2001

Hot Topics: Practical Estate Planning and Drafting After the Tax Act of 2001

John B. O'Grady

HOT TOPICS

PRACTICAL ESTATE PLANNING AND DRAFTING AFTER THE TAX ACT OF 2001

John B. O'Grady
McGuireWoods LLP
One James Center
901 East Cary Street
Richmond, VA 23219
jogrady@mcguirewoods.com

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PRACTICAL ESTATE PLANNING AND DRAFTING AFTER THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

I. **Introduction.** I would like to thank Howard Zaritsky for allowing me to use his outline. I have edited the outline in certain places, however, it is not to be interpreted as an editorial of the material. Rather, I have attempted to shorten the length for publication purposes. Howard's thorough review of the material is a tremendous resource for all of us. I have also added a few sections for the purpose of illustrating the changes. On June 7, the President signed into law Pub. L. 107-16, 107th Cong., 1st Sess. (2001), "The Economic Growth and Tax Relief Reconciliation Act of 2001" ("the Tax Act of 2001"), which reforms the estate, gift, and GST taxes, increases the available exemptions, and then repeals the estate and GST taxes in 2010. The Tax Act of 2001 will dramatically alter the practice of estate planning during the next eight years, while the estate, gift, and GST taxes are reformed, and thereafter, when there may be no estate or GST tax. Estate planners must now evaluate all estate plans in light of the present estate tax rules, the increased exemptions and lowered rates between 2002 and 2009, and the possibility of repeal of the estate and GST taxes in 2009. This additional level of complexity will alter the utility and features of most estate planning documents, render certain estate planning tools irrelevant, and render other estate planning tools especially important.

II. **Repeal of the Estate and Generation-Skipping Transfer Taxes (and Retention of the Gift Tax).** The most far-reaching and potentially important provision of the Tax Act of 2001 is Section 501(a), which repeals the estate and generation-skipping transfer (GST) taxes with respect to estates of decedents dying after December 31, 2009, and to other generation-skipping transfers made after December 31, 2009. Tax Act of 2001 §§ 501(a), 501(b); IRC §§ 2210(a), 2664.

A. **Estate Tax Preserved for Certain Recapture Situations.** The legislative history of the Tax Act of 2001 distinguishes between the imposition of the estate tax on a decedent dying after December 31, 2009, and the imposition of a special recapture tax after that date with respect to the estate of a decedent who dies before January 1, 2010. The legislative history states that the disposition after December 31, 2009, of property for which the estate of a decedent who died before January 1, 2010, was allowed the tax benefits of special use valuation (Section 2032A), the deduction for interests in qualified family owned businesses (Section 2057), or deferral of estate taxes attributable to a business interest (Section 6166), will still result in the recapture of the previous estate tax benefits, to the extent provided under present law. The repeal of the estate tax will not prevent the imposition of these recapture taxes. See H. Conf. Rpt. 107-84, 107th Cong., 1st Sess., 147 Cong. Rec. H2773-H2774 (May 25, 2001).

B. **Estate Tax Preserved for Certain Qualified Domestic Trusts.** The estate tax will continue to be imposed after 2009 in certain cases with respect to qualified domestic trusts (QDOTs) created for the benefit of a non-citizen surviving spouse, where the spouse whose will or trust created the QDOT died before January 1, 2010. Tax Act of 2001 § 501(a); IRC § 2210(b). The estate tax will be imposed with respect to an estate of a decedent dying after December 31, 2001, in the following two situations:

1. The estate tax will be imposed on any distribution after December 31, 2009, and before January 1, 2021, from a QDOT, before the date of the death of the noncitizen surviving spouse; and

2. The estate tax will be imposed on the value of the property remaining in a QDOT on the date of death of the noncitizen surviving spouse if such surviving spouse dies before January 1, 2010.

C. **Retention of Gift Tax**. The Tax Act of 2001 does not repeal the gift tax. Rather, it retains the gift tax even with respect to gifts made after December 31, 2009.

1. Retaining the gift tax with a top rate equal to the highest marginal individual income tax rate has the effect of imposing a flat 35 percent gift tax, because the first gift tax rate bracket on gifts of over $1 million (the new gift tax exemption) would be 41 percent, but it is then reduced in 2010 to the highest individual income tax rate. Thus, gifts made after December 31, 2009, would be subject to a flat 35 percent gift tax rate.

2. The legislative history does not disclose why the gift tax was retained, but it seems likely that Congress was concerned that the unlimited right to make gifts without gift tax would lead to the use of intrafamily gifts to shift income from family members in higher income tax brackets to those in lower income tax brackets.

3. After the repeal of the estate and GST taxes, "a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under" the grantor trust rules. Tax Act of 2001, § 511(e), IRC § 2511(c).

4. This provision appears to have been intended to avoid the situation in which a transfer might be incomplete for gift tax purposes but complete for income tax purposes, thereby shifting taxable income without incurring a gift tax.

III. **Estate, Gift, and GST Tax Rate Reductions and Exemption Increases**. The Tax Act of 2001 reduces the top estate, gift, and GST tax rates applicable before 2010, and increases the gift and GST exemptions and the applicable exclusion amount (the estate tax exemption equivalent of the unified credit). Tax Act of 2001 §§ 511, 521; IRC §§ 2001, 2010, 2631(a).

A. **Rate Reductions and Exemption Increases**. The top marginal estate and gift tax rate (which is also the single GST tax rate), and the estate, gift, and GST exemptions will be changed between 2002 and 2010, according to the following schedule:

Taxable Events in:	Top Rate	Exemption
2001	55%, plus 5% surtax on certain estates or gifts Over $10 million	$675,000 for estate and gift taxes; $1,060,000 GST exemption (indexed for inflation)
2002	50% (surtax repealed)	$1 million estate and gift tax; $1,100,000 GST exemption (indexed for inflation)
2003	49%	$1 million estate and gift tax; $1,100,000 GST exemption (indexed for inflation)
2004	48%	$1.5 million for estate and GST taxes; $1 million for gift tax
2005	47%	$1.5 million for estate and GST taxes; $1 million for gift tax
2006	46%	$2 million for estate and GST taxes; $1 million for gift tax
2007	45%	$2 million for estate and GST taxes; $1 million for gift tax
2008	45%	$2 million for estate and GST taxes; $1 million for gift tax

2009	45%	$3.5 million for estate and GST taxes; $1 million for gift tax
2010	Full repeal of estate and GST taxes; gift tax retained at top income tax rate	$1 million for gift tax

B. **Gift Tax Exemption Frozen at $1 Million**. After 2002, however, the gift tax exemption remains $1 million, while the estate and GST tax exemptions are increased in stages, up to $3.5 million in 2009. Tax Act of 2001 § 521(c); IRC § 2631(a).

IV. Carryover Basis for Property Received From a Decedent.

A. **Generally**. The Tax Act of 2001 gives a person who receives property from a decedent who dies after December 31, 2009, an adjusted basis in the property equal to the lesser of the fair market value of the property on the date of the decedent's death, or the adjusted basis of the property in the hands of the decedent. Tax Act of 2001 §§ 541, 542; IRC §§ 1014(f), 1022. Thus, the step-down in basis under present law for loss assets received from a decedent is preserved, while the step-up in basis for appreciated assets is eliminated. Tax Act of 2001 §§ 541, 542; IRC §§ 1014(f), 1022(a).

B. **$1.3 Million Aggregate Basis Increase**. The Tax Act of 2001 permits the executor of a decedent's estate to allocate additional basis to and among a decedent's assets. The two basis adjustments are the $1.3 million "aggregate basis increase" and the $3 million "spousal property basis increase."

1. The allocation of the aggregate basis increase is made by the executor on an asset-by-asset basis, and cannot raise the basis of any asset above its fair market value on the date of the decedent's death. Once made, the allocation can be changed only as permitted by the Secretary of the Treasury. Tax Act of 2001 § 542(a); IRC § 1022(b)(3)(B).

2. The $1.3 million limitation on the aggregate basis increase is increased by two types of otherwise-unused losses.

   a. First, the executor adds to the $1.3 million aggregate basis increase the sum of the amount of any capital loss carryover (under Section 1212(b)), and the amount of any net operating loss carryover (under Section 172), which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent.

b. Second, the executor adds to the $1.3 million aggregate basis increase the sum of the amount of any losses that would have been allowable (under Section 165) had the property acquired from the decedent been sold at fair market value immediately before the decedent's death. Tax Act of 2001 § 542(a); IRC § 1022(b)(2)(C).

