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2010 Transfer Tax Changes

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2010 Transfer Tax Changes -
Actual Reform or Repairing a Leaky Dike with a Band-Aid

by George D. Karibjanian, Esq.

Introduction

The last session of the 111th Congress - the so-called "lame duck session" - was certainly an active session. This particular Congress was able to do something that neither the 109th nor 110th Congresses were able to do - pass pertinent estate tax legislation in the form of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act"). On the "importance" scale, the legislation rates a 12 out of 10; however, once the excitement and thrill of new legislation wanes, it becomes obvious that on a "permanence" scale, the legislation rates a 2 out of 10 because the legislation sunsets in less than two years. This article briefly discusses the pre-2002 law as to the estate, gift and generation-skipping transfer ("GST") taxes, the changes

presented to such taxes by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") (including the major changes for 2010 and beyond), the changes to such taxes made by the 2010 Act, technical issues not clarified by the 2010 Act, and what could happen to such taxes in 2013 and beyond.

A Journey in Mr. Peabody's "Wayback Machine" to Life As It Existed Pre-EGTRRA

Before a person can understand the importance of certain provisions of the 2010 Act, it is helpful to understand what has transpired to lead to such changes. Thus, we board Mr. Peabody's famous "Wayback Machine" to the year 2001. In 2001, estate and gift taxes were "unified," meaning that the tax rates and the "applicable credit amount" (as defined in § 2010(c) **FN1**) were the same for both transfer taxes. **FN2.**

The exemption amount, i.e., the "applicable exclusion amount" as defined in § 2010(c) (and as may be referred to herein as simply the "exemption amount"), was a unified $1 million for the estate and gift tax, with a separate $1 million exemption amount for GST tax purposes.

The estate and gift taxes rates topped out at 55% for property in excess of $3 million **FN3**, with a 5% "surtax" for property in excess of $10,000,000 but under $17,184,000 - this surtax had the effect of phasing out the applicable exclusion amount. **FN4.**

Pursuant to § 2641, the GST rate was, and is, established as the highest then applicable estate and gift tax rate - which, in 2001, was 55% - and did not take the surtax into account.

Major Transfer Tax Reform in 2002 - EGTRRA

With the passage of EGTRRA on June 7, 2001 **FN5**, specific changes were made to the various transfer taxes.

In general, the estate and gift taxes ceased to be unified due to changes in their respective exemption amounts. While the estate tax exemption increased gradually over time, maximizing in 2009 at $3.5 million **FN6**, the gift tax exemption remained fixed at $1 million.

The estate and gift tax rates remained unified, with the maximum tax rate lowered to 50%, falling 1% per year until remaining steady at 45%. **FN7.**

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This page contains a single entry by Associate Editor - 3 published on *January 12, 2011 12:44 AM*.

Estate Analyst: The Year of the Ginormous Loophole was the previous entry in this blog.

The Outlook for Estate Planning Practitioners is the next entry in this blog.

Find recent content on the main index or look in the archives to find all content.

CATEGORIES

Asset Protection (30)
Business Succession (5)
Elder Care (2)
Estate Planning +Taxation (87)
Fiduciary Issues (13)
Insurance (6)
Investments (19)
Marketing (1)
Miscellaneous (7)
Multigenerational Values (6)
Philanthropy (6)
Practice Management (4)
Professional Responsibility (4)
Retirement Benefits (4)
Taxation + Tax Planning (34)
Valuation (10)

MONTHLY ARCHIVES

January 2011 (3)
December 2010 (1)
November 2010 (3)
October 2010 (1)
September 2010 (9)
August 2010 (5)
July 2010 (3)
June 2010 (3)
March 2010 (1)
February 2010 (2)

The state death tax credit under § 2011 was phased out over 4 years and converted into a state death tax deduction. **FN8.** The change no longer afforded a "dollar-for-dollar" credit to prevent property from being taxed for both Federal and state purposes - effective as of 2005, up to 45% of the gross estate was subjected to both Federal and state estate taxes.

The phase-out of the state death tax credit presented an issue for some states - in particular, Florida. Until EGTRRA, Florida, like many states, was a "credit" state, meaning that no separate estate tax was imposed and the state would accept as payment of state estate taxes the amount of the state death tax credit determined under § 2011. However, under Florida law, it is not possible to enact any new estate taxes absent a constitutional amendment. **FN9.** Thus, with the conversion of the state death tax credit to a deduction, Florida no longer had a state estate tax and therefore lost all revenue that was generated from such taxes. **FN10.**

The most significant changes enacted by EGTRRA were set for the year 2010. In 2010, both the estate tax and GST tax both commonly referred to as "repealed." "Repeal," however, is actually a misnomer as EGTRRA provides in § 501(a) thereof that the chapters of the Code pertaining to the estate and GST taxes are not applicable for 2010. For example, new § 2210 provides that the provisions of Chapter 11 (the estate tax) shall not apply to the estates of decedents dying after December 31, 2009, and new § 2664 provides that the provisions of Chapter 13 (the GST tax) shall not apply to generation-skipping transfers after December 31, 2009. The gift tax remains in effect, with a flat tax rate of 35%. **FN11.**

Pursuant to §§ 901(a) and (b) of EGTRRA, the entire EGTRRA "sunsets" on December 31, 2010, with pre-EGTRRA law becoming effective as of January 1, 2011. This means a return to:

(1) Estate and gift taxes unified again with an exemption of $1 million;

(2) Top estate and gift tax rate, and, by definition, the GST tax rate, is 55%, with reimplementation of the 5% surtax;

(3) State death tax credit is restored; and

(4) After 2010, the Code is to be applied as if EGTRRA never existed.

Post-2001 Tax Reform - An Overview

January 2010 (3)
November 2009 (3)
October 2009 (6)
August 2009 (2)
July 2009 (3)
June 2009 (2)
May 2009 (7)
April 2009 (9)
March 2009 (9)
February 2009 (7)
January 2009 (2)
December 2008 (7)
November 2008 (2)
October 2008 (4)
September 2008 (53)

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Beginning in 2002, the popular belief was that the EGTRRA changes intended for 2010 would never occur because surely Congress would pass legislation that would prevent the loss of the estate tax (and Congress naturally responded, using its best Leslie Neilsen impression, by stating "Of course we will pass legislation. Relax... we have plenty of time to do this. And don't call us 'Shirley'").

