Planning for the Next Generation: Installment Sale to an Intentionally Defective Grantor Trust

John B. O'Grady
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Installment Sale to Grantor Trust

Step 1: Fund the Trust
You establish a grantor trust and make a gift to the Trust. The gift should be between 10-20% of the appraised value of the asset to be sold. The gift will use some or all of your remaining unified credit.

Step 2: The Sale
You sell the assets to the Trust. The Trust gives you a promissory note. Because you are treated as the owner of the Trust, there is no gain or loss recognized as a result of the sale.

Step 3: Payments on the Note
Each year the Trust makes principal and interest payments to you. Because the Trust is a grantor trust, you will continue to be taxed individually on the Trust’s income and gain.
Frequently Asked Questions Concerning An Installment Sale To An Intentionally Defective Grantor Trust

1. Why make the Sale?

By selling an asset, such as a closely held business, to an intentionally defective grantor trust, you have the opportunity to transfer significant assets to a trust for the benefit of your children while removing the asset from your estate for estate tax purposes. The transaction offers an opportunity to leverage depleted asset values along with possible valuation discounts (e.g., minority interests).

2. What kind of Trust will be created?

As a general description, you will create a trust that is intentionally drafted so that you will be treated as the owner of the trust assets for income tax purposes, but not for gift, estate, or other transfer tax purposes. You will not be a beneficiary of the trust. Instead, the trust will be established for the benefit of your descendants.

3. How do I fund the Trust?

The trust will need to be funded with seed money. Generally, you will make a gift of cash or other liquid assets with a value that equals 10-20% of the appraised value of the assets that will be sold to the trust. The gift to the trust may use some, or all, of your remaining unified credit amount. As a result, you will owe gift tax on any amounts that are in excess of your remaining credit.

4. How will the Sale to the Trust work?

You sell the asset, such as an ownership interest in a closely held business, to the trust in exchange for a promissory note bearing interest at the applicable federal rate. The trust then uses the income that it receives from the assets to make payments to you to pay down the promissory note.

5. Will I have to pay capital gains tax because of the Sale?

Because you are treated as the owner of the trust assets for income tax purposes, and transactions between you and the trust have no income tax consequences, there is no gain or loss recognized upon the sale.

6. What happens after the Sale?

During your lifetime, you will continue to receive payments from the trust until the promissory note is paid off. Because you will be considered the owner of the trust, you will continue to be taxed individually on the trust income and gain.
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Estate Tax Changes Past, Present and Future

Charting the rates,
Planning for mates,
Watching the states,
Handling the waits,
And predicting the fates
Of the effective dates.

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Estate Tax Changes Past, Present and Future

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Estate Tax Changes Past, Present and Future

Ronald D. Aucutt


I. THE TURBULENCE CREATED BY THE 2001 TAX ACT

A. The Phase In and Out of EGTRRA

The changes to the estate, gift, and GST taxes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") are summarized as follows:

<table>
<thead>
<tr>
<th>Year-by-Year Summary of the Changes Made by EGTRRA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Estate Tax</strong></td>
</tr>
<tr>
<td>Exclusion</td>
</tr>
<tr>
<td>Lowest rate</td>
</tr>
<tr>
<td>Top rate</td>
</tr>
<tr>
<td>5% bubble</td>
</tr>
<tr>
<td>2001: Yes</td>
</tr>
<tr>
<td>QFOBI</td>
</tr>
<tr>
<td>2001: Yes</td>
</tr>
<tr>
<td>State tax credit</td>
</tr>
<tr>
<td>2001: 100%</td>
</tr>
</tbody>
</table>

| **GST Tax**                                      |
| Exemption                                        |
| Rate                                             |

| **Gift Tax**                                     |
| Exclusion                                        |
| 2001: $675,000 | 2002: $1 million |
| Lowest rate                                      |
| 2001: 37% | 2002: 41% |
| Top rate                                         |
| 5% bubble                                        |
| 2001: Yes | 2002: No   |

B. The Gift Tax

1. The gift tax was not repealed, but was left in place, reportedly to discourage indiscriminate transfers of income-producing or appreciated assets from one taxpayer to another to avoid or reduce income tax liabilities.

2. Consistent with that objective, the gift tax rate in 2010 was reduced to 35 percent, which was the top long-term income tax rate enacted by EGTRRA, but the gift tax exemption was capped at $1 million, which was thought to better serve the income tax objectives of the gift tax in a post-estate tax world.

C. The State Death Tax Credit

1. The federal credit for state death taxes was repealed, which has produced
dramatically different results from state-to-state, depending on the existence and structure of the state estate tax. In a strictly “coupled” state, where the state tax is tied to the federal credit from time to time, there is no state tax.

2. In a “decoupled” state, where the state tax typically is tied to the federal credit in effect at some point before 2002, there is a state tax. Section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and (in 2009) federal tax rates. Federal Form 706 was redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a “tentative taxable estate” net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The “tentative taxable estate” in effect was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

3. The following table shows the resulting marginal rates on the largest estates, including the results under the 2010 Tax Act:

<table>
<thead>
<tr>
<th>Top Marginal Estate Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>2009</strong></td>
</tr>
<tr>
<td>“Coupled” State</td>
</tr>
<tr>
<td>Ordinary “Decoupled” State</td>
</tr>
<tr>
<td>“Decoupled” State/No Deduction</td>
</tr>
<tr>
<td><strong>2010-2012</strong></td>
</tr>
<tr>
<td>“Coupled” State</td>
</tr>
<tr>
<td>Ordinary “Decoupled” State</td>
</tr>
<tr>
<td>“Decoupled” State/No Deduction</td>
</tr>
<tr>
<td><strong>2013</strong></td>
</tr>
<tr>
<td>All States (Under Current Law)</td>
</tr>
</tbody>
</table>

4. The landscape is further complicated by other departures from the federal model in various jurisdictions, such as jurisdictions that decoupled their tax systems after 2001 not only from the federal credit for state death taxes but also from the phased increases in the federal unified credit, so that the state exemption is less than the federal exemption. In 2011, only North Carolina and possibly Delaware have exemptions and filing thresholds of $5 million.


D. Carryover Basis

1. For 2010, EGTRRA added carryover basis rules that change the way executors and beneficiaries determine the income tax basis of property acquired from a decedent, which is used to calculate gain or loss upon sale of the property and in some cases to calculate depreciation deductions. Instead of a basis equal to the
value on the date of death (or “alternate valuation date,” generally six months after death), the basis will be the value on the date of death or the decedent’s basis in the property, *whichever is less*.

2. As somewhat of a substitute for the estate tax exemption, each decedent’s estate will be allowed $1.3 million of basis increase (increased by the decedent’s capital loss and net operating loss carryovers and by the capital loss that would have been recognized if the decedent’s loss assets had been sold for their fair market value immediately before the decedent’s death), which the executor may allocate to individual assets to eliminate up to $1.3 million of that unrealized appreciation. The executor will also be able to allocate an additional $3 million of basis increase to any assets passing to a surviving spouse, either outright or in certain kinds of trusts.

### E. Three Shall Nots and One Had Never Been

1. **Not Really Repeal**

   a. Section 2210(a) stated that “this [estate tax] chapter shall not apply to the estates of decedents dying after December 31, 2009.”

   b. Section 1014(f) stated that “[t]his section [providing for a stepped-up basis at death for appreciated assets] shall not apply with respect to decedents dying after December 31, 2009.”

   c. Section 2664 stated that “[t]his [GST tax] chapter shall not apply to generation-skipping transfers after December 31, 2009.” It was the entire chapter that did not apply, not just the tax. All definitions, exemptions, rules, etc. were inapplicable. But the GST tax chapter was inapplicable only in the case of generation-skipping transfers.

2. **Watching a Byrd at Sunset**

   a. It was well known that the “repeal” of the federal estate tax took effect in 2010, for only one year. In 2011, EGTRRA was to “sunset” and the estate tax law return to where it would have been without the enactment of EGTRRA — namely the former 55 percent rate (with a 60 percent “bubble”), a credit for state death taxes, and the $1 million exemption that would have been reached in 2006 under the phased in changes made by the Taxpayer Relief Act of 1997.

   b. Specifically, section 901(a) of EGTRRA stated:

```
SEC. 901. SUNSET OF PROVISIONS OF ACT.

(a) IN GENERAL.—All provisions of, and amendments made by, this Act shall not apply—

(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

(2) in the case of title V, to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010.

(b) APPLICATION OF CERTAIN LAWS.—The Internal Revenue Code of
```
1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

c. Section 901 was the only section in the ninth and last title of EGTRRA, entitled “Compliance with Congressional Budget Act.”

i. The Congressional Budget Act of 1974 (2 U.S.C. § 621 et seq.) prescribes the procedures by which Congress adopts spending and tax priorities in a budget resolution and implements those priorities in a streamlined process of budget reconciliation. In a rule added in 1985 and amended in 1990, sponsored by the late Senator Robert Byrd (D-WV) (and hence known as the “Byrd Rule”), section 313 of the Budget Act (2 U.S.C. § 644) makes “extraneous” provisions in budget reconciliation subject to a point of order in the Senate. “Extraneous” is defined to include the reduction of net revenues in years beyond the period provided for in the budget resolution. Since the 2001 budget resolution generally covered ten years, a net reduction of taxes beyond the tenth year would have been ruled out of order.

ii. A point of order under the Byrd Rule can be waived by a vote of 60 Senators (just as a Senate filibuster against general legislation can be broken by a vote of 60 Senators). H.R. 1836, which became EGTRRA, originally passed the Senate, on May 23, 2001, by a vote of 62-38 (while the conference report on EGTRRA passed the Senate on May 26, 2001, by a vote of only 58-33). H.R. 1836, however, garnered 62 votes only with a “sunset” provision in it. The Senate was not asked to vote on a non-sunsetting repeal, and presumably the votes were just not there. In the Senate consideration of H.R. 1836, amendments to eliminate the estate tax repeal were defeated by votes of 43-56 and 42-57. Even an amendment to preserve the estate tax only for estates greater than $100 million was defeated by a vote of 48-51.

d. The “as if ... had never been enacted” language of section 901(b) of EGTRRA attracted a lot of attention and created a lot of speculation and exasperation. This was particularly true in the context of the GST tax. It is safe to surmise that members of Congress in 2001 did not think about how this language might affect estate planning in 2010 and 2011. Indeed, it is unlikely that they expected the EGTRRA changes to still be in effect without modification and permanence by 2010. It is certain that the “had never been enacted” language was not cobbled together just to torment estate planners nine years later. Indeed, as of 2001, it was not unprecedented repeal, override, or sunset language.

i. Similar language had been used, ironically, in the 1980 repeal of the original 1976 carryover basis regime. Section 401(b) of the Crude Oil Windfall Profit Tax Act of 1980 (Public Law 96-223) stated:

Exception to the extent necessary to carry out subsection (d)
[which allowed executors of decedents dying from January 1, 1977, to November 6, 1978, to elect the 1976 carryover basis regime, despite its repeal], the Internal Revenue Code of 1954 shall be applied and administered as if the provisions repealed by subsection (a), and the amendments made by those provisions, had not been enacted.

ii. In a different context, the words “if the Revenue Act of 1948 had not been enacted” appear in section 1014(b)(7) itself.

II. PAST REMINISCENCES

A. The World War I Era

1. In the Revenue Act of September 8, 1916, as the United States was on the brink of entering World War I, Congress enacted the current estate tax, imposed at rates of 1 percent to 10 percent on taxable estates over $50,000. In the Act of March 3, 1917, the rates were generally increased by half, to levels of 1 1/2 percent to 15 percent. In explaining the Senate bill, which would have doubled rates to 2 percent-20 percent, the Finance Committee said:

   Such a tax, when used as an emergency measure, is necessarily unequal in operation. Only if continued at the same rate for many years – the period of a generation – does it become equal for all persons in like situation. If levied as a war tax, that is, as a temporary emergency measure, it falls only upon the estates of those who happen to die during the period of the emergency. Particularly is it to be remembered that perhaps a majority of those dying during the war and leaving estates to be taxed will be soldiers and sailors dying in defense of our country. On the other hand, as a permanent measure, such a tax, even at the rates already fixed by existing law, trenches in considerable degree on a sphere which should be reserved to the States.

   S. REP. No. 103, 65TH CONG., 1ST SESS. 14 (1917) (emphasis added).

2. In its version of the Revenue Act of 1926, when the gross rates ranged from 1 percent to 20 percent, the House of Representatives raised the state death tax credit to 80 percent of the basic tax, while the Senate version would have repealed the estate tax. In support of repeal, the Finance Committee quoted the excerpts from its 1917 report that are italicized above. S. REP. NO. 52, 69TH CONG., 1ST SESS. 8 (1926). In short, the Finance Committee of 1917 and 1926 seems to have cited the same arguments in support of doubling the tax and in support of repealing the tax! The 1926 House-Senate conference, of course, accepted the House approach.

B. The Kennedy-Johnson Studies and the Nixon Administration

On February 5, 1969, less than two weeks after the inauguration of President Nixon, Congress published a multi-volume Treasury Department work entitled “Tax Reform Studies and Proposals,” reflecting work that had been overseen by Assistant Secretary of the Treasury for Tax Policy Stanley Surrey during the Kennedy and Johnson Administrations. It included a number of estate and gift tax proposals. The following list of the estate and gift tax proposals gives the date each proposal was eventually
enacted in some form:

1. Taxation of appreciation at death or at the time of gifts (carryover basis enacted in 1976, repealed in 1980, and enacted again in 2001, effective 2010).

2. Unification of the gift and estate taxes.
   b. Same base – tax-inclusive (1976, for gifts within three years of death).


6. An “orphan exclusion” equal to the amount of the gift tax annual exclusion multiplied by the number of years by which the orphan is under 21 (roughly in 1976 – repealed in 1981).


8. More rational allocation of deductions between estate tax and income tax returns (in part by the “Hubert regulations” in 1999).


11. Discontinuance of “flower bonds” redeemable at par to pay estate tax (last issued 1971, last matured 1998).

C. The Ford Administration

“Blueprints for Basic Tax Reform” was published by the Treasury Department January 17, 1977, during the last week of the Ford Administration, in response to Secretary of the Treasury William Simon’s lament that the United States should “have a tax system which looks like someone designed it on purpose.” In the context of proposing a comprehensive model of income taxation that depended on a dramatically broader tax base, “Blueprints” assumed that transfers by gift or at death would be recognition events. Such capital gains, whether by gift, at death, or otherwise, would be fully taxed at ordinary income rates, with adjustments to the basis of corporate stock for retained earnings and to the basis of all assets for general price inflation. Pre-enactment gain would be excluded, following the precedent of the “carryover basis at death” rules that were enacted in 1976. “Blueprints” was not embraced by the incoming Carter Administration.

D. The Reagan Administration

1. “Tax Reform for Fairness, Simplicity, and Economic Growth” (popularly called “Treasury I”) was published by Treasury on November 27, 1984, just weeks after President Reagan’s landslide reelection. It included the following (at vol. 2, pp.
a. Imposition of gift tax, like the estate tax, on a “tax-inclusive” basis.

b. Imposition of tax only once, when beneficial enjoyment ceases, ignoring retained powers (a proposal that kindled an “easy to complete”/“hard to complete” debate).

c. Treatment of all powers of appointment as general powers of appointment if the holder could benefit from them, without regard to complicating concepts such as “ascertainable standards” and “adverse interests.”

d. Valuation of fractional interests in an asset at their pro rata share of the value of the asset owned or previously transferred by the transferor or the transferor’s spouse.

e. A simplified GST tax (compared to the GST tax enacted in 1976) with a $1 million exemption and a flat rate (in this proposal equal to 80 percent of the top estate tax rate).

f. Elimination of the phase-out of the credit for tax on prior transfers from a member of the same or a younger generation.

g. Expansion of section 6166 deferral of the payment of estate tax to all cases where the estate lacks sufficient cash or marketable assets, without regard to whether it holds an interest in a business. Liquidity would be reevaluated annually on an “if you have it send it in” basis (or at least send in 75 percent of it).

h. Conversion of the IRD deduction under section 691(c) to a basis adjustment.

i. Replacement of the separate rate schedule for calculating the maximum state death tax credit with a maximum credit equal to a flat 5 percent of the taxable estate. This would have resulted in a substantially smaller state death tax credit in most cases.

j. Repeal of section 303, which provides for exchange treatment of stock redemptions to pay certain taxes and funeral and administration expenses.

2. “The President’s Tax Proposals to the Congress for Fairness, Growth, and Simplicity” was published by the White House on May 29, 1985. It was popularly called “Treasury II” or “White House I” or sometimes “Regan II” in reference to the fact that Donald T. Regan was the Secretary of the Treasury who signed the transmittal letter for “Treasury I” and had become the White House chief of staff by May 1985. Based generally on Treasury I, it was the rough model for the Tax Reform Act of 1986. It contained no proposals affecting transfer taxes.

a. Ultimately, the Tax Reform Act of 1986 (Public Law 99-514) did enact a supposedly simpler GST tax (but at a rate equal to 100 percent, not 80 percent, of the top estate tax rate).

b. In the Omnibus Budget Reconciliation Act of 1987 (“OBRA”) (Public Law
100-203), the House of Representatives added a repeal of the state death tax credit, a rule valuing interests in family-owned entities at their pro rata share of the total value of all interests in the entity of the same class, and rules regarding “disproportionate” transfers of appreciation in estate freeze transactions. H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1041-44. The House-Senate conference retained only the estate freeze rules, as section 2036(c) (which in turn was repealed in 1990 and replaced with the supposedly more workable rules of chapter 14).

c. The other transfer tax suggestions of Treasury I have not been enacted.

E. The Clinton Administration

1. The Clinton Administration’s budget proposals for fiscal 1999 included a proposal to “eliminate non-business valuation discounts,” described as follows:

   The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds readily marketable assets (including cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (i.e., not subject to the limits on valuation discounts). No inference is intended as to the propriety of these discounts under present law.


   a. The Clinton Administration’s budget proposals for fiscal 2000 and fiscal 2001 repeated this proposal, except that “readily marketable assets” was changed to “non-business assets” and “the propriety of these discounts under present law” was changed to “whether these discounts are allowable under current law.”

   b. This proposal was reduced to legislative language in section 276 of H.R. 3874, 106th Cong., 2d Sess., introduced on March 9, 2000, by the Ranking Democrat on the House Ways and Means Committee, Rep. Charles Rangel of New York. This bill would have added a new section 2031(d) to the Code, the general rule of which read as follows:

   (d) VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS—For purposes of this chapter and chapter 12—

   (1) IN GENERAL—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), the value of such interest shall be determined by taking into account

   (A) the value of such interest's proportionate share of the nonbusiness assets of such entity (and no valuation discount
shall be allowed with respect to such nonbusiness assets), plus

(B) the value of such entity determined without regard to the value taken into account under subparagraph (A).

c. A slightly different articulation of this rule appeared in section 303 of H.R. 1264, 107th Cong., 1st Sess., which Rep. Rangel introduced on March 26, 2001, partly as an alternative to the Republican proposals that became EGTRRA:

(d) VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS—For purposes of this chapter and chapter 12—

(1) IN GENERAL—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092)—

(A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and

(B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

Rep. Rangel’s 2001 bill would also have added a new section 2031(e) to the Code, to read as follows:

(e) LIMITATION ON MINORITY DISCOUNTS—For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family (as defined in section 2032A(e)(2)) of the transferee have control of such entity.


d. Clinton Administration proposals have inevitably experienced a bit of a revival now that Democrats control the Congress and White House. Democratic staff members have publicly referred to them as a possible model for legislative drafting. This is perhaps reflected in H.R. 436, the current version of Rep. Pomeroy’s bill, discussed in Part VII.A on page 27.

e. The same Clinton Administration’s proposed budgets also recommended the repeal of the personal residence exception from section 2702.

2. The “Death Tax Elimination Act of 2000” (H.R. 8) was passed in 2000 by large majorities in Congress, including 59 Senators, but it was vetoed by President Clinton. H.R. 8 would have—

a. reduced the top rate from 55 percent to 40.5 percent in annual steps from
2001 through 2009,

b. converted the “unified credit” to an exemption, thereby allowing the exemption to be applied to the top marginal rate rather than to the lower rates as the credit is,

c. eliminated the 5 percent surtax that results in the 60 percent “bubble” for taxable estates larger than $10 million,

d. repealed the estate tax, gift tax, and generation-skipping transfer tax (GST tax), beginning in 2010, and

e. replaced the estate, gift, and GST taxes with a carryover basis regime, beginning in 2010.

III. REPUBLICAN-LED EFFORTS TO REPEAL OR REFORM

A. Early Efforts After 2001 To Make Repeal Permanent

1. In the consideration of H.R. 2646, the Farm Security and Rural Investment Act of 2002, which President Bush signed on May 13, 2002, the Senate added an expression of the “sense of the Senate” that the estate tax repeal should be made permanent. Even though such an expression had no statutory or other binding effect whatsoever, it garnered only 56 votes, with 42 votes opposed, although the two Senators not voting (Senators Bennett of Utah and Domenici of New Mexico) were Republicans who had supported the repeal of the estate tax in the past.

a. The repeal measure the Republican leadership agreed to consider would only make the repeal of the estate and GST taxes in 2010 permanent for the years 2011 and beyond. Until 2010, the rates would fall and the unified credit would rise, on the schedule enacted in 2001. The gift tax unified credit would continue to be limited, so as to shelter gifts only up to $1 million, and after 2009 the gift tax would continue in effect, with a 35 percent rate. The state death tax credit would be phased out by 2005, and carryover basis would be enacted as a permanent replacement for the estate tax, beginning in 2010.

b. This permanent repeal measure involved a suspension of the budget reconciliation rules under which EGTRRA was crafted, and therefore it required the vote of 60 Senators – the same 60-vote requirement that contributed prominently to the odd results in EGTRRA in the first place.

c. The vote was held on June 12, 2002. The vote was 54-44, and the measure therefore failed. (The two Senators not voting supported repeal.)

d. Before voting on permanent repeal, the Senate took up alternatives offered by
Democratic Senators, including accelerated increases in the unified credit (which failed by a vote of 38-60) and expansion of qualified family-owned business interest (QFOBI) relief (which failed by a vote of 44-54).

B. Reports of Compromise Efforts

1. The October 22, 2003, Washington Post reported that Senator Jon Kyl (R-AZ), an important member of the Senate Committee on Finance who has been a major player in actively advocating permanent repeal of the estate tax, was at that time considering abandoning that position in exchange for an increase in the estate tax exemption to $15 million per person and a decrease in the estate tax rate, above that exemption, to 15 percent, the current income tax rate on capital gains.

2. The Post report was silent as to what, if anything, Senator Kyl would do about the gift and GST taxes, about adjustment of basis at death, and about state death taxes. The Post also reported that Senator Kyl’s proposal had gained the interest of several Democratic Senators and the support of several important lobbyists. The article implied that the impetus for Senator Kyl’s proposal was the growth of the deficit and the risk that if a Democrat were elected President in 2004 permanent repeal or substantial reduction of the estate tax would be a dead letter.

3. Then, on October 23, 2003, one day after the Post report, Senator Kyl repudiated the article. As if to leave no doubt, on the same day Senator Kyl introduced S.J. Res. 20, to express “the sense of the Congress that the number of years during which the death tax ... is repealed [that is, 2010] should be extended, pending the permanent repeal of the death tax.”

C. The 2004 Election

1. On the day after his reelection in 2004, President Bush referred to the “political capital” that he had earned and intended to “spend.” He also made it clear that one of the centerpieces of his domestic agenda was to make permanent the tax cuts enacted in 2001 and 2003, including the repeal of the estate and GST taxes.

2. Also in the 2004 election, the Republicans maintained control of the House and gained four seats in the Senate. Fifty-five was more Republicans than there had been in the Senate since Herbert Hoover was President. This gain in the Senate immediately triggered a lot of speculation about the new votes that might be available for permanent repeal of the estate tax.

3. Extrapolating from the 59 Senate votes for H.R. 8 (which President Clinton vetoed) in 2000, the 58 votes for EGTRRA in 2001, and especially the 54 votes for the up-or-down repeal vote in June 2002 (with two absent Senators expressing support for repeal), some observers attempted to predict the likely votes for repeal in light of the intervening personnel changes. See, e.g., Sullivan, “60-Vote Majority at Hand for Estate Tax Repeal,” TAX NOTES, Nov. 29, 2004, at 1174.

4. Some also cited the intangible effect of the “Daschle factor” – the likelihood that Democrats in “red states” carried by President Bush, especially those up for reelection in 2006, would have second thoughts about opposing the supposedly popular repeal of the estate tax. Id.
5. It is harder still to evaluate the intangible factor of weighing votes rather than counting them. A vote in 2000 for a measure everyone knew President Clinton would veto, a vote in 2001 for a repeal for only one year nine years in the future, and a vote in 2002 where the counting had already been done were not necessarily indicative of how lawmakers would vote on a measure with a realistic chance of success, when it is actually necessary for them to take responsibility for their actions (as the 2006 votes were to show).

D. The Final Push for Repeal or Compromise

1. The permanent repeal of the federal estate tax was placed before the Senate when, by a more or less bipartisan vote of 272-162 on April 13, 2005, the House passed the 109th Congress’s version of H.R. 8 (the “Death Tax Repeal Permanency Act of 2005”) to eliminate the 2011 “sunset” that limits repeal to just the year 2010. [Of the 272 Members of the House who voted for H.R. 8 in April 2005, 216 (almost a majority) returned to the Democratically-controlled 110th Congress, and 179 (a sizable minority, consisting of 142 Republicans and 37 Democrats) returned to the 111th Congress.]

2. At the end of July 2005, just before the August recess, Senate Majority Leader Bill Frist of Tennessee filed a motion of “cloture” on H.R. 8, basically the Senate form of “calling the question,” which requires approval of 60 Senators. When the Senate was scheduled to reconvene on September 6, the day after Labor Day, there was only one matter that might have been ahead of that cloture motion, a cloture motion on the “Native Hawaiian Government Reorganization Act of 2005.”

3. Meanwhile, with full repeal lacking 60 votes, compromise efforts continued. The idea of a 15 percent rate, mentioned in the October 22, 2003, Washington Post, although quite a departure from the top 55 percent rate of just a few years ago and even the 45 percent top rate achieved in 2007 under present law, had proved remarkably durable, and it remained the target rate openly discussed by Senator Kyl and others as the compromise discussions reached a public crescendo. In contrast, the $15 million exemption level reported in October 2003 was elusive. Following the 2004 elections, the most often mentioned aspiration was an exemption of $10 million. In mid-July (2006), $8 million was mentioned in the press, and by the end of July it was $3.5 million.

4. By Labor Day, the pressures of dealing with Hurricane Katrina had become too much for the Senate, and the estate tax vote was postponed.

a. Opponents of repeal of the estate tax asked how Congress could possibly consider huge tax cuts for the nation’s wealthiest families when multitudes on the Gulf Coast had been left with nothing.

b. Supporters of repeal asserted that more than ever the economy needed stability in tax policy, especially regarding the taxation of saving and investment, which would be so important in the Gulf Coast rebuilding effort.

5. On May 2, 2006, a “Summit for Permanent Death Tax Repeal” convened at the National Press Club in Washington. It was sponsored by the Family Business
Estate Tax Coalition, and participants included Senator Kyl, Ways and Means Committee Member Congressman Kenny Hulshof (R-MO) (who retired from Congress and ran, unsuccessfully, for Governor of Missouri in 2008), and Al Hubbard, Assistant to the President for Economic Policy and Director of the National Economic Council. The consensus at the Summit was to support a compromise of a 15 percent rate, a $5 million exemption (indexed for inflation), and continued stepped-up basis for appreciated assets, all effective January 1, 2010.

6. On June 8, 2006, the Senate considered a cloture motion to take up H.R. 8, which the House had passed in April 2005, thus returning the debate to the posture that had been expected before the hurricanes of late August 2005. The motion was only to take up H.R. 8, not necessarily to approve it but possibly to amend it with something like Senator Kyl’s 15 percent/$5 million proposal.

   a. Prior to the vote, however, Senator Kyl had floated the suggestion that he would agree to a second rate of, say, 30 percent, imposed on taxable estates over, say, $30 million. That made it unlikely that the last few necessary Democratic votes would support a 15 percent rate that did not include a 30 percent super-rate.

   b. The vote was 57-41 in favor of cloture, three votes short of the necessary 60. (The two Senators who did not vote would have voted no.)

E. PETRA

On June 22, 2006, by a vote of 269-156, the House of Representatives passed a new bill, H.R. 5638, called the “Permanent Estate Tax Relief Act of 2006” (“PETRA”).

