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A View from the Audience at Heckerling

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The recently concluded 45th Annual Heckerling Institute on Estate Planning had a vibe unlike any other. The overarching dynamic, of course, was the massive changes to the estate, gift and generation-skipping transfer tax landscape brought about by The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010"), which President Obama signed into law on December 17, 2010. The techniques in the estate planner's toolbox all of a sudden require reexamination with the increased gift, estate tax and generation-skipping transfer (GST) tax exemptions unified at $5 million with a 35% maximum tax rate beginning in 2011, and the introduction of portability of lifetime exemption amounts between spouses for estate and gift tax (but not GST tax) purposes. And for those who may have thought that 2010 had already been confined to the history books, TRA 2010 retroactively restored the estate and GST tax systems as of January 1, 2010 (although subject to an "opt out" for 2010 decedents for purposes of the estate tax), and established a maximum tax rate of 35%, with the notable exception that GSTs occurring during 2010 are instead subject to a *zero percent* tax rate. But alas, permanence is not to be found in the new law, as it is scheduled to sunset after December 31, 2012.

So what were the principal themes that dominated the 2011 Heckerling conference?

Two-Year Patches May Become the New Norm

A number of speakers expressed the view that we may be looking at a series of legislative patches going forward, perhaps every two years. TRA 2010 expires after 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. None of the speakers expected that to occur (other than perhaps temporarily subject to retroactive adjustment). The majority view was that $5 million exemptions (with indexing) and 35% tax rates may be with us for awhile.

Is Estate Tax Repeal Still on the Horizon?

A few speakers – including Louis A. Mezzullo – expressed the view that we may not have seen the last of federal estate and GST tax repeal. Rather, with a $5 million exemption, a 35% top rate, and portability of the exemption between spouses, the estate tax now provides a dwindling amount of revenues. Combine that with the strength

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and persistence and of the lobby for repeal of the "death tax" of which Professor Michael V. Graetz spoke as the initial speaker for the Lloyd Leva Plaine Distinguished Lecture,– depending upon what happens in the 2012 elections – it should not be a shock if estate tax repeal again occurs in 2013. Accordingly, because we do not know what the future holds, planners should emphasize flexibility in their estate planning documents to adapt to various circumstances. The best way to accomplish such flexibility is to contemplate the use of disclaimers and to authorize an independent trustee to change the default terms of the instrument to adjust to potential changed circumstances.

The $5 Million Gift Tax Exemption Creates a Great Opportunity for Gifting and Leveraged Transfers

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. The speakers unanimously concurred that this paves the way for leveraging strategies that can transfer vast amounts of wealth outside of the gross estate. In addition to outright gifts, the most favored approach was the use of grantor trusts. The primary example employed posited a married couple that would transfer $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.[1] 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.[2]

Is There a Recapture or "Clawback" Risk if the Estate Tax Exemption is Later Reduced Below $5 Million for a Client Who Has Gifted $5 Million

There was considerable debate whether a material risk exists that clients who gift away $5 million during their lifetimes may later become subject to estate tax on such gifts if the estate tax applicable exclusion amount is later reduced below $5 million. As a number of speakers pointed out, the instructions to the Form 706 (the United States Estate and Generation-Skipping Transfer Tax Return) suggest this result. The majority view of the speakers, however, was that it would be unlikely that the Internal Revenue Service would punish taxpayers who gifted away $5 million during their lifetimes in reliance on current law exemptions that ceased to exist at their death.

Rescission is Likely Unavailable in Most Jurisdictions to Undo Gifts during 2010 in Excess of the $1 Million Gift Tax Exemption Amount for 2010

A number of speakers – including the excellent Recent Developments Panel of Dennis I. Belcher, Samuel A. Donaldson and Beth Shapiro Kaufman -- addressed the issue of how one can undo a gift made in 2010 in excess of their $1 million gift tax exemption that produced gift taxes that would not have been incurred had the client waited until 2011 to make such gift due to the increase in the lifetime gift tax exemption amount to $5 million in 2011. The consensus was that, while this is ultimately a matter of state law, the ability to invoke rescission to undo the gift will generally be unavailable in many jurisdictions. This is because the client and the client's advisor were not

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proceeding under any mistake of fact or law concerning the 2010 gift tax exemption amount. Rather, the client and the advisor simply guessed wrong about the law to be in effect *in 2011*. The better route to undo such a transfer would instead be through qualified disclaimers (provided that the gift had not yet been accepted by the donor within the guidelines set forth in the Section 2518 regulations), or through what was sometimes described by the speakers as "self-help."

Could Portability Spur on the 21st Century Marriage of Convenience?

Considerable attention was devoted to TRA 2010's portability provisions, which 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.[3] As Professor Sam Donaldson humorously noted, it would not be so far-fetched if some marriages were to occur solely to take advantage of a poorer spouse's $5 million applicable exclusion amount.

Credit Shelter Trusts versus Portability

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. As the speakers emphasized, however, portability does not dispense with the need to use credit shelter trusts in estate planning. The following considerations support the use of credit shelter 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 for portability purposes 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 trust is excluded from the gross estate of the surviving spouse; and
- There is no portability of the GST exemption.

How to Obtain a Step-Up in Basis for Property in the Credit Shelter Trust

The speakers emphasized that estate planners who advise clients to fully fund their credit shelter trusts will need to consider techniques to achieve a step-up in basis of the assets held in the credit shelter trust. The following techniques were discussed at the conference:

- Include a broad distribution standard in favor of the surviving spouse in the credit shelter trust – such as in the best interests of the surviving spouse – so that additional property can be distributed out to the surviving spouse that can qualify for the step-up in basis upon such spouse's death.
- Consider giving an independent trustee the ability to confer a testamentary general power of appointment upon the surviving spouse to produce estate tax inclusion equal to the unused exemption amount. That, however,

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could expose the independent trustee to fiduciary liability for his or her actions or inactions, so broad exoneration provisions should be included in the governing instrument.

- Consider including a formula provision in the Will or trust conferring a testamentary general power of appointment upon the surviving spouse in an amount equal to the unused exemption amount. This eliminates the complexities that attend giving an independent trustee distribution authority. The trade-off, however, is that it creates a real risk that assets will be diverted to persons that the first spouse to die did not want to benefit (such as another spouse or the children thereof).

- If applicable state law permits the rule against perpetuities *not* to be anchored by reference to the date of creation of an instrument that confers a limited power of appointment, consider exercising such limited power of appointment to trigger estate tax inclusion (and therefore a step-up in basis) through an appointment in further trust that comports with the "Delaware tax trap" provisions of IRC § 2041(a)(3).

The Need to Elect Out of Automatic Allocation of GST Exemption for Direct Skips

Finally, the speakers' most pervasive admonition was that 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 zero percent GST tax rate applies.[4] 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 zero percent 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 of IRC § 2653 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 to 2010 GST transfers.

Endnotes

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

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

3 TRA 2010 § 303.

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

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