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Overview

The Congress has failed in its attempts to extend the federal estate tax for deaths in 2010.¹ That means that the estate tax (and the generation-skipping transfer tax (GSTT)²) does not exist for deaths in 2010.³ Federal gift tax stays in place, but at a flat 35 percent rate and a maximum exclusion of \$1 million.⁴

The expiration of the estate tax for 2010 has significant income tax and accounting implications for practitioners and their clients, and leads to some unique planning considerations and opportunities.

New Income Tax Basis Rule for Deaths in 2010

A new income tax basis rule is in effect for 2010 for inherited assets.⁵ Under the rules in effect for deaths through 2009, the income tax basis in an inherited asset was the asset's fair market value as of the date of the decedent's death.⁶ But, for property acquired from the estate of a 2010 decedent that is sold in 2010, the property's basis is the *lesser* of the decedent's adjusted basis in the property or the property's fair market value as of the time of the decedent's death.⁷ So, no basis step-up is allowed (but basis could go down).

Two significant exceptions to the carry-over basis rule may apply – (1) the estate of a married

person is entitled to a \$3 million basis increase (termed the “aggregate spousal basis increase”) to be allocated to the property passing to or for the benefit of the surviving spouse (either outright or to a qualifying trust for the surviving spouse);⁸ and (2) the executor can allocate an additional \$1.3 million of aggregate basis to other assets (on an asset-by-asset basis).⁹

Computing gain on sale of inherited assets.

For assets inherited from the estate of a 2010 decedent that the heir then sells in 2010, the heir would have to pay capital gain tax on any excess amounts not covered by the basis increase rules.¹⁰ That much is clear. What is not as clear is how an heir is to compute gain (if any) on sale of assets that are inherited in 2010, but aren't sold until after 2010. The lack of clarity is caused by the language the Congress chose to use to sunset EGTRRA.¹¹

That language is as follows:

EGTRRA, Sec. 901(a):

“[a]ll 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.”¹²

EGTRRA, Sec. 901(b):

“[t]he Internal Revenue Code of 1986 and the Employment 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.”¹³

Those provisions lead to the conclusion (based on a strict reading of the statutory provisions) that the modified carryover basis rule is only applicable to assets inherited in 2010 that are also sold in 2010. The EGTRRA sunset provisions referenced above have the effect, in essence, of erasing EGTRRA from the Code at the stroke of midnight on December 31, 2010. The Congress stated that intent twice by noting first in Sec. 901(a) that EGTRRA *does not apply to tax years* beginning after 2010 *or to decedents dying and gifts made after 2010*. Second, the Congress reiterated that point by stating in Sec. 901(b) that all provisions of the Internal Revenue Code are to be applied to estates after 2010, gifts made after 2010 *and tax returns filed for tax years beginning after 2010 as if EGTRRA had never been enacted*. Thus, when filing a tax return to report gain associated with the post-2010 sale of an asset that was inherited from a 2010 decedent’s estate, the basis computation is to be conducted as if EGTRRA was never enacted. That means that the pre-EGTRRA basis rule (fair market value as of the date of the decedent’s death) applies. Thus, a strict interpretation of the EGTRRA sunset provisions produces the result that (for 2010 inherited assets) the heirs will receive a fair market value basis if the inherited assets are sold after 2010.¹⁴

Another possible interpretation that has been adopted by some¹⁵ is tied to the manner in which I.R.C. §1022 (the modified carry-over basis rule) was added to the Code by EGTRRA. Under that line of reasoning, it is noted that I.R.C. §1022 was added by Sec. 542 (a) of EGTRRA which specifies the scope of I.R.C. §1022 as being “property acquired from a decedent dying after December 31, 2009.” Section 542 is part of title V, which is referred

to in subparagraph (2) of Sec. 901(a) and, thus, subparagraph (1) of Sec. 901(a) is not included in the sunset provision. So, under this line of thinking, all that Sec. 901(a) specifies is that EGTRRA does not apply to *estates* after 2010. As for Sec. 901(b) and its statement that EGTRRA doesn’t apply to “years, estates, gifts, and transfers described in subsection (a),” one possible interpretation is that the reference to “years” is meaningless because only subparagraph (2) applies in the case of “title V” (which includes Sec. 542). Thus, EGTRRA only sunsets with respect to decedent’s estates occurring after 2010 and property acquired from those estates after 2010. But, the EGTRRA modified carry-over basis rule would still apply to a tax return reporting gain on sale of a 2010 inherited asset filed for a tax year beginning after 2010.¹⁶

So, which approach is correct? A fundamental rule of statutory construction is that the Congress is presumed to have chosen statutory language for a purpose and that the Congress intended that purpose. That is to say, words mean things. That intent would seem to be clear inasmuch as the Congress, in both Sec. 901(a) and Sec. 901(b), evidenced an intent to sunset all of the EGTRRA provisions with respect to all tax years (for whatever purpose – estate tax, gift tax, income tax, etc.) beginning after 2010.