C. **$3 Million Spousal Property Basis Increase**. The Tax Act of 2001 permits the executor of a decedent's estate to increase the basis of property acquired from the decedent by the decedent's surviving spouse by $3 million, in addition to any adjustments made by the $1.3 million aggregate basis increase. Tax Act of 2001 § 542(a); IRC § 1022(c). This is referred to as the "spousal property basis increase."

1. Again, the amount allocated to the property received from a decedent by the surviving spouse cannot increase its basis above the fair market value of the property on the date of the decedent's death.

2. The spousal property basis increase is allowed only for property passing to a surviving spouse outright or in a qualified terminable interest property ("QTIP") trust. Tax Act of 2001 § 542(a); IRC § 1022(c).

3. A decedent is not deemed to own property merely because the decedent holds a general power of appointment over that property. Tax Act of 2001 § 542(a); IRC § 1022(d)(1)(B)(iii). This provision appears to have been intended to prevent the use of the so-called "tax basis trust," under which one spouse would create a trust to hold appreciated assets, and give the other spouse a general power of appointment over the trust, with the intent of obtaining a basis increase when the other spouse died.

1. The executor cannot allocate the aggregate basis increase or spousal property basis increase to the following types of assets:

   a. items of income in respect of a decedent (Section 691); or

   b. property acquired by the decedent by lifetime transfer for less than adequate and full consideration in money or money's worth, during the three-year period ending on the date of death, other than property acquired by gift from the decedent's spouse.

D. **Reporting Requirements**. The Tax Act of 2001 substitutes a basis return for the federal estate tax return, and adopts other reporting requirements deemed necessary to enforce the new carryover basis rules. Tax Act of 2001 § 542(b); IRC §§ 6018, 6019, 6716.

1. Section 6018 will require the executor of the estate of a decedent who dies after December 31, 2009, to file a return containing basis information. The aggregate basis increase and spousal property basis increase are allocated on this return.

    a. The executor will be required to report the basis and character (capital gains or ordinary income) of all property acquired from a decedent, if the total fair market value of the property acquired from a decedent's estate (other than cash) exceeds the $1.3 million aggregate basis adjustment (determined without regard to losses and loss carryovers that are otherwise added to the $1.3 million figure for purposes of allocating the aggregate basis increase). Tax Act of 2001 § 542(b); IRC § 6018(b).

    b. The executor must also report on the return appreciated property with a value of more than $25,000 that was acquired from a decedent, but that was ineligible for allocation of any portion of the aggregate basis increase because it was acquired by the decedent by transfer for less than adequate and full consideration within three years of the decedent's death, and was required to be included on a gift tax return.

    c. The decedent's executor must include in this return:

        i. the name and taxpayer identification number of the recipient of such property;

        ii. an accurate description of such property;

        iii. the adjusted basis of such property in the hands of the decedent and its fair market value at the time of death;

        iv. the decedent's holding period for such property;

        v. sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;

        vi. the amount of aggregate basis increase and additional basis increase for property acquired by a spouse, allocated to each asset; and

vii. such other information as the Secretary may by regulations prescribe.

2. The executor must also report to the recipient of the property, the name, address, and telephone number of the executor, and the data provided to the IRS regarding the asset acquired by this recipient. These returns must be filed with the decedent's income tax return for the decedent's last taxable year.

3. The Tax Act of 2001 imposes a penalty of $10,000 for each failure to report to the IRS transfers at death of non-cash assets in excess of $1.3 million in value, and a penalty of $500 for each failure to report to the IRS the receipt by a decedent of appreciated property valued in excess of $25,000 within three years of death. A $50 penalty is imposed for each failure to provide the required information to a beneficiary. Tax Act of 2001 § 542(b)(4); Int.. Rev. Code § 6716.

V. Phase-Out of State Death Tax Credit

A. **Good Bye Credit**. The Tax Act of 2001 phases-out the state death tax credit by 2005. Tax Act of 2001 § 531; IRC § 2011(g). The Tax Act of 2001 reduces the state death tax credit by 25 percent in 2002, 50 percent (from present figures) in 2003, and 75 percent (from present figures) in 2004, before repealing it entirely in 2005.

B. **Hello Deduction**. The state death tax credit will be replaced with an unlimited state death tax deduction with respect to estates of decedents dying after December 31, 2004. Tax Act of 2001 § 531(a)(3); IRC § 2011(g). This will create a disparity between and among state death taxes, and may actually become a significant factor in the decision of some clients as to their residence.

C. **State Death Tax Increases Offset Federal Tax Cuts**. In many states, the repeal of the state death tax credit will not repeal the state death tax, but merely increase its cost.

1. In states like Virginia, there will still be a substantial death tax, and the conversion of the credit into a deduction may more than offset most of the other tax cuts under the Tax Act of 2001.

a. Va. Code § 58.1-902 imposes a state estate tax in an amount equal to the federal credit.

b. Va. Code § 58.1-901, however, defines the "Federal credit" by stating, in part, that:

In no event, however, shall such amount be less than the federal credit allowable by § 2011 of the Internal Revenue Code as it existed on January 1, 1978.

c. See similar rule in D.C. Code § 47-3701 et seq. (But adopting as the critical date January 1, 1986).

d. In these states, the reductions in the state death tax credit will not lower the state estate tax. Thus, between 2002 and 2005, the federal credit will drop, but the state death taxes will remain the same.

   i. This will lead to substantially higher total death taxes.

   ii. See Exhibit I.

e. Many other states like New York or South Carolina, will reach the same result simply by not automatically adopting all amendments to the Internal Revenue Code. See S.C. Code §§ 12-16-20(5), 12-6-40(A) (adopting only amendments through December 31, 1999); and N.Y. Tax Law §§ 951, 1021 (adopting only amendments through July 22, 1998).

2. Some other states have true soak-up statutes, that will produce no state death tax after the repeal of the federal credit. See Md. Code General Tax §§ 7-301 *et. seq.*

3. At least one state with a true soak-up statute also has a constitutional prohibition against imposing any state death tax other than one measured by the federal credit for state death taxes. See Fl. Const. Art. VII, § 5(a), which states:

> No tax upon estates or inheritances or upon the income of natural persons who are residents or citizens of the state shall be levied by the state, or under its authority, in excess of the aggregate of amounts which may be allowed to be credited upon or deducted from any similar tax levied by the United States or any state.

D. **Planning May Stay Complex**. One may still consider leaving property in long-term trusts to avoid state death taxes of up to 16 percent, and perhaps create nonmarital shares.

VI. **Conservation Easement Rules Eased Slightly**. The Tax Act of 2001 liberalizes the deduction under Section 2031(c) for contribution of certain conservation easements, by eliminating the requirement that the easement area fall within 25 miles from an urban area, wilderness or national park. The new law requires only that the easement relate to land that is located within the United States or its possessions. The new rules also clarify that the date for determining the easement compliance is the date on which the contribution is made, not the date of the decedent's death. These changes both apply to estates of decedents dying after December 31, 2000. Tax Act of 2001 § 551; IRC § 2031(c)(8)(A).

VII. **Liberalized Rules for Allocating GST Exemption**. The Tax Act of 2001 makes several important technical changes in the GST tax rules relating to allocation of GST exemption. These changes make it easier to allocate the GST exemption, and they are generally effective after December 31, 2000.

A. **Automatic Allocation to Certain Lifetime Transfers**. The Tax Act of 2001 allocates a donor's GST exemption automatically to lifetime transfers that are not direct skips, but that are made to generation-skipping trusts.

1. This rule applies with respect to transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods (ETIP) ending after that date. Tax Act of 2001 § 561(a); IRC § 2632(c); See also Harrington, Plaine & Zaritsky, *Generation-Skipping Transfer Taxes*, ¶ 4.04 (2d ed.).

