

ESTATE PLANNING UNDER THE 2001 TAX ACT

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The Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Tax Act”) makes the most profound legislative changes to the estate tax system (including a one year repeal of the estate and generation-skipping transfer tax with carryover basis) since the adoption of the federal estate tax. Part One of this outline summarizes the major estate planning provisions of the 2001 Tax Act. Part Two analyzes planning implications of the 2001 Tax Act for the estate planner.

PART ONE—OVERVIEW OF ESTATE PLANNING PROVISIONS OF THE 2001 TAX ACT

I. THE JOURNEY THROUGH THE 107TH CONGRESS.

- A. The House Journey. The “Death Tax Elimination Act of 2001” (H.R. 8) passed the House in a landslide vote of 274-154 on April 4, 2001. It would have replaced the unified credit with an exemption (which has the effect of favoring large estates because an exemption reduces estate taxes at the top applicable rate bracket whereas a credit removes taxes at the lowest rate bracket.) The top marginal estate, gift and generations-skipping transfer (GST) rates would have been reduced from 55% to 39% over a 10 year period (by 2010) and would have repealed the estate, gift and GST taxes in 2011. A carryover basis system (similar to the system in the 2001 Tax Act) would have been instituted in 2011.
- B. The Senate Journey. The “Restoring Earnings to Lift Individuals and Empower Families Act of 2001” (the “RELIEF Act”—isn’t that cute) (H.R. 1836) passed the Senate in a vote of 62-38 on May 23, 2001. It retained the concept of a unified credit rather than an exemption, but raised the credit (for estate and GST purposes) in stages to the equivalent of a \$4 million exemption equivalent by 2010. It also reduced the top marginal estate and GST rates to 45% by 2007, and would have repealed the estate and GST taxes in 2011. The gift tax exemption equivalent would have increased to \$1.0 million in 2002 and stayed at that level. The top marginal gift tax rate would have become 40% in 2011 and remained in effect even after repeal of the estate and GST taxes. It would also have instituted a carryover basis system (similar to the 2001 Tax Act) in 2011.
- C. Sunset Provision in Senate Bill. Under the Senate bill (and eventually the 2001 Tax Act), all of provisions of the 2001 Tax Act sunset effective January 1, 2011. As to the estate, gift and GST provisions, “[t]he Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts and [generation-skipping] transfers ... as if the provisions and amendments [of the Act] had never been enacted.” 2001 Tax Act § 901(b). Following sunset, all rates in effect in 2001, including the 5% surtax, will apply. The applicable exclusion amount will be \$1 million (as scheduled beginning in 2006 under the pre-2001 Tax Act law) for both estate and gift taxes. The GST exemption will be \$1 million indexed for inflation since 1997. The carryover basis provisions would expire and there would be a step-up in basis at death.

The purpose of including the sunset provision was to avoid a 60% Senate vote requirement in the Senate. The 2001 Tax Act was part of a “budget reconciliation” authorized by the Congressional Budget Act of 1974, which provides that a budget reconciliation process may occur only once a year, and that legislation under a budget reconciliation procedure is not subject to filibuster in the Senate (which may only be broken by a vote of 60 Senators.) The Congressional Budget Act of 1974 was amended in 1990 to provide what is now called the Byrd Rule (named after the amendment’s author, Senator Byrd of West Virginia). The Byrd Rule makes out of order inclusion of any items that are “extraneous” to budget resolution. This would include increases in deficits beyond the fiscal years covered by the reconciliation and decreases in revenue beyond the scope

of the budget resolution. Because the budget reconciliation covers up to ten years, it is “extraneous,” and out of order, to reduce taxes beyond the ten-year budget window. The Byrd rule can be waived only by a majority vote of 60 Senators. See generally Aucutt, Still Debating the Prospects for Estate Tax Repeal, 28 EST. PLAN. 383 (August 2001). Senate leaders believed that the Act would not be supported by 60 Senators. Based on the history of Senators voting on estate tax repeal in the prior legislative session, it appeared that 60 Senators would not vote for total estate tax repeal. (The 2000 tax legislation was not part of a budget reconciliation, so was not subject to the Byrd rule, but it was subject to filibuster in the Senate. No filibuster occurred in the last legislative session, because it was apparent that President Clinton would veto the legislation, which he in fact did.) Eventually 62 Senators voted for the 2001 Tax Act—with the sunset provision included.

The “bottom line” is that all of the provisions in the 2001 Tax Act sunset on January 1, 2011. Steve Leimberg aptly summarizes this result by observing that the military would simply say “AS YOU WERE.” The sunset assures that there will be future tax legislation in the upcoming years that will, among other things, address the estate tax provisions.

- D. Conference Report. The conference report on the “Economic Growth and Tax Relief Reconciliation Act of 2001” was generally patterned after the Senate version. It was approved by Congress on May 26, 2001 (by a House vote of 240-154 and a Senate vote of 58-33). It became Public Law 107-16 after being signed by President Bush on June 7, 2001.
- E. Summary of the Political Process. The tortuous path of the tax legislation, and the haggling by the respective parties over the legislation, with results that no one would have ever predicted (a one year repeal) bring to mind Barney Jones’ description of the process. He observes that the political activity that we see in crafting tax legislation is effectively explained by the “Latin” derivation of the word “politics.” The word “poli” means “many” and the word “tics” means “blood sucking parasites.”

II. EXECUTIVE SUMMARY OF ESTATE PLANNING CHANGES.

- A. Major Categories of Changes. The 2001 Tax Act makes five major categories of estate, gift and GST tax changes.
 - 1. Repeal. The most drastic change is a repeal of the estate and GST taxes beginning in 2010 (but for only one year under the sunset provision).
 - 2. Phase In of Reduced Estate and GST Rates and Increased Estate and GST Credits. The 5% surtax is eliminated in 2002, and the top estate and GST rates are slowly decreased (1% per year) to 45%. The unified credit as adjusted for estate and GST purposes to raise the applicable exclusion amount in stages to \$3.5 million by 2009. To offset the federal revenue losses of these changes, the state death credit is phased out over four years and replaced by a deduction rather than a credit.
 - 3. Lower and Modify Gift Tax. The gift tax applicable exclusion amount jumps to \$1.0 million in 2002, and remains constant. The top marginal gift tax rates will decrease to 45% by 2007 (in line with the estate and GST tax rate reductions) and will become 35% in 2010. Reasons quoted for keeping the gift tax system intact are (1) to provide a backstop against income tax abuse through transfers to relatives with lower income tax brackets, and (2) to provide a barrier to wholesale transfers in 2010 before the re-emergence of the estate and GST tax system in 2011 under the sunset provision.
 - 4. Carryover Basis. Stepped-up basis at death will be eliminated, and carryover basis will apply with two major adjustments, a \$1.3 million basis adjustment and a \$3.0 million separate basis adjustment allowed for transfers to surviving spouses or the QTIP trusts.

5. Other General Amendments. Miscellaneous other amendments are made, which will be applicable until the sunset provision reverses all of the amendments in 2011. (However, most of the other general amendments are non-controversial and are likely to remain long-term.)

B. Future Legislative Changes. The existence of the sunset provision virtually assures that there will be future legislative changes to the estate, gift and GST tax area. This creates an environment of substantial uncertainty. The ultimate outcome will depend on future economic, budgetary and political changes. (Up to five future Congresses (2002-03, 2004-05, 2006-07, 2008-09, and 2010-11) and two future presidents could be involved in the ultimate decision before the sunset in 2011.)

III. RATE REDUCTIONS.

A. Immediate Reduction in 2002. Two changes are made beginning in 2002. First, the 5% surtax for estate and gift transfers exceeding \$10 million is repealed. Second, the top marginal rate bracket is decreased from 55% to 50%. 2001 Tax Act § 511 (a)-(b). These changes apply to decedents dying after and gifts made after December 31, 2001. 2001 Tax Act § 511 (f)(1).

B. Phased In Rate Reductions. The top marginal estate, gift and GST tax rates decrease by 1% per year beginning in 2003 until the rates get to 45% in 2007. The top marginal rates are: 2002-50%, 2003-49%, 2004-48%, 2005-47%, 2006-46%, and 2007-2009-45%. 2001 Tax Act § 511(c). (Observe, the rates decline very slowly.)

C. Gift Tax Rate Reductions. The gift tax top marginal rate drops to 35% beginning in 2010. 2001 Tax Act § 511(d). (Section 511(d) of the 2001 Tax Act is entitled "Maximum Gift Tax Rate Reduced to Maximum Individual Rate After 2009," but the body of the statutory provision just refers to a 35% top bracket.) The 35% rate applies to gifts over \$500,000, effectively meaning that there is a flat 35% tax once the aggregate gifts exceed the gift tax applicable exclusion amount of \$1.0 million.

IV. UNIFIED CREDIT/APPLICABLE EXCLUSION AMOUNT INCREASES.

A. Credit Is Not Changed to an Exemption. The 2001 Tax Act does not follow the House version of changing the unified credit to an exemption. (That change effectively would have lowered the overall taxes for taxpayer in higher rate brackets. An exemption effectively reduces the estate subject to the top rate bracket while a credit effectively reduces taxes at the lowest rate brackets and does not impact the amount of the estate taxed at the highest rate brackets.)

B. Immediate Increase in 2002. The unified credit is increased in 2002 so that the applicable exclusion amount is \$1.0 million. (The phase in of the applicable exclusion amount under prior law would not have reached \$1.0 million until 2006.) This increase applies for gift and estate tax purposes, for gifts made after and decedents dying after December 31, 2001. (The GST exemption for 2002 and 2003 remains at \$1.0 million, indexed for inflation since 1997. This amount is \$1,060,000 in 2001, and will likely increase again in 2002.)

C. Estate Tax Applicable Exclusion Amount. The estate tax applicable exclusion amount increases in stages to \$3.5 million in 2009. This phase-in occurs slowly, with much of the increase coming in the last year. The applicable exclusion amount is \$1.0 million for two years (2002-2003), \$1.5 million for two years (2004-2005), \$2.0 million for three years (2006-2008), and makes the big jump to \$3.5 million in 2009. I.R.C. § 2010(c).

D. Gift Tax Applicable Exclusion Amount. The gift tax applicable exclusion amount jumps to \$1.0 million for gifts made beginning in 2002, but it remains constant at that amount. I.R.C. § 2505(a)(1). The gift tax applicable exclusion amount is not even indexed for inflation.

V. GST EXEMPTION INCREASES.

- A. 2002 and 2003. The GST exemption will be \$1.0 million, indexed for inflation since 1997, in 2002 and 2003. The GST exemption is \$1,060,000 in 2001, Rev. Proc. 2001-13, 2001-03 I.R.B. 337, and will likely increase again in 2002. (Section 521(e)(3) makes clear that the changes to the GST exemption apply only to decedents dying and GST transfers made after December 31, 2003.)
- B. 2004 and Afterward. After 2003, the GST exemption is the same as the estate tax applicable exclusion amount. I.R.C. 2631(c).
- C. Sunset in 2011. If the law reverts to its pre-2001 Tax Act state in 2011, presumably the GST exemption will drop back to \$1.0 million, indexed for inflation from 1997.

VI. CREDIT FOR STATE DEATH TAXES.

- A. Background of State Death Tax Credit. The state death tax credit was enacted as a compromise of a dispute between the federal government and the states as to which governmental entity should have the authority to tax transfers at death. An estate is allowed a credit for state death taxes, including estate, inheritance, legacy, or succession taxes, actually paid by the estate or any heir with respect to property included in the federal gross estate. The maximum credit is the lesser of the net tax paid to a state or a statutory ceiling under a table in section 2011 of the Code. The maximum state death tax credit would be \$1,082,800 plus 16% of the adjusted taxable estate (i.e., the taxable estate less \$60,000) above \$10,040,000. For smaller estates, much of the overall tax is paid to states rather than to the federal government, because the state credit is allowed before any dollars are paid to the federal government. Even for larger estates, about 29% (i.e., 16%/55%) of the overall death tax is paid to states rather than to the federal government. Most states use the maximum federal state death credit to constitute the state's estate tax.
- B. Phase Out of Credit From 2002-2004. The state death tax credit is reduced to 75% of its current ceiling level in 2002, 50% in 2003, and 25% in 2004.
- C. Change From Credit to Deduction Beginning in 2005. In 2005, the credit is repealed and replaced with a deduction of death taxes (i.e., estate, inheritance, legacy, or succession taxes) paid to any state or to the District of Columbia. There is no statutory ceiling on the amount of deduction that will be allowed. However, there are strict time period during which the state taxes must be paid to receive the federal deduction. The state taxes must have been paid and claimed before the later of: (1) four years after filing the federal estate tax return, (2) 60 days after a decision of the Tax Court regarding the estate tax becomes final if a petition is filed with the Tax Court, (3) the expiration of the period of extension under section 6166 if a section 6166 payout of estate taxes is allowed, (4) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision by any court in an refund suit becomes final.
- D. Effect Is to Shift Much of Burden of Estate Tax Changes Away From Federal Government. Most states have death taxes equal to the amount of the federal state death tax credit. (This is sometimes referred to as a "pick-up tax.") As the federal credit is reduced and eventually eliminated, the state death taxes will decrease accordingly. The overall effect is that the total federal revenues does not decrease significantly over the next seven years—but at the cost of substantial decreases in state death tax revenues. For example, Ron Aucutt describes an example of a decedent with a \$10 million estate who lives in a state with only a pick-up tax. Until the year 2009, federal revenues do not decrease by more than 7% from the level of federal estate taxes in 2001. Aucutt, Still Debating the Prospects for Estate Tax Repeal, 28 EST. PLAN. 383 (August 2001). Of course, the state death taxes will decrease by 25% per year until they are eliminated in 2005 (unless the state passes a new state death tax.)

Some states have state death taxes that exceed the federal credit. Some other states have state death taxes that are based on the amount of the federal credit in effect in an earlier year. E.g., N.Y. TAX LAW § 951(a) (NY estate tax based on federal state death tax credit in effect on July 22, 1998); CODE OF VA. § 47-3701(4) (defines “federal credit” as no less than the credit in effect on January 1, 1986). Other states, no doubt, will enact similar laws. For example, Rhode Island amended its estate tax law in June of 2001 to refer to the federal state death credit in effect as of January 1, 2001. R.I. GEN. LAWS § 44-22-1.1(2). In these states (and in other states that enact state death taxes beyond the pick-up tax) the overall reduction in federal and state death taxes will be comparatively small over the next seven years. See Aucutt, Still Debating the Prospects for Estate Tax Repeal, 28 EST. PLAN. 383 (August 2001) (as an example, for a \$10 million taxable estate, the combined federal and state death taxes will not be reduced by more than 19% until 2009).

The revenue losses to states will be staggering, in an economy when state budgets are already in a precarious condition. Many states will likely revise their state estate tax laws, enact estate tax systems independent of the federal state death tax credit, and staff up their enforcement divisions. Once that occurs, dismantling the new state systems through future amendments of the federal estate tax laws (and the federal state death tax credit) will be increasingly difficult. State estate taxes will become more and more important as time goes on.

VII. GIFT TAXES.

- A. Rate Reduction. The top gift tax rate will decrease to 50% in 2002 and by 1% per year thereafter until it is 47% in 2007. The gift tax top marginal rate drops to 35% beginning in 2010. 2001 Tax Act § 511(d). (Section 511(d) of the 2001 Tax Act is entitled “Maximum Gift Tax Rate Reduced to Maximum Individual Rate After 2009,” but the body of the statutory provision just refers to a 35% top bracket.) The 35% rate applies to gifts over \$500,000, effectively meaning that there is a flat 35% tax once the aggregate gifts exceed the gift tax applicable exclusion amount of \$1.0 million.
- B. Applicable Exclusion Amount Increase. The gift tax applicable exclusion amount will increase to \$1.0 million in 2002. It will stay constant at that level thereafter. I.R.C. § 2505(a)(1). The gift tax applicable exclusion amount is not indexed for inflation.
- C. Retention of Gift Tax System. Reasons quoted for keeping the gift tax system intact are (1) to provide a backstop against income tax abuse through transfers to relatives with lower income tax brackets, and (2) to provide a barrier to wholesale transfers in 2010 before the re-emergence of the estate and GST tax system in 2011 under the sunset provision.
- D. Transfers to Trusts Beginning in 2010 Are Gifts Except for Transfers to Grantor Trusts.
 1. General Rule. Section 2511(c) treats transfers in trust after December 31, 2009 as taxable gifts unless the trust is treated as wholly owned by the donor or the donor’s spouse under sections 671-679 of the Code. The purpose of this change is to prevent transfers to shift income tax without being subject to the gift tax by having the transfer made to a non-grantor trust with the donor retaining sufficient control (such as the power to shift the asset among donees) to make the gift incomplete for gift tax purposes.
 2. Cannot Just Use Testamentary Power of Appointment to Make Gift Incomplete, Because May Not be a Wholly Grantor Trust. Query, how can a transfer be made to a trust, with a retained power in the grantor to avoid having a complete gift, without making the trust a grantor trust as to the grantor in its entirety? One way is to create an irrevocable trust for beneficiaries other than the grantor, but have the grantor retain a testamentary power of appointment to change the trust terms. Section 674(b)(3) provides an exception from the grantor trust rules for testamentary powers of appointment. However, that exception does not apply to the extent

that the power can be exercised over income that is accumulated without the consent of an adverse party. Even in that situation, however, the grantor is treated as the owner of only the income of the trust. Therefore, the trust would not be treated as wholly owned by the grantor under the grantor trust rules, so Section 2511(c) would treat the transfer to the trust as a completed gift.

3. Availability of Annual Exclusions for Trust Transfers. Literally, this statute might seem to remove gift tax exclusions available under section 2053 (such as the annual exclusion) for gifts to trusts. Apparently, this was not intended, and a technical correction, explanatory legislative history, or regulations will likely clarify this result. This possible uncertainty makes even more important drafting a Crummey trust to give a donor the right to direct that any particular gift is not subject to withdrawal rights. In the unlikely event that the legislation eventually is interpreted to disallow annual exclusions, a donor could direct that gifts in 2010 and afterward would not be subject to withdrawal rights, to avoid the risk that a beneficiary would exercise the withdrawal right if the withdrawal right does not allow an annual exclusion. (This flexibility for Crummey trusts is helpful in any event.)
4. Effect if Grantor Trust Later Becomes Non-Grantor Trust. There is no discussion in the statute or the legislative history of the gift tax effect if a grantor trust, which received a transfer after 12-31-2009, subsequently becomes a non-grantor trust during the grantor's lifetime. Presumably, a completed gift would result at that time, based on the value of the transferred asset (or trust assets attributable to the transferred asset) at that later time. If the particular asset transferred after 2009 is not still in the trust, making this determination could be cumbersome.

VIII. CARRYOVER BASIS.

- A. General Rule—No Stepped Up Basis. Under current law, assets received from a decedent generally receive a basis equal to the fair market value of the property at the date of death of the decedent. I.R.C. § 1014. The general purpose of the stepped-basis rule is to avoid double taxation, subjecting the same property to both estate taxation and income taxation when the asset is sold after the decedent's death. The stepped-up basis rule avoids the capital gains tax on the sale, up to the gain in the asset at the date of death. With the repeal of the estate tax, there is no need for the stepped-up basis to avoid the double taxation. (As a more practical matter, coupling carryover basis with the repeal of the estate tax is necessary for fiscal reasons, to offset some of the revenue loss due to the estate tax repeal.) For decedents dying after December 31, 2009, section 1014 will not apply, and the stepped-up basis under section 1014 is no longer allowed. I.R.C. § 1014(f). For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2). **(Observe, that while no step-UP in basis is allowed, the basis of property can be stepped-DOWN.)** The Conference Report refers to this as the "modified carryover basis regime."
- B. "Property Acquired from the Decedent". The carryover basis regime, applies to "property acquired from the decedent." In addition, the permitted basis adjustments described below apply to "property acquired from a decedent" that was "owned by the decedent" at the time of death. Also, the information return required under new § 6018 applies to "property acquired from a decedent." "Property acquired from the decedent" includes the following: (1) Property acquired by bequest, devise or inheritance; (2) property acquired by the decedent's estate from the decedent; (3) property transferred by the decedent during his lifetime to a qualified revocable trust defined in section 645(b)(1); (4) property transferred during lifetime to another trust over which the decedent reserved the right to alter, amend, or terminate the trust in a way that would change the enjoyment of the trust; and (5) any other property passing from the decedent by reason of death to the extent that it passes without consideration (for example, property held as joint tenants with right of survivorship or as tenants by the entirety). I.R.C. § 1022(e).

- C. \$1.3 Million Basis Adjustment. Under the existing estate tax and stepped-up basis rules, a certain amount of property can pass without either estate tax or capital gains tax on pre-death appreciation. To keep this same concept, the 2001 Tax Act provides two amounts of property that can still receive a stepped-up basis. The first is a \$1.3 million basis adjustment. I.R.C. § 1022(b). (This is a basis increase of \$1.3 million, not a stepped-up basis on assets having a date of death value of \$1.3 million.)
1. Increased by Unused Losses and Loss Carryovers. The \$1.3 million amount is increased by any capital loss carryover under section 1212(b), the amount of any net operating loss carryover under section 172 which would (but for the decedent's death) be carried over from the decedent's last taxable year to a later year, plus the total amount of losses that would have been allowable under section 165 if the property had been sold at fair market value immediately before the decedent's death. I.R.C. § 1022(b)(2)(C). Thus, while there can be a step DOWN in basis at death, the aggregate amount by which some estate assets receive a decrease in basis is added to the \$1.3 million amount to result in additional increased basis for other assets that are appreciated at the time of death (assuming the estate has appreciation in appreciated estate assets exceeding the \$1.3 million [and \$3.0 million, if applicable] basis adjustments that would be allowed in any event.
 2. Non-Resident Aliens. Decedents who are non-residents and non-citizens of the United States only get a \$60,000, rather than a \$1.3 million basis increase. Furthermore, they do not receive the benefit of increasing the basis adjustment by built-in losses and loss carryovers. I.R.C. § 1022(b)(3).
 3. Anomaly for Many Decedents Dying in 2006-2009 vs. 2010. The disparity between the estate exemption (\$2.0 million in 2006-08, and \$3.5 million in 2009) and the \$1.3 million basis adjustment after 2009 creates the anomaly that some people will actually be better off (for tax purposes, at least) dying in 2006-2009 rather than in 2010 after the estate tax is repealed and carryover basis is instituted. If the client has an estate that is covered by the exemption (up to \$2.0 million in 2006-08 and \$3.5 million in 2009), there will be no estate tax, but the basis adjustment would be only \$1.3 million, which might not provide a full basis step-up if the estate has a great deal of appreciation.
- D. \$3.0 Million Basis Adjustment For Property Passing to a Surviving Spouse. The basis of property transferred to a surviving spouse ("qualified spousal property") can be increased by an additional \$3.0 million. (Thus, the basis of property transferred to surviving spouses can be increased by a total of \$4.3 million (plus the amount of built-in losses and loss carryovers).) "Qualified spousal property" includes property passing outright to a spouse or passing as qualified terminable interest property
1. Outright Transfer Property. Property passing outright to the surviving spouse includes any property acquired from the decedent by his or her surviving spouse, unless on the lapse of time or the occurrence of an event of contingency, the interest passing to the spouse will fail and (1) the property will pass to another person for less than an adequate and full consideration in money or money's worth, or (2) the property "is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust." For purposes of the second exception, an interest is not considered to terminate or fail merely because it is the ownership of a bond, note or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term. I.R.C. § 1022(c)(4)(B). In addition, an interest that is conditioned on survival for 6 months after the decedent's death will not be excluded from the definition of outright transfer property if the spouse does not in fact die within such 6 month period. I.R.C. § 1022(c)(4)(C). Observe that

such a survivorship requirement should not be used for decedents dying after 12-31-2009, because if the surviving spouse in fact dies within such six month period, the \$3.0 million basis adjustment available for property passing to a surviving spouse would not be available.

2. Qualified Terminable Interest Property. This is defined to mean property that passes from the decedent and the spouse is entitled to all the income for life payable annually or at more frequent intervals. In addition, no person can have a power to appoint any part of the property to anyone other than the surviving spouse during the spouse's lifetime. I.R.C. § 1022(c)(5). In addition, regulations may provide for an annuity to be treated in a manner similar to an income interest in property. Id.

Generally speaking, this is property that would qualify for a QTIP election under current law. One possible difference from the QTIP trust rules is that income must be "payable annually or at more frequent intervals" under section 1022. There is identical language in section 2056(b)(5) (for life estate with general power of appointment marital trusts) and 2056(b)(7) (for QTIP trusts). Rulings and regulations under section 2056 recognizing trusts that merely allow the spouse the right to withdraw income even if the income is not required to be distributed annually. Rev. Rul. 2000-2, 2000-1 C.B. 305; Treas. Reg. § 20.2056(b)-5(f)(8). It is not yet known whether regulations or rulings under section 1022 will be as expansive as the rulings under section 2056 (even though the statutory requirement is identical), and to be conservative, trusts intended to qualify for the \$3.0 million spousal basis adjustment should mandate that income be paid at least annually until regulations or rulings make clear that a "right to withdraw" approach is sufficient. There would be no necessity of having anyone make a QTIP election (indeed, no estate tax return would be filed if the estate tax is repealed.)

Observe that property in a marital deduction "estate trust" would not qualify for the \$3.0 million basis adjustment because the income would not be payable at least annually.