In an ultimate game of "political volleyball," Congressional discussions regarding estate tax reform began as far back as 2005, which thereafter became politically charged.

In order to understand how more than 6 years could pass without any legislative action as to the estate tax, a "primer" on a certain legislative process is required. Everyone who has seen the classic James Stewart movie "Mr. Smith Goes to Washington" knows that a Senator who does not favor proposed legislation can block a vote by not relinquishing the Senate floor in a process known as a "filibuster." For legislation to pass the Senate without the threat of filibuster, a minimum of 60 votes are needed. This is due to the "Cloture Rule" of the Senate **FN12**, which, when invoked, will defeat a filibuster of proposed legislation and place a time limit on consideration of such legislation. Specifically, with a vote of three-fifths of the full Senate, of which three-fifths of the 100 member Senate is 60, further floor consideration of a pending matter can be limited to only 30 additional hours (which has the effect of eliminating an extended filibuster).

During this time period, the Republicans spoke openly about eliminating the estate tax altogether; Democrats, however, wanted to preserve the tax in order to tax the wealth transfer of the wealthier taxpayers. **FN13.** As a result, severe rifts developed along party lines.

By 2008, President Obama is elected and the Democrats achieved overwhelming control of both the House of Representatives and Senate, with a breakdown as follows: as to the House of Representatives, 261 Representatives were Democrats (including five Delegates and the Resident Commissioner) and 180 Representatives were Republicans, and as to the Senate, 56 Senators were Democrats, 2 Senators were Independents and 41 Senators were Republicans, with 2 Senate seats temporarily vacant (one seat from Minnesota was open as a result of an election dispute, and one seat from Illinois was open as a result of the resignation from the Senate by President Obama and an ongoing dispute as to the appointment of a replacement by Illinois Governor Rod Blagojevich).

By July 2009, the open Illinois seat was filled by Democrat Roland Burris, and it was determined that Democrat Al Franken had won the Minnesota election (yes, at long last, we would

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have a decade of him, Al Franken); thus, the Senate breakdown became 58 Democrats, 40 Republicans and 2 Independents. The 2 Independents - Sen. Joseph Lieberman of Connecticut and Sen. Bernie Sanders of Vermont - favored the Democratic agenda; so this meant that the Democrats had achieved the goal of 60 votes and could invoke the Cloture Rule to block any Republican filibuster.

The primary legislative emphasis for the Obama Administration was health care reform. Almost all legislative efforts were directed at health care, which meant that any discussions concerning estate tax reform were "backburnered." After all, the prevailing thought in 2009 was that there was still time to enact changes since the most drastic changes in EGTRRA would not take effect until January 1, 2010.

Arguably the most pivotal date with respect to 2009 estate tax reform occurred on August 25, 2009, as on this date, Sen. Edward Kennedy (D-Ma) died. Due in large part to the voter rebellion over the lengthy health care debate, a surprising upset occurred as Republican Scott Brown won the special election to fill Sen. Kennedy's vacant Senate seat. As a result, the Senate consisted of only 59 Democrats and Independents, which, on a hardline party stance, was not enough to invoke the Cloture Rule and, without any Republicans willing to cross party lines, would not be able to defeat a filibuster on proposed estate tax reform legislation.

On December 3, 2009, the House passed legislation that would have extended the exemption and rates established under EGTRRA; however, by December 27, 2009, the bill could not survive the Senate and was tabled. **FN14.** Thus, December ended without any estate legislation. Unbelievable as it seemed 8 years prior, 2010 - or, in estate tax dialect, "the year that was never supposed to happen," - actually arrived.

2010 - The Year that Was Never Supposed to Happen

As of January 1, 2010, under the law as then in effect, the estates of persons dying in 2010 would not be subject to the Federal estate tax. As stated earlier, it is important to note that under EGTRRA, the estate tax was not technically repealed; instead, the provisions of Chapter 11 of the Code were deemed to not apply to the estates of persons dying in 2010. **FN15.**

Basis Increase

Since Chapter 11 was not applicable, neither were the "step up" in basis provisions under § 1014, meaning that assets passing at death did not receive a "date of death" cost basis, but rather retained the cost basis in the hands of the decedent. This presented a nightmare for executors and advisors as to "basis tracing," or determining the decedent's cost basis in each asset. This was especially difficult for assets such as mutual funds with dividend reinvestment.

EGTRRA did provide some "step-up" relief in the form of basis increase amounts ("Basis Increase") under § 1022. Under § 1022(b), a total of $1.3 million in Basis Increase was granted to each decedent. The Basis Increase is not based on the total value of assets, but rather applies to $1.3 million of built-in, unrealized gain on such assets. A second Basis Increase was granted to a married decedent. Under § 1022(c), a total of $3 million of additional Basis Increase was awarded to each decedent as to property passing outright to a surviving spouse or to a trust that would have qualified for "qualified terminable interest property" ("QTIP") treatment had QTIP been in effect. **FN16.**

Formula Problems

Many estate planning documents provide for the use of a decedent's maximum amount of available applicable exclusion amount (usually referred to as the "credit portion") by establishing a "formula," which often provides for the disposition of the "maximum amount that may pass free upon the testator/settlor's death from the imposition of the Federal estate tax, taking into account all applicable marital and charitable deductions" (or other words of similar import). Similar clauses are utilized for the use of GST exemption.

In anticipation of 2010, many practitioners modified such clauses to insert the phrase "if the Federal estate tax is then in effect" or words of similar import, with similar language added for GST provisions. However, many documents remained in effect without such language, which created interpretation issues if a death occurred in 2010.

Such clauses are subject to two potential interpretations. First, the phrase "maximum amount" could mean that the amount passing thereunder is unlimited, meaning that the entire estate/trust passes under the formula clause (i.e., to the credit portion), thus avoiding the other provisions of the governing instrument. Second, the use of the phrase "Federal estate tax" could be interpreted as negating the "maximum amount" since the Federal estate tax is not in effect for 2010; therefore, no property passes to the credit portion and all property passes under the other provisions of the governing instrument.

