The Two-Year "Solution"

An Introduction to the Solutions Provided and Issues Raised by the Estate, Gift, and GST Tax Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

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Legal Experience
Bill Pargaman has been certified by the Texas Board of Legal Specialization as a specialist in Estate Planning and Probate Law. He is also a Fellow in the American College of Trust and Estate Counsel. Bill's practice involves the preparation of wills, trusts and other estate planning documents, charitable planning, and estate administration and alternatives to administration. Additionally, he represents clients in contested litigation involving estates, trusts and beneficiaries, and tax issues. His practice also includes the organization and maintenance of business entities such as corporations, partnerships, and limited liability entities.

Education
- Doctor of Jurisprudence, *with honors*, University of Texas School of Law, 1981, Order of the Coif, Chancellors
- Bachelor of Arts, Government, *with high honors,* University of Texas at Austin, 1978, Phi Beta Kappa

Professional Licenses
- Attorney at Law, Texas, 1981

Court Admissions
- United States Tax Court

Speeches and Publications
Mr. Pargaman has been a speaker, author, or course director at numerous seminars, including:
- State Bar of Texas, Advanced Estate Planning and Probate Course, Estate Planning and Probate Drafting Course, and Advanced Guardianship Law Course
- Real Estate, Probate and Trust Law Section Annual Meeting
- University of Houston Law Foundation, General Practice Institute, and Wills and Probate Institute
- South Texas College of Law, Wills and Probate Institute
- Austin Bar Association, Estate Planning and Probate Section Annual Probate and Estate Planning Seminar
- Austin Bar Association and Austin Young Lawyers Association Legal Malpractice Seminar
- Houston Bar Association Probate, Trusts & Estate Section
- Austin Chapter, Texas Society of Certified Public Accountants, Annual Tax Update
- Texas Bankers Association, Advanced Trust Forum
- Estate Planning Council of Central Texas, Amarillo Area Estate Planning Council, Corpus Christi Estate Planning Council, East Texas Estate Planning Council, and South Plains Trust & Estate Council
- Austin Association of Life Underwriters
- Austin Chapter, University of Texas Medical Branch (Galveston) Alumni Association
- SAGE Group, University of Texas

Professional Memberships and Activities
- American College of Trust and Estate Counsel, Fellow
- State Bar of Texas
  - Real Estate, Probate and Trust Law Section, Member
  - Real Estate, Probate, and Trust Law Council, Member, 2004–2008
  - Legislative – Probate Committee, Member, 2000–Present (Chair, 2008–Present)
  - Trust Code Committee, Member, 2000–Present (Chair, 2004–2008)
  - Uniform Trust Code Study Project, Articles 7–9 & UPIA, Subcommittee Member, 2000–2003
- Texas Board of Legal Specialization (Estate Planning and Probate Law), Examiner, 1995-1997
- Estate Planning Council of Central Texas, Member (President, 1991-1992)

- Austin Bar Association, Member
  - Estate Planning and Probate Section, Member (Chair, 1992-1993, Board Member, 1997-1999)

Honors

- Listed in *The Best Lawyers in America®*
- Listed in *Texas Super Lawyers* (Texas Monthly)
- Listed in *The Best Lawyers in Austin* (Austin Monthly)

Community Involvement

- St. Stephen's Episcopal School Professional Advisory Council, Member
- City of Austin, XERISCAPE Advisory Board, Past Member
- Volunteer Guardianship Program of Family Eldercare, Inc. of Austin, Past Member, Advisory Board

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EDUCATION:

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- LL.B., The University of Texas School of Law (1965)

PROFESSIONAL ACTIVITIES:

- Distinguished Texas Probate and Trust Attorney Lifetime Achievement Award, Presented by Real Estate, Probate and Trust Law Section of the State Bar of Texas
- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization (1977 –)
- Fellow, American College of Trust and Estate Counsel (Admitted 1980)
- Past Chair, Estate and Gift Tax Committee, American College of Trust and Estate Counsel (1995-1998)
- Board of Regents, American College of Trust and Estate Counsel (1994-2000)
- Texas State Chairman, American College of Trust and Estate Counsel (1989-1994)
- Academician, International Academy of Trust and Estate Law (Admitted 1990)
- Past Chair, Council of Real Estate, Probate and Trust Law Section, State Bar of Texas
- Legislative Chairman, Council of Real Estate, Probate and Trust Law Section, State Bar of Texas (1991-1997)
- Chair, Texas Academy of Probate and Trust Lawyers (2008-2009)
- Certified Public Accountant
- Who's Who in American Law (1984-)
- Who's Who in America (1985-)
- Best Lawyers' in America (1985-) (one of only 1,347 lawyers nationwide who have been included for 25 straight years)
- Super Lawyers' in Texas (2003-2010) – Named one of Top 50 lawyers in Central and West Texas without regard to specialty (2008-2010)
- Trained Mediator – ACTEC mediator training

PUBLICATIONS &
SPEAKING ENGAGEMENTS:

Extensive speaking in estate planning, community property law and employee benefits areas, including programs for State Bar of Texas, American College of Trust and Estate Counsel, International Academy of Estate and Trust Law, University of Notre Dame, American Law Institute-American Bar Association (ALI-ABA), American Bar Association, New York University Institute on Federal Tax, New York State Bar Estate Planning Institute, Southwestern Legal Foundation, UCLA-CEB, University of Texas, American Institute on Federal Taxation, Texas Society of Certified Public Accountants. Additionally, published articles in Estate Planning Magazine, the ACTEC Journal, Trusts and Estates Magazine, and Texas Tech Estate Planning and Community Property Law Journal. Active contributor to ACTEC list serve.

EDUCATOR:

Adjunct Professor, University of Miami School of Law, LLM Program in Estate Planning (2007-2009)

COMMUNITY ACTIVITIES:

President, Zachary Scott Theater Center (1969-1972)
Chair, Austin Arts Commission (1975-1981)
President, Paramount Theater (1985-1988)
Austin Tomorrow Task Force

LEGISLATIVE ACTIVITIES:

Active in the legislative activities for the Real Estate, Probate & Trust Law Section and the Texas Academy of Probate Lawyers.

FAMILY:

Wife - Mary Ann Golden. Married February 5, 1966. Mary Ann has been active in and served as President of the Austin Women's Symphony League, Laguna Gloria Art Guild, and the Austin Woman's Club. She is a breast cancer survivor.
Son - Phillip T. Golden is married and is a Director, Marketing and Products and General Counsel, Pro Star Energy Consultants, Houston, Texas.
Pamela E. Golden is married and working for Spencer Stuart, an international executive search firm. She and her husband have one son, Calvin Dexter de Winter born March 10, 2007, and one daughter, Hazel Tyson de Winter, born March 4, 2010.

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1. Scope and Introduction.

At the time this article is being written, the ink is dry on President Obama's signature on the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 tax bill"), but much of the ink has yet to be written on all of the analysis of the 2010 tax bill. This article is intended to provide an **introductory** explanation of the effect of the legislation understandable to practitioners familiar with the area. The article will also discuss some of the issues raised by the legislation, but will not attempt to answer all of them. More detailed explanations will be left to other articles and presentations.

2. A Brief History.

In order to understand where we find ourselves in early 2011, it may be helpful to recap the history of federal transfer taxes over the past. To figure out where we are now, we need to go back about 35 years.

2.1 Before 1977. Prior to 1977, we had separate gift and estate tax systems. The tax-free amount for lifetime taxable gifts was $30,000, while the tax-free amount for estate tax purposes was $60,000. In addition, there was no "unlimited" marital deduction.[1]

2.2 TRA 1976. The Tax Reform Act of 1976 was a major change to the transfer tax system. It "unified" the estate and gift tax provisions, and increased the tax-free amount of $60,000 in stages so that by 1981, the tax-free amount exceeded $175,000, and both taxes became subject to the same progressive rate schedule. It also introduced the "minimax" marital deduction, providing a minimum value to the maximum allowable marital deduction of $250,000 regardless of the size of a spouse's separate estate.[2]

2.3 ERTA. The Economic Recovery Tax Act of 1981 made two more significant changes to the estate tax laws. First, the tax-free amount was increased again, so that by 1986 it reached $600,000. Second, and perhaps more importantly, the 1981 tax act introduced the "unlimited marital deduction," allowing married couples for the first time to assure that no estate taxes need be paid while either of them was alive. (This tax bill also increased the annual exclusion for gift tax purposes from $3,000 to $10,000.)