3. Coordination with \$1.3 Million Basis Adjustment. The \$3.0 million basis adjustment can ONLY be made with respect to property passing outright to a surviving spouse or to a QTIP trust. The \$1.3 million basis adjustment is available for property that passes either to a surviving spouse or to others. Thus, the executor could elect for property passing to the spouse to receive a full \$4.3 million increase in basis, or could choose to increase the basis of property passing to the surviving spouse by \$3.0 million and to increase the basis of property passing to others by \$1.3 million.

E. Requirements Common to Both Basis Adjustments.

1. Allocated on Asset-By-Asset Basis. The Conference Report makes clear that the basis increase is allocable on an asset-by-asset basis. For example, the basis increase can be allocated to a share of stock or a block of stock.
2. No Asset Can Have Basis Adjusted Above Fair Market Value. In no case can the basis of an individual asset be adjusted above its fair market value. I.R.C. § 1022(d)(2).
3. Allocation Made By Executor. The executor is to allocate the two basis adjustments to specific assets on "the return required by section 6018." I.R.C. § 1022(d)(3)(A). (Section 6018 describes the information return required for transfers at death of non-cash assets over \$1.3 million and for appreciated properties received by a decedent within three years of death that do not qualify for the basis adjustments under section 1022(d)(C). See Part One, Section IX.B. of this outline.)

What if there is a revocable trust? Section 1022(d)(3)(A) says the "executor" shall allocate the basis adjustments on the return required by section 6018. Section 6018 (a) says the "executor" shall file the information return, and section 6018(b)(4), entitled "*Returns by*

trustees or beneficiaries,” provides that if the executor cannot make a complete information return for any property, the executor is to file a description of such property and the name of every person holding a legal or beneficial interest in the property. Section 6018 does not discuss revocable trusts. However, the Senate and Conference Report to section 6018 says that the information report is to be filed by “the executor of the estate (or the trustee of a revocable trust).” Presumably, regulations will eventually detail the procedures for the trustee of a revocable trust to file the information report, and to make the basis adjustments on the return due under section 6018. The regulations also, hopefully, will make clear how the allocation responsibility will be divided between an executor under a pour-over will and the trustee of a revocable trust. For example, what if there is a will that pours over to a revocable trust, and an executor is appointed under the will? Would that executor be entitled to make all basis allocation decisions even if there are very few assets in the probate estate and very large assets in the revocable trust?

4. Allocation Can Be Changed Only With IRS Consent. Once the executor makes the basis adjustment allocation, it can be changed only as provided in regulations. I.R.C. § 1022(d)(3)(B).
5. Inflation Adjustment. The \$1.3 and \$3.0 million amounts (and the \$60,000 amount for a non-resident alien) are indexed for inflation occurring after December 31, 2009. I.R.C. § 1022(d)(4). The adjustments will be made in increments of \$100,000 for the \$1.3 million amount, \$250,000 for the \$3.0 million amount, and \$5,000 for the \$60,000 amount. I.R.C. § 1022(d)(4)(B).
6. Property Acquired From a Decedent. The carryover basis regime only applies to “property acquired from a decedent.” Only such property may have its basis adjustment under either of the two adjustments. See Part One, Section VIII.B. of this outline.
7. Ownership. Property must be “owned by the decedent at the time of death.” I.R.C. 1022(d)(A). Ownership is defined more narrowly than “property acquired from a decedent.” A very important example of this distinction is that property in a QTIP trust at the surviving spouse’s death is not treated as being “owned” by the surviving spouse, and therefore cannot qualify for the \$1.3 million basis adjustment at the surviving spouse’s subsequent death (unless the trustee distributed the property to the surviving spouse outright prior to his or her death.) Similarly, assets that had been transferred by a spouse (the donor-spouse) during his or her lifetime to a QTIP trust for the other spouse would not qualify for the \$3.0 million spousal basis adjustment at the donor-spouse’s death. The following ownership rules apply.
 - a. Joint Tenancy With Surviving Spouse. Property held as joint tenants or tenants by the entirety with the surviving spouse is deemed to be owned one-half by the decedent (and therefore, one-half is eligible for the basis increase.) I.R.C. § 1022(d)(1)(B)(i)(I).
 - b. Joint Tenancy With Others Than Spouse. Property held as joint tenants with right of survivorship with anyone other than the surviving spouse is deemed to be owned by the decedent to the extent the property is attributable to consideration furnished by the decedent. I.R.C. § 1022(d)(1)(B)(i)(II).
 - c. Joint Tenants Acquired Interests by Gift, Devise or Inheritance. If multiple joint tenants acquired their interests by gift, devise or inheritance, and if their interests are not otherwise specified or fixed by law, the decedent joint tenant will be treated as the owner to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants. I.R.C. § 1022(d)(1)(B)(i)(III).

- d. Qualified Revocable Trust. Property transferred by the decedent during his lifetime to a qualified revocable trust (under section 645(b)(1)) is considered to be owned by the decedent (and thus eligible for the basis increase). I.R.C. § 1022(d)(1)(B)(ii).
 - e. Powers of Appointment. The decedent shall NOT be treated as owning any property solely be reason of holding a power of appointment with respect to such property. I.R.C. § 1022(d)(1)(B)(iii). (Accordingly, property in a general power of appointment marital trust appears not to qualify for the \$1.3 million basis adjustment at the surviving spouse's subsequent death, unless the spouse exercises the power of appointment to leave the assets to his or her estate.)
 - f. Community Property. The decedent is treated as owning the surviving spouse's one-half share of community property 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. I.R.C. § 1022(d)(1)(B)(iv). Accordingly, the decedent's one-half interest in the community property and the surviving spouse's interest in the community property are both eligible for the \$1.3 and \$3.0 million basis adjustments.
8. Ineligible Property. The following types of property are not eligible for the basis adjustments.
- a. Gifts to Decedent Within Three Years Other Than Spousal Gifts. Property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the three year period ending on the decedent's death generally does not qualify for the basis adjustments. I.R.C. § 1022(d)(C)(i). However, property gifted to the decedent within three years of death by the decedent's spouse do qualify for the basis adjustments, unless the spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration. I.R.C. § 1022(d)(C)(ii). Query what happens if the property is acquired within the proscribed three year period for partial consideration. Is the entire property ineligible for the basis adjustment, or only a portion of the property attributable to the gift element of the transfer?
- This section clearly allows pre-mortem interspousal transfers to transfer low basis assets to a dying spouse in order to be able to fully utilize the spouse's \$1.3 and \$3.0 million basis adjustments. Observe, that a one year restriction applies in similar situations under current law to achieve a step-up in basis. Section 1014(e) provides that if a decedent had acquired appreciated property within one of his death and such property passes from the decedent to the donor of such property (or the spouse of such donor), no step-up in basis is allowed for such property at the decedent's death. All of § 1014 (including §1014(e)) no longer applies to decedents dying after 12-31-2009.
- This provision is not as important in community property states as in common law states, because both halves of community property qualify for the basis adjustments, without the necessity of transferring assets to the dying spouse.
- b. Income In Respect of a Decedent. Property that constitutes a right to receive income in respect of a decedent under section 691 does not qualify for a basis adjustment. I.R.C. § 1022(f).
 - c. Stock of Certain Entities. Stock in the following entities does not qualify for the basis adjustments: (1) foreign personal company; (2) domestic international sales corporation (of a former DISC); (3) foreign investment company; and (4) passive foreign investment company unless the decedent shareholder had made a qualified electing fund election. I.R.C. § 1022(d)(D).

IX. REPORTING REQUIREMENTS. The 2001 Tax Act requires certain new returns to be filed to provide information for administration of the new basis rules.

- A. Lifetime Gifts. Within 30 days of filing a gift tax return, each recipient of a gift must receive a copy of the information included in the return with respect to the gift. I.R.C. § 6019(b). This section presumably applies to gifts made after December 31, 2009. The effective date provision in the legislation is not totally clear, because the effective date for the section of the Act in which this change is included is for “estates of decedents dying after December 31, 2009.” 2001 Tax Act § 542(f)(1). Presumably, this will be interpreted to apply to gifts after 2009.
- B. Transfers at Death. For decedents dying after December 31, 2009, two types of transfers at death of “property acquired from the decedent” (with the same meaning as is afforded to that term under § 1022(e)) must be reported on returns to the IRS under new section 6018. The two types of property that must be reported are: (1) transfers at death of non-cash assets in excess of \$1.3 million; and (2) appreciated property received by a decedent within three years of death that does not qualify for the basis adjustments by reason of § 1022(d)(1)(C) and which was required to be reported on a gift tax return. The return is to be filed by the executor. I.R.C. § 6018 (a). If the executor is unable to make a complete return with all the information described below, the executor is still required to file a return under § 6018 giving a description of the property and the name of every person holding an interest in the property. The IRS may contact those persons in turn to file an information return. I.R.C. § 6018(b)(4).

The information required to be furnished to the IRS with the return under § 6018 is as follows:

- (1) the name and TIN of the recipient of the property,
- (2) an accurate description of the property,
- (3) the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
- (4) the decedent’s holding period in the property,
- (5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
- (6) the amount of basis increase allocated to the property under the \$1.3 million and \$3.0 million basis adjustments, and
- (7) any other information that regulations may prescribe. I.R.C. § 6018(c)

The return to the IRS is required to be filed with the decedent’s final income tax return or such later date specified in regulations. I.R.C. § 6075(a). Observe that this could be a short period of time for decedents who die late in the calendar year (unless the decedent’s final income tax return is extended.)

In addition to the return required to be filed with the IRS, the person required to file that return must also furnish to each recipient of property described in the return a written statement giving similar information with respect to the property passing from the decedent to such person. I.R.C. 6018(e).

There is no statute of limitations operating against the IRS with respect to values reported on the § 6018 report. The IRS could question those values years later when beneficiaries sell the assets. (This is probably the same as under current law. Values listed on an estate tax return, even after the period for assessment of additional estate taxes has run, probably are not binding on the IRS for income tax purposes [i.e., determining the amount of the basis step-up].)

- C. Penalties for Failure to File Required Information.

1. Failure to Report to Beneficiaries or Donees. Any person required to report to beneficiaries or donees under § 6018(e) or § 6019 shall pay a penalty of \$50 for each failure to report such required information. I.R.C. § 6716(b).
2. Failure to Report to IRS. Any person required to report to the IRS under § 6018 (for transfers of non-cash assets over \$1.3 million or for certain transfers within three years of death) who fails to do so in a timely filed return shall pay a penalty of \$10,000 for each such failure (except that the penalty is limited to \$500 in the case of a failure to furnish information required under § 6018(b)(2)—which requires reporting certain gifts within three years of death.) I.R.C. § 6716(a).
3. Reasonable Cause Exception. No penalty is imposed with respect to any failure that is due to reasonable cause. I.R.C. § 6716(c).
4. Intentional Disregard. If any failure to report to the IRS or a beneficiary is due to intentional disregard of the rules, the penalty is 5 percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a life time gift.) I.R.C. § 6716(d).

X. SPECIAL GAIN PROVISIONS.

Many of the special gain provisions are included to coordinate with the modified carryover basis rules that would apply for decedents dying after December 31, 2009.

- A. Transfer of Property Subject to a Liability. Gain is not recognized at the time of death when the estate or any beneficiary (other than a tax-exempt beneficiary) acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, no gain is recognized by the estate on the distribution of such property to a beneficiary of the estate (other than to a tax-exempt beneficiary) by reason of the liability. I.R.C. § 1022(g). The term "tax-exempt beneficiary" is defined to include specified governmental entities, an organization exempt from income tax, and foreign person or entity, and to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance. I.R.C. § 1022(g)(2).

If a beneficiary is bequeathed property with liabilities in excess of the basis of the property, the beneficiary may realize substantial gain on the disposition of the property. For example, if a beneficiary receives property with a gross value of \$120,000, basis of \$10,000, and subject to a \$110,000 liability, the bequest would have a net value of \$120k minus \$110k or \$10,000. However, a sale of the property would generate a taxable gain of \$120k minus \$10k, or \$110,000, which would generate a capital gains tax (at 20%) of \$22,000. The income tax liability would exceed the net value of the bequest. See Berall & Harrison, Should We Anticipate 2010 and the Arrival of Carryover Basis? Is There Planning That Can Be/Should Be/Must Be Done Now? What About a "Head-In-The-Sand" Prayer That It Never Becomes a Reality (Or "I'll Be Retired By Then"), ANNUAL NOTRE DAME TAX & ESTATE PL. INST. at 23-10 (2001). The beneficiary would want to disclaim the bequest. Indeed, there would be a rush by all beneficiaries to disclaim the bequest. Pity the second (or third or fourth) cousin who fails to get notice of the problem (or cannot be located) and fails to disclaim the property. The statute prevents the family from being able to avoid the income tax liability by having the property escheat to the state or affirmatively leaving the property to a government or other tax-exempt entity. (Indeed, the purpose of this provision is to prevent taxpayers from borrowing against their property, leaving the cash to beneficiaries [obviously with a full basis], and leaving the encumbered property to charity. Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act—More Than You Can Count, 95 J. TAX'N 74, 81 (Aug. 2001).)

To be fair to the unsuspecting beneficiary who would get stuck with the tax liability, the estate should sell or allow the foreclosure of the property so that the inherent income tax liability would be borne by the estate generally. (In fact, query whether the executor-beneficiary of the estate who disclaims and does not dispose of the property at the estate level, but “sticks” the income tax liability on other remote family members, would have liability for the deceitful action.)

- B. Exclusion for Gain on the Sale of a Principal Residence. The income tax exclusion of up to \$250,000 on the sale of a principal residence is extended to estates and beneficiaries and trusts which, immediately before the decedent’s death, met the definition of a qualified revocable trust as defined in § 645(b)(1). I.R.C. § 121(d)(9). The Conference Report indicates that if the decedent’s estate or an heir sells the decedent’s principal residence, \$250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent’s period of ownership and occupancy of the property as a principal residence can be added to the heir’s subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence.

There does appear to be any time limit on when the estate or beneficiary can avail itself of the decedent’s \$250,000 exclusion under section 121.

Observe that a testamentary trust does not qualify for the exclusion under section 121. Therefore, if all of the estate passes to testamentary trusts, the estate should sell the residence and then distribute the sale proceeds to the testamentary trust.

- C. Transfer of Property in Satisfaction of a Pecuniary Bequest. Distributions of property in kind from trusts or estates that are in satisfaction of pecuniary bequests or pecuniary amounts are treated as taxable sales or exchanges, and gains or losses may result. See Reg. § 1.661(a)-2(f)(1); Kenan v. Comm’r, 114 F.2d 217 (2nd Cir. 1940); Rev. Rul. 60-87, 1960-1C.B. 286 (funding pecuniary marital deduction bequest); Rev. Rul 74-178, 1974-1 C.B. 196 (distribution in satisfaction of a debt). This could produce enormous gain under a carryover basis regime. Fortunately, the 2001 Tax Act provides that gain is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent’s death (not the property’s carryover basis). I.R.C. § 1040(a). A similar rule will apply to certain trusts (to be described in future regulations.) I.R.C. § 1040(b). (Before such regulations are issued, a section 645 election should be made for “qualified revocable trusts,” to treat them as an estate, if they will make in-kind distributions to satisfy pecuniary bequests.)

Losses generally cannot be recognized for transactions between various categories of related parties, including transactions between an estate and a beneficiary of the estate. However, The Taxpayer Relief Act of 1997 made clear that the loss disallowance rules for estates does not extend to a sale or exchange that is in satisfaction of a pecuniary bequest. I.R.C. § 267(b)(13). How will losses on funding pecuniary bequests be treated under the 2001 Tax Act? The Act itself does not address losses. However, the Senate Report, which was accepted in the Conference Agreement, states that gain “or loss” is recognized only to the extent that the fair market value at the time of transfer exceeds the fair market value at the date of death.

The basis of property acquired in a transaction of funding pecuniary bequests with in-kind assets is the basis of the property immediately before the exchange increased by the amount of the gain recognized to the estate or trust on the exchange. I.R.C. § 1040(c).

- D. Transfers to Foreign Trusts, Estates and Nonresident Aliens. The present law rule, providing that transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange, is expanded. The new law adds that transfers by a U.S. person to a nonresident who is not a U.S.

citizen is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor. I.R.C. § 684(a). Exceptions from the gain recognition rule include transfers to grantor trusts, and lifetime transfers to non-resident aliens. I.R.C. § 684(b).

- E. Private Foundations Rules Extended to Certain Nonexempt Split-Interest Trusts. Under section 4947(a)(2), non-exempt split-interest trusts are subject to certain of the private foundation excise taxes (excess business holdings, jeopardy investments and taxable expenditures) if contributions to the trust were deductible for income, estate or gift tax purposes under sections 170, 2055, or 2522. The 2001 Tax Act adds that non-exempt split-interest trusts are also subject to those excise taxes if distributions from the trust are deductible under section 642(c) of the Code. I.R.C. § 4947(a)(2)(A). For example, a “non-qualified” charitable lead trust would (providing that all trust income is distributed annually to charitable beneficiaries) would be covered by this rule.

What does extending the private foundation restrictions have to do with estate tax repeal and carryover basis? This special rule is reflective of Congressional staffers’ attempts to respond to the comments of various experts about the effects of estate tax repeal and potential planning “loopholes.” For example, John Wallace, in the 2001 Joseph Trachman Memorial Lecture at the American College of Trust and Estate Counsel meeting, relayed a technique being suggested by some creative planners. If there were no estate tax and no need for an estate tax deduction for “qualified” charitable gifts, astute planners might suggest that charitable bequests be made to non-exempt trusts, for which no tax deduction is permitted for contributions to the entity. Such entities are not subject to some of the restrictive private foundation restrictions (5% minimum payout rule, and restrictions on self-dealing, excess business holdings, inappropriate political activities, and expenditures), but avoid paying any income taxes (under section 642(c)) so long as the trustee makes charitable distributions pursuant to the agreement equal to the trust’s annual income. Wallace, A View Through a Glass Darkly: The Impact of Transfer Tax Repeal on Trusts and Estates Lawyers, 27 ACTEC J. 6, 19 (2001).

- F. Effective Date. The changes described in this Section X are all in connection with the adoption of the carryover basis system and apply to decedents dying after or transfers after December 31, 2009.

XI. ESTATE TAX PROVISIONS EXTEND BEYOND DATE OF ESTATE TAX REPEAL.

- A. QDOTS. If the first spouse died before January 1, 2010, the QDOT tax (which applies generally when distributions are made from the QDOT to the spouse or at the surviving spouse’s subsequent death) will apply to distributions to the surviving spouse before his or her death if the distributions are made on or before December 31, 2020. I.R.C. § 2210(b)(1). Thus for distributions to the surviving spouse, the QDOT tax on distributions continues to apply for eleven years after the estate tax is repealed. (This seems to be an unduly harsh penalty on noncitizen surviving spouses that does not apply to citizen spouses.) The QDOT tax that applies at the surviving spouse’s subsequent death does not apply if the surviving spouse dies after December 31, 2009. I.R.C. § 2210(b)(2).
- B. Recapture Provisions. The 2001 Tax Act does not specifically mention whether various recapture rules will apply for estates of decedents who die before the estate tax is repealed. However, the Senate Report addresses this issue directly:

“Prior to repeal of the estate tax, may estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax or other estate tax. Because repeal of the estate tax is effective for decedents dying after December 31, 2010 [which was the

effective date of the repeal provision in the Senate bill], these estate tax recapture provisions generally will continue to apply to estates of decedents dying before January 2, 2011.”

The various recapture and other provisions that would continue to apply are summarized below.

1. Special Use Valuation. The recapture tax imposed under § 2032A(c) continues to apply for estates of decedents who die before December 31, 2009. The recapture tax applies if certain disqualifying events occur within 10 years of the decedent’s death.
2. QFOBI Deduction. The QFOBI recapture provisions, which apply, for example if an heir ceases to use the property in a qualified manner within 10 years of the decedent’s death, would continue to apply for estates of decedents who die before December 31, 2009.
3. Section 6166 Installments. Estates of decedents who die before December 31, 2009 that qualify for extended payments of estate tax under section 6166 would continue to make payments after 12-31-09. The acceleration rules would continue to apply (for example if more than 50% of the value of the business is distributed, sold or otherwise disposed of).
4. Qualified Conservation Easements. A donor may retain a development right in the conveyance of a conservation easement. However, the advantage of an estate tax deduction for the easement is disallowed if there is not an agreement to extinguish the development rights within two years after the decedent’s death, or the date of the sale of the land subject to the easement. This liability for additional tax is continued after 12-31-09 for the estates of decedents who die on or before that date.

XII. ESTATE TAX INSTALLMENT PAYMENTS.

- A. Permissible Number of Shareholders or Partners Expanded to Meet “Closely-Held” Test. Section 6166(b)(9)(B)(iii)(I) is revised to expand from 15 to 45 the number of shareholders or partners that are permitted in order for the business to meet the “closely-held” test. The alternative 20% test (i.e., 20% or more capital interest in a partnership or 20% or more voting stock in a corporation) was not changed. The provision applies to decedents dying after 12-31-01.
- B. Qualified Lending and Financing Business. Interests in a qualifying lending and financing business (as defined in section 6166(b)(1)(B)) is treated as stock in an active trade or business and qualifies for the installment payment provisions. For this business interest, the installment payments must be made over 5 years. §6166(b)(10)(A)(ii-iii). The Conference Report says that no inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under present law. The provision applies to decedents dying after 12-31-01.
- C. Holding Companies; Stock of Operating Subsidiaries Do Not Have to be Non-Readily Tradable. The installment payment provisions are expanded to include holding companies where the holding company stock is not readily tradable, but the stock of operating subsidiaries is readily tradable. For this type of holding company stock, the estate tax must be paid over 5 years. §6166(b)(8)(ii). (The holding company rules have previously provided that the 5 year deferral of principal provision does not apply. For this special type of holding company, the entire tax must be paid over the first 5 years.) The provision applies to decedents dying after 12-31-01.

XIII. SPECIAL USE VALUATION RECAPTURE TAX REFUND.

Prior to the Revenue Act of 1997, several cases had held that a cash rental by a qualified heir other than a surviving spouse was not a qualified use. The Taxpayer Relief Act of 1997 amended the recapture provision, effective for decedents dying after December 31, 1976, to provide that a surviving spouse or a lineal descendant of the decedent is not treated as failing to use qualified real property in

a qualified use solely because the spouse or descendant rents the property to a member of the family of the spouse or descendant on a net cash basis. I.R.C. § 2032A(c)(7)(E). That change was made effective for cash leases entered into after 1976 (the effective date of the original special use valuation provisions.) However, the 1997 Act made no provision for lineal descendants who had already paid a recapture tax under the prior law. For many of those persons, the refund claim period had already run before the adoption of the 1997 Act. The IRS ruled in various Technical Advice Memoranda that the 1997 Act revision did not constitute a waiver of the period of limitations to seek a refund claim as to such recapture tax. The 2001 Tax Act provides that a claim for refund may be made with respect to such recapture tax within one year after the date of enactment (i.e., by June 7, 2002). 2001 Tax Act § 581.

XIV. QUALIFIED CONSERVATION EASEMENT.

- A. Background. An executor can elect to exclude from the taxable estate 40% of any land subject to a qualified conservation easement, up to a maximum exclusion of \$400,000 in 2001 and \$500,000 thereafter. The 40% amount is reduced by 2 percentage points for each percentage point by which the value of the qualified conservation easement is less than 30 percent of the value of the land. Such percentage amount, as so reduced, is the “applicable percentage” that may be excluded from the taxable estate.
- B. Eliminate Distance Requirement. The 2001 Tax Act expands the availability of the qualified conservation easement exclusion by eliminating the requirement that the land be located within 25 miles of a metropolitan area, national park or wilderness area or within 10 miles of an Urban National Forest. The land may be located anywhere in the United States or its possessions. I.R.C. § 2031(c)(8)(A)(i).
- C. Clarification of Valuation Date. For purposes of determining the “applicable percentage,” values to be used are the values as of the date of the contribution. I.R.C. § 2031(c)(2).
- D. Effective Date. The qualified conservation easement amendments are effective for decedents dying after December 31, 2000. 2001 Tax Act §551(c).

XV. GENERATION-SKIPPING TRANSFER TAX REVISIONS.

- A. GST Exemption Increases. The GST exemption will remain at \$1.0 million, indexed for inflation since 1997 for 2002 and 2003. Thereafter, the GST exemption will be the same as the estate tax applicable exclusion amount. See Part One, Section V of this outline.
- B. Repeal. In 2010, the GST tax does not apply. There is commonplace discussion of the estate and GST taxes being “repealed” in 2010. However, Section 2664 (added by the 2001 Tax Act) says that Chapter 13 (the GST tax) “shall not apply to generation-skipping transfers after December 31, 2009.” Accordingly, all of Chapter 13 remains in the Code, but just does not apply to transfers after December 31, 2009.
- C. Sunset. The sunset provision in Section 901(a) of the 2001 Tax Act includes provisions of and amendments to the Act affecting generation-skipping transfers after December 31, 2010. Section 901(b) provides 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.” Thus, after December 31, 2010, the Internal Revenue Code of 1986 “springs back” and is to be applied as if the provisions and amendments made by the 2001 Act had never been amended. Presumably the GST exemption will be the 2003 amount of the GST exemption, indexed for inflation from 1997 to 2011.

The literal language of the sunset provision raises a host of unanswered questions. For example, what if GST exemption is automatically allocated to a trust under the new automatic allocation

rules in the 2001 Tax Act? If the 1986 Code is applied after 2010 as if the provisions and amendments in the 2001 Tax Act “had never been enacted”, then will the trust be treated as if none of the automatic GST exemption allocations had been made (because they clearly would not have been made if the 2001 Tax Act “had never been enacted”)? That is a ludicrous question, not to be taken as a serious uncertainty. However, the literal language of the sunset provision does raise these kinds of issues.