Drastic results could occur, especially if the beneficiaries of the intended credit portion differ from those in the residuary dispositions.

In response to this issue, 19 states and the District of Columbia passed state statutes specifically addressing this issue. Some states, such as Virginia, automatically apply the law in effect in 2009, meaning that a formula provision in dispute would be interpreted as applying the 2009 applicable exclusion amount of $3.5 million. **FN17.** Others, such as Florida, allow for judicial interpretation of the testator/settlor's intention and allow the introduction of extrinsic evidence to determine the amount, if any, passing under the formula provision. **FN18.**

GST Issues

The non-applicability of Chapter 13 is only for 2010; after 2010, generation-skipping transfers would be subject to the GST tax. A multitude of problems are presented by the non-applicability of Chapter 13, two of which are described below.

First, while the GST provisions are not effective, it is unclear as to what happens to transfers that have GST tax potential for which GST exemption would have been automatically allocated pursuant to § 2632(c)(3)(A), such as contributions to irrevocable insurance trusts with Crummey invasion powers. If the GST tax is not applicable, then the transfer is not a GST transfer and therefore it would seem that it is impossible for GST exemption to be allocated to such transfers. More importantly, it is further unclear as to what happens in 2011 when the GST tax is revived. One could argue that it is then possible to effect a "late allocation" of GST exemption, but such "late allocations" do not relate back to the time of the transfer but rather on the date of allocation. **FN19.** Query, though, if it is even possible to effect a "late allocation" since at the time of contribution, the contributed amounts were not GST transfers because the GST tax was not then in effect. Further, even if a "late allocation" is permitted, such allocation could be problematic for the transferor if the value of the contributed assets substantially appreciated between the date of contribution and the date of allocation.

Second, what happens to property transferred in trust in 2010 if such property is distributed to a skip person in years following 2010. Recall that above, it was stated that § 901(b) of EGTRRA provided that for years after 2010, the law was to be interpreted as if EGTRRA never existed. The best way to describe the confusion created by this concept is to present two examples.

Example 1 - Transfers to a Direct Skip Trust

In the first example, suppose that in 2010, an individual creates a trust whereby the Trustees have absolute discretion to distribute income and principal to or for the benefit of the individual's grandchildren, and, upon the death of the last grandchild, the remainder passes to more remote descendants.

If the GST applied to this transfer, pursuant to § 2652(c), the only persons holding an "interest" in the trust for purposes of the Code are "skip persons," or persons defined under § 2613 (a)(1) as assigned to a generation which is 2 or more generations below the transferor.

Because all "interests" are held by "skip persons," and because distributions are only payable to "skip persons," if the GST tax applied to the transfer, § 2613(a)(2) provides that the trust itself is a "skip person."

The individual then funds this trust in 2010 with $10 million. The transfer is not subject to the GST tax because Chapter 13 is not then in effect; thus, the only taxes paid are gift taxes at 35%.

In 2011, the Trustees wish to distribute all $10 million to the grandchildren. The question is whether such distribution is subject to the GST tax.

At first glance, it would appear that the GST tax would be applicable because the "transferor" of the property under § 2652(a)(1) is the individual, who is the grandparent of the recipients. Therefore, this should be a GST transfer as a "taxable distribution" under § 2612(b).

However, it could be argued that since, in 2011, the law is to be applied as if EGTRRA were never applicable, then the initial transfer in 2010 would have been considered to be a "direct skip" under § 2612(c). As a direct skip, the property would thus have been subject to the GST tax; if so, then the "step-down" rule of § 2652(a) should apply. The "step-down" rule generally provides that if there is a GST, and immediately after such transfer such property is held in trust, then, for purposes of applying the GST tax rules to subsequent transfers from the trust, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer. The intention of the "step-down" rule is that it prevents the GST tax from imposition on transfers for which the GST tax was already imposed.

The argument is that since EGTRRA is deemed not to have existed, there was a GST in 2010 and therefore the "step-down" rule would apply to cause the transferor of the trust, for GST purposes, to be one generation above the grandchildren and therefore, the distribution to the grandchildren would not be subject to the GST tax.

It may be countered that this reasoning is flawed, for if EGTRRA is deemed not to have applied, then it could also be argued that a GST tax is retroactively for the initial transfer from 2010.

Example 2 - Transfers to a Direct Skip Trust Upon Death

For this example, assume the same facts as Example 1, but the trust was not created inter-vivos by the individual but by the individual's revocable trust as a result of the individual's death in 2010.

An argument could be made by interpreting the EGTRRA repeal in an opposite manner than in Example 1, in that the client died in 2010 when Chapter 11 (the estate tax) was not in effect. Pursuant to § 2612(c)(1), a "direct skip" requires that a tax under Chapters 11 (estate) or 12 (gift) be imposed. Since Chapter 11 was not in effect for 2010, and since this was a testamentary and not inter-vivos transfer (and thus, not a gift), there was no transfer under which a tax under Chapters 11 or 12 was imposed so this was not a GST. Without classification as a GST, there is no "transferor" for purposes of determining the GST tax effect of a transfer. Thus, without a "transferor," all distributions from the trust should not be subject to the GST tax.

Letters From Washington - How Congress Spent Its Lame Duck Session

As of January 1, 2010, estates of decedents were not responsible for the payment of estate taxes. Courtesy of such notable 2010 deaths of extremely wealthy individuals such as Texas oil billionaire Dan Duncan and New York Yankees principal owner George Steinbrenner, when estate tax reform would be discussed, it was often discussed with an eye towards "retroactivity." **FN20.** However, experts were divided as to whether any retroactive legislation would survive a Constitutional challenge. Some argue that a retroactive imposition of the estate tax is simply the modification of an existing tax, which would be Constitutional, but others argue that it would technically be a "new" tax and therefore unconstitutional. **FN21.**

As 2010 progressed, the Treasury Department was at a gridlock in proceeding with new administrative rules - do they proceed with 2010 laws or do they hold off in case new legislation provides for retroactivity? As of May 2010, Treasury hadn't even started on rules for 2010.