2.4 TRA 1986. In 1986, the Tax Reform Act of 1986 permanently repealed the generation-skipping transfer tax system that had been first introduced in the 1976 tax act (but had never gone into effect) and enacted the version of the generation-skipping tax that we are familiar with today, designed to discourage taxpayers from avoiding estate taxes in younger generations by making dispositions in ways that would not be subject to estate or gift taxes in those younger generations. The GST tax originally included a GST exemption of $1 million.

2.5 TPA 1997. The Taxpayer Protection Act of 1997 increased the estate and gift tax-free amount once again in stages so that by 2006, that tax-free amount was scheduled to increase to $1 million. The 1997 tax act also indexed both the GST exemption and the annual exclusion for gift tax purposes for inflation following 1997.

2.6 The End of "Permanent" Changes. Note that all of the changes described above were "permanent," meaning that once they went into effect, they included no schedule expiration dates.

2.7 EGTRRA. However, in 2001, by which time the tax-free amount had increased to $675,000, the Economic Growth and Tax Relief Reconciliation Act of 2001 increased the tax-free amount to $1 million the following year (2002), and contained further increases to $3.5 million by 2009. Beginning in 2004, the GST exemption was "unified" with the tax-free amount for estate tax purposes beginning in 2004. In addition, the highest marginal tax rate, which had been 55%, was decreased in stages so that by 2007, the highest rate was reduced to 45%. And the topper was that no estate tax would be imposed on the estate of anyone dying after 2009! Those in favor of this bill hailed the anticipated end to the dreaded "death tax!" The gift tax still remained (ostensibly to prevent income tax

[1] The marital deduction had been introduced in 1948 as a means of "equalizing" the treatment of estates in common law states (where often most of the assets were "owned" by just one of the spouses) with community property states (where the ownership of most assets of the spouses was equal by state law). In effect, the marital deduction was limited to one-half of a spouse's separate assets. (The 1948 change also introduced the concept of "gift-splitting.")

[2] The 1976 legislation also first introduced a version of a generation-skipping transfer tax, but since that version never went into effect, it will not be discussed here.

avoidance), with a tax-free amount of $1 million for lifetime taxable gifts and a maximum marginal rate this year of 35%. That's where we are today.

2.8 "This tape will self-destruct in five seconds. Good luck, Jim."[3] But there was a catch. Almost all of us are familiar with the Senate rule requiring 60 votes to end a filibuster. There was (and is) a similar Senate rule requiring 60 votes to pass any tax reduction having an effect lasting more than 10 years. The 2001 tax act had enough votes to pass, but not enough votes to satisfy this permanency rule. Therefore, the 2001 tax act (which included many other well-known tax breaks, such as the 15% capital gains rate and favorable taxation of dividends) included a "self-destruct" clause, providing that all of the changes contained in the act would expire at the end of 2010, leaving us in the same position as if the 2001 act had never passed.

2.9 What Could Have Happened. So where could we have been in 2011 had the 2001 tax act been allowed to expire at the end of 2010? Remember, the 1997 tax act (which received sufficient votes to satisfy the permanency rules) would have increased the tax-free amount to $1 million by 2006. Therefore, we would have had a tax-free amount of $1 million for both estate and gift tax purposes. And the GST tax (which was also on "hiatus" in 2010) would have come back with a tax-free amount of $1.36 million ($1 million, indexed for inflation following 1997).

2.10 Did That Make Sense? A rhetorical question. Of course this made no sense. That's why immediately following the passage of the 2001 act, virtually the entire estate planning profession confidently predicted that Congress would clean up this mess long before 2009 arrived. But Congress had other things on its collective mind (or nothing at all, depending on your perspective). As the end of 2009 approached, we remained confident that Congress would make some change, rather than allowing us to enter 2010 without any estate tax. In fact, in December of 2009, the House passed a bill effectively freezing the estate tax at 2009 levels – a tax-free amount of $3.5 million and a tax rate of 45% for estates above that level. But later that month, the Senate Finance Committee failed to pass the bill out for a floor vote.

2.11 Early 2010 Proposals. In early 2010, there was still some anticipation that Congress might try to pass some type of estate tax bill that would take effect retroactively to the beginning of the year. No estate tax bill came even close to receiving any significant action. None appears imminent.

3. The Genesis of TRUIRJCA.

After the November elections, Congress finally appeared ready to tackle the looming "crisis" involving the expiration of the 2001 tax act changes. Surprisingly to estate tax practitioners, during this period, the estate tax went from being a step-child in the Bush tax cut extension negotiations to being the poster child for what some consider the excesses of what became known as the Obama-GOP compromise. Let's go all the way back to December 2nd for the background.

3.1 The Baucus Bill is Introduced. Sen. Max Baucus (D-MT), chairman of the Senate Finance Committee, introduced a bill on December 2nd that contained his proposed estate tax compromise. The tax-free amount for estate tax purposes would have been **permanently** set at $3.5 million, and the maximum rate would have been 45%. (This was the state of the estate tax law in 2009.) The bill also contained generous deferrals of estate taxes on agricultural land. The main downside to practitioners was the effective date language. Many of our clients were waiting until year-end to make large taxable gifts in order to take advantage of 2010's 35% rate on gift taxes. The Baucus bill raised the rate back to 45% effective the date of introduction – December 2nd.

3.2 The Baucus Bill Fails. Two days later, on Saturday, December 4th, the Baucus bill fell seven votes shy of reaching the necessary 60 votes to break a filibuster in the Senate. So much for that solution.

3.3 The Obama-GOP Compromise. Two more days, and on Monday, December 6th, President Obama and the GOP leadership in Congress announced that they had reached a compromise on the Bush tax cut extension. The outlines of the estate tax portion were a $5 million tax-free amount and a 35% tax rate. Far more generous than any year of the Bush tax cut, excluding 2010 when there were no estate taxes. But we estate planners were waiting for more details. No actual language was provided at the time.

3.4 The House Democratic Caucus Rejects Obama-GOP Compromise Three days after that, on the morning of Thursday, December 9th, the House Democratic Caucus met, and by what has been reported as a virtually unanimous voice vote, rejected the Obama-GOP compromise. The caucus' ire was aimed at extending the Bush tax cuts for those making more than $250,000. And at what they considered to be overly-generous estate tax provisions. One Representative, Lloyd Doggett (D-TX), stated their

[3] If you're too young to know where this comes from, google it.

position succinctly: "If it's take it or leave it, we'll leave it." But the caucus vote was not binding on anyone.

3.5 The Senate Amendment to House Amendment to Senate Amendment Later that evening, the Senate Amendment to House Amendment to Senate Amendment to H.R. 4853 was released. This bill was co-sponsored by Senate Majority Leader Harry Reid (D-NV) and Senate Minority Leader Mitch McConnell (R-KY). This bill contained the text of the legislation enacting the Obama-GOP Compromise. The "short title" of the bill was the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." Let's just shorten that to TRUIRJCA.

3.6 TRUIRJCA Passes On Tuesday, December 14th, the Senate passed TRUIRJCA. On Thursday, December 16th, the House passed TRUIRJCA – without amendment, but only after some significant legislative arm-twisting. On Friday, December 17th, President Obama signed TRUIRJCA into law (using 11 pens – one for each letter in his name).

4. TRUIRJCA Highlights and Lowlights

4.1 The Good. The estate, gift, and generation-skipping highlights of TRUIRJCA include:

- Restoration of the estate tax for 2010 deaths with a $5 million tax-free amount and a 35% tax rate, as the default regime.
- "Election out" of the estate tax default regime for those estates where the current estate-tax-free system is more beneficial (*e.g.*, the George Steinbrenner estate).
- "Reunification" of the estate and gift tax, meaning there will be an increase in the tax-free amount for lifetime gifts from $1 million to $5 million beginning in 2011.
- Indexing the $5 million tax-free amount for inflation after 2011.
- "Portability" of a deceased spouse's unused tax-free amount to the surviving spouse beginning in 2011.
- Reinstatement of the application of the generation-skipping transfer tax rules to 2010 transfers – except that there will still be no GST tax actually imposed on 2010 generation-skipping transfers because the rate is zero.