1. PETRA, effective January 1, 2010, would have provided

   a. a $5 million exemption equivalent (indexed for inflation after 2010),

   b. an initial rate tied to the top income tax rate on general capital gains under section 1(h)(1)(C) (currently 15 percent, but returning to 20 percent in 2011 if Congress does not act),

   c. a rate equal to double that rate on taxable estates over $25 million (not indexed),

   d. gift tax exemptions and rates re-conformed to the estate tax (rather than a special exemption of $1 million and a special rate of 35 percent as in 2010 under current law),

   e. repeal of the deduction for state death taxes (which itself replaced the phased-out credit for state death taxes in 2005),

   f. retention of a stepped-up basis at death for appreciated assets, and

   g. repeal of the 2011 “sunset” for the other transfer tax provisions of EGTRRA.

2. PETRA would also have provided a mechanism for a surviving spouse’s estate and gift (but not GST) exemptions to be increased (but no more than doubled) by the amount of the exemption that was not used by that spouse’s predeceased
spouse.

a. This in effect would have allowed a surviving spouse an exemption of up to $10 million (in 2010 and thereafter), indexed for inflation, if the first spouse to die did not use any exemption – if, for example, the estate of the first spouse to die were left entirely to the surviving spouse.

b. This treatment would have to be elected on a timely estate tax return of the first spouse to die, and the Internal Revenue Service would have been authorized to reexamine that return at the time the surviving spouse died, no matter how much time had passed, for the purpose of determining the exemption available to the surviving spouse (but not for the purpose of changing the tax with respect to the first return).

c. The $25 million level for the higher rate would not have been transferable between spouses.

3. In addition, PETRA included a relief provision for the timber industry, widely viewed as an effort to attract the votes of Senators from timber-growing states.

4. The Bush Administration, despite its official commitment to full and permanent repeal of the estate tax, announced on June 22 that it supported PETRA “as a constructive step toward full repeal of the death tax.”

5. On June 27, Senator Frist announced that PETRA would not be brought to the Senate floor before the Fourth of July recess.

F. ETETRA

On July 29, 2006, by a somewhat less enthusiastic and less bipartisan vote of 230-180, the House of Representatives passed still another bill, H.R. 5970, called the “Estate Tax and Extension of Tax Relief Act of 2006” (“ETETRA”).

1. ETETRA modified PETRA by
   a. phasing in the $5 million exemption equivalent in $250,000 annual increments from $3.75 million in 2010 (up from $3.5 million in 2009) to $5 million in 2015,
   b. delinking the top estate tax rate (but not the initial 15 percent rate) from the capital gains tax rate,
   c. phasing in the top 30 percent rate in 2 percent annual increments from 40 percent in 2010 (down from 45 percent in 2009) to 30 percent in 2015,
   d. extending the indexing for inflation (after 2015) to the $25 million bracket amount, and
   e. removing the “miscellaneous” provisions of EGTRRA from the repeal of the sunset, meaning that they again would be scheduled to expire in 2011.

2. In addition to the estate tax provisions and the timber relief provision, ETETRA included two-year “extenders” of the research credit and other expiring provisions, an increase in the minimum wage to $7.25 per hour by June 1, 2009, and a number of other tax changes not related to the estate tax. The estate tax
provisions, extenders, and minimum wage increase were popularly referred to as

3. On August 3, the Senate cloture motion to take up consideration of H.R. 5970 failed by a vote of 56-42. Senator Frist changed his vote to no only to preserve his right to request reconsideration later in the year, and Senator Baucus (D-MT), who was expected to vote yes, was absent because of the recent death of his nephew in Iraq, thus suggesting that the total votes for cloture might have been 58. The only Senator to change from his June 8 vote was Senator Byrd (D-WV).

G. Adjournment

1. After recessing for the November 7 elections and returning for a “lame duck” session, the 109th Congress adjourned without enacting ETETRA-like changes or any other significant changes to the estate, gift, and GST taxes.

2. Congress did, however, enact a number of the extenders that had been in ETETRA, but without estate tax changes, without an increase in the minimum wage (which was postponed to 2007), and without even the relief provisions for the timber industry that had originated in PETRA.

IV. REASSESSING THE LIKELIHOOD OF REPEAL

A. Milestones in the History of the Repeal Movement

1. President Reagan’s low-key interest in repeal, which produced only a reduction of the top rate from 70 percent to 50 percent, in a phased reduction that ultimately leveled off at 55 percent,

2. President Reagan’s legacy of populist support for tax cuts of all kinds, coupled with increasing unrest among some economists and some leaders of public opinion with the economic and personal burden of the tax increasingly referred to as the “death tax,”

3. the Republican takeover of the House of Representatives in 1994, spurred by a “Contract with America” in which tax relief was prominent,

4. President Bush’s presidential campaign of 2000, drawing on two decades of growing anti-tax sentiment in promising to return huge projected budget surpluses to the American people in “Tax Cuts with a Purpose,” including repeal of the death tax,

5. the “repeal” itself in EGTRRA, albeit only after nine years and then only for one year,

6. the immediate commitment from the 2001 Republican leadership to “make the tax cuts permanent,” even as projected budget surpluses dwindled,

7. history-defying Republican mid-term election gains in 2002, followed by still more Republican gains in the presidential year of 2004,

8. an October 2003 Washington Post report – immediately denied but publicly affirmed after the 2004 election – that Senate Finance Committee member and repeal supporter Jon Kyl was working with other Senators to craft a bipartisan compromise proposal that would increase the exemption to $15 million and
decrease the rate, above that exemption, to 15 percent, the current income tax rate on capital gains,

9. the perennial endorsement of full repeal by the House of Representatives, culminating in a 272-162 vote in April 2005 for the current version of H.R. 8, the “Death Tax Repeal Permanency Act of 2005,”

10. the scheduling for just after Labor Day in 2005 of a Senate vote to take up H.R. 8, to either approve it or, more likely, to amend it along the lines of Senator Kyl’s compromise,

11. the abrupt postponement of that vote after Hurricane Katrina,

12. the recommittment of the Senate Republican leadership to an estate tax vote in 2006, affirmed at a retreat of Republican Senators in January, announced by Senate Majority Leader Bill Frist (R-TN) in February, and reaffirmed in Senator Frist’s call in an April 21, 2005, letter to Republican Senators to “end the death tax forever,”

13. a resolve by representatives of most pro-repeal constituencies at a May 2 “Summit for Permanent Death Tax Repeal” to get behind Senator Kyl’s 15 percent compromise, with a $5 million exemption, as the most practical way to achieve at least a substantial measure of estate tax relief,

14. a 57-41 Senate vote on June 8 on a “cloture” motion to take up H.R. 8, which thereby failed for lack of the required 60 votes,

15. passage by the House of two new estate tax compromise bills customized to attract the support of 60 Senators – H.R. 5638, the “Permanent Estate Tax Relief Act of 2006” (“PETRA”) by a vote of 269-156 on June 22, and H.R. 5970, the “Estate Tax and Extension of Tax Relief Act of 2006” (“ETETRA”) by a vote of 230-180 on July 29, and

16. a 56-42 Senate vote on August 3 on a cloture motion to take up consideration of H.R. 5970, which thereby also failed for lack of the required 60 votes.

B. What Might Have Been

1. We will probably never know how the Senate would have voted just after Labor Day in 2005, if Katrina had not intervened. But it is clear that even before Republicans lost control of Congress to the Democrats in the 2006 election, the effort for total repeal had simply lost too much traction to have a meaningful chance of recovery. Consider the following:

2. In October 2003, Senator Kyl was publicly insisting on full and permanent repeal and denying rumors of compromise, but by the end of 2004 his push for a 15 percent rate instead of full repeal was a matter of general knowledge. Even before the June 8 cloture vote, it was understood in the Senate that Senator Kyl would accept a 30 percent rate for the largest estates – an understanding that later was reflected in PETRA and ETETRA. Once willingness to compromise in this way is conceded, it is very hard to credibly reassert a “purist” position.

3. As late as April 21, 2005, a letter from Majority Leader Frist called on his
Republican colleagues to “end the death tax forever,” but by summer he was leading the effort to bring ETETRA to a vote, with its 15 percent and 30 percent rates.

4. The Bush Administration’s official position had been to favor full and permanent repeal, but the White House called PETRA “a constructive step toward full repeal of the death tax.” Again, once a compromise effort is dignified in that way, it can become, in effect, the new agenda.

5. The opposition to repeal – indeed even the opposition to substantial reduction – has been resolute and deep, as indicated by the failure of the ETETRA “sweeteners” to change more than one Senator’s vote.

6. Meanwhile, the support for total repeal has been diluted both by years of frustrations and by the realization that carryover basis would be a very unwelcome substitute.

7. Unlike 2001, when large budget surpluses were forecast, the current fiscal climate of large budget deficits fuels the unease of politicians and voters with “tax cuts for the rich.”

8. As a practical matter, estate tax repeal will usually require 60 votes in the Senate.

V. “OPTIONS” PRESENTED BY THE JOINT COMMITTEE STAFF

On January 27, 2005, the Staff of the Joint Committee on Taxation published a 430-page Report entitled OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, as requested in February 2004 by Chairman Grassley and Ranking Member Baucus of the Senate Finance Committee. The Report may be viewed at http://www.house.gov/jct/s-2-05.pdf. Under the heading of Estate and Gift Taxation, it presents five proposals estimated to raise revenue by $4.2-4.7 billion over ten years.

A. Perpetual Dynasty Trusts

1. The first proposal is labeled “Limit Perpetual Dynasty Trusts (secs. 2631 and 2632).” The purpose of this proposal is described as follows:

   Perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation. In addition, perpetual dynasty trusts deny equal treatment of all taxpayers because such trusts can only be established in the States that have repealed the mandatory rule against perpetuities.

2. The proposal would prohibit the allocation of GST exemption to a “perpetual dynasty trust” that is subject either to no rule against perpetuities or a significantly relaxed rule against perpetuities. If an exempt trust were moved to a state that had repealed the rule against perpetuities, the inclusion ratio of the trust would be changed to one. (Presumably this latter rule would apply only if the relocation of the trust produced a change in the governing law, and a similar rule would also apply if the situs state changed its governing law.)

3. The details, not disclosed in the Report, will be important.

   a. For example, the proposal states that it would apply in a state that relaxes its
rule against perpetuities to permit the creation of interests for individuals more than three generations younger than the transferor. Presumably, the statutory language would be drafted so as not to be harsher than present law under a classical rule against perpetuities, which easily allows transfers to great-great-grandchildren.

b. Likewise, rather than an outright prohibition on allocation of GST exemption, as the proposal says, it seems more appropriate to simply limit allocation of the transferor’s GST exemption to a one-time use (permitting a tax-free transfer to grandchildren) and then allow the allocation of GST exemption, again for one-time use, by members of each successive generation also.

c. An overall objective of tax-neutrality among jurisdictions would be salutary, but elusive.

B. Valuation Discounts

1. The second proposal is labeled “Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624).” The purpose of this proposal is described as follows:

   The proposal responds to the frequent use of family limited partnerships (“FLPs”) and LLCs to create minority and marketability discounts. ... The proposal seeks to curb the use of this strategy frequently employed to manufacture discounts that do not reflect the economics of the transfers during life and after death.

2. The proposal would determine valuation discounts for transfers of interests in entities by applying aggregation rules and a look-through rule. The aggregation rules are what the Report calls a “basic aggregation rule” and a “transferee aggregation rule.”

   a. The basic aggregation rule would value a transferred interest at its pro rata share of the value of the entire interest owned by the transferor before the transfer. For example, a transferred 20 percent interest would be valued at one-fourth the value of an 80 percent interest if the transferor owned an 80 percent interest and at one-half the value of a 40 percent interest if the transferor owned a 40 percent interest.

   b. The transferee aggregation rule would take into account the interest already owned by the transferee before the transfer, if the transferor does not own a controlling interest. For example, if a person who owns an 80 percent interest transfers a 40 percent interest by gift and the other 40 percent interest at death to the same transferee, the gifted 40 percent interest would be valued at one-half the value of the 80 percent interest originally owned by the donor and the bequeathed 40 percent interest would be valued at one-half of the value of the 80 percent interest ultimately owned by the donee/legatee.

   c. Interests of spouses would be aggregated with the interests of transferors and transferees. The proposal explicitly (and wisely) rejects any broader family attribution rule “because it is not correct to assume that individuals always will cooperate with one another merely because they are related.”
3. The look-through rule would require the portion of an interest in an entity represented by marketable assets to be valued at its pro rata share of the value of the marketable assets, if those marketable assets represent at least one-third of the value of the assets of the entity.

4. The proposal takes a measured approach which appears designed to avoid the uncertain and overbroad reach of previous legislative proposals. Nevertheless, the successive focus on what the transferor originally owned and on what the transferee ends up with – in contrast, for example, to the simple aggregation with the transferor’s previous transfers – could produce some curious results.
   a. Transferors with multiple transferees – e.g., parents with two or more children – would apparently have more opportunities to use valuation discounts than transferors with only one transferee.
   b. Transfers over time could apparently be treated more leniently than transfers at one time.
   c. The results illustrated in the examples, based on the assumption that a majority (i.e., more than 50 percent) represents control, would apparently be easier to avoid in an entity like a limited partnership or LLC, where a 99 percent interest is often a noncontrolling interest.
   d. Testing valuation discounts ultimately against what the transferee ends up with would encourage successive transfers (retransfers) or transfers split, for example, between a child and a trust for that child’s descendants.

C. Lapsing Crummey Powers

1. The third proposal is labeled “Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503).” The purpose of this proposal is described as follows:

   Recent arrangements involving Crummey powers [i.e., lapsing powers of withdrawal from a trust] have extended the “present interest” concept far beyond what the Congress likely contemplated in enacting the gift tax annual exclusion, resulting in significant erosion of the transfer-tax base.

2. The proposal offers three options for curbing the use of lapsing Crummey powers.
   a. Limit Crummey powers to “direct, noncontingent beneficiary(ies) of the trust.” This would repudiate the broad use of Crummey powers sustained in Cristofani v. Commissioner, 97 T.C. 74 (1991).
   b. Limit Crummey powers to powers that never lapse. As the proposal acknowledges, “[t]his option effectively eliminates Crummey powers as a tax planning tool.”
   c. Limit Crummey powers to cases where “(1) there is no arrangement or understanding to the effect that the powers will not be exercised; and (2) there exists at the time of the creation of such powers a meaningful possibility that they will be exercised. This option requires a facts-and-circumstances analysis of every Crummey power.”
3. Again curiously, the proposal does not explore the possibility of making “tax-vesting” (includibility in the powerholder’s gross estate), rather than actual non-lapsing, the test, even though a tax-vesting test is already used for trusts for minors under section 2503(c) and for all GST tax purposes under section 2642(c)(2).

4. Indeed, if lapsing Crummey powers were ever eliminated, Congress might at the same time recognize the desirability of allowing section 2503(c) trusts to extend beyond age 21, even for life, subject to a tax-vesting requirement patterned after section 2642(c)(2).

5. The proposal is silent about its possible application to lapsing rights of withdrawal at age 21 to qualify a trust under section 2503(c), although the principles seem to be the same.

D. Consistent Basis

1. The fourth proposal is labeled “Provide Reporting for a Consistent Basis Between the Estate Tax Valuation and the Basis in the Hands of the Heir (sec. 1014).” The idea is that an heir will be required to use as the income tax basis the same value that is used for estate tax purposes, with the rather noncontroversial objective of consistency. To implement this rule, the executor would be required to report the basis to each recipient of property and to the IRS.

2. Consideration might be given to a vehicle analogous to Form 8082 (by which beneficiaries of an estate can report an income tax position that is inconsistent with the Form K-1 received from the executor) to permit the use of a different basis by the heir if the inconsistency is disclosed and explained to the IRS.

E. 529 Plans

1. The fifth and final proposal is labeled “Modify Transfer Tax Provisions Applicable to Section 529 Qualified Tuition Accounts (sec. 529).” This proposal would essentially subject 529 plans to the transfer tax rules that are generally applicable.

2. An exception is the special rule allowing the use of five annual gift tax exclusions for a single transfer, which apparently would not be changed.

VI. “MIDDLE CLASS” FOCUS UNDER DEMOCRATIC LEADERSHIP

A. The Fiscal 2008 Congressional Budget Resolution (March 2007)

1. On March 21, 2007, in the context of finalizing the fiscal 2008 budget resolution (S. Con. Res. 21), the Senate, by a vote of 97-1 (with only Senator Feingold (D-WI) opposed), approved an amendment offered by Senator Baucus (joined by Senators Mary Landrieu (D-LA), Mark Pryor (D-AR), Evan Bayh (D-IN), and Bill Nelson (D-FL)) that in effect would make the $132 billion surplus projected for 2012 available to offset tax cuts in both 2011 and 2012, including selective extension of the tax cuts enacted in 2001 and 2003.

2. Senator Baucus stated that under this amendment “the Senate’s highest priority for any surplus should be American families.” 153 CONG. REC. S3469 (daily ed.
Accordingly, the first priority Senator Baucus cited was improving children’s health care coverage under the State Children’s Health Insurance Program (SCHIP). Senator Baucus continued:

Then our amendment takes the rest of the surplus and returns it to the hard-working American families who created it. Our amendment devotes the rest of the surplus to the extension and enhancement of tax relief for hard-working American families.

Here are the types of tax relief about which we are talking. We are talking about making the 10-percent [income] tax bracket permanent.

We are talking about extending the child tax credit.

We are also talking about continuing the marriage penalty relief.

We are also talking about enhancing the dependent care credit.

We are talking about improving the adoption credit.

We are talking about [taking] combat pay [into account] under the earned-income tax credit, otherwise known as the EITC.

We are **talking about reforming the estate tax**. **We want to try to give American families certainty. We want to support America’s small farmers and ranchers, and in this amendment, we have allowed room for estate tax reform that will do that.**

And we talk about returning surplus revenues to hard-working American families.

3. Senator Kent Conrad (D-ND), the Chairman of the Senate Budget Committee (and a former North Dakota Tax Commissioner), responded:

Madam President, I thank very much Senator Baucus for his leadership on this very important amendment. This amendment is to reassure all those who have benefited from the middle-class tax cuts that those tax cuts will go forward, that those children who are not now currently covered under the SCHIP legislation will have the opportunity to be covered.

The Senator has also provided for small business because we have a number of provisions that are critically important to small business and, of course, to prevent the estate tax from having this bizarre outcome, which is now in the law, where the exemption would go down to $1 million from $3.5 million just two years before. That makes no sense. So the Senator provides for room in this amendment to deal with estate tax reform.

The precise contours of that will be up to, obviously, the Finance Committee.

4. In response to the ensuing discussion of several of the points he had made, Senator Baucus subsequently said (*id.* at S3470):

There is an underlying answer to all these questions; namely, these are questions the Finance Committee is going to address and find the appropriate offsets and deal with the pay-go when it comes up at that time.

5. After being asked specifically about the estate tax, Senator Baucus stated that the
amendment “contemplates extending the estate tax provisions that are in effect in 2009 permanently.”

a. In the context of this budget resolution, of course, “permanently” meant only through 2012 (or perhaps only through 2011, since the tax from 2011 estates would generally be payable in fiscal 2012, which begins October 1, 2012).

b. The prospect of extending 2009 law through 2011 or 2012 was intriguing. It reflected some thoughtful attention to the concerns about the instability of the estate tax law, especially as 2010 approached.

c. Moreover, by eliminating the repeal year of 2010, an extension actually picked up some revenue to offset the revenue lost in 2011 and 2012. The revenue loss in 2011 and 2012, when the exemption would increase from $1 million (under current law) to $3.5 million, would be complicated by the fact that the top federal rate would go from 39 percent (net of the state death tax credit) under current law to something like 37.8 percent, 38.8 percent, or 45 percent (as in the table on page 1).

d. Since the revenue gain from 2010 would have been a one-time gain, it would not have been available again to mitigate revenue losses, meaning that permanent estate tax reduction would become even more expensive if this extension were enacted.

6. On March 23, 2007, the Senate rejected a variation of Senator Kyl’s proposal to direct the tax-writing committees to report an estate tax exemption of $5 million (indexed for inflation) and a top rate no higher than 35 percent. The vote was 48-51. The vote was severely partisan; no Democrat voted for it, and only one Republican (Senator Voinovich) voted against it. The four Senators who voted for cloture on H.R. 8 in June 2006 but not for Senator Kyl’s March 2007 amendment were Senators Baucus, Lincoln (D-AR), Bill Nelson (D-FL), and Ben Nelson (D-NE).

7. On the same day, by a vote of 25-74, the Senate rejected an amendment offered by Senator Ben Nelson that he described as follows (id. at S3667 (March 23, 2007)):

   Like the Kyl amendment, our amendment will allow us to accommodate the Landrieu proposal of a $5 million [exemption] and 35 percent [rate] with a surcharge for the largest estates. Unlike the Kyl amendment, this amendment is fiscally responsible and deficit neutral [that is, it will be paid for].

Only four Republicans (Senators Susan Collins and Olympia Snowe of Maine, Richard Lugar of Indiana, and George Voinovich of Ohio) voted for Senator Nelson’s amendment.

8. Thus, with only Senators Collins, Lugar, and Snowe voting for both the Kyl amendment and the Nelson amendment, it might be said that 70 Senators voted on March 23 for an exemption of $5 million and a top rate no greater than 35 percent (at least if it can be “paid for” and depending on what Senators Nelson and Landrieu meant by “a surcharge for the largest estates”).
9. The Senate approved the overall budget resolution on March 23 by a largely partisan vote of 52-47.

10. On May 9, 2007, when the Senate was considering the appointment of Senators to the House-Senate conference on the budget resolution, Senator Kyl offered the following motion (id. at S5838 (May 9, 2007)):

That the conferees on the part of the Senate on the disagreeing votes of the two Houses on the concurrent resolution S. Con. Res. 21 (the concurrent resolution on the budget for fiscal year 2008) be instructed to insist that the final conference report include the Senate position to provide for a reduction in revenues, sufficient to accommodate legislation to provide for permanent death tax relief, with a top marginal rate of no higher than 35%, a lower rate for smaller estates, and with a meaningful exemption that shields smaller estates from having to file estate tax returns, and to permanently extend other family tax relief, so that American families, including farmers and small business owners, can continue to enjoy higher after-tax levels of income, increasing standards of living, and a growing economy, as contained in the recommended levels and amounts of Title I of S. Con. Res. 21, as passed by the Senate.

a. In explaining the motion, Senator Kyl said: “While the motion does not specify that amount, an exemption of $5 million per estate indexed for inflation is what is contemplated.” Id. at S5839.

b. Senator Conrad opposed the motion, on the grounds that it was not paid for and that the subject was already covered by the Baucus amendment in the Senate resolution, which he as a Senate conferee would be committed to support. Id.

c. Nevertheless, Senator Kyl’s motion passed by a vote of 54-41, with eight Democrats in favor and no Republicans opposed.

d. The binding effect of such a motion to “instruct” conferees was unclear. Even provisions “sufficient to accommodate” the desired legislation would still leave the implementation up to the tax-writing committees.

11. On May 17, 2007, the House and Senate approved the budget resolution with intriguing references to the estate tax.

a. The provisions of the budget resolution applicable to the House of Representatives (section 303(b)(2)) permit one or more bills, joint resolutions, amendments, motions, or conference reports that provide for tax relief for middle-income families and taxpayers and enhanced economic equity, such as extension of the child tax credit, extension of marriage penalty relief, extension of the 10 percent individual income tax bracket, modification of the Alternative Minimum Tax, elimination of estate taxes on all but a minute fraction of estates by reforming and substantially increasing the unified credit, extension of the research and experimentation tax credit, extension of the deduction for State and local sales taxes, and a tax credit for school construction bonds ... provided that such legislation would not increase the deficit or decrease the surplus for the total over the period of fiscal years 2007 through 2012 or the
period of fiscal years 2007 through 2017.


b. With respect to the corresponding language of the budget resolution applicable to the Senate (section 303(a)), an overview prepared by the staff of the Senate Budget Committee stated:

The Conference Agreement supports middle-class tax relief, including extending marriage penalty relief, the child tax credit, and the 10 percent bracket subject to the pay-as-you-go rule. It also supports reform of the estate tax to protect small businesses and family farms. House provisions include additional procedural protections to help ensure fiscal responsibility.

c. The proviso that the contemplated tax relief “not increase the deficit or decrease the surplus for the total over the period of fiscal years 2007 through 2012 or the period of fiscal years 2007 through 2017” — what the Senate Budget Committee’s overview refers to as “procedural protections to help ensure fiscal responsibility” — can fairly be interpreted to mean that under the budget resolution the Ways and Means Committee will not include any tax relief provisions that are not “paid for” through increases of other taxes or projected budget surpluses. This will be an especially hard standard to meet in view of the current deficit that the budget needs to overcome and the commitment of Ways and Means Committee Chairman Charlie Rangel (D-NY) and other Members of Congress to give priority to the very expensive task of fixing the individual alternative minimum tax.

B. The Fiscal 2009 Congressional Budget Resolution (March 2008)

1. In the consideration of the fiscal 2009 budget resolution (S. Con. Res. 70) on March 11, 2008, Senator Baucus again proposed an amendment that would make projected surpluses available for middle-class tax relief. He said, at 154 CONG. REC. S1840 (daily ed. March 11, 2008):

This amendment would take the surplus in the budget resolution and give it back to the hard-working American families who earned it. It would make permanent the 10-percent tax bracket. It would make permanent the child tax credit. It would make permanent the marriage penalty relief. And it would make permanent the changes to the dependent care credit. Further, it would make changes to the tax law to honor the sacrifices our men and women in uniform make for us every day. We lower the estate tax to 2009 levels. And it would allow middle-income taxpayers who do not itemize their deductions to nonetheless take a deduction for property taxes.

2. Once again, Senator Conrad chimed in:

Mr. President, I thank the chairman of the Finance Committee, Senator Baucus, for this excellent amendment. This will extend the middle-class tax cuts, the 10-percent bracket, the childcare credit, and the marriage penalty relief provisions. All those tax cuts will be extended.

In addition, as I understand it, the chairman of the Finance Committee has crafted an amendment that will include significant estate tax reform because we are now in this unusual situation of where, under current law, the estate tax will
go from a $3.5-million exemption per person in 2009 to no estate tax in 2010, and then in 2011, the estate tax comes back with only $1 million exemption per person. The amendment of the Senator from Montana would make certain it stays at $3.5 million and is allowed to rise with inflation.

3. And again, Senator Baucus’s amendment was approved with only Senator Feingold opposed. The vote was 99-1.

4. On the following day, as he had in 2007, Senator Kyl offered an amendment that would provide a $5 million estate tax exemption (indexed for inflation) and a top rate of 35 percent. Id. at S1922 (daily ed. March 12, 2008). An alternative, “paid for,” amendment offered by Senator Salazar (D-CO) was defeated by a vote of 38-62. Id. at S2044. Senator Kyl’s amendment was then defeated by a vote of 50-50. Id.

   a. Vice President Cheney had been in the presiding officer’s chair and recognized Senators Salazar and Kyl just before the vote on Senator Salazar’s amendment (id.), but he was no longer in the Senate chamber to break the tie after the vote on Senator Kyl’s amendment

   b. During the debate, Senator Kyl complained (id. at S1923-24):

      The American people need to understand what is really going on. Each year we pass a budget that, theoretically, allows for a reform of the estate tax, but then we don’t do anything about it. And the budget itself isn’t law. The budget is merely a goal, a blueprint of where we want to go for the year. If you don’t follow it up with a bill, you haven’t done anything. But Members here pat themselves on the back and go back home and tell their constituents that they voted to cut the estate tax. Oh, that is wonderful, people say. But it is never followed up with an actual bill.

      So the chairman of the Finance Committee said: Well, he would have the goal of marking up a bill this spring. He has since advised me he has no plans whatsoever for a real bill on estate tax, and said: It won’t happen.

5. Democratic Senators Landrieu and Lincoln voted for Senator Kyl’s amendment, while Republican Senator Voinovich voted against it. Republican Senators Collins, Snowe, and Voinovich joined 35 Democrats, including Senators Landrieu and Lincoln, to vote for Senator Salazar’s amendment. Thus, only four Senators (Collins, Landrieu, Lincoln, and Snowe) voted for both amendments, meaning that 84 Senators (including Senators Obama, Biden, Clinton, and Salazar) voted for substantial estate tax relief, albeit in what were essentially “free” votes. (But 71 of those Senators who voted for some form of a $5 million exemption and 35 percent rate returned to the 111th Congress and were there to vote on the Lincoln amendment discussed in Part VII.D, beginning on page 29.)