2. No automatic allocation will occur under this rule in six specific situations.

a. No automatic allocation will occur if the trust provides for distribution or withdrawal of more than 25 percent of the trust corpus by one or more nonskip-persons before reaching 46 years of age, or before a specified date that will or may be reasonably expected to occur before the individual (or each individual) reaches 46 years of age (as determined under Treasury regulations).

b. No automatic allocation will occur if the trust provides for distribution or withdrawal of more than 25 percent of the trust corpus by one or more nonskip-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 ten years older than such individuals.

c. No automatic allocation will occur if the trust provides for mandatory distribution of 25 percent or more of the trust corpus to the estate of, or subjects such corpus to a general power of appointment held by, one or more non-skip persons if they die on or before a date or event that will or may be reasonably expected to occur before the individual (or each individual) reaches 46 years of age (as determined under Treasury regulations).

d. No automatic allocation will occur if the any part of the trust would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.

e. No automatic allocation will occur if the trust is a charitable lead annuity trust, charitable remainder annuity trust, or a charitable remainder unitrust.

f. No automatic allocation will occur if the trust is a charitable lead unitrust the noncharitable beneficiary of which is a non-skip person.

3. Transferors can elect not to have these automatic allocation rules apply. This election is made on a timely-filed gift tax return for the 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 Secretary.

B. **Retroactive Allocations Will be Sometimes Permitted.** The Tax Act of 2001 allows a transferor to make a retroactive allocation of GST exemption to a transfer in trust, if a beneficiary of the trust dies before the transfer (but after the date of enactment). This retroactive allocation is available only if the predeceasing beneficiary was both a non-skip person and a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, assigned to a generation younger than the generation of the transferor. Tax Act of 2001 § 561(a); IRC § 2632(d); see also Harrington, Plaine & Zaritsky, *Generation-Skipping Transfer Taxes*, ¶ 4.04 (2d ed.).

C. **Rules on Trust Severing Liberalized.** The Tax Act of 2001 allows severance of a single trust into multiple trusts, if:

1. the division were made fractionally;

2. the terms of the new trusts provide, in the aggregate, for the same succession of interests of beneficiaries as in the original trust; and

3. the undivided trust, if it has an inclusion ratio other than one (1:0) or zero (0:1), were divided into two trusts, one of which has an inclusion ratio of one and the other of which has an inclusion ratio of zero. Tax Act of 2001 § 562; IRC § 2642(a)(3).

D. **Determining the Value of Property on Timely GST Exemption Allocation.** The Tax Act of 2001 provides that the value of property for purposes of determining the

GST inclusion ratio (and, thereby, the rate of GST tax imposed on taxable events), in connection with timely and automatic allocations of GST exemption, is the value finally determined for gift or estate tax purposes. The value for purposes of an allocation that was made at the end of an ETIP, is its estate or gift tax value at the end of the ETIP. Tax Act of 2001 § 563; IRC § 2642(b); see also Harrington, Plaine & Zaritsky, *Generation-Skipping Transfer Taxes*, ¶ 3.05 (2d ed.).

E. **Treasury May Extend Time to Make Allocation**. The Tax Act of 2001 directs the Treasury Secretary to grant extensions of time to allocate GST exemption and to grant exceptions to the time requirement, considering all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. The time for making the allocation (or election) would be treated as if not expressly prescribed by statute, for this purpose. Tax Act of 2001 § 564; IRC § 2642(g); see also Harrington, Plaine & Zaritsky, *Generation-Skipping Transfer Taxes*, ¶4.04 (2d ed.).

F. **Substantial Compliance Suffices for Allocations**. The Tax Act of 2001 provides that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption establishes that GST tax exemption were allocated to a particular transfer or a particular trust. Tax Act of 2001 § 564; IRC § 2642(g).

1. A taxpayer who demonstrates an intent to have an inclusion ratio of zero with respect to a particular transfer or trust, shall be deemed to have allocated to the transfer sufficient GST exemption to produce a zero inclusion ratio, if possible.

2. The Treasury is directed to consider all relevant circumstances to determine whether there had been substantial compliance, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

3. Oddly, this is merely authorizing the IRS to take a position that they have been long taking. See Priv. Ltr. Ruls. 199909034 (March 8, 1999); 199937026 (Sept. 20, 1999); 199909034 (March 8, 1999), 200017013 (May 1, 2000); 200027009 (July 10, 2000); and 200040013 (Oct. 10, 2000); also Harrington, Plaine & Zaritsky, *Generation-Skipping Transfer Taxes*, ¶ 4.04[1][b] (2d ed.).

VIII. **Qualified Family Owned Business Rules Repealed**. The Tax Act of 2001 repeals entirely the rules by which an estate may claim a deduction of up to $675,000 for certain interests in a qualified family owned business interest. The new law repeals these rules with respect to estates of decedents dying after December 31, 2003. Tax Act of 2001 § 521(d); IRC § 2057(j).

IX. **Deferred Payment of Estate Taxes Attributable to Closely-Held Business Interests Rules Eased Slightly**. The Tax Act of 2001 expands Section 6166 in two small ways, with respect to estates of decedents dying after December 31, 2001.

A. **Qualifying Lending and Finance Businesses**. Section 6166 deferral will be allowed for interests in qualifying lending and financing businesses. Tax Act of 2001 §§ 571, 572; IRC § 6166(b)(10).

B. **Closely-Held Business Redefined**. The Tax Act of 2001 raises from 15 to 45 the number of partners of a partnership or shareholders of a corporation that will be eligible for deferral under Section 6166. Tax Act of 2001 §§ 571; IRC §§ 6166(b)(1)(B)(ii), 6166(b)(1)(C)(ii), 6166(b)(9)(B)(iii)(I).

X. **Waiver of Statute of Limitations on Certain Farm Valuations**. The Tax Act of 2001 resolves a question raised by the Tax Reform Act of 1997 with respect to the special valuation rules of Section 2032A, which permits a reduction in the value of real estate used in certain closely-held businesses or family farms.

A. **1997 Act Creates the Problem**. Section 504(c) of the Tax Reform Act of 1997 expanded the class of heirs eligible to lease property for which special-use valuation was claimed without the recapture of the tax benefits previously allowed. The Tax Reform Act of 1997 amendment applied to leases entered into after December 31, 1976, but the IRS later ruled privately that the retroactive effective date in the changes made by the Tax Reform Act of 1997 did not waive of the period of limitations otherwise applicable on a taxpayer's claim. Tech. Adv. Memo. 9843001 (October 23, 1998). The IRS ruled that a taxpayer's claim for refund of the recapture tax paid on account of the cessation of a qualified use was barred under the generally applicable statute of limitations on refund claims.

B. **2001 Act Eliminates It**. The Tax Act of 2001 provides that a claim for refund or credit shall be allowed, if it was barred by operation of law or rule of law on the date of enactment or within one year thereafter, if the taxpayer filed the claim before the date one year after the date of enactment. Tax Act of 2001 § 581.

XI. **Sunset Provisions**. All of the estate, gift, and GST tax provisions of the Tax Act of 2001 will expire on December 31, 2010.

A. **Budget Act**. This change was required to comply with the Congressional Budget Acts of 1974 and 1990, which require a vote of 60 senators to pass a bill that would decrease revenues for a fiscal year more than ten years after the present fiscal year.

B. **Import**. The sunset provision means that, unless Congress re-enacts these changes, the estate and GST taxes will be repealed only with respect to estates of decedents and taxable events in 2010, and the estate, gift, and GST tax laws will be restored to their current state on January 1, 2011.

C. **Effect of Sunset**. Were the estate, gift, and GST tax provisions of the Tax Act of 2001 to expire on January 1, 2011, the estate and GST taxes would be resurrected, with a top estate and gift tax rate (and the only GST tax rate) of 55 percent, and a five percent surtax on certain transfers of over $10 million.

1. The estate tax applicable exclusion amount and the GST exemption would again become disassociated, and the applicable exclusion amount would be the $1 million it was scheduled to reach in 2006.

2. Carryover basis would disappear and the present basis rules would be returned, the state death tax credit and QFOBI exclusion would be resurrected, and the technical changes made in 2001 to the conservation easement rules, the GST exemption allocation rules, and the lien for special use tax recapture would expire.

XII. **Planning Issue 1. Re-Educating Clients**. Probably the biggest problem facing estate planners under the Tax Act of 2001 will be explaining to existing and future clients that the estate tax has not been repealed, that it may never be repealed, that it might be repealed, and that even if it is repealed, good estate planning will remain an important part of the client□s overall financial plan. It will, of course, be easier to explain this to existing clients, to whom the estate planner can send a letter detailing the real effect of the new law.