4.2 The Bad. The [admittedly not so] "lowlights" of TRUIRJCA include:

- While the tax-free amount for estate and GST tax purposes was increased to $5 million in 2010, the tax-free amount for gift tax purposes in 2010 remained at $1 million.
- The "portable" unused tax-free amount from a deceased spouse is not indexed for inflation.
- Portability will require the filing of an estate tax return in the deceased spouse's estate in situations where one would not currently be required.
- The portable unused tax-free amount from a deceased spouse could be lost in the event of remarriage and death of the subsequent spouse.

4.3 And the Ugly. But, the catch is that all of these provisions, and all of the other estate and gift tax provisions contained in the 2001 Bush tax cut bill (like deemed allocations of GST exemption), were only extended for two years. Thus, we're likely to see a reprise of these same arguments at the end of 2012, in the lame duck session that follows the 2012 elections.

5. TRUIRJCA Translation.

As practitioners know, the devil is in the details – in this case, the exact statutory language. For example, it's taken ten years for many to understand that EGTRRA's one-year repeal of the GST tax in 2010 did **not** mean that 2010 transfers were forever exempt from GST taxes. TRUIRJCA changes this. Whereas EGTRRA made the entire GST transfer tax system inapplicable for 2010 transfers, TRUIRJCA takes the opposite approach, and makes the entire GST transfer tax system applicable, but without any tax on 2010 GST transfers.

The following is an attempt to "translate" the actual language of the TRUIRJCA provisions into language more easily understood by tax professionals.

> **SECTION 1. SHORT TITLE; ETC.**
> (a) SHORT TITLE.—This Act may be cited as the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010".

What It Means. Short title, indeed!

> **SEC. 101. TEMPORARY EXTENSION OF 2001 TAX RELIEF.**
> (a) TEMPORARY EXTENSION.—
> (1) IN GENERAL.—Section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 is amended by striking "December 31, 2010" both places it appears and inserting

"December 31, 2012".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall take effect as if included in the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001.

What It Means. In general, the provisions of EGTRRA that were scheduled to expire at the end of 2010 are given a two year reprieve. Therefore, absent further legislation, the changes made by EGGTRA (both good and bad) still expire at the end of 2012, with all the attendant uncertainties that existed in 2010.

SEC. 301. REINSTATEMENT OF ESTATE TAX; REPEAL OF CARRYOVER BASIS.

(a) IN GENERAL.—Each provision of law amended by subtitle A or E of title V of the Economic Growth and Tax Relief Reconciliation Act of 2001 is amended to read as such provision would read if such subtitle had never been enacted.

What It Means. This repeals two portions of Title V of EGTRRA –

- Subtitle A, which makes chapter 11 (estate taxes) inapplicable to the estates of decedents dying after 2009, and chapter 13 (GST taxes) inapplicable to generation-skipping transfers after 2009.

- Subtitle E, which repeals the step-up in basis and institutes the $1.3 million general basis adjustment and the $3 million spousal basis adjustment.

This rest of Title V of EGTRRA, dealing with rates, exemption amounts, and state death taxes, remains intact.

(b) CONFORMING AMENDMENT.— On and after January 1, 2011, paragraph (1) of section 2505(a) of the Internal Revenue Code of 1986 is amended to read as such paragraph would read if section 521(b)(2) of the Economic Growth and Tax Relief Reconciliation Act of 2001 had never been enacted.

What It Means. This is a clean-up provision repealing the EGTRRA changes to the reference to the lifetime gift tax exemption that would have taken place after the repeal of the estate tax. (EGTRRA removed the reference to the tax-free amount for estate tax purposes in determining the amount of the tax-free amount for gift tax purposes since the former didn't exist after 2009 under EGTRRA.)

(c) SPECIAL ELECTION WITH RESPECT TO ESTATES OF DECEDENTS DYING IN 2010.—Notwithstanding subsection (a), in the case of an estate of a decedent dying after December 31, 2009, and before January 1, 2011, the executor (within the meaning of section 2203 of the Internal Revenue Code of 1986) may elect to apply such Code as though the amendments made by subsection (a) do not apply with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code). Such election shall be made at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide. Such an election once made shall be revocable only with the consent of the Secretary of the Treasury or the Secretary's delegate. For purposes of section 2652(a)(1) of such Code, the determination of whether any property is subject to the tax imposed by such chapter 11 shall be made without regard to any election made under this subsection.

What It Means. Since subsection (a) repeals the repeal of the estate tax, executors of the estates of 2010 decedents (*e.g.*, George Steinbrenner's executor) are given the election of opting back in to the repeal of the estate tax (and carryover basis with the $1.3 million and $3 million basis adjustments).

However, even if the executor elects back in to the no-estate-tax regime, the decedent will still be considered the transferor for GST tax purposes (as if the estate has been subject to estate taxes).

(d) EXTENSION OF TIME FOR PERFORMING CERTAIN ACTS.—

(1) ESTATE TAX.—In the case of the estate of a decedent dying after December 31, 2009, and before the date of the enactment of this Act, the due date for—

(A) filing any return under section 6018 of the Internal Revenue Code of 1986 (including any election required to be made on such a return) as such section is in effect after the date of the enactment of this Act without regard to any election under subsection (c),

(B) making any payment of tax under chapter 11 of such Code, and

(C) making any disclaimer described in section 2518(b) of such Code of an interest in property passing by reason of the death of such decedent, shall not be earlier than the date which is 9 months after the date of the enactment of this Act.

What It Means. For 2010 decedents **who die prior to the date of enactment (December 17, 2010)**, the following deadlines are extended until 9 months after the date of enactment (*i.e.*, September 19, 2011, since September 17th is a Saturday):

- Filing an estate tax return;
- Paying estate taxes; and
- Making disclaimers.

However, since a qualified disclaimer must also be effective under state law, state disclaimer statutes may also need to be modified to accommodate an extended deadline.

For a decedent dying on or after December 17th, the normal deadlines will apply. These are generally 9 months following the date of death, except for filing a large estate basis allocation return (if the executor opts out of application of the estate tax). The large estate return would generally be due April 18, 2011 (Friday, April 15th, is a holiday – Emancipation Day). However, Section 301(c) gives the Secretary of the Treasury the discretion to provide a different deadline for electing out. Steve Akers has explained that the literal language of Section 301(d)(1)(A) (involving multiple double and triple negatives) **does not** extend the due date of the large estate basis allocation return, but remember that it may be extended until October 15, 2011, by filing for an automatic extension of the due date for the decedent's final income tax return. (And since October 15th falls on a Saturday, the actual due date would be October 17th.) Rumors also abound that the Internal Revenue Service will administratively extend the deadline to that date anyway.

> (2) GENERATION-SKIPPING TAX.—In the case of any generation-skipping transfer made after December 31, 2009, and before the date of the enactment of this Act, the due date for filing any return under section 2662 of the Internal Revenue Code of 1986 (including any election required to be made on such a return) shall not be earlier than the date which is 9 months after the date of the enactment of this Act.

What It Means. For 2010 generation-skipping transfers made prior to December 17th, the deadline for filing a return reporting the generation-skipping transfer is extended until 9 months after the date of enactment (*i.e.*, until September 19, 2011).

> (e) EFFECTIVE DATE.— Except as otherwise provided in this section, the amendments made by this section shall apply to estates of decedents dying, and transfers made, after December 31, 2009.

What It Means. In general, this section applies to decedents dying, and transfers made, after 2009. **Therefore, the default rule is that the repeal is retroactive.** However, read on to see how the retroactive tax is modified, and remember that the estates of 2010 decedents can elect to take advantage of the estate tax repeal.