The new Act is unclear as to decedents who die in 2010 creating GST trusts under their wills. The transfer in 2010 will not be subject to estate tax, so no transferor can be determined under the GST tax rules. Therefore, even though the GST tax “springs back” in 2011, “without a transferor, generation assignments cannot be determined and thus it appears that the GST tax would not apply.” Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 120-21 (2001).

D. Additional Automatic Allocations Under 2001 Tax Act.

1. Rationale for Change. Taxpayers may inadvertently omit making GST exemption allocations on a timely-filed gift tax return for trusts from which generation-skipping transfers are likely to occur. The Act provides for an automatic allocation in situations where a GST is likely to occur, unless the taxpayer elects out of automatic allocation. The Act attempts to identify those types of trusts for which it is more likely than not that the taxpayer would want to make a GST exemption allocation, and apply a presumption in those situations that the GST exemption is allocated (rather than under current law where the presumption is that no GST exemption is allocated).
2. Automatic Allocation to Indirect Skips to “GST Trusts”. Any unused portion of an individual’s GST exemption is deemed allocated to an “indirect skip.” I.R.C. § 2632(c)(1). An “indirect skip” is defined as a transfer (other than a direct skip) after December 31, 2000 that is subject to the tax imposed by chapter 12 (the gift tax) that is made to a “GST trust”. The deemed allocation also applies to estate inclusion periods (ETIPs) that end after December 31, 2000 for trusts that are “GST trusts”. (For the December 31, 2000 effective date, see Section 561(c) of the 2001 Tax Act.) GST exemption is automatically allocated to such a transfer to the extent necessary to produce the lowest possible inclusion ratio for such property. The automatic allocation for ETIPs is deemed to be made at the close of the ETIP, based on the fair market value of the trust property at that time. I.R.C. § 2632(c)(4).
3. Definition of “GST Trusts” to Which the Deemed Automatic Allocation Applies. A “GST trust” is defined as a trust that could have a GST with respect to the transferor except the following.
 - f. Pass to Non-Skip Person Before Age 46. The trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (i) before the individual reaches age 46, (ii) on or before one or more dates specified in the trust instrument that will occur before the individual reaches age 46, or (iii) upon the occurrence of an event that (in accordance with Treasury regulations) may reasonably be expected to occur before the individual reaches age 46. I.R.C. §2632(c)(3)(B)(i).
 - f. Pass to Non-Skip Persons on Death of Another Individual Who is More Than Ten Years Older Than Such Non-Skip Persons. The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals. I.R.C. §2632(c)(3)(B)(ii). *Example: Trust is created primarily to provide for client’s parents (age 70). Trust assets will pass to client’s child (age 40) upon the death of the client’s parents.*

- f. Pass to Estate of or General Power of Appointment to Non-Skip Person Who Dies Before Age 46 or the Death of Other Identified Persons Who Are More Than Ten Years Older. The trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (a) or (b), more than 25 percent of the trust corpus must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals. I.R.C. §2632(c)(3)(B)(iii).
 - f. Includible in Gross Estate of Non-Skip Person if He or She Died Immediately After the Transfer. The trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer. I.R.C. §2632(c)(3)(B)(iv). *Example: Trust terminates and passes to child at age 50 (so the trust does not meet the exception in clause (a).) However, if the child dies before age 50, the child has a general power of appointment. The trust meets this exception, and is not a “GST trust.”*
 - f. CLAT, CRAT or CRUT. The trust is a charitable lead annuity trust, charitable remainder annuity trust, or a charitable remainder unitrust. I.R.C. §2632(c)(3)(B)(v).
 - f. CLUT With Non-Skip Person as Beneficiary. The trust is a charitable lead unitrust with a non-skip person as the non-charitable beneficiary upon the termination of the charitable lead interest. I.R.C. §2632(c)(3)(B)(vi).
 - g. General Rules In Applying These Exceptions. In applying these tests, the value of transferred property is not considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right of withdrawal within the gift tax annual exclusion amount described in Section 2503(b). *(Example: Trust is a Crummey trust, giving child the right to withdraw all contributions--\$10,000—in 2001. If the child were to die immediately after the trust is created, a portion of the trust would be in the child’s estate, so exception (d) would be satisfied but for this rule. Because the right of withdrawal is within the gift tax annual exclusion amount, the trust can still be a GST trust, unless one of the other exceptions is met.)* Also, it is assumed that powers of appointment held by non-skip persons will not be exercised. I.R.C. §2632(c)(3)(B)(vi).
4. Election Against Automatic Allocation. Transferors can elect not to have the automatic allocation rules apply to an indirect skip on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury. I.R.C. §2632(c)(5)(A)(i)(I). Also, transferors can elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust (so that a one-time election out is sufficient without having to make the election out each year that a gift is made to the trust.) I.R.C. §2632(c)(5)(A)(i)(II). Such election may be made on a timely filed gift tax return for the calendar year for which the election is to become effective. I.R.C. §2632(c)(5)(B)(ii).

An example of a common situation where automatic allocation would not be desired is an irrevocable life insurance trust, that lasts for the lifetime of the insured’s spouse, then remains in further trust for the children until they reach age 30. This situation does not meet any of the exceptions. Therefore, the trust is a “GST trust” as to any transfers made to the trust before the children have reached age 30. Automatic allocations would be made to any gifts to the trust – despite the fact that in all likelihood the trust assets will pass to the insured’s children (not grandchildren) and any GST exemption allocation would be wasted.

Another common example is the termination of a GRAT, which would end the ETIP period and if the trust is a “GST trust,” automatic allocation would apply. Unless the entire GRAT remainder passes into a single dynasty trust, that can be fully “covered” by the automatic GST exemption allocation, it is likely that automatic exemption allocation would not be desirable. The planner should target all GRATs that terminate in 2001, to determine if a gift tax return should be filed by 4-15-02 electing out of automatic allocation for the GRAT.

When should the one-time election against automatic allocation be made? Once made, it is irrevocable. An advantage of not having automatic allocation apply to all transfers to a trust is to keep the flexibility of filing late with respect to a particular transfer to the trust if the value of that transfer declines by the time the exemption allocation is made. For that reason, some planners have suggested filing the one-time irrevocable election against automatic allocation for all dynasty trusts, and rely on the planner to plan carefully the best use of exemption allocations for all transfers to the trust. Other planners have suggested that is problematic, because after the “one-time” election against automatic allocation is filed, the automatic allocation rule would never apply to transfers from that transferor to that trust. The client may not use the current planner forever, and there is no assurance that careful planning attention would always be devoted to future transfers for many years into the future. One situation where the one-time election against automatic allocation might make sense is for life insurance trusts where the planner is routinely filing late, to make GST exemption allocations based on the value of the insurance in the trust at the time of the exemption allocation rather than being based on the total premium payments in the prior year. Without a one-time election against automatic allocation, if the trust is a “GST trust,” every year the transferor would need to file a return by April 15 electing out of automatic allocation, and file another return on April 16 making the late allocation.

5. Election To Treat a Trust as a GST Trust So That Automatic Allocation Rules Apply to Future Transfers to the Trust By That Individual. Also, a transferor may elect to treat any trust as a GST trust with respect to any or all transfers made by the individual to such trust (so that the deemed automatic allocation of GST exemption will apply as to current and future transfers to the trust by that individual—without having to file returns and make GST exemption allocations each year that transfers are made to such trust.). I.R.C. §2632(c)(5)(A)(ii). Such election may be made on a timely filed gift tax return for the calendar year for which the election is to become effective. I.R.C. §2632(c)(5)(B)(ii).
6. Effective Date of New Automatic Allocation Rules. The automatic allocation rules discussed in this paragraph C of the outline apply to transfers subject to estate or gift tax after December 31, 2000 and ETIPs that end after December 31, 2000. Economic Growth and Tax Relief Reconciliation Act of 2001 § 561(c).
7. Record-Keeping Problem. Having various automatic allocations will create record-keeping problems. If GST exemption allocations are made on gift tax returns, the returns maintain a record of what exemption has been allocated. If there are substantial automatic allocations, doing the record-digging years later to determine the amount of GST exemption that has automatically been allocated (and what exemption the person has remaining) could be an arduous task. For example, if there are automatic allocations for premium payments paid annually for insurance owned by an irrevocable life insurance trust, determining the aggregate amounts of the premium payments (particularly for group term payments that often are not “run through” the trust bank account) could be quite difficult. This problem also reinforces the wisdom of running all contributions to the trust through a trust bank account.

E. Retroactive Allocation of GST Exemption Under 2001 Tax Act.

1. Rationale. The legislative history recognizes that a transferor likely will not allocate GST exemption to a trust that will probably only benefit non-skip persons. However, if a taxable

termination occurs from a trust because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and GST exemption had not been allocated to the trust (because the transferor anticipated that the assets would pass to the child), the GST tax would be due even if the transferor had unused GST exemption. "The Committee believes it is appropriate to provide that when there is an unnatural order of death (e.g., when the second generation dies before the first generation transferor), the transferor can allocate generation-skipping transfer tax exemption retroactively to the date of the respective transfer to the trust." (House Report to the 2001 Tax Act, p. 37)

2. General Rule Allowing Retroactive Allocation. If a lineal descendant of the transferor predeceases the transferor, then the transferor can retroactively allocate any unused GST tax exemption to any previous transfer (or transfers on a chronological basis). The retroactive allocation can be made if:
 - f. A non-skip person has an interest or a future interest in a trust to which any transfer has been made,
 - f. Such person is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse,
 - f. Such person is in a generation younger than the generation of the transferor, and
 - f. Such person dies before the transferor. I.R.C. §2632(d)(1).
3. Election Made on Timely Filed Gift Tax Return. The election to have a retroactive allocation is made on a timely filed gift tax return for the year of the non-skip person's death. I.R.C. §2632(d)(2).
4. Timing and Values Used for Retroactive Allocation. Exemption is allocated retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to the trust. I.R.C. §2632(d)(2)(A). The allocation is effective immediately before the non-skip person's death, and the amount of the transferor's unused GST exemption available to be allocated is determined immediately before such death. I.R.C. §2632(d)(2)(B-C).

F. Substantial Compliance Under 2001 Tax Act.

1. Rationale. Prior to the 2001 Tax Act, some letter rulings have recognized GST exemption allocations even though all of the technicalities were not followed.

An example of a common problem situation is an attempt to allocate exemption in Part 1 on page 4 of the Form 709 to transfers that are not direct skips. (The proper procedure is to report the exemption allocation on Part 2 and attach a separate "home-made" [meaning there is no IRS form] Notice of Allocation.) For example, in Letter Ruling 199919027, the taxpayer reported the transfers on the wrong schedules, and did not attach Notice of Allocation of GST Exemption statements. However, the ruling reasoned that the taxpayer evidenced an intent to make the GST exemption allocation, and concluded that the taxpayer substantially complied with the requirement for making a GST exemption allocation. (In addition, that ruling also held that section 9100 relief was available for a gift reported on a return for a subsequent year. In that situation, a gift tax return was timely filed on April 15, 1998 to report gifts made in 1997, but no GST exemption was allocated on that return. An amended return was filed within 6 months making the proper GST exemption allocation.) See also Ltr. Ruls. 199939024, 199937026, & 199909034; Tech. Adv. Memo. 9534001.

Prior to the 2001 Tax Act, there was no statutory rule providing that substantial compliance with the requirements for allocating GST tax exemption will suffice. In light of the complexity of the allocation rules, the 2001 Tax Act provides that substantial compliance with the GST tax exemption allocation rules should be sufficient to constitute a timely allocation in the discretion of the IRS.

2. Substantial Compliance Sufficient, Based on All Relevant Circumstances. An allocation of GST exemption that demonstrates an intent to produce the lowest possible inclusion ratio shall be deemed to allocate so much of the transferor's unused GST exemption as is necessary to produce the lowest inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate. I.R.C. § 2642(g)(2).

G. Valuation of Exemption Allocations to Transfers Effective at Death.

The general rule is that the value for GST purposes of property includible in the decedent's gross estate is the same as its value for estate tax purposes. Treas. Reg. §26.2642-2(b)(1). If alternate valuation is used for estate tax purposes, that value will apply for GST purposes also. Property valued under the special use valuation provisions of Section 2032A will use the special use value for GST purposes (but only if the recapture agreement provides for the recapture of GST tax.) Id. The 2001 Tax Act codifies that the finally determined estate tax value controls for transfers as a result of the transferor's death. I.R.C. §2642(b)(2)(A). However, if the regulatory requirements (as described in Reg. §26.2642(b)) regarding post-death changes are not met, the value of property shall be determined as of the time of the distribution concerned. Id.

H. Relief From Late Elections Under 2001 Tax Act.

1. Rationale for Change. Failing to make a timely GST exemption allocation requires that the value on the date of allocation be used, which can be a huge disadvantage if the property has appreciated substantially after the time of the original gift. There is no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return. The IRS has taken the position that relief under section 301.9100 is not available because the statute describes the effect of timely filed elections and the 9100 regulatory relief cannot be granted to statutorily prescribed elections.
2. IRS Has Discretion to Recognize Late Elections As If Timely Made. The Treasury Secretary is directed to adopt regulations describing the circumstances and procedures for granting extensions of time to make the election to allocate GST exemption and to grant exceptions to the time requirement. If such relief is granted, the gift or estate tax value of the transfer to trust would be used for determining the GST exemption allocation. I.R.C. § 2642(g)(1)(A).
3. 9100 Relief. Section 301.9100 of the Procedure and Administration Regulations provides the standards used to determine whether to grant an extension of time to make an election whose due date is prescribed by a regulation (and not expressly provided by statute). The statute says that for purposes of determining whether to grant relief for a late allocation, "the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute." I.R.C. § 2642(g)(1)(B). This is intended to rebut the IRS's reason for taking the position that it could not grant 9100 relief for late allocations. The legislative history indicates that no inference is intended with respect to the availability of relief from late elections prior to the 2001 Tax Act. Notice 2001-50 (issued August 1, 2001) provides guidance regarding the procedures for requesting relief for retroactive GST exemption allocations. It concludes that "[t]axpayers requesting relief should follow the procedures for requesting a private letter ruling under section 301.9100 contained in section 5.02 of Rev. Proc. 2001-1 (or its successor), 2001-1, I.R.B. 1, 28.

4. Standards for Exercising Discretion; Procedures for Requesting Relief. The Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. I.R.C. § 2642(g)(1)(B). Notice 2001-50 summarizes the following standard for relief: “In general, under section 301.9100-3, relief will be granted if the taxpayer established to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government.”
5. Effective Date. The statute applies to requests pending on, or filed after, December 31, 2000.
6. Planning. Some have suggested filing these requests for relief early, because the waiting line may get long. The IRS will want to be assured that the taxpayer is not manipulating the system by waiting to determine whether or not the property appreciates. A common situation that arises is where the tax return preparer assumed (incorrectly) that gifts to Crummey Trusts that are covered by the annual exclusion are exempt for GST purposes. It would seem that the inadvertent failure to allocate in those situations would be easy to demonstrate if there is any other documentation suggesting that the parties intended the trust to be GST exempt, or if GST exemption was allocated to other gifts to the trust in excess of annual exclusions.

What if the planner allocated GST exemption late after the values have gone up, so more exemption was allocated than if the exemption allocation had been made timely. If the planner is now successful in obtaining relief to make a late election, the exemption allocation will be deemed to have been made timely based on the date of gift values. What happens to the additional exemption that was allocated in the late election? Once the relief is granted to make the late election, allocating as if made on a timely return, the trust would have a zero inclusion ratio as of the time of the deemed timely allocation. “[A]n allocation of GST exemption to a trust is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust.” Reg. § 26.2632-1(b)(2). Therefore, the allocation made on the late return is ignored.

- I. Severances Under 2001 Tax Act. If a trust is severed in a “qualified severance,” the resulting trusts are treated as separate trusts for GST purposes. I.R.C. § 2642(a)(3)(A).
 1. Significance. The significance of this severance authorization in the 2001 Tax Act cannot be underestimated. It can be extremely useful in planning with trusts that are not tax efficient with respect to the GST tax. A very common problem situation is where GST exemption allocations have not been made appropriately in the past, and a trust has an inclusion ratio of between 0 and 1. (For example, at a decedent’s death, perhaps no GST exemption allocation was made on Schedule R of the Form 706, and there was automatic allocation to all potential GST trusts under the will—leaving all trusts in a partially exempt status.) Every year that a distribution is made to a younger generation beneficiary from a partially exempt trust, a return must be filed and some GST tax must be paid. Under prior law, there was no possibility of dividing a partially exempt trust into two trusts—one of which was fully exempt and one of which was fully non-exempt. In addition, there was no authority under the severance regulations to sever an inter vivos trust that is not included in the grantor’s estate for GST purposes—so that the trust could be severed before GST exemption is allocated to the newly created trusts (again, to create fully exempt and fully non-exempt trusts).
 2. “Qualified Severance”. A qualified severance is the division of a single trust and the creation (by any means available under the instrument or local law) of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. I.R.C. § 2642(a)(3)(B)(i). There is an additional requirement for a trust that has an inclusion ratio between zero and 1. In that situation, a severance is a qualified severance

only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. The trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1. I.R.C. §2642(a)(3)(B)(ii). In addition, regulations may describe other severances as “qualified severances.” I.R.C. § 2642(a)(3)(B)(iii).

3. Fractional Division. For trusts with an inclusion ratio between zero and 1, the statute does not require a fractional division of each and every asset, but merely a division based on “the total value of all trust assets.” Presumably the same approach will be applied to trusts with an inclusion of ratio of zero or one that are to be severed before allocating GST exemption to just one of the severed trusts. See Treas. Reg. §26.2654-1(b)(1)(C) which imposes a requirement for regulatory severances that the severance (1) be on a fractional basis as to each and every asset, or (2) be based on the total fair market value with a fairly representative approach, or (3) be required by the instrument on the basis of a pecuniary amount. Query whether regulations to the severance statute will take a similar approach or will be more expansive in allowing non pro rata funding in light of the specific statutory language.
4. Same Succession of Interests. The severed trusts do not each have to be identical to the original trust—as long as, in the aggregate, the severed trusts provide the same succession of interests. Similar language is used in the severance regulations that were finalized on December 26, 1995. The Preamble to those regulations indicates that “vertical slices” are permitted, but not “horizontal slices” creating life estate and remainders. For example, a trust that provides for income to spouse with remainder to child and grandchild could be severed to create one trust with income to spouse and remainder to child and another with income to spouse and remainder to grandchild. However, a trust providing for an income interest to child with remainder to grandchild could not be divided into one trust for the child and another for the grandchild. This flexibility to create non-identical trusts can be very useful. For instance, the first example, under which one trust may be created with remainder to child and another with remainder to grandchild would permit allocating GST exemption just to the trust for the grandchild. Many state severance statutes only permit severances into identical trusts. In those states, it is important for trust instruments to allow severances into non-identical trusts in order to take advantage of this flexibility if it should ever be needed.
5. Effective Date. The statute applies to severances after December 31, 2000.

PART TWO—PLANNING IMPLICATIONS UNDER 2001 TAX ACT

- I. Wills and Revocable Trusts—Planning for Exemption Increases/Repeal.
 - A. Be Wary of GST or Estate Tax at First Spouse’s Death. For a married couple, estate taxes will be generated at the first spouse’s death if non-spousal gifts are made that exceed the decedent’s remaining applicable exclusion amount. Each \$1.00 of non-spousal bequest at a 55% marginal rate bracket generates an estate tax of \$1.22. As the maximum marginal rate bracket is reduced under the 2001 Tax Act rate decreases, the cost will also decrease. In 2002, when the maximum rate is 50%, the tax cost is \$1.00 for every \$1.00 of non-spousal bequest. By 2007, when the top marginal rate bracket is 45%, the tax cost is \$.82 for every \$1.00 of non-spousal bequest at the top bracket (ignoring the fact that the state death tax credit becomes a deduction.)
 - B. Do Not “Overfund” Non-Spousal Bequest. The planning complications are particularly difficult for married couples. At the death of a single person, the planning is not changed in a significant way except that the overall estate taxes may be reduced as the estate tax applicable exclusion amount increases and the rates decrease. (However, the overall tax decrease is relatively small until 2009, as discussed in Part One, Section VI.D. of this outline.)

One way of addressing this issue with the client is to discuss how the client would dispose of his or her estate if there were no estate tax. Those goals can then be addressed in light of the increasing estate tax exemption and possible repeal.

1. Scenarios of Problem Situations. The first scenario below (all to bypass trust/marital trust plan) will not raise planning complexities in most situations. All of the remaining scenarios described below will present planning concerns (primarily to the surviving spouse) in increasing order of severity.
 - a. All to Bypass Trust/Marital Trust Plan. If the client has a typical formula bequest that leaves the entire estate to a bypass trust or a marital trust, this planning may continue to be appropriate even after estate tax repeal. As the exemption increases or if there is ultimate estate tax repeal, the formula may result in all of the decedent's estate (at the first spouse's death) passing to the bypass trust. If the client has already made the decision to have all of his or her estate pass into trusts (i.e., a bypass trust for the benefit of the surviving spouse and one or more QTIP marital trusts), the increase in exemptions and even ultimate possible repeal may not result in a need to change the client's will or revocable trust. The decision to use a Marital Trust is not to save estate taxes, but for other non-tax reasons, including the ability to control where assets will pass at the second spouse's death and to provide asset protection for the surviving spouse. These reasons should continue to apply even if there is no estate tax.
 - b. Exemption Formula Bequest to Bypass Trust/Balance Outright to Surviving Spouse. This is the classic problem situation in planning for exemption increases. The client wants to leave the exemption to a bypass trust to save estate taxes at the second spouse's death, but wants to leave the balance of the estate outright to the surviving spouse. The client may be thinking that a substantial part of the estate will pass outright to the surviving spouse. As the exemption increases (or if there is estate tax repeal), the entire estate may pass to the bypass trust, leaving nothing to pass outright to the surviving spouse. This may be contrary to the client's (and the spouse's) wishes.
 - c. All to Bypass Trust/Marital Trust; Desire for More Flexibility in Marital Trust If No Marital Deduction Needed. Even if the client wants to leave the entire estate to a bypass trust or to a marital trust, there may still be a desire to revise the terms of the trusts if there is no need to qualify for the marital deduction at the first spouse's death or if there is no estate tax.
 - (1) Revision to Marital Trust Terms if Marital Deduction Not Needed. If the applicable exclusion amount is large enough so that no estate taxes are due at the first spouse's death even if there is no marital deduction, there may be a desire to revise the terms of the marital trust, to delete some of the terms that are necessary to qualify the trust for the marital deduction. These include (i) deletion of the mandatory income requirement, (ii) permitting the trustee to make distributions to beneficiaries other than the surviving spouse, and (iii) giving the surviving spouse a lifetime power of appointment to appoint the assets to persons other than the surviving spouse. Under the "Clayton trust" regulation, the terms of the marital trust may be revised under the trust document (for example, to include these additional provisions) if the executor does not make a QTIP election for the marital trust. Reg. § 20.2056(b)-7(d)(3).
 - (2) Revisions to Bypass Trust Terms if No Estate Tax Concerns. If there is no estate tax, or if the applicable exclusion amount is large enough to cover the surviving spouse's estate even if the assets of the bypass trust are included in the surviving spouse's estate, the client might wish to give the surviving spouse increased flexibility over the bypass trust, including serving as trustee without an ascertainable standard on

distributions or having a power to withdraw whatever he or she wants to from the trust. (However, including broad withdrawal powers for the surviving spouse will impact the degree of asset protection available for the surviving spouse.)

- d. Bequest to Trust For Children. If the will or revocable trust leaves a formula bequest of as much as possible without causing estate taxes to be paid (typically, the applicable exclusion amount) to a trust for the client's children, there may be a desire to change the will or revocable trust as the applicable exclusion amount increases or if there is repeal. The client may have signed the will or revocable trust under the impression that the formula bequest would leave up to \$1.0 million to the trust for children (as the applicable exclusion amount increased to \$1.0 million by 2006 under the prior law.) The client may have been comfortable that the surviving spouse would still have sufficient assets for his or her needs even with this bequest to trust for children. The formula clause could end up leaving the client's entire estate to the trust for children, with nothing passing to or for the benefit of the surviving spouse.

The client's willingness to leave substantially more assets to the trust for children than the amount that may have been anticipated under prior law may still be acceptable to the client if the surviving spouse has some controls over the trust, even if he or she is not a beneficiary of the trust. For example, if the spouse is a trustee, or has a power of appointment to shift the assets among the client's children as needed, the client may be more willing to leave increased assets to the trust than if the spouse has no control over the trust for children.

- e. Outright Formula Bequest to Children. The surviving spouse may be even less inclined to leave substantially increased amounts under a formula bequest that passes outright to children. Furthermore, as the applicable amount increases (or if there is estate tax repeal), the client may wish for a significant part of the bequest to pass to a trust for the children to provide management assistance and asset protection for the children.
- f. Bequest to Children of Prior Marriage. The situation is particularly sensitive if the client leaves a formula bequest to children by a prior marriage. For example, if husband has two children by a prior marriage and two children of his current marriage and if the marital estate is predominantly community property, the husband's plan current plan may be to leave all of his applicable exclusion amount to his children by prior marriage, anticipating that his wife will leave her one-half of the community estate to the children by the current marriage. However, if the husband dies first, he may be unwilling to leave all of his one-half of the community estate to his children by a prior marriage, in order to make sure that his wife has sufficient assets to provide for her support.
2. Planning Approaches to Afford Desired Flexibility to Accommodate Increased Exemptions or Estate Tax Repeal. The classic problem that planners are struggling with is how to take into account increasing exemptions or the ultimate repeal of the estate tax.