By August 2010, with no legislation on the horizon, the Treasury Department informally announced that rule making procedure development had begun under the assumption that there would be no estate taxes for 2010. **FN22.**

Throughout the first half of 2010, several legislative attempts for estate tax reform had failed to proceed beyond committee discussions. Estate tax reform became the topic of election rhetoric during the summer primary season and into the general election season.

In November 2010, the mid-term elections were held and the Republicans overwhelmingly won back control of the House and narrowed the gap in the Senate. Realizing that the post-election Congressional session - informally referred to as the "lame duck" session - was the last chance at reform, progress was finally made.

On December 1, 2010, after several attempts, traction was gained when President Obama and Congressional leaders announced that they would "jump-start" tax cut negotiations. **FN23.**

On December 6, 2010, President Obama announced a compromise agreement with Senate Republicans calling for, among other items, extensions of the Bush tax cuts through 2012 and an increase in the estate/gift tax exemption to $5 million. **FN24.** House Democrats were outraged and publicly stated that the Bill will never be introduced on the House floor. **FN25.**

On December 9, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Bill") is introduced to the Senate. **FN26.** After considerable debate, the Democratic Senators agree to ready the Bill to be presented to the Senate for a vote. **FN27.** The popular belief was that if the House does not pass the Bill, and with it major Bush extenders for items such as unemployment and withholding, the Bill will be passed by the new Republican House in 2011, but only after many Americans feel the pinch in the first half of January 2011. Blame would be laid squarely upon the Democratic leadership which would be used against them in the 2012 elections.

Finally, on December 15, 2010, the full Senate votes in favor of the Bill which then moved to the House. **FN28.** Early in the morning of December 17, 2010, for the reasons set forth above, the

House begrudgingly passes the Bill. **FN29.** Shortly thereafter, President Obama signs the Bill into law as the 2010 Act. **FN30.**

The 2010 Act and What It Means To You, the Home Viewer

Estate Taxes

The 2010 Act moves swiftly and concisely to change certain provisions in EGTRRA while maintaining the integrity of the non-modified provisions therein.

Primary Changes

Section 301(a) of the 2010 Act repeals all provisions of the Code amended by subtitles A or E of title V of EGTRRA and EGTRRA is amended to read as if such provisions never existed. Such provisions are:

(a) Chapter 11 (i.e., the estate tax) non-applicability for 2010, meaning that the Federal estate tax is in effect for all of 2010 (yes, Virginia, this means "retroactivity");

(b) The carryover basis provisions of § 1022 are repealed; and

(c) Chapter 13 (i.e., the GST) non-applicability for 2010 (discussed in greater detail below);

Section 302(a) of the 2010 Act raises the exemption amount to $5 million for estates of decedents dying in 2010, 2011 and 2012. It cannot be stressed enough that the increase in the exemption applies retroactively for all of 2010.

Section 302(b) of the 2010 Act provides that, beginning in 2011, gift tax exemption is again unified with the estate tax exemption, meaning that such exemption is increased to $5 million. Unlike the estate tax, the increase in the gift tax exemption does not apply for 2010.

Section 301(c) of the 2010 Act provides for a special election for estates of decedents dying in 2010 - such estates may elect to "opt out" of the EGTRRA repeals referred to in § 301(a) of the 2010 Act (the "Opt-Out Election"). This means that executor of the estate of a decedent who died 2010 has an option - the estate can remain subject to Federal estate taxes, or the estate can elect to not have the estate tax applied and accept the carryover basis treatment.

Estates most likely to remain subject to estate tax for 2010 would be those estates that have total assets less than $5 million (or the amount of the decedent's available estate tax exemption) and built-in gain in excess of the applicable § 1022 adjustments.

For example, suppose that a single decedent dies in 2010, with a total gross estate of $4.75 million and assets with built-in, unrealized gain of $3.5 million. The decedent has not used any gift or estate tax exemption during his/her lifetime. If the executors of his/her estate exercise the Opt-Out Election, the estate would have no estate tax but would only be able to shelter $1.3 million of the $3.5 million built-in gain, thus subjecting $2.2 million of built-in gain to capital gains tax. However, by allowing the estate tax to be assessed, the applicable exemption amount of $5 million encompasses the entire estate, so no estate tax is assessed and, since the estate tax is applicable, all assets receive a full step-up in basis under § 1014.

Contrast the preceding example with the following example: a single decedent dies in 2010 with a total gross estate of $5.005 billion and $0 cost basis in the assets. The decedent has not used any gift or estate tax exemption during his/her lifetime. By not exercising the Opt-Out Election, the executors would subject the estate to estate taxes on $5 billion of property at 35%, for total estate taxes due of $1.75 billion. If the executors exercise the Opt-Out Election, the only applicable tax would be an eventual capital gains tax of 15% on the disposition of the assets, which, if it is assumed that the entire estate is liquidated upon death, results in taxes payable of $750 million. By exercising the Opt-Out Election, the executors will have saved the estate $1 billion in total taxes.

As discussed above, the issue of "constitutionality" would surface with any retroactive legislation on account of the issue as to whether the 2010 estate tax is a "new" tax. However, because the Opt-Out Election is very pro-taxpayer, and because the Opt-Out Election gives the estate a choice to pay the lowest overall taxes, constitutionality should not become an issue because it is unlikely that any taxpayer would raise an objection to the option of paying lower taxes. The only foreseeable challenge could stem from probate litigation where the Opt-Out Election would affect the ultimate distribution of assets among beneficiaries.