> **SEC. 302. MODIFICATIONS TO ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES.**
>
> (a) MODIFICATIONS TO ESTATE TAX.—
>
> (1) $5,000,000 APPLICABLE EXCLUSION AMOUNT.—Subsection (c) of section 2010 is amended to read as follows:
>
> "(c) APPLICABLE CREDIT AMOUNT.—
>
> "(1) IN GENERAL.—For purposes of this section, the applicable credit amount is the amount of the tentative tax which would be determined under section 2001(c) if the amount with respect to which such tentative tax is to be computed were equal to the applicable exclusion amount.
>
> "(2) APPLICABLE EXCLUSION AMOUNT.—
>
> "(A) IN GENERAL.—For purposes of this subsection, the applicable exclusion amount is $5,000,000.
>
> "(B) INFLATION ADJUSTMENT.—In the case of any decedent dying in a calendar year after 2011, the dollar amount in subparagraph (A) shall be increased by an amount equal to—
>
> "(i) such dollar amount, multiplied by
>
> "(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 2010' for 'calendar year 1992' in subparagraph (B) thereof.
>
> If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the nearest multiple of $10,000.".
>
> (2) MAXIMUM ESTATE TAX RATE EQUAL TO 35 PERCENT.—Subsection (c) of section 2001 is amended—
>
> (A) by striking "Over $500,000" and all that follows in the table contained in paragraph (1) and inserting the following:
>
> "Over $500,000 .... $155,800, plus 35 percent of the excess of such amount over $500,000.",
>
> (B) by striking "(1) IN GENERAL.—", and
>
> (C) by striking paragraph (2).

What It Means. What we commonly refer to as the tax-free amount is, and has been for some time, referred to as the applicable exclusion amount. Similarly, what we call the unified credit is actually the applicable credit amount.

The general rule is that the applicable exclusion amount – or the tax-free amount – for estate tax purposes will now be $5 million.

Since the default rule is now that 2010 decedents are subject to estate taxes, and the general rule is that this section applies to decedents dying, generation-skipping transfers, and gifts made after 2009, 2010 decedents have a $5 million tax free amount, not the 2009 $3.5 million tax-free amount.

And, in addition, after 2011, this tax-free amount is indexed for inflation after 2010 to the nearest $10,000.

The maximum rate on taxable estates will now be 35%.

(b) MODIFICATIONS TO GIFT TAX.—
(1) RESTORATION OF UNIFIED CREDIT AGAINST GIFT TAX.—
(A) IN GENERAL.—Paragraph (1) of section 2505(a), after the application of section 301(b), is amended by striking "(determined as if the applicable exclusion amount were $1,000,000)".
(B) EFFECTIVE DATE.—The amendment made by this paragraph shall apply to gifts made after December 31, 2010.
(2) MODIFICATION OF GIFT TAX RATE.—On and after January 1, 2011, subsection (a) of section 2502 is amended to read as such subsection would read if section 511(d) of the Economic Growth and Tax Relief Reconciliation Act of 2001 had never been enacted.

What It Means. Next, estate and gift taxes are once again "unified" with the same $5 million indexed tax-free amount.

However, this reunification has its own effective date – for gifts after 2010. (The tax-free amount for 2010 gifts remained at $1 million.)

EGTRRA Section 511(d) tied the maximum gift tax rate to the maximum income tax rate once the estate tax was repealed. This EGTRRA provision is now unnecessary, so the maximum gift tax rate will also be 35%.

(c) MODIFICATION OF GENERATION-SKIPPING TRANSFER TAX.— In the case of any generation-skipping transfer made after December 31, 2009, and before January 1, 2011, the applicable rate determined under section 2641(a) of the Internal Revenue Code of 1986 shall be zero.

What It Means. 2010 generation-skipping transfers are not exempt, and do not create an inclusion ratio of zero. They are subject to GST taxes, but the applicable rate in determining GST taxes due is zero, so no GST taxes will be due on 2010 transfers.

Note, however, that by using this mechanism, all other GST rules apply, so since the applicable exclusion amount for estate tax purposes will be $5 million in 2010, and the GST exemption is tied to the applicable exclusion amount for estate tax purposes, everyone has a $5 million GST exemption in **2010**. This also means that 2010 gifts in trust for grandchildren (when the GST applicable rate is zero) will not be subject to GST tax when later distributions are made to the grandchildren, because the "move-down" rule of Section 2653 applies (although distributions to their descendants would be subject to GST tax unless GST exemption is allocated to those gifts).

(d) MODIFICATIONS OF ESTATE AND GIFT TAXES TO REFLECT DIFFERENCES IN CREDIT RESULTING FROM DIFFERENT TAX RATES.—
(1) ESTATE TAX.—
(A) IN GENERAL.—Section 2001(b)(2) is amended by striking "if the provisions of subsection (c) (as in effect at the decedent's death)" and inserting "if the modifications described in subsection (g)".
(B) MODIFICATIONS.—Section 2001 is amended by adding at the end the following new subsection:
"(g) MODIFICATIONS TO GIFT TAX PAYABLE TO REFLECT DIFFERENT TAX RATES.—For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute—
"(1) the tax imposed by chapter 12 with respect to such gifts, and
"(2) the credit allowed against such tax under section 2505, including in computing—
"(A) the applicable credit amount under section 2505(a)(1), and
"(B) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).".
(2) GIFT TAX.—Section 2505(a) is amended by adding at the end the following new flush sentence:
"For purposes of applying paragraph (2) for any

calendar year, the rates of tax in effect under section 2502(a)(2) for such calendar year shall, in lieu of the rates of tax in effect for preceding calendar periods, be used in determining the amounts allowable as a credit under this section for all preceding calendar periods.".

What It Means. This provides technical computational guidance for calculating estate taxes at the highest marginal brackets, taking into account lifetime gifts. While current law has similar provisions, the added guidance includes a mechanism for determining how the computation works with respect to the gift credit amount that is used the calculation. A detailed explanation of how this works would require its own seminar paper, but it basically makes the gift tax rate in effect at the date of death or the date of the gift applicable to all prior gifts to avoid variations caused by different applicable credit amounts. However, for those interested, an excellent and detailed explanation **can** be found in Steve Akers' paper, *Estate Planning Effects and Strategies Under the "Tax Relief ... Act of 2010,"* cited at the end of this article.

(e) CONFORMING AMENDMENT.— Section 2511 is amended by striking subsection (c).

What It Means. This repeals Section 2511(c), the provision that went into effect in 2010 treating all transfers in trust as completed gifts unless the trust is a wholly "grantor trust" as to the donor.

(f) EFFECTIVE DATE.— Except as otherwise provided in this subsection, the amendments made by this section shall apply to estates of decedents dying, generation-skipping transfers, and gifts made, after December 31, 2009.

What It Means. The general rule is that the changes in the tax-free amount and maximum rates (and the repeal of Section 2511(c)) are retroactive to the beginning of 2010. However, remember there is a special post-2010 effective date for the increased tax-free amount for **gift** tax purposes.

SEC. 303. APPLICABLE EXCLUSION AMOUNT INCREASED BY UNUSED EXCLUSION AMOUNT OF DECEASED SPOUSE.

(a) IN GENERAL— Section 2010(c), as amended by section 302(a), is amended by striking paragraph (2) and inserting the following new paragraphs:

"(2) APPLICABLE EXCLUSION AMOUNT.—For purposes of this subsection, the applicable exclusion amount is the sum of—

"(A) the basic exclusion amount, and

"(B) in the case of a surviving spouse, the deceased spousal unused exclusion amount.

"(3) BASIC EXCLUSION AMOUNT.—

"(A) IN GENERAL.—For purposes of this subsection, the basic exclusion amount is $5,000,000.

"(B) INFLATION ADJUSTMENT.—In the case of any decedent dying in a calendar year after 2011, the dollar amount in subparagraph (A) shall be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 2010' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the nearest multiple of $10,000

What New Code Sections 2010(c)(2) and (3) Mean. This amends the tax-free amount as already amended by Section 302(a) of this act.

In Section 302(a)(2), the tax-free amount is referred to as the "applicable exclusion amount." It is $5 million indexed after 2011 for inflation after 2010.

This amendment introduces an additional twist. Now, the $5 million indexed for inflation is referred to as the "basic exclusion amount," and the "applicable exclusion amount" is redefined to be the sum of the basic exclusion amount and, in the case of a surviving spouse, the "deceased spousal unused exclusion amount."

"(4) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT.—For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term 'deceased spousal unused exclusion amount' means the lesser of—

"(A) the basic exclusion amount, or

"(B) the excess of—

"(i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over

"(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

What New Code Section 2010(c)(4) Means. First, a surviving spouse only gets the benefit of portability from a deceased spouse dying **after** 2010. Therefore, even though the estate tax is technically reinstated for 2010 by Section 301 with a $5 million tax-free amount under Section 302, the benefits of portability won't kick in until 2011.