For example, assume that husband and wife have a total community property estate of \$2.0 million. If the husband dies this year and leaves everything to his wife, in anticipation of the applicable exclusion amount increasing to \$2.0 million in 2006, and if the wife unexpectedly dies next year when the applicable exclusion amount is only \$1.0 million, the wife's estate will owe substantial estates on the \$1.0 million of the estate that is in excess of the applicable exclusion amount. Therefore, if husband dies this year, he may want to use a bypass trust for his one-half of the \$2.0 million estate. However, if the husband dies in January of 2006 (when the exemption is \$2.0 million) and if the combined estate is still \$2.0 million, he may want to leave his entire one-half of the community property estate outright to his wife, in anticipation that her estate (even taking into account the amounts received from him) would not be subject to estate tax at her subsequent death. If the husband were to die in August of 2005 (when the

exemption is \$1.5 million, but only four months before it will increase to \$2.0 million), the couple might make the decision to leave everything outright to her as well at husband's death, taking the risk that she would live at least four more months, beyond 12-31-2005, and taking the risk that the Congress would not change the applicable exclusion amounts before 2006. The spouses have to take into consideration the expected growth in the assets, and be comfortable that the assets will not grow to the point that there would be an estate tax if the wife were to die in a later year.

What flexibilities are available without drafting a different disposition for different years, depending on various alternate dates of death (and having to organize the will into separate volumes because it could no longer be bound all into one volume)?

- a. Typical Bypass Trust/Marital Trust Formula Approach. For the client who wants to leave the entire estate either to a bypass trust or marital trust, the client may not be greatly concerned that most if not all of the estate passes into the bypass trust rather than the marital trust. Giving the surviving spouse considerable powers over and interests in the bypass trust will facilitate making the client comfortable with this approach as the exemption amount increases. These would include (1) naming the spouse as a co-trustee or as a sole trustee (with appropriate restrictions on distributions so that the spouse does not have a general power of appointment under section 2041 over the bypass trust if the estate tax is not repealed by the time of the spouse's subsequent death); (2) giving the spouse a testamentary limited power of appointment over the bypass trust; (3) giving the spouse an inter vivos limited power of appointment over the bypass trust; (4) naming the spouse as the sole or at least the preferred beneficiary of the bypass trust; (5) including specific precatory directions to the trustee (other than the spouse) to be extremely generous in making distributions to the spouse if the assets passing to the bypass trusts exceed X% of the estate; (6) giving a trustee other than the spouse, or a "trust protector" the authority to make distributions of as much or all of the trust outright to the spouse as the trustee or trust protector deems to be in the best interest of the spouse, and (7) providing that the surviving spouse would no longer be a beneficiary if the spouse remarried.
- b. Two Bypass Trusts/Marital Trust Approach. The will could specify that if more than X% of the estate is passing to the bypass trust, a defined portion (percentage or amount) of the bypass trust would be segregated into a separate bypass trust. One bypass trust would be the classic bypass trust for the benefit of the surviving spouse and descendants (or perhaps primarily for the benefit of the descendants). The second bypass trust would be for the exclusive (or primary) benefit of the spouse, and the spouse would be given some of the "maximum control" features described in the preceding paragraph.
- c. Partial QTIP Election; "Clayton QTIP" Approach. The will could specify that all of the estate passes to a QTIP trust, and the executor would have the authority to decide whether to make a QTIP election for some or all of the trust. The executor would have the flexibility not to make the QTIP election of a sufficient portion of the trust to utilize an "appropriate" portion of the decedent's available estate tax exemption, taking into consideration increases in the exemption amount and other factors that the executor determines to be appropriate. See Kasner, The 'Completely QTIPable' Estate Plan, 2001 Tax Notes Today 167-21 (August 22, 2001).

In addition, if the executor does not make the QTIP election for all of the trust, the unelected portion of the trust could switch to having different terms, such as (i) deletion of the mandatory income requirement, (ii) permitting the trustee to make distributions to beneficiaries other than the surviving spouse, and (iii) giving the surviving spouse a lifetime power of appointment to appoint the assets to persons other than the surviving spouse. Reg. § 20.2056(b)-7(d)(3). (This regulation was adopted in reaction to various cases in

which the IRS unsuccessfully took the position that having trust terms that would qualify for QTIP treatment only if a QTIP election were made would not be satisfactory, including Estate of Clayton, 976 F.2d 1486 (5th Cir. 1992.) If this approach is used, it is important to include a broad exculpatory provision to protect the executor from liability, because the tax election by the executor could shift benefits among beneficiaries.

(1) Interpretation After Estate Tax Repeal.

A complexity with this approach is dealing with a decedent who dies when there is no estate tax in effect. In that situation, the concept of making or not making a QTIP election would not apply. The will or revocable trust should make clear what should happen if there is no estate tax. See Blattmachr and Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74 (Aug. 2001). If there is no estate tax, the client probably would not want the marital deduction required restrictions to apply, (except, perhaps, as necessary to qualify for the \$3.0 million spousal basis adjustment, as discussed below). In that case, providing that the terms will be adjusted to remove the marital deduction restrictions if a QTIP election is not made should reach the intended result if there is no estate tax and no QTIP election can be made.

(2) Coordination With \$3.0 Million Spousal Basis Adjustment.

Beware that revising the terms of a QTIP trust for persons dying after 2009, in order to remove some of the restrictions required for QTIP trusts if there is no estate tax and no need for the marital deduction, may mean that assets left to the QTIP trust would not qualify for the \$3.0 million spousal basis adjustment. See Part Two, Section IV.E.4. of this outline. A complicated formula approach could be used, which would direct that if carryover basis applies, the terms of the QTIP would be revised to relax the restrictions only for the amount in excess of a defined formula amount of assets to qualify for the \$3.0 million spousal basis adjustment. For a start at drafting the defined formula amount of assets to qualify for the \$3.0 million spousal basis adjustment, see the sample clause (prepared by Ellen Harrison) in Part Two, Section IV.E.8.d.(7) of this outline.

d. Disclaimer Plan.

- (1) All to Spouse; Disclaim to Bypass Trust. The will or revocable trust could leave all of the decedent's estate to the surviving spouse or to a QTIP trust, and provide that any assets disclaimed by the spouse would pass to a bypass trust having the spouse as a potential beneficiary (or the will could provide that disclaimed assets would pass to the decedent's children or trusts for children.) The spouse would then be able to disclaim to the extent of the first decedent spouse's available exemption, if the surviving spouse determined that there was a significant chance of having to pay a significant amount of estate taxes at the spouse's subsequent death. The spouse would have the flexibility to disclaim as to none, some, or all of the bequest to the spouse or to the QTIP trust.

Under the disclaimer regulations, the spouse could disclaim using a formula amount, to provide a "savings clause" against disclaiming "too much" and generating an estate tax at the first spouse's death. Reg. § 25.2518-3(d), Ex. 20. The spouse could disclaim as to specific assets, as long as the disclaimed assets actually "leave" the trust and pass to someone other than the disclaimant. Reg. § 25.2518(a)(2). (A removal of the disclaimed property to another trust under the same instrument is sufficient. Ltr. Rul. 8951041.) Some letter rulings have approved disclaimers of percentage undivided interests, even though the executor could use his discretion in selecting which assets would fund the disclaimed portion. E.g., Ltr. Rul. 8652016. The spouse could disclaim

a pecuniary amount, or a “reverse pecuniary amount” (i.e., everything in excess of \$X.) Reg. § 25.2518-3(c). The disclaimed assets can pass into a trust having the spouse as a beneficiary. I.R.C. § 2518(b)(4)(A). The surviving spouse can serve as a fiduciary over the disclaimed assets as long as he or she does not retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Reg. § 25.2518-2(d)(2). The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Reg. § 25.2518-2(e)(1)(i), §25.2518-2(e)(2), & § 25.2518-2(e)(5)(Ex. 12). In effect, the spouse has a great deal of flexibility in making disclaimers.

There are several disadvantages of relying on the disclaimer approach. The most important is that the spouse may refuse to disclaim assets, even though a disclaimer would be appropriate based on the tax situation. Planners commonly work with situations where disclaimers are appropriate, but, for whatever reason, the surviving spouse refuses to disclaim. The spouses may not be willing to rely on each other to make the disclaimer decision, which could result in substantial tax savings for their children. The disclaimer approach is particularly suspect where the disclaimed assets would eventually pass to (and save estate taxes for) children of the first decedent spouse by a prior marriage. Professor Jeffrey Pennell has aptly described this inherent uncertainty over whether the surviving spouse will actually disclaim by observing that the three greatest lies are (1) “the check is in the mail,” (2) “I’m from the government and I want to help you,” and (3) “Of course, I’ll disclaim if it will save taxes.” Pennell, Estate Tax Marital Deduction, 843 T.M. (BNA) at A-11, n.46.

Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a limited power of appointment over disclaimed assets. Reg. § 25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). However, a family member other than the surviving spouse-disclaimant (such as the spouse’s brother or sister) could have a power of appointment that could be exercised at the spouse’s death (or earlier if that is desired).

In addition, there is the risk that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible, or that the spouse dies before signing a written disclaimer. Estate of Chamberlain, 87 A.F.T.R.2d 2001-2386 (9th Cir. 2001), *aff’g by unpub’d order*, T.C.M. 1999-181. See Zaritsky, Disclaimer-Based Estate Planning—A Question of Suitability, 28 EST. PL. 400 (Aug. 2001).

- (2) All to Bypass Trust; Disclaim to Surviving Spouse. The reverse planning alternative is to leave the entire estate to a bypass trust. If the marital deduction is needed to avoid estate taxes at the first spouse’s death, non-spousal beneficiaries of the trust could disclaim their interests in a manner that would qualify the bequest for the marital deduction. (If the surviving spouse does not have a mandatory income interest in the bypass trust, the trust could provide that if the spouse disclaims, the trust assets would pass to a QTIP trust .) This approach would be appropriate particularly if the client thinks that having all of the assets pass to the bypass trust will most likely be the desired result (i.e., because the estate will likely be less than the available exemption amount or because of a belief that the estate tax will be repealed.) This approach would require the difficulty of being able to obtain disclaimers by a number of descendants who may be beneficiaries of the trust (including minors or potential unborn beneficiaries).
- e. Formula Limitations. Instead of utilizing the simplicity and flexibility of either a Clayton QTIP approach, or a disclaimer approach, the will or revocable trust could try to take into account possible different scenarios based on formulas. For example, the bequest could put a “cap” on the amount of the estate that would pass to the bypass trust (so that the

entire estate would not pass to the bypass trust under a “maximum amount that can pass without estate tax” clause as the exemptions increase or if the estate tax were repealed.) Alternatives would include (1) a dollar cap, (2) a percentage cap, (3) a cap based on the greater of a dollar amount or a specified percentage, or (4) a cap based on the lesser of a dollar amount or a specified percentage, or (5) other creative formulations.

For example, a formula credit shelter pecuniary bequest (or the numerator in a formula credit shelter fractional bequest) could include the following after the existing formula language: “*provided that the determined amount shall not exceed one million five hundred thousand dollars (\$1,500,000).*” Howard Zaritsky suggests adding language to clarify the testator’s intent: “*I recognize that leaving only one million five hundred thousand dollars (\$1,500,000) as the Estate Tax Exemption Share may, in some cases, increase the estate taxes due at my *spouse’s* death, but I choose to impose this limitation on the Estate Tax Exemption Share in order to assure that my *spouse* receives an amount that I believe to be sufficient.*”

- f. Consider State Death Taxes in Bypass Trust Bequest Formula. This planning situation could apply in the event of estate tax repeal, or even if there is still a federal estate tax but the federal exemptions make the federal estate tax inapplicable to the client’s (and spouse’s) estate. If a state has a substantial estate tax in addition to the federal state tax credit, the planner may want to leave assets to a bypass trust, to the extent that the state does not have a complete marital deduction, to avoid imposition of the state taxes a second time at the spouse’s subsequent death. The client may want to leave assets to the surviving spouse (or to a recognized marital trust), up to the amount of state exemptions for assets passing to a spouse. The spouse may move to another state prior to his or her subsequent death that does not have a significant state death tax, so that state death taxes could be avoided entirely. An example of such a clause is as follows:

“My ‘Estate Tax Exemption’ means the largest amount that can pass to the Family Trust as a Formula Gift without increasing my federal estate tax, or if I die when there is no federal estate tax, without increasing my state death tax if my state’s death tax law permits an unlimited exemption or deduction for transfers to a surviving spouse and an exemption or credit against the state death tax regardless of the person to whom property passes, and shall mean my entire estate, to the extent not effectively disposed of by the foregoing provisions of this document, if there is no federal estate tax or state death tax in effect at the time of my death.” Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act—More Than You Can Count, 95 J. TAX’N 74, 86-87 (Aug. 2001).

If the state recognizes a QTIP trust for state marital deduction purposes (be aware that Oklahoma does not), using a QTIP trust disposition may be better than an outright bequest or a bequest to a general power of appointment trust. “Presumably, property in the ... QTIP will not be included in the gross estate of the surviving spouse for federal estate tax purposes if the federal estate tax is back in effect when the survivor dies. Property passed outright to the surviving spouse or over which the survivor holds a general power of appointment presumably would be.” Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act—More Than You Can Count, 95 J. TAX’N 74, 86 n.42 (Aug. 2001).

- g. Must Coordinate With Carryover Basis Planning. The planning for how much assets to pass to a surviving spouse, QTIP, or bypass trust should also contemplate carryover basis effects. A detailed discussion of planning for carryover basis is in Part Two, Section IV of this outline.

For example, assets passing to a spouse or to a QTIP qualify for a \$3.0 million basis adjustment. This factor may be of little importance to persons preparing wills or revocable trusts currently, if the planner and client believe there is a very small chance that there will ultimately be estate tax repeal with carryover basis. However, as we get closer to 2010, this will become a more important factor if carryover basis is still scheduled to occur in 2010. In that case, the client who would otherwise leave a substantial part of the estate to children or to a bypass trust will be faced with how much to leave to the spouse or QTIP to take advantage of the \$3.0 million basis adjustment. (This is a \$3.0 million basis adjustment, and a bequest of a much higher value may be needed to constitute assets that could take advantage of the full \$3.0 million adjustment.) As another example, if carryover basis applies, the planner may want to coordinate using “Clayton QTIP trust” provisions (which revise the terms of a trust for which no QTIP election is made) with the desire to leave assets with \$3.0 million of appreciation to a trust that satisfies the requirements for “qualified terminable interest property” in section 1022(c)(5).

- h. Consider Using General Statement of Intent. Consider including a general statement of the testator’s intent regarding the intended primary beneficiary[ies] of the estate. Such a general statement, even if it is only precatory, could give helpful guidance to the executor and the surviving spouse that will assist in making appropriate disclaimer and QTIP elections. It can also help greatly in resolving ambiguities that may emerge in formulas as a result of increasing exemptions or estate tax repeal. For an example of such a clause, see Blattmachr & Detzel, Estate Planning Changes In the 2001 Tax Act—More Than You Can Count, 95 J. TAX’N 74, 85 (Aug. 2001).

C. Coordination With Increased GST Exemption and Other GST Changes.

1. Classic Three Trust Approach. The classic three-trust GST plan is to have three trusts in the “typical” GST oriented plan under prior law: (1) A bypass trust, equal to the remaining estate tax applicable exclusion amount, with GST exemption also being allocated to this trust so that it is GST exempt; (2) A “reverse QTIP trust,” (or exempt QTIP trust), for which an election has been made under section 2652(a)(3) to treat the first decedent as the transferor for GST purposes, equal in amount to the decedent’s remaining GST exemption (taking into consideration the amount of GST exemption allocated to the bypass trust); and (3) A non-exempt QTIP comprised of the balance of the estate, which is not exempt from the GST tax at the second spouse’s subsequent death unless the surviving spouse allocates GST exemption to the trust.
2. Reduced Need for Three Trust Approach After GST Exemption Equals Estate Tax Exemption Amount. The necessity of using “reverse” QTIP trusts will be lessened substantially, beginning in 2004, under the 2001 Tax Act. In 2004, the estate tax applicable exclusion amount will equal the GST exemption amount (i.e., \$1.5 million). Therefore, for a person who dies in 2004 or later, if he has as much (or more) remaining estate tax applicable exclusion amount as he has GST exemption, there can be a formula bequest of the remaining GST exemption amount into a bypass trust (or to a dynasty trust just for the descendants) without generating an estate tax at the first spouse’s death.
3. May Need Exempt and Non-Exempt Bypass Trust. If the client has previously used some of his or her GST exemption in situations that did not require an equal use of his or her estate tax exemption amount, special planning will be needed for the bypass trust. For example, if a GRAT terminates and passes to an exempt and non-exempt trust, the client will allocate GST exemption but often would not have used up any substantial amount of his or her applicable exclusion amount for the GRAT transaction. Another example is if the client makes annual exclusion gifts to a Crummey trust that is not a vested trust for grandchildren. In that case, the client does not use up any of his estate and gift exemption amount on the transfer, but GST exemption must be allocated to the transfer for the trust to be GST exempt. I.R.C. §

2642(c)(2).

In that situation, the standard bequest to the bypass trust would exceed the remaining GST exemption amount. In order to avoid having a trust that is partially subject to the GST tax, the bequest to the bypass trust will need to be split into two bypass trust bequests: one bypass trust will be GST exempt and the other will be non-exempt. (Observe, this does not occur frequently under existing law, because the GST exemption is significantly more than the estate and gift tax exemption amount.)

There are two methods of dealing with this possibility.

- a. Discretionary Division Approach. The will or revocable trust could grant broad authority to the trustee to divide trusts if there are tax advantages to doing so. Having separate exempt and non-exempt trusts affords much greater planning flexibility than having a single partially exempt trust, and would justify making the division under a “tax advantages” type of authorization. A Texas statute authorizes non-judicial division by a trustee for tax savings purposes, but the divided trusts must be identical to each other. TEX. PROP. CODE § 112-057. The instrument could authorize the trust to divide trusts into trusts having different terms (as described in the following paragraph) for exempt vs. non-exempt trusts. Alternatively, Keith Novick, in Dallas, Texas, suggests that the bypass trust might provide that it would have varying terms depending on the inclusion ratio of the trust; the divided trusts would then automatically have different terms for the exempt and non-exempt trust. (This would seem to be permissible, but there are no rulings or cases, confirming the viability of this approach.) In many situations, the simplicity of the discretionary division approach will make it the preferred approach over the formula approach.
 - b. Formula Approach. The will or revocable could include formulas to create an exempt bypass trust, equal to the lesser of the remaining GST exemption amount or the applicable exclusion amount. The balance of the applicable exclusion amount, if any, would pass to a GST non-exempt bypass trust. (The trusts could have different terms. The exempt bypass trust could prefer the interests of grandchildren or more remote beneficiaries over the interests of children. The non-exempt trust could be exclusively for the benefit of children during their lifetimes, and might last until the death of the last surviving child in order to defer the application of the GST tax as long as possible.)
4. GST Formula Bequest May Generate Estate Tax. With the GST exemption amount becoming equal to the estate tax applicable exclusion amount beginning in 2004, it will become more likely that a bequest to grandchildren or to an exempt trust equal to the GST exemption amount will generate estate taxes at the first spouse’s death. This would occur if the decedent has made gifts using up any of his or her applicable exclusion amount without allocating an equal amount of GST exemption to the transfer. For example, assume the client makes gifts equal to children equal to his or her applicable exclusion amount and dies in 2006. The client will have no remaining applicable exclusion amount for estate tax purposes, but will have a GST exemption of \$2.0 million. If the will or revocable trust has a bequest to grandchildren or to a non-marital exempt trust equal to the GST exemption amount, there will be estate taxes generated about equal to the amount of the bequest. (If the average estate bracket were 50%, there would be \$1 of estate tax for every \$1 dollar of bequest that did not qualify for the marital or charitable deduction.)

Accordingly, it will be even more important in the future to condition GST exemption bequests as being the lesser of the remaining estate tax applicable exclusion amount or the remaining GST exemption amount.

5. Interpretation of GST Formula Bequest After GST Repeal. If the GST tax is repealed, a formula GST bequest (equal to the amount of the testator's remaining GST exemption) will be ambiguous if the GST tax is repealed. If there is no GST exemption, this formula may be interpreted as being a bequest of zero. The instrument should clarify the testator's intent. For example:

"My 'Available GST Exemption' shall mean my entire estate [or other desired amount], to the extent not effectively disposed of by the foregoing provisions of this document, if there is no federal generation-skipping tax in effect at the time of my death."

Blattmachr & Detzel, Estate Planning Changes In the 2001 Tax Act—More Than You Can Count, 95 J. TAX'N 74, 88 (Aug. 2001).

6. Defer GST Tax By Maximizing Number of Non-Skip Persons. In light of the possible repeal of the GST tax, take steps to delay any taxable distribution or taxable termination until after 2009. Do not provide for mandated distributions to younger generation beneficiaries before 2010, and provide for multiple non-skip beneficiaries to minimize the likelihood of a taxable termination by the deaths of all non-skip person beneficiaries before 2010.
7. Clarify Possible Ambiguity In Light of Automatic Exemption Allocations. An ambiguity may arise if a decedent dies after making direct skip transfers or transfers to trusts that are "GST trusts" under the new automatic allocation rules (see Part One, Section XV.D. of this outline), but before the gift tax return is filed with respect to such transfers. Those transfers will have an automatic allocation of GST exemption, unless a tax return is filed electing out of automatic allocation. If the decedent's will or revocable trust contains a formula bequest of the decedent's remaining GST exemption, there will be an ambiguity regarding the amount of the bequest (depending on whether the possible automatic allocations are subtracted). The formula clause should make the intent clear.

D. Property Ownership so Each Spouse Can Utilize Estate Tax Exemption Amount.

1. The Problem. Assume that wife owns assets worth \$3.0 million and the husband owns assets worth \$100,000. This type of situation is more prevalent in common law states, but can certainly arise in Texas where a spouse has substantial separate property. If the wife dies first in 2002, she can make a formula bequest of \$1.0 million to a bypass trust and leave the balance of her estate to the husband or to a QTIP trust. The amount left to the bypass trust will be exempt from tax at husband's subsequent death, and the husband will have his own exemption amount. If the husband subsequently dies in 2006 when his exemption amount is \$2.0 million, the \$1.0 million in the bypass trust and the \$2.0 million that he received from wife will not be subject to estate tax, and only the additional \$100,000 would be subject to estate tax. On the other hand, if husband dies first, he only has \$100,000 to leave to the bypass trust, and at wife's subsequent death in 2006, only the \$100,000 bypass trust and the wife's \$2.0 million exemption amount will pass free of estate tax. Wife's remaining \$1.0 million would be subject to the estate tax. In effect, husband's estate tax exemption amount was wasted because he did not own sufficient assets at his death to fully utilize his exemption.

The same situation applies for GST exemption purposes also. In the above example, if husband dies first, he can only utilize \$100,000 of his \$1,060,000 GST exemption, and the balance is wasted.

2. Especially in Common Law States or If One Spouse Has Substantial Separate Property. The situation can arise whenever there is a substantial disparity of ownership between the spouse, and one spouse owns significantly less than the estate and GST exemption amounts.
3. Interspousal Gifts. The problem can be cured by having interspousal gifts between the spouses before the non-propertied spouse dies. Optimally, sufficient assets will be transferred

to the non-propertied spouse so that he or she can make full use of his or her estate and GST exemption amounts.

4. Problem More Acute Under 2001 Tax Act. This problem situation will become more and more prevalent as the estate and GST exemption amounts increase. By 2009, when the estate and GST exemptions are \$3.5 million, failing to take full advantage of these exemptions if the non-propertied spouse dies first without owning sufficient assets to take advantage of these generous exemption amounts can result in substantial additional estate and GST taxes for the family (assuming there is an estate and GST tax after 2009.)
5. Immediate Pre-Death Gifts Can Be Made. Gifts to the non-propertied spouse can be made immediately prior to the non-propertied spouse's death. The only limitation would be if the propertied spouse made the transfer to the non-propertied spouse with an express or implied understanding that the spouse would be leaving the property back to a bypass trust for the benefit of the propertied spouse in his or her (soon to be "matured") will. Contrast this situation with the operation of section 1014(e) under prior law, where transfers to a spouse (or anyone else) had to be made at least one year before the donee's death to get a step-up in basis if the property passes back to the donor. (See Part Two, Section VIII.E.8.a. of this outline for a discussion of how section 1014(e) would be changed under the carryover basis rules.)

If a "propertied spouse" is unwilling to make current gifts to a "non-propertied" spouse, consider giving someone a power of attorney to make gifts to the non-propertied spouse to allow him or her to fully utilize the exemption equivalent available to the spouse if the agent determines that it would be reasonable to do so, in his sole discretion. Because of the large increase in the applicable exclusion amount, this will be even more important in the future than in the past.

If the "propertied spouse" is uncomfortable making these large gifts to the other spouse, keep in mind that the gift can be made to a lifetime QTIP trust for the benefit of the non-propertied spouse. This grants a considerable degree of control over the ultimate disposition of the assets (for example, to pass ultimately to the propertied spouse's descendants.) See Part Two, Section II.C. 5. below regarding the tax effects of the possibility of allowing the donee spouse to leave the assets back to a bypass trust for the benefit of the donor-spouse.

6. Review Survivorship Designations. Survivorship designations should be reviewed, to assure that there will be sufficient assets passing other than by the survivorship designation to fund fully the exemption bequest. Survivorship designations may have been made some years ago with the thought of leaving about \$600,000-700,000 that does not pass to the surviving spouse under the survivorship designation and that can be used to fund the bypass trust.