A. **Actual Repeal of the Estate and GST Taxes is Uncertain**. Politicians and the press have announced the repeal of the estate tax, and while most news articles state somewhere in the late paragraphs that actual repeal will occur only in 2010, many clients will read the headlines, listen to the sound bites, and believe that the estate tax has been eliminated.

1. Many of these clients will conclude that there is no longer a need for estate tax planning.

a. One of the difficult issues to understand and to communicate to clients is the uncertainty that surrounds the repeal of the estate and GST taxes.

b. One cannot ignore the current imposition of the estate tax, the possibility that the estate tax will be repealed in 2010, the possibility that the estate tax will not be repealed in 2010, and the possibility that the estate tax, if repealed in 2010, will be revived by the sunset provisions in 2011. New estate planning will need to address all of these possibilities.

2. The actual repeal of the estate and GST taxes in 2010 is uncertain, because there will be three Congresses (the 108th, 109th, and 110th) and at least one more president elected before 2010, and any of them can muster the forces required to delay or eliminate the repeal of the estate and GST taxes.

B. **Sunset Provisions Could Render Repeal Temporary**. The sunset provisions of the Tax Act of 2001 make it easy for a future Congress to retain the estate and GST taxes.

1. A legislative impasse in Congress or between Congress and the President could prevent the re-enactment of the tax cuts of the Tax Act of 2001, and cause the estate and GST tax repeals to expire (and the estate and GST taxes to be restored) on January 1, 2011.

2. A client who insists on believing the legislative declaration that the estate and GST taxes will be repealed on January 1, 2010, should consider that the same statute restores those taxes.

3. The client will not be able to take advantage of these repeals unless he or she dies during calendar year 2010. Relatively few clients will be able to time their demise so precisely.

4. On June 6, 2001, the chairman of the House Committee on Ways and Means, William Thomas (R-Cal.) and the House majority leader, Richard Armey (R-Texas), called for an immediate repeal of the sunset provisions. The ranking republican on the Senate Finance Committee, Charles Grassley (R-Iowa), however, stated that such a proposal would not succeed in the Senate, where 60 votes would be required to eliminate the sunset provisions. See BNA Daily Tax Rept. (June 7, 2001). Thus, it appears that the sunset provisions could not be eliminated by even the current Congress.

C. **Continued Need for Estate Planning**. Good estate planning involves far more than estate tax planning.

1. Good estate planning is and will remain important, even if the estate tax is eliminated, in order to accomplish the following nontax goals:

a. assuring the correct disposition of the client□s assets;

b. assuring that a client□s assets are not left outright to spouses or children who are not capable of managing those assets competently;

c. assuring appropriate management of the client□s assets in case of disability;

d. avoiding unnecessary administration expenses by avoiding probate, where appropriate;

e. maximizing the federal and state benefits available to the client, particularly in case of disability and old age;

f. limiting the claims of creditors (including former spouses) of a beneficiary;

g. avoiding or minimizing family disharmony in light of multiple marriages and family groups and dysfunctional relationships between family members;

h. assuring proper succession to the ownership of a closely-held business; and

i. minimizing income taxes on a decedent's estate and heirs.

2. These considerations make a compelling case for sound estate planning, even if there is no estate tax in effect.

XIII. Planning Issue 2. Testamentary Marital Deduction and GST Exemption Planning

A. **Generally**. Traditionally, one of the most important parts of the estate plan for a married couple is a will or revocable trust that takes full advantage of the unified credits of both spouses. This is usually accomplished by leaving a share of the estate equal to the decedent's unused applicable exclusion amount (the exemption equivalent of the decedent's unified credit for estate tax purposes), in a form that will not be includable in the gross estate of the surviving spouse.

1. The nonmarital share in moderate-sized estates is usually left to a trust for the lifetime benefit of the surviving spouse, or for the joint benefit of the surviving spouse and other family members.

2. The nonmarital share may, however, be left to or in trust for other family members, with no benefit for the surviving spouse.

3. This latter approach is appropriate in larger estates, where the surviving spouse will not require any of the benefits from the nonmarital share, and in certain situations in which the client wishes to provide benefits for family members other than the spouse even before the surviving spouse□s death.

4. It is also common for the wills or revocable trusts of a couple whose estate and dispositions warrant it, to take steps to assure the full use of both spouses' GST exemptions.

   a. This is typically done where the combined estates of the couple exceed the sum of the one applicable exclusion amount and one GST exemption, and where the estate may pass to one or more skip-persons.

   b. This planning involves dividing the estate of the first spouse to die into three shares.

      i. The nonmarital share is again equal to the applicable exclusion amount, and passes as described above.

      ii. A second share (sometimes referred to as "the reverse QTIP share" or "the GST-exempt marital share") is equal to the difference between the decedent's GST exemption ($1,060,000 in 2001) and the nonmarital share ($675,000 in 2001), and is left in a QTIP marital trust as to which an election is made under Section 2652(a)(3), to treat the first spouse to die as the transferor for GST tax purposes. Such a trust is known as a "reverse QTIP" trust, and it assures the full use of the first deceased spouse's GST exemption.

      iii. The third share is the marital share, which is equal to the remaining residuary estate.

B. **Smaller Estates Will Not Need Estate Tax Planning**. The increase in estate tax applicable exclusion amount will remove some moderate-sized estates of married clients from the need to engage in complicated tax planning. For these clients, the Tax Act of 2001 is truly an important estate planning development. Again, however, an estate planner may choose not to change documents that create a nonmarital trust for the estate of the first deceased spouse, despite the fact that their combined estates do not exceed $1.3 million after 2004, because the existing arrangement still provides insulation against estate taxes in case the surviving spouse's separate estate grows significantly after the first spouse's death.

C. **Larger Estates Must Re-evaluate Formula Clauses Because of the Increased Applicable Exclusion Amount**. An estate planner should consider the effect of increased exemptions and possible estate and GST tax repeal on the estate plan of a client whose documents create a nonmarital share and a marital share, particularly if these shares are held for the benefit of different set of beneficiaries.

1. Such divisions are usually based on a formula that creates a nonmarital share equal to the greatest amount that can pass free of tax because of the decedent's applicable exclusion amount.

   a. The client who executed such a will or revocable trust before 2001 reasonably expected that it would produce a nonmarital share equal to $675,000 in 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million after 2005. IRC § 2010(c).

   b. He or she did not anticipate that it would produce an exemption share equal to $1.5 million in 2004, $2 million in 2006, or $3.5 million in 2009. Increased exemptions, and the repeal of the estate and GST taxes, can dramatically alter the intended result of these formula clauses.

2. The increased applicable exclusion amount may not require that a will or revocable trust that creates separate marital and nonmarital shares be amended, if the two shares pass to similar trusts for the lifetime benefit of the surviving spouse.

3. The increases in the applicable exemption amount and the GST exemption can create a serious problem if the marital and nonmarital shares do not benefit the same persons, or benefit them in substantially different ways.

4. A formula clause that automatically adopts the increased applicable exclusion amounts may result may create even more serious problems, if the nonmarital share is held for the joint benefit of the surviving spouse and family members with whom the surviving spouse does not get along well. The simultaneous inflation of the nonmarital share and reduction in the marital share may lead to serious disputes over the proper disposition of a nonmarital share, which can result in litigation and increased fiduciary fees.

5. An estate planner may wish to put an artificial cap on the amount of the nonmarital share in such situations, to prevent the nonmarital share from growing to the full size of the applicable exclusion amount.

   a. The amount of this cap will depend upon the goals of the client, the needs of the surviving spouse, and whether the surviving spouse is to receive any of the benefit of the nonmarital trust.

   b. The arbitrary cap on the nonmarital share can be expressed as a fractional share of the total residuary estate, or as a specific dollar amount (which can, of course, be converted into the numerator of a fractional share). There is no legal reason why a fractional nonmarital share could not be coupled with a pecuniary cap, and *vice versa*, but it would add unnecessary complexity and make the document more difficult to draft and review.

c. Consistency suggests that the same general approach be used to describe the cap as is used to describe the nonmarital share generally, so that a pecuniary cap should be used together with a pecuniary nonmarital share.

6. An arbitrary cap on the nonmarital share would increase the surviving spouse□s taxable estate, by increasing the marital share.

   a. This increase could cause the surviving spouse□s estate to be subject to estate taxes, if the combination of the surviving spouse□s separate assets and the enlarged marital share exceed the surviving spouse□s applicable exclusion amount.

   b. This can be avoided if the excess of the first spouse□s applicable exclusion amount over the arbitrary cap on the nonmarital trust is held in a second ("spousal") nonmarital trust, for the exclusive benefit of the surviving spouse.