C. Finance Committee Hearings

On October 4, 2007, while the Senate Finance Committee was considering the tax features of an energy, conservation, and agriculture tax package entitled the Heartland, Habitat, Harvest, and Horticulture Act of 2007, Senator Kyl proposed an amendment that would set the estate tax exemption at $5 million indexed for inflation, tie the
estate tax rate above $5 million to the capital gains tax income tax rate (currently 15 percent), and add a 30 percent bracket beginning at $25 million. (This is essentially the same as ETETRA.) Senator Kyl withdrew the amendment after Chairman Baucus promised to hold a hearing on estate tax reform “later in the year,” with the goal of marking up a bill in the spring of 2008.

1. The Finance Committee held that hearing on November 14, 2007. A manufacturer from Iowa and a rancher from Nevada advocated repeal of the estate tax or at least a substantial increase in the exemption. Warren Buffett of Berkshire Hathaway supported a progressive estate tax (with an exemption of perhaps $4 million) as necessary to prevent “plutocracy.” Practitioner Conrad Teitell of Stamford, Connecticut, pointed out the caprice of current law and the complexities and uncertainties faced in estate planning. Both Chairman Baucus and Ranking Member Grassley complained about the estate tax, expressed their preference for repeal, but offered a commitment to serious reform as an achievable alternative. Chairman Baucus promised more extensive hearings in 2008 with a goal of major changes in the 111th Congress (2009-2010). See http://finance.senate.gov/library/hearings/download/?id=d92e8705-b9ee-46cf-9313-1954eba380f6.

2. A second hearing was held on March 12, 2008. Three professors discussed alternatives to the estate tax system, largely donee-based taxes such as inheritance taxes and inclusion of inheritances in income, as well as income taxes on gains imposed at the donor level. It was clear that the Senators in attendance (three Democrats and three Republicans at various times) were not inclined to replace the estate tax with another regime, although they obviously were aware of the coming anomaly in 2010 and 2011 and seemed interested in finding some way to avoid it. Both Democrats and Republicans expressed concern for the liquidity problems of family-owned farms and businesses. One of the witnesses was New York University School of Law Professor Lily Batchelder, who, it was announced May 17, 2010, has been appointed the Chief Tax Counsel for the Committee. See http://finance.senate.gov/library/hearings/download/?id=74cdc8a6-010a-4faa-b820-c0d8740d5d27.

3. A third hearing was held on April 3, 2008. Witnesses were invited to discuss
   a. the need to clarify, modernize, simplify, and otherwise improve the rules for deferred payment of estate tax under section 6166,
   b. the “portability” of transfer tax exemptions (and exemption equivalents represented by the unified credit) from deceased spouses to surviving spouses,
   c. reunifying the estate and gift tax unified credits, and
   d. the effect of the estate tax on charitable giving.

The topics provide clues about the “targeted” relief to look for in any legislation (tied to family farms and other family businesses which have been a vocal concern of Senators, especially Democrats like Senator Lincoln). See http://finance.senate.gov/library/hearings/download/?id=57f554d9-c027-42e2-90d7-f74001059ed.
VII. THE INCREDIBLE ONE-HUNDRED-ELEVENTH CONGRESS

A. The First Pomeroy Bill (H.R. 436)

1. On January 9, 2009, Rep. Earl Pomeroy (D-ND) introduced H.R. 436, called the "Certain Estate Tax Relief Act of 2009." It received a great deal of attention, but the attention was probably overdone (not surprising in the atmosphere of anticipation that prevailed in January 2009). H.R. 436 was not even featured on Rep. Pomeroy's own website.

2. H.R. 436 would freeze 2009 estate tax law – a $3.5 million exemption equivalent (with no indexing) and a 45 percent rate.

3. H.R. 436 would also revive, effective January 1, 2010, the "phaseout of graduated rates and unified credit" of pre-2002 law, expressed as a 5 percent surtax.
   a. The pre-2002 surtax applied only to taxable estates between $10,000,000 and $17,184,000. Because of the increase in the unified credit to match a $3.5 million exemption, the surtax under H.R. 436 would apply to taxable estates from $10 million all the way up to $41.5 million.
   b. In other words, the marginal rate between $10 million and $41.5 million would be 50 percent (45 percent plus 5 percent), and the ultimate tax on a taxable estate of $41.5 million, calculated with the current unified credit of $1,455,800, plus the 5 percent surtax on $31.5 million (the excess over $10 million), would be $18,675,000 – exactly 45 percent of $41.5 million.
   c. At least the old 5 percent surtax used to work that way when there was a federal credit and no deduction for state death taxes. Today, it would still work that way in "coupled" states where in effect there is no state death tax. Once again, the repeal of the state death tax credit makes the math more complicated in "decoupled" states that impose their own tax. In those states, the actual numbers will depend on the structure of the state tax, but in general the combined federal and state marginal rates for taxable estates between $10.1 million and $41.5 million will be 56.9 percent in states that conform to the federal deduction for their own state taxes and 58.0 percent in states that have decoupled even from that federal deduction.
   d. Regardless of the stature or future of H.R. 436 in general, the revival of the surtax idea might gain traction in a revenue-minded and middle-class-focused congressional environment. No idea ever fades away completely.
   e. If a surtax like this were enacted, it would be one more reason to be careful in providing blanket general powers of appointment in trusts subject to the GST tax, because at least the GST tax is imposed at a flat 45 percent rate.

4. H.R. 436 would add a new section 2031(d), generally valuing transfers of nontradeable interests in entities holding nonbusiness assets as if the transferor had transferred a proportionate share of the assets themselves. If the entity holds both business and nonbusiness assets, the nonbusiness assets would be valued under this special rule and would not be taken into account in valuing the transferred interest in the entity. Meanwhile, new section 2031(e) would deny a
minority discount (or discount for lack of control) in the case of any nontradeable entity controlled by the transferor and the transferor’s ancestors, spouse, descendants, descendants of a spouse or parent, and spouses of any such descendants. The statutory language is identical to the bills introduced by Rep. Rangel in 2001 and Rep. Pomeroy in 2002, 2005, and 2007, discussed in Part II.E.I.c on page 9. These rules would apply for both gift and estate tax purposes and would be effective on the date of enactment.

B. The Arithmetic of the Estate Tax

1. Although the estate tax was not prominent in the 2008 presidential campaign, President Obama’s campaign embraced making permanent the 2009 estate tax law, with a $3.5 million exemption and 45 percent rate.

2. Freezing the federal estate tax at its 2009 level would have increased federal revenues for fiscal 2011 – the 12 months that began October 1, 2010 – because that is when the tax would have been due with respect to decedents dying in 2010.

3. After 2010, reversing the EGTRRA “sunset” and “reducing” the federal estate tax to its 2009 level would of course have reduced federal revenues (relative to what the pre-2002 law would produce in 2011). But that reduction of federal revenue would have been of less magnitude and different composition than might sometimes be assumed, because, if the EGTRRA sunset were allowed to run its course and pre-2002 law, including the credit for state death taxes, returned in 2011, the net federal rate on the largest estates would not increase very much.

4. If pre-2002 law returned, at the level of a taxable estate of $3.5 million (the 2009 exemption), the net federal marginal rate would be 45.4 percent, as it was before 2002. At a taxable estate of $3.6 million, it would drop to 44.6 percent, and never again would be above 45 percent, the current federal rate in states with no deductible state death tax. At a taxable estate just under $10 million, the net federal marginal rate would be 39.8 percent. Because of the 5 percent surtax under old section 2001(c)(2), the net marginal rate would become 44.8 percent at $10 million and then 44 percent over $10.1 million. At a little over $17 million, the net marginal rate would fall to 39 percent, the net rate on all taxable estates above that level. These rates compare to the 2009 net federal marginal rate on the largest estates of 45 percent in “coupled” states, 38.8 percent in ordinary “decoupled” states, and 37.8 percent in “decoupled” states where the state tax itself is not allowed as a deduction in computing the state tax.

5. Putting it another way, the following table shows the net federal tax paid, if Congress had not changed the law, on a small and large taxable estate (with no adjusted taxable gifts or other complexities, and no state estate tax):

<table>
<thead>
<tr>
<th>Taxable Estate</th>
<th>Federal Estate Tax Owed</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2009</td>
<td>2011 (before 2010 Tax Act)</td>
</tr>
<tr>
<td>$5 million</td>
<td>$675,000</td>
<td>$1,653,400</td>
</tr>
<tr>
<td>$50 million</td>
<td>$20.9 million</td>
<td>$19.7 million</td>
</tr>
</tbody>
</table>

6. The upshot of all this is that a return to pre-2001 law in 2011, compared to 2009
law, would have collected more federal revenue, but mostly from estates at the low end of the range of taxable estates. The very largest estates would actually get a federal tax cut in many states. It is a bit of an oversimplification to ignore state taxes and other factors, but the prima facie effect of raising substantial revenue from the smallest taxable estates and reducing the net federal marginal rates and even the net federal tax on the estates of the richest decedents would not have fit well with popular notions of “tax cuts for the rich” versus “middle class tax relief.”

C. The Obama Administration’s Fiscal 2010 Budget Proposal

1. The ambitious document announcing the Administration’s proposed budget, “A New Era of Responsibility: Renewing America’s Promise,” was published February 26, 2009. In a summary of the adjustments to baseline projections to reflect selective (targeted) continuation of the 2001 and 2003 tax cuts, a footnote (footnote I to Table S-5) stated that “the estate tax is maintained at its 2009 parameters.” Apparently the gift tax exemption was assumed to remain $1 million, and the exemptions were not indexed for inflation or portable between spouses.

2. On June 11, 2009, revenue estimates from the Joint Committee on Taxation scored the ten-year cost of the Administration proposal at about 43 percent of current-law estimates.

D. The Fiscal 2010 Congressional Budget Resolution

1. The House and Senate versions of the budget resolution, H. Con. Res. 85 and S. Con. Res. 13, both as proposed by the respective Budget Committees and as passed by the House and Senate respectively, allowed for 2009 estate tax law to be made permanent.

2. On April 2, 2009, the Senate, by a vote of 51-48, approved an amendment offered by Senator Blanche Lincoln (D-AR) and cosponsored by Senators Jon Kyl (R-AZ), Ben Nelson (D-NE), Chuck Grassley (R-IA), Mark Pryor (D-AR), Pat Roberts (R-KS), Mary Landrieu (D-LA), Michael Enzi (R-WY), Susan Collins (R-ME), and John Thune (R-SD). The precise wording of Senator Lincoln’s amendment is:

The Chairman of the Senate Committee on the Budget may revise the allocations of a committee or committees, aggregates, and other appropriate levels and limits in this resolution for one or more bills, joint resolutions, amendments, motions, or conference reports that would provide for estate tax reform legislation establishing—

(1) an estate tax exemption level of $5,000,000, indexed for inflation,

(2) a maximum estate tax rate of 35 percent,

(3) a reunification of the estate and gift credits, and

(4) portability of exemption between spouses, and

provided that such legislation would not increase the deficit over either the period of the total of fiscal years 2009 through 2014 or the period of the total of fiscal
years 2009 through 2019.

3. In short, Senator Lincoln’s 2009 amendment had about the same effect as would have the amendment proposed by her cosponsor Senator Nelson in 2007 (see Part VI.A.7 on page 22) and by Senator Salazar in 2008 (see Part VI.B.4 on page 25) – that is, in Senator Nelson’s words, “[l]ike the Kyl amendment, [but] fiscally responsible and deficit neutral.” In an environment of extreme fiscal challenges, that effect could be very small.

4. As if to leave no doubt about the aspirational nature of this amendment, the Senate then immediately approved, by a vote of 56-43, a amendment offered by Assistant Majority Leader Richard Durbin (D-IL), providing that “[i]n the Senate, it shall not be in order to consider any bill, joint resolution, amendment, motion, or conference report that would provide estate tax relief beyond $3,500,000 per person ($7,000,000 per married couple) and a graduated rate ending at less that 45 percent unless an equal amount of tax relief is provided to Americans earning less than $100,000 per year and that such relief is in addition to the amounts assumed in this budget resolution.” Senator Kyl mildly opposed the Durbin amendment, but Senators Lincoln, Nelson, and Pryor themselves voted for it.

5. On April 29, 2009, the conference report on the budget resolution was passed by votes of 233-193 in the House and 53-43 in the Senate. The Lincoln amendment was not included.

E. The First Baucus Bill (S. 722)

1. Meanwhile, on March 26, 2009, Chairman Max Baucus (D-MT) of the Senate Finance Committee had introduced the “Taxpayer Certainty and Relief Act of 2009” (S. 722), including Title III captioned “Permanent Estate Tax Relief.”

2. Consistent with the Obama Administration’s budget proposal, S. 722 would make permanent the current $3.5 million estate tax applicable exclusion amount and 45 percent rate. It would again fully unify the gift tax with the estate tax by providing a single exclusion amount of $3.5 million, and it would also make the cap on the reduction of value under the special use valuation provisions of section 2032A equal to the applicable exclusion amount. Beginning in 2011, it would index the applicable exclusion amount for inflation.

3. S. 722 would also make permanent the other transfer tax changes made by EGTRRA, including the rules affecting the allocation of GST exemption. And it would provide for the “portability” of the unused gift and estate tax unified credit of a deceased spouse to the surviving spouse and the surviving spouse’s estate.

4. The portability provisions of S. 722 are identical to those in the 2006 House-passed bills, except that the iterative portability of the unified credit to spouses of spouses is prohibited.
   a. In other words, if Husband 1 dies after 2009 without using his full exclusion amount, and his widow, Wife, marries Husband 2 and then dies, Wife’s estate could use her own exclusion amount plus whatever amount of Husband 1’s exclusion amount was not used. Husband 2’s estate could use his own
exclusion amount plus whatever amount of Wife’s basic exclusion amount was not used. But Husband 2’s estate could not use any of Husband 1’s unused exclusion amount transmitted through Wife’s estate. Some commentators describe this as requiring privity between the spouses.

b. Husband 2’s estate could still use the unused exclusion amount of any number of his predeceased wives (and S. 722 would make that explicit), subject only to the overall limitation that the survivor’s exclusion amount could be no more than doubled.

F. The McDermott Bill (H.R. 2023)

   a. a $2 million exemption equivalent, indexed for inflation after 2010,
   b. an initial rate of 45 percent (over $1.5 million in the tax table), a rate of 50 percent over $5 million, and a rate of 55 percent over $10 million (with these amounts also indexed for inflation after 2010),
   c. restoration of the credit for state death taxes and repeal of the deduction for state death taxes,
   d. gift tax exemptions and rates re-conformed to the estate tax,
   e. retention of a stepped-up basis at death for appreciated assets,
   f. repeal of the 2011 “sunset” for other transfer tax provisions of EGTRRA, and
   g. portability of the unified credit between spouses (as in PETRA and ETETRA, not requiring “privity” between spouses as in S. 722).

2. The staff of the Joint Committee on Taxation estimated that H.R. 2023 would cost $202 billion over ten years, or about 37 percent of current-law revenue estimates (compared to 43 percent of current-law estimates for the cost of the Administration proposal to make 2009 estate tax law permanent).

G. Ways and Means Committee Engagement and the Second Pomeroy Bill

1. On October 22, 2009, Ways and Means Committee members Shelley Berkley (D-NV), Kevin Brady (R-TX), Artur Davis (D-AL), and Devin Nunes (R-CA) introduced H.R. 3905, called the “Estate Tax Relief Act of 2009.”
   a. Under H.R. 3905, in each of the ten years from 2010 through 2019, the estate tax applicable exclusion amount would increase by $150,000 and the top rate would decrease by 1 percent. Thus, by 2019 the exemption and rate would be $5 million and 35 percent, the levels embraced aspirationally by a majority of Senators while considering the fiscal 2010 budget resolution (see part VII.D, beginning on page 29). The $5 million exemption would be indexed for inflation after 2019.

b. In addition, the deduction for state death taxes would be reduced 10 percent
per year through 2019, when it would be eliminated entirely.

c. H.R. 3905 would abandon carryover basis and make permanent the other 2001 transfer tax changes, including the several helpful rules regarding allocation of the GST exemption. But it would not reunify the gift and estate tax exemptions or make the exemption portable between spouses.

2. Meanwhile, on November 4, the House Small Business Committee held a hearing entitled “Small Businesses and the Estate Tax: Identifying Reforms to Meet the Needs of Small Firms and Family Farmers.” Three family business owners and a think tank scholar argued that if the estate tax cannot be abolished, at least there should be greater relief for family businesses and farms. The statements of Chairwoman Nydia Valazquez (D-NY) and the witnesses are available at http://www.house.gov/smbiz/hearings/hearing-11-4-09-estate-tax/hearing-witnesses-estate-tax.htm.

3. On November 18, 2009, the Democratic members of the Ways and Means Committee reportedly agreed to go forward with only a one-year extension of the 2009 estate tax law but had second thoughts when Majority Leader Steny Hoyer (D-MD) reconvened them and urged them to embrace a permanent solution.

4. Then on the following day (November 19), Congressman Earl Pomeroy (D-ND), the Ways and Means Committee member whom Chairman Rangel had tapped to put the permanent statutory language together, introduced H.R. 4154, a very simple bill that would only freeze 2009 law, including the estate tax exemption of $3.5 million, the gift tax exemption of $1 million, the top rate of 45 percent, a stepped-up basis at death for appreciated assets, a deduction (and no credit) for state death taxes, and the special rules for conservation easements, section 6166, and allocation of GST exemption enacted in 2001.

   a. The supporters of the bill in the floor debate focused on the need for predictability in planning and the unfairness of carryover basis.
   b. Those voting no presumably did so mainly because they would have preferred to see the estate tax permanently repealed or more significantly reduced – the House of Representatives then included over 170 members who were among the 272 votes for permanent repeal the last time that issue had come before the House in April 2005. Indeed, the opposition in the floor debate before the vote supported the Berkley-Brady bill (H.R. 3905), which would have phased in a $5 million exemption and 35 percent rate by 2019 and indexed the exemption for inflation after that. A few voting no, however, were Democrats who have expressed a preference for a higher tax, including, for example, a reduction of the exemption to $2 million and a return to a top rate of 55 percent. Other Democrats of that view voted yes.

H. Senate Refusal To Act in 2009

1. H.R. 4154 reached the Senate when the Senators were preoccupied with health care reform. On December 16, 2009, Finance Committee Chairman Max Baucus
(D-MT) asked the Senate for unanimous consent to bring H.R. 4154 to the floor, approve an amendment to extend 2009 law for only two months (not permanently), and approve the bill as amended.

2. In response, the Republican Leader, Senator Mitch McConnell (R-KY), asked Senator Baucus to agree to consideration of an amendment reflecting, as Senator McConnell described it, “a permanent, portable, and unified $5 million exemption that is indexed for inflation, and a 35-percent top rate.”
   a. By use of the word “permanent,” of course, Senator McConnell was advocating legislation that would eliminate not just all or part of the 2010 repeal year, but also the return to a higher tax in 2011.
   b. By “portable,” he was affirming the ability of a surviving spouse to use any estate tax exemption available to but not used by the first spouse to die.
   c. By “unified,” Senator McConnell was supporting the increase of the $1 million gift tax exemption to be equal to the estate tax exemption, as it had been before 2004.
   d. By “indexed for inflation,” he was embracing annual increases in the unified exemption with reference to increases in the consumer price index, as the GST exemption was indexed from 1999 through 2003 (and will be indexed again in 2011 unless Congress changes the law).

3. Portability, unification, and indexing had been approved in two bills passed by the House of Representatives in 2006 and included in S. 722 introduced by Chairman Baucus in March 2009. A $5 million exemption and 35 percent top rate, along with unification, indexing, and portability, had been part of the amendment, sponsored by Senator Blanche Lincoln (D-AR), that received 51 votes in the consideration of the fiscal 2010 Congressional Budget Resolution in April 2009. And it was the measure that 84 Senators (including then Senators Obama, Biden, Clinton, and Salazar) voted for, albeit in two separate votes, in the consideration of the fiscal 2009 budget resolution (S. Con. Res. 70) on March 11, 2008 (described in Part V1.B.5 on page 25).

4. Senator Baucus objected to Senator McConnell’s request, whereupon Senator McConnell objected to Senator Baucus’s request, and all practical hopes of transfer tax legislation in 2009 died.

5. In the course of the debate, Senator Baucus stated:

   Mr. President, clearly, the right public policy is to achieve continuity with respect to the estate tax. If we do not get the estate tax extended, even for a very short period of time, say, 3 months, we would clearly work to do this retroactively so when the law is changed, however it is changed, or if it is extended next year, it will have retroactive application.

I. The “Responsible Estate Tax Act”

1. On June 24, 2010, a bill dubbed “the liberals’ bill,” the “Responsible Estate Tax Act” (S. 3533), was introduced by Senators Sanders (I-VT), Whitehouse (D-RI),
Harkin (D-IA), Brown (D-OH), and Franken (D-MN). A companion bill, H.R. 5764, was introduced in the House by Rep. Linda Sanchez (D-CA) on July 15, 2010.

2. These bills would restore a unified credit equivalent to a $3.5 million exemption effective January 1, 2010, with a flat 39 percent rate used to calculate the pre-unified credit tax on the amount of the taxable estate from $750,000 to $3.5 million. The tax would then be imposed at rates of 45 percent over $3.5 million, 50 percent over $10 million, 55 percent over $50 million, and 65 percent over $500 million.

   a. The 65 percent rate is cast as a 10 percent “surtax,” but it has the same effect as a 65 percent rate, and it has no ceiling. It replaces the former 5 percent surtax on taxable estates over $10 million.

   b. Like the former 5 percent surtax, the 10 percent surtax would not affect the GST tax rate, which would be 55 percent as it was before 2002.

   c. There was a typo in section 3(a)(2) of S. 3533 and H.R. 5764 as introduced. This “surtax” is said to replace section 2011(c)(2). The correct reference would be section 2001(c)(2).

3. These bills would abandon carryover basis, restore the credit for state death taxes, and make permanent the other 2001 transfer tax changes, including the rules regarding allocation of the GST exemption. But they would not reconform the gift and estate tax exemptions, index the exemption or brackets for inflation, or make the exemption portable between spouses.

4. These bills would increase the cap on the reduction in value under the special use valuation rules of section 2032A (then $1 million) to $3 million (indexed for inflation as it has been since 1998). And they would increase the maximum exclusion from the gross estate under section 2031(c) by reason of a conservation easement from the lesser of $500,000 or 40 percent of the net value of the land to the lesser of $2 million or 60 percent of the net value of the land.

5. Finally, S. 3533 and H.R. 5764 include the same valuation discount provisions included in the first Pomeroy bill, H.R. 436 (see Part VII.A.4 on page 27 and Part II.E.1.c on page 9), and statutory language implementing the Administration’s revenue proposals regarding basis and GRATs (see Part IX.B.7 beginning on page 66 and Part IX.C.6 beginning on page 70).

J. The Second “Baucus Bill”

1. On December 2, 2010, in a “lame duck” session, Senator Max Baucus (D-MT), the chairman of the Senate Finance Committee, introduced an amendment to pending tax legislation entitled the “Middle Class Tax Cut Act of 2010” and widely known as the “Baucus Bill.”

2. As with Senator Baucus’s previous proposals, such as S. 722 he had introduced on March 26, 2009 (Part VII.E beginning on page 30), the amendment would permanently reinstate 2009 estate tax law, with a 45 percent rate and $3.5 million exemption, effective January 1, 2010, indexed for inflation beginning in 2011.
Executors of decedents who died in 2010 would be able to elect out of the estate tax into the carryover basis regime that had been 2010 law. In a result viewed by many as “too good to be true” and thus possibly an oversight, the Baucus Bill apparently would have left a testamentary trust completely free of GST tax forever if that election were made.

3. The December 2010 Baucus Bill also revived the idea of the “portability” of the unified credit, or “exclusion amount” or “exemption,” by making the portion of the exemption not used by the last predeceased spouse available to the surviving spouse.

4. The December 2010 Baucus Bill would have provided substantial estate tax relief targeted to real estate.
   a. The value of family farmland that met certain qualifications and passed to a “qualified heir” would not be subject to estate tax until it was disposed of by a qualified heir.
   b. The cap on the special use valuation reduction under section 2032A – then $1 million, the statutory cap of $750,000 indexed for inflation since 1999 – would be tied to the applicable exclusion amount ($3.5 million in the Baucus Bill) and would be indexed for inflation beginning in 2011.
   c. The treatment of a disposition or severance of standing timber on qualified woodland as a recapture event under section 2032A(c)(2)(E) would be made inapplicable to a disposition or severance pursuant to a forest stewardship plan developed under the Cooperative Forestry Assistance Act of 1978, 16 U.S.C. § 2103e.
   d. Certain contributions and sales of qualified conservation easements would likewise not result in recapture under section 2032A.
   e. The limitation on the exclusion from the gross estate by reason of a qualified conservation easement under section 2031(c) would be increased from $500,000 to $5 million.

5. Finally, the December 2010 Baucus Bill also included the requirement for consistency in basis reporting and a minimum ten-year term for GRATs that were proposed in the 2009 and 2010 Administration budget proposals.

K. The Deal Between the President and Some Congressional Leaders

1. On December 6, 2010, President Obama announced on national television that he and certain congressional leaders had agreed on “the framework of a deal” to permit the 2001 and 2003 income tax cuts – the so-called “Bush tax cuts” – to be extended for two years. The President reported that the agreement included a one-year 2 percent payroll tax reduction, a 13-month extension of employment benefits desired by many Democrats, and an extension of the estate tax for two years – presumably 2011 and 2012 – with a $5 million exemption and a 35 percent rate (an exemption and rate that then Senator Obama himself had voted for in the consideration of the fiscal 2009 budget resolution on March 11, 2008, described in Part VI.B.5 on page 25).
2. It appears that the congressional leaders the President reached this agreement with were mostly Republicans, and the initial reactions of Republicans were supportive, even if not enthusiastic, while surprised Democrats originally reacted with skepticism or even hostility. As the days passed, Republican criticisms also emerged while more Democratic support began to be heard. In the House of Representatives in particular, the Democratic resistance was directed largely at the estate tax proposal, believed by many to be both overly generous and extraneous to the core elements of the compromise.

L. The 2010 Tax Act

1. On December 9, 2010, the Senate released the text of an amendment (S. Amdt. 4753) to implement the agreement announced by President Obama. The amendment, offered by the Senate leaders, Senators Harry Reid (D-NY) and Mitch McConnell (R-KY), to an Airport and Airway Trust Fund funding measure (H.R. 4853), was entitled the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.” The Reid-McConnell Amendment provided
   a. an extension of the EGTRRA sunset for two years, until December 31, 2010,
   b. an estate tax exemption of $5 million and estate tax top rate of 35 percent, beginning January 1, 2010,
   c. an opportunity for executors of 2010 estates to elect out of the estate tax into the 2010 carryover basis rules,
   d. a GST exemption of $5 million beginning January 1, 2010,
   e. a GST tax rate of zero in 2010 and 35 percent beginning January 1, 2011,
   f. a gift tax exemption of $5 million and a gift tax top rate of 35 percent, beginning January 1, 2011,
   g. indexing of the $5 million exemption for inflation, beginning in 2012, and
   h. portability of the unified credit (“exemption”) from a deceased spouse to the surviving spouse, as in the December 2010 Baucus Bill, but
   i. nothing addressing GRATs, consistent basis, targeted relief for real estate, or valuation discounts, and
   j. nothing to permanently remove the shadows of “sunset” from the other changes made by EGTRRA, affecting the GST exemption (expanded deemed allocations and elections, retroactive allocations, qualified severances, determinations of value, and relief from late allocations), conservation easements, and section 6166. (All those provisions are only extended for two years.)

2. On December 15, 2010, the Senate approved the Reid-McConnell Amendment by a vote of 81-19.

3. On December 16, 2010, by a vote of 194-233, the House of Representatives defeated an amendment to replace the estate, gift, and GST tax changes of the bill,
generally with 2009 law with an election out for 2010 estates.

4. At midnight between December 16 and 17, the House approved the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 by a vote of 277-148.

5. On December 17, 2010, President Obama signed the Act, which became Public Law 111-312.

VIII. THE CLARIFIED AND MODIFIED 2010-2012 LAW

A. The Sunset in General

1. Section 101(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 ("the 2010 Tax Act") simply extends the sunset in the oft-discussed section 901 of EGTRRA for two years by replacing "December 31, 2010" with "December 31, 2012." As a result, everything that was expected to expire at the end of 2010 is now scheduled to expire at the end of 2012 instead.