It would have been easy for the Congress to specify that the EGTRRA provisions expired for some things and not for others. That is the argument espoused by some as detailed above – EGTRRA sunsets for decedent’s estates after 2010, but not for basis computation purposes for heirs that inherit assets in 2010 but don’t sell those assets until after 2010. But, the Congress did not take that approach.

The “partial EGTRRA sunset” theory also suffers from another shortcoming. If a donor makes taxable gifts during 2010, pays a gift tax at a rate of 35% (the rate applicable to taxable gifts in 2010) and dies after 2010, will the gift tax with respect to “adjusted taxable gifts” that is subtracted in the calculation of the estate tax (assuming the estate tax is restored) under

section 2001(b)(2) (line 7 of part two of Form 706 (2009 version of the federal estate tax return) be the 35% tax (the EGTRRA rate), or will it be the higher pre-EGTRRA rate that “would have been payable” (see section 2001(b)(2)) if the 35% rate “had never been enacted” (see section 901(b) of EGTRRA)? The latter approach would be consistent with the way the unified gift and estate tax system has operated since 1977, including the similar treatment I.R.C. §2502(a)(2) gives to pre-1977 gifts. Thus, applying the “partial EGTRRA sunset” rule would not appear to be the correct approach to apply to a post-2010 estate when 2010 taxable gifts are involved. A strong argument can be made that Congressional intent was to have EGTRRA Secs. 901(a) and (b) operate to have the system work the way it has worked since 1977. That would mean that EGTRRA provisions don't apply to post-2010 tax years - for purposes of the computation of the estate tax post-2010 where 2010 taxable gifts are involved. That would also be consistent with the strict reading of the sunset provisions – that no provision in EGTRRA applies to any type of tax return involving a post-2010 tax year.

Note: Applying pre-EGTRRA gift tax rates to 2010 adjusted taxable gifts where death occurs after 2010 is also consistent with the application of the “Byrd rule” – that EGTRRA provisions not have a negative budget impact in post-2010 years.

To date, the IRS has said nothing on this issue. Unless the Congress takes action to clarify the sunset provision, the matter will have to be sorted out by the courts.¹⁷

The basis increase. As noted above, for 2010 deaths, property passing outright to the surviving spouse or to a qualified trust for the surviving spouse is eligible for a basis increase of up to \$3 million (limited by the fair market value of the property at the date of the decedent's death). Also, property passing to person's other than the surviving spouse is eligible for up to a \$1.3 million basis increase

(again limited by the property's fair market value).¹⁸

In order to qualify for a basis increase, the property must have been “acquired from the decedent” and “owned by the decedent at the time of his death.” The following meet the test:

- Property acquired by bequest, devise or inheritance, or by the decedent's estate, from the decedent;
- Property transferred by the decedent to a living trust or any other trust the decedent could amend or revoke; and
- Any other property passing from the decedent without consideration by reason of the decedent's death

For jointly owned property, the “fractional share” rule applies to property held by the decedent and spouse as joint tenants, and the “consideration furnished” rule applies to other joint interests of the decedent. For community property, the decedent is treated as having owned the surviving spouse's 50 percent share of community property which will be eligible for a basis increase.

But, some property interests are not eligible for a basis increase:

- Property over which the decedent had a general power of appointment;¹⁹
- Property in a QPRT or GRAT that ends before its term of years due to the settlor's death;
- IRD property;
- Property acquired by the decedent by gift within three years of death (unless received from the decedent's spouse);
- QTIP property in the surviving spouse's estate

Allocating the basis increase. I.R.C. §1022(d)(3) specifies that the executor is to allocate the basis increase amount (on an asset-by-asset basis) to the non-spousal assets in a manner that is “fair.” But, what is fair? That can depend on the tax attributes of the asset under consideration. An equal pro-rata

allocation of the basis increase amount across all of the assets based on their relative fair market value may not actually be fair. The executor should give consideration to numerous things – the character of the gain on eventual sale (ordinary income or capital gain