7. A spousal nonmarital trust that holds the excess of the first spouse□s applicable exclusion amount over the arbitrary cap on the primary nonmarital trust, can give the surviving spouse extensive rights in and powers over the trust fund, without causing the entire trust fund to be included in the surviving spouse□s gross estate. The broadest possible spousal nonmarital trust would give the surviving spouse the following rights and powers:

   a. the right to all income, distributed currently;

   b. the right to distributions of principal in such amounts as the surviving spouse determines to be necessary for his or her health, education, support, or maintenance;

   c. the right to distributions of principal in such amounts as the trustee, other than the surviving spouse, determines to be appropriate for any purpose;

   d. the noncumulative right to withdraw annually the greater of five percent of the trust fund or five thousand dollars;

e. a testamentary power to appoint the trust fund to a class of beneficiaries that does not include the surviving spouse, his or her creditors, his or her estate, or its creditors;

f. the right to serve as the sole trustee or as a co-trustee, or to remove and replace other persons serving as trustees.

D. **Reviewing Formula Clauses in Light of Repeal and Carryover Basis.** An estate planner should consider the possible repeal of the estate tax on formula clauses that create a marital and a nonmarital share.

1. A reduce-to-zero formula that leaves to the nonmarital share the largest amount that can pass without estate taxes could create a 100 percent nonmarital disposition and no marital share, if the estate tax were repealed. See Exhibit II.

2. On the other hand, a reduce-to-zero formula clause that leaves the nonmarital share an amount equal to the decedent's applicable exclusion amount could create a 100 percent marital disposition and no nonmarital share, if the estate tax (including the applicable exclusion amount) were repealed.

3. The $3 million spousal property basis increase means that, even after repeal of the estate tax in 2010, wills and revocable trusts may still need to consider creating a marital share sufficient to attract the full basis adjustment.

   a. A practical approach for many estates will be to create a nonmarital share with property that represents $1.3 million in appreciation, and then to create a marital residue.

   b. This will assure that the maximum amount of appreciation is sheltered by the two basis increases.

   c. A client whose estate is large enough that there is more than $4.3 million in appreciation in assets to which these basis increases can be allocated, may leave the remaining assets, after satisfying the marital and nonmarital shares sufficiently to take advantage of both basis increases, to whomever the client chooses, without special tax considerations.

4. It is important to note, however, that property left to a surviving spouse in a QTIP martial trust will qualify for the $3 million spousal property basis increase in the estate of the first spouse to die, but will not be treated as an asset of the surviving spouse at his or her later death.

a. Therefore, the surviving spouse□s executor would not be able to allocate any of the $1.3 million aggregate basis increase to assets in a QTIP trust created by the first spouse.

b. Thus, a client should consider leaving a surviving spouse outright assets representing sufficient appreciation to take full advantage of the surviving spouse□s aggregate basis increase.

c. Alternatively, the client could leave these assets in a QTIP, but direct the trustee to distribute to the surviving spouse enough principal to take advantage of the surviving spouse□s aggregate basis increase. This would, however, not be appropriate planning, if the surviving spouse is expected to have different beneficiaries from those of the first spouse to die, or if the surviving spouse is likely to need professional management of his or her assets.

E. **Planning for the Equalization of GST and Estate Tax Exemptions.** The equalization of the GST exemption and the applicable exclusion amount after 2004, will affect much estate planning that previously focused on the best utilization of the decedent's GST exemption. This equalization of the GST exemption and the applicable exclusion amount will simplify most, but not all, wills and trusts that include GST planning.

1. The reverse QTIP trust is typically created to be equal to the difference between the GST exemption and the decedent's applicable exemption amount. These two figures will be the same in most estates after December 31, 2003, rendering the reverse QTIP unnecessary in many estates. Elimination of the reverse QTIP trust should significantly simplify estate planning documents for many clients.

2. In 2002 and 2003, the GST exemption will probably be $100,000 larger than the estate tax exemption, which probably justifies creating a reverse QTIP, though individual administration costs should be considered.

3. Some estates will still need a reverse QTIP trust to take full advantage of the decedent's GST exemption, even after the GST exemption and applicable exclusion amount are equalized.

a. A reverse QTIP trust should still be used where an individual makes lifetime or testamentary transfers that exhaust a significant portion of his or her applicable exclusion amount, but do not attract allocation of any GST exemption.

b. An individual will exhaust applicable exclusion amount, but not GST exemption, by making significant lifetime gifts, nonprobate transfers, or pre-residuary bequests to children or other non-skip persons. The GST exemption in such an estate will exceed the applicable exclusion amount, and a reverse QTIP trust should be created to assure that the decedent's entire GST exemption is utilized to minimize the chance of imposition of a GST tax.

4. In some estates, only a small amount of the decedent's applicable exclusion amount will have been utilized to shelter from tax transfers to children and other non-skip persons.

a. This would occur where, for example, personal effects of little intrinsic value were left to the children.

b. Creating a reverse QTIP trust to take advantage of a very small amount of available GST exemption would make little sense, because the administrative cost of the trust could easily outweigh the potential tax savings.

c. The precise amount of preresiduary and similar transfers that will justify creating a reverse QTIP trust is a matter of judgment that each estate planner must make, considering the anticipated costs of administering the trusts in question.

F. **Drafting for Enhanced Flexibility**. Estate planners should consider modifying an estate plan to increase the flexibility to deal with the growing applicable exclusion amounts and GST exemption, and the possible repeal (and revival) of the estate and GST taxes.

1. One method for increasing flexibility is by leaving assets outright to a surviving spouse, and providing that the surviving spouse may make a qualified disclaimer of that amount that he or she, after the decedent's death, determines appropriate to fund the nonmarital share.

a. This allows the surviving spouse to determine the ultimate division of the estate between a marital and nonmarital share, based on the facts existing after the date of the decedent's death.

b. There are, however, several disadvantages to disclaimer planning.

i. First, it is impractical unless the beneficiaries of the nonmarital share (to which the disclaimed marital share would be added) are also the beneficiaries of the surviving spouse. A surviving spouse is not likely to make a disclaimer that will benefit relations of the decedent with whom the surviving spouse does not relate amicably.

ii. Second, after the first spouse's death, the surviving spouse may be disinclined to give up assets that will otherwise pass to him or her. This is a common problem with older surviving spouses, who may not understand that they have more assets than they will require, and may be unwilling to part with actual dominion and control over any portion of the decedent's assets.

iii. Third, a disclaimer by a surviving spouse is qualified, for estate and gift tax purposes, only if it is made in writing, within nine months after the decedent's death, before the surviving spouse has accepted any of the benefits of the disclaimed assets, and without any direction on the part of the disclaiming spouse. A surviving spouse may accept benefits from the assets before meeting with an estate planner to discuss whether or not to disclaim, rendering any future disclaimer nonqualified.

2. Another method to increase flexibility is to leave the estate entirely to a trust that can constitute a QTIP trust, and to direct the trustee to divide the trust after the decedent's death, as needed to take the best advantage of the estate tax applicable exclusion amount, the GST exemption, the estate tax marital deduction, and the aggregate spousal basis increase. This approach is useful only where the client desires that the entire estate benefit the surviving spouse during his or her lifetime, but it is superior to the use of disclaimers because the surviving spouse is not given the opportunity to disqualify the post mortem estate planning by accepting benefits.

XIV. **Planning Issue 3. Life Insurance Planning**. The increased applicable exclusion amount and possible repeal of the estate tax will dramatically alter estate and tax planning with life insurance. They will not, however, eliminate the need for life insurance in many, many estate plans.

A. **Lessened Liquidity Demands**. A substantial portion of the life insurance bought as part of a client's estate planning is intended to pay the estate taxes imposed with respect to the client's estate or that of the client's surviving spouse.

1. This is particularly true with second-to-die life insurance policies, that pay only when the surviving spouse dies. The reduction in a client's projected

estate taxes on account of lower rates and greater exemptions, and the possible repeal of the estate taxes, will reduce the estate's liquidity requirements, and may reduce the amount of life insurance needed to provide for these needs.