Next, the deceased spousal unused exclusion amount (or DSUEA) of the surviving spouse is limited to the **lesser** of:

- the basic exclusion amount (*i.e.*, the indexed $5 million amount – or whatever it is when the surviving spouse dies) or
- the excess of the **last** deceased spouse's **basic** exclusion amount over that spouse's taxable estate **including** adjusted taxable gifts.

> "(5) SPECIAL RULES.—
>
> "(A) ELECTION REQUIRED.—A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse under paragraph (2) unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account. Such election, once made, shall be irrevocable. No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return.
>
> "(B) EXAMINATION OF PRIOR RETURNS AFTER EXPIRATION OF PERIOD OF LIMITATIONS WITH RESPECT TO DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT.—Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.
>
> "(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this subsection."

What New Code Sections 2010(c)(5) and (6) Mean. A surviving spouse may only take advantage of the last deceased spouse's DSUEA if the executor of the deceased spouse's estate filed an estate tax return making a DSUEA election. So won't we have to file estate tax returns in every case when a deceased spouse dies, no matter how small the estate, since we won't know if the survivor may win the lottery and need the DSUEA?

The election must be made on a timely-filed return, so the survivor can't wait and see if it will be needed later.

Even though the statute of limitations for assessing additional estate or gift taxes on the deceased spouse's estate has expired, that estate may still be reexamined for purposes of determining the proper DSUEA. This appears similar to the rule for determining the proper amount of adjusted taxable gifts.

> (b) CONFORMING AMENDMENTS.—
>
> (1) Paragraph (1) of section 2505(a), as amended by section 302(b)(1), is amended to read as follows:
>
> "(1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by".
>
> (2) Section 2631(c) is amended by striking "the applicable exclusion amount" and inserting "the basic exclusion amount".
>
> (3) Section 6018(a)(1) is amended by striking "applicable exclusion amount" and inserting "basic exclusion amount".

What It Means. Since the portability provisions introduce the new "basic exclusion amount" term to refer to the indexed $5 million amount, and the term "applicable exclusion amount" will now include the DSUEA, certain other provisions, such as the GST exemption and the threshold for filing returns, need to be revised to refer to the basic, not the applicable, exclusion amount.

> (c) EFFECTIVE DATES.—
>
> (1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to estates of decedents dying and gifts made after December 31, 2010.
>
> (2) CONFORMING AMENDMENT RELATING TO GENERATION-SKIPPING TRANSFERS.—The amendment made by subsection (b)(2) shall apply to generation-skipping transfers after December 31, 2010".

What It Means. Portability is effective for post-2010 decedents. And since new Code Section 2010(e)(4) only provides a DSUEA for a deceased spouse dying after 2010, portability will only apply if the **first** of two spouses dies after 2010

Again, there is no portability for any unused tax-free amount of a 2010 deceased spouse.

SEC. 304. APPLICATION OF EGTRRA SUNSET TO THIS TITLE.

Section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 shall apply to the amendments made by this section.

What It Means. Section 901 of EGTRRA is the section that says all of EGTRRA expires at the end of 2010. But Section 901 of EGTRRA is in turn amended by Section 101(a)(1) of this bill to extend the expiration to the end of 2012. So this is intended to incorporate the same expiration date for all of the amendments describe above. It refers to amendments made by this "section," but since Section 304 makes no amendments, surely it is intended to refer to amendments made by Title III of this bill (*i.e.*, **all** of the estate, gift and GST tax amendments).

6. Choose Your "Poison" for 2010 Decedents.

TRUIRJCA essentially creates two different tax regimes for 2010 decedents. The executor of the decedent's estate gets to decide which will be more beneficial.

6.1 The Default Regime. By default, TRUIRJCA retroactively reenacts the estate tax for all 2010 decedents, but with the following characteristics:

- A basic exclusion amount (or tax-free amount) of $5 million.
- A 35% flat rate on estates above $5 million.
- New basis for all assets equal to their fair market value as of the date of death (the old rule we're familiar with).
- State death tax deduction, not credit.
- No filing requirement for gross estates (plus adjusted taxable gifts) under $5 million.

These are the default rules that will apply to all 2010 decedents. An executor need do nothing to take advantage of them.

6.2 The "Opt-Out" Regime. However, TRUIRJCA avoids constitutional objections to retroactivity for larger estates by allowing the executors of estates of 2010 decedents to opt out of the default rules and allow the no-estate-tax-but-carryover-basis rules that EGTRRA provided for 2010 to apply. This regime imposes no estate tax regardless of the size of the estate, but imposes a modified carryover basis. A proposed large estate basis allocation Form 8939 has been issued by the IRS, but no instructions are available, and there is no indication when the form will be finalized. This will be the choice for estates significantly above the $5 million tax-free amount.

6.3 Is the Choice Obvious? In most cases, it will be. **But do not be lulled into a false sense that it is obvious!** Remember, "all generalizations, including this one, are untrue." The biggest issues will arise from wills or trusts containing formula clauses where the application of the formula could result in a different disposition (and, of course, the construction issues raised by that circumstance. See the discussion at Section 6.6 below).

- For estates below $5 million, there is probably no reason to opt out of the default regime. There won't be any estate taxes due, the assets will all get a new basis equal to their fair market value, and no estate tax return will be required.
- For estates significantly above $5 million, opting out of the estate tax will make sense, despite the increased future income tax that will be due when assets without a full stepped-up basis are sold.
- There is a range of estates above $5 million where the executor will actually have to run the numbers to determine whether the estate taxes that will be due will be outweighed by potential additional capital gains taxes.

6.4 An Oversimplified Example. Assume a "taxable" estate of a 2010 decedent of $7.775 million. The assets have a zero basis (yes, this is very oversimplified!).

- The default estate tax rules will impose a 35% estate tax on the assets above $5 million, or $971,250. But all of the remaining assets will have a basis equal to their fair market value on the date of death, so there is no further capital gain exposure for pre-death appreciation.
- If the executor opts out of the default estate tax regime, there will be no estate tax (saving $971,250 in estate taxes). But the $7.775 million in assets will have a maximum basis of $1.3 million after the basis adjustment allocation provided by EGTRRA, leaving an unrealized

capital gain of $6.475 million. When those assets are eventually sold, they will generate $971,250 in capital gains taxes (if the rate at that time is still 15%). Of course, those taxes won't be paid until after the assets are sold.

So the "uncertain" range where the executor will have to crunch the numbers appears to be between $5 million and somewhere north of $7.775 million.

6.5 Optimal Marital Deduction Wills. If the 2010 decedent is a first spouse with a will containing optimal marital deduction planning, the choice may not be as easy if the estate is significantly in excess of $5 million. Let's say the first spouse's estate is valued at $20 million.

- The default rules will provide a new basis in all of the assets, including the surviving spouse's half of the community estate.
- No taxes will be due – the formula clause will result in a $15 million marital deduction gift.
- But that's an extra $15 million that will be taxable in the survivor's estate, when "opting out" **might** send all of that $15 million to a bypass trust.

6.6 Fiduciary Conflicts. The difficulty in the decision to be made by the executor extends beyond the tax issues.

- What if the tax-free amount passes to the children by a prior marriage? The opt-out election could quadruple their current inheritance from $5 million to the full $20 million.
- What if the executor is the surviving spouse who is not the parent of the children (or just doesn't get along with them)?
- Or reverse the situation – what if the children are the executors?
- Or pity the poor third-party executor stuck between this rock and a hard place!

A declaratory judgment proceeding might help, but if there is little agreement among the beneficiaries, what are the chances that there will be a resolution by the filing deadline?

6.7 Additional Factors. And here's a "partial" list of factors for the executor to consider, provided courtesy of ACTEC Fellows Dana Fitzsimons and Ron Aucutt:

- Calculation and apportionment of estate tax burden.
- Impact of election on formula clauses.
- Projected date of sale of each asset.
- Ability to allocate basis.
- Basis of each estate asset.
- Date of death value of each estate asset.
- Projected future value of each asset.
- Projected earnings from each asset.
- Tax character of any future gains or earnings on assets.
- Identity of the beneficiaries.
- Cash needs of the beneficiaries.
- Future income and estate tax rates.
- Domicile of beneficiaries and personal income tax information.
- Availability of asset-specific tax deductions and credits.
- Potential for disagreement among beneficiaries concerning the allocation of basis.
- Conflicts of interest in making the election and allocating basis.
- The availability of binding consents or court approval.
- Whether a compensating equitable adjustment is appropriate, and whether it should be approved by a court.