2. This includes the "Bush" income tax cuts that were scheduled to expire at the end of 2010 and were the main engine that drove the extraordinarily intense discussions that led to consideration of the Reid-McConnell Amendment. But, read together with section 304 of the 2010 Tax Act, it also includes the new estate, gift, and GST tax provisions introduced by the 2010 Tax Act.

B. The Estate Tax Exemption and Rate

1. Title III of the 2010 Tax Act, under the heading of "Temporary Estate Tax Relief," gives special attention to the estate, gift, and GST taxes, because of the unique disruption of those taxes in 2010. Section 301 reinstates the estate tax and repeals carryover basis for 2010. Section 302(a) establishes an estate tax applicable exclusion amount, or "exemption," of $5 million and a top estate tax rate of 35 percent, effective January 1, 2010. It also indexes that $5 million exemption for inflation, beginning in 2012, and, being found in the context of a two-year extension, also ending in 2012.

2. The 35 percent rate, like the 2010 gift tax rate, takes effect at a level of $500,000. In other words, the "progressive" rates, or "run up the brackets," occur only below $500,000.

3. The $5 million exemption and 35 percent rate, effective even for 2010, are a bit of a surprise, and it is understandable that they attracted special attention, especially in the attempted House amendment. While the rest of the measures extending the 2001 tax cuts simply maintain the 2010 status quo through 2011 and 2012, the estate tax component of the compromise is different in two respects.

a. First, unlike the income tax compromises, which prevent, in effect, a tax increase on January 1, 2011, the estate tax deal is a tax increase compared to former 2010 law but represents a tax cut when compared to 2009.

b. Second, this tax cut is effective not just in 2011 and 2012, but also, in large
part, retroactively in 2010.

C. The Election out of the Estate Tax into Carryover Basis for 2010 Estates

1. Background

a. One complication of the attempted repeal of the estate tax in 2001 (to take effect in 2010) and the manner in which it became a reality in 2010 was the abrupt introduction of the modified carryover basis regime of section 1022, without technical corrections, without regulations or other guidance, without forms or instructions, and without much serious study at all. Discomfort with the impending carryover basis regime was a principal argument cited in 2009 by congressional supporters of legislation to make the 2009 law permanent and prevent the 2010 law enacted in 2001 from taking effect. See Part VII.G.5.a on page 32. Because Congress did not act in 2009, however, carryover basis now will apply to property passing from a decedent who died in 2010 and whose executor elects that the estate tax not apply.

b. Under pre-2010 and post-2010 law, and under 2010 law without an election out of estate tax, a decedent’s beneficiaries inherit assets with a basis for computing depreciation and capital gains equal to the fair market value of the assets on the date of the decedent’s death. This basis adjustment is typically referred to as a “basis step-up,” because it is assumed that one’s basis in assets is lower than the fair market value of assets on the date of death. However, the adjustment actually works in both directions, and if the fair market value of an asset on the date of death is lower than the decedent’s basis, the asset’s basis is stepped down for all purposes, so that the beneficiaries inherit the property with a lower basis. One historical reason for the basis adjustment rules is apparently the perceived unfairness of imposing a double tax on a beneficiary who inherited assets – first an estate tax and then a capital gains tax when the executor or beneficiary subsequently sold the asset, especially if the sale was necessary to raise money to pay the estate tax. This reasoning would not fully apply in the absence of an estate tax.

2. The Now Elective 2010 Carryover Basis Regime

a. The basic rule in 2010 under section 1022 is that a decedent’s basis in appreciated property will remain equal to the decedent’s basis in the property if the fair market value of the property on the date of death is greater than the decedent’s basis. If the fair market value of an asset on the date of death is less than the decedent’s basis, the basis will be stepped down to the fair market value on the date of death, just as it would have been under former law. This rule applies separately to each item of property.

b. Under section 1022(a), carryover basis applies to “property acquired from a decedent,” which is defined in section 1022(e). The definition does not cover all property the value of which would have been included in a decedent’s gross estate, such as property that would have been included in the gross estate of a surviving spouse by reason of a QTIP election under section.
2056(b)(7) at the first spouse’s death and property that would be included in a decedent’s gross estate under section 2036 solely because the decedent had been the grantor and beneficiary of a grantor retained annuity trust (“GRA”) or a qualified personal residence trust (“QPRT”).

i. Section 4.01(3)(i) of Rev. Proc. 2011-41, 2011-35 I.R.B. 188, clarifies that property subject to a general power of appointment defined in section 2041 (if it applied) is subject to carryover basis.

ii. In the case of a GRAT or QPRT, the basis of the assets is likely to be the decedent’s basis anyway. Example 1 of Rev. Proc. 2011-41 illustrates that carryover basis will not apply to the assets of a QPRT if the grantor dies during the QPRT term and those assets pass to the grantor’s child. But if in that case those assets pass to the grantor’s estate (which is common because it results in a lower taxable gift), Example 2 of Rev. Proc. 2011-41 states that then those assets are subject to carryover basis. Presumably the rule for a GRAT would be the same (except that a reversion to the grantor’s estate would not be as common).

c. Section 6018, as applicable to the estate of a decedent who died in 2010 and whose executor elects out of the estate tax, requires reporting to the IRS and to recipients of property from the decedent, if the fair market value of all property except cash acquired from the decedent exceeds $1.3 million.

i. Before the enactment of the 2010 Tax Act, the IRS released a draft Form 8939 for this purpose. But the draft indicated that the form would be heavily dependent on the instructions, and the IRS has not released any instructions yet.

ii. Section 6075(a), as applicable to the estate of a decedent who died in 2010 and whose executor elects out of the estate tax, requires the report to the IRS (Form 8939) to be “filed with the return of the tax imposed by chapter 1 for the decedent’s last taxable year [that is, the decedent’s final 1040 due April 18, 2011] or such later date specified in regulations.” April 18 came and went without any such regulations, but on March 31, 2011, an IRS News Release (IR-2011-33) announced that Form 8939 will not be due on April 18, 2011, and should not be filed with the final Form 1040. The news release concluded:

Treasury and the IRS plan to issue future guidance that will provide a deadline for filing Form 8939 and for electing to have the estate tax rules not apply to the estates of persons who died in 2010. The prior deadline was April 18, which remains the deadline for filing a decedent’s final Form 1040 this filing season. The forthcoming guidance will also explain the manner in which an executor of an estate may elect to have the estate tax not apply.

A reasonable period of time for preparation and filing will be given between issuance of the guidance and the deadline for filing Form 8939 and for electing to have the estate tax rules not apply. The Form 8939 is not currently available, but will be made available soon after
the guidance is issued. Both will be made available on IRS.gov.

iii. The IRS has also indicated that the carryover basis rules will be explained in Publication 4895, which has not been released yet either.


i. Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, will be used to make what Notice 2011-66 calls “the Section 1022 Election” out of the estate tax, as well as to report the value and basis of property as required by section 6018 and to allocate the basis increases discussed below.

ii. **Form 8939 must be filed on or before January 17, 2012.** (Notice 2011-66 originally said November 15, 2011, and, curiously, even Notice 2011-76, which announces the January 17 due date, states that “the Treasury Department and IRS intend to confirm in regulations ... that Form 8939 is due on or before November 15, 2011.”)

iii. In general, the IRS will not grant extensions of time to file Form 8939 and will not accept a Form 8939 filed late, and, once made, the Section 1022 Election and basis increase allocations will be irrevocable. As explicit exceptions, the IRS will allow additional Forms 8939 to make additional allocations of Spousal Property Basis Increase as additional property is distributed to the surviving spouse, and will allow other changes to a timely filed Form 8939, except making or revoking a Section 1022 Election, on or before July 17, 2012 (six months after January 17). The IRS also retains the discretion, under “9100 relief” procedures, to allow an executor to amend or supplement a Form 8939 or even to file a Form 8939 (and thus make the Section 1022 Election) late. Obtaining 9100 relief can be cumbersome and expensive, and the IRS has made it clear in Notice 2011-66 that its standards for that relief are likely to be quite restrictive, except in the case of the allocation of additional basis increases to assets that are discovered, or revalued in an IRS audit, after Form 8939 is filed. Such an audit could occur when an asset is sold many years or even decades after the Form 8939 is filed, which means that most attempted “formula” allocations would be ill-advised (and in any event there can be no “protective” elections). In all other case, the IRS should be expected to be very strict, especially when a long time has passed since January 17, 2012. But this anticipated strictness may need to be balanced against one of the apparent historical purposes of the Section 1022 Election, which was to relieve concern for a constitutional challenge to what would otherwise have been an unmitigated retroactive reinstatement of the estate tax.

iv. Ordinarily Form 8939 will be filed by the executor appointed by the
appropriate probate court. Sometimes, however, there is no such executor, such as when all of the decedent's property is held jointly or held in trust. In that case, a Form 8939, or multiple Forms 8939 as the case may be, will be filed by the trustees or others in possession of that property (often called "statutory executors" after the definition in section 2203). Notice 2011-66 states that if those statutory executors do not agree regarding the election, or attempt in the aggregate to allocate more basis increase than the law allows, the IRS will notify those statutory executors that they have 90 days to resolve their differences. If the executors fail to resolve their differences within 90 days, the IRS, after considering all relevant facts and circumstances disclosed to it, will determine whether the election has been made and how the allocations should be made. As with most "facts and circumstances" judgments, it will be impossible to know how the IRS might make those decisions.

v. In support of that regime, the 2010 estate tax return (Form 706) posted on the IRS website on September 3, 2011 (the Saturday before Labor Day), includes the following sentence in the declaration above the signature line: "I (executor) understand that if any other person files a Form 8939 or Form 706 (or Form 706-NA) with respect to this decedent or estate, that [sic] my name and address will be shared with such person, and I (executor) also hereby request [that] the IRS share with me the name and address of any other person who files a Form 8939 or Form 706 (or Form 706-NA) with respect to this decedent or estate."

e. Notice 2011-76 confirms other helpful relief:

i. An automatic six-month extension of time to file an estate tax return for a 2010 decedent can be obtained by timely filing a Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes. This is true whether the decedent died before December 17, 2010 (the date of enactment of the 2010 Tax Act), or on or after that date.

ii. In a break from normal procedure, a six-month extension of time to pay the estate tax will also be automatic; Notice 2011-76 states that the executor "is not required to substantiate ... the reason." It is not clear why the Notice uses the word "substantiate" and does not just say it is not necessary even to state a reason.

iii. But the Notice goes on to state:

The IRS will not impose late filing and late payment penalties under section 6651(a)(1) or (2) on estates of decedents who died after December 31, 2009, and before December 17, 2010, if the estate timely files Form 4768 and then files Form 706 or Form 706-NA and pays the estate tax by March 19, 2012. The IRS also will not impose late filing or late payment penalties under section 6651(a)(1) or (2) on estates of decedents who died after December 16, 2010, and before January 1, 2011, if the estate timely files Form 4768 and then files Form 706 or
Form 706-NA and pays the estate tax within 15 months after the
decedent's date of death.

Section 6651(a)(1) relates to the failure to file, and section 6651(a)(2)
relates to the failure to pay. So not only does this statement make it
clear that estates of decedents who died before December 17 and on or
after that date are treated the same, but it also addresses filing and
paying with the same language. This confirms that the standard for
"substantiating," or even stating, a reason for an extension of time to pay
the tax is going to be a very low standard indeed. But a timely Form
4768 has to have been filed.

iv. Notice 2011-76 confirms that tax that is paid late under such an
automatic six-month extension will still, of course, bear interest.

v. Finally, Notice 2011-76 provides that if the Section 1022 Election is
made and the income tax liability of someone who sold property in 2010
that had been received from the decedent is thereby increased,
"reasonable cause and good faith will be presumed" and no penalty
under section 6651(a)(2) or 6662(a) will be imposed. Such a taxpayer
should write "IR Notice 2011-76" across the top of the amended return
that is required to report consistently with the Section 1022 Election.
The Notice refers only to property "disposed of" and does not apply by
its terms to adjustments to depreciation (although an argument fro relief
based on Notice 2011-76 would appear to be compelling).

the same day as Notice 2011-66, elaborates the rules governing the allocation of
the basis increases discussed below and providing a number of other
clarifications, including:

i. Section 4.06(1) of Rev. Proc. 2011-41 provides that the recipient’s
holding period of property subject to the carryover basis rules includes
the decedent’s holding period (whether or not the executor allocates any
basis increase to the property).

ii. Section 4.06(2) provides that such property generally retains the
character it had in the hands of the decedent.

iii. Section 4.06(3) provides that the depreciation of property in the hands of
the recipient is determined in the same way it was in the hands of the
decedent.

iv. Sections 4.06(4), (5), and (6) address the specialized rules under Code
sections 469 (passive activity losses), 1040 (recognition of gain on the
satisfaction of a pecuniary bequest with appreciated property), and 684
(sale or exchange treatment of transfers to nonresident aliens).

v. Section 4.07 clarifies that a testamentary trust that otherwise qualifies as
a charitable remainder trust under Code section 664 will still qualify if
the executor makes a Section 1022 Election, even though the election out
of the estate tax will mean that no estate tax deduction under section 2055 will be allowable, which would appear to have disqualified the trust under Reg. § 1.664-1(a)(1)(iii)(a).

g. Section 7 of Rev. Proc. 2011-41 states that the IRS expects 7,000 executors to file Form 8939.

3. The General Basis Increase

a. Two modifications in section 1022 lessen the harshness of the 2010 carryover basis regime. The first applies to property passing to any one or more individuals. The second applies with respect to property passing to a surviving spouse.

b. The first modification, provided by section 1022(b), is called simply a “basis increase” in the statute, but is called the “General Basis Increase” in Rev. Proc. 2011-41. The General Basis Increase is the sum of the “Aggregate Basis Increase,” which is $1.3 million, and the “Carryovers/Unrealized Losses Increase.” The Carryovers/Unrealized Losses Increase in turn has two components:

i. the amount of a decedent’s unused capital loss carryovers and net operating loss carryovers and

ii. “the sum of the amount of any losses that would have been allowable under section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent’s death” (section 1022(b)(2)(C)(ii)). Section 4.02(2)(b) and Example 3 of Rev. Proc. 2011-41 make it clear that this second component of the Carryovers/Unrealized Losses Increase includes all unrealized losses in capital assets at the moment of the decedent’s death, without regard to the limitations on immediate deductibility that would apply for income tax purposes in the event of an actual sale. Thus, the amount of those unrealized losses, in effect, becomes available to increase the basis of appreciated assets (up to their fair market value at death).

c. The General Basis Increase may not increase the basis of any asset in excess of the fair market value of that asset as of the date of the decedent’s death.

i. Section 4.04(2) of Rev. Proc. 2011-41 provides that the fair market value of an undivided portion of property for this purpose is a proportionate share of the fair market value of the decedent’s entire interest in that property at death.

ii. The drafters of this provision reportedly intended it to apply not only to determine the fair market value cap on the allocation of basis increase, but also to the allocation of the basis increase itself. Thus, if a decedent bequeaths an asset to one person for life and then to a second person, this provision would require, in effect, an allocation of basis increase to the asset itself, not separately to the life estate or the remainder, and the respective bases of the temporal interests would be determined under the
uniform basis principles set out in Reg. §§ 1.1014-4 & -5.

iii. The same outcome was reportedly also intended for undivided fractional interests ("vertical slices") in property. In that case, for example, if real estate with a value of $1,000,000 and basis of $500,000 were devised to two recipients in undivided shares of 40 percent and 60 percent, basis increases of $200,000 and $300,000, respectively, could be allocated to those shares. It would then be likely that the 40 percent share would have a basis ($400,000) that exceeded its fair market value.

d. The executor of the decedent’s estate must make an election to take advantage of this increase and allocate it to specific assets on Form 8939.

e. Section 1022(d)(1)(B)(ii) provides that some property interests that are not held through simple outright ownership will qualify for the General Basis Increase, including a portion of joint tenancy property, the decedent’s half of community property, the surviving spouse’s half of community property if the deceased spouse owned at least half of the whole community property interest, and property held in trusts that are revocable by the grantor.

f. The General Basis Increase cannot be applied to some property the value of which would have been included in the decedent’s gross estate if the election out of estate tax had not been made. As noted above (Part VIII.C.2.b on page 38), carryover basis does not apply to a QTIP trust of which the decedent was the beneficiary and may or may not apply to a GRAT or a QPRT of which the decedent was the grantor. If carryover basis applies, then the General Basis Increase might apply. For example, carryover basis would apply to a QPRT in which the grantor has a reversion in the event of death during the QPRT term, and Example 2 of Rev. Proc. 2011-41 confirms that the General Basis Increase would also apply. But in the case of property subject to the decedent’s general power of appointment, section 4.01(3)(i) of Rev. Proc. 2011-41 clarifies that carryover basis applies, but Code section 1022(d)(1)(B)(iii) provides that the General Basis Increase may not be allocated to that property.

g. Property acquired by a decedent by gift within three years of the decedent’s date of death from anyone other than the decedent’s spouse also does not qualify for the General Basis Increase, under section 1022(d)(1)(C).

h. A frequent question since carryover basis was enacted in 2001, and especially since it became effective at the beginning of 2010, is whether an executor may allocate basis increases to property that has already been distributed or sold. Section 4.03 of Rev. Proc. 2011-41 says yes. Example 4 of Rev. Proc. 2011-41 even acknowledges that the basis of property that has declined in value since the decedent’s death and is then sold may be increased by allocation of basis increases up to date-of-death value, thus generating a loss on the sale.

4. The Spousal Property Basis Increase

a. The second modification, provided by section 1022(c), is a $3 million
increase in basis for property passing to the surviving spouse, called the “Spousal Property Basis Increase.” The basis of property eligible for the General Basis Increase may be increased by an additional $3 million, but not in excess of the fair market value of the property as of the date of the decedent’s death, if and only if such property is transferred to the surviving spouse, outright or as “qualified terminable interest property” for the exclusive benefit of the surviving spouse.

b. Section 1022 provides its own definition of “qualified terminable interest property” and does not simply refer to the definition of “qualified terminable interest property” contained in the estate tax marital deduction provision of section 2056. Because the QTIP election provided in section 2056(b)(7)(B)(i)(III) is omitted from section 1022(c)(5)(A), a so-called Clayton QTIP trust (Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992) – see Reg. § 20.2056(b)-7(d)(3)(i) as amended in 1998), in which the spouse’s mandatory income interest is conditioned on the executor’s QTIP election, is not eligible for the Spousal Property Basis Increase. A general power of appointment marital trust that would qualify for the marital deduction for estate tax purposes will satisfy the requirements for the Spousal Property Basis Increase, because, as under the estate tax rules, it will not be a “terminable” interest at all.

c. As noted above, the three-year rule does not apply to property acquired by the decedent from the decedent’s spouse unless, during the three-year period, the transferor spouse acquired the property by gift or inter vivos transfer. The law when the estate tax applies (section 1014(e)) limits death-bed transfers to a spouse in order to obtain a step-up in basis when the transferred property was given back to the surviving spouse. The limitations in the carryover basis rules exclude spouses. Property transferred from a healthy spouse to a terminally ill spouse that passes passing back to the healthy spouse in 2010 is eligible for both the $1.3 million General Basis Increase and the $3 million Spousal Property Basis Increase.

d. Also as noted above (part VIII.C.3.h on page 44), section 4.03 of Rev. Proc. 2011-41 confirms that an executor may allocate the basis increases to property that has already been distributed or sold. With regard to the Spousal Property Basis Increase, section 4.02(3) of Rev. Proc. 2011-41 actually contemplates allocations to property that has already been distributed to the surviving spouse as those distributions are made. (Notice 2011-66 allows the filing of additional Forms 8939 for that purpose.) Section 4.02(3) of Rev. Proc. 2011-41 also allows allocation of the Spousal Property Basis Increase to property that the executor has sold, but only to the extent that the applicable Form 8939 includes documentation that the sale proceeds are appropriately earmarked for the surviving spouse.

5. The Election for 2010 Estates

a. As many expected, the 2010 Tax Act deals with the “retroactivity” of the 2010 estate tax provisions by permitting an executor to elect out of the estate
tax back into the carryover basis regime enacted for 2010 in EGTRRA 2001. Under section 301(c) of the 2010 Tax Act, “[s]uch election shall be made at such time and in such manner as the [IRS and Treasury] shall provide” and shall be irrevocable except with IRS consent. It had been hoped that Form 8939 would include an opportunity to make that election or, better, that the filing of Form 8939 itself would be treated as the election. Notice 2011-66 confirms this.

b. The vast majority of executors will not need or want such an election, because they will be perfectly satisfied with the reinstated estate tax and a stepped-up basis for appreciated assets.

i. This includes executors of most estates that would not pay estate tax anyway, such as estates under $5 million (at least in states without a state estate tax), estates that pass largely to charity, and some estates that pass largely to a surviving spouse.

ii. But if the “estate” consists, for example, of a QTIP trust of which the decedent was the beneficiary as surviving spouse and in which the assets have declined in value, plus cash and modest other assets (less than $1.3 million), then the election might be considered in order to preserve the higher basis of the assets in the QTIP trust (because that basis would be “stepped-down” under section 1014 if the estate tax applied).

iii. Executors facing only a modest estate tax might also forgo the election, to get the benefit of the stepped-up basis.

iv. Even executors for whom the estate tax burden may be substantial may still consider the estate tax superior to carryover basis if basis presents unusual challenges, such as in the estate of a real estate developer.

v. Still other executors may elect out of the estate tax to avoid estate tax controversy or uncertainty – for example, to avoid the revaluation of assets, or an assertion that the value of assets transferred during life is taxed under section 2036, or an assertion that a power of appointment held by the decedent is a general power rather than a limited power.

c. In most estates significantly larger than $5 million, the election out of the estate tax and into carryover basis will be a clear choice, because it will avoid an estate tax that is paid sooner and at a presumably higher rate than the additional income tax that would thereby be incurred on the sale of appreciated assets. This will likely be a small percentage of 2010 estates, and therefore it is appropriate that the default outcome in the absence of an election is that the reinstated estate tax applies. As noted above, section 7 of Rev. Proc. 2011-41 states that the IRS expects 7,000 executors to file Form 8939.

6. Factors Influencing the Election

In any event, the following factors are among those that should be considered in making the election between the estate tax and the carryover basis regime:
a. Calculation and apportionment of estate tax burden.
b. Impact of state death taxes, particularly in states with an exemption below $5 million.
c. Likelihood that the asset will be sold before the recipient’s death.
d. Anticipated date of sale of each asset.
e. Decedent’s basis in each asset.
f. Ability to allocate basis increases.
g. Date of death value of each asset.
h. Projected future value of each asset.
i. Projected earnings from each asset.
j. Tax character of any future gains or earnings on assets.
k. Identity of the beneficiaries.
l. Revenue needs of the beneficiaries.
m. Future tax rates.
n. Domicile of beneficiaries and personal income tax information.
o. Availability of asset-specific deductions and credits, including depreciation.
p. Impact of election on formula clauses.
q. Potential for disagreement among beneficiaries concerning the allocation of basis.
r. Conflicts of interest in making the election and allocating basis.
s. Aggressiveness of positions that will be taken if the estate tax return is filed.
t. Aggressiveness of positions taken and valuation discounts claimed on the decedent’s previously filed gift tax returns and those gift tax returns of the decedent that will be filed contemporaneously with the estate tax return.
u. Whether “adequate disclosures” were made on the decedent’s previously filed gift tax returns.
v. Magnitude of the expense and aggravation factor associated with filing the estate tax return versus filing the Form 8939.
w. The availability of binding consents or court approval.
x. Whether a compensating equitable adjustment is appropriate, and whether it should be approved by a court.

D. Indexing for Inflation

1. The indexing of the applicable exclusion amount in 2012 will follow the normal indexing rules that have been applicable to income tax brackets since 1993 and in various transfer tax contexts – such as the $10,000 gift tax annual exclusion, the
maximum decrease in value attributable to special-use valuation under section 2032A, the amount of value on which estate tax deferred under section 6166 is payable at a special interest rate, and the former $1 million GST exemption—since 1999.

2. The inflation adjustment is computed by comparing the average consumer price index (CPI) for the 12-month period ending on August 31 of the preceding year with the corresponding CPI for 2010. Thus, the inflation adjustment to the applicable exclusion amount in 2012 will be computed by dividing the CPI for the 12 months ending August 31, 2011, by the CPI for the 12 months ending August 31, 2010.

3. Indexing will occur in $10,000 increments, so the amount applicable in any year will be a relatively round number.
   a. But, unlike the typical inflation adjustments on which the indexing is patterned, the result of the calculation will not be rounded down to the next lowest multiple of $10,000. It will be rounded to the nearest multiple of $10,000 and thus possibly rounded up. If enacted, this will not make a huge difference in practice—obviously not more than $10,000 in any year.
   b. It will also need to be remembered that the calculation will be repeated every year with reference to the CPI for the 12 months ending August 31, 2010. Because of the rounding rule, it will be a mistake to assume that the applicable exclusion amount for any particular year will simply be inflation-adjusted for the following year. All annual calculations will be redone with reference to the 2010 baseline and then rounded to the nearest multiple of $10,000.

4. Of course, it seems silly to speak of “annual” calculations when the 2010 Tax Act provides for indexing for just one year, 2012. Clearly, the legislation was written in contemplation of the 2011-2012 rule being extended, presumably before the end of the presidential election year of 2012. This reminds us somewhat of what Congress did in 2001, but without the gap or disruption of a repeal year like 2010, which will not be repeated under the 2010 Tax Act.

E. The GST Tax

1. The GST tax exemption and rate remain tied to the estate tax applicable exclusion amount and top rate, just as they have been since 2004. As a result, the estate tax applicable exclusion amount, gift tax applicable exclusion amount, and GST exemption are the same for the first time ever.

2. The reinstatement of the estate tax for 2010 means that once again there is an applicable exclusion amount and therefore a GST exemption for inter vivos transfers in 2010. In fact, it is $5 million.

3. For any taxable distribution or taxable termination with respect to a trust or a “direct skip” gift in 2010, section 302(c) of the 2010 Tax Act sets the 2010 GST tax rate at zero, regardless of inclusion ratios or any other calculations.
   a. This is hugely significant, addressing a number of questions that EGTRRA
created for 2010 and 2011 by providing in section 2664 of the Code that the GST tax chapter “shall not apply to generation-skipping transfers after December 31, 2009” and providing in section 901(b) of EGTRRA, in relevant part, that “[t]he Internal Revenue Code of 1986 ... shall be applied and administered to ... [generation-skipping transfers after December 31, 2010] as if [Code section 2664] had never been enacted.” For example –

i. Is it possible to allocate GST exemption to 2010 transfers?

ii. Will the “move down” rule of section 2653 apply to “direct skip” transfers in trust in 2010?

iii. Can a “reverse QTIP” election under section 2652(a)(3) be made for a transfer in 2010?

iv. Will GST exemption allocated to transfers before 2010 still affect the inclusion ratio even to the extent that that GST exemption exceeded the indexed GST exemption that would have been available if EGTRRA “had never been enacted”?

v. Will deemed allocations of GST exemption provided for by section 2632(c), which was added by EGTRRA, still be effective after 2010?

vi. Will elections in and out of automatic allocations, provided for by section 2632(c)(5), which was added by EGTRRA, still be effective after 2010?

vii. Will retroactive allocations of GST exemption in the case of the death of a non-skip person, provided for by section 2632(d), which was added by EGTRRA, still be effective after 2010?

viii. Will late allocations of GST exemption pursuant to “9100 relief” allowed by section 2642(g), which was added by EGTRRA, still be valid after 2010?

ix. Will qualified severances under section 2642(a)(3), which was added by EGTRRA, be respected after 2010?

b. The technical key for answering all these questions was to allow the GST tax chapter to “apply” without actually resulting in a GST tax. Setting the GST tax rate at zero is the elegantly simple way to accomplish that.

c. Because inter vivos transfers in 2010 to trusts that are “direct skips” – for example, where only grandchildren and not children of the donor are beneficiaries – qualify for the “move down” rule of section 2653, so that future distributions to grandchildren when the GST tax rate is not zero will not be taxed, it may be important to affirmatively elect on the 2010 gift tax return not to permit a deemed allocation of GST exemption under section 2632(b) or (c). This will not always be desirable, however, because the “move down” permits the tax-free skip of only a generation or two, while the allocation of GST exemption would cause a long-term trust to be exempt as long as it lasts.
d. But if the 2010 direct skip gift is made outright to a skip person, there are no future GST tax characteristics to protect and no conceivable reason to want GST exemption to be allocated. The IRS acknowledges this in section II.B of Notice 2011-66, which states:

[Reg. § 26.2632-1(b)(1)(i)] provides that “... a timely filed Form 709 accompanied by payment of the GST tax (as shown on the return with respect to the direct skip) is sufficient to prevent an automatic allocation of GST exemption with respect to the transferred property.” Because it is clear that a 2010 transfer not in trust to a skip person is a direct skip to which the donor would never want to allocate GST exemption, the IRS will interpret the reporting of an inter vivos direct skip not in trust occurring in 2010 on a timely filed Form 709 as constituting the payment of tax (at the rate of zero percent) and therefore as an election out of the automatic allocation of GST exemption to that direct skip. This interpretation also applies to a direct skip not in trust occurring at the close of an estate tax inclusion period (ETIP) in 2010 other than by reason of the donor’s death.