E. Flexibility

1. Avoid Redoing Will Each Year, But Urge Periodic Review. Despite the fact that estate planning attorneys are, by and large, engaging and extremely delightful people, clients will not want to visit their estate planning attorneys to redo and (and pay for) Wills each year, to take into consideration exemption increases, assets increases, legislative changes, etc. However, in light of the almost certainty of continuing significant estate tax legislation, and in light of the drastic effects that the increasing exemptions in future law changes will have on clients' estate plans, clients should be urged to have a periodic review of the estate plans over the next decade in particular.
2. Draft Multiple Wills in One? One approach would be to draft separate plans, in effect, in a single will or revocable trust based on the date of the client's death. The will or revocable trust could provide for differing dispositions, trust terms, etc based on the year of the testator's

death. This would be cumbersome, and would seem ill advised (at least for clients who are not nearing an incapacity problem), in light of the almost certainty that there will be further changes in the estate tax legislation.

3. Carryover Basis Planning. Special planning (with revised dispositive plans for many clients) will be needed if carryover basis is in effect. However, under the 2001 Tax Act, that does not occur for nine years. That's an eternity in a world where future estate tax legislative changes are a given. Most people will not want to plan for (and more particularly pay for) detailed arrangements now of what will happen in nine years under a carryover basis system, knowing that the rules will probably change (and perhaps drastically) by that time. They will want the flexibility to incorporate necessary revisions as 2010 approaches, taking into consideration the client's asset situation (including how much unrealized appreciation there is in the assets) and the estate tax and carryover basis laws at that time.
4. Planning For Incapacity. For most people, drafting wills based on the current laws, and taking into consideration exemption increases that will occur over about the next five years, would seem to be the reasonable approach. Clients must understand that, in light of all the uncertainty about estate tax laws, they must have their estate plan reviewed periodically. However, what if the well-intended client becomes disabled and cannot change his or her plan?
5. Powers of Appointment; Independent Trustee or Trust Protector with Broad Powers. Persons who create irrevocable trusts currently or who die in the next several years will want to incorporate flexibility into their trust documents to make adjustments in light of changed laws. For example, trusts designed to save estate taxes at the surviving spouse's death or at children's deaths may be changed radically if there is no estate tax or GST tax in the future. Traditional devices to afford flexibility will be helpful. Planners often have experienced the wisdom of having broad powers in trustees to make distributions or to transfers assets to new trusts with revised terms to adjust for changing family or asset or tax law situations. Examples of powers that could be used include the following.
 - a. Testamentary Powers of Appointment. Give beneficiaries testamentary limited powers of appointment, including the authority to appoint assets in further trust (with changed trust terms.)
 - b. Inter Vivos Limited Powers of Appointment. Give beneficiaries, the power, at any time, to make adjustments by having inter vivos limited powers of appointment. (Gift tax issues will be raised, however, if a beneficiary exercises a power of appointment in a manner that decreases the beneficiary's interest in the trust assets.)
 - c. Independent Trustee With Broad Discretion Over Distributions. Giving a trustee very broad discretion over distributions affords tremendous flexibility. If there is estate tax repeal or if exemptions increase to the point that there are no estate tax savings, trust assets can be distributed outright to beneficiaries. If there is carryover basis, and a QTIP trust has been created for the surviving spouse, distributions of assets outright to the surviving spouse could enable the surviving spouse to take full advantage of the \$1.3 million basis adjustment at his or her subsequent death. Broad distribution powers, not limited by ascertainable standards, should only be held by someone other than beneficiaries or grantors, to avoid treating the beneficiary or grantor as owing the assets for estate (or, sometimes, income) tax purposes.

Even though trustees are given total and absolute discretion over distributions, courts generally have still imposed duties on trustees to act in the same within the bounds of reasonable judgment in exercising that discretion. See In re Wilson, 140 B.R. 400 (Bkrcty. N.D. Tex. 1992) (trust allowed distributions in discretion of trustee as the trustee

determines to be in the best interest of the beneficiary; court can not substitute its discretion for that of the trustee and can interfere with exercises of discretionary powers only in cases of fraud, misconduct or clear abuse of discretion); Lucas v. Lucas, 3675 S.W. 2d 372, 376 (Tex. Civ. App.--Beaumont 1962, no writ); RESTATEMENT (SECOND) OF TRUSTS § 187, Comment j (1959) (“trustee will not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust , or ordinarily to act arbitrarily without an exercise of his judgment”).

- d. Trust Protector With Broad Powers of Over Distributions. Foreign trusts have long used the concept of “trust protectors” with extremely broad dispositive powers. Those concepts could be used in domestic trusts also.
- e. Independent Trustee or Trust Protector With Power to Amend Trust or Distribute to New Trust. Give an independent trustee or a trust protector the very broad power to change the terms of the trust or to convey the assets to a new trust. The new trust terms could take into account changes in family situations, assets, or tax laws. An example of such a clause is as follows:

“This trust may be amended by the Trust Protector to the minimum extent necessary to achieve the settlor’s objective to benefit his wife and his descendants and minimize federal income, estate, gift and generation-skipping transfer taxes; provided, however, that during the settlor’s lifetime, no amendment shall be made to Paragraph [one retaining the settlor’s power to amend and revoke, and giving that power to the attorney in fact] and no amendment shall be effective without the settlor’s prior written consent; provided further, however, that the settlor shall be presumed to have consented to an amendment thirty (30) days after written notice is mailed to the settlor (and his guardian or attorney-in-fact if the settlor is under a disability) and no response is received. The Trust Protector also may amend the administrative provisions of this Trust to the minimum extent necessary to cause an institutional Trustee to accept appointment as a Trustee. Notwithstanding the foregoing, no amendment may be made which would reduce the amount passing to the marital trust determined as of the settlor’s date of death, disqualify property passing to the marital trust for the federal estate tax marital deduction or the basis adjustment allowed under section 1022(c), or disqualify any disclaimer under section 2518.” Berall & Harrison, Should We Anticipate 2010 and the Arrival of Carryover Basis? Is There Planning That Can Be/Should Be/Must Be Done Now? What About a “Head-In-The-Sand” Prayer That It Never Becomes a Reality (Or “I’ll Be Retired By Then”), ANNUAL NOTRE DAME TAX & ESTATE PL. INST. at 23-35 (2001).

For a lengthy example of a Trust Protector clause, see Gassman & Gullecas, Practical Planning Techniques and Client Communication Tools for Estate Tax Planners After EGTRRA of 2001, Leimberg Information Services (July 31, 2001). For an earlier outstanding article with forms for powers of amendment, powers to create new trusts, and special powers of appointment for building flexibility, see McBryde & Keydel, Building Flexibility in Estate Planning Documents, TRUSTS & ESTATES 56 (Jan. 1996).

Whenever anyone is given the broad power to amend the trust terms, the planner must be careful that the power cannot be exercised in a manner that would disqualify a desired marital deduction, charitable deduction, or annual exclusion.

- f. Exoneration From Liability. Finding someone willing to serve as a trustee or trust protector with extremely broad powers to amend the trust may be difficult. There is very little case law in the United States regarding the liability of trust protectors. The trustee or trust protector who is given such broad authority will typically be given a broad exculpation from

liability for either exercising or failing to exercise the broad power to change trustees, amend the trust, or distribute the trust assets to a new trust.

Alan Grossman, from Clearwater, Florida, offers the following as an example of an exculpatory clause for trust protectors:

“A Trust Protector shall have no duty to monitor any trust created hereunder in order to determine whether any of the powers and discretions conferred under this instrument should be exercised. Further, the Trust Protector shall have not duty to keep informed as to the acts or omissions of others or to take any action to prevent or minimize loss. Any exercise or non-exercise of the powers and discretions granted to the Trust Protectors shall be in the sole and absolute discretion of the Trust Protector, and shall be binding and conclusive on all persons. The Trust Protector is not required to exercise any power or discretion granted under this instrument. Absent bad faith on the part of the Trust Protector is exonerated from any and all liability for the acts or omissions of any other fiduciary or any beneficiary hereunder or arising from any exercise or non-exercise of the powers and discretions conferred under this instrument.” Glassman & Gullecase, Practical Planning Techniques and Client Communication Tools for Estate Tax Planners After EGTRRA of 2001, Leimberg Information Services (July 31, 2001).

6. Testamentary Planning—Be Sure Flexibility Does Not Disallow Marital or Charitable Deduction. Assets must “pass” to the spouse from the decedent to qualify for the marital deduction. I.R.C. § 2056(a). Any assets after death that might possibly be diverted from the spouse after death will not qualify for the marital deduction. In addition, for a QTIP trust, no one (including the spouse) can have any power to divert benefits to anyone other than the spouse during his or her lifetime. Similarly, no one should have the power after the decedent’s death to direct assets from charity in a manner that would cause loss of the charitable deduction. Therefore, any power to change the testamentary plan must be exercised before the testator’s/settlor’s death.
7. Revocable Trust; Powers of Appointment, Broad Dispositive Powers for Trustee, Trust Protector. A revocable trust agreement could give an independent trustee, a trust protector, or other non-beneficiary persons the power to make distributions from a revocable trust, to convey assets to new trusts, or to change the trust terms. Such provisions would clearly seem to be recognized under traditional trust law principles. This provides a way for a person who does not want to draft a multi-volume will to make appropriate adjustments to the plan as future tax laws change, if the person becomes incompetent. An obvious downside is that this is an extremely broad power that could be used to disrupt the client’s intentions. However, clients may be very comfortable giving this power to their spouses in homogeneous family situations. Safeguards against abuse could include (i) giving precatory direction to the powerholder (which would be helpful in almost all situations), (ii) using a checks and balances system that would require multiple persons to agree with certain changes, and (iii) providing that the power would exist only following the disability of the settlor (but this would require being able to convince third parties of the settlor’s incapacity).
8. Revocable Trust, With Power of Attorney to Revise Trust. As a general rule, agents acting under a power of attorney do not have the authority to change the principal’s **will**. However, at least in some states, a power of attorney can authorize an agent to change the agent’s revocable trust. E.g., CALIF. PROB. CODE § 4264 (agent under durable power of attorney can—in addition to a list of enumerated powers—create, modify, or revoke a trust if it is expressly authorized in the power of attorney); FLA. STAT. § 709.08(7)(b) (agent under power of attorney may “[c]reate, amend, modify, or revoke any document or other disposition effective at the principal’s death or transfer assets to an existing trust created by the principal . . . [if and only if] expressly authorized by the power of attorney”; but agent may not “[e]xecute

or revoke any will or codicil for the principal”); INDIANA CODE § 35-5-5-15 (agent may “exercise all powers with respect to estates and trusts the principal could exercise. However, the attorney in fact may not make or change a will”); INDIANA TRUST CODE § 30-4-3-1(d) (“Unless the terms of the trust provide otherwise, a power of revocation or modification may only be exercise by the settlor personally”); REV. CODE WASH. § 11.94.050 (power of attorney may authorize agent to make, alter, or amend trusts, life insurance policies, annuities, beneficiary designation, securities in beneficiary form, payable on death beneficiary designations, community property agreements and any other provision for non-probate transfer at death in non-testamentary instruments, but does not allow any authority to make, amend or revoke a will or codicil”).

The power of attorney would have to contain very explicit authorization. The power of attorney should obviously be a durable power of attorney, that would survive the principal’s incompetency. In light of the very broad authority under this power to totally change the settlor’s estate plan, the principal might want to condition the power on the settlor’s incompetency.

9. Power of Attorney to Revise Will. Giving an agent a power of attorney to change the principal’s will would not be recognized in most states. E.g., INDIANA TRUST CODE § 30-4-3-1(d); REV. CODE WASH. § 11.94.050.

In some states, a court in a conservatorship or guardianship proceeding, may authorize making or amending an estate plan or a will. CALIF. PROB. CODE § 2580(b)(13) (conservator may seek authority to make a will); INDIANA CODE § 29-3-9-4 (Guardianship Code authorizes implementation of court-determined estate planning).

F. Miscellaneous Drafting Issues.

1. Definition of “Repeal”. Formula clauses that describe differing dispositions if there is repeal of the estate tax must carefully define repeal. The clause should not say “if I die after the federal estate tax has been repealed, ...” because it may be repealed in 2010, but be reinstated under the sunset provision in 2011. If the client dies in 2012, the estate tax literally “has been repealed” and an ambiguity would result. A preferable approach would be to draft “if I die when the federal estate tax is not applicable” Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 129 (2001).

In addition, such clauses should refer to federal, and not state death taxes, because it is likely that many states will continue to have state death tax systems even if the federal estate tax is repealed. For further discussion of the practical problems of defining when “repeal” is deemed to occur, see Part Two, Section II. C. 2. of this outline.

2. Reference to Estate and GST Tax Code Sections. The 2001 Tax Act does not repeal the estate tax sections from the Internal Revenue Code in 2010, but just states that for persons in 2010, that chapter 11 and chapter 13 “shall not apply.” I.R.C. §§ 2210 & 2664. Technically, the estate tax provisions are not repealed--they would just have no effect for decedents dying in 2009. What if the will or revocable trust uses formulas based on estate or GST code provisions that no longer apply if a person dies after 2009? Lloyd Leva Plaine suggests the following definition:

“(a) “Code” refers to the Internal Revenue Code of 1986, as amended, and reference to any provision or section of that Code shall be deemed to refer to the provision or section of the federal tax laws, in effect on the date of my death, that corresponds to the provision or section referred to that was in effect at the time of the execution of this

instrument. Notwithstanding the provisions of the previous sentence, if there is no provision or section of the federal tax law at the date of my death that corresponds to such provision or section, and if the federal estate tax is not applicable (as defined in Paragraph (b) of this Item) at my death, then [for purposes of determining the amount of property that passes under a provision of this instrument and/or for any other purpose(s), even if not for all purposes or references to a provision or section of the federal tax law, a reference to a provision or section of the federal tax law shall nevertheless be deemed to refer to the provision or section that was in effect at the time of the execution of this instrument or the provision that was in effect immediately before the tax law became inapplicable, if the independent executor or nonbeneficiary trustee, in his sole discretion, determines that such result or results is more consistent with my intention.]

[ALTERNATIVE FOR BRACKETED CLAUSE: such provision or term shall be interpreted by the independent executor or nonbeneficiary trustee in such manner as such independent executor or nonbeneficiary trustee considers advisable keeping in mind the general scheme of distribution of this instrument and the purposes for which any trusts created herein are being established.] The provisions of the previous sentence shall not apply if their inclusion in this instrument would cause any property passing under this instrument that would otherwise qualify for the federal estate tax, marital deduction, charitable deduction, special use valuation or Qualified Family Owned Business deduction, to fail to qualify. The independent executor or nonbeneficiary trustee shall not bear any liability for any decision made by such person in good faith pursuant to the power granted to him under the terms of the second sentence of this Subparagraph.

(b) For purposes of this instrument, the federal estate tax shall be “applicable” at a person’s death if the federal estate tax of Subtitle B, Chapter 11 of the Code (Sections, 2001, et. seq.) is then applicable and a federal estate, federal inheritance, or other federal transfer tax is imposed on such person’s assets on account of his or her death and shall not be applicable if the federal estate tax of Subtitle B, Chapter 11 of the Code (Sections 2001, et. seq.) is not then applicable and no federal estate, federal inheritance, or other federal transfer tax is imposed on such person’s assets on account of his or her death.”.

Plaine & Wilkenfeld, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 135-36 (2001).

3. Marital Deduction “Unidentified Asset” Clause. Formula marital deduction clauses often provide that any assets that would not qualify for the marital deduction must pass to the bypass trust. The “unidentified asset” clause is included because of Regulation §20.2056(b)-2, which provides that the marital deduction is reduced to the extent that it could be funded with assets that do not qualify for the marital deduction. If there is no estate tax, and therefore no marital deduction, no asset could qualify for the marital deduction, so this clause might be interpreted to leave the entire estate to the bypass trust. Plaine, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, 27 ACTEC J. 119, 133 (2001). The unidentified asset clause is of limited utility, following 1981 when it became possible to make a QTIP election for many types of previously nondeductible terminable interests. The clause should probably be eliminated in many plans, but in any event, give careful consideration of whether to leave this clause in wills and revocable trusts as we near 2010 if it appears that the estate tax will “stay repealed.”
4. Trustee Removal Clauses. Revenue Ruling 95-58, 1995-2 C.B. 191, provides that section 2038 is not triggered by the retained power to remove a trustee and appoint a successor who is not the grantor or a person who is related or subordinate to the grantor within the meaning of I.R.C. § 672. That issue also arises under section 2041, and the IRS has extended the

same principle of Rev. Rul. 95-98 to section 2041 in Letter Ruling 9735023. If there is no estate tax, such limitations on the appointment of successor trustees would be unnecessary, and may not be desired by the client. A trustee removal clause may be drafted to permit removal and appointment of successors by reference to what is permissible under section 2041. That may be meaningless if there is no section 2041 following repeal. Plaine, Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, at 36 (July 2001).

- G. Pre-Mortem Planning in Late 2001. As morbid as it might seem initially, terminally ill clients who will be subject to estate taxes at death (i.e., there will be no marital deduction) should consider not having Directives to Physicians (or "living wills") in effect during 2001. Persons dying in January, 2002, rather than in December, 2001, get the benefit of a decrease of rates, from the top marginal bracket of 60% (for estates over \$10 million) or 55% (for estates over \$3 million) to 50%, and the increase of the exemption from \$675,000 to \$1.0 million. This can result in a substantial overall estate tax savings.

II. TRANSFER PLANNING; IRREVOCABLE TRUSTS.

A. Transfer Planning Still Important.

1. Estate Tax Not Repealed for Nine Years. Even if the client believes the estate tax eventually will be repealed, the estate tax is not repealed for another nine years. While the top marginal rates drop somewhat over that period, there is still a top marginal rate of 45%. If the client's estate will not likely fully be sheltered from the estate tax by the increasing exemption amounts, the client will probably be as motivated to avoid a 45% tax as to avoid a 55% tax. Transfer planning to shift appreciation over the next nine years would still be important for those clients, in case the client were to die before the estate tax is repealed.
2. Possibility of Legislative Change. The mere existence of the sunset provision assures that the revisions made in the 2001 Tax Act will be revisited. The increasing budget demands and the specter of budget deficits rather than surpluses all suggest that there will be increasing scrutiny on a tax that only impacts a very small percentage of the country. (If the exemption were to end up permanently at somewhere between \$2.0 and \$3.5 million, the percentage of estates that would be subject to the estate tax could be well under 1% of all decedents.) Most wealthy clients have expressed extreme doubt that the estate tax will remain repealed after 2009. Transfer planning, to remove future appreciation from the transfer tax base, continues to be important until there is certainty (if there ever can be certainty) that the estate tax will remain repealed.
3. Desire to Make Family Transfers in Light of Continuing Gift Tax. The gift tax is not repealed, and many wealthy families will not be willing to wait until their deaths (when their children actuarially would be in their 60s) before making transfers of enjoyment of the family wealth to their children and grandchildren. Many clients experience a great deal of joy and satisfaction in being able to transfer assets to their descendants while the parents can watch them enjoy (and see how they manage) the assets.

B. Transfers Without Gift Tax.

1. Emphasis on Transfer Without Gift Tax. In light of the possible repeal of the estate tax, clients will be more reluctant than ever to pay gift tax. Transfers that can be made without payment of current gift taxes will become paramount in transfer planning.
2. Great Timing. The timing is great for transfer planning in light of (i) current depressed valuations of stocks and other assets, and (ii) extremely low interest rates (and AFRs).

3. Using Exclusions. Transfers covered by the gift tax annual exclusion (\$10,000, indexed for inflation from 1997), the tuition exclusion and the medical exclusion can be made free of gift tax or use of the estate and gift tax applicable exclusion amount. Over time, substantial values can be transferred within the exclusion amounts.
4. Section 529 Plans. A planning technique that is seeing much more interest under the 2001 Tax Act is to utilize annual exclusions to make gifts to "qualified state tuition programs" (often referred to as Section 529 plans) for children or grandchildren. See generally Schlesinger, Qualified State Tuition Programs; More Favorable After 2001 Tax Act, 28 EST. PL. 412 (Sept. 2001).

Using Section 529 plans for gifting purposes is very tax advantageous. The gifts qualify for the gift tax and GST tax annual exclusion even though (a) the donor retains the right to change the beneficiaries of the plan at any time, and (b) the donor can re-acquire the funds at any time (although there would be an income tax penalty for doing so.) In addition, the plans are even more advantageous under the 2001 Tax Act because all income earned by the fund will be forever exempted from federal income tax as long as the assets are used for specified education purposes. I.R.C. § 529(a). The assets that remain in the plan at the donor's death are excluded from the donor's gross estate for estate tax purposes (except for a prorated amount if the donor makes the five year election and dies within that five year period, as described below). Prop. Reg. § 1.529-5(d)(1). (If a beneficiary dies before the plan assets have been used, the assets are in the beneficiary's gross estate, I.R.C. §529(c)(4)(B), but the beneficiary's estate often would be covered by the estate tax exemption amount.)

Transfers to such plans qualify for the gift tax and GST tax annual exclusion, and an election may be made to utilize annual exclusions for up to five years in funding a Section 529 Plan for a beneficiary. I.R.C. § 529(c)(2)(B); Prop. Reg. § 1.529-5(b)(2)(if aggregate contributions exceed gift tax annual exclusion for current year, donor may elect to have total contribution taken into account for gift tax purposes ratably over a five-year period).. *For example, a married couple with four grandchildren children can each "front load" contributions to a Section 529 plan in the amount of \$50,000 for each grandchild, thus instantly removing 2 donors X \$50,000 X 4 grandchildren, or \$400,000 from their estates without using any of their applicable exclusion or GST exemption amounts.* If a donor makes the five-year election and dies before the end of the five-year period, the portion of the contribution (but not the earnings) "allocable to calendar years beginning after the date of death" of the decedent is includible in the decedent's gross estate.

5. Utilize Increased Gift Tax Exemption Amount. The gift tax applicable exclusion amount is increasing to \$1.0 million in 2002 (rather than increasing in stages to \$1.0 million by 2006 under prior law.) Many clients who have previously made gifts to fully utilize their gift tax applicable exclusion amount (currently at \$675,000) will want to make additional gifts in January 2002 to utilize the additional gift exemption amount. However, if an individual has previously made lifetime gifts in excess of the \$675,000 exemption (and paid gift tax), the individual will not just be able to make an additional \$325,000 of gifts in January, 2002. The gift tax is calculated based on the marginal rate imposed on aggregate lifetime gifts (other than gift covered by exclusions), and a gift of a full \$325,000 amount would mean that aggregate lifetime gifts would exceed \$1.0 million. The excess gifts over \$1.0 million are taxed at 41%, while the unified credit will only cover gifts taxed up to 39% under the rate table.

For example, if aggregate lifetime gifts of \$775,000 have previously been made (\$100,000 over the current limit), what is the amount of additional gift (in excess of gifts covered by exclusions) that can be made in January, 2002 without paying gift tax? The credit increases from \$220,550 to \$345,800, or an increase of \$125,250. The prior aggregate lifetime taxable gifts of \$775,000 leave \$225,000 to be taxed at the 39% bracket, which applies on gifts up to

*\$1.0 million (which would use \$87,750 of the credit increase). The remaining credit increase (\$125,250 - 87,750, or \$37,500) would be taxed a 41% bracket. Therefore, additional gifts (above \$225,000) of $\$37,500/.41$, or \$91,463.41, could be made without generating current gift tax. So, total gifts that could be made in January 2002, without paying gift taxes, would be $\$225,000 + \$91,463$, or **\$316,463--rather than \$325,000.***

- a. Maximize Use of Increased Exemptions--Give to Dynasty Trusts. To maximize benefits from the available gift tax exemption amount, consider transfers that would also take advantage of the available GST exemption. The "double dip" would assure that future increases in value will be exempt from both the estate tax and the GST tax.
 - b. Maximize Use of Increased Exemptions--Give to Grantor Trusts. Make gifts to grantor trusts, rather than just using the exemptions with outright gifts, to create the flexibility of selling additional assets to the trusts in the future. (As discussed in Part Two, Section II. B. 8. d. below, sales to grantor trusts are very advantageous, but there must be some minimal equity in the trusts prior to the sale. If all gift exemptions have been utilized with prior gifts other than to grantor trusts, it may be difficult to get the necessary initial "seeding" amount in the grantor trust without further gifts that would generate current gift taxes.)
 - c. Larger Amounts Justify More Detailed Planning. As the gift tax exemption amount increases, and larger gifts can be made to trusts within the gift tax exemption amount, more and more detailed planning is justified for the donee-trusts. Planning considerations that would become more and more important as larger amounts are transferred to the trust include (i) using lifetime trusts for children to provide GST advantages and asset protection advantages, (ii) detailed planning regarding trustees and trustee succession, (iii) detailed planning regarding distribution standards, (iv) possible use of unitrust distribution provisions to build in a greater degree of planning of when distributions would be made to beneficiaries, and (v) possible use of incentive clauses to help assure that the trust assets do not become a disincentive to beneficiaries from becoming productive citizens.
6. Undivided Interest Valuation Adjustments. Making transfers of assets to take advantage of fractionalization discounts can maximize use of available exclusions and exemptions. Available techniques would include transfers of undivided interests in real estate, interests in closely held businesses, and limited partnership interests. For example, making a gift of an undivided 2.5% interest in a vacation home worth \$1,000,000, might be valued at $\$1,000,000 \times .025 \times .80$ (reflecting a 20% undivided interest discount), or \$20,000 (rather than \$25,000 without the discount). Furthermore, that would leave the client owning an undivided interest, and the client's undivided interest might be valued at $\$1,000,000 \times .975 \times .80$, or \$780,000 (rather than \$975,000 without the discount).