Section 301(d) of the 2010 Act provides that for an estate of a decedent dying in 2010, the earliest date to file any form or make any pertinent election (i.e., the Opt-Out Election) is the date 9 months from the date of the enactment of the 2010 Act. Since the 2010 Act became law on December 17, 2010, such deadline becomes September 19, 2011 (the 9 month date, or

September 17, is a Saturday, so the deadline is pushed forward to the next business day). This provides welcome relief for the executors of decedents who died earlier in 2010 and would be outside of the statutory 9 month filing deadline. **FN31.**

Opt-Out Election Could Create More Havoc with Formula Clause Interpretation Issues

The 2010 Act does not resolve all open issues created by EGTRRA. Certain interpretation issues described above still remain. As stated earlier, if a formula provision references "the maximum amount that may pass free of Federal estate tax" or words of similar import, the question arises as to what was intended by the decedent. While the problem was apparently resolved by the repeal of the EGTRRA provisions suspending Chapter 11 in 2010, query what happens if an estate exercises the Opt-Out Election for estate taxes in 2010.

As stated above, the Florida Statutes (specifically, F.S. §§ 733.1051 and 736.04114) allow for limited judicial construction during such period of time in 2010 while the provisions of EGTRRA as to 2010 are applicable. The statutes, however, do not contemplate the scenario where the executors voluntarily elect to apply such conditions. As a result, two major issues surface.

First, there is an estate tax and a statutory applicable exclusion amount in effect for 2010, so it must be determined whether an interpretation issue even exists because the default statutory provisions resolve the issue. In other words, must the court "piggyback" the Federal estate tax treatment of the estate, or can the Court state that the election has no bearing on the interpretation of the clause and determine that the plain language of the pertinent statutes (absent the Opt-Out Election) clearly solve the formula thus failing to create an ambiguity.

Second, if the court assumes such interpretation responsibility, query whether the default statutory provisions can be used as extrinsic evidence. For example, if the court must determine the meaning of "applicable exclusion amount" after an Opt-Out Election is exercised, can such court use the amount listed in the statute that the executor voluntarily determined should not apply for Federal estate tax purposes?

As also stated above, the Virginia Statutes (specifically, Va. Code Ann. § 64.1-62.4) applies the law as would be in effect in 2009, so, under the assumption that the statute would still apply to an "optional" application of the 2010 laws, the issues surrounding the Florida statutes would seemingly not apply because the Virginia law provides that law in effect in 2009 would apply (i.e., $3.5 million exemption).

This presents a further dilemma for the executor, especially if the executor is the surviving spouse. Under Virginia, and, for this purpose, it is assumed that an application of the Florida provisions would determine that the formula will apply the 2009 amounts, the use of 2009 amounts creates a funding difference of $1.5 million, or the difference between $5 million and $3.5 million. If the beneficiaries of the credit portion provisions (which are presumed to be the intention behind the particular formula provision) and the remainder provisions are different, and if the surviving spouse is the executor/trix, query whether is this a power to shift beneficial enjoyment of the property and thus includible in the spouse's estate under § 2041. For this reason, it is highly suggested that the decision concerning the Opt-Out Election not be made by a surviving spouse or a beneficiary whose beneficial interest will be affected by the election.

Exemption Portability

Section 303 of the 2010 Act provides that § 2001(c) is amended so that each taxpayer's estate and gift tax exemption amounts include any unused exemption from a spouse who died after 2010. For example, if the first spouse dies in 2011 and fails to utilize $3 million of his/her exemption amount, the unused amount is transferred to the surviving spouse, giving that spouse a total exemption of $8 million. Section 303 of the 2010 Act also provides that the amount subject to portability terminates if the surviving spouse has a subsequent deceased spouse, in which case the surviving spouse can only utilize the unused portion of the second spouse's exemption.

For example, assume that a spouse (the "First Deceased Spouse") dies with $3 million of unused exemption. The surviving spouse later remarries and then such new spouse dies (the "Second Deceased Spouse") with $1 million of unused exemption. Under the provisions of Section 303 of the 2010 Act, the surviving spouse's available exemption after the Second Deceased Spouse's death is only $6 million, composed of his/her own $5 million exemption and the $1 million of unused exemption from the Second Deceased Spouse.

Statutorily, a spouse cannot use a predeceased spouse's unused exemption from a prior spouse. Pursuant to new § 2010(c)(4), a "deceased spousal unused exclusion amount" is defined as the lesser of the deceased spouse's "basic exclusion amount" or the excess of the deceased spouse's "basic exclusion amount" of the last such deceased spouse of such surviving spouse, over the amount with respect to which the tentative tax is determined on the estate of such deceased spouse. By example, assume that A dies, survived by B, and A fails to fully utilize his/her exemption amount, which, pursuant to statute (described below), is allocated to B. B then

marries C. B dies and does not utilize all of the exemption afforded to him/her. Pursuant to the statutory construction, and assuming that all elections are made, C can only use the amount of B's unused "personal" exemption and not the total amount of B's unused "personal exemption and the unused exemption allocated to B upon A's death. Applying actual numbers, A dies, survived by B, and A only utilizes $3 million of exemption, in which case $2 million is allocated to B. If upon B's death, since B is married to C, C can receive B's unused exemption. However, under the statutory analysis, C only receives B's $5 million of exemption and not the total amount of exemption that B had at his/her disposal, which was his/her "personal" $5 million plus $2 million from A.

While this seems obvious, it is interesting to note that the Committee Reports to the 2010 Act differ in its analysis of this provision. In particular, Example 3 thereunder would actually award the full $7 million to C. **FN32.** This accomplished by the application of, using our example from above, B's applicable exclusion amount, which would include the unused exemption received from A. The example differs from the statute in that the example uses the "applicable exclusion amount" whereas the statute states to use the "basic exclusion amount."

As for how the surviving spouse succeeds to the deceased spouse's unused spousal exemption, § 303 of the 2010 Act provides that a deceased spouse's unused exemption may only be utilized by the surviving spouse if the deceased spouse's executors allow for it to be so utilized by electing as such on the deceased spouse's Federal estate tax return (a "706"). Once made, the election is irrevocable. The estate tax return must be timely filed, including extensions; thus, if not elected on a timely filed return, the election cannot be made on a late filed 706 or a supplemental 706.

