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Death and Taxes:

What might Benjamin Franklin say about them today

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Benjamin Franklin said, "in this world nothing can be said to be certain, except death and taxes." With the federal estate tax repealed for 2010 and no new estate tax legislation or other "patch" currently in place, estate planners and taxpayers have found themselves navigating a brave new world in which Benjamin Franklin's notion of certainty has been eradicated—at least when it comes to estate taxes. But, alas, Benjamin Franklin's world may be only temporarily upturned. Indeed, if Congress fails to enact any estate tax legislation before the end of the year, we will have the federal estate tax—and the generation-skipping transfer tax—laws that existed in 2001 return on Jan. 1, 2011.

Today's Topsy-Turvy World Where Death and Taxes No Longer Coincide (At least for Now)

Simply put, the unthinkable has occurred—we are currently living in a one-year bubble in which there is no federal estate tax and no generation-skipping transfer (GST) tax. To round out the transfer tax picture, there is still a gift tax, although the top gift tax rate during 2010 for lifetime transfers in excess of $1 million has been reduced to 35 percent (from 45 percent in 2009). In addition, the step-up in basis regime upon death has been replaced with an effectively unworkable carryover basis system.

Practically nobody in the estate planning community thought that Congress would fail to enact some provisional estate and GST tax, if only as a one-year patch. To briefly revisit how this came about, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) substantially changed the landscape of estate and gift taxes. EGTRRA, among other things, provided for the complete repeal of the federal estate tax and the GST tax on Jan. 1. Under the sunset provisions of EGTRRA, this repeal is to last only one year, and will be reversed on Jan. 1, 2011, such that the estate and GST taxes will be resurrected on that date, based on the tax system that existed in 2001 when EGTRRA was enacted.

Until the end of 2009, most CPAs and estate tax attorneys expected Congress to step in and prevent the estate tax and the GST tax repeal. But that didn't happen. The Obama administration proposed extending the estate tax at its 2009 level, with a $3.5 million exemption and a 45 percent rate on assets that exceed that amount. The House approved the administration's proposal last year, but Republican opponents blocked action in the Senate. More recently, Senators Jon Kyl (R-Ariz, Republican Whip) and Blanche Lambert

Lincoln (D-Ark.) reintroduced legislation that would exempt up to $5 million from estate taxes and impose a 35 percent tax rate on assets that exceed that amount. But the likelihood that such proposals—or any other proposals for that matter—will get enacted before the end of this year continues to diminish as the calendar inches closer to 2011.

The federal estate tax and the GST tax are no longer in effect in 2010, but the gift tax is still in effect during 2010. A 35 percent tax rate applies to gifts during 2010, with donors continuing to have a $1 million lifetime exemption, the $13,000-per-donee annual exclusions, and the Section 2503(e) unlimited exemption for the direct payment of tuition and medical expenses. Accordingly, donors who are inclined to make gifts in excess of those thresholds should consider doing so in 2010 as a 35 percent gift tax rate applies, instead of the 45 rate that applied in 2009.

In addition, those donors who are inclined to consider such leveraged gifting techniques as grantor retained annuity trusts (GRATs)[1] should engage in such planning sooner rather than later. Indeed, there are several legislative proposals that, as a practical matter, would effectively extend the minimum survivorship term for a grantor to successfully utilize a GRAT from two years to ten years.[2]

The Accompanying Enigma of Carryover Basis

As a trade-off for estate tax repeal, Congress deemed it necessary to have a "basis backstop" to the income tax for persons dying during 2010, so that a built-in capital gains tax liability would apply to highly appreciated assets that are inherited. Congress codified this in the carryover basis provisions of Section 1022 of the Internal Revenue Code, which sprang into effect for decedents dying in 2010.

Under the carryover basis provisions, for decedents dying after Dec. 31, 2009 (and prior to Jan. 1, 2011), the basis of property acquired from the decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. Significantly, while no step-up in basis is allowed, the basis of property could be *stepped-down*.

There are two exceptions from the carryover basis provisions. First, the executor can allocate up to $1.3 million (increased by certain unused losses and loss carryovers) to increase the basis of assets. Second, the executor can allocate up to $3 million to increase the basis of assets passing to a surviving spouse, either outright or in a qualified terminable interest property (QTIP) trust. This is an increase of $1.3 million and $3 million, *not* assets having a value of $1.3 million and $3 million, so the allocation process may get complicated. In any event, the basis of an asset cannot be increased in excess of its fair market value.

Carryover basis can be a complete nightmare both for taxpayer compliance and for IRS administration. It may be extremely difficult for an executor to determine the basis of the decedent's assets to report this to the IRS (as well as to the decedent's beneficiaries). In addition, the increases to basis are allocated by the executor. This could give rise to fiduciary liability upon an executor for allocating basis increases to assets distributed to one beneficiary as opposed to another.