Be aware that creating fractionalized interests for the client, with a significant valuation adjustment, might prove disadvantageous if the estate tax exemptions eventually rise to the point of eliminating estate taxes for the client. The step up in basis would be limited to the fair market value of the fractionalized asset (taking into consideration the valuation adjustment.) Even if carryover basis applies, there are substantial basis adjustments permitted up to the fair market value of property.

7. Low Interest Loans. Simple low interest loans afford tremendous appreciation shifting without incurring any gift tax. The AFR (annual rate) for September, 2001 is 3.82% for short term loans (up to 3 years), and 4.82% for mid-term loans (over 3 and up to 9 years). Simple low interest rate loans to children, so that they can invest in assets (with current depressed values) may be able to yield substantial value transfers over the years. Loans to children would cause the donor to receive taxable income as the interest is paid, but if the loan proceeds are used by the children for investment purposes, they should be entitled to receive investment interest

deductions (which results in a further effective transfer from the older generation--the overall income tax to the family may be about neutral, with the older generation reporting income and the younger generation receiving deductions).

Low interest loans or sales of assets with low interest rate loans to grantor trusts (which are treated as being owned by the grantor for federal income tax purposes under section 671-677 of the Code) will avoid having any recognition of interest income or any current recognition of gain on a sale.

8. Leveraged Transfers. Leveraged transfers can maximize use of the available gift tax exemption amount (which will remain fixed at \$1.0 million).

a. Transfers of Fractionalized Interests; Limited Partnership Interests. Transferring fractionalized interests, with appropriate valuation adjustments, can maximize the value of underlying assets that are transferred. Limited partnership interests may be valued at substantial discounts. Efforts by the IRS to ignore the inherent restrictions on the value of limited partnership interests have been rejected by the courts. *E.g.* Kerr v. Comm'r, 113 T.C. 449 (1999); Estate of Strangi v. Comm'r, 115 T.C. No. 35 (2000); Estate of Jones v. Comm'r, 116 T.C. No. 11 (2001); Estate of Dailey v. Comm'r, T.C. Memo 2001-263 (2001) (40% discount for gift of limited partnership interests in partnerships owning only blocks of stock in three publicly traded securities); Estate of Church v. U.S., 2000-1 U.S.T.C. ¶ 60,369 (W.D. Tex 2000), *aff'd in unpublished opinion* (5th Cir. 2001). Transfers under any of the leveraged techniques described below are often made with limited partnership interests.

If estate tax repeal remains in place permanently and carryover basis becomes applicable, there may be a tax reason to liquidate partnerships if all partners are in agreement. Valuation discounts would not save any estate taxes and would limit the basis step (under the \$1.3 and \$3.0 million basis adjustments) to the fair market value of the limited partnership interests.

If the estate tax is repealed permanently, and if the partners do not want to liquidate the partnership (to continue to use the partnerships for various non-tax purposes), the partnership agreement could be revised in a manner that would avoid or minimize valuation discounts. For example, the agreement could be modified to name the parent as the sole general partner, so that the parent's executor could argue that under state law, the decedent had the unilateral power to liquidate the partnership and reach the partnership assets, to minimize or eliminate discounts. Alternatively, the partnership agreement could be revised to give limited partners the right to withdraw and receive a pro rate value of the partnership assets. (Section 2704--which would no longer exist anyway--refuses to recognize partnership provisions that are more restrictive than state law. There is no law that would prohibit recognizing partnership provisions that grant more rights to partners than would otherwise exist under state law.)

b. GRATs. Grantor retained annuity trusts are very advantageous leveraged transfers for various reasons, in maximizing transfer planning in light of the 2001 Tax Act.

(1) Walton GRATs; No Gift on Creation. Under the Tax Court's unanimous decision in Walton v. Comm'r, 115 T.C. No. 41 (2000), gifts to GRATs may result in no (or an extremely small) current gift for gift tax purposes. The IRS has taken the position that under Reg. § 25.2702-3(e) (Ex. 5) transfers to a GRAT would result in an initial gift (sometimes a substantial current gift) because the retained interest had to be calculated based on the right to receive the retained annuity based on the term or the sooner death of the grantor. The Walton case said that the regulation did not apply to a trust, which provided that if the grantor did not survive to receive all of the annuity

payments, the remaining annuity payments would be paid to her estate. GRATs should be structured to follow the Walton format to minimize any gift tax consequences on funding of the GRAT.

Carlyn McCaffrey, in comments at the 2001 ABA Annual Meeting Real Property, Probate and Trust Law Section has suggested the following GRAT structure to comply with the Walton reasoning. Annuity payments would continue to be made to the grantor's estate for the full GRAT term if the grantor dies before the end of the term. If the grantor dies during the term, the grantor would have a testamentary limited power of appointment to specify how the property would pass at the end of the GRAT term. The grantor would bequeath the right to the remaining annuity payments to the spouse and would exercise the power of appointment to leave the remainder of the assets (following the payment of annuity payments for the full GRAT term) to the surviving spouse. This should not create a nondeductible terminable interest because no passage of time will defeat the spouse's right to receive everything that was in the GRAT at the grantor's death.

- (2) Savings Clause. The regulations specifically sanction using a valuation "savings clause" in creating a GRAT. The annuity amount can be specified by reference to a percentage of the originally contributed property. Reg. § 25.2702-3(b)(1)(ii)(B). This substantially reduces the risks of a significant gift tax adjustment in a gift tax audit. A determination that the property was undervalued will operate to increase the amount of the annuity payments, and will not significantly increase the amount of the taxable gift on the creation of the GRAT. (However, the savings clause sanctioned in the regulation only protects against gift tax exposure on a revaluation of the original transfer to the trust--and not transfers of assets in satisfaction of annual annuity payments.) For other transfer techniques, the use of valuation adjustment clauses has been scrutinized by the IRS. See Part Two, Section II. B. 8. e. of this outline.
 - (3) GST Disadvantage May Not Be As Important Under 2001 Tax Act. One of the disadvantages of using a GRAT, as compared to other transfer techniques, is that GST exemption cannot be allocated until the end of the GRAT term. However, if one believes that the GST tax ultimately will be repealed, this disadvantage would not be important.
- c. Sales of Assets to GRAT Remainder. Another method of maximizing leveraged transfers, without paying current gift taxes, would be to seed assets to the vested remainder interest under a GRAT. For example, assume that a GRAT currently has assets worth \$1.0 million that requires an additional annuity payment of \$200,000 to the grantor in one year. If the grantor survives another year, and if the assets remain the same value, the GRAT provides that the remaining assets (or \$800,000) will be distributed to an existing irrevocable grantor trust. While the trust that will receive the remainder interest has no assurance that the grantor will survive the remaining year, or that the GRAT trust assets will not depreciate, the value of the remainder can be valued actuarially. The client might decide to sell additional assets to the irrevocable grantor trust, taking into consideration the present actuarial value of its interest in the GRAT. In effect, the remainder value in the GRAT could provide the "seed" money to justify a substantial current sale of assets to the trust. Advantages of the sale include (1) appreciation over the next year will have been shifted to the trust, and (2) if the trust is GST exempt, appreciation over the next year will be in a GST exempt trust without the requirement of allocating additional GST exemption. There are no cases (and no commentary that I am aware of) discussing this very attractive planning alternative.

d. Sales to Grantor Trusts.

- (1) Continues as Very Effective Leveraged Transfer Strategy. A very effective method of transferring future appreciation with a minimum of current gift taxable transfers is to sell assets to an irrevocable grantor trust, which is treated as being owned by the grantor for federal income tax purposes but which is excluded from the grantor's estate for estate tax purposes. Highly appreciating (hopefully) assets are sold to the trust in return for a low interest note. (For example, using the September 2001 AFR, the note could be a 3 year note with a 3.82% interest rate, or a 9 year note with a 4.82% interest rate.) Advantages of this technique include (i) all appreciation above a very low interest rate is transferred, (ii) no gift results from the sale, (iii) there is no requirement that the seller survive a specific number of years, (iv) the trust can be GST exempt from the outset (as compared to a GRAT, which can have GST exemption made to it only at the end of the GRAT term), (v) the note may provide for very low annual payments (perhaps interest only) with a balloon payment at the end, and (vi) there will be no gain recognition on the initial sale to the trust (at least as long as the grantor survives and the trust is a grantor trust), and (vii) interest payments will not generate taxable income as long as the trust is a grantor trust.
- (2) Shift Toward Using Longer Term/Slower Pay Notes. There may be more of a shift toward using extremely slow pay notes (perhaps even balloon notes that are due just before the seller's anticipated life expectancy.) If the note is never paid, and if the seller lives to 2010, and if the estate tax is (and stays) repealed, the grantor could bequeath the note to the trust (or to beneficiaries of the trust) with no estate tax.
- (3) Sale With Bequest of Note. If the estate is repealed, the remaining note could be bequeathed to the purchaser with no estate tax. Thus, sales will be extremely efficient ways to transfer assets during lifetime without gift taxes.
- (4) Easier to Provide "Equity Cushion" With Increased Gift Tax Exemption. One of the disadvantages of the sale to grantor trust technique is that there must be some initial funding in the trust before sale. A rule of thumb (and only a rule of thumb) is that the trust should have a net value of about 10% of the value sold to the trust. However, the increase of the gift exemption under the 2001 Tax Act to \$1.0 million in January, 2002 makes it easier to get a significant initial "seed" amount into the irrevocable trust without having to pay current gift taxes.
- (5) Shift Toward Using Lesser Equity Cushion If No Estate Tax Concern. If there is no estate tax, there may be a shift toward using less equity cushion on the trust to support notes given by the trust. Part of the concern over having a sufficient equity cushion in the trust is to avoid a section 2036(a)(1) argument, that the seller has made a transfer and retained all of the income from the transferred assets. (That reasoning has been used to invalidate some private annuity transactions where an asset was sold to a trust with few other assets in return for a private annuity. E.g., LaFargue v. Comm'r, 800 F.2d 936 (9th Cir. 1986); Benson v. Comm'r, 80 T.C. 789 (1983).) That issue will not be important if there is no estate tax. A related issue that would continue to have importance is whether the sale would be treated as a deemed gift if there is not sufficient equity in the trust to support the valuation of the note given by the trust.
- (6) Continuing Disadvantage--No Sanctioned Value Savings Clause. Another disadvantage is that there is no IRS sanctioned valuation savings clause that can be used with respect to either the initial gift to the trust, or the sale to the trust.

- e. Defined Value Clauses. Because of the added importance of avoiding payment of current gift taxes in an environment where estate taxes may not apply to a client (either because of estate tax repeal or because of the greatly increased estate tax exemption amount), defined valuation clauses take on added importance. The IRS traditionally has refused to give effect to valuation savings clauses. E.g., Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert denied, 323 U.S. 756 (1944); Ward v. Comm'r, 87 T.C. 78 (1986); Harwood v. Comm'r, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986); Rev. Rul. 86-41, 1986-1 T.C. 300. However, the Tenth Circuit Court of Appeals recognized a sale adjustment clause in a sale agreement if the IRS determined that the stock was sold for less than fair market value. King v. U.S., 545 F.2d 700 (10th Cir. 1976).

An alternative, that seems distinguishable, is a clause that defines the transfer in terms of the value of the property. This type of clause was approved by the IRS in Technical Advice Memorandum 8611004, where the decedent had assigned “such interest in x partnership ... as has a fair market value of \$_____.” The valuation savings clauses invalidated by Procter and its progeny have generally involved situations in which the transferee either conveys some of the transferred property back to the transferor or pays any “excess value” to the transferor. A defined value clause is distinguished because it is fundamental in defining the amount initially transferred, and is not just a “condition subsequent.” If the defined value clause were invalidated, it would be impossible to determine the amount of the gift because the clause itself defines the amount of the transfer. See McCaffrey & Kalik, Using Valuation Clauses to Avoid Gift Taxes, 125 TR. & EST. 47 (Oct. 1986). Traditional marital deduction formula clauses in wills are classic examples of defined value clauses that have been recognized for the IRS for many years. The formula amount that is transferred to the bypass trust is defined in terms of the value of the property.

An example fractional formula transfer clause, with a provision for a small gift being produced if the IRS asserts higher values for gift tax purposes (to rebut a possible “mootness” argument), is as follows:

“I hereby transfer to the trustees of the Trust a fractional share of the property described in Schedule A. The numerator of the fraction is (a) \$1,000,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the “Gift Tax Value”) over \$1,000,000. The denominator of the fraction is the Gift Tax Value of the property.” McCaffrey, Tax Tuning the Estate Plan by Formula, UNIV OF MIAMI SCHOOL OF LAW PHILIP E. HECKERLING INST. ON EST. PL. 3-14 (1999).

The Tax Court recently refused to recognize a defined value clause in a gift transaction because the parties did not respect the clause. Knight v. Comm'r, 115 T.C. No. 36 (2000). The IRS has recently addressed a defined value clause-type situation in Field Service Advice Memorandum 200122011. In that FSA, a transfer was made to a children's trust of a percentage interest in a partnership equal to \$x, and the balance of the partnership interest was transferred to a charity. The charity obtained an appraisal and sold its partnership interest back to the partnership, in redemption of its interest. The IRS viewed this as a Procter-type clause that would not be respected. The underlying case addressed in that FSA has been tried, but no opinion has yet been issued.

- f. Consideration in Whether to Report Non-Gift Transfers. The adequate disclosure regulations expressly permit the disclosure of a transfer or other transaction that is not viewed as a gift, to start the statute of limitations for gift tax purposes. Reg. § 301.6501(c)-1(f)(4). Examples of such non-gift transfers could include gifts that qualify for the annual exclusion, a possible gift portion of a sale transaction, and a gift that is incomplete because

of a retained power or interest Reg. § 301.6501(c)-1(f)(5). An oft-debated question is whether to report non-gift transfers on a gift tax return. The advantage is that the reporting triggers the running of the statute of limitations on the reported value. A downside is that the disclosure may bring IRS attention to a transaction that might otherwise go undetected. The 2001 Tax Act may provide additional fodder for the argument not to report. If the transaction is not reported on a gift tax return, it will most likely come up (if at all) on the estate tax return for the donor at his or her subsequent death. If the client is unlikely to file an estate tax return at his or her death (due to increased exemption amounts or repeal of the estate tax), the client may be less inclined to report the transaction currently on a gift tax return.

- g. Private Annuities and Self-Canceling Installment Notes. Private annuities and self-canceling installment notes are helpful in situations where the client is not expected to live to full life expectancy. The full value of the asset transferred in the sale transaction is removed from the estate and the client may receive relatively few payments in return to be included in the client's gross estate for estate tax purposes. If a client has concerns about the likelihood of living to 2010, but if the client still has a long enough life expectancy to use the IRS's actuarial tables in valuing annuity and lifetime payments, the client might consider using a private annuity or self-canceling installment note sale. However, clients with a long life expectancy (well past 2009) may be less inclined to use a private annuity or self-canceling installment note. If the client has no estate tax concerns after 2009 (due to repeal or the increased exemption amount), the transactions would not save estate taxes but may result in additional income tax costs. There is an ordinary income element in each annuity payment in a private annuity transaction, see Rev. Rul. 69-74, 1969-1C.B. 43, and the decedent's estate may recognize gain on the cancellation of an installment note, see Estate of Frane v. Comm'r, 998 F.2d 567 (8th Cir. 1993).
- h. Qualified Personal Residence Trust. A QPRT does result in some significant gift element, unlike a GRAT which can be structured to result in no gift for gift tax purposes. If a client has a substantial amount of gift tax exemption left, this may be of no concern to the client, if he or she would not likely make gifts of other assets. However, for the client who does want to maximize current transfers to descendants, the QPRT may not be as attractive as other techniques in utilizing the client's available gift tax exemption.
- i. Split Purchase Transactions. Split interest transfers offer the possibility of extreme leveraged transfers. Under this technique, younger generation beneficiaries would purchase the remainder interest in an asset following the life estate or term interest of older generation family members. The remainder interest may be valued at a very low amount, based on the life expectancy of a life tenant in the case of a life estate or the expected term of a term interest. Cases over the last five years have recognized that sales of remainder interests, for the actuarial value of the remainder interest, should be effective in removing the full value of the underlying property from the client's estate. E.g., Estate of Magnin, 184 F.3d 1074 (9th Cir. 1999); D'Ambrosio, 101 F.3d 309 (3rd Cir. 1996); Wheeler, 116 F.3d 749 (5th Cir. 1997). Those cases involve situations that were not subject to section 2702. However, if a remainder interest is purchased in a transaction where the parent retains an interest that constitutes a qualified interest under section 2702, the transaction should be recognized. For example, children could purchase (with "old and cold money") a remainder interest in a vacation home following the joint lives of the parents. No gift would be made at all for gift tax purposes. None of the value of the vacation home would be included in the gross estate of the parents at their subsequent deaths, even though the parents may have paid most of the purchase price of the home, based on the actuarial of the life estates for the last of them to die. For an outstanding discussion of the advantages, disadvantages, and planning ramifications of this technique, see Zaritsky, GRATs, GRUTs and QPRTs (and Competing Techniques for Large Intrafamily Transfers), 2001 UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL

(Workshop Materials) at 2-91 to 2-98 (2001); & Jacobs, Splitting The Difference, Bloomberg Wealth Manager 48 (March 2001).

9. Take Steps to Delay GST Transfer. In designing newly created irrevocable trusts, take steps to minimize the likelihood of a taxable distribution or taxable termination before 2010 (in light of the possible repeal of the GST tax in 2010.) Do not provide mandated distributions to younger generations before 2010, and maximize the number of non-skip person beneficiaries of each trust (to minimize the possibility of a taxable termination by the deaths of all non-skip person beneficiaries before 2010).

For existing non-exempt trusts, consider having someone exercise a limited power of appointment (if it exists) to designate additional non-skip person beneficiaries, or consider a court reformation proceeding to add additional potential non-skip person beneficiaries.

10. Gift Selection—High Basis Assets. If the donor considers whether to give high or low basis assets in selecting the appropriate gift assets, generally speaking, gifting high basis assets continues to be advisable. Even if carryover basis eventually applies, the significant basis adjustments that would be available at the donor's death may be sufficient to provide a full basis step-up for the retained low basis assets.

C. Irrevocable Trusts With "Bail-Out" Flexibilities.

As discussed in Part Two, Section II.A. above, transfer planning is still important for various reasons. However, if estate tax repeal becomes permanent, or if the estate tax no longer applies to the donor because of increases in the estate tax exemptions, even taking into account the trust assets, the transfers will no longer save estate taxes, and the donor may wish to regain as much control and interest as possible in the transferred assets.

Some of the "bail-out" alternatives depend upon giving an independent trustee or a "trust protector" the authority to make special distributions or to make trust changes of various kinds at a described time (such as when the estate tax no longer applies). The concept of a trust protector is not new (and is rather common in planning with foreign trusts). For examples of the types of powers that can be given to a trust protector, see Part Two, Section I.E.5. of this outline.

1. Summary. Examples of additional control/beneficial interest features that might be used once an "estate tax repeal trigger" (see Part Two, Section II.C.2. below) occurs are as follows.
 - a. Trustee Removal. The power to remove the trustee without having to appoint an "independent" party as successor trustee.
 - b. Permit Trustee Remover to Name Donor as Successor Trustee. An independent party could be given the power to remove the trustee and name the donor as successor trustee. However, there should still be ascertainable standards on distributions. See Part Two, Section II.C.3.a. of this outline.
 - c. Permit Donor To Remove and Appoint Self as Successor Trustee. As described above, the donor's distribution authority as trustee should be limited by an ascertainable standard.
 - d. Inclusion of Spouse As a Beneficiary Currently. If the spouse does not own any interest in the transferred property, the spouse could be made a current discretionary beneficiary of the trust from the outset. See Part Two, Section II.C.4. of this outline.
 - e. Shift to Spouse as Primary Beneficiary. If an estate tax repeal trigger occurs, an independent party could have the right to cause the donor's spouse to become a (or the primary) beneficiary of the trust. If there is no estate tax, assets could then be distributed

to the spouse, as appropriate, and the donor/spouse marital unit could get back the assets when there is no longer an estate savings for having assets in trust. As long as the spouse does not contribute to this trust, having the spouse as a potential beneficiary should not subject the trust assets to the spouse's creditors' claims.

- f. Distribute All Assets to Spouse. Rather than just causing the spouse to be a beneficiary, the estate tax repeal trigger could trigger some independent party's authority to distribute the assets outright to the spouse.
 - g. Granting Spouse Power of Appointment, Including to Donor, Currently. If the spouse has a power of appointment to appoint the assets outright or in trust for the donor at a later time, the existence of the power (if there is no understanding that it will be exercised in favor of the donor) should not cause estate inclusion problems for the donor. (However, there is relatively little law on point.) See Part Two, Section II.C.5. of this outline.
 - h. Granting Spouse Power of Appointment, Including to Donor, Upon Estate Tax Repeal Trigger Event. Alternatively, the spouse's power of appointment could arise only on the occurrence of an estate tax repeal trigger.
 - i. Terminate Trust Early and Distribute to Children. An independent trustee or trust protector could have the authority to terminate the trust early and distribute the assets to children-beneficiaries (if the trust no longer had GST benefits, and if the family determined that they did not want asset protection for the children-beneficiaries.)
 - j. Power to Retransfer to Donor After Estate Tax Repeal Trigger. Perhaps the ultimate in a bail-out provision would be the explicit direction or authority of an independent person to distribute trust assets directly to the grantor after the estate tax repeal trigger occurs. If the donor dies before 2010, would the mere existence of this clause cause the trust assets to be included in the grantor's estate? See an extended discussion of this issue in Part Two, Section II.C.6. of this outline.
2. Determining When Additional Control/Increased Interest Features Would be Triggered. The trustee might want to regain control and regain some degree of beneficial interest in the trust whenever the trust no longer saves estate taxes for the donor. That might occur either because the estate tax exemptions increase enough so that the trust assets, when combined with the donor's other assets, still would not generate an estate tax to the donor. Alternatively, the clause might be triggered if estate tax repeal became "permanent."

References in this section to "estate tax repeal trigger" refer to the event or events as described in the trust instrument that would apply if the estate tax does not apply to the donor or if the estate tax is repealed within the described definition.

- a. Formula Defining Estate Tax Repeal Trigger. Both of those triggers would be difficult to define in the trust instrument. There is no assurance that a mere increase in estate tax exemptions would prevent estate taxes to the donor in the future. That would depend on future tax law changes and the degree to which the trust assets and the donor's other assets subsequently increased in value. Similarly, drafting a provision that triggers upon an estate tax repeal is problematic. The estate tax is repealed under the 2001 Tax Act, but only for one year. Therefore, the clause cannot be triggered simply upon the repeal of the estate tax. Even if the estate tax repeal survives sunset of the 2001 Tax Act, how would we know that the estate tax would not be reenacted one, two or five years later if budget deficits occur? (However, if that were to happen and the donor had not regained actual ownership of the assets, it is possible--if not likely--that the trust would be grandfathered from application of the new estate tax.)

- b. Formula Based on Estate Tax Not Applying After Specified Date. Perhaps the clause could be triggered if there is no federal estate applicable to the donor for a specified number of years. For example, perhaps that would be if there is no federal estate tax applicable after 12-31-2011. The 2011 date would be used to assure that the estate tax stays repealed for at least a minimum amount of time after the planned sunset. Alternatively, a date two, three, four, or five years later could be used--to give more comfort that the estate tax will stay repealed.
- c. Give Independent Party Discretion to Determine Estate Tax Repeal Trigger. In light of the difficulty in fashioning an objective formula, another possibility would be to give an independent party (someone other than the donor or any potential beneficiary) considerable discretion to determine when the estate tax repeal provisions would apply. This would be especially important if the trigger can occur not only upon the repeal of the estate tax, but when the estate tax becomes irrelevant to the donor and the donor's family due to increased exemptions.

3. Features Affording Flexibilities to Regain Control.

- a. Independent Trustee With Very Broad Powers. Under traditional planning principles, an irrevocable trust can be planned with an "independent" trustee who could be given extremely broad powers, including broad powers over distributions to beneficiaries, powers to terminate a trust early, and powers to extend a trust beyond the original term (as well as many other broad powers). With careful planning and by prohibiting the trustee from making any distributions for the benefit of the grantor, directly or indirectly, those powers generally can be included without causing estate inclusion for the grantor. This type of plan can indirectly give the grantor a substantial degree of influence over the timing and amounts of distributions from the trust. See Aucutt, Structuring Trust Arrangements for Flexibility, 2001 UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. Ch. 9 (2001); Moore, New Horizons in the Grant and Exercise of Discretionary Powers, 15 UNIV. OF MIAMI INST. ON EST. PL. Ch. 6 (1981) (including discussion of power to make distributions to existing or new trusts).
- b. Trustee Removal Clause. Under current estate tax law, having the donor as trustee can cause estate inclusion problems unless the donor's fiduciary control is strictly limited to distributions within ascertainable standards. Even that authority is not specifically sanctioned by statute or regulations, but by court recognized exceptions. See Estate of Gokey, 72 T.C. 721 (1979), aff'd in part and remanded in part, 735 F.2d 1367 (7th Cir. 1984) ("support, care, welfare and education" of children and "care, comfort, support or welfare" of spouse); Digby, Drafting Donor-Trustee Irrevocable Trusts Without Adverse Income, Gift or Estate Consequences to the Donor and Drafting Defective Grantor Trusts, STATE BAR OF TEXAS 6TH ANN. ADV. DRAFTING: EST. PL. & PROB. COURSE (1995).