A note of caution: § 2010(c)(5)(B), as added by § 303(a) of the 2010 Act, provides that the statute of limitations on the deceased spouse's estate tax return is extended so that the Secretary may make determinations as to the amount of available exemption. The power granted by new § 2010(c)(5)(B) allows the first spouse's estate to be audited, even after the applicable assessment statutes of limitation have been closed, in order to determine the amount of unused exemption. For example: assume the first spouse (the "First Spouse") dies on January 1, 2011, never having made any taxable gifts and owning one individual asset (i.e., individually or in his/her revocable trust), which is a limited partnership interest in a family limited partnership. The First Spouse's executor has the interest professionally valued at $3 million, which assumes a 35% discount in valuation. Under the First Spouse's governing instrument, the entire estate is divided into shares for the children, per stirpes, with each share held in trust for a child's lifetime. Under these facts, the First Spouse has $2 million of unused exemption, which is attributed to the First Spouse's

surviving spouse (the "Surviving Spouse") as a result of an election made by the First Spouse's executor on the First Spouse's 706.

Assuming for this purpose that the changes made by the 2010 Act remain in effect for the foreseeable future, the Surviving Spouse dies on January 1, 2019 (exactly 7 years after the First Spouse), not having remarried or having a subsequent deceased spouse, which is beyond both the 3 year statute of limitations under § 6501(a) and the 6 year substantial omission statute under § 6501(e)(2). In determining the Surviving Spouse's Federal estate tax, the Surviving Spouse's executors apply a total exemption of $7 million, composed of the Surviving Spouse's $5 million exemption and the First Spouse's $2 million of unused exemption.

Upon audit, the Service questions the $2 million of the First Spouse's exemption; pursuant to § 2010(c)(5)(B), the Service may review the First Spouse's return, even though the § 6501(a) and § 6501(e)(2) statutes of limitations have closed, in order to "determine" the amount of the First Spouse's unused exemption. The provisions of new § 2010(c)(5)(B) would allow the Internal Revenue Service (the "Service") to re-investigate the valuation of the partnership interest, and, upon the revaluation, suppose that it is discovered that an unintentional error had been made in the valuation and not only was the valuation low, but the discount was overstated, so that the actual value of the interest was $7 million after applying a 25% discount.

The effect of this is that the Surviving Spouse loses the $2 million of unused exemption from the First Spouse; however, because the assessment statutes of limitation under § 6501 are closed, the Service cannot assess additional taxes against the estate of the First Spouse. The potential ramifications of a re-valuation can extend beyond the particular 706's as such valuation may be the basis for additional gifting that could then be re-examined if the above-referenced statutes of limitation are not closed as to such gift tax returns.

It is presumed that in a situation described above, where a Surviving Spouse remarries and then the new spouse dies, if the requisite statute of limitations with respect to the First Spouse's 706 have otherwise closed but for the § 2010(c)(5) "review" provisions with respect to the First Spouse's unused exemption, upon the new spouse's death the statute closes as to the First Spouse.

Gift Taxes

As stated above, pursuant to § 302(b)(1) of the 2010 Act, beginning in 2011, reunification exists between the estate and gift taxes, with the gift tax exemption raised to $5 million and a top tax rate of 35%.

Section 302(d) of the 2010 Act clarifies the calculation of the gift tax when prior gifts are involved (which affects the gift and estate tax calculations) so that all portions of the calculation are determined using the rates in effect at the time of the gift or the date of death, whichever is applicable. The reason for this is to uniformly calculate all aspects of the marginal tax calculation at the same rate and prevent an offset calculated at a rate in excess of the current rate.

For example, assume that an individual dies in 2012, having a gross estate of $9 million and having made $1 million of taxable gifts in 2009 when the top transfer tax rate was 45% (for all purposes of this example, flat tax rates will be assumed). Under § 2001(b), the estate tax is calculated by first calculating the tax on the sum of the gross estate and the amount of adjusted taxable gifts (the "tentative tax"), after which the tentative tax is reduced by the amount of gift tax that would have been paid if the current rates were applicable at the time such gifts were made.

To effect the change contemplated by Section 302(d) of the 2010 Act, § 2001 is modified by adding a new § 2001(g), which provides that both the tax rate to the gift tax component to § 2001 (b) and the tax rate used to determine any credits used to offset such gift tax are calculated using current rates. Thus, under § 2001(b)(1), the "tentative tax" is based on $10 million ($9 million in the taxable estate plus $1 million in adjusted taxable gifts). The offset for gift taxes payable under § 2001(b)(2) is determined as follows: adjusted taxable gifts of $1,000,000, resulting in a gift tax payable at 35% of $350,000, reduced by the applicable credit amount under § 2505(a)(1), also determined at 35%, which is $350,000, resulting in a net offset of $0. Without the changes made by new § 2001(g), the applicable credit offset would be determined at a higher rate and provide for a greater offset, which, if amounts were different, would provide for a skewed result.

"Portability" as provided under § 303 of the 2010 Act also applies to the gift tax when making lifetime gifts. If a spouse receives unused spousal exemption from a predeceased spouse, such exemption may be used to increase the amount of lifetime gifts that the surviving spouse can make. However, the same rules apply, so that if a surviving spouse later remarries and outlives the second spouse, the unused spousal exemption from the first deceased spouse is lost, and if such exemption was utilized for a lifetime gift, the tax is recovered at death in the calculation of the estate tax.

Suppose that A dies in 2011, survived by spouse B, and A's unused exemption, which succeeds to B, is $2 million (for all purposes of this example, assume that current law remains in effect for all years). In 2013, B gifts $7 million to his/her descendants, paying $0 in gift taxes on account of the use of his/her "basic" $5 million exemption and the $2 million unused spousal exemption. In 2015, B marries C, who is independently wealthy. In 2016, C dies, survived by spouse B, and C fully utilizes his/her exemption amount, meaning that there is no unused spousal exemption passing to B. B dies in 2017 with a taxable estate of $4 million.