But perhaps the strangest part of carryover basis is that it lends itself to the argument that it is nothing more than a "bad dream" for executors who do not dispose of the 2010 decedent's property during the "witching year" of 2010. The EGTRRA's sunset provision expressly states that "[a]ll 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) … to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010."[3]

Reinforcing the "Alice in Wonderland" nature of the statutory latticework, the EGTRRA's sunset provisions further specify that "[t]he Internal Revenue Code of 1986 … shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) *as if the provisions and amendments described in subsection (a) had never been enacted*."[4]

In light of the EGTRRA's sunset provisions and, in particular, its "as if it had never been enacted" language, it is possible to construe the carryover basis provisions as if intended by Congress solely to apply to inherited property that is actually disposed of during 2010. Accordingly, in the case of 2010 decedents with assets having aggregate built-in appreciation in excess of $1.3 million, inherited property generally should not be sold or otherwise distributed until 2011 (if that is feasible) to provide an argument to avoid the application of carryover basis.

A Cloudy Crystal Ball – What Could Happen?

There are three distinct possibilities for what could happen in the coming months:

1. Congress may fail to act, in which case federal estate tax and the old pre-EGTRRA provisions reappear in 2011.

2. Congress may enact new laws mid-year and make them effective prospectively (as of the date of enactment, or as of Jan. 1, 2011).

3. Congress may exact new laws and try (subject to possible constitutional arguments) to make them retroactive to an earlier date (e.g., retroactive to Jan. 1, 2010).

   The retroactive possibility may be most troubling to practitioners and beneficiaries. While many are put off by the notion of billionaires' estates escaping taxation, more disconcerting is the idea that the estate tax laws may change months after a person's death. Likewise, one making a gift expecting a 35 percent gift tax rate would likely be upset to find the rate subsequently increased. Fear of retroactive changes, however unlikely, may postpone many taxpayers from making estate plan updates or current year gifts.

With each passing day—and, particularly, with a congressional election looming in November—it becomes more and more likely that the first of these scenarios will come to pass, namely, that Congress will fail to act before year's end, in which case, the old pre-EGTRRA provisions will reappear in 2011. Simply put, in a world in which courage and political alliances often do not go hand in hand, that is the easiest practical option for Congress to pursue–after all, how many members of Congress wish to go on record for supporting substantial tax increases?

Should this prediction prove accurate, the estate tax would return on Jan. 1, 2011, imposing a 55 percent top rate on taxable estates in excess of $1 million. Ironically, it would therefore have the effect of subjecting middle-class taxpayers to the federal estate tax, while billionaires with the taxwise timing of having died during 2010 will have escaped the federal estate tax altogether.

So maybe, at the end of the day, it will turn out that after a one-year hiatus, at least when it comes to the estate tax, Benjamin Franklin's famous maxim will once again ring true.

Endnotes

1 The basic GRAT is essentially simple: the grantor transfers property into an irrevocable trust (the GRAT) for a specified number of years, retaining the right to receive an annuity (a fixed amount payable not less frequently than annually). Upon termination of the GRAT, the trust assets are paid to the remaindermen named by the grantor, typically his or her children, or to a trust of which the grantor's spouse and issue are beneficiaries. In essence, the grantor creates a GRAT to transfer its <u>remainder</u> at termination. This transfer is a taxable gift that is deemed to occur upon creation of the GRAT. The remainder is valued for tax purposes by subtracting the interest retained by the grantor—the annuity—from the value of the initial transfer into the GRAT. The Internal Revenue Service ("IRS") requires that the value of the retained annuity be calculated on an actuarial basis using an assumed interest rate published by the IRS that is in effect for the month that the GRAT is funded.

The tax benefit of the GRAT therefore arises if the investments held in the GRAT <u>outperform</u> the assumed interest rate used in the gift tax calculations. In this event there is a tax free transfer to the extent of that extra performance from grantor to remaindermen because the <u>actual</u> value of the remainder at termination will be greater than the value that was calculated for gift tax purposes.

2 On June 15, 2010, the House of Representatives passed HR 5486, the "Small Business Jobs Relief Act of 2010". The bill contains the identical provisions regarding GRATs that were contained in an earlier bill (HR 4849, the "Small Business and Infrastructure Jobs Tax Act of 2010"), which the House passed on March 24, 2010. The House reiterated these provisions again on July 1st in an amendment to HR 4899, and these provisions have also been introduced in the Senate in S 3533 and S 3548. Those provisions contain the following:

- A requirement that a GRAT have a minimum 10 year term;
- A requirement that the annuity payment not be reduced from one year to the next during the first 10 years of the GRAT term; and
- A requirement that the remainder interest at the time of the transfer have "a value no greater than zero."

As in the prior House bill, this bill contains no guidance regarding the parameters of the "greater than zero" requirement.

The proposed provisions regarding GRATs generally would only apply to transfers made ***after*** the law becomes effective. The one variation to this is S 3548, which provides that these GRAT provisions would apply to transfers made after December 31, 2010.

3 EGTRRA § 901(a).

4 EGTRRA § 901(b) (emphasis added).

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