The “payment of tax (at the rate of zero percent)” is certainly an odd notion, but again, like the zero rate itself, it produces the right result.

e. The 2010 gift tax return (Form 709) that the IRS posted on its website on March 18, 2011, is consistent with this approach. In Part 3 of Schedule C, the “applicable rate” in column G is filled in as “0,” and column H, which instructs “multiply col. B by col. G,” is also filled in with “0.” Similarly, in the 2010 estate tax return (Form 706) posted on the IRS website on September 3, 2011, line 8 of Part 2 of Schedule R, line 8 of Part 3 of Schedule R, and line 6 of Schedule R-1 all provide for the calculation of “GST tax due” by multiplying the previous line by zero. Meanwhile, the second page of Schedule R-1 (page 26 of the entire return) includes the usual comprehensive instructions for trustees about the payment of the (zero) tax.

f. Although the huge uncertainties about 2010 have been eliminated, it is still a good idea to review all past transfers with generation-skipping potential and use the 2010 gift tax return as an opportunity to affirm, clarify, modify, or make any allocations or elections with respect to the GST exemption.

4. Because the GST exemption is tied to the estate tax, it also will be indexed for inflation, beginning in 2010.

5. It was once thought that a testamentary generation-skipping trust created by reason of a decedent’s death in 2010 might escape GST tax forever, because the property in the trust would not have been subject to estate tax, and therefore there would be no “transferor” under section 2652(a)(1)(A) and no “skip person” under section 2613(a)(1). That result is reversed by the 2010 Tax Act.

a. In the majority of estates for which no election back into carryover basis is made, the GST tax will work fine. The tax rate on direct skips will be zero and the GST exemption allocable to trusts created at death will be $5 million. If the estate is smaller than $5 million and no estate tax return is filed, the deemed allocation under section 2632(e) will ordinarily work just fine. Only
when there are two or more potentially generation-skipping trusts and the total value of all such trusts is greater than the available GST exemption and it is undesirable to permit section 2632(c) to allocate that GST exemption proportionately among those trusts will an affirmative allocation be needed.

b. If the executor elects out of the estate tax into carryover basis, which will probably occur in the largest estates that are likely to include generation-skipping trusts, the result is the same, but the analysis is more complicated. A sentence added to the end of section 301(c) of the Reid-McConnell Amendment, which became the 2010 Tax Act, that had not appeared in the Baucus Bill makes it clear that such an election will not affect the treatment of property placed in a generation-skipping trust as "subject to the tax imposed by chapter 11" for purposes of section 2652(a)(1)(A). Therefore, the decedent will be the "transferor," "skip persons" will be defined with reference to that transferor under section 2613, and that will govern the taxation of the trust in the future.

c. There is no specific reference to the other important way that the GST tax rules are linked to the estate tax rules, which is the definition of the GST exemption in section 2631(c) by reference to the estate tax applicable exclusion amount in section 2010(c). But the election under section 302(c) is explicitly stated to 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)" – in other words, with respect to the suspension of the estate tax and the imposition of carryover basis, not with respect to chapter 13 – meaning that for purposes of section 2631(c) (part of chapter 13) the $5 million applicable exclusion amount in section 2010(c) remains available.

i. This analysis is confirmed by the Joint Committee staff's explanation of the Reid-McConnell Amendment, which states that "[t]he $5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election … to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules." STAFF OF THE JOINT COMMITTEE ON TAXATION, 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 (JCX-55-10) at 50 n.53 (Dec. 10, 2010).

ii. This result is again confirmed in section II.D of Notice 2011-66, which states that "references to chapter 11 in [chapter 13] will be construed as if the decedent was subject to chapter 11 even if the decedent’s executor made the Section 1022 Election."

iii. Notice 2011-66, as amplified by Notice 2011-76, also confirms that GST exemption in the case of an election out of the estate tax will be allocated on Schedule R or R-1 of Form 8939, Allocation of Increase in Basis for
Property Acquired From a Decedent, which the IRS news release accompanying Notice 2011-66 (IR-2011-83) said the IRS expects to issue “early this fall.” The automatic allocation rules will apply if the executor does not make, or timely revokes, a Section 1022 Election, or files a Form 8939 without attaching a Schedule R or R-1. (These Schedules R and R-1 are likely to be identical or very similar to the Schedules R and R-1 that accompany Form 706.)

F. Extension of Time for Performing Certain Acts

Section 301(d) of the 2010 Tax Act provides that the due date for certain acts will be no earlier than nine months after the date of enactment, which is September 17, 2011. Because that is a Saturday, those acts will be due no earlier than Monday, September 19, 2011 (although care in this regard is always warranted, especially in the case of disclaimers, which are not returns required to be filed with the IRS and therefore are not clearly covered by sections 7502 and 7503, but are addressed only to the extent Reg. § 25.2518-2(c)(2) applies). The acts that are extended are

1. filing an estate tax return with respect to the estate of a decedent who died after December 31, 2009, and before December 17, 2010,
2. making any election on the estate tax return of a decedent who died after December 31, 2009, and before December 17, 2010,
3. paying any estate tax with respect to the estate of a decedent who died after December 31, 2009, and before December 17, 2010,
4. making any disclaimer of an interest in property passing by reason of the death of a decedent who died after December 31, 2009, and before December 17, 2010 (but care will still be required to ensure that the disclaimer is permitted under state law, or, if not, that section 2518(c)(3) can provide a workaround),
5. filing a return reporting any generation-skipping transfer after December 31, 2009, and before December 17, 2010, and
6. making any election required to be made on a return reporting any generation-skipping transfer after December 31, 2009, and before December 17, 2010.

G. The Gift Tax

1. The gift tax was not changed for 2010. The exemption remained $1 million, and the rate remained 35 percent.
2. Beginning January 1, 2011, the gift tax chapter no longer has its own unified credit (“determined as if the applicable exclusion amount were $1,000,000,” as section 2505(a)(1) provided for gifts from 2002 through 2009) or its own rate schedule. It is once again the same as the estate tax unified credit and rates.
   a. This is introduced in section 302(b)(1) of the 2010 Tax Act under the heading “Restoration of unified credit against gift tax.” It is awkward to refer to a “unified” credit since 2004, when the estate tax exemption increased to $1.5 million but the gift tax exemption remained at $1 million, although the credits
were still “unified” in the sense that the credit used affected the credit available both for future gifts and for estate tax purposes.

b. Under the 2010 Tax Act, the estate and gift tax calculations will again be identical and, in that sense, once again “unified.”

c. Beginning in 2012, the gift tax exemption will therefore be indexed for inflation, because it will be identical to the indexed estate tax exemption.

3. There will likely be a surge in gift-giving in 2011 and 2012.

a. For many donors, a $5 million lifetime exemption, $10 million for a married couple, will be enough to accomplish estate planning objectives with simple gifts, outright or, more likely for larger gifts, in trust. Because the GST exemption is also $5 million, those trusts can be generation-skipping or even perpetual, without any gift or GST tax paid.

b. In other cases, more creative use of the gift tax exemption will be desirable. Just as the former $1 million dollar exemption could be leveraged, so can the $5 million exemption, except there is five times as much of it. The basic techniques for leveraging the gift tax exemption have not changed and include life insurance, installment sales, AFR loans (including forgiveness), GRATs, QPRTs, and the use of entity-based valuation discounts as in closely held businesses and family limited partnerships.

c. In all of these cases, growth in the value of asset following the gift will escape estate tax. And any gift tax paid will escape estate tax if the donor survives for three years after the gift, which reduces the 35 percent gift tax rate to an estate-tax-equivalent rate (or “net gift” rate) of about 26 percent \((0.35 ÷ 1.35)\).

4. Inevitably, discussion of gift tax rates leads to considerations of basis.

a. The basis of property for purposes of determining gain is the donor’s basis if the property is acquired by gift, but the date-of-death (or alternate valuation date) value if the property passes at death. For low basis assets, it has always been necessary to compare the estate tax saved with the additional income tax on capital gain that may be incurred.

b. Estate tax rates are still likely to be higher than the capital gain tax rate in the typical case, but the spread is smaller, meaning that there may be less priority for making leveraged transfers of appreciated assets likely to be sold soon after death.

c. For assets subject to depreciation, this observation may be even more true, because depreciation will typically reduce taxes at ordinary, not capital gains, rates.

d. In the case of a surviving spouse who is a beneficiary of a QTIP trust, an alternative method of making a gift is to relinquish part or all of the income interest in the trust, thus triggering a gift under section 2519. The assets in the QTIP trust might have a higher basis than the surviving spouse’s own
assets.

5. The possibility of a surge in gifts followed by a return to a $1 million applicable exclusion amount in 2013 (e.g., if Congress does not act) has also created concerns that some of the current gift tax saving would be “recaptured” or “clawed back” by an increased estate tax at death. This concern about “claw back” arises from the provision of former section 2001(b)(2) (which is scheduled to be revived in 2013) that after calculating a tentative tax on the sum of the taxable estate and adjusted taxable gifts there is subtracted “the aggregate amount of tax which would have been payable under chapter 12 [i.e., gift tax] with respect to gifts made by the decedent after December 31, 1976, if the provisions of subsection (c) (as in effect at the decedent’s death) [which deals only with tax rates] had been applicable at the time of such gifts.”

a. For a gift in 2011 and death in 2013, for example (assuming no change in law), this amount will tend to be greater than the gift tax actually paid, because it will be calculated on the higher rates in effect in 2013.

b. But this amount will tend to be smaller than the amount of the tentative tax attributable to the adjusted taxable gifts, because it appears to be calculated using the larger unified credit resulting from using the 2011 applicable exclusion amount. Section 2001(b)(2) expressly requires a substitution only of the current rates in section 2001(c) in reconstructing the hypothetical gift tax payable, not a substitution of the current applicable exclusion amount in section 2010(c).

c. Because the adjustment under section 2001(b)(2) is a reduction of the estate tax, a reduction of that reduction by using the 2011 applicable exclusion amount will result in an increase in the resulting estate tax. The estate tax (plus the gift tax paid, if any) would ordinarily not be as high as it would have been if the gift had not been made, but it could result in an effective tax on the taxable estate greater than 55 percent.

6. The claw back can be illustrated this way:

a. Assume an unmarried individual who has never before made a taxable gift makes a $5,000,000 taxable gift in 2011. The “tentative tax” under sections 2502(a)(1) and 2001(c) would be $155,800 plus 35 percent of the excess of the taxable gift over $500,000, or $1,730,800. The unified credit under sections 2505(a) and 2010(c) would be the same ($1,730,800), and the tax payable would be zero.

b. Assume that the individual dies in 2013 with a taxable estate of $5,000,000 and, of course, “adjusted taxable gifts” (the 2011 taxable gift) of $5,000,000. The “tentative [estate] tax” computed under section 2001(b)(1) on the sum of those two amounts would be $1,290,800 plus 55 percent of the excess of $10,000,000 over $3,000,000, or $5,140,800.

c. The estate tax unified credit would return to its pre-2002 level of $345,800.

d. In calculating the hypothetical gift tax to subtract under section 2001(b)(2),
the “tentative [gift] tax” that would have been computed under sections 2502(a)(1) and 2001(c) in 2011 using 2013 rates would likewise be $1,290,800 plus 55 percent of the excess (of $5,000,000 in this case) over $3,000,000, or $2,390,800.

i. Using the 2011 unified credit of $1,730,800, the section 2001(b)(2) reduction would be $2,390,800-$1,730,800 or $660,000, and the estate tax would be $5,140,800-$660,000-$345,800 (unified credit) or $4,135,000.

ii. If the 2011 unified credit were recalculated using 2013 rates (but the 2011 applicable exclusion amount), it would also be $1,290,800 plus 55 percent of the excess (of $5,000,000) over $3,000,000, or $2,390,800. The section 2001(b)(2) reduction would be zero, and the estate tax would be $5,140,800-$345,800 (unified credit) or $4,795,000.

iii. If the 2011 unified credit were recalculated using both 2013 rates and the 2013 applicable exclusion amount of $1,000,000, it would be $345,800. In that case, the section 2001(b)(2) reduction would be $2,390,800-$345,800 or $2,045,000, and the estate tax would be $5,140,800-$2,045,000-$345,800 (unified credit) or $2,750,000.

e. If the gift had not been made, and the estate tax were computed only on a taxable estate of $10,000,000, it would be $5,140,800-$345,800 (unified credit) or $4,795,000 (the same as in clause ii above). On the other hand, if the 2011 taxable gift of $5,000,000 had been made under 2013 (or 2001) law, a gift tax of $2,045,000 would actually have been paid, and, together with the estate tax (computed under clause iii above) of $2,750,000, the total taxes would also be $4,795,000, confirming that in a static tax structure the computation works right (although if the donor survived for three years the total tax would be reduced by excluding the gift tax paid from the taxable estate).

f. But if the estate tax were simply 55 percent of the taxable estate of $5,000,000, which is intuitively what it ought to be to preserve the benefit of the lower tax at the time of the gift, the estate tax would be $2,750,000. Indeed, if the donor died in 2012 instead of 2013, the “tentative [estate] tax” computed on $10,000,000 would be $155,800 plus 35 percent of the excess of $10,000,000 over $500,000, or $3,480,800; there would be no reduction for gift tax paid, and after the unified credit of $1,730,800 the estate tax would be $1,750,000, which is simply 35 percent of $5,000,000.

g. This intuitively correct estate tax of $2,750,000 is less than the amounts computed in clauses i and ii above (which is the feared claw back), but identical to the amount computed in clause iii, suggesting that the solution to the claw back problem might be to simply take the approach illustrated in clause iii.

h. This intuitive view of the estate tax (and thus the approach illustrated in clause iii) are supported by legislative history. The wording of section
2001(b)(2) was intended “to prevent the change in rates from having a retroactive effect to gifts made prior to” the phase-in of the lower rates enacted by the Economic Recovery Tax Act of 1981. H.R. REP. NO. 97-201, 97TH CONG., 1ST SESS. 156 (1981). This wording was occasioned by the phased lowering of rates in 1981; it was not needed for the phased increase in the unified credit in 1976, because the increased unified credit is applied after the section 2001(b) calculation, and therefore such increases would take care of themselves. The objective of the calculation was to tax the taxable estate consistently in the proper rate bracket – in other words, to ensure that, as in the gift tax calculation, “previous taxable gifts only affect the starting point in determining the applicable rate.” H.R. REP. NO. 94-1380, 94TH CONG., 2D SESS. 13 (1976). In 1976, the gift tax structure was specifically designed to provide that “the reduction for taxes previously paid is to be based upon the new unified rate schedule even though the gift tax imposed under present [i.e., pre-1977] law may have been less than this amount.” Id. (emphasis added). There is no reason to doubt that Congress would intend the same policy judgment again if the gift tax “may have been less” than a future estate tax and therefore no reason to suspect that Congress would have intended the “claw back” that is now causing speculation and concern. That policy judgment would be the justification for Treasury and the IRS (in forms and instructions, for example) to apply the same treatment to the applicable exclusion amount in section 2010(c) as to the rates in section 2001(c); the technical justification is that rates and exemptions (unified credits) have always been treated together in defining the burden of the tax and therefore in determining whether a “change in rates” would have “a retroactive effect.”

7. Section 302(d) of the 2010 Tax Act adds a new section 2001(g) to the Code intended to conform the deduction for tax attributed to adjusted taxable gifts in the calculation of the estate tax to the new gift and estate tax applicable exclusion amount and rates. Section 2001(g) reads as follows:

(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).

a. Section 2001(g) is not completely clear, in the absence of implementing forms and instructions. It appears to be well-meaning and likely intended, among other things, to prevent any untoward “recapture” or “claw back” of a gift tax exemption in the form of an increased estate tax, including the
increased estate tax that could take effect in 2013 if Congress does not act. But section 2011(g) has two limitations:

i. Like the previous wording of section 2001(b)(2), section 2001(g) expressly requires a substitution only of the current *rates* in section 2001(c) in reconstructing the hypothetical gift tax payable, not a substitution of the current *applicable exclusion amount* in section 2010(c).

ii. Besides, section 2001(g) itself is scheduled to sunset in 2013 when it might most be needed.

b. Thus, until there are forms, instructions, or other published guidance from the Internal Revenue Service on this subject, there will always be a certain risk in making gifts in 2011 and 2012. Of course, if the exemptions and rates in the 2010 Tax Act are made permanent, this question will be academic.

c. A similar addition is made to section 2505(a), relating to the treatment of previous gifts in calculating the tax on current gifts, which restores the full cumulative exemption of $1 million for 2010 in most cases.

8. In what is called a “conforming amendment,” section 302(e) of the 2010 Tax Act repealed section 2511(c), which had treated certain transfers in trust as a gift if the trust was not a grantor trust.

9. There is a glitch in the description of the effective date of the $5 million gift tax exemption.

a. The $5 million gift tax exemption is provided for in two ways.

i. Section 302(b)(1)(A) of the 2010 Tax Act deletes “(determined as if the applicable exclusion amount were $1,000,000)” from section 2505(a)(1) of the Code. Section 302(b)(1)(B) states that “[t]he amendment made by this paragraph shall apply to gifts made after December 31, 2010.”

ii. Section 302(b)(2) of the 2010 Tax Act states that “[o]n 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.”

b. While those references to an effective date of January 1, 2011, are clear enough standing alone, section 302(f) of the 2010 Tax Act states that “[e]xcept 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.” Obviously, the words “this subsection” (which are meaningless, because nothing else is provided in subsection (f)) should be “this section” (which would ratify the January 1, 2011, effective dates in section 302(b). And no one would seriously argue that the *general* effective date language in section 302(f) should override the *specific* effective date language in section 302(b).

c. The other reference to a specific effective date in section 302 of the 2010 Tax
Act (the provision for inflation adjustments “in a calendar year after 2011”) is hardwired into section 2010(c)(2)(B) of the Code itself and is not affected by this glitch.

d. A similar, but more consequential, glitch appeared in section 304 of the original Reid-McConnell Amendment, which provided, nonsensically, that “[s]ection 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 shall apply to the amendments made by this section.” Before Senate action, the word “section” was changed to “title” by unanimous consent, thereby clarifying that the estate, gift, and GST tax amendments would sunset at the end of 2010 as contemplated.

H. Portability

1. Section 303 of the 2010 Tax Act includes provisions for the portability of the unified credit between spouses that are identical to those in the Baucus Bill, conformed to the exclusion amount ($5 million) and effective date (January 1, 2011) of the 2010 Tax Act.

2. Under section 2010(c)(5)(A), portability is not allowed “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.”

   a. Such an election will keep the statute of limitations on that estate tax return open forever, but only for the purpose of determining the amount of unused exemption, not to make adjustments to that return itself. (The regular statute of limitations will prevent any adjustments to the predeceased spouse’s return as such.)

   b. It is not clear why this election is required for the surviving spouse to use the unused exemption of the predeceased spouse. But such an election has been in every legislative version of portability since 2006, despite criticisms. It is possible that Congress thought an election by the predeceased spouse’s executor was necessary in order to keep the return open even for such a limited purposes.

   c. The IRS’s August 25, 2011, draft of the 2011 estate tax return (Form 706) said nothing about portability, which fueled speculation that the “election” of portability required by section 2010(c)(5)(A) will be presumed in the case of any return for a married decedent that provides the information necessary to determine the exclusion amount that was available and the exclusion amount that was used, and therefore the amount of “deceased spousal unused exclusion amount” contemplated by section 2010(c)(4). Arguably part 4 of the August 25 draft does that, because it asks for the customary information about beneficiaries other than charity and the surviving spouse (line 5), as well as all federal gift tax returns (line 7a). (Information about taxable gifts is also collected, as usual, on lines 4 and 7 of the tax computation in Part 2.)
d. Sure enough, the updated draft of the instructions for the 2011 return (dated September 2, 2011, but not released until a few days later) ended the speculation and, in the instructions to line 4 of Part 4 (on page 13), provided the much-anticipated, albeit labored, reassurance that “[t]he executor is considered to have elected to allow the surviving spouse to use the decedent’s unused exclusion amount by filing a timely and complete Form 706.” The final instructions posted on the IRS website on September 28, 2011, are the same.

e. Those instructions go on to specify that an executor who does not wish to make the election may (1) attach a statement to that effect to the return, (2) write “No Election under Section 2010(c)(5)” across the top of the return, or (3) simply file no return, if a return is not otherwise required.

f. Curiously, the August 25 draft 2011 return changed “applicable credit amount” to “applicable exclusion amount,” on lines 9, 10, and 11 of Part 2. That change might once have been intended to reflect the shift in section 2010(c) to a focus on the “exclusion amount” rather than the credit in the accounting that is required between spouses. But it would have made no sense to deduct the “applicable exclusion amount” from the “gross estate tax,” which would have been the effect of that change. The discussion of lines 9 and 10 in the subsequent September 2 draft of the instructions retained the correct reference to the “applicable credit amount.” And in the final Form 706 posted on the IRS website on September 20 and again reposted on September 28, 2011, the word was changed back to “credit.”

g. Until we know whether portability will be made permanent, it is prudent to assume that it will be and therefore to consider an election every time a married person dies (unless that person uses the entire exemption or it is very unlikely that the surviving spouse’s total estate will exceed the exemption).

i. To the extent that the smallest estates may have the most unused exemption to pass on and therefore need the election the most, it might be hard to see portability as a simplification, especially as long as a return that is not required for estate tax purposes is still required to make the portability election. And in the case of a return that is not otherwise required it will be most difficult to know what the instructions to line 4 of Part 4 mean by a “complete” return. Presumably further guidance will clarify that it only means complete enough to determine how much of the predeceased spouse’s unified credit was used. For example, a return showing no adjusted taxable gifts on line 4 of Part 2 and “all to spouse” on line 4c of Part 4 would arguably be complete enough.

ii. In contrast, if the couple’s combined estate is well under the exemption, there may be no reason to get involved with portability at all.
3. Each iteration of the portability proposal has been more restrictive in its treatment of the vexing issue of the surviving spouse who may have succeeded to unused exemptions from more than one predeceased spouse.

a. The House-passed “Permanent Estate Tax Relief Act of 2006” (“PETRA”) (Part III.E.2 on page 13) and “Estate Tax and Extension of Tax Relief Act of 2006” (“ETETRA”) (see Part III.F beginning on page 14) avoided complex tracing and anti-abuse rules by simply limiting any decedent’s use of exemptions from previous spouses to the amount of that decedent’s own exemption. In other words, no one could more than double the available exemption by accumulating multiple unused exemptions from previous spouses.

b. S. 722 in March 2009 (Part VII.E.4 on page 30) restricted portability still further by limiting the source of unused exemption to a spouse or spouses to whom the decedent had personally been married. Thus, if Husband 1 died without using his full exemption, and his widow, Wife, married Husband 2 and then died, Wife’s estate could use her own exemption plus whatever amount of Husband 1’s exemption had not been used. Ultimately, Husband 2’s estate could use his own exemption plus whatever amount of Wife’s own exemption had not been used. But Husband 2’s estate could not use any of Husband 1’s unused exemption transmitted through Wife’s estate. Some commentators describe this as requiring “privity” between the spouses.

c. The December 2010 Baucus Bill (Part VII.I.3 on page 35) went still further by limiting portability to just one predeceased spouse, the “last such” deceased spouse. The 2010 Tax Act follows the December 2010 Baucus Bill in this respect. (Presumably remarriage followed by divorce revives the status of the “last such deceased spouse,” who therefore need not be the “last spouse.”)

4. These limitations – the surviving spouse’s own exemption can be no more than doubled and the increase is limited to the unused exemption from just one predeceased spouse – seem redundant (except in the case where the exemption might be reduced in the future). But the wording of the new limitation to just one predeceased spouse produces a result that does not seem to have been intended.

a. The Joint Committee Staff’s Explanation includes the following three examples, which do a good job of illustrating what was probably intended:

Example 1. – Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1’s estate tax return to permit Wife to use Husband 1’s deceased spousal unused exclusion amount. As of Husband 1’s death, Wife has made no taxable gifts. Thereafter, Wife’s applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2. – Assume the same facts as in Example 1, except that Wife
subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2’s estate tax return to permit Wife to use Husband 2’s deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2’s $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2’s $1 million unused exclusion). Thereafter, Wife’s applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Example 3. — Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1’s death, Wife’s applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife’s estate tax return to permit Husband 2 to use Wife’s deceased spousal unused exclusion amount, which is $4 million (Wife’s $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2’s applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

TECHNICAL EXPLANATION, supra, at 52-53 (emphasis to Example 3 added).

b. The problem with Example 3 is that under section 2010(c)(4)(B) the “deceased spousal unused exclusion amount” that is portable from Wife to Husband 2 is the excess of Wife’s “basic exclusion amount” (which is $5 million) over the amount with respect to which Wife’s tentative tax is determined under section 2001(b)(1) (which is Wife taxable estate of $3 million). The excess of $5 million over $3 million is $2 million, not $4 million as in Example 3.

c. Even if Wife tried to “use” Husband 1’s deceased spousal unused exclusion amount by making $2 million of taxable gifts and left a taxable estate of only $1 million, the amount with respect to which Wife’s tentative tax is determined under section 2001(b)(1) would still be $3 million (a $1 million taxable estate plus $2 million of adjusted taxable gifts), and her deceased spousal unused exclusion amount would still be only $2 million.

d. The discrepancy occurs because Example 3 uses Wife’s $7 million applicable exclusion amount, while section 2010(c)(4)(B)(i) uses her $5 million basic exclusion amount.

e. The result in Example 3 was probably intended. When the staff of the Joint Committee on Taxation prepared its GENERAL EXPLANATION OF TAX...
LEGISLATION ENACTED IN THE 111TH CONGRESS (JCS-2-11, March 2011), it repeated Example 3 unchanged. Id. at 555.

f. On March 23, 2011, the Joint Committee staff published an “Errata” for the General Explanation (JCX-20-11), including just two items – 24 pages of revised budget effect estimates and the following:

On page 555, add the following footnote 1582A to the word “amount” in the next to last sentence in example 3:

The provision adds new section 2010(c)(4), which generally defines “deceased spousal unused exclusion amount” of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last 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. A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the provision.

5. Treasury is given broad authority to flesh out the portability rules in regulations.

6. Under the 2010 Tax Act, portability will apply only in 2011 and 2012 and only when the predeceased spouse has died in 2011 or 2012, another signal that a extension of this provision beyond two years was contemplated. The Obama Administration’s fiscal 2012 budget proposals include a proposal to make portability permanent. See Part IX.A on page 64.

7. A credit shelter trust will still offer advantages over portability, especially in the largest estates, including

a. professional management and asset protection during the surviving spouse’s life,

b. protection of the expectancy of children from diversion by the surviving spouse, especially in cases of second marriages and blended families, as well as remarriage of the surviving spouse,

c. sheltering intervening appreciation and accumulated income from estate tax,

d. preservation of the predeceased spouse’s exemption even if the surviving spouse remarries, the exemption is reduced, or portability sunsets,

e. use of the predeceased spouse’s GST exemption, because portability applies only to the gift and estate taxes, and

f. avoiding the filing of an estate tax return for the predeceased spouse’s estate, if the estate is not so large as to otherwise require a return.

8. On the other hand, for many couples, portability will offer advantages, including

a. simplicity, including relief of any concern about the titling of assets,
b. greater perceived security for the surviving spouse by accommodating an outright bequest that confers complete control over the entire estate, without the intervention of a trust,

c. a second step-up in basis for appreciated assets, and

d. avoidance of state estate tax on the first estate in states with an estate tax and no state-only QTIP election.

I. Comment

1. On December 16, 2009, when Senator Baucus asked unanimous consent that the Senate pause from its consideration of health care reform and approve an extension of 2009 transfer tax law for just two or three months, Senator McConnell asked Senator Baucus to agree to consideration of an amendment reflecting, as Senator McConnell described it, “a permanent, portable, and unified $5 million exemption that is indexed for inflation, and a 35-percent top rate.” See Part VII.H.2 on page 33. Senator Baucus objected to Senator McConnell’s request, whereupon Senator McConnell objected to Senator Baucus’s request, and all hopes of transfer tax legislation in 2009 died.