2. Liquidity will remain a problem, because of estate administration expenses, state death taxes (which are likely to increase due to the elimination in 2005 of the state death tax credit), and because of unrealized capital gains taxes in a client□s estate will be preserved by carryover basis rules after the repeal of the estate tax. The carryover basis rules will create larger liquidity problems for estates that include a substantial amount of property to which no basis increase can be allocated, such as retirement plan death benefits and other items of income in respect of a decedent.

3. Estate planners should, however, be very careful about reducing the face amount of life insurance policies when the presently-foreseeable liquidity needs have dropped.

    a. Future growth in the value of the estate assets can increase liquidity demands, possibly when the client□s health has deteriorated and the cost of additional insurance has greatly increased.

    b. It may be better to borrow against policies that now seem to be larger than is otherwise necessary, thereby decreasing the coverage and increasing the assets available for other investments.

4. Many clients will suggest converting permanent life insurance to ten-year term policies, anticipating the repeal of the estate tax.

    a. This is ill-advised, because the estate tax may not actually be repealed.

    b. A term policy may become unsuitable if the client□s health deteriorates before Congress determines not to repeal the estate tax, and the client may not then be able to convert the policy back to a permanent policy.

B. **Income Tax Advantages of Life Insurance**. Life insurance will also remain highly desirable, because the investments that make up the cash surrender value grow without current income tax, and the death benefits are received without income tax. The replacement of the estate tax with carryover basis for income tax purposes will cause clients to focus more on the income tax treatment of life insurance, and may cause many clients to buy life insurance as a tax-sheltered investment.

XV. **Planning Issue 4. Family Limited Partnerships and Other Discount Planning.** The family limited partnership ("FLP"), family limited liability company ("family LLC"), and other forms of family holding company have become important estate planning tools. These entities allow an individual to consolidate assets for easier management, make gifts to family members of an undivided interest in a group of assets or businesses, insulate assets from the claims of creditors, and reduce the estate and gift tax value of assets. See discussion of the use of family holding companies, in Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions*, ch. 16; Spero, *Asset Protection: Legal Planning & Strategies*, ch. 7; Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis With Forms*, chs. 9 and 10 (3rd ed.); Zaritsky & Aucutt, *Structuring Estate Freezes*, ch. 9 (2d ed.).

A. **Continued Use Pending Repeal.** Estate planners should continue to create FLPs, family LLCs, and family holding companies, because they are an effective tool for achieving both tax and nontax goals.

1. Furthermore, it is important to acknowledge that the Tax Act of 2001's promise of possible estate tax repeal may never be realized; a client may well die before the estate tax is actually repealed, the sunset provisions may limit repeal to estates of decedents dying in 2010, and Congress may change its collective mind.

2. Thus, the valuation discounts created by FLPs, family LLCs, and family holding companies should remain an important part of estate tax planning.

B. **Unwinding FLPs In Case of Repeal.** On the other hand, if the estate tax is repealed and the carryover basis rules enacted, estates that do not have sufficient appreciation to take full advantage of all of the aggregate basis increase and spousal property basis increase may find the reduced value of an interest in an FLP, a family LLC, or a family holding company, to be counterproductive.

1. These clients may want to increase the value of their assets, increasing their net appreciation and creating sufficient opportunity to take full advantage of the basis increases allowed by the carryover basis rules.

2. Such clients may want to liquidate these entities and hold separate assets, rather than interests in an FLP, family LLC, or family holding company.

3. The possible income tax advantages that will come from liquidating an FLP, family LLC, or family holding company after the repeal of the estate tax, will be greatest if the underlying assets are distributable to the partners in whole units, rather than in partial interests as tenants in common.

a. The Tax Court has repeatedly valued an undivided partial interest in real estate with a significant discount for lack of control and marketability. On the valuation discounts for undivided partial interests in real estate, see *Estate of Forbes v. Commissioner*, T.C. Memo. 2001-72 (2001) (30 percent discount); *Lefrak v. Commissioner*, T.C. Memo. 1993-526 (30 percent discount); *Estate of Cervin v. Commissioner*, T.C. Memo. 1994-550 (20 percent discount); *Williams v. Commissioner*, T.C. Memo. 1998-59 (44 percent discount); and *Estate of Stevens v. Commissioner*, T.C. Memo. 2000-53 (25 percent discount).

b. Thus, the distribution to a partner of a fractional interest in a parcel of improved real estate or other illiquid asset will not completely eliminate the undesirable valuation discounts.

4. Executors may also be placed in the odd position of arguing for lower discounts and higher values in interests in these entities, to create room for larger basis adjustments.

C. **Unwinding FLPs If No Repeal.** A client should be sure to review the use of FLPs and family LLCs as increased applicable exclusion amounts reduce the client's estate tax liability. A client does not want to discount the estate below the level at which the exemptions shelter it from liability. This wastes the basis step-up. Thus, a client with a $3 million estate may want to terminate the use of FLPs or family LLCs when the exemptions rise to $2 million.

XVI. Planning Issue 5. Lifetime Gifts

A. **Increased Gift Tax Exemption.** The increase in the gift tax lifetime exemption from $675,000 in 2001 to $1 million in 2002 should encourage some clients to make larger taxable gifts, at least sufficient to utilize the client's full lifetime exemption.

1. These gifts will shift future appreciation and income to other family members without additional gift or estate taxes, and will save estate taxes if the client dies when there is still a federal estate tax imposed with respect to the client's estate.

2. Furthermore, even if the estate tax is repealed, there is no real disadvantage to making lifetime gifts sufficient to utilize one's $1 million exemption.

a. This is particularly true, because the carryover basis rules would apply basis rules similar to the gift tax rules to assets received from a decedent.

b. Of course, assets given away during the decedent's lifetime would not generally be eligible for the $1.3 million aggregate basis increase or $3 million spousal property basis increase.

3. Care should be given when advising clients on the amount that may be given tax free. See Exhibit III.

B. Beware of Current Tax Payments. Estate planners should generally avoid recommending gifts that will require the actual payment of gift tax, during the phase-out of the estate tax.

1. Traditionally, taxable gifts that require gift tax payment have been attractive, because the gift tax is computed on the value of the property received by the donee, without consideration of the gift tax payment that the donor will also make (a "tax exclusive" computation), while the estate tax is computed on the total amount available to transfer, including both the amount that the beneficiary will receive and the amount that will be used to pay the estate taxes on that transfer (a "tax-inclusive" computation).

2. An estate planner should, however, be cautious about recommending that a client make a gift that requires payment of a current gift tax, both because the future rate cuts in the gift tax could make a later gift more appealing, and because the estate tax may be repealed. The effective gift tax rate may be lower than the effective estate tax rate, but it is not lower than the zero rate that would apply were the estate tax repealed.

3. An estate planner may recommend gifts that will require a gift tax when the client□s health and age suggest that the client will not be alive when (and if) the estate tax is repealed. A gift that requires payment of a gift tax may still be advantageous if it can remove from a client□s gross estate income and appreciation even for a relatively few years, or if it creates significant valuation discounts that might not be available had the asset be held until death.

XVII. Planning Issue 6. Business Succession Planning. Planning for the succession in ownership of interests in closely-held businesses is one of the most important areas of estate planning. The Tax Act of 2001 will affect several important aspects of planning for business succession.

A. Liquidity Problems Eased. One of the most significant estate planning problems for owners of interests in closely-held businesses is lack of liquidity.

1. Closely-held businesses are inherently illiquid, and partial interests in such businesses are virtually nonmarketable.

2. This makes it especially difficult for an estate that consists largely of interests in a closely-held business to raise cash to pay estate taxes, even with the estate tax deferral provisions allowed such interests under Section 6166.

3. The increase in the applicable exclusion amount and reduction in the estate tax rates reduces the amount of the estate tax on an estate, and thereby eases the problems of liquidity. Obviously, the repeal of the estate tax in 2010 would ease these problems even further.

4. The reduction or elimination of estate taxes, however, does not eliminate all liquidity demands on an estate that includes interests in a closely-held business.

   a. An estate will still require cash to pay state death taxes, which are likely to increase significantly when the state death tax credit is repealed in 2005, and expenses of estate administration.

   b. Furthermore, many closely-held businesses incur significant cash requirements when a key owner-employee dies, because of the high cost of replacing such an employee.

   c. Thus, life insurance that is presently maintained to provide liquidity with respect to a closely-held business interest should be maintained, though the appropriate levels of coverage should be re-evaluated.