Are we having fun yet?

7. The Newly-Reunified Gift Tax.

7.1 Reunification. Beginning in 2011, the tax-free amount for gift lifetime taxable gifts is tied to the tax-free amount for estate tax purposes. Therefore, the exemption is increased from $1 million to $5 million, indexed for inflation after 2010 beginning in 2012. And the flat rate applicable to cumulative gifts in excess of the $5 million tax-free amount will be 35%.

7.2 Prior Law. EGTRRA increased the tax-free amount for both estate and gift tax purposes to $1 million beginning in 2001. Then, the tax-free amount for estate tax purposes began to rise, while the tax-free amount for gift tax purposes remained at $1 million. The reason behind this "deunification" was to discourage gifts to persons who could realize gains in lower income tax brackets, who then gifted the assets back to the original donor.

7.3 Year-End 2010 Gifts. EGTRRA not only eliminated estate taxes for 2010 decedents but also lowered the gift tax rate on taxable gifts exceeding the cumulative $1 million lifetime limit to the maximum income tax rate of 35%. With the expiration of EGTRRA at the end of the year looming and the potential return of a 55% estate tax rate, many taxpayers considered making large taxable gifts before the end of the year to lock in the 35% rate on those assets. Once TRUIRJCA was enacted, large gifts to lock in the 35% rate became unnecessary. For those who had already made gifts during 2010, there was serious consideration as to whether rescission was possible.

7.4 Gifts in 2011 and 2012. With the increased $5 million tax-free amount available for lifetime gifts, many taxpayers with large estates are considering making taxable gifts utilizing that full exemption before the end of 2012 in case the tax-free amount drops after 2012 (as it will if Congress takes no action or if Congress returns to a lower applicable exclusion amount). But what if the exemption does drop, say, to $3.5 million in 2013 when a taxpayer who had made a taxable gift of $5 million in 2012 dies?

- If the taxpayer is unmarried and taxes would have been paid anyway, the full $5 million will be pulled back in as an adjusted taxable gift. The estate will be given a credit for the taxes that would have been payable on that $5 million, but at the rates in effect in 2013. The result will be a "clawback" of the gift that previously produced no gift taxes, and the estate taxes on the remaining assets will be increased. But at the very least, the taxpayer was able to get all of the post-gift appreciation and income on the $5 million gift out of his or her estate, tax-free. So the beneficiaries are probably still ahead.

- But what if the taxpayer is married and the will contains an optimum marital deduction formula clause. When the $5 million in adjusted taxable gifts are pulled back into the estate, there is automatically a $1.5 million taxable estate, on which the estate taxes must be paid from the marital share. Therefore, despite utilization of the unlimited marital deduction, estate taxes may be due at the first spouse's death.

- The additional estate tax will reduce the marital deduction, which will in turn generate more tax, which will further reduce the marital deduction, and so on, increasing the overall tax liability. The same thing happens with a charitable gift to the extent that taxes may be paid from the charitable gift.

- Suppose there are not enough assets in the estate to pay the tax. Can the IRS reach the donees on a transferee theory? One would think not because the gift to the donees is not transferred from the estate.

- Worst case scenario, the tax-free gift was to a different class of beneficiaries (*e.g.*, the children by the first marriage) than the beneficiaries of the estate (*e.g.*, the surviving spouse).

8. Generation-Skipping Transfer Tax.

8.1 $5 Million GST Exemption in 2010. As noted above, while the tax-free amount for gift tax purposes was increased to $5 million only after 2010, the tax-free amounts for the reinstated estate and generation-skipping transfer taxes were increased to that amount retroactively for all of 2010. This means that any 2010 gifts to trusts that qualify as indirect skips will remain exempt (within the new GST exemption limits) under the automatic allocation rules. And the $5 million GST exemption also applies to 2010 decedents, even if the estate elects out of the estate tax regime. But it is unclear how the estate will allocate that exemption amount. The executor wouldn't be filing an estate tax return with a Schedule R if he or she elects out of the estate tax regime. On the other hand, the current draft of Form 8939 (the form we'll use for allocating the $1.3 million and $3 million spousal basis adjustments) has no provision for allocating GST exemption. That omission is completely understandable, since the draft form was issued the same day TRUIRJCA passed (and therefore there was no GST exemption when the form was being crafted). This is another reason we expect that a Fall, 2011, administrative extension of the due date for this return is likely, and that advice will provided as to how this election is to be made.

8.2 The Temporary GST Tax Holiday is Over. TRUIRJCA introduced an interesting GST tax benefit, but it only arose upon enactment and expired at the end of 2010.

(a) The EGTRRA Environment. EGTRRA provided that none of the GST tax statutes would apply to any GST transfer after 2009 (which provision also expired at the end of 2010, making all of the GST tax statutes "reapplicable" after 2010.) If you were to make a large gift to your grandchildren in 2010, that gift would be subject to all of the normal gift taxes, but unlike other years, you would not incur any GST taxes. The transfer would be a "direct skip" that is a GST transfer and would normally be subject to GST tax. But since none of the GST tax statutes applied to any GST transfer in 2010, no additional GST tax would be due.

However, few clients want to make outright gifts to their grandchildren, preferring instead to make the gifts to the grandchildren in trust. A 2010 gift to a trust for grandchildren would be a direct skip that would escape GST tax because of the inapplicability of the tax to GST transfers this year. But then the assets are in the trust. Eventually, assets would be distributed from the trust to your grandchildren. If those distributions took place after 2010, when the GST tax returned, they would be considered taxable distributions or terminations subject to GST tax at that time. EGTRRA did not provide that any 2010 transfers were forever exempt from the application of the GST tax. Rather, it merely provided that the GST tax statutes would not apply to any GST transfer taking place in 2010. And in this case, the client had not, and could not, apply any of the client's GST exemption to the initial gift, because the client had no GST exemption in 2010 to allocate.

(b) The TRUIRJCA "GST Holiday." TRUIRJCA changed the application of the GST tax in 2010. All of the GST statutes were reinstated, with a $5 million GST tax exemption tied to the tax-free amount for estate tax purposes. But to avoid retroactivity complaints, the tax rate on 2010 GST transfers was effectively reduced to zero. Therefore, if a gift was made to a trust for grandchildren (treated as a "skip person"), that gift would be a direct skip subject to GST taxes, but generating a GST tax of zero. Because this was a GST transfer, however, a "move down" rule applies, causing the "deemed transferor" of the trust to be considered a person one generation above the grandchildren. Therefore, future distributions to the grandchildren would not be taxable distributions or terminations subject to GST tax, since the grandchildren were only one generation below the new "deemed transferor." This doesn't mean that the trust became exempt. Future distributions to the descendants of the grandchildren would be subject to the GST tax. But at least one free generation-skip became available. This same reasoning applied to distributions from already existing but otherwise nonexempt trusts. However, since the zero tax rate expired at the end of 2010, the tax holiday was short-lived.

CAVEAT. If you wish to take advantage of the "GST Holiday" and the zero tax rate for direct skips from a decedent, you must make sure that the automatic allocation rules for the GST exemption don't undo your careful planning. You can do so either by allocating the full GST exemption to other gifts intended to utilize the $5 million GST exemption, such as gifts to dynasty trusts that qualify as indirect skips, or by filing a gift tax return electing out of automatic allocation of the GST exemption, or some other return yet-to-be-determined.

8.3 The GST Tax in 2011 and 2012. The GST exemption for 2011 and 2012 remains tied to the tax-free amount for estate tax purposes, or $5 million indexed for post-2010 inflation beginning in 2012. The tax rate on GST transfers exceeding this exemption remains tied to the maximum estate tax rate of 35%. And the automatic allocation and qualified severance rules contained in EGTRRA are preserved.