2. Except for permanence, the 2010 Tax Act has fulfilled Senator McConnell’s request.

3. But lack of permanence is important.

a. Many observers, including the author of this outline, have long thought that the true congressional consensus in a stand-alone estate bill would arrive at a rate less than 45 percent and an exemption greater than $3.5 million, possibly not going quite as far as 35 percent and $5 million (although 51 Senators did in April 2009), possibly phased in to make it cost less, and possibly accompanied by some revenue raisers to make it look as if they tried to control the cost.

b. But to do it all it once, without a phase-in (indeed to do it retroactively to January 1, 2010, for estate and GST tax purposes), to not even pretend to pay for it, to link it to the income tax cuts; to link the income tax cuts in turn to a bad economy, to insist on indexing and portability and “unification” at the same time, and to sunset it all in two years – just tees it up for two more years of contention.

IX. THE ADMINISTRATION’S REVENUE PROPOSALS

The Treasury Department’s “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals” (“Greenbook”) was released on May 11, 2009. See http://www.treas.gov/resource-center/tax-policy/Documents/gmbk09.pdf. An Appendix, on page 125, confirmed that “[e]state and gift taxes are assumed to be extended at parameters in effect for calendar year 2009 (a top rate of 45 percent and an exemption amount of $3.5 million).” At pages 119-23, as revenue raisers dedicated to health care reform, three revenue-raising proposals were described under the heading “Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms,” requiring consistency in
value for transfer and income tax purposes, modifying rules on valuation discounts, and requiring a minimum term for GRATs. On page 112, under the heading “Insurance Companies and Products,” the Greenbook proposed to “modify the transfer-for-value rule [applicable to life insurance policies] to ensure that exceptions to that rule would not apply to buyers of polices” in life settlement transactions.

The “General Explanations of the Administration’s Fiscal Year 2011 Revenue Proposals” was released on February 1, 2010. See http://www.treas.gov/resource-center/tax-policy/Documents/greenbkl0.pdf. Again, an Appendix, on page 147, stated that “[e]state and gift and GST taxes are assumed to be extended at parameters in effect for calendar year 2009 (a top rate of 45 percent and an exemption amount of $3.5 million).” (The words “and GST” are added in the 2010 Greenbook.) In footnotes on pages 124 and 126, the 2010 Greenbook stated:

The Administration’s baseline assumes that the laws governing the estate, gift and generation-skipping taxes as in effect during 2009 are extended permanently. Consequently, the discussion of Current Law set forth above reflects the applicable law as in effect during 2009.

The 2010 Greenbook included the same estate and gift tax proposals (pages 122-26), except that they were under the overall heading of “Reduce the Tax Gap and Make Reforms” and not tied to health care reform. The 2010 proposals were identical to the 2009 proposals, except in one detail related to GRATs described below, and on page 69 there was the same life insurance proposal as in the 2009 Greenbook.

The “General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals” was released on February 14, 2011. See http://www.treas.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf. In a footnote to the table of contents, the 2011 Greenbook states, among other things, that “[t]he Administration’s policy proposals reflect changes from a tax baseline that modifies the Budget Enforcement Act baseline by … freezing the estate tax at 2009 levels.” The 2011 Greenbook includes the life insurance proposal (page 51) and the same three estate and gift tax proposals (pages 125-28). In addition, at pages 123-24, the 2011 Greenbook includes a proposal to make permanent the portability of unused exemption between spouses and, at pages 129-30, a proposal to generally terminate an allocation of GST exemption to a trust after 90 years.

A. “Make Permanent the Portability of Unused Exemption Between Spouses”

1. Under the heading of “Current Law;” the 2011 Greenbook describes the 2011-12 portability regime of the 2010 Tax Act. (See Part VIII.G beginning on page 52.)

2. The Greenbook proposes to extend portability beyond 2012 permanently.

3. The Greenbook offers the following support for portability:

Without this portability provision, spouses are often required to retitle assets into each spouse’s separate name and create complex trusts in order to allow the first spouse to die to take full advantage of his or her exclusion. Depending upon the nature of the couple’s assets, such a division may not be possible. Such a division also has significant consequences under property law and often is not consistent with the way in which the married couple
would prefer to handle their financial affairs. Portability would obviate the need for such burdensome planning.

4. The Greenbook continues the acknowledgment that the exemption is portable only from the “last” predeceased spouse, without commenting on the discrepancy between the statute and the Joint Committee Staff’s Explanation. See Part VIII.H.4 beginning on page 60.

5. The Greenbook estimates that this proposal would reduce federal revenues by $3.681 billion over fiscal years 2012-21.

B. “Require Consistency in Value for Transfer and Income Tax Purposes”

1. Under section 1014(a)(1), the basis of property acquired from a decedent is “the fair market value of the property at the date of the decedent’s death,” with appropriate adjustments in section 1014 for the alternate valuation date and so forth. It is possible for the recipient of property from a decedent to claim, for income tax purposes, that the executor somehow just got the estate tax value too low, and that the recipient’s basis should be greater than the estate tax value. Usually, of course, such claims are made after the statute of limitations has run on the estate tax return. Such claims can be accompanied by elaborate appraisals and other evidence of the “real” date-of-death value that, long after death, is hard to refute. Invoking principles of “privity,” the Service is able to insist on using the lower estate tax value when the recipient was one of the executors who signed the estate tax return, but otherwise it has had no tool to enforce such consistency.

2. The Greenbook proposal would require the income tax basis of property received from a decedent or donor to be equal to the estate tax value or the donor’s basis.

a. On September 8, 2009, the staff of the Joint Committee on Taxation released a publication entitled “Description of Revenue Provisions in President’s Fiscal Year 2010 Budget Proposal, Part One: Individual Income Tax, Estate and Gift Tax Provisions” (JCS-2-09). Regarding this Administration Greenbook proposal, the JCT publication stated (emphasis added):

The proposal requires that the basis of property received by reason of death under section 1014 generally must equal the value of that property claimed by the decedent’s estate for estate tax purposes."

Under the proposal there would be instances in which the value of an asset reported by an executor to an heir differs from the ultimate value of the asset used for estate tax purposes. For example, if the IRS challenges an estate valuation and prevails, the executor will have reported to the heir a valuation that is artificially low, and the heir may arguably be overtaxed on a subsequent sale of the asset. This same problem exists under present law to the extent the initially reported estate tax value is presumptively the heir’s basis. To provide complete consistency between estate tax valuation and basis in the hands of an heir may be impractical as ultimate determination of value for estate tax purposes may depend upon litigation, and an heir may sell an asset before the determination of value for estate tax purposes.

By requiring the value of an asset reported for transfer tax purposes to be
b. It is hard to reconcile this with the Greenbook’s statement that “[t]his proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes ...” (emphasis added).

3. The Greenbooks provide that the executor or donor would be required to report the necessary information to both the recipient and the Service. Regulations (i) could extend this reporting requirement to annual exclusion gifts and estates for which no estate tax return is required and (ii) could provide relief for the surviving joint tenant or other recipient who has better information than the executor.

4. The 2011 Greenbook adds a couple noncommittal references to the 2010 elective carryover basis regime.

5. The proposal would be effective, unless it is changed, as of the date of enactment.

6. The proposal was estimated to raise tax revenue over ten years by $1.87 billion in the 2009 Greenbook, $2.103 billion in the 2010 Greenbook, and $2.095 billion in the 2011 Greenbook.

   a. The similar proposal floated by the staff of the Joint Committee on Taxation in 2005, described in Part V.D on page 20, was estimated to raise less than $50 million over ten years.

   b. The June 11, 2009, Joint Committee on Taxation estimated the ten-year revenue gain from the 2009 Greenbook proposal at $935 million, exactly half the Administration estimate.


   a. A new section 6035(a) would require executors to report to the Service and to each person receiving property from a decedent the fair market value (or other relevant attributes) of all such property. A new section 6035(b) would require donors of gifts to report comparable information, including the donor’s adjusted basis in every case, to the Service and to donees.

   b. As anticipated in the Greenbooks, Treasury would be authorized to prescribe regulations—

      i. applying the rules to situations where no estate tax return is required or to gifts excluded by section 2503,

      ii. addressing “situations in which the surviving joint tenant or other
recipient may have better information than the executor,” and

iii. addressing “the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.”

The reference to “the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate of gift tax return” appeared relevant to the JCT staff’s suggestion that basis must be the value originally claimed on an estate tax return, without regard to subsequent adjustments. But, being cast in terms of the “timing” of the “reporting,” it provided some ground for hope, but little clarity. The statutory language did not use the well-understood phrase “as determined for estate or gift tax purposes” that the Greenbooks use, and even the Greenbooks do not use the familiar phrase “as finally determined for estate or gift tax purposes.”

c. New sections 1014(f) and 1015(f) would mandate that in the case of any property subject to reporting under section 6035, except as provided in regulations, “the basis of the property in the hands of the person acquiring such property shall be calculated using the information reported to such person …”

d. Both the failure to report under section 6035 and the failure to use a consistent basis under section 1014(f) or 1015(f) would be subject to penalties.

e. Under S. 3533 and H.R. 5764, these rules would apply to returns filed after the date of enactment.


a. Among other things, the Baucus Bill would have provided welcome clarification that the basis would be adjusted to the value “as finally determined for purposes of chapter 11.”

b. In the case of a sale before the estate tax value is finally determined, the Baucus Bill would required that the basis reported on the estate tax return be used, thereby adding one more issue to be considered before selling an asset for more than the value on the estate tax return before the estate tax audit is concluded.

9. In what appeared to be an unintended change from current substantive law, the Greenbook proposal would apparently require the basis of even property acquired by gift to be no greater than the gift tax value. Under section 1015(a), the basis for determining the donee’s gain can be greater than the gift tax value if that was the donor’s basis. The statutory language in S. 3533 and H.R. 5764 does not imply such a change.
10. It is not clear from the Greenbooks how the proposed changes would deal with adjustments based on tax payments, such as the increases in basis for the gift tax and GST tax attributable to appreciation, under sections 1015(d) and 2654(a).

a. It will not always be easy to get finality under these rules, especially the rules governing the payment of GST tax on taxable terminations occurring at death, which depend on the relevant inclusion ratio. Under Reg. § 26.2642-5, this inclusion ratio is not final until the later of the running of the statute of limitations on the transferor’s estate tax or the running of the statute of limitations with respect to the first GST tax return filed using that inclusion ratio.

b. The wording of S. 3533 and H.R. 5764 that basis “shall be calculated using the information reported” appears to permit all such allowable adjustments.

C. “Modify Rules on Valuation Discounts”

1. The Greenbooks recalled that sections 2701-2704 were enacted to curb techniques designed to reduce transfer tax value but not the economic benefit to the recipients.

a. Specifically, the Greenbooks pointed out that section 2704(b) provides that certain “applicable restrictions” that would otherwise justify valuation discounts are ignored in intra-family transfers of interests in family-controlled corporations and partnerships, but added that “[j]udicial decisions and the enactment of new statutes in most states have, in effect, made section 2704(b) inapplicable in many situations.”

b. The Greenbooks also stated that “the Internal Revenue Service has identified additional arrangements designed to circumvent the application of section 2704.”

c. Section 2704(b) applies to an “applicable restriction,” which section 2704(b)(2) defines as “any restriction (A) which effectively limits the ability of the corporation or partnership to liquidate, and (B) with respect to which either ... (i) [t]he restriction lapses, in whole or in part, after the transfer ... [or] (ii) [t]he transferor or any member of the transferor’s family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.” Section 2704(b)(3) provides exceptions for “(A) any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or (B) any restriction imposed, or required to be imposed, by any Federal or State law.”

d. Under section 2704(b)(4), Treasury has the authority to “provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor’s family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.” Since 2003, a guidance project under section 2704 has been on the Treasury-IRS Priority Guidance Plan.
See Part XII.B.15 on page 102.

2. Using section 2704(b) as a framework, the Greenbook proposal would create a more durable category of “disregarded restrictions.”

   a. Disregarded restrictions would “include” restrictions on liquidation of an interest that are measured against standards prescribed in Treasury regulations, not against default state law.

   b. Although the Greenbook did not say so, it is possible that the “disregarded restrictions” in view, which “include” certain limitations on liquidation (the current scope of section 2704(b)(2)(A)), may also include other restrictions, such as restrictions on management, distributions, access to information, and transferability. If so, it might call for reconsideration of the famous disclaimer in the 1990 conference report that “[t]hese rules do not affect minority discounts or other discounts available under [former] law.” H.R. REP. NO. 101-964, 101ST CONG., 2D SESS. 1137 (1990). After all, even the regulation authority under section 2704(b)(4) extends to “other restrictions.”

   c. On the other hand, the September 8, 2009, Joint Committee staff’s publication stated that “because the proposal targets only marketability discounts, it would not directly address minority discounts that do not accurately reflect the economics of a transfer.” The JCT staff pointed out that other possible approaches include the “look through” rules of the Clinton Administration’s budget proposals (Part II.E.1 on page 8) and the JCT staff’s own 2005 proposals (Part V.B beginning on page 18) and the aggregation rules of the 2005 proposals and the Reagan Administration’s “Treasury I” (Part II.D.1.d on page 7).

   d. Disregarded restrictions would also include limitations on a transferee’s ability to be admitted as a full partner or other holder of an equity interest, thus apparently denying the opportunity to value a transferred interest as a “mere” “assignee” interest and possibly applying in an unspecified way to “carried interests.”

   e. Treasury would be empowered by regulations to treat certain interests owned by charities or unspecified “others” as if they were owned by the transferor’s family.

   f. In any event, the Greenbooks were careful to cast their references in terms of “entities,” not just corporations and partnerships.

3. The Greenbooks included some other references that could be significant.

   a. Regulations could “create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met.” While no details were given, it is hard to imagine regulations that prescribe “safe harbor” discounts, and it is particularly odd that a proposal to limit opportunities to “circumvent” section 2704 would contemplate that section 2704 could be avoided simply by the way governing documents are drafted. But perhaps
this authority could be used to protect actual family operating businesses or to protect the holder of a restricted noncontrolling interest received from others (including ancestors) if that holder did not create those restrictions and never had a meaningful opportunity to remove those restrictions.

b. The Greenbook promised to “make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.” This could override the harsh “reverse-Chenoweth” result seen in Technical Advice Memoranda 9050004 (Aug. 31, 1990) and 9403005 (Oct. 14, 1993) (all stock owned by the decedent valued as a control block in the gross estate, but the marital bequest valued separately for purposes of the marital deduction), relying on Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987) (estate of a decedent who owned all the stock of a corporation entitled to prove a control premium for a 51-percent block bequeathed to the surviving spouse for purposes of the marital deduction), and Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981). Such a result would reinforce the fairness of the proposal and would be very welcome.

4. The proposal would apply, unless it is changed, to transfers – gifts and deaths – after the date of enactment. Consistent with section 2704 itself, the proposal would not apply to restrictions created on or before October 8, 1990. Under section 7805(b)(2), regulations issued within 18 months of the date of enactment could be retroactive to the date of enactment.

5. The proposal was estimated to raise revenue over ten years by $19.038 billion in the 2009 Greenbook, $18.667 billion in the 2010 Greenbook, and $18.166 billion in the 2011 Greenbook. (The June 11, 2009, Joint Committee on Taxation revenue estimates skipped this proposal, because of its lack of specificity – a “failure to score” that diminishes the proposal’s revenue-raising appeal in Congress.)

6. When the Responsible Estate Tax Act (S. 3533 and H.R. 5764) included statutory language for the other Greenbook proposals, it did not implement this proposal (possibly because its revenue effect would be so hard to estimate), but, in section 7, merely reproduced valuation discount provisions from previous bills. See Part VII.1.5 on page 34.

D. “Require a Minimum Term for Grantor Retained Annuity Trusts (GRATs)”

1. After reciting the history of section 2702 and the use of GRATs, the Greenbooks note that “[t]axpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor’s death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.”

2. While rumors had occasionally been heard of congressional plans to limit the attractiveness of GRATs by imposing a minimum gift tax value for the remainder (such as 10 percent), the Greenbooks instead propose to increase the mortality
risk of GRATs by requiring a minimum ten-year term.

a. A footnote compares the ten-year term to the minimum ten-year term of "Clifford trusts" under section 673 (before its amendment by the Tax Reform Act of 1986). Similarly, the September 8, 2009, Joint Committee staff's publication included a summary of the grantor trust rules, not self-evidently connected to the issue of GRATs.

b. Both the Greenbooks and the JCT staff publication focus on the effect of the proposal in increasing the mortality risk of a GRAT, not necessarily its effect in diminishing the upside from volatility.

c. The JCT staff publication noted that even a ten-year GRAT could be used "as a gift tax avoidance tool" and that a ten-year minimum term might encourage the use of GRATs by younger taxpayers. As an alternative way of achieving more accurate valuation, the JCT staff publication suggested valuation of the remainder interest for gift tax purposes at the end of the GRAT term when the remainder is distributed — embracing the "hard to complete" approach floated by the Reagan Administration’s "Treasury I" (Part II.D.1.b on page 7).

3. The Greenbook discussions actually ratify the use of "zeroed-out" GRATs, within the constraint of a minimum ten-year term. In the single substantive change from the 2009 Greenbook, the 2010 and 2011 Greenbooks add that "the proposal would also include a requirement that the remainder interest have a value greater than zero and would prohibit any decrease in the annuity during the GRAT term." Nevertheless, the 2010 and 2011 Greenbooks go on to say, like the 2009 Greenbook, that "although a minimum term would not prevent 'zeroing-out' the gift tax value of the remainder interest, it would increase the risk of the grantor's death during the GRAT term and the resulting loss of any anticipated transfer tax benefit."

4. The proposal would apply to GRATs created after the date of enactment.

5. The proposal was estimated to raise revenue by $3.25 billion over ten years in the 2009 Greenbook and $2.959 billion over ten years in the 2010 and 2011 Greenbooks. (The June 11, 2009, Joint Committee on Taxation estimates scored the ten-year revenue gain from the Administration proposal at $2.28 billion.)

6. These limitations on GRATs were included in section 307 of the "Small Business and Infrastructure Jobs Tax Act of 2010" (H.R. 4849), which the House of Representatives passed by a vote of 246-178 on March 25, 2010. The vote was partisan; only four Republicans voted for the bill and only seven Democrats voted against it. Reminiscent both of the Greenbooks' explanations and of the 1990 legislative history of section 2702 itself, the House Ways and Means Committee offered the following "Reasons for Change":

The valuation rates and tables prescribed by section 7520 often produce relative values of the annuity and remainder interests in a GRAT that are not consistent with actual returns on trust assets. As a result, under present law, taxpayers can use GRATs to make gifts of property with little or no transfer tax
consequences, so long as the investment return on assets in the trust is greater than the rate of return assumed under section 7520 for purposes of valuing the lead and remainder interests. The Committee believes that such uses of GRATs for gift tax avoidance are inappropriate.

In some cases, for example, taxpayers "zero out" a GRAT by structuring the trust so that the assumed value of the annuity interest under the actuarial tables equals (or nearly equals) the entire value of the property transferred to the trust. Under this strategy, the value of the remainder interest is deemed to be equal to or near zero, and little or no gift tax is paid. In reality, however, a remainder interest in a GRAT often has real and substantial value, because taxpayers may achieve returns on trust assets substantially in excess of the returns assumed under section 7520. Any such excess appreciation passes to the remainder beneficiaries without further transfer tax consequences.

In addition, grantors often structure GRATs with relatively short terms, such as two years, to minimize the risk that the grantor will die during the trust term, causing all or part of the trust assets to be included in the grantor’s estate for estate tax purposes. Because GRATs carry little downside risk, grantors frequently maintain multiple short-term, zeroed-out GRATs funded with different asset portfolios to improve the grantor’s odds that at least one trust will outperform significantly the section 7520 rate assumptions and thereby allow the grantor to achieve a transfer to the remainder beneficiaries at little or no gift tax cost.

The provision is designed to introduce additional downside risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. Relative to shorter-term (e.g., two-year) GRATs, a GRAT with a 10-year term carries greater risk that the grantor will die during the trust term and that the trust assets will be included in the grantor’s estate for estate tax purposes. The provision limits opportunities to inappropriately achieve gift tax-free transfers to family members in situations where gifts of remainder interests in fact have substantial value.


7. The GRAT limitations contained in H.R. 4849, like the Administration’s recommendations, were to apply to transfers made after the date of the enactment – that is, after the date the President signs it into law.

8. The same provisions appeared in

a. section 531 of the “Small Business Jobs Tax Relief Act of 2010” (H.R. 5486), which the House of Representatives passed by a vote of 247-170 (with five Republicans in favor and eight Democrats against) on June 15, 2010,

b. the supplemental appropriations bill (H.R. 4899) that the House approved on July 1, 2010,

c. section 8 of the “Responsible Estate Tax Act” (S. 3533 and H.R. 5764), introduced by Senator Sanders on June 24, 2010, and Rep. Linda Sanchez on July 15, 2010 (see Part VII.1.5 on page 34), and

d. section 308 of the December 2010 “Baucus Bill” (see Part VII.J.5 on page
9. These provisions appeared again in section 301 of the "Trade Adjustment Assistance Extension Act of 2011," (S. 1286), introduced on June 28, 2011, by Senators Casey (D-PA) and Brown (D-OH), neither of whom is a member of the Finance Committee. Unlike the other bills, this provision, as introduced, would apply to GRATs funded after December 21, 2010. There seems to be little or no chance that Congress would pass such retroactive legislation.

10. If a minimum ten-year term for GRATs is required, it will be harder to realize one of the chief benefits of a GRAT, which is capturing upside volatility in the GRAT for the benefit of the next generation. (The Greenbooks and the JCT staff publication focused on the effect of the proposal in increasing the mortality risk of a GRAT, not necessarily its effect in diminishing the upside from volatility.)

a. With currently depressed values, difficulty in predicting the timing of recovery, and relatively low interest rates under section 7520, many clients have recently been opting for GRATs with terms longer than the typical two years anyway.

b. But requiring a minimum ten-year term would encourage more customizing of the terms of a GRAT, including greater use of level GRATs or GRATs in which the annuity increases in some years but not others or increases at different rates in different years. For example, the typical 20 percent increase in the annuity payment each year would produce a payment in the tenth year equal to about 5.16 times the payment in the first year.

c. A ten-year GRAT might also demand greater monitoring and active management. For example, if the asset originally contributed to the GRAT achieves its anticipated upside early in the ten-year term (maybe in the first year or two as is hoped for with a two-year GRAT), the grantor can withdraw that asset and substitute another asset of equivalent value with upside potential. If the grantor holds that withdrawn appreciated asset until death, this will also permit the asset to receive a stepped-up basis.

d. A longer term for the GRAT will also permit a lower payout rate, which could make it easier to fund the annuity payments with cash (as with S corporation stock where the corporation distributes cash to equip its shareholders to pay income tax) and thereby avoid an annual appraisal.

e. A lower payout rate could result in a smaller amount includible in the grantor's gross estate under section 2036 if the grantor dies during the ten-year term. Under Reg. § 20.2036-1(c)(2)(i) (promulgated in April 2008) that includible amount is the amount needed to sustain the retained annuity interest without invasion of principal – that is, in perpetuity. Thus, for example, a ten-year GRAT with a level payout created when the section 7520 rate is 2.0 percent (as in September 2011) will require a payout equal to about 11.1 percent of the initial value. If the section 7520 rate when the grantor dies is 5.0 percent (as it was as recently as December 2007), the amount included in the grantor's gross estate will be 222 percent of the initial value.
That would represent a lot of appreciation, but often that is exactly what is hoped for when a GRAT is created. In that case, any appreciation in excess of 122 percent will pass tax-free to the next generation, even if the grantor dies during the ten-year term (unless the GRAT instrument provides for a reversion to the grantor, a general power of appointment, or a similar feature that would result in total inclusion of the date-of-death value in the gross estate).

11. Planners who don’t mind monitoring the requirements of two sets of tax rules in the same transaction will be intrigued by the possibility of placing a preferred (frozen) interest in a partnership (or LLC) that meets the requirements of section 2701 into a GRAT that meets the requirements of section 2702.

a. This technique is described in Angkatavanich & Yates, “The Preferred Partnership GRAT—A Way Around the ETIP Issue,” 35 ACTEC JOURNAL 289 (2009). In the paradigm addressed in this thoughtful article, the partnership (or LLC) is formed by the prospective grantor’s capital contribution in exchange for the preferred interest and a capital contribution by a GST-tax-exempt generation-skipping trust in exchange for the growth interest in the partnership. The payouts on the preferred interest are structured to be “qualified payments” within the meaning of section 2701(c)(3).

b. Even if the grantor dies during the GRAT term, the underlying appreciation in the partnership growth interest will still escape estate tax.

c. Moreover, the appreciation in the partnership growth interest will be captured in a generation-skipping trust, unlike the typical GRAT.

E. “Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption”

1. This proposal, new in the 2011 Greenbook, is reminiscent of an option presented by the staff of the Joint Committee on Taxation in January 2005. See Part V.A beginning on page 17.

a. Unlike the 2005 option, which would have in effect limited an allocation of GST exemption to one generation, the 2011 Greenbook proposal would limit the duration of GST exemption to 90 years, requiring the inclusion ratio of a trust to reset to zero on the ninetieth anniversary of the creation of the trust.

b. Like the 2005 option, the 2011 Greenbook cites the repeal or limitation of the Rule Against Perpetuities in many states as the occasion for this proposal. The 2005 option would have been harsher than present law under a classical rule against perpetuities, which easily allows transfers to great-great-grandchildren. The current proposal could also be harsher than present law under a classical rule against perpetuities, which would permit some trusts to last longer than 90 years, but it would not be nearly as uneven or arbitrary in that respect.

c. The 2011 Greenbook proposal is also more tailored to the structure of chapter 13.
2. If enacted, the proposal would presumably prompt a lot of distributions to young beneficiaries in 90 years. It is hard to know how to plan for that now (other than to provide trustees with discretion); the entire estate tax is barely 90 years old.

3. The proposal would apply to trusts created after the date of enactment and to additions to trusts made after the date of enactment.

4. Understandably, the proposal to subject all trusts to tax after 90 years is estimated to have only a negligible effect on fiscal 2012-21 revenues.

X. INTERPRETING 2010 ESTATE PLANNING DOCUMENTS

A. In General

1. Many wills and revocable trusts contain references to the Internal Revenue Code and use terminology tied to definitions and other provisions found in the transfer tax provisions of the Code. Many of the bequests under these documents are defined in terms of tax concepts. Common phrases include “maximum marital deduction” and “unified credit amount.” Some estate planning documents may contain some form of interpretational clause related to tax terms, such as:

   Tax-related terms shall be construed in the context of the federal revenue laws in effect at my death.

   If the words and concepts used in a formula to define the size of a bequest are not applicable for federal tax purposes, do they have any meaning in interpreting and administering the estate?

2. If the federal estate tax does not apply, it appears easy to conclude that nothing passes under a provision that leaves to a spouse “…the minimum amount needed to reduce the federal estate tax to zero,” whereas everything would pass to a beneficiary under a provision that leaves to the beneficiary “…the maximum amount that can pass free of federal estate tax.” The problem of interpretation arises when the document also contains words such as “marital deduction” and “unified credit.”

3. Because most estate planners believed that Congress would act before the end of 2009, many documents of decedents who died in 2010 do not contain provisions addressing the possibility that the federal estate tax will not apply.

B. Marital Formulas

1. For a married couple, it is customary for the estate of the first to die to be divided into a Marital Trust and a Family Trust (sometimes called a B Trust, a Credit Shelter Trust, a Bypass Trust, or a Residual Trust) according to a formula under which the Family Trust would be funded with the deceased spouse’s unused exemption and the Marital Trust would receive the balance of the estate. A typical formula would fund the Family Trust first by use of a fraction and contain language such as the following in arriving at the numerator:

   …the largest value of the Trust Assets that can pass free of federal estate tax by reason of the unified credit….
Notice how, with the words “by reason of the unified credit” included, this provision probably produces an amount of zero if the federal estate tax does not apply. If those words (which were arguably superfluous in 2009) were omitted, the provision would probably produce an amount equal to the value of all the Trust Assets.

2. Other documents may create and fund the Marital Trust first and use language such as:

...the lesser of the maximum marital deduction allowable to my estate or the minimum amount necessary to reduce my federal estate taxes to zero.

3. Such formula language can be found in either pecuniary bequests or the numerators of fractional bequests. In the case of fractional bequests, the formula language frequently might define the denominator of the fraction as follows:

The denominator of the fraction shall equal the value of the Trust Assets as finally determined for federal estate tax purposes.