B. **Buy-Sell Agreements**. Many closely-held businesses have buy-sell agreements among the business owners or between the business and its owners, that restrict lifetime and testamentary transfers of business interests, and that require the estate of a deceased business owner to offer to sell the decedent's interest on death.

1. These agreements are often relied upon to provide liquidity for the estate of a deceased business owner.

2. Some business owners may consider terminating their buy-sell agreements if the estate tax is repealed.

3. Any inclination to terminate these agreements should be avoided, because these agreements also provide a sound method for shifting business control at the death of an owner, and preclude the disposition of business interests to persons with whom the existing owners do not wish to deal.

4. The carryover basis rules, if implemented, will raise special problems for buy-sell agreements.

a. Most buy-sell agreements have been drafted with the expectation that there will be no income tax on the sale of the business interest after the decedent's death, because of the step-up in basis on the date of death.

b. The repeal of the step-up in basis and the introduction of the carryover basis rules will render these sales taxable to the decedent's estate or successors, and reduce the proceeds available to the sellers.

c. Estate planners should take this into account in planning the division of the estate and the amount of assets, including life insurance, that may be required to implement the desired estate plan.

C. **Repeal of the Qualified Family Owned Business Rules.** The Tax Act of 2001 repeals the $675,000 deduction for certain qualified family owned business interests (QFOBI) under Section 2057, with respect to estates of decedents dying after December 31, 2003.

1. It is unlikely that extensive planning has been undertaken in many cases to take advantage of the QFOBI deduction, in light of the complexity of its rules and the fact that they were effective initially only in 1998.

2. Also, the QFOBI rules are repealed effective in 2004, when the applicable exclusion amount will be increased to $1.5 million. Therefore, the QFOBI rules are eliminated only after the applicable exclusion amount is increased sufficiently to compensate for the repeal of the QFOBI deduction.

XVIII. Planning Issue 7. Charitable Giving

A. **Reduction in Estate Tax Benefits.** The increase in the estate tax applicable exclusion amount, the repeal of the estate tax, and the implementation of a carryover basis will have an effect on a donor's charitable giving.

1. Most charitable giving is based primarily on the nontax desire of the donor to encourage and support the activities of the charity in question. The increase in the estate tax applicable exclusion amount, however, will mean that more estates will have no estate tax even without charitable giving, and the ultimate repeal of the estate tax will mean that no estate will have an estate tax even without charitable giving.

2. Therefore, the estate tax motivation for donors to make charitable gifts or to make larger gifts than they might otherwise have made will be reduced or eliminated.

B. Giving Low-Basis Assets to Charity.

1. The carryover basis rules that are scheduled to become current law in 2010 will tend to encourage charitable gifts of low-basis assets. Charities are not generally taxable on their capital gains, and thus do not suffer any detriment from the receipt of low-basis assets.

   a. Furthermore, leaving low-basis assets to charity allows the decedent's executor to allocate all of the decedent's aggregate basis increase and spousal property basis increase among assets passing to the decedent's family members.

   b. Even better tax savings occur if the charitable bequest is made by designating the charity as the beneficiary of a qualified retirement plan or other tax-deferred retirement benefit.

      i. No portion of the decedent's aggregate basis increase or spousal property basis increase can be allocated to such assets, because they are items of IRD.

      ii. The receipt of such assets generally produces ordinary compensation income, rather than capital gains. These items are received by charities, however, without current income tax liability.

      iii. Thus, it is far better to satisfy a charitable gift with retirement plan benefits than with even other highly-appreciated assets.

2. The repeal of the estate tax and the implementation of carryover basis will mean that individuals who give inherited property to charity will usually be making gifts of appreciated assets. The income tax rules impose limitations on the deduction of charitable gifts of appreciated property.

C. Charitable Remainder Trusts and Pooled Income Funds. The repeal of the estate tax renders the estate tax charitable deduction insignificant after 2010, and deprives charitable remainder trusts and pooled income funds of one of their primary tax advantages.

1. A charitable remainder trust involves an irrevocable transfer of property to a charity in trust, with a reservation to the donor or gift to other persons of a fixed annuity payable at least annually, or a fixed percentage of the annual value of the trust assets, payable at least annually (a unitrust interest.)

2. A pooled income fund involves an irrevocable transfer of property to a trust of which the charity is the trustee, reserving to the donor or another person a lifetime income interest, and providing that the trust assets pass to the charity at the income beneficiary's death.

3. Charitable remainder trusts and pooled income trusts are both tax-exempt entities, and one of the major reasons donors make gifts to these trusts is that it enables the donor to convert a highly-appreciated asset into one generating more income, without first paying capital gains taxes.

D. **Charitable Lead Trusts**. The repeal of the estate tax and the increase in the applicable exclusion amount will not deprive inter vivos charitable lead trusts of their importance as estate planning tools. A charitable lead trust is the reverse of a charitable remainder trust; an annuity or unitrust amount is paid to charity for a fixed term of years, and the remainder goes to family members on terms that the grantor has selected. The gift and estate tax value of the transfer to the family members is reduced by the value of the charitable annuity or unitrust amount.

1. Inter vivos charitable lead trusts should remain popular despite the Tax Act of 2001.

   a. These are devices that have traditionally been used only by the wealthier clients, whose estates are likely to be taxable notwithstanding the scheduled increases in the applicable exclusion amount.

   b. Furthermore, the fact that the gift tax exemption will not be raised above $1 million, even if the estate tax is repealed, suggests that these trusts may still pose a good tool for transferring family wealth to one's children and descendants during one's lifetime, at a substantially reduced gift tax cost.

2. Testamentary charitable lead trusts will remain popular, as long as there is a federal estate tax.

   a. Charitable lead trusts are most often used as a means of avoiding federal estate taxes, even at the cost of making substantial charitable gifts and deferring the receipt of the benefits by one's family.

   b. The elimination of the estate tax will cause many clients to look more closely at outright charitable gifts, coupled with immediate trusts for family members, both because of the increased simplicity and because this approach would give family members a more immediate benefit.

XIX. Planning Issue 8. Post Mortem Estate Planning. There are several reasons why post mortem estate planning is likely to become even more important because of the Tax Act of 2001.

A. Allocation of Basis Increases. The carryover basis rules that will become applicable when the estate tax is repealed in 2010, grant the executor broad discretion to allocate the decedent's $1.3 million aggregate basis increase and $3 million spousal property basis increase among assets.

1. The executor will need to pay careful attention to the precise assets to which these increases are allocated, unless the governing instrument dictates how these basis increases are to be allocated.

2. The executor has a fiduciary duty to treat all beneficiaries fairly and equally. The executor should, therefore, allocate the available basis increases fairly, so that each beneficiary receives a proportionate share of these increases.

3. On the other hand, there is a distinct advantage to allocating the aggregate basis increase to assets that will produce ordinary income when sold, such as property that would be held by the beneficiary for sale to customers in the ordinary course of business.

4. Allocating more basis increase to these assets would produce the greatest total tax savings, but the savings would inure to one beneficiary, rather than equally to all beneficiaries.

5. Also, a formula clause in a will or revocable trust that divides the assets between a marital and nonmarital share in a manner sufficient to use the $1.3 million aggregate basis increase and $3 million spousal property basis increase can create serious fiduciary problems.

    a. The executor's power to select assets to fund this share will determine the value of the share, because the executor is required only to select assets with a certain level of appreciation.

    b. The governing instrument should specify whether the executor is to select assets that will produce the largest possible nonmarital share, the smallest possible nonmarital share, or assets fairly representative of all available appreciation and depreciation.

    c. Absent such a direction, however, the executor will need to take special pains to treat all beneficiaries fairly in selecting assets to fund the marital and nonmarital shares.

B. Disclaimers. The possible repeal of the estate tax and the increases that will occur in the applicable exclusion amount place a premium on creating an estate plan that offers the family members flexibility to create marital and nonmarital shares that are appropriate in size and composition.

1. One approach to this type of flexible planning, as has been discussed, is to leave assets outright to the surviving spouse, and to allow the surviving spouse to determine by post mortem disclaimer, the amount of assets that should pass to the nonmarital share.

2. Such disclaimers are a fundamental component of post mortem estate planning, and the estate planner will need to counsel both the surviving spouse and the other family members about the impact of and need for such disclaimers, as well as attempt to help avoid having the surviving spouse disqualify a disclaimer by accepting benefits from the estate assets before attempting to disclaim them.

