus, if a grandchild has an interest in the trust, the transferor level will be moved down to the child level so that subsequent distributions to grandchildren would not generate a GST tax, but a distribution to someone two or more generations below the transferor would generate a GST tax.

An "interest in a trust is defined in IRC § 2652(c). A person holds an interest if, at the time, the determination is made, the person (1) has the right (other than a future right) to receive income or corpus from that trust, or (2) is a permissible current recipient of income of corpus. (Certain rules apply if the trust is a charitable trust.) *See* IRC § 2652(c)(1). However, an interest that is used primarily to postpone or avoid any GST tax is disregarded. *See* IRC § 2652(c)(2). Also, the fact that a distribution may satisfy another person's support obligation is disregarded if such use is discretionary or is pursuant to an UGMA or UTMA transfer. *See* IRC § 2652(c)(3).

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20 IRC § 2632(b)(3); Treas. Reg. § 26.2632-1(b)(1).

21 TRA 2010 § 302(e).

22 *See* I.R.C. § 2102(c)(1).

23 *See* I.R.C. § 2505(a).

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