To be cautious, irrevocable trusts are typically planned with someone other than the donor as the trustee. Furthermore, giving the donor a removal power over trustees can cause estate inclusion problems unless any successor trustee is subject to the same limitations as would be necessary for the trustee to serve as the trustee directly. Revenue Ruling 95-58, 1995-2 C.B. 191 recognizes that the donor may retain a removal power over trustees without requiring inclusion of the trust assets in the donor's gross estate under section 2038 if the donor must appoint someone who is unrelated and not subordinate to the donor within the meaning of section 672 of the Code. Upon the estate tax repeal trigger, the donor may want to remove restrictions on appointing only an "independent trustee" as the successor trustee, in order to leave the flexibility to maximize the donor's control.

- c. Permit Trustee Remover to Name Donor as Successor Trustee. Upon the estate tax repeal trigger, the instrument might authorize the trustee remover to appoint the donor as a

successor trustee. Alternatively, the trust instrument might provide that the donor would automatically serve as successor trustee whenever a trustee ceases to serve, once the estate tax repeal trigger has occurred. Even in those situations, however, the trustee's distribution authority should be limited by an ascertainable standard. (See the discussion in the preceding paragraph.) Having a contingency beyond the grantor's control before the designation right arises, even where the contingency does not occur before the grantor's death, does NOT prevent the application of section 2036(a)(2), which applies if the grantor retains the power to designate who receives the property or income therefrom. Reg. § 20.2036-1(b)(3).

- d. Permit Donor To Remove and Appoint Self as Successor Trustee. The donor's control would be maximized, upon the occurrence of the estate tax repeal trigger, if the donor had a trustee removal power, and could appoint himself or herself as the successor trustee. The donor's distribution powers as trustee should still be limited by ascertainable standards, or else (as discussed in the preceding paragraph) the trust would be subject to estate inclusion if the donor died before the estate tax repeal trigger occurred. Reg. § 20.2036-1(b)(3).
- e. Retain Limitation on Making Distributions to Donor or in Satisfaction of Donor's Legal or Contractual Obligations. If the donor should become the successor trustee at some time under any of these flexibilities, it would still be important to keep restrictions on any distributions to the donor or in satisfaction of any of the donor's legal or contractual obligations. If those distributions were allowed, the trust might be subjected to claims of the donor's creditors.

4. Inclusion of Spouse as Beneficiary.

- a. Inclusion of Spouse Currently. Irrevocable trusts can include the donor's spouse as a beneficiary, without creating estate inclusion problems for the donor or the spouse, as long as the spouse does not contribute anything to the trust and as long as the trust assets do not include a life insurance policy on the spouse's life. However, including the spouse as a beneficiary makes the trust a grantor trust for income tax purposes under Section 677(a)(1)-(2), at least as to the income (but perhaps not the corpus) of the trust. Inclusion problems would also exist if the spouse had made transfers to the donor, with the understanding that the donor would retransfer the assets back to the spouse.

If the spouse is a potential beneficiary, the trust instrument should restrict the trustee from making any distributions from the trust in satisfaction of the donor's support obligation. Some courts have held that an independent trustee could be given the *discretion* to make distributions in support of the donor's dependent without directly causing estate inclusion under section 2036(a)(1). Comm'r v Douglass Estate, 143 F.2d 961 (3d Cir. 1944). However, conservative planners typically draft irrevocable trusts to prohibit distributions to the settlor or in satisfaction of the settlor's obligations, partly over concern that a trust with the grantor as a discretionary beneficiary may cause inclusion under section 2036(a)(1) if the grantor's interest would subject the trust to the grantor's creditors claims. See Part Two, Section II.C.6.a.(2) of this outline. Similarly, conservative planners prohibit the trustee from making distributions in satisfaction of legal support obligations of the trustee. See Upjohn v. United States, 72-2 U.S.T.C. ¶ 12,888 (W.D. Mich. 1972). For an excellent discussion of the tax effects if a trust does not absolutely prohibit satisfying legal obligations of the donor or of a trustee, see Pennell & Fleming, Avoiding the Discharge of Obligation Theory, PROBATE & PROPERTY 49 (Sept./Oct. 1998).

A donor might be much more willing to transfer substantial assets to a trust, knowing that the assets could be used to provide for support needs of the donor's spouse.

- b. Inclusion of Spouse if No Estate Tax. Alternatively, the trust instrument could provide that the donor's spouse would become a beneficiary upon the occurrence of the estate tax repeal trigger. This could be the authority to shift the primary beneficiary to the trust to the donor's spouse. This would give assurance that the trust assets could be used to provide for the financial security of the donor's spouse. Also, the trust could give an independent trustee (someone other than the donor, the donor's spouse, or any potential beneficiary of the trust) the authority, following the occurrence of the estate tax repeal trigger, to have wide discretion in determining when to make distributions to the spouse, including outright distribution of the entire trust assets to the spouse.
5. Spouse With Broad Limited Power of Appointment, Including Appointment to Grantor. A person other than the grantor, including the grantor's spouse, could be given a broad inter vivos or testamentary power of appointment to appoint the trust assets to anyone, including the grantor, other than the appointer (or his creditors, or estate or creditors of his estate). Alternatively, this power of appointment could be limited to a testamentary power of appointment, particularly for the grantor's spouse. In this manner, the trust could provide support to the donor's spouse for his or her lifetime, then be made available back to the donor for his or her lifetime.

- a. Completed Gift for Gift Tax Purposes. Despite the fact that the property may eventually be returned to the donor, the transfer is a completed gift, because the donor has so parted with dominion and control as to leave him in no power to change its disposition whether for his own benefit or for the benefit of another. Reg. § 25.2511-2(b). Also, the donor has retained no power to revest beneficial title to the property in himself, which also makes a gift incomplete. Reg. § 25.2511-2(c). Letter Ruling 9141027 held that a transfer to an irrevocable trust for the donor's spouse was a completed gift even though the spouse had a special testamentary power of appointment to appoint the assets to a trust for the benefit of the donor, and even though the IRS found that an implied agreement existed between the spouses that the donee spouse would in fact execute a codicil to her will appointing the trust assets to a trust for the benefit of the donor. However, to assure that the initial transfer is treated as a completed gift, there should be no express or implied agreement regarding the exercise of the power of appointment.

Furthermore, if a creditor of the donor could reach the trust assets, the gift would be incomplete. Until the power of appointment is exercised appointing some interest in the property to the creditor, a creditor arguably would have no rights in the trust property. However, if the spouse holds an inter vivos power of appointment and if the donor's creditor is also a creditor of the spouse, underlying state law may afford creditors rights to the property, since the spouse would have the current power to appoint the property in a manner that would satisfy the donor's and spouse's creditors. To avoid this argument, the spouse should not hold an inter vivos power of appointment, or at least should be restricted from the appointing the property in a manner that would have the effect of satisfying the spouse's creditors.

- b. Application of Section 2702. If the gift is complete, does §2702 apply in valuing the gift? Section 2702 should not apply, because the spouse will not have held an interest in the transferred property, both before and after the transfer. Ltr. Rul. 9141027.
- c. Inclusion in Spouse's Estate. Whether the trust is included in the spouse's estate depends on whether, under traditional planning principles, the spouse has a power over the trust that is taxable under section 2041. Two letter rulings in 1991 addressed situations in which the donee-spouse had a power of appointment to appoint the trust property back to the donor. In Letter Ruling 9140068, the transfer was to an inter vivos QTIP trust, and the trust assets were includible in the donee spouse's estate under section 2044. In Letter Ruling 9141027, the transfer was to a trust that was not included in the spouse's estate.

Letter Ruling 9128005 involved an outright transfer from husband to wife, where the wife, on the same day as the gift, executed a codicil leaving the property back to a trust for the husband if she predeceased him. The property was obviously included in her gross estate.

- d. Inclusion in Donor's Estate. The main issue is whether the trust assets are included in the donor's gross estate, (1) if the donor predeceases the spouse, or (2) if the spouse predeceases and in fact appoints the trust property to a trust for the benefit of the donor.

Section 2036(a)(1) includes in a decedent's gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer by trust or otherwise, under which the decedent has *retained* for the decedent's life or for any period which does not in fact end before the decedent's death the possession or enjoyment of, or the right to the income from the property. Has the donor *retained* an interest in the trust, if the spouse must later exercise the power to leave the assets back to the donor? Regulation § 20.2036-1(a) provides that an interest or a right is treated as being *retained* or reserved if at the time of the transfer there was an *understanding, express or implied*, that the interest or right would later be conferred.

The regulations address such a contingency with respect to section 2038 and 2036(a)(2), dealing with powers that the donor could regain upon the occurrence of contingencies, but does not address the effect of such a contingency under section 2036(a)(1), which is the relevant section. Reg. §§ 20.2038-1(a)(3) & 20.2036-1(b)(3).

In two letter rulings in 1991, where transferred property would be included in the spouse's estate, the IRS ruled that the assets would not be in the donor's estate. In one ruling, the donee-wife died first and appointed the assets to a trust for the donor-husband, under a will executed on the same day as the date of the original gift of property to the wife. Ltr. Rul. 9128005. In another, the ruling stated that the donee-wife of an inter vivos QTIP would, on the same day the trust was funded, execute a codicil to her appointing the assets to a trust for the donor-husband. That ruling concluded that the trust assets would not in the donor's estate, whether he died before donee-wife, or whether she died first after appointing the assets to a trust for his benefit. The ruling reasoned that the original donor-husband is not considered the transferor of the Subtrust for his benefit, so sections 2036 or 2038 are inapplicable. Ltr. Rul. 9140069. Even though the ruling postulated that the codicil exercising the power of appointment would be signed on the same day that the gift was originally made to the QTIP trust, the IRS did not even discuss whether an implied agreement existed. Perhaps the IRS was satisfied that the asset was included in the estates of one of the spouses.

In another 1991 ruling, where the original transfer was made to a trust that was not included in the spouse's estate for estate tax purposes, the IRS concluded that the trust assets would be included in the gross estate of the donor because the spouse intended to exercise the power of appointment to leave the assets to a trust for the donor's benefit. Ltr. Rul. 9141027. In that ruling, the donor-husband proposed transferring assets to an irrevocable trust for his wife's benefit, and the donee-wife proposed exercising her testamentary power of appointment (by a will executed on the same day the original transfer is made to the trust) to appoint the property, under a standard marital deduction formula approach, to a bypass trust for the benefit of the original donor-husband. The IRS concluded, based on these facts, that an implied agreement existed that the transferred property would later be transferred for the donor's use and benefit.

"A [the original donor] and B [the original donee] agreed that if A transfers property to the Spousal Trust for the benefit of B, B will execute a Codicil to her will that will appoint Spousal Trust principal to a trust under which A may be a beneficiary. This

implied agreement between A and B results in A retaining benefits of property that he plans to transfer. It is not necessary that A has definite right to the property. In view of the facts presented, *the possibility that A may reacquire* an interest in previously transferred property after B dies constitutes a retained interest in the transferred property. Therefore, the value of the Spousal Trust will be includible in A's gross estate under section 20.2036-1(a) of the regulations." (emphasis added).

Under the facts of the ruling, finding an implied agreement to appoint the property back to the donor seems clear, based on the representation that the donee spouse planned to exercise the power of appointment by signing a revised will on the very day that the gift was made to the trust. The italicized words in the ruling suggest that the mere existence of the power caused the estate inclusion problem for the original donor, and not the actual exercise of the power of appointment.

Various other possible restrictions would help bolster the argument that the spouse's power of appointment would not cause an estate inclusion problem for the donor. The actual exercise of the power, or even more conservatively, the manner in which the power of appointment could be exercised in favor of the donor-spouse, could be limited in the following possible ways. The appointment for the donor could be limited to payments for the health, support and maintenance of the donor. (Observe, however, that there no cases suggesting an ascertainable standard exception for section 2036(a)(1) like there are for sections 2036(a)(2) and 2038. Additionally, the permissible trust could require that distributions could be made to the grantor only after other income and assets of the donor had been exhausted, so that A's creditors could not reach the property. See Covey, Current Developments, 1992 UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 115.8.

If case law subsequently becomes clear that the mere existence of the power causes estate inclusion problems for the original donor, the donee-spouse could release the power of appointment, but the release would have to occur more than 3 years before the donor's death under section 2035.

- e. Summary. Giving the donee-spouse a testamentary power of appointment to appoint the assets back to the donor or to a trust for the benefit of the donor should not create inclusion problems for the donor as long as there is no express or implied agreement that the spouse would exercise the power of appointment for the donor. Do not have the spouse sign a new will exercising the power of appointment for some period of time. Make sure that the spouses understand that there really is no preconceived plan of whether the power of appointment will be exercised, but that it is just included to provide helpful flexibility. Other restrictions, discussed above, that could be added would help bolster a non inclusion argument, but should not be necessary.
6. Independent Trustee, Trust Protector, or Other Independent Person Can Include Grantor as Beneficiary. The maximum possible flexibility could be maintained by giving someone independent of the grantor the power to leave the assets in a trust for the donor's primary benefit, or even to distribute the assets outright to the donor in the person's independent discretion. Would such a provision create estate inclusion problems for the donor over the trust assets? Bottom line--this is a more aggressive position than just giving the donor's spouse a testamentary power of appointment, which could only be exercised at a later time that might never occur prior to the donor's death (i.e., if the donor predeceases the spouse who holds the testamentary power of appointment.). However, if this power to include the donor as a beneficiary could only be exercised after an estate tax repeal trigger, that would provide an additional argument if the donor were to die before the estate tax repeal occurs.
 - a. Section 2036(a)(1).

- (1) Retention Requirement. Section 2036(a)(1) applies if the donor *retains* the power to obtain the possession or enjoyment of, or the right to the income from, the property. Arguably, the donor has not *retained* anything, because someone else, independent of the donor, makes the decision later to include the donor as a beneficiary.
- (2) Includible if Settlor's Creditors Can Reach. If the donor's creditors can reach the trust assets, because of the potential discretion to distribute assets to the donor, section 2036(a)(1) would apply. UNIF. TRUST CODE §505 (2000) (settlor's creditors can reach whatever "can be distributed to or for the settlor's benefit"); RESTATEMENT (THIRD) OF TRUSTS § 60, Comment f (if settlor is discretionary beneficiary, creditors can reach maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor"); Rev. Rul. 77-378, 1977-2 C.B. 347 (gift complete, even though trust assets were distributable to settlor in trustee's complete discretion, where donor's creditors could not reach trust assets); Rev. Rul. 76-103, 1976-1 C.B. 293 (gift incomplete, where trust assets were distributable to settlor in trustee's complete discretion and where donor's creditor could reach trust assets; also trust assets included in donor's estate under § 2038 because of donor's control to terminate the trust by relegating the grantor's creditors to the entire trust property); Estate of Uhl v. Comm'r, 241 F.2d 867 (7th Cir. 1957)(donor to receive \$100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce \$100 per month included in estate under §2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); Outwin v. Comm'r, 76 T.C. 153 (1981) (trustee could make distributions to settlor in its absolute and uncontrolled discretion, but only with consent of settlor's spouse; gift incomplete because settlor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the creditor's gross estate under sections 2036(a)(1) or 2038(a)(1)); Estate of German v. U.S., 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on §2036(a)(1), because settlor's creditors could not reach trust assets where trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of nonbeneficiaries).
- (3) "Alaska Trusts". Some states (Alaska was the first) have amended their trust and creditor laws to provide that creditors cannot reach trust assets merely because the trustee may, in its discretion, make distributions to the settlor, if certain procedural requirements are satisfied. Alaska, Delaware, Nevada, and Rhode Island now have such laws. Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74 (August 2001). A trust that meets those requirements could safely permit someone to take steps to include the donor as a beneficiary upon the occurrence of an estate tax trigger. However, it is not clear that a person living in another state, who creates a trust governed by the laws of one of those four states, would necessarily be exempted from creditors claims in the state of domicile.
- (4) Become Potential Beneficiary Only on Repeal of Estate Tax. Whether the settlor's creditors can reach the trust assets, because of the fact that distributions may be made to the settlor at some point in the future is a matter of state law. Whether a creditor can reach property that is distributable to the grantor only after a contingency occurs that is within the sole control of Congress (i.e., the estate tax repeal decision after 2010) is unclear. States probably have scant, if any, law on point. It would seem, though, that creditors would not have a current right to reach trust assets, until the contingency which gives rise to the possible discretionary distribution occurs.

- b. Section 2036(a)(2). Section 2036(a)(2) applies if the donor has retained “the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. Having a contingency beyond the grantor’s control before the designation right arises, even where the contingency does not occur before the grantor’s death, does NOT prevent the application of section 2036(a)(2). Reg. § 20.2036-1(b)(3). Accordingly, the trust instrument should not provide that the grantor would become trustee with complete discretion over distributions upon the occurrence of an estate tax repeal trigger. That would cause inclusion of the assets in the grantor’s estate if he dies before the repeal of the estate tax.
 - c. Section 2037. Allowing the grantor to become a beneficiary upon the occurrence of an estate tax repeal trigger would not cause inclusion under section 2037. That section applies if a donor makes a transfer with a reversionary interest that exceeds 5% of the value of the property immediately before the donor’s death AND if “possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent. That would not be the case.
 - d. Section 2038. Section 2038 (power to control beneficial enjoyment) does not apply if the power is “subject to a contingency beyond the decedent’s control which did not occur before his death.” Reg. § 20.2038-1(b). Therefore, having additional rights be subject to the occurrence of an estate tax repeal trigger makes section 2038 inapplicable.
 - e. Section 2041. Similarly, Section 2041 (possessing general power of appointment) does not apply if the power is exercisable only upon the occurrence during the decedent’s lifetime of an event or a contingency which did not in fact take place or occur during the decedent’s lifetime. Reg. § 20.2041-3(b).
- D. Increased Importance of Trust Income Tax Issues. If there is no estate tax, a major tax planning consideration may shift to the income tax area--to make sure that using trusts for non-tax reasons does not create income tax disadvantages. There may be increased emphasis on creating trusts in favorable state income tax jurisdictions.

III. LIQUIDITY PLANNING

- A. Short Term Life Insurance To Cover Temporary (??) Estate Tax Concerns. Clients who feel strongly that the estate tax will be repealed permanently might choose to avoid complicated planning strategies to avoid estate taxes over the next nine years, and just fund irrevocable life insurance trusts with relatively cheap 10-year level term life insurance. Married couples could use inexpensive “second to die” insurance. The “rely on insurance” approach may also be attractive to clients who think their combined marital assets will not exceed, say, \$2.0 million, so that no estate taxes would be due with increased estate tax exemptions even if the estate tax is not totally repealed. That may prove to be a terrible decision if the estate tax ultimately is not repealed, and the client has lost the ability to transfer appreciation over the next nine years with leveraged transfer planning strategies.
- B. Consider Future Growth in Assessing Insurance Needs. If the decision is made to insure against estate taxes rather than plan to reduce estate taxes over the nine year period before repeal, take into consideration anticipated growth of assets and the possibility of increased estate taxes.
- C. Do Not Rush to Cancel Policies. Do not rush out immediately and cancel policies in contemplation of repeal. There is a significant (if not strong) likelihood that the estate tax will not ultimately be and stay repealed. It is likely that there may be additional legislative consideration of the federal estate tax over the next several years. There is no need to act in a precipitous manner.

- D. Flexible Universal Life Products. In light of the uncertainty, having as much flexibility as possible is extremely important. The flexibility of a universal life insurance policy, rather than being mandated to make premium payments each year with a standard whole life policy, would be most helpful. For example, clients with universal life policies who no longer anticipate a long term need to maintain the policy may make the decision not to make additional premium payments if the policy can still stay in force over the next nine years without further payments.
- E. Other Needs For Life Insurance. There are many uses and needs of life insurance other than for the payment of estate taxes. The most important among these is providing financial security for the insured's spouse if the spouse does not have the same earning capacity as the insured, or if the spouse has reduced earning capabilities during child rearing years. These needs would include assuring that education expenses and other child rearing expenses for children can be assured. Various other reasons include key-man insurance to avoid financial crippling of a business at the loss of key employees, insurance to fund buy-sell agreements, insurance to equalize the financial interests of children if certain large illiquid assets (such as closely held business interests) are left to just one child, and funding to pay income taxes that may be due (under a carryover basis system) on an anticipated post-death sale of assets as part of the estate administration process.
- F. Income Tax Advantage of Insurance. Under a carryover basis system, life insurance will become one of the favored income tax-free investments. The build-up in value inside an insurance policy would be received income tax-free at the insured's death. Appreciation in other types of assets eventually would be subject to income taxation under a carryover basis system unless the appreciation can be covered with the permitted basis adjustments. Private placement insurance, with various ways of giving the insured indirect input into the investments within the policy, will become more and more important as an income tax-favored investment alternative.
- G. Consider Borrowing From Rather Than Canceling Policies. If the client no longer sees an urgent need for insurance coverage, consider borrowing cash value from the policy rather than canceling the policy in order to access the value in the policy. This approach retains the ability to keep the policy in force in the event that the estate tax is not ultimately repealed.

IV. CARROVER BASIS PLANNING STRATEGIES.

- A. Don't Get Too Worked Up--2010's a Long Way Off. The carryover basis regime does not come into effect until 2010. The carryover basis system adopted in the 1976 Tax Act differed in many respects from the approach in the 2000 legislation. It is likely that there will be legislative changes to the system before 2010. Furthermore, there are many complex drafting issues that commentators will debate over the ensuing nine year period. Why not let others "invent and reinvent and reinvent the wheel?" They have nine years to get it right.

With few exceptions, there is very little that needs to be drafted into estate planning instruments currently, assuming the client remains competent to revise the instruments as 2010 approaches (or that strategies are used, as discussed in Part Two, Section I.F. of this outline, to provide flexibility to deal with potential incompetency.) A few exceptions, that do need to be addressed currently, are summarized in Part Two, Section IV.F. of this outline.

- B. Run the Numbers--Is There Even an Issue? The basis adjustment allowed to every estate will be \$1.3 million. Typically, an estate would have to be considerably larger than \$1.3 million to have unrealized appreciation (not counting income in respect of a decedent—or IRD-- items) in excess of \$1.3 million. If a client's estate in 2010 will likely have appreciation of well under \$1.3 million, there are no issues at all. All of the assets (except IRD items) can be stepped up to fair market value and all of the carryover basis complexities can be ignored for that client. (This will be the case for many clients.) Furthermore, the \$1.3 million will be growing; the \$1.3 million basis adjustment is indexed for inflation using 2009 as the base year. I.R.C. § 1022(d)(4)(A)(ii).

C. Basis Adjustment Allocation Issue Closely Tied to Distribution Issue.

1. Discretionary Distributions of Low Basis and High Basis Property. Under a carryover basis system, deciding how to divide low basis vs. high basis assets among beneficiaries makes a huge difference in the potential tax costs to the various beneficiaries. This issue is every bit as important, if not more so, than deciding how to allocate basis adjustment among beneficiaries. Executors have dealt with this issue for years, but it has only been critical with respect to deciding how to allocate income in respect of a decedent items or assets that have substantial post-death appreciation. (However, the basis adjustment issue seems to be getting all the attention, perhaps because it is a new issue that planners have not had to consider previously.)
2. Distributions to Spouse. Under the carryover basis regime, assets will have to be distributed to the spouse that have at least \$3.0 million of appreciation to be able to utilize fully the \$3.0 million basis adjustment of assets passing to a surviving spouse or QTIP.
3. Formula Bequest Tied to Basis. In 2010 (if we still have carryover basis), we may fairly frequently see tax driven formula clauses tied to basis issues in determining the amount of various bequests under the will. For example, the testator may want to assure being able to take full advantage of the \$3.0 million spousal basis adjustment, but may want to leave substantial assets for children. A formula clause could leave at least enough to the spouse to take advantage of the \$3.0 million basis adjustment. Many complexities arise in drafting such a formula. For example, does the client want to leave as much value as possible to the spouse under that clause (by funding the bequest with assets that have relatively little appreciation), or does the client want to leave as little as possible to the spouse under this bequest (by funding the bequest with assets that are almost 100% appreciation)? See Part Two, Section E.8.d. of this outline.

D. Allocation Issues and Alternatives.

1. Executor Can Allocate Basis Adjustment. The executor can choose which assets will receive the \$1.3 million basis adjustment (for any bequests) and the \$3.0 million basis adjustment (for bequests to a spouse or QTIP). Apparently, the basis may be allocated to any asset included in the decedent's estate, not just assets passing under the will. See Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 88 (August 2001). For a discussion of the coordination with the trustee of a revocable trust in making this basis adjustment allocation, see Part One, Section VIII.E.3. of this outline.
2. Big Dollar Issue. This decision can mean many hundreds of thousands (or millions) of dollars to the beneficiaries. (The first spouse's \$1.3 + \$3.0 million adjustment, plus the surviving spouse's \$1.3 million adjustment, is a total of \$5.6 million of basis adjustment for the couple. At a 20% capital gains tax, this would mean \$1.12 million of tax savings for the recipients who receive the assets with the stepped-up basis.)
3. Fiduciary Issue. The executor owes fiduciary duties to the beneficiaries. Beneficiaries who feel slighted by the "big dollar" allocation decision by the executor may choose to hold the executor accountable to establish that he or she satisfied its fiduciary duties to beneficiaries. Corporate trustees have expressed concern over the potential responsibility associated with the basis adjustment allocation decision. (Reportedly, this issue will be addressed at length in the October 2001 issue of Practical Drafting published by U.S. Trust Company.) Furthermore, to the extent that the executor allocates the basis increase to any assets passing outside the will, the beneficiaries under the will may complain that the fiduciary violated the fiduciary's duty of loyalty to the takers under the will. See Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 88 (August 2001).