C. Estate Planning Repairs. Some clients and potential clients will believe that they no longer need estate tax planning, both because they have heard that the estate tax has been repealed, and because they want to believe that they do not need estate planning. The best efforts of estate planners to educate their clients and the public will not convince everyone that estate planning remains an important part of their total financial plan.

1. Many clients avoid estate planning because it requires them to admit and deal with their own mortality. The fear of high estate taxes has motivated many reluctant individuals to seek estate planning, and many of these persons will grasp at the promise of even a future repeal to relieve them from their duty to have their estate planned.

2. As a result, the Tax Act of 2001 can reasonably be expected to create many estates with inadequate estate planning. This means that estate planners should anticipate spending a greater portion of their time repairing faulty estate plans through sound *post mortem* estate planning.

Exhibit I

TABLE 6 Tax on a Taxable Estate of $10 Million (assuming no adjusted taxable gifts and a pick-up state tax only)						
Year	State Pick-Up Estate Tax		Net Federal Estate Tax		Gross Estate Tax	
	Tax	Change from 2001	Tax	Change from 2001	Gross Tax	Change from 2001
2001	$1,067,600	—	$3,852,650	—	$4,920,250	—
2002	$800,700	-25%	$3,629,300	-6%	$4,430,000	-10%
2003	$533,800	-50%	$3,821,200	-1%	$4,355,000	-11%
2004	$266,900	-75%	$3,798,100	-1%	$4,065,000	-17%
2005	0	-100%	$3,985,000	+3%	$3,985,000	-19%
2006	0	-100%	$3,680,000	-4%	$3,680,000	-25%
2007	0	-100%	$3,600,000	-7%	$3,600,000	-27%
2008	0	-100%	$3,600,000	-7%	$3,600,000	-27%
2009	0	-100%	$2,925,000	-24%	$2,925,000	-41%
2010	0	-100%	0	-100%	0	-100%

Year	Top Federal Estate Tax Rate	Top Effective Rate for Virginia
2001	60%	60%
2002	50%	54%
2003	49%	57%
2004	48%	60%
2005	47%	55.48%
2006	46%	54.64%
2007	45%	53.8%
2008	45%	53.8%
2009	45%	53.8%
2010	0%	16%
2011	60%	60%

Exhibit II

A. Asset Subject to Division. If my wife survives me, my Trustee shall divide the principal of the assets held at my death and other assets received by my Trustee that are included in my gross estate for federal estate tax purposes after payment of any charges under Article VII (collectively the "Trust Assets") into the Family Trust and the Marital Trust in the manner described in this Article.

B. Family Trust Fractional Share. The Family Trust shall consist of a fractional share of the Trust Assets. The numerator of the fraction shall equal the largest value of the Trust Assets that can press free of federal estate tax by reason of the unified credit (which is also know as the applicable credit amount) and the credit for state death taxes (to the extent the use of such credit does not increase state death taxes) allowable to my estate, after reduction by reason of (1) my adjusted taxable gifts, (2) other dispositions of property included in my gross estate for which no marital, charitable or other deduction is allowed in computing my federal estate tax and (3) administration expenses and other changes to principal that are not claimed and allowed as federal estate tax deductions. The denominator of the fraction shall equal the value of the Trust Assets based upon values as finally determined for federal estate tax purposes.

C. Marital Trust Fractional Share. The Marital Trust shall consist of the remaining fractional share of the Trust Assets.

D. Tax Elections. Any portion of the Marital Trust for which the marital deduction is not allowed in computing my federal estate tax by reason of a qualified disclaimer shall not be deemed a disposition of property under clause (2) of paragraph B. Transfer taxes incurred at my death and attributable to a qualified disclaimer of property included in my gross estate shall not be deemed charges to principal under clause (3) of paragraph B. I realize that the fractional shares of the Family Trust and Marital Trust may otherwise be affected by the exercise of certain tax elections.

E. Assets Not Subject to Division. My Trustee shall segregate and add to the Family Trust all assets that are not included in my gross estate, and such assets shall not be subject to the fractional division described in this Article.

F. Allocation of Assets. My Trustee shall not allocate to the Marital Trust any property or proceeds of property that cannot qualify for the marital deduction. To the extent possible, my Trustee shall not allocate to the Marital Trust any assets upon which a foreign death tax is payable. In other respects my Trustee may allocate assets as my Trustee may deem to be in the best interests of the beneficiaries, valuing each asset on the date of allocation.

G. Allocation of Income. Income earned on the Trust Assets before the division (and income on assets used to make the payments under Article VII) shall retain its character as income and shall be allocated in the same fractions. Income earned on assets that are not included in my gross estate shall retain its character as income in the Family Trust.

Exhibit III

Chart No. 1 - Taxable Gift availlable between 2001 and 2010 based upon various 2000 Taxable Gifts

Assuming prior taxable gift in 2000 [1] of:	**Scenario 1** **0**	**Scenario 2** **675,000**	**Scenario 3** **1,000,000**	**Scenario 4** **1,500,000**	**Scenario 5** **2,000,000**	**Scenario 6** **3,000,000**	**Scenario 7 [2]** **3,000,000 (in 2000)** **250,500 (in 2002)**
Maximum 2001 Tax Free Gift	675,000	0	0	0	0	0	0
Maximum 2002 Tax Free Gift	1,000,000	325,000	302,907	278,333	255,612	250,500	250,500
Maximum 2003 Tax Free Gift	1,000,000	325,000	302,907	278,333	278,333	255,612	0
Maximum 2004 Tax Free Gift	1,000,000	325,000	302,907	278,333	260,938	260,938	0
Maximum 2005 Tax Free Gift	1,000,000	325,000	302,907	278,333	266,489	266,489	0
Maximum 2006 Tax Free Gift	1,000,000	325,000	302,907	278,333	272,283	272,283	0
Maximum 2007 Tax Free Gift	1,000,000	325,000	302,907	278,333	278,333	278,333	0
Maximum 2008 Tax Free Gift	1,000,000	325,000	302,907	278,333	278,333	278,333	0
Maximum 2009 Tax Free Gift	1,000,000	325,000	302,907	278,333	278,333	278,333	0
Maximum 2010 Tax Free Gift	1,000,000	315,000	315,000	315,000	315,000	315,000	0

[1] 2000 and 2001 maximum applicable credit was 220,550 on $675,000.
[2] Scenario 7 shows that at higher levels of taxable gifts, incremental increases in taxable gifts do not equal the incremental decreases in future available tax free gifts.

Chart No. 2 - Taxable Gift availlable between 2001 and 2010 based upon various 1995 Taxable Gifts

Assuming prior taxable gift in 1995 [3] of:	**Scenario 1** **0**	**Scenario 2** **675,000**	**Scenario 3** **1,000,000**	**Scenario 4** **1,500,000**	**Scenario 5** **2,000,000**	**Scenario 6** **3,000,000**	**Scenario 7 [2]** **3,000,000 (in 1995)** **50,455 (in 2001)** **250,500 (in 2002)**
Maximum 2001 Tax Free Gift	675,000	75,000	67,683	61,667	56,633	50,455	50,455
Maximum 2002 Tax Free Gift	1,000,000	392,683	367,442	340,000	312,245	306,000	250,500
Maximum 2003 Tax Free Gift	1,000,000	392,683	367,442	340,000	312,245	312,245	0
Maximum 2004 Tax Free Gift	1,000,000	392,683	367,442	340,000	318,750	318,750	0
Maximum 2005 Tax Free Gift	1,000,000	392,683	367,442	340,000	325,532	325,532	0
Maximum 2006 Tax Free Gift	1,000,000	392,683	367,442	340,000	332,609	332,609	0
Maximum 2007 Tax Free Gift	1,000,000	392,683	367,442	340,000	340,000	340,000	0
Maximum 2008 Tax Free Gift	1,000,000	392,683	367,442	340,000	340,000	340,000	0
Maximum 2009 Tax Free Gift	1,000,000	392,683	367,442	340,000	340,000	340,000	0
Maximum 2010 Tax Free Gift	1,000,000	394,286	394,286	394,286	394,286	394,286	0

[3] 1995 maximum applicable credit was 192,800 on $600,000.
[2] Scenario 7 shows that at higher levels of taxable gifts, incremental increases in taxable gifts do not equal the incremental decreases in future available tax free gifts.