9. Portability.

9.1 The Concept. "Portability" is a concept that has been bandied about for a number of years. In common law jurisdictions, complex planning is often necessary to equalize the estates of the spouses (something that happens automatically in community property jurisdictions). If the non-propertied spouse died first, his or her applicable exclusion amount was lost. Additionally, ever since the advent of the unlimited marital deduction, it has been possible for spouses to delay any taxation of their estates until after the survivor's death. But in order to preserve the benefit of both spouses' tax-free amounts, some form of tax planning, such as a bypass trust, was required. Wouldn't it be simpler to just let the first spouse pass along his or her tax-free amount to the survivor, eliminating the need for a bypass trust?

9.2 Estate and Gift – But Not GST – Tax Portability. First, portability only applies to the tax-free amount for estate and gift tax purposes. If the first spouse leaves any of his or her GST exemption unused, there is no provision for transferring that unused GST exemption to the surviving spouse.

9.3 The "Deceased Spousal Unused Exclusion Amount." The key to portability is the introduction of a new concept – deceased spousal unused exclusion amount, or DSUEA. A surviving spouse's applicable exclusion amount (*i.e.*, that spouse's tax-free amount, for estate and gift tax purposes), will be equal to their basic exclusion amount of $5 million (indexed for inflation after 2011), plus their DSUEA. (The reason portability doesn't apply for GST exemption purposes is that that exemption is tied to the basic exclusion amount, not the applicable exclusion amount. Got it?) As noted above, the surviving spouse's DSUEA is limited to the **lesser** of:

- the basic exclusion amount (*i.e.*, the indexed $5 million amount – or whatever it is when the surviving spouse dies) or
- the excess of the **last** deceased spouse's **basic** exclusion amount over that deceased spouse's taxable estate **including** adjusted taxable gifts.

9.4 Notable DSUEA Characteristics. Note several things about the survivor's DSUEA:

(a) No Inflation Adjustment. The survivor's DSUEA, unlike his or her basic exclusion amount, is not indexed for inflation. So unlike assets placed in a bypass trust, you don't shield future appreciation from tax.

(b) Availability of Addition Basis Increase at Survivor's Death. But unlike assets in a bypass trust, assets covered by the survivor's DSUEA will be eligible for a step-up in basis at the survivor's death

(c) Only the DSUEA From the <u>Last</u> Deceased Spouse Counts. You only get to add the unused exclusion amount of your **last** deceased spouse. You keep the DSUEA from your last deceased spouse even when you remarry. But if the subsequent spouse dies before you, you lose the prior DSUEA (because the prior spouse is no longer the **last** deceased spouse) and substitute the DSUEA from the later spouse. Imagine the estate planner advising his or her surviving spouse client not to remarry because of the danger of losing a large DSUEA from a prior spouse if the subsequent spouse predeceases and uses up most or all of his or her exclusion amount! Or if the spouse has already remarried, advising him or her to divorce an ailing second spouse (who is unlikely to have any unused exclusion amount) before that second spouse "matures" into a "last surviving spouse."

(d) No DSUEA Tacking. The survivor's DSUEA only includes the portion of the **basic** exclusion amount that is left unused by the last deceased spouse. If that spouse had his or her own DSUEA, the surviving spouse doesn't get any benefit from that. And it appears that you use up the deceased spouse's basic exclusion amount first when determining whether there's any unused tax-free amount. In other words, if the last spouse had a large DSUEA from a prior spouse, there's no way any benefit from that prior DSUEA will be transferred to the surviving spouse. Effectively the surviving spouse's DSUEA from the last deceased spouse will be determined as if that last deceased spouse has no DSUEA from his or her previous spouse. At least that's the conclusion that the literal language of the statute leads one to.

(e) Joint Committee Example 3. However, example 3 on page 53 of the Joint Committee on Taxation's technical explanation of TRUIRJCA would lead to a different "first-in-first-out" tacking of one spouse's DSUEA to a survivor's DSUEA. This example is just wrong, and cannot be reconciled with the statute. The JCT has indicated that a technical correction will make this the applicable law. If this example is correct, consider the following: H1 dies with a DSUEA of $5 million. W remarries and makes taxable gifts of $2 million while W's second spouse, H2, is alive. Now W has $3 million of H1's DSUEA left. Then, H2 dies with a DSUEA of $5 million. W now has W's $5 million basic exclusion amount, plus H2's $5 million, **plus** the $2 million dollars of taxable gifts covered by H1's DSUEA. Really? What a deal so long as W remarries (tax-)wisely.

9.5 Taking Advantage of Portability. As noted above, a surviving spouse may only claim the benefits of a DSUEA from a prior spouse if the executor of that prior spouse's estate filed an estate tax return and made a DSUEA election. So an estate tax return would be required in virtually every estate of a decedent with a surviving spouse, no matter how small, if the executor wanted to protect the possibility of the surviving using the unused tax-free amount of the first spouse. And the DSUEA election must be made on a **timely-filed** estate tax return. You can't wait and see whether it will be useful later on. Other problems:

- Will the executor be able to accurately estimate the value of the survivor's estate? (The survivor could buy a winning lottery ticket, after all!)
- Will the executor be able to accurately estimate the tax-free amount otherwise available to the survivor at his or her death? (Can any of you tell us what the tax-free amount will be in any year after 2012?)
- What if the first spouse's relatively small estate passes entirely to children by a prior marriage? Why would the executor spend any of their money preparing an estate tax return designed to preserve a larger tax-free amount to be used at the death of the surviving spouse who is not the beneficiaries' parent?
- There is no statute of limitations on the estate tax

return that makes the DSUEA election for purposes of examining whether the amount of the DSUEA claimed is accurate.

9.6 A Clear Benefit of Portability. Because of the considerations and concerns noted above, the authors are unlikely to rely on portability as a primary estate planning strategy in most cases. However, there is one area where portability provides a clear benefit. Where a large part of a couple's assets consist of interests in retirement plans, it can be extremely complicated to pour the first spouse's retirement benefits into a bypass trust and also preserve the benefits of deferred minimum required distributions. Making these benefits payable outright to the surviving spouse is often the best strategy from an income tax standpoint. But that strategy may leave the first spouse's estate vulnerable to an underfunded bypass trust. Portability solves this problem by allowing the first spouse to just transfer the portion of his or her tax-free amount that would have covered the portion of the plan benefits otherwise passing to the bypass trust to the surviving spouse, reducing the problem of underfunding the bypass trust. Not a perfect solution, but very possibly better than the solutions previously available to us.

9.7 But Does Portability Really Matter? Remember, all of the amendments made by TRUIRJCA only last for two years. Therefore, portability literally applies only if the first spouse dies **after** 2010, and the surviving spouse dies **before** 2013. The drafters must anticipate that the application of this provision will be extended beyond 2012, but just as there is no crying in baseball, there is no guarantee as to what Congress will "surely" do. But portability sounds so fair, we believe that it is here to stay.

10. Planning for Married Couples in the TRUIRJCA Environment.

10.1 Desire for Simplicity. When was the last time a client called you up and asked for a "complicated" will?

(a) Everything Outright to Surviving Spouse. Portability, while not perfect, clearly makes this a viable option. And unlike a bypass trust strategy, it allows for an additional step-up in basis for all assets at the survivor's death.

(b) Everything Outright to Surviving Spouse, With Disclaimer Trust. This provides the option to the surviving spouse of utilizing a trust with the same tax benefits of a bypass trust. But unless the law has changed to eliminate portability, how often would the survivor disclaim into a disclaimer trust? And remember, unlike a traditional bypass trust, a surviving spouse may not retain any special power of appointment over a bypass trust.

(c) Why Not Keep Things Simple? These "outright to spouse" options may not be appropriate in all situations:

- What if this is a blended family with children from prior marriages, and each spouse wants to assure some future inheritance by that spouse's children?
- What if a spouse is concerned about the possibility that the survivor may remarry and give some of the first spouse's property to that new spouse, instead of the first spouse's children?
- Remember that the DSUEA is not indexed for inflation. So unlike a bypass trust, the future appreciation of assets won't necessarily be protected by portability.
- Assets placed in a bypass trust should be protected from the surviving spouse's creditors. That won't be the case for outright gifts to the survivor, except to the extent those gifts consist of otherwise exempt assets.
- The first spouse's GST exemption is not portable and is lost when assets are given outright to the survivor. So portability may not be advisable where the couple is interested in GST planning for their descendants.
- The first spouse may want to force professional money management by a third-party trustee (perhaps to protect a spendthrift spouse from his own proclivities) that an outright gift would not provide.
- And this may all go away in two years!