At first glance, one would assume that B would owe estate taxes of $1.4 million, or 35% of the taxable estate of $4 million, as adjusted taxable gifts of $7 million were offset by the use of $7 million of exemption; however, under the unused spousal exemption rules, this is not the case because at the time of death, B only has his/her own "basic" exemption amount; therefore, what was protected from tax upon the initial gift/transfer will now come back and be subject to estate tax. Under the revised § 2001(b) calculations, the tax is calculated as follows:

(a) § 2001(b)(1) tentative tax of $3.85 million, determined as 35% of the sum of the gross estate of $4 million and adjusted taxable gifts of $7 million.

(b) § 2001(b)(2) reduction for the gift taxes payable on adjusted taxable gifts, which are $2.45 million in gross gift taxes, reduced by $2.45 million of applicable credit amount utilized in the year of the gift, resulting in a net reduction of $0, and setting the estate tax before credits of $3.85 million (the "Gross Tax").

(c) Because the § 2001(b)(2) reduction uses the applicable gift tax credit at the time of the gift to reduce the gift taxes payable, which is itself a reduction, this has the effect of negating the use of the current credit; for this reason, the current credit is used in the calculation to offset the Gross Tax.

(d) Thus, the Gross Tax of $3.85 million is then offset by the applicable credit of $1.75 million (which is 35% of $5 million), resulting in a total estate tax due the estate of $2.1 million.

Despite the potential testamentary recovery of transfer taxes, utilizing unused spousal exemption can enhance any freezing or exemption leveraging transaction at a potential cost of estate taxes on said exemption amount; any appreciation generated by the use of said exemption passes free of gift or estate taxation. Through the use of common "freeze" techniques, gifting can

increase which can "freeze" potentially recoverable amounts while allowing appreciation to escape taxation.

Suppose an individual, who has $2 million of "basic" gift tax exemption and has $3 million of unused spousal gift tax exemption, wishes to transfer $50 million to subsequent generations through the sale of such interests to intentionally defective grantor trusts, with the client financing such purchase/sale through promissory notes.

Customary practices usually provide that the creation of the trusts must be accompanied by "seed" funds which give said trusts collateral in which to borrow against, which is usually 10% of the eventual holdings. Through the use of the unused spousal exemption, the individual can gift up to $5 million to the trusts free of gift tax (while not pertinent to this example, the individual would also allocate up to $5 million of his/her GST exemption to this transfer). The use of the unused spousal exemption allows the individual to transfer an additional $2 million free of gift tax, thus further enhancing the transaction. Prior to the individual's death, he/she remarries and survives the new spouse, who does not leave any unused spousal exemption to the individual. Upon the individual's death far into the future, even if the value in the trusts has increased by 500%, other than the notes, the only ramifications to the individual's estate is the estate taxation on the additional $2 million of unused spousal exemption lost on account of the remarriage and death.

There are other advantages in effecting lifetime gifts.

Notwithstanding portability, individuals may seek to gift amounts in excess of their applicable exemption amount so as to pay gift taxes at the current 35% rate, which, much like current interest rates, may never be lower than the present.

As was the case even before 2011, the payment of gift taxes may actually save on overall transfer taxes. The payment of estate taxes is a "tax inclusive" payment, meaning that estate taxes are paid not only on property passing to beneficiaries, but also on property used to pay the taxes themselves. The payment of gift taxes is a "tax exclusive" payment, meaning that gift taxes are only paid on the amount transferred to beneficiaries; however, if the individual paying the gift taxes dies within three years of the date of the gift (the "3 Year Period"), § 2035(b) includes such gift taxes into the individual's gross estate. By surviving the 3 Year Period, the amount of the gift taxes escapes further transfer taxation.

GST Taxes

The 2010 Act repeals the provisions if EGTRRA that suspend the application of Chapter 13 for 2010; therefore, the GST tax is fully operational for all of 2010. However, as provided in § 302 (c) of the 2010 Act, the GST tax rate is established at 0% for 2010.

As a result of the above two changes, the examples set forth above in the GST section of the EGTRRA discussion are now resolved.

Under Example #1, a settlor transfers funds to a "direct skip trust" under which all "interests" under § 2652(c) are skip persons. The issue presented above concerned transfers from this trust in 2011 and beyond. The issue is now resolved - since the GST tax is in effect for 2010, but with a tax rate of 0%, the transfer into the trust is a GST and, therefore, the "step-down" rule of § 2652(a) clearly applies. Thus, distributions from the trust in 2011 and beyond have a "transferor" for GST tax purposes of an individual one generation above the oldest generation with an "interest" in the trust. Since the current beneficiaries are grandchildren, the "transferor" is deemed to be at the "parent" level, so such transfers are definitively not subject to the GST tax.

Under Example #2, a decedent transfers funds to a "direct skip trust" under which all "interests" under § 2652(c) are held by skip persons. The issue was whether a transfer existed considering as upon the funding of the trust, no Chapter 11 or 12 tax was assessed. Because the estate tax under Chapter 11 is reinstated, there is a transferor so there is clearly a GST. Furthermore, even if the executor exercises the Opt-Out Election, § 301(c) of the 2010 Act provides that the provisions of § 2652(a)(1), which defines "transferor," shall be interpreted as if a Chapter 11 tax were assessed. Therefore, regardless of whether the "opt out" election is made, there is a "transferor" so there is a GST.

Hooray...Reform Passed So We Can All Now Rest Easy....Um....Not Quite - 2013 is Less Than 2 Years Away

The 2010 Act is not a permanent change but all such changes are actually deemed to be "part of" EGTRRA. The deadline for the sunset of EGTRRA was extended from December 31, 2010 to December 31, 2012, so if no new legislation is passed by that time, EGTRRA will sunset and the ramifications outlined above will become reality. This calls to mind a movie quote recited by the late actor Lane Smith, familiar to most as the District Attorney arguing against Joe Pesci in the 1992 comedy, "My Cousin Vinny." In 1992's "The Distinguished Gentleman," Smith plays Congressman Dick Dodge, who, as the Chairman of the Committee on Power and Industry, is

addressing the incoming freshman Congressmen on one of their first days as Congressmen (of which Eddie Murphy is one). Dodge states, "The people you see not only provided tonight's hospitality. They are the people you serve . That's our system of checks and balances at its best. Their support helped get you elected...your work will help them...and their support will help you in your next campaign, which I remind you is already less than two years away." **FN33.** That line - "less than two years away" - provides the greatest insight as to how this author foresees the development of further estate tax legislation. Considering what has happened with Congress over the last 6 years or so (i.e., vitriol, debate, anger, etc.), and when you consider that Congressional primary season begins in earnest in only 17 - 18 months from now (assuming most start their campaigns in earnest in May or June 2012), it is debatable at best as to whether Congress will move quickly to re-open the estate tax discussion. Further, considering that 2012 is a presidential election year, Congress may simply wait to gauge the political climate before undertaking further estate tax reform. If and when Congress discusses further extensions of EGTRRA or even full repeal, using the past as our gauge, one can surmise that the discussions will likely not be "warm" and "fuzzy" (this is perhaps the understatement of the young millennium). In this author's opinion, it is highly probable that any additional legislation will occur just like it did in 2010, meaning during the "lame duck," post-election Congressional session."