4. Potential Conflicts of Interest. If a beneficiary is the executor, substantial conflicts of interest can arise. Exercise of the discretion in a manner that unduly benefits the executor will be scrutinized. Having an independent or corporate executor will be desirable in many situations to make the basis adjustment allocations and avoid the significant conflicts of interest that would arise if a beneficiary makes those decisions.
5. Exoneration From Liability. In light of the wide discretion and the potential for huge shifts of economic value by the basis adjustment decision, many fiduciaries are maintaining that it is only fair to exonerate the executor from liability for the basis adjustment allocation decision. Some planners have suggested that standard exculpation clauses for tax elections made by the executor should cover these elections also.
6. Beneficiary Consents; Probate Court Approval. Similar to the manner in which executors now seek consents from beneficiaries as to discretionary distribution decisions, the preferred approach will be to work with the beneficiaries in dividing the estate assets and in making basis adjustment allocations in a manner that is agreeable to all estate beneficiaries. Executors will seek consents to the basis adjustment decisions.

In some states, where an executor can seek court approval for actions by the executor, executors may wish to seek court approval of basis adjustment decisions where the beneficiaries do not unanimously consent to the executor's decisions.

7. Various Issues for Direction or Guidance. Some of the possible factors that the executor might consider in the allocation process, and issues that the clients could address in the will or revocable trust, include the following factors.
 - a. General Desire for Equality or Approach for Allocating Among Beneficiaries. Absent contrary directions or guidance in a decedent's will, the executor would have a fiduciary duty to treat the beneficiaries impartially. The will should give the executor guidance. For example, is the general goal to treat all beneficiaries of the residuary estate fairly, or does the client want the executor to favor some beneficiaries over others? If the executor is the surviving spouse, the client might want to give the spouse complete discretion, and explicitly provide that the spouse, as executor, would not be required to treat all beneficiaries fairly.
 - b. Favor Particular Specific Bequests; Preference to Residuary or Particular Residuary Bequests? The will or revocable trust might want to favor particular specific bequests. For example, if the client contemplates that a highly appreciated closely held business would be sold relatively soon after the client's death, the client might want to specifically express that the basis adjustment should be allocated among the beneficiaries of that interest.

To the extent that the value of the decedent's residence does not exceed \$250,000, there should be no need to allocate basis adjustment to the residence, because of the availability of the \$250,000 exclusion under section 121. See Part One, Section X.B. of this outline.

If there are not particularly sensitive or valuable specific bequests, the client may wish to prefer allocating the basis adjustment among some or all of the beneficiaries of the residuary estate.

- c. Allocate to Children of First Marriage? If there are children of a prior marriage and of the current marriage, the client may wish to allocate his or her \$1.3 million adjustment among his or her children (or trusts for them). The client may feel that the surviving spouse (or more precisely, children of the surviving spouse who he or she may designate as the

executor) will likely allocate the surviving spouse's \$1.3 million basis adjustment among the surviving spouse's children. Also the surviving spouse or a QTIP trust may receive assets to which the first decedent-spouse's \$3.0 million basis adjustment may be made, which may subsequently be distributed to the second spouse's children. (However, using a QTIP trust rather than an outright bequest can help to assure that assets remaining in the QTIP trust at the surviving spouse's subsequent death will be allocated among all of the decedent's children as his or she deems to be appropriate.)

- d. Allocate to Easy to Value Assets? If the executor allocates the basis adjustment to difficult-to-value assets, the IRS may subsequently contest the date of death value ascribed to the assets by the executor. If the IRS succeeds in arguing that the executor overvalued the date of death value of the asset, the basis adjustment allocation would end up not having allocated the full possible basis adjustment. That complexity could be avoided by allocating the basis adjustment to easy-to-value assets (such as a stock and bond portfolio.)
- e. Assets Most Likely to Be Sold in Near Future. The client may want the executor to prefer allocating the basis adjustment to assets that will likely be sold soon after the decedent's date of death.
- f. Tax Brackets of Beneficiaries. The client may want the executor to favor allocating the adjustments to assets passing to high bracket beneficiaries, especially if the income tax brackets of the beneficiaries are dramatically different. The client might even make some additional bequest to low tax bracket beneficiaries to account for this difference.

E. Planning and Drafting Strategies.

1. No Need to Act Hastily. The carryover basis system does not get implemented until 2010. There's plenty of time between now and then for future legislative changes, for planners' thinking to get crystallized, and for waiting to see if a problem ever really develops in the client's particular situation. There's no need to go out and draft complicated formulas and funding provisions now. (As discussed in Part Two, Section IV.F. below, drafting issues that are particularly important now include (1) giving authority to an independent trustee or trust protector to make outright distributions to the surviving spouse from a QTIP, without reference to an ascertainable standard, if the client is willing to do so, and (2) giving an independent person a power of attorney authorizing gifts to the client's spouse.)
2. Begin Maintaining Good Basis Records. Reviewing old records to determine the basis of assets can be cumbersome and expensive. At least going forward, maintain good basis information records, and update them on an annual basis. In this respect, the 2001 Tax Act version of carryover basis is more difficult to administer than the 1976 version--which provided a fresh start adjustment to 1976. (The 2001 version is also more difficult to administer because of all the basis adjustment allocation decisions--none of which were allowed under the 1976 version.)
3. Determine If There is a Potential Problem, Based on Anticipated Appreciation of the Estate Assets. Be aware that all of the monetary amounts described below will be indexed for inflation, beginning with a base year of 2009.
 - a. Under \$1.3 Million of Appreciation. If the anticipated total appreciation of the client's or a married couple's (for married clients) estate in 2010 will be well under \$1.3 million, there is no need for any action. The basis adjustment will provide a full step-up in basis regardless which spouse dies first and regardless where the assets pass at each spouse's death.

- b. Over \$1.3 Million of Appreciation. If it is anticipated that the total appreciation of a married couple's assets in 2010 will exceed \$1.3 million, it is important to plan (in 2010) so that (1) the first spouse to die has sufficient assets to take advantage of the \$1.3 and \$3.0 million basis adjustments, and (2) sufficient assets pass to the surviving spouse to utilize the \$3.0 million spousal basis adjustment.
- c. Over \$1.3 Million But Under \$5.6 Million of Appreciation. If the \$1.3 million and \$3.0 million basis adjustment allowed at the first spouse's death plus the \$1.3 million basis adjustment allowed at the second spouse's death (assuming he or she has that much appreciated assets other than assets in a QTIP trust), or a total anticipated appreciation of \$5.6 million, is well more than the anticipated amount of appreciation at the second spouse's death, there is no need to be concerned with the difficulties of how to allocate the basis adjustment among beneficiaries. All beneficiaries could get a full stepped basis (except beneficiaries receiving income in respect of a decedent assets). However, it will be important to plan so to assure that the full \$1.3 million plus \$3.0 million basis adjustment can be utilized at the first spouse's death.
4. Classic Disclaimer Plan or All to QTIP Plan Accommodates Carryover Basis Planning. Planning for flexibility to accommodate increases in the exemptions and possible repeal often will utilize one of two approaches: (1) All to a QTIP trust, and depend upon partial QTIP elections to utilize the first decedent-spouse's exemption amount (or so much of it as seems appropriate based on the client's wishes as to minimum amounts that should pass exclusively for the surviving spouse); or (2) All outright to spouse, and rely on disclaimers by the spouse to utilize the first spouse's exemption amount. Either of these approaches will also flexibly accommodate full use of the \$1.3 adjustment and the \$3.0 million spousal basis adjustment because assets in the QTIP trust or assets passing to the spouse outright that are not disclaimed would qualify for the \$3.0 million spousal basis adjustment.

The only possible complicating factor is that if the will uses a "Clayton QTIP" approach, and provides that with a first spousal death beginning in 2010, some of the QTIP restrictions would no longer apply. In that case, the \$3.0 million spousal basis adjustment would no longer be available for assets passing to that QTIP trust. See Part Two, Section I.B.2.c.(2) of this outline.

5. Consider Authorizing Outright Distributions to Spouse From QTIP. As discussed in Part One, Section VIII.E.7. of this outline, assets in a QTIP trust at the second spouse's death will not qualify for the \$1.3 million basis adjustment available to the surviving spouse. Property must be "owned" by a decedent prior to death to qualify for either of the basis adjustments, and property in a QTIP does not meet that test.

Consider with the client whether to give an independent trustee or a trust protector (in particular, someone other than the surviving spouse) the authority to make unrestricted distributions of QTIP trust assets outright to the surviving spouse, not subject to an ascertainable standard. Without such an explicit provision in the instrument, the fiduciary would only be permitted to make principal distributions to the surviving spouse in accordance with any standards listed in the agreement. This is drafting that should be considered currently. If the first spouse dies in the near future, leaving most of the estate to a QTIP trust, there may be no ability years later when the surviving spouse dies to take advantage of the surviving spouse's \$1.3 million basis adjustment (if there is a carryover basis system in place at his or her subsequent death) if the spouse does not own (outright) assets with at least \$1.3 million of appreciation at that time.

For the client who is using a QTIP trust to assure who will receive the remaining assets at the spouse's subsequent death, this may present a troublesome decision. The client in that situation might want to require the approval of more than one independent person. The client

might to require the approval of persons who would be “affiliated” with remainder beneficiaries of the QTIP trust (for example, perhaps aunts or uncles of those beneficiaries, who are not related to the surviving spouse’s anticipated beneficiaries.) The client also might want to condition the existence of the power on there being a carryover basis system in effect or on there being significant tax advantages from the exercise of the power, other than tax benefits that might result from subsequent gifts of the distributed assets by the surviving spouse (to avoid a potential argument that the power indirectly gives someone the right to make distributions to a person other than the surviving spouse).

6. Provide Allocation Guidance. The client may want to give guidance to the executor in making the allocation decision.
 - a. General Fairness Statement. There could be a very general statement that the client would want the executor to treat all beneficiaries of the estate in a fair manner.
 - b. Particular Beneficiaries (or Class). The guidance could indicate that the basis adjustment generally should be allocated to particular beneficiaries (for example, children and children of deceased children of the client).
 - c. Pro Rata Guidance. The guidance could suggest that the allocation generally would be allocated on a pro rata basis (based on the ratio that the percentage of unrealized appreciation in each asset acquired from the decedent bears to the unrealized appreciation in all assets acquired from the decedent). See Mezzullo, Estate Planning Under the New Tax Law, ABA TAX SECTION, REAL PROP. PROB. & TRUST LAW SECTION, CENTER FOR CONTINUING LEGAL EDUCATION SMALL BUSINESS COUNCIL OF AMERICA TELECONFERENCE, at 20 (2001).
 - d. Non-Probate Assets. The executor has the discretion to allocate the basis adjustment among all assets “owned” by the decedent, which would include non-probate assets. The guidance could specifically address whether the executor has the authority to allocate the basis adjustment to recipients of non-probate assets. (Without such a specific direction, beneficiaries under the will might complain that the executor is violating its duty of loyalty to the will beneficiaries. See Part Two, Section IV.D.3.)
7. Consider Whether to Provide Broad Exoneration to Executor. The basis allocation decision may shift substantial value among estate beneficiaries. In light of the potential disputes that might arise, it would be appropriate to provide the executor with broad exculpatory provisions with respect to the basis allocation decisions. See Part Two, Section D.5. of this outline.
8. Special Difficulties in Qualifying for \$3.0 Million Spousal Basis Adjustment. Many of the really difficult drafting issues will evolve around qualifying for the \$3.0 million spousal basis adjustment.
 - a. Substantial Tax Advantage; Typically Want to Qualify. The advantage of an additional \$3.0 million of basis step-up can yield substantial tax savings to the family (i.e., \$3.0 million times 20% capital gains rate, or \$600,000.) Typically, the client will want his or her family to be able to take advantage of \$600,000 of tax savings, even in a split family situation.
 - b. If Concern About Spouse’s Disposition, Use QTIP. In a split family situation, the client would probably want to use a QTIP trust, to be able to control where the assets would pass following the second spouse’s death.
 - c. Do Not Use Survivorship Requirement. An interest that is conditioned on survival for 6 months after the decedent’s death will not be excluded from the definition of outright transfer property if the spouse does not in fact die within such 6 month period. I.R.C. §

1022(c)(4)(C). Observe that such a survivorship requirement should not be used for decedents dying after 12-31-2009, because if the surviving spouse in fact dies within such six month period, the \$3.0 million basis adjustment available for property passing to a surviving spouse would not be available.

- d. Paradigm Shift--Bequests Based on Combination of Value and Basis. Drafting formula bequests to leave enough to the spouse (or QTIP trust) to take advantage of the \$3.0 million spousal basis adjustment will be a significant paradigm shift from planning with traditional formula clauses based just on values. The primary focus of the bequest will be to on the difference between fair market value and the adjusted basis of assets (i.e. the "appreciation"), in order to leave assets with appreciation of at least \$3.0 million to the spouse or QTIP trust. That creates a huge additional complication. To pass assets with a specified amount of appreciation can leave a substantial variance in the value passing under the bequest. If the bequest passes property that has a basis of zero, the bequest would be valued at \$3.0 million. However, it conceivably could also be interpreted as a bequest of assets worth \$100 million, having a basis of \$97 million.
- e. Tax-Driven Formula Bequest. Formula bequests may be utilized to assure the availability of the \$3.0 million spousal basis adjustment. Here's a classic understatement--"The challenge will come in drafting such a bequest." Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 88 (August 2001).
- (1) Must Give Direction of Which Assets to Select. In light of the huge discrepancy of values that could pass to beneficiaries if the clause just left "assets having appreciation of \$3.0 million" to the surviving spouse, the clause must give guidance to the executor as to how to select assets in satisfaction of this bequest. A mere general direction to treat beneficiaries fairly is not sufficient. That really gives the executor no guidance at all as to the testator's thinking of what would be fair. This is not just a matter of allocating basis adjustment among the amounts received by the estate beneficiaries. Funding this bequest determines the amounts to be received by the various beneficiaries.
 - (2) Smallest or Largest Amount Alternative. One alternative would be to give the executor general guidance to fund the bequest with assets having as small appreciation as possible (which would have the effect of leaving more value to the spouse under this formula bequest) or to leave assets with as large appreciation as possible (which would minimize the value of this bequest to the spouse.) The executor at least needs guidance.
 - (3) Likelihood of Sale. Just funding the bequest based on the amounts of appreciation (smallest or highest) in the assets does not take into consideration other important factors, such as when the assets will likely be sold. It would be more advantageous to get the basis adjustment on the assets most likely to be sold first. If the clause is just tied to distributing assets in satisfaction of this formula bequest that have as much appreciation as possible, the executor may not have the flexibility to consider those other important factors.
 - (4) Minimum Amount to Children. Another alternative would be to leave the executor wide discretion in choosing which assets to use for funding, but specify that a minimum amount of value must be left to the non-spousal bequest.
 - (5) Mechanical Valuation Difficulties. The executor will be faced with difficult valuation complexities in funding the bequest. The values passing under this bequest to the

spouse will be highly dependent on the adjusted basis and date of death values of the selected assets. If either of those are incorrect (and both could be difficult to determine with accuracy), the amount funded in satisfaction of the bequest will be incorrect. Filing the report under section 6018 does not start the statute of limitations on the determination of the basis of the assets, and the IRS could contest the values years later as assets are sold and income tax returns are filed.

- (6) Disclaimer to Spouse May Not Work. A client who strongly wishes to leave a certain amount of property to children or to trusts for descendants may want to rely on disclaimers to leave sufficient assets to the surviving spouse to qualify for the full \$3.0 million spousal adjustment. However, it is not totally clear that disclaimed property, which passes to the surviving spouse as a result of the disclaimer, would qualify for the \$3.0 million spousal adjustment. Blattmachr & Detzel, Estate Planning Changes in the 2001 Tax Act--More Than You Can Count, 95 J. TAX'N 74, 89 (August 2001). Section 1022(c)(4)(A) defines outright transfer property in terms of property "acquired from the decedent." Section 1022(c)(5)(A)(i) defines qualified terminable interest property in terms of property "which passes from the decedent." Would these include interests passing by way of disclaimers?

The marital deduction rules provide an analogy. Section 2056(a) allows the marital deduction for property which "passes or has passed" from the decedent to the surviving spouse. Section 2518(a) provides that if a person makes a qualified disclaimer, "this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person." Regulation § 20.2056(d)-2(b) makes clear that if a beneficiary other than a surviving spouse makes a qualified disclaimer, which causes the property to pass to a surviving spouse, the disclaimed interest is treated as "passing directly from the decedent to the surviving spouse."

The uncertainty arises in that (i) there is no specific regulation addressing this issue as there is for the marital deduction, and we do not yet know if regulations to section 1022 will adopt the same approach, and (ii) in 2010, section 2518 continues in effect (the repeal provision provides that "chapter 11 of subtitle B" (the estate tax provisions) will not apply, and section 2518 is in chapter 12 of subtitle B), but section 2518 applies only "for purposes of this subtitle," i.e. subtitle B dealing with estate, gift and GST taxes. Section 1022 is in subtitle A, dealing with income taxes, so the disclaimer statute would not apply to section 1022.

- (7) Sample Clause. Do you want to be the first to draft this nightmare of a formula clause with funding directions? (Me neither.) Fortunately, Ellen Harrison has given planners an excellent starting point to draft such a clause for their particular client situations. Observe that this clause addresses most of the various factors addressed in this section regarding tax-driven formula bequests:

"(B) Alternative Disposition if Federal Estate Tax is not in Effect If the federal estate tax is not in effect at my death, then:

(1) If my Spouse and any Descendant survives me. If my wife/husband and any descendant of mine survives me, I devise and bequeath to my said Trustee, to hold in trust pursuant to the provisions of the Marital Trust described in FOURTH hereof the smallest amount, if any, that would be necessary to maximize the additional adjustments to basis allowed by section 1022(c)(2)(B) after taking into account basis adjustments allowed under section 1022(b) and basis adjustments allowable for qualified spousal property that is specifically bequeathed to my husband/wife or that passes to him/her outside of the provisions of my Will; provided, however, that the amount of unrealized gain that

would be excludable under Section 121 (hereinafter 'section 121 gain') shall not be considered an allowable adjustment. For purposes of this SIXTH (A) it shall be assumed, regardless of what in fact occurs, that my executor will allocate the adjustments allowed by section 1022(b) to assets that are eligible for a basis adjustment (other than section 121 gain) in the following order: first to assets passing outside of this Will to anyone other than my husband/wife or charity; second to property specifically bequeathed to anyone other than my husband/wife or charity; finally to those other assets passing under this Will that have the highest basis in order to maximize the value of the bequest to the Family/ Residuary Trust. I intend that the income interest of my wife/husband in the Marital Trust under FOURTH be a 'qualifying income interest for life' within the meaning of section 1022(c)(5) and any provision of this Will which would be inconsistent with my intent shall be void. My executor shall use date of death fair market value and basis to determine the amount of this bequest and to fund this bequest provided that the aggregate fair market value of assets used to fund this bequest on the date it is paid shall not be less than the amount of this bequest. The foregoing formula shall not be construed to require that my executor allocate basis to assets used to fund this or any other bequest or to assets passing outside of this Will. My executor is not required to make any specific allocation, and no equitable adjustments shall be required as a result of my executor's allocation of basis adjustments to any assets, whether or not passing under this Will." Berall & Harrison, Should We Anticipate 2010 and the Arrival of Carryover Basis? Is There Planning That Can Be/Should Be/Must Be Done Now? What About a "Head-In-The-Sand" Prayer That It Never Becomes a Reality (Or "I'll Be Retired By Then"), ANNUAL NOTRE DAME TAX & ESTATE PL. INST. at 23-38 to 23-39 (2001).

9. "Reverse Discount Planning". If carryover basis becomes applicable, there will be a major paradigm shift between the IRS and taxpayers on valuation issues. The IRS will argue for low values and for large discounts for date of death values, and taxpayers will argue for high values and for low discounts. The planner can consider this in planning current transfers to take advantage of fractionalization discounts.
 - a. Some Assets Cannot Be "Unfractionalized". Some types of assets will be difficult to "unfractionalize." For example, if a parent transfers sliver interests in a vacation home over the years, and only owns an undivided 75% interest in the vacation home before his death, that cannot be unfractionalized (unless he's willing to buy back the 25% interest that had been transferred over the years.) Without such a purchase, the interest will be valued as an undivided 75% interest in a vacation home at the parent's death.
 - b. Partnership Interests. On the other hand, some types of interests can be "unfractionalized" if all of the parties agree. For example, if various family members own interests in a partnership, all of the partners could collectively agree to amend the partnership agreement if the estate tax is repealed, to provide that any limited partner would have the right at any time to withdraw and receive a pro rata portion of the total value of the partnership assets. Alternatively, the partners could agree to have only one general partner, who would have the unilateral authority under state law at any time to withdraw and force the liquidation of the partnership. In that case, to the extent that the partnership holds in-kind assets (such as real estate), there may still be a fractionalization discount as to those specific assets. However, to the extent that the partnership owns liquid stocks and bonds, those assets would not be subject to a fractionalization discount.
 - c. Leave Flexibility for Pre-Mortem Repurchases to Convert Minority to Majority Interest. The parties may leave the flexibility for the client to repurchase sufficient interests to convert a minority interest into a majority interest, thus removing minority interest discounts. There

is a three year look back window for purposes of the basis adjustment, but that only applies to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the three years prior to death. I.R.C. § 1022(d)(c)(i). It would not apply to a repurchase for full consideration of an interest in the property. Of course, the IRS could still attempt to make a "sham transaction" argument, see Estate of Murphy, T.C. Memo 1990-472, but they would be battling uphill against the specific wording [and very apparent exception for full consideration transfers] in the statute. Indeed, another paragraph of section 1022 [§1022(g)(2)(d)] adopts a "principal purpose of tax avoidance" exception, but section 1022(d)(C) does not.

Planning fractionalized transfer transactions with grantor trusts during the phase-in years will be very helpful in leaving open this flexibility. If a grantor trust owns the asset, it could be repurchased by the grantor in a pre-mortem transaction without having the seller recognize taxable income on the sale.

10. Maintain Community Property Status of Assets. The carryover basis rules maintain the basis step-up advantage given to spouses who own community property. Both the decedent's one-half and the surviving spouse's one-half of community property would be entitled to a basis step-up at death using the decedent spouse's \$1.3 and \$3.0 million basis adjustments. However, for clients with very large estates (who have unrealized appreciation well in excess of \$4.3 million), there is not as strong of a basis step-up advantage for maintaining property as community property as there was in the past. (The unrealized appreciation in excess of \$4.3 million at the first spouse's death would not receive a step-up in basis.)
11. Interspousal Transfers. The clients should consider whether to make interspousal transfers so that each spouse will own sufficient assets to take advantage of the full \$1.3 plus \$3.0 million of basis adjustment, regardless of which spouse dies first. (We're talking about pretty large estates here--where each spouse would own assets with assets having \$4.3 million of unrealized appreciation.)

For spouses having widely disparate estate values, QTIP trusts are often used to equalize the estates for estate tax purposes. That will not be effective for the basis adjustment rules, because assets in a QTIP trust for the benefit of the decedent-spouse will not be treated as "owned" by that spouse for purposes of the basis adjustment rules. See Part One, Section VIII.E.7. of this outline.

To take advantage of the basis adjustment for each spouse, in the event of a sudden unanticipated death, the "propertied" spouse would have to be willing to transfer outright ownership of assets to the other spouse. (The only other alternative, which may give at least the appearance of more control to the propertied spouse, would be to acquire assets in the names of both spouses as joint tenants with right of survivorship. Each spouse would be treated as owning one-half of joint tenancy property for purposes of the basis adjustments. I.R.C. § 1022(d)(1)(B)(i). However, the "propertied" spouse would then run the risk of dying first, and having the spouse acquire all of the joint tenancy property under the survivorship provision.)

12. Pre-Mortem Gifts to Spouse. The interspousal transfers can be delayed until it is apparent that the non-propertied spouse will likely die first. The new carryover basis rules clearly permit pre-mortem interspousal transfers to transfer low basis assets to a dying spouse in order to be able to fully utilize the spouse's \$1.3 and \$3.0 million basis adjustment. There is no three-year waiting period for transfers to spouses, unless the "donor spouse" acquired the property in whole or in part by gift or inter vivos transfer for less than adequate and full consideration during within three years prior to the transferee-spouse's death. I.R.C. § 1022(d)(1)(C)(ii). See Part One, Section VIII.E.8.a. for a discussion of how this compares to the current one-

year rule that does apply to spouses in order to receive a step-up in basis at death if the property is left back to the original owner-spouse.

- F. Don't Panic (Yet); Summary of Immediate Actions. Bottom Line--there's no need to panic (yet). Wait until closer to 2010 before full-fledged panic sets in. In the meantime, items that should be addressed currently include the following.
1. Discretionary Distributions from QTIPs. In drafting current wills and revocable trusts, authorize distributions from a QTIP outright to the surviving spouse in the discretion of an independent trustee. See Part Two, Section IV.E.5. of this outline.
 2. Power of Attorney Authorizing Broad Gifts to Spouse. Consider giving someone a power of attorney to make gifts to the spouse (either an unlimited gift provision, or permit gifts taking into consideration tax advantages, including basis adjustments that might be allowed under a system of carryover basis).
 3. Maintain Good Basis Records. See Part Two, Section IV.E.2. of this outline.
 4. Authorize Basis Allocation and Exoneration. This is not as urgent to do currently. However, some planners are now beginning routinely to insert provisions authorizing executors to make basis adjustment allocations among the property passing to beneficiaries, and providing exoneration to the executor for those allocation decisions.