10.2 Traditional Formula Planning. Formula marital deduction gift/bypass trust wills should still work (but with perhaps some different spin), and take advantage of whatever tax-free amounts are available at each spouse's death.

(a) The 2010 Conundrum Shouldn't Arise Again. We are all well aware of the concerns that arose regarding the construction of some formula clauses for decedents who died in 2010 while there was no estate tax in effect. A number of states have enacted legislation trying to deal with this construction issue in various manners. But despite the fact that TRUIRJCA only modifies and extends the EGTRRA rules for two years, the same problem won't arise again (at least under currently-enacted law). At the end of 2012, we don't reenter a year with a suspended estate and GST tax. Rather, the same tax structure will continue to apply – just with reduced exemptions and increased rates. The EGTRRA problem of a 2010 with a completely different – but completely temporary – tax structure appears to be behind us. And let's hope Congress doesn't do anything to reintroduce that problem in the future!

(b) After 2012. If you rely on the traditional formula planning, in most cases it should work during the next two years, when the tax-free amounts are \$5 million+, and also following that period when the tax-free amounts may fall to \$1 million (or about \$1.4 million for the indexed GST exemption).

10.3 "One Lung" Trust. In this technique, the assets passing to the surviving spouse (other than specific gifts) are left in a single trust for the surviving spouse which will qualify for QTIP treatment. If no marital deduction is needed, then no QTIP election is made, and the trust becomes a bypass trust. If only a partial QTIP election is needed, then the trust is bifurcated into elective and non-elective shares. This can be done on a fractional share or pecuniary basis as in normal marital formulas. If desired, the case of *Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992), allows different terms for the non-elective share (such as a HEMS distribution standard for income rather than mandatory income distribution). In short, an automatic bypass trust is created and the marital deduction is still available if needed. This also **p**reserves the ability to give the surviving spouse the flexibility of a special power of appointment, which disclaimer planning does not. Disadvantages?

- No basis step-up.
- Possible fiduciary issues.

11. This is a Tax Bill, Not an Estate Planning Bill. Remember, Congress enacted this as part of a delicately crafted compromise (or not-so-delicately, depending on your perspective). Clearly, the bill focuses on the political ramifications of the transfer tax laws. It was not drafted just to make our jobs as estate planners easier, nor was it drafted giving much, if any consideration to the multitude of fiduciary problems it created or the difficulty of planning in two-year windows.

12. There's More to TRUIRJCA … .

12.1 Extension of Expiring Bush Income Tax Cuts. TRUIRJCA extends all of the other Bush income tax cuts enacted in EGTRRA and a subsequent 2003 tax bill that were set to expire at the end of 2010. These include:

- All of the Bush-era income tax cuts, including tax cuts for taxpayers with incomes over \$200,000, if single, or \$250,000, if married.
- The maximum 15% rate on capital gains and dividends.
- The repeal of the personal exemption phase-out and itemized deduction limitations for high-income taxpayers.

But these extensions are only through the end of 2012.

12.2 Restoration of Certain Expired Tax Cuts. TRUIRJCA extends many income tax provisions that expired at the end of 2009. These include:

- The \$100,000 IRA charitable rollover available to individuals over 70½ directly from an IRA to a "qualified charity," including permission to treat January, 2011, transfers as having been made in 2010.
- Optional state and local sales tax deduction.
- Enhanced deductions for conservation easement donations.

But most of these extensions only apply to 2010 and 2011.

13. But TRUIRJCA Does Not Contain … .

There are a number of recently-discussed provisions that TRUIRJCA **<u>does not</u>** contain.

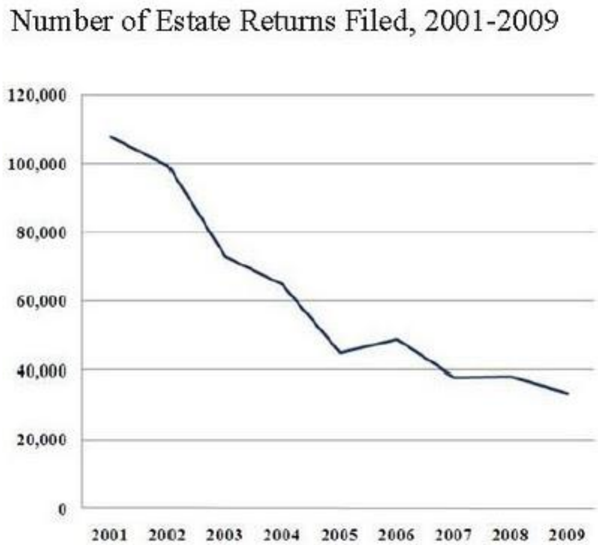
13.1 Elimination of Short-Term GRATS. One Treasury proposal would have required a minimum 10-year term for grantor retained annuity trusts. Short-term GRATs are still available.

13.2 Restriction on Valuation Discounts. Another Treasury proposal would have significantly restricted valuation discounts for transfers of interests in family limited partnerships or similar entities.

13.3 Basis Consistency Rules. Treasury has also proposed rules that would require that the value reported for estate tax purposes be used for later income tax basis purposes.

14. Some Startling Numbers.

Here's a chart from the IRS that shows the number of estate tax returns filed between 2001 and 2009:



This chart represents the year in which returns were filed, not the year in which the decedent died, and includes both taxable and nontaxable estates. Here is more detailed information breaking down the total estate tax returns and the taxable returns for each year:

Filing Year	All Returns	Taxable Returns
2001	108,071	51,736
2002	99,603	45,018
2003	73,128	33,302
2004	65,039	31,329
2005	45,070	20,250
2006	49,050	22,798
2007	38,031	17,416
2008	38,373	17,172
2009	33,515	17,713

There are several things to note about these numbers. First, they are based on the years the returns are filed. Therefore, they don't match up exactly with the increasing tax-free amount. For example, very few returns for 2009 decedents with a $3.5 million tax-free amount were actually filed in 2009. Most of the returns filed that year were for 2008, or even late-2007, decedents, who had a $2 million tax free amount.

Based on the numbers for returns filed in 2009 for estates above $5 million, which is the last year for which the IRS has provided statistics, we may expect no more than 8,200 returns will be filed in 2011, with no more than 4,300 of those actually reporting taxable estates.

With return numbers this low, is it possible the IRS will have the capability of examining virtually every return filed? Will the IRS place increased emphasis on examining gift tax returns?

15. Other [Free] Resources.

As noted at the beginning of this paper, this paper has been written only as an introduction to the solutions provided by TRUIRJCA, and the new issues it raises. There will be more in-depth articles coming out over the ensuing months. However, in the meantime, here are links to some of the additional resources freely available on the internet that the reader may find helpful:

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010:

http://www.gpo.gov/fdsys/pkg/BILLS-111hr4853enr/pdf/BILLS-111hr4853enr.pdf

Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United States Senate:

www.jct.gov/publications.html?func=startdown&id=3716

Summary of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 Prepared by the Estate and Gift Tax Committee o fthe Real Property Trust & Estate Law Section of the American Bar Association:

http://www.abanet.org/rppt/cmtes/te/Income_Transfer_Group/Estate_Gift_Tax/ABA%20TRA%202010%20summary %20v6.pdf

Estate Planning Effects and Strategies Under the "Tax Relief … Act of 2010" (and many other helpful Steve Akers articles):

http://www.bessemer.com/advisor

Form 8939, Allocation of Increase in Basis for Property Acquired from a Decedent (December 16, 2010, Draft):

http://www.irs.gov/pub/irs-dft/f8939--dft.pdf (Sorry, no draft instructions are available!)

Comments to IRS of ABA's Section of Real Property, Probate and Trust Law on Draft Form 8939:

http://meetings.abanet.org/webupload/commupload/RP509000/newsletterpubs/ABA-Section-of-Real-Property-Trust-and-E-Draft-8939.pdf

ACTEC/ABA RPTE Section Daily Reports of Highlights of the 45th Annual Philip E. Heckerling Institute on Estate Planning presented by the University of Miami School of Law Center for Continuing Legal Education:

http://www.abanet.org/rppt/meetings_cle/heckerling/2011/