Regardless of whether 2013 arrives with 2001 law, an extension of 2011 law or something entirely new, one item is certain - the 2010 "repeal" of the estate tax is not part of the legislation. In the short-term, practitioners may wish to consider removing all references to "whether the estate tax is then in effect" and the "1022 amount" from their respective documents. However, given the turbulent recent history, who can have any definitive thought on what provisions "should" or "should not" be included, because who knows what will happen next.

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1. For all purposes of this article, unless otherwise indicated, statutory references shall be to the particular section or sections of the Internal Revenue Code of 1986, as amended, which may also be referred to herein as the "Code."

2. The GST tax was never unified with the estate and gift tax because it is conceptually different. The GST will be explained in greater detail later in this article.

3. § 2001(c)(1), as in effect prior to 2002.

4. § 2001(c)(2), as in effect prior to 2002.

5. Public Law 107-16, 6/7/2001.

6. § 2010(c), as in effect under EGTRRA, for years beginning prior to 1/1/10.

7. § 2001(c)(2), as in effect under EGTRRA, for years beginning prior to 1/1/10.

8. § 2011(b)(2), as in effect under EGTRRA, for years beginning prior to 1/1/13.

9. Article VIII, Section 5(a) of the Florida Constitution prohibits Florida from enacting any tax on inheritance or estates other than what would be credited against the Federal tax.

10. By one estimate, the amount of annual revenue lost by the State of Florida is $1.86 billion, or the second highest among the states (behind California) and representing 10% of all national losses by the states. See Citizens for Tax Justice, The Effects of the Bush Tax Cuts on State Tax Revenues, May 2001.

11. § 2502(a)(2), as in effect under EGTRRA, for years beginning before 1/1/13.

12. Rule 22 of the Rules of the Senate.

13. See, for example, Edmund L. Andrews, G.O.P. Fails in Attempt to Repeal Estate Tax, New York Times, June 9, 2006.

14. CCH Tax Briefings, 2009 Federal Estate Tax (H.R. 4154), Dec. 28, 2009.

15. § 2210, as in effect under EGTRRA.

16. For the definition of QTIP, see § 2056(b)(7) and § 2523(f).

17. Va. Code Ann. § 64.1-62.4 (West 2010).

18. Fla. Stat. Ann. §§ 733.1051 and 736.04114 (2010).

19. See generally Treas. Reg. § 26.2632-1(b)(4)(ii)(A).

20. See generally William P. Barrett, Steinbrenner's Death Well-Timed For Estate Tax, Forbes, July 13, 2010.

21. See generally Beth Shapiro Kaufman, 2010: The Anatomy of a Train Wreck, Estate Planning Journal, May 2010, discussing the constitutionality issue and distinguishing a reinstatement of the estate tax in 2010 as the imposition of a "new tax" as opposed to a retroactive application of a current tax; for an example of a court upholding a retroactive change in an existing estate tax, see NationsBank of Texas v. U.S., NationsBank of Texas N.A. v. U.S., 88 AFTR 2d 2001-6580, 269 F.3d 1332 (2001, CA Fed Cir), aff'g, 84 AFTR 2d 99-5001, 44 Fed. Cl. 661 (Ct. Fed. Cl. 1999), wherein the Court of Appeals for the Federal Circuit affirmed that Congress acted constitutionally when it passed the Omnibus Budget Reconciliation Act of 1993 in August 1993 which, retroactively to January 1, 1993, increased the top estate and gift tax rate to 55%.

22. Jeff Carlson, Torie Cole, Stephen K. Cooper and Paula Cruickshank, Federal Tax Day - Current, CCH Weekly Report from Washington, D.C., M.1, Aug. 2, 2010.

23. Paula Cruickshank and Jeff Carlson, Federal Tax Day - Current, White House and Congressional Leaders Agree to Jump-Start Tax-Cut Negotiations, W.1, Dec. 1, 2010.

24. Paula Cruickshank and Jeff Carlson, Federal Tax Day - Current, President Announces Tentative Tax-Cut Agreement, W.1, Dec. 7, 2010.

25. Stephen Cooper, Jeff Carlson and Paula Cruickshank, Federal Tax Day - Current, House Democrats Reject Obama-GOP Tax Agreement, C.1, Dec. 10, 2010.

26. Id.

27. Jeff Carlson, Stephen K. Cooper and Paula Cruickshank, Federal Tax Day - Current, Senate Readies Tax Cut Bill for Test Vote, C.1, Dec. 13, 2010.

28. Jeff Carlson and Paula Cruickshank, Federal Tax Day - Current, Senate Approves Tax Cut Package, C.1, Dec. 16, 2010.

29. Federal Tax Day - Current, Tax Cut Measure Heads to President, C.1, Dec. 17, 2010. (Note: no authors were attributed to this article.)

30. Jeff Carlson, Stephen K. Cooper and Paula Cruickshank, Federal Tax Day - Current, President Signs Tax-Cut Package, W.1, Dec. 20, 2010.

31. § 6075(a).

32. JCT Rep. No. JCX-55-10, Portability of Unused Exemption Between Spouses, Example 3

33. Movie Script, "The Distinguished Gentleman," Revised 4/3/92, scene 65.

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