If the federal estate tax does not apply, and therefore there is no federal estate tax audit process, how would that value be determined even if one can clear the hurdle of interpreting the numerator?

C. GST Tax Formulas

1. It is likewise common for dispositions to long-term generation-skipping trusts to be defined with reference to the largest trust that would be exempt from GST tax by reason of the allocation of GST exemption. This can be true of a married person who is setting aside an “exempt marital trust” (perhaps by means of a “reverse QTIP” election), an unmarried person who is allocating assets only among various forms of dispositions to descendants, or a preexisting trust that terminates upon the death of the income beneficiary (typically a surviving spouse) and is allocated among various forms of dispositions to descendants of the grantor or the income beneficiary or both.

2. Unlike a marital formula, a typical formula based on the GST exemption will not dramatically change the disposition among beneficiaries, but will only affect the part of each beneficiary’s share that is held in a tax-advantaged long-term trust.

D. Charitable Formulas

1. Many charitable bequests are phrased in terms of a percentage of the “adjusted gross estate” or have a floor or ceiling based on such a concept. For example, the following would be typical:

I leave $1 million to ABC University, provided in no event shall such amount exceed 10 percent of my adjusted gross estate as computed by subtracting from the entire value of my gross estate as finally determined for federal estate tax purposes the aggregate amount of the deductions actually claimed and allowed to my estate for funeral expenses, debts and claims against my estate, and the costs of administering my estate.

2. For larger estates that take advantage of testamentary charitable lead annuity trust planning, the following language is frequently used:
The Annuity Amount shall be an amount equal to the amount found by (1) multiplying the net fair market value of the assets of the Charitable Trust as of the date of my death by (2) such percentage as shall be required at that time in order to reduce the value of the remainder of the Charitable Trust to zero for federal estate tax purposes.

3. Where there is no spouse and the decedent was charitably inclined, an amount equal to the unused unified credit may have been given to family members, with the residue going to charity. If the federal estate tax does not apply, does charity get the entire estate?

E. Possible Repeal Language in Estate Planning Documents

1. The first and most important step is to examine estate planning documents to determine whether they contain provisions that take into account the possibility of estate tax repeal, such as:

   ...however, if at my death the federal estate tax does not exist or does not apply to my estate, all such assets shall constitute the Family Trust.

Such a provision should work just fine if the federal estate tax does not apply, if the terms of the Family Trust are acceptable to the estate owner and do not accidentally exclude an intended beneficiary. For example, if the surviving spouse is the sole income beneficiary of both the Marital Trust and the Family Trust and can receive discretionary principal distributions, there may be no problem. However, if the Family Trust is for the benefit of children to the exclusion of the surviving spouse, the quoted language would in effect disinherit the spouse and may cause the spouse to file for an elective or statutory share of the estate or to institute legal proceedings to prevent this result.

2. If a document says “if the federal estate tax has been repealed,” would a probate court construe this as applying to the actual (now elective) 2010 law which, although popularly referred to as “repeal,” states only that “[t]his [estate tax] chapter shall not apply to the estates of decedents dying after December 31, 2009”? If so, would “has been repealed” be interpreted after the 2010 Tax Act to include “has been repealed but has since been reinstated”?

F. Possible Savings Provisions in Estate Planning Documents

1. Estate planning documents that do not contain language explicitly addressing estate tax repeal should be examined to determine whether they contain any other form of “savings” clauses. For example, some marital deduction formula provisions contain language such as:

   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.

2. A logical interpretation of this language is that if the estate tax provisions do not apply, there is no gross estate, and if there is no gross estate, no assets are included in a gross estate. Thus all assets are allocated to the Family Trust.

3. A similar result might be reached under a provision directing that property that
does not qualify for the marital deduction shall not be allocated to the Marital Trust, but instead to a Family Trust.

G. Interpretation of Formula Clauses Under State Law

1. The elective inapplicability of the federal estate tax presents unique and complex challenges for fiduciaries. The most significant of these challenges is likely to be the uncertainty in interpreting formula clauses in wills and trusts for decedents dying in 2010, for example, those that divide assets between marital and family or credit shelter shares or trusts or between generation-skipping exempt and non-exempt shares.

2. As discussed above, many formula clauses will be based on tax determinations that will not apply, such as the applicable exclusion amount, unified credit, or GST exemption, and will not address death during the 2010 repeal (which few thought would actually become law). The meaning of these terms is far from certain where the tax concepts are repealed. In addition, formula clauses may have a radically different meaning if the federal estate tax does not apply, and could result in extreme situations such as the total disinheritance of the surviving spouse (and loss of property to which basis may be allocated), or just the opposite, in ways that are contrary to the testator’s intent. Boilerplate provisions related to the marital deduction could also complicate the interpretation of these clauses. The interpretation of formula clauses in many cases will create inheritance “winners” and “losers,” and disappointed heirs may seek to punish fiduciaries on the ground that the fiduciary improperly distributed assets in breach of a fiduciary duty (such as the duty of loyalty and the duty to treat beneficiaries equally). Complex family situations (such as second marriages) will increase the possibility of fiduciary risk in interpreting formula clauses.

3. Some fiduciaries may seek the guidance of the court in dealing with formula clauses. Judicial relief, however, may be affected by limitations on admission of extrinsic evidence of the testator’s intent. Furthermore, the Internal Revenue Service and the federal courts may not feel bound by whatever interpretation is approved by a state court even though the parties themselves are bound under state law, particularly in the rather typical case where the formula is not ambiguous, just unwelcome, and there is no genuine dispute among the parties.

4. In 2010, 19 states and the District of Columbia enacted default rules of construction or other relief for formula clauses that do not expressly contemplate estate tax repeal.

a. In Virginia, for example, House Bill 755 (one of the first in the nation to be drafted) was approved by the House of Delegates by a vote of 97-0 on February 2, 2010, approved by the Senate by a vote of 40-0 on February 24, 2010, and signed into law by the Governor on April 7, 2010. House Bill 755 adds a new section 64.1-62.4 to the Code of Virginia, creating a presumption that tax-sensitive language in wills and trusts throughout 2010 be construed as it would have been construed on December 31, 2009, and permitting a court proceeding to rebut that presumption, as follows:
§ 64.1-62.4. Certain formula clauses to be construed to refer to federal estate and generation-skipping transfer tax laws applicable to estates of decedents dying after December 31, 2009, and before January 1, 2011.

A. A will or trust of a decedent who dies after December 31, 2009, and before January 1, 2011, that contains a formula referring to the “unified credit,” “estate tax exemption,” “applicable exemption amount,” “applicable credit amount,” “applicable exclusion amount,” “generation-skipping transfer tax exemption,” “GST exemption,” “marital deduction,” “maximum marital deduction,” “unlimited marital deduction,” “inclusion ratio,” “applicable fraction,” or any section of the Internal Revenue Code relating to the federal estate tax or generation-skipping transfer tax, or that measures a share of an estate or trust based on the amount that can pass free of federal estate taxes or the amount that can pass free of federal generation-skipping transfer taxes, or that is otherwise based on a similar provision of federal estate tax or generation-skipping transfer tax law, shall be deemed to refer to the federal estate tax and generation-skipping transfer tax laws as they applied with respect to estates of decedents dying on December 31, 2009. This provision shall not apply with respect to a will or trust that is executed or amended after December 31, 2009, or that manifests an intent that a contrary rule shall apply if the decedent dies on a date on which there is no then-applicable federal estate or generation-skipping transfer tax. If the federal estate or generation-skipping transfer tax becomes effective before that date, the reference to January 1, 2011, in this subsection shall refer instead to the first date on which such tax becomes legally effective.

B. The personal representative or any affected beneficiary under the will or other instrument may bring a proceeding to determine whether the decedent intended that the formulae under subsection A be construed with respect to the law as it existed after December 31, 2009. Such a proceeding shall be commenced within 12 months following the death of the testator or grantor.


c. The questions now about such remedial statutes are:

i. Do they still apply now that the federal estate tax has been reinstated retroactively?

ii. Had the federal estate tax “become effective” before the decedent died?
iii. How much can post-death events (like the enactment of federal legislation) affect the construction of an instrument that speaks as of the date of death?

iv. How could anyone who died in 2010 (at least before December) have contemplated a $5 million exemption?

v. Does the federal estate tax still apply if the executor elects out? (Note that the GST tax applies in any event, but with a zero rate.)

d. To address problems like that, on January 20, 2011, State Senator John S. Edwards (D-Roanoke) introduced Senate Bill 1423, to amend § 64.1-62.4 as follows [deleting material struck through and inserting material italicized]:

§ 64.1-62.4. Certain formula clauses to be construed to refer to federal estate and generation-skipping transfer tax laws applicable to estates of decedents dying after December 31, 2009, and before January 1, 2011 in 2010.

A. A will or trust, or other instrument of a decedent who dies after December 31, 2009, and before January 1, 2011, that contains a formula referring to the “unified credit,” “estate tax exemption,” “applicable exemption amount,” “applicable credit amount,” “applicable exclusion amount,” “generation-skipping transfer tax exemption,” “GST exemption,” “marital deduction,” “maximum marital deduction,” “unlimited marital deduction,” “inclusion ratio,” “applicable fraction,” or any section of the Internal Revenue Code relating to the federal estate tax or generation-skipping transfer tax, or that measures a share of an estate or trust based on the amount that can pass free of federal estate taxes or the amount that can pass free of federal generation-skipping transfer taxes, or that is otherwise based on a similar provision of federal estate tax or generation-skipping transfer tax law, shall be deemed to refer to the federal estate tax and generation-skipping transfer tax laws as they applied with respect to estates of decedents dying on December 31, 2009 in 2010 regardless of whether the decedent’s personal representative or other fiduciary elects not to have the estate tax apply with respect to the estate. This provision shall not apply with respect to a will or trust, or other instrument that is executed or amended after December 31, 2009, or that manifests an intent that a contrary rule shall apply if the decedent dies on a date on which there is no then-applicable federal estate or generation-skipping transfer tax. If the federal estate or generation-skipping transfer tax becomes effective before that date, the reference to January 1, 2011, in this subsection shall refer instead to the first date on which such tax becomes legally effective.

B. The personal representative, trustee, other fiduciary, or any affected beneficiary under the will, trust, or other instrument may bring a proceeding to determine whether the decedent intended that the formulæ under subsection A will, trust, or other instrument be construed with respect to the law as it existed after December 31, 2009. Such a proceeding shall be commenced within 12 months following the death of the testator or grantor prior to January 1, 2012. In such a proceeding, the court may consider extrinsic evidence that contradicts the plain meaning of the will, trust, or
other instrument. The court shall have the power to modify a provision of a will, trust, or other instrument that refers to the federal estate tax or generation-skipping transfer tax laws as described in subsection A to (i) conform the terms to the decedent’s intention or (ii) achieve the decedent’s tax objectives in a manner that is not contrary to the decedent’s probable intention. The court may provide that its decision, including any decision to modify a provision of a will, trust, or other instrument shall be effective as of the date of the decedent’s death. A person who commences a proceeding under this section has the burdens of proof, by clear and convincing evidence, and persuasion in establishing the decedent’s intention that the will, trust, or other instrument be construed in a manner other than as provided in subsection A.

C. For purposes of this section, interested persons may enter into a binding agreement to determine whether the decedent intended that the will, trust, or other instrument shall be construed in a manner other than as provided in subsection A, and to conform the terms of the will, trust, or other instrument to the decedent’s intention without court approval as provided in subsection B. Any interested person may petition the court to approve the agreement or to determine whether all interested persons are parties to the agreement, either in person or by adequate representation where permitted by law, and whether the agreement contains terms the court could have properly approved. In the case of a trust, the agreement may be by nonjudicial settlement agreement pursuant to § 55-541.11. “Interested person” means any person whose consent is required in order to achieve a binding settlement were the settlement to be approved by the court.

Senate Bill 1423 was approved by votes of 40-0 in the Senate and 99-0 in the House of Delegates. Governor McDonnell signed it into law on March 26, 2011.

H. Disclaimers and Spousal Elections

1. If the inapplicability of the federal estate tax would cause more of an estate to pass to a surviving spouse than was intended by the decedent, a disclaimer may allow the family to achieve the intended disposition. For example, if an estate plan calls for a Family Trust that benefits only the decedent’s children and a Marital Share that passes outright to the surviving spouse, certain formula division language could result in the Marital Share receiving the full amount of the estate. In a harmonious family, and assuming the appropriate remainder beneficiaries, a disclaimer by the surviving spouse could achieve the result that the decedent presumably intended. The special rule in the 2010 Tax Act extending the time to make a qualified disclaimer for federal tax purposes (see Part VIII.F.4 on page 52) may help, but state law requirements must be consulted also.

2. If the reverse occurs and a formula division results in a Family Trust or other beneficiaries receiving the entire estate and a surviving spouse receiving nothing, a surviving spouse has certain rights under state law (unless waived by premarital or other agreement). In most states, a surviving spouse has the right to take an elective share of the deceased spouse’s estate instead of the share provided in the
The elective share typically ranges from one-third to one-half of the estate. Unless waived, a surviving spouse also has certain automatic rights to a deceased spouse’s retirement benefits.

I. Other Contexts Where Tax Terminology Might Be Used

More difficult still are uses of tax references in documents other than a typical will or revocable trust. For example:

1. Provisions in a GRAT designed to qualify for the marital deduction or give the grantor a general power of appointment if the grantor dies during the GRAT term, but only to the extent the value of the GRAT assets is included in the gross estate.

2. Provisions in a life insurance trust to the same effect if the grantor dies within three years after the transfer of a life insurance policy.

3. Provisions in a buy-sell agreement tying a purchase price to the value of assets for federal estate tax purposes.

4. Provisions in a pre-nuptial agreement promising a bequest defined with reference to the gross estate or other federal estate tax terms.

XI. IMPORTANT AREAS OF PRACTICE BESIDES TRANSFER TAX PLANNING

1. Planning for the disposition of the client’s assets upon death.

2. Asset protection planning.

3. Planning for marital and other dissolutions.

4. Planning for physical disability.

5. Planning for legal incapacity.


7. Using business entities to accomplish non-tax objectives.

8. Charitable giving (for its own sake, and for income tax reasons).

9. Retirement planning.


11. Fiduciary litigation.

12. Planning for clients with property in more than one state, including ownership, asset protection, state taxation, and probate issues (in addition to state estate tax).


15. Planning for U.S. citizens or resident aliens who own property in other countries.

16. Planning for nonresident aliens with assets in the United States or who plan to move to the United States.

17. Planning for clients who intend to change their citizenship.
18. Planning to live with non-tax regulatory regimes, including Sarbanes-Oxley, the Patriot Act, HIPAA, Dodd-Frank, and charitable governance reform.

XII. PENDING ADMINISTRATIVE GUIDANCE

A. Distractions of the Current Legislative Environment

It is obvious that the environment of long legislative uncertainty followed by abrupt and dramatic action has been as challenging for those who administer the tax laws and provide guidance to taxpayers as it has been to taxpayers and their advisors. The following are examples of the administrative guidance that is required or desirable.

1. Dealing with 2010 Decedents (without regard to the 2010 Tax Act)
   a. The mechanics for reporting basis and allocating basis increases under sections 1022(b) and (c) and 6018. See Part VIII.C.2.c on page 39. [Addressed in part by Notice 2011-66. Still need Form 8939.]
   b. The availability of basis increases for assets that have been sold or distributed. [Addressed favorably by Rev. Proc. 2011-41.]
   c. Default rules if no allocations (or incomplete allocations) are made.
   d. De minimis rules.
   e. Reliance on reasonable estimates of purchase prices.
   f. The documentation needed when basis increases produce a basis that is clearly far less than the fair market value of an asset.
   g. The due date for reports of basis and allocations of basis increases. [January 17, 2012, according to Notice 2011-76.]
   i. The effect of the carryover basis rules on holding periods. [Tacking of decedent's holding period confirmed by Rev. Proc. 2011-41.]

2. Dealing with 2010 Decedents and Transfers (after the 2010 Tax Act)
   a. The time and manner for electing out of estate tax (and into the modified carryover basis regime) in the case of a decedent dying in 2010. [Generally addressed by Notice 2011-66, pending release of Form 8939.]
   b. The manner of taking advantage of the extensions of time provided by the 2010 Tax Act, including
      i. the specialized information to be reported and any annotations to be made on the affected returns,
      ii. the application of Reg. § 25.2518-2(c)(2) in the case of disclaimers, and
      iii. clarification of whether those extended due dates may themselves be extended in the usual way. [Resolved, with respect to estate tax returns for decedents who died in 2010, by Notice 2011-76.]
c. Announcement of a one-time policy of administrative forbearance in the form of relaxed enforcement with respect to various self-help measures that may have been employed, in the absence of guidance, to deal with the uncertainties created by 2010 law (before the 2010 Tax Act) and by the abrupt enactment of the 2010 Tax Act.

i. Examples of such extraordinary measures include formula gifts, disclaimers, rescissions, judicial reformations, non-judicial settlements, spousal elections, and the enactment of, construction of, and reliance on remedial state statutes.

ii. With regard to rescissions, the cases most often cited are Breakiron v. Gudonis, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010) (recognizing rescission of a disclaimer from a QPRT on the basis of a mistake of law as to the timeliness of the disclaimer); Neal v. United States, 187 F.3d 626 (3rd Cir. 1999) (recognizing rescission of the release of a retained interest to avoid triggering former section 2036(c), which was later repealed retroactively); and Berger v. United States, 487 F. Supp. 49 (W.D. Pa. 1980) (recognizing reformation of a trust unnecessarily made irrevocable).

iii. The unintended and unwelcome consequences of such actions, which the announcement should relieve, could include disregard of the action, an indefinite marital or charitable bequest, gift or income tax consequences to beneficiaries viewed as redirecting or exchanging their interests, and uncertainty about the GST tax status of a trust.

d. Confirmation that GST exemption may be allocated to testamentary transfers in 2010 even if the executor elects out of estate tax. See Part VIII.E.5.c on page 51. [Confirmed by Notice 2011-66.]

3. Dealing with Portability

a. The mechanics of electing portability of the exemption when a married person dies on or after January 1, 2011, including

i. whether there will be a simplified estate tax return for the purpose of making the election, especially for small or “all to spouse” estates,

ii. who the “executor” is who can make the election when there is little or no property for a statutory executor under section 2203 to “possess,” and

iii. the extent to which the election may be deemed made (which, after ten years of difficulties, was the resolution regarding the QTIP election enacted in 1981). [Addressed favorably by Notice 2011-82 and the instructions for the 2011 estate tax return, but only for the case where an estate tax return is filed.]

b. The calculation, in general, of the portable deceased spousal unused exclusion amount in the case of remarriage. See Part VIII.H.4 on page 60.

c. The manner of using the portable deceased spousal unused exclusion amount
for gift tax purposes, including

i. the ordering of the use of the predeceased spouse’s unused exclusion amount and the donor spouse’s own basic exclusion amount, and

ii. the operation of the limit on portability if a surviving spouse uses the deceased spousal unused exclusion amount for lifetime gifts and then, having remarried, is widowed again and receives still more deceased spousal unused exclusion amount.

4. Dealing with Other Issues Going Forward
   a. The scope of new section 2001(g), and the last sentence of section 2505(a), relating to the treatment of previous gifts for both gift and estate tax purposes. [Addressed appropriately in the 2010 gift tax return.]
   b. The effect of any possible decrease in the estate tax applicable exclusion amount on the calculation of the gift tax that “would have been payable” for purposes of section 2001(b)(2) (the “claw back” issue). See Part VIII.G.5 beginning on page 54.
   c. The treatment for GST tax purposes after 2012, if Congress does not change the law, of trusts to which GST exemption was allocated under provisions of EGTRRA, including the effect of (i) previous allocations of GST exemption in excess of the 2013 GST exemption, (ii) deemed allocations under section 2632(c), (iii) elections in and out of automatic allocations under section 2632(c)(5), (iv) retroactive allocations in the case of the death of a non-skip person under section 2632(d), (v) late allocations pursuant to “9100 relief” under section 2642(g), and (vi) qualified severances under section 2642(a)(3).

B. Treasury-IRS Priority Guidance Plan

The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2011, was released on September 2, 2011. The Plan lists the following 17 projects under the heading of “Gifts and Estates and Trusts”:

1. Regulations under §67 regarding miscellaneous itemized deductions of trusts and estates.
   a. Section 67, added to the Code in 1986, is the source of the limitation of “miscellaneous itemized deductions” to 2 percent of adjusted gross income. In the case of an estate or trust, section 67(e)(1) exempts from the 2 percent floor “costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.”
   b. This project, which first appeared in the 2006-07 Priority Guidance Plan, addresses the conflict between O'Neill Irrevocable Trust v. Commissioner, 994 F.2d 302 (6th Cir. 1993) (holding that section 67(e)(1) exempts the investment advice expenses of multi-generation trusts) and the opposite holdings in Mellon Bank v. United States, 265 F.3d 1275 (Fed. Cir. 2001), Scott v. United States, 328 F.3d 132 (4th Cir. 2003), and William L. Rudkin

i. In Mellon, the Federal Circuit court stated that section 67(e)(1) “treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts.” 265 F.3d at 1281. Nevertheless, the court rested its conclusion merely on the observation that “[i]nvestment advice and management fees are commonly incurred outside of trusts.” Id.

ii. In Scott (in which the author of this outline participated), the Fourth Circuit quoted the reference to “unique” expenses in Mellon, but immediately added that “[p]ut simply, trust-related administrative expenses are subject to the 2 percent floor if they constitute expenses commonly incurred by individual taxpayers.” 328 F.3d at 140.

iii. In Rudkin, Judge (now Justice) Sotomayor wrote (emphasis added):

While the Federal and Fourth Circuits’ approach properly focuses the inquiry on the hypothetical situation of costs incurred by individuals as opposed to trusts, that inquiry into whether a given cost is “customarily” or “commonly” incurred by individuals is unnecessary and less consistent with the statutory language. We believe the plain text of § 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual. We therefore hold that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner.

c. Published on July 26, 2007, when that Second Circuit articulation was the most recent word on the subject, the proposed regulations (REG-128224-06) would apply the 2 percent floor to all expenses of an estate or trust except expenses that are “unique” to an estate or trust. An expense is considered “unique” only if “an individual could not have incurred that cost in connection with property not held in an estate or trust.”

i. As “unique” fiduciary activities, the cost of which is fully deductible, the proposed regulations cite fiduciary accountings, required judicial filings, fiduciary income tax returns, estate tax returns, distributions and communications to beneficiaries, will or trust contests or constructions, and fiduciary bonds.

ii. As examples of services that are not “unique” to a trust or estate, the costs of which are subject to the 2 percent floor, the proposed regulations cite the custody and management of property, “advice on investing for total return,” preparation of gift tax returns, defense of claims by creditors of the grantor or decedent, and the purchase, sale, maintenance, repair, insurance, or management of property not used in a trade or business.
iii. The proposed regulations would require the “unbundling” of unitary fiduciary fees or commissions, so as to identify the portions attributable to activities and services that are not “unique” and are therefore subject to the 2 percent floor. For example, under this proposed approach, if 30 percent of a trustee’s fee is allocable to fiduciary bonds and accountings, fiduciary income tax returns, and distributions and communications to beneficiaries, while 70 percent of the fee is allocable to custody, management, and investment advice, then only 30 percent of the fee will be fully deductible as an “above-the-line” expense, and the other 70 percent will be deductible only to the extent it exceeds 2 percent of the trust’s equivalent of “adjusted gross income.” Under section 67(e), the “adjusted gross income” of a trust is calculated after allowable charitable deductions, distribution deductions, and the above-the-line deductions of any “unique” expenses. Often fiduciary fees subject to the 2 percent floor will not be deductible, and that will effectively increase the cost of these fiduciary services.

d. The phrase “advice on investing for total return,” as an example of a service that is not unique to an estate or trust, has generated a lot of speculation.

i. The litigated cases have included the taxpayers’ argument that the demands of the duty of prudent investment and the duty of impartiality distinguish investment advice to a fiduciary from investment advice to an individual, especially in the context of a multi-generation trust. Thus, the specific reference to the “total return” that is an element of prudent investment might be read as an explicit repudiation of that argument.

ii. On the other hand, it could be read as an acknowledgment that advice on investing not just to get richer (“total return”) but to help a fiduciary balance successive interests (often expressed as interests in “income” and “principal”) really is different – maybe even “unique.” If that is the way the final regulations are clarified, then an effort to create a modern, flexible trust that minimizes the role of archaic concepts of “income” and “principal” might be penalized with higher income taxes. That would not be the first irony in tax law, but it is sure to be one of the most widely discussed.

e. On January 16, 2008, a unanimous opinion by Chief Justice Roberts affirmed the Second Circuit and held that a trustee’s investment advisory fees are subject to the 2 percent floor.

i. Nevertheless, rejecting the notion (apparently entertained by the Second Circuit) that “would not” means “could not,” (128 S. Ct. at 787), the Court seemed more inclined to the tests employed by the Federal Circuit in Mellon Bank and the Fourth Circuit in Scott.

ii. In addition, references in the Supreme Court’s Knight opinion to “a somewhat ambiguous exception,” “uncertainty,” and “the absence of regulatory guidance” seem to leave the door open for Treasury to

f. As proposed, the regulations would apply to “payments made after the date final regulations are published in the Federal Register.” Proposed Reg. § 1.67-4(d). The Service received written comments about the proposed regulations and held a public hearing on November 14, 2007.

g. On February 27, 2008, the Service issued Notice 2008-32, 2008-11 I.R.B. 593, providing, among other things, that comments on the proposed regulations would continue to be welcome through May 27, 2008, but that meanwhile fiduciaries would not be required to “unbundle” a unitary fiduciary fee on 2007 income tax returns.


i. On April 1, 2010, the Service released Notice 2010-32, 2010-16 I.R.B. 594, extending the same relief from unbundling to 2009 returns. It is possible that the final regulations on the application of the 2 percent floor to trusts were near completion before the end of 2009 and that the IRS did not expect to extend this relief for another year. If so, this may be another example of how the inability of Congress to act before the end of 2009 to stabilize the estate tax law for 2010 created a distraction.

j. On April 13, 2011, the Service released Notice 2011-37, 2011-20 I.R.B. 785, again extending the relief from unbundling. As a departure from the practice of past years, however, Notice 2011-37 does not provide just one more annual extension, that is, for 2010 returns. This time, the extension applies to all “taxable years that begin before the date that the final regulations are published.” In effect, this is at least a two-year extension, because it applies not just to returns for 2010, but also to returns for 2011, which has already begun without final regulations. Put another way, under Notice 2011-37, when final regulations are issued, any “unbundling” requirement will not be applied retroactively to any year that has already begun.

k. On September 6, 2011, the Internal Revenue Service withdrew the 2007 proposed regulations and released new proposed regulations.

i. Adopting a *Mellon-Scott-Knight* formulation, new Proposed Reg. § 1.67-4(a) would provide that a miscellaneous itemized deduction of an estate or non-grantor trust is subject to the 2 percent floor if it “commonly or customarily would be incurred by a hypothetical individual holding the same property.” Examples, in Proposed Reg. § 1.67-4(b)(1), are “costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust.” Other examples, in Proposed Reg. § 1.67-4(b)(2), are “ownership costs” that attach to a particular asset,
such as “condominium fees, real estate taxes, insurance premiums, maintenance and lawn services, automobile registration and insurance costs, and partnership costs deemed to be passed through to and reportable by a partner.”

ii. Under Proposed Reg. § 1.67-4(b)(3), the costs of preparing tax returns would be characterized with reference to the type of return. The costs of individual income tax and gift tax returns, as well as tax returns for a sole proprietorship or a retirement plan, are generally viewed as “costs commonly and customarily incurred by individuals and thus ... subject to the 2-percent floor.” But the costs of returns that by their nature are filed only by executors or trustees are not subject to the 2 percent floor, including estate and GST tax returns and fiduciary income tax returns, of course, but also including a decedent’s final income tax return.

iii. Under Proposed Reg. § 1.67-4(b)(4), the cost of investment advice would continue to be subject to the 2 percent floor. There is an exception, a variation of the last paragraph of the Supreme Court’s Knight opinion, for “special” investment advice “attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen).”

iv. Proposed Reg. § 1.67-4(c)(1) would retain the requirement for single fees to be “unbundled” into components that are subject to the 2 percent and components that are not, except that, under Proposed Reg. § 1.67-4(c)(2), if the fee “is not computed on an hourly basis,” only the investment advice component would have to be unbundled, by “[a]ny reasonable method.” Payments made out of the bundled fee to third parties, or fees assessed on top of the bundled fee, for services subject to the 2 percent floor would also have to be accounted for separately.

v. The Notice of Proposed Rulemaking invites public comments by early December and announces a public hearing scheduled for December 19, 2011. Proposed Reg. § 1.67-4(d) provides that the regulations will apply to taxable years beginning on or after the date that the final regulations are published in the Federal Register.

2. Final regulations under §642(c) concerning the ordering rules for charitable payments made by a charitable lead trust. Proposed regulations were published on June 18, 2008.

a. This project first appeared in the 2007-08 Priority Guidance Plan.

b. Proposed Reg. §§ 1.642(c)-3(b)(2) & 1.643(a)-5(b) (REG-101258-08) would allow provisions in the governing instrument of an estate or trust that specify the source from which income amounts are to be paid to charities to be respected for federal tax purposes only when the provisions have “economic effect independent of income tax consequences” – that is, apparently only if those provisions affect the amount that is paid to charity. In the absence of
effective specific provisions in the governing instrument or in local law, the
amount of income distributed to each charitable beneficiary will consist of
the same proportion of each class of items of income of the estate or trust as
the total of each class bears to the total of all classes.

c. The proposed regulations provide no example (and in an annuity or unitrust
context it is hard to think of one) of an ordering regime that affects the
amount that is paid to charity. Thus, the proposed regulations are in
substance a prohibition.

d. Although the proposed regulations themselves do not include an effective
date, the preamble to the notice of proposed rulemaking states that “[t]he
regulations, as proposed, apply to trusts and estates for taxable years
beginning after the date final regulations are published in the Federal
Register.”

i. It is not explicitly stated whether and how the regulations would apply to
existing irrevocable trusts, but the preamble expresses the belief of the
IRS and Treasury, based on “the structure and provisions of Subchapter J
as a whole” and supported by a chain of references and cross-references,
that the result in the proposed regulations is already required by the law
and regulations.

ii. When publishing sample charitable lead unitrust forms in July 2008, the
Service stated: “A provision in the governing instrument of a charitable
lead trust that provides for the payment to charity to consist of different
classes of income determined on a non pro rata basis will not be
respected because such a provision does not have economic effect
independent of the income tax consequences of the payment. See
§1.642(c)-3(b)(2) and (3).” Rev. Proc. 2008-45, 2008-30 I.R.B. 224, §
5.02(10); Rev. Rul. 2008-46, 2008-30 I.R.B. 238, § 5.02(10).

e. These rules are to be distinguished from the ordering rules (sometimes
unflatteringly described as “worst-in-first-out”) mandated by section 664(b)
and applied within statutory classes with explicit reference to tax rates under
Reg. § 1.664-1(d). Those ordering rules apply to distributions to
noncharitable beneficiaries from charitable remainder trusts. By statute, the
treatment of charitable remainder trusts and charitable lead trusts is not
symmetrical in this respect.

3. Guidance concerning adjustments to sample charitable remainder trust forms
under §664.

a. This project was new in the 2008-09 Priority Guidance Plan.

b. When it published sample charitable lead unitrust forms in Rev. Proc. 2008-
Service completed a round of sample forms for various split-interest trusts.

c. Now the Service apparently intends to go over its work again, to reflect
updates in the law, practice, and thinking, at least with respect to charitable
remainders. (The 2011-12 Plan adds the word "remainder," which had been implicit by the reference to section 664 anyway.)

4. Guidance concerning private trust companies under §§671, 2038, 2038, 2041, 2042, 2511, and 2601.

a. Privately owned and operated trust companies are becoming an option that families with large trusts are turning to in increasing numbers, and state law authority for such private trust companies is being continually refined.

b. The description of this topic might be significant.

i. When this project first appeared, on the 2004-05 Priority Guidance Plan, it was described as “Guidance regarding family trust companies.”

ii. On the 2005-06, 2006-07, and 2007-08 Priority Guidance Plans, it was described as “Guidance regarding the consequences under various estate, gift, and generation-skipping transfer tax provisions of using a family-owned company as the trustee of a trust.” The omission of income tax issues from that formulation was a source of concern, because income tax issues have frequently been addressed in the relevant letter rulings. Indeed, in the first such letter rulings, Letter Rulings 9841014 and 9842007 (July 2, 1998), the only issue was whether a family-owned trust company was a “related or subordinate party” with respect to the living grantors of various trusts, within the meaning of section 672(c), an income tax rule.

iii. On the 2008-09 and 2009-10 Priority Guidance Plans, the description was a more comprehensive and reassuring “Revenue ruling regarding the consequences under various income, estate, gift, and generation-skipping transfer tax provisions of using a family-owned company as a trustee of a trust. A proposed Rev. Rul. was published on August 4, 2008.”

iv. That reassurance regarding comprehensive treatment is maintained in the current Priority Guidance Plan by the listing of the Code sections that were addressed in the proposed Revenue Ruling.

v. Dropping the reference to the proposed Revenue Ruling might indicate that Treasury and the IRS are reviewing the basic approach of the proposed Revenue Ruling, which attracted a large number of diverse public comments.


d. The proposed revenue ruling addresses five tax issues faced by trusts of which a private trust company serves as trustee:

i. Inclusion of the value of trust assets in a grantor’s gross estate by reason of a retained power or interest under section 2036 or 2038.

ii. Inclusion of the value of trust assets in a beneficiary’s gross estate by
reason of a general power of appointment under section 2041.

iii. Treatment of transfers to a trust as completed gifts.

iv. Effect on a trust’s status under the GST tax either as a “grandfathered” trust or as a trust to which GST exemption has been allocated.

v. Treatment of a grantor or beneficiary as the owner of a trust for income tax purposes.

While these are not the only issues that the use of private trust companies can present, these are the most common issues. It is especially encouraging to see grantor trust treatment addressed, in view of the omission of income tax from the formulation of this project on the current Priority Guidance Plan.

e. The proposed revenue ruling posits several trusts, illustrating both the creation of new trusts and the introduction of a private trust company as a trustee of an old trust. The trusts have the following features:

i. The trustee has broad discretionary authority over distributions of both income and principal.

ii. Each successive primary beneficiary has a broad testamentary power of appointment (although not as broad as a power to appoint to anyone in the world other than the beneficiary’s estate, creditors, and creditors of the estate).

iii. The grantor or primary beneficiary may unilaterally appoint (but not remove) trustees, with no restrictions other than on the ability to appoint oneself.

f. The proposed revenue ruling presents two situations – Situation 1, in which the private trust company is formed under a state statute with certain limitations, and Situation 2, in which the private trust company is formed in a state without such a statute but comparable limitations are included in the governing documents of the private trust company itself.

g. The basic premise of the proposed revenue ruling, as stated in the second paragraph of Notice 2008-63, is:

The IRS and the Treasury Department intend that the revenue ruling, once issued, will confirm certain tax consequences of the use of a private trust company that are not more restrictive than the consequences that could have been achieved by a taxpayer directly, but without permitting a taxpayer to achieve tax consequences through the use of a private trust company that could not have been achieved had the taxpayer acted directly. Comments are specifically requested as to whether or not the draft revenue ruling will achieve that intended result.

h. Consistently with this basic premise, the proposed revenue ruling provides that the hypothetical private trust companies it addresses generally avoid tax problems by the use of certain “firewall” techniques. For example:

i. A “Discretionary Distribution Committee” (“DDC”) with exclusive
authority to make all decisions regarding discretionary distributions. Anyone may serve on the DDC, but no member of the DDC may participate in the activities of the DDC with respect to a trust of which that DDC member or his or her spouse is a grantor or beneficiary, or of which the beneficiary is a person to whom that DDC member or his or her spouse owes an obligation of support.

ii. In Situation 2, an “Amendment Committee” with exclusive authority to amend the relevant sensitive limitations in the private company’s governing documents (which are imposed by statute in Situation 1). A majority of the members of the Amendment Committee must be individuals who are neither members of the relevant family nor persons related or subordinate (within the meaning of section 672(c)) to any shareholder of the company.

i. A paragraph near the end of the proposed revenue ruling identifies three factual details that are not material to the favorable tax conclusions, explicitly confirming that the conclusions would not change if those details changed. No doubt the public comments on the proposed revenue ruling will point out other factual details of uncertain materiality. Some likely examples (not exhaustive):

i. The designation of a “primary beneficiary” of each trust, possibly excluding so-called “pot” or “sprinkle” trusts.

ii. The assumed requirement of an independent “Discretionary Distribution Committee” for each trust administered by the private trust company, possibly excluding a differently conceived body with a similar effect, a different committee for different trusts, and any exception for trusts for customers other than family members administered by family-owned trust companies that offer fiduciary services to the public.

iii. The explicit prohibition of certain express or implied reciprocal agreements regarding distributions, possibly excluding such prohibitions derived from general fiduciary law.

5. Regulations under §1014 regarding uniform basis of charitable remainder trusts.

a. This project was new in the 2008-09 Priority Guidance Plan, where, as in the 2009-10 Priority Guidance Plan, it was described as “Guidance under §643 regarding uniform basis rules for trusts.”

b. Reg. §§ 1.1014-4 & -5 provide that the basis of property held in trust or otherwise shared by holders of term and remainder interests is apportioned among the beneficial interests in proportion to the actuarial value of the interests. Section 1001(e) and Reg. § 1.1001-1(f) provide that when an interest in property for life or a term of years or an income interest in property in a trust is sold, its basis is generally disregarded, unless the sale is a part of a transaction in which the entire interest in property is transferred.

c. It is likely that this guidance project is intended to address the results when
the income and remainder beneficiaries of a charitable remainder trust sell their respective interests in a coordinated sale designed to circumvent the rules governing commutation of CRT interests.

d. Notice 2008-99, 2008-47 I.R.B. 1194, effective October 31, 2008, described this type of transaction and stated that “the IRS and Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on the sale or other disposition of appreciated assets.” Accordingly, the Notice identified this type of transaction as a reportable “transaction of interest” for purposes of sections 6111 and 6112 and Reg. § 1.6011-4(b)(6).

e. In Rev. Proc. 2010-3, 2010-1 I.R.B. 110, §4.01(39), the Service identified “[w]hether the termination of a charitable remainder trust before the end of the trust term as defined in the trust’s governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, causes the trust to have ceased to qualify as a charitable remainder trust within the meaning of §664” as an area “in which rulings or determination letters will not ordinarily be issued.” Rev. Proc. 2011-3, 2011-1 I.R.B. 111, §4.01(39) is the same.


   b. The rest of the needed guidance, then, will await the publication of Form 8939 and its instructions. See Part XII.A.1 on page 83.

7. Guidance on portability of Unified Credit between spouses under §2010(c).

   See Part VIII.H beginning on page 58 and Part XII.A.3 beginning on page 84.

8. Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on April 25, 2008.

   a. This first appeared in the 2007-08 Priority Guidance Plan.

   b. The preamble to the proposed regulations, Proposed Reg. § 20.2032-1(f) (REG-112196-07), appears to view these regulations as the resolution of “[t]wo judicial decisions [that] have interpreted the language of section 2032 and its legislative history differently in determining whether post-death events other than market conditions may be taken into account under the alternate valuation method.”

   c. In the first of these cases, Flanders v. United States, 347 F. Supp. 95 (N.D. Calif. 1972), after a decedent’s death in 1968, but before the alternate valuation date, the trustee of the decedent’s (formerly) revocable trust, which held a one-half interest in a California ranch, entered into a land conservation agreement pursuant to California law.
The conservation agreement reduced the value of the ranch by 88 percent. Since that reduced value was the value of the ranch at the alternate valuation date (which until 1971 was one year after death), the executor elected alternate valuation and reported the ranch at that value.

Citing the Depression-era legislative history to the effect that alternate valuation was intended to protect decedents’ estates against “many of the hardships which were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distribution to the beneficiaries,” the court held that “the value reducing result of the post mortem act of the surviving trustee” may not be considered in applying alternate valuation.

d. The second of these cases was *Kohler v. Commissioner*, T.C. Memo 2006-152, *nonacq.*, 2008-9 I.R.B. 481, involving the estate of a shareholder of the well-known plumbing fixture manufacturer. The executor had received stock in a tax-free corporate reorganization that had been under consideration for about two years before the decedent’s death but was not completed until about two months after the decedent’s death.

i. The court rejected the Service’s attempt to base the estate tax on the value of the stock surrendered in the reorganization (which had been subject to fewer restrictions on transferability), on the ground that Reg. § 20.2032-1(c)(1) prevents that result by specifically refusing to treat stock surrendered in a tax-free reorganization as “otherwise disposed of” for purposes of section 2032(a)(1).

ii. The court also noted that the exchange of stock must have been for equal value or the reorganization would not have been tax-free as the parties had stipulated (although, ironically, the executor’s own appraiser had determined a value of the pre-reorganization shares of $50.115 million and a value of the post-reorganization shares of $47.010 million – a difference of about 6.2 percent). The court distinguished *Flanders*, where the post-death transaction itself reduced the value by 88 percent.

iii. The Tax Court in *Kohler* viewed the 1935 legislative history relied on in *Flanders* as irrelevant, because Reg. § 20.2032-1(c)(1) (promulgated in 1958) was clear and unambiguous and because “the legislative history describes the general purpose of the statute, not the specific meaning of ‘otherwise disposed of’ in the context of tax-free reorganizations.”

e. The proposed regulations make no change to Reg. § 20.2032-1(c)(1), on which the *Kohler* court relied. But they invoke “the general purpose of the statute” that was articulated in 1935, relied on in *Flanders*, and bypassed in *Kohler* to beef up Reg. § 20.2032-1(f), to clarify and emphasize, with both text and examples, that the benefits of alternate valuation are limited to changes in value due to “market conditions.”

f. While the proposed regulations have been referred to as the “anti-*Kohler* regulations,” their most significant impact will be felt by efforts to bootstrap
an estate into a valuation discount by distributing or otherwise disposing of a minority or other noncontrolling interest within the six-month period after death (valuing it as a minority interest under section 2032(a)(1)) and leaving another minority or noncontrolling interest to be valued six months after death (also valued as a minority interest under section 2032(a)(2)).

i. Section 2032(a)(3) prevents the use of alternate valuation in the case of changes in value resulting from the “mere lapse of time,” but Reg. § 20.2032-1(f) illustrates that exception only with reference to life estates, remainders, reversions, and similar interests, as well as patents, and Reg. § 20.2032-1(f)(1) contains only a passing non-proscriptive reference to a decline in value “because of economic conditions.”

ii. The proposed regulations specifically add “post-death events other than market conditions” to “mere lapse of time.”

iii. Examples 4 and 5 of Proposed Reg. § 20.2032-1(f)(3)(ii) specifically address the discount-bootstrap technique – Example 4 in the context of a limited liability company and Example 5 in the context of real estate – and leave no doubt that changes in value due to “market conditions” do not include the valuation discounts that might appear to be created by partial distributions. Example 3 reaches the same result with respect to the post-death contribution of estate property to a limited partnership.

g. When finalized, the regulations are proposed to be effective April 25, 2008, the date the proposed regulations were published.

9. Final regulations under §2036 regarding graduated grantor retained annuity trusts. Proposed regulations were published on April 30, 2009.

a. Item 8 in the 2007-08 Priority Guidance Plan was entitled “Final regulations under sections 2036 and 2039 regarding the portion of a split-interest trust that is includible in a grantor’s gross estate in certain circumstances in which the grantor retains an annuity or other payment for life.”

i. Although a reference to “split-interest” trusts typically brings to mind a charitable remainder trust, the estate tax charitable deduction usually diminishes the importance of estate inclusion in the case of a CRT.

ii. The more interesting question, of course, is presented by a grantor retained annuity trust (GRAT), where there can be a large difference, for example, between the present value of the unpaid annuity amounts, the amount needed to generate the prescribed annuity without depleting the principal (cf. Rev. Rul. 82-105, 1982-1 C.B. 133, describing the portion of a CRT that is included in the gross estate), and the entire value of the trust assets that the Service has viewed as included in the gross estate under section 2039 (Letter Ruling 9345035; Technical Advice Memorandum 200210009).

b. Proposed regulations (REG-119097-05) were published in the Federal Register on June 7, 2007, taking the relatively welcome position that the
Service will apply section 2036 and will refrain from applying section 2039. Final regulations, Reg. §§ 20.2036-1(c) & 20.2039-1(e), T.D. 9414, published on April 23, 2008, took the same view.

c. Under the new regulations, the amount includible in the gross estate with respect to a retained interest in trust is the amount needed to generate the retained interest without invasion of principal – that is, in perpetuity – up to the entire date-of-death value of the trust assets. Reg. § 20.2036-1(c)(2)(i). In the case of a GRAT, this will usually result in inclusion of the entire value of the assets, unless the assets have increased enormously in value.

d. The preamble to the 2008 final regulations revealed that Treasury and the Service considered and rejected the argument that section 2036 is not applicable to a retained annuity interest in a GRAT to the extent the annuity is not payable from trust income. This argument was made in Whitty, “Repercussions of Walton: Estate Tax Inclusion of GRAT Remainders,” PROBATE & PROPERTY, May/June 2005, at 13; and Whitty, “Heresy or Prophecy: The Case for Limiting Estate Tax Inclusion of GRATs to the Annuity Payment Right,” 41 REAL PROP., PROBATE & TR. J. 381 (Summer 2006). Although the argument was viewed as aggressive by some estate planners, it resulted in the deletion from many GRAT forms of directions such as to pay the annuity amounts “from income and, to the extent that income is not sufficient, from principal,” in order to preserve the opportunity to make the argument if the occasion arises. Under the regulations, it is likely that the result is the same whether the annuity is paid from income or principal, because the regulation looks only to the generic amount of the annuity. See Reg. § 20.2036-1(c)(2)(i) & (iii), Example 2. Nevertheless, it is unlikely that such directions (which do not have much substantive effect either) will be reinstated in GRAT forms.

e. The proposed regulations offered one GRAT example, which is retained in the final regulations. Reg. § 20.2036-1(c)(2)(iii), Example 2. But unlike most GRATs, the GRAT in the example

i. runs for the shorter of the stated term or the grantor’s life, not as a Walton-style GRAT, running for a fixed term with annuity payments directed to the grantor’s estate if the grantor dies during the term;

ii. is not graduated (that is, does not include an annual increase in the annuity, which, if paid in perpetuity, will always exhaust the GRAT if the graduation rate – usually 20 percent – exceeds the 7520 rate);

iii. provides for monthly, not annual, GRAT payments;

iv. continues for ten years, relatively long as GRATs go; and

v. produces a relatively high taxable gift, about 14 percent of the initial value transferred to the GRAT (for a 60-year-old grantor in June 2007).

The final regulations added a statement to the example that the calculation of the amount included in the gross estate is the same for a fixed term as for a
term ending on the earlier of a fixed date or the grantor’s death. The preamble to the final regulations acknowledged that an example using a graduated GRAT would be helpful and appropriate, but stated that the issue requires further consideration. This current project is the result.

f. Proposed regulations (REG-119532-08) pursuant to this project were published in the Federal Register on April 30, 2009.

i. Proposed Reg. § 20.2036-1(c)(2)(ii) provides that, in the case of a graduated GRAT, the amount includible with respect to the amount payable for the year of the decedent’s death (called the “base amount”) is the amount required to make that payment in perpetuity. (This is the same as the rule under the current regulations.) The additional amount includible with respect to each annual increment in future years (called the “periodic addition” for each year) is the amount required to make that incremental payment in perpetuity, discounted for the passage of time before that increment takes effect. The total amount includible in the gross estate is the sum of the base amount and all the periodic additions, but not to exceed the total fair market value of the trust property on the date of the decedent’s death.

ii. The new proposed regulations also provide rules for valuing the annuity payments when those payments are paid for the joint lives of the decedent and another recipient, or to the decedent following the life of another recipient.

iii. The new regulations are proposed to be effective when final regulations are published in the Federal Regulations.

10. Revenue ruling on whether a grantor’s retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor’s gross estate under §2042.

a. This project first appeared on the 2009-10 Priority Guidance Plan. The 2011-12 Plan is the first to specify that the contemplated guidance will be a revenue ruling.

b. Such a power of substitution is often used to make a trust a grantor trust under section 675(4)(C).

c. In Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), acq., 1977-1 C.B. 1, the Tax Court held that a grantor’s power to reacquire an insurance policy from a trust and substitute other property of equal value was not the retention of incidents of ownership in the policy and therefore did not bring the insurance proceeds into the insured’s gross estate under section 2038 or 2042.

d. Rev. Rul. 2008-22, 2008-16 I.R.B. 796, cited Jordahl and ruled as follows:

A grantor’s retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the
grantor’s gross estate under §2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust’s investments or the level of income produced by any or all of the trust’s investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

e. Because the inclusion of life insurance in the gross estate is governed by section 2042, not section 2036 or 2038, the insured’s right, in effect, to withdraw an insurance policy from a trust for equivalent value is not directly addressed by Rev. Rul. 2008-22. This project appears to be intended to fill that gap.

11. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

12. Revenue procedure providing procedures for filing protective claims for refunds for amounts deductible under §2053.

a. Items 11 and 12 were new in the 2008-09 Priority Guidance Plan (although the 2011-12 Plan is the first to specify that the contemplated guidance regarding protective claims will be a revenue procedure). Both projects are outgrowths of the project that led to the final amendments of the section 2053 regulations in October 2009.

b. The part of project 11 relating to “present value concepts” is evidently aimed at the leveraged benefit obtained when a claim or expense is paid long after the due date of the estate tax, but the additional estate tax reduction is credited as of, and earns interest from, that due date.

i. If this project results in a deduction of only the present value of the payment, as of the due date of the tax, and the discount rate used in the calculation of the present value is the same as the rate of interest on the tax refund, and the interest is not subject to income tax (or the discount rate is also reduced by the income tax rate), then the invocation of “present value concepts” might make very little difference on paper. But it might require legislation to accomplish all these things.

ii. Since claims or expenses are rarely paid exactly on the due date of the tax, the precise application of such principles might be exceedingly complicated. Presumably that is not intended.
13. Notice on decanting of trusts under §§2501 and 2601.

This project is new this year, although it has been anticipated for some time, at least since the publication at the beginning of 2011 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111, in which new section 5.17 including decanting among the “areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise.”

14. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.

a. This first appeared in the 2007-08 Priority Guidance Plan.

b. The background of this project is section 564(a) of EGTRRA, which added subsection (g)(1) to section 2642, directing Treasury to publish regulations providing for extensions of time to allocate GST exemption or to elect out of statutory allocations of GST exemption (when those actions are missed on the applicable return or a return is not filed).

i. Before EGTRRA, similar extensions of time under Reg. § 301.9100-3 (so-called “9100 relief”) were not available, because the deadlines for taking such actions were prescribed by the Code, not by the regulations. The legislative history of EGTRRA stated that “[n]o inference is intended with respect to the availability of relief from late elections prior to the effective date of [section 2642(g)(1)],” and section 2642(g)(1)(A) itself directs that the regulations published thereunder “shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of [section 2642(g)(1)].” Section 2642(g)(1)(B) adds:

In determining whether to grant relief under this paragraph, the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

ii. Shortly after the enactment of EGTRRA, Notice 2001-50, 2001-2 C.B. 189, acknowledged section 2642(g)(1) and stated that taxpayers may seek extensions of time to take those actions under Reg. § 301.9100-3. The Service has received and granted several requests for such relief over the years since the publication of Notice 2001-50.

c. In addition, Rev. Proc. 2004-46, 2004-2 C.B. 142, provides a simplified method of dealing with pre-2001 gifts that meet the requirements of the annual gift tax exclusion under section 2503(b) but not the special “tax-vesting” requirements applicable for GST tax purposes to gifts in trust under section 2642(c)(2).
1. Gifts subject to Crummey powers are an example.

ii. In such cases, GST exemption may be allocated on a Form 709 labeled “FILED PURSUANT TO REV. PROC. 2004-46,” whether or not a Form 709 had previously been filed for that year.

iii. Post-2000 gifts are addressed by the expanded deemed allocation rules of section 2632(c), enacted by EGTRRA.

d. Proposed Reg. § 26.2642-7 (REG-147775-06) was published on April 16, 2008. When finalized, it will oust Reg. § 301.9100-3 in GST exemption cases and become the exclusive basis for seeking the extensions of time Congress mandated in section 2642(g)(1) (except that the simplified procedure for dealing with pre-2001 annual exclusion gifts under Rev. Proc. 2004-46 will be retained).

e. The proposed regulations resemble Reg. § 301.9100-3, but with some important differences. Under Proposed Reg. § 26.2642-7(d)(1), the general standard is still “that the transferor or the executor of the transferor’s estate acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government.” Proposed Reg. § 26.2642-7(d)(2) sets forth a “nonexclusive list of factors” to determine whether the transferor or the executor of the transferor’s estate acted reasonably and in good faith, including (i) the intent of the transferor to make a timely allocation or election, (ii) intervening events beyond the control of the transferor, (iii) lack of awareness of the need to allocate GST exemption to the transfer, despite the exercise of reasonable diligence, (iv) consistency by the transferor, and (v) reasonable reliance on the advice of a qualified tax professional. Proposed Reg. § 26.2642-7(d)(3) sets forth a “nonexclusive list of factors” to determine whether the interests of the Government are prejudiced, including (i) the extent to which the request for relief reflects hindsight, (ii) the timing of the request for relief, and (iii) any intervening taxable termination or taxable distribution. Noticeably, the proposed regulations seem to invite more deliberate weighing of all these factors than the identification of one or two dispositive factors as under Reg. § 301.9100-3.

f. “Hindsight,” which could be both a form of bad faith and a way the interests of the Government are prejudiced, seems to be a focus of the proposed regulations. This is probably explained by the obvious distinctive feature of the GST tax – its effects are felt for generations, in contrast to most “9100 relief” elections that affect only a current year. There simply is more opportunity for “hindsight” over such a long term. Thus, the greater rigor required by the proposed regulations seems to be justified by the nature of the GST tax and consistent with the mandate of section 2642(g)(1)(B) to “take into account all relevant circumstances ... and such other factors as the Secretary deems relevant.”

g. Proposed Reg. § 26.2642-7(h)(3)(i)(D) requires a request for relief to be accompanied by “detailed affidavits” from “[e]ach tax professional who
advised or was consulted by the transferor or the executor of the transferor’s estate with regard to any aspect of the transfer, the trust, the allocation of GST exemption, and/or the election under section 2632(b)(3) or (c)(5).” The references to “any aspect of the transfer” and “the trust” appear to go beyond the procedural requirement of Reg. § 301.9100-3(e)(3) for “detailed affidavits from the individuals having knowledge or information about the events that led to the failure to make a valid regulatory election and the discovery of the failure.” Presumably, a professional who advised only with respect to “the transfer” or “the trust” would have nothing relevant to contribute other than a representation that they did not advise the transferor to make the election, a fact that the transferor’s own affidavit could establish. Out of concern about returning to the supercharged “fall on your sword” days before the reformation of the 9100 rules reflected in Rev. Proc. 92-85, 1992-2 C.B. 490, the author of this outline recommended the relaxation of that requirement in a comment letter dated July 3, 2008.

h. Ironically, section 2642(g)(1), having been enacted by EGTRRA, was once scheduled to “sunset” on January 1, 2011, and now is scheduled to “sunset” on January 1, 2013.

15. Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations or partnerships.

a. This item is carried over from the 2003-04, 2004-05, 2005-06, 2006-07, 2007-08, and 2008-09 plans.

b. It is apparently intended to address section 2704(b)(4), which states, in the context of corporate or partnership restrictions that are disregarded:

The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor’s family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

c. Since May 2009, the status of this regulation project must be reevaluated in light of the Administration’s related revenue proposal described in part IX.B.7.e beginning on 67.

16. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

a. The Heroes Earnings Assistance and Relief Tax Act of 2008 (the “HEART” Act) enacted a new income tax “mark to market” rule when someone expatriates on or after June 17, 2008, and a new succession tax on anyone who receives a gift or bequest from someone who expatriates on or after June 17, 2008. The new successions tax is provided for in section 2801, comprising all of new chapter 15.

b. Referring to the guidance contemplated by this project, Announcement 2009-57 (released July 16, 2009), states:
The Internal Revenue Service intends to issue guidance under section 2801, as well as a new Form 708 on which to report the receipt of gifts and bequests subject to section 2801. The due date for reporting, and for paying any tax imposed on, the receipt of such gifts or bequests has not yet been determined. The due date will be contained in the guidance, and the guidance will provide a reasonable period of time between the date of issuance of the guidance and the date prescribed for the filing of the return and the payment of the tax.

17. Final regulations under §7520 updating the mortality-based actuarial tables to be used in valuing annuity interests for life, or term of years, and remainder or reversionary interests. Proposed regulations were published on May 4, 2009. This project was completed on August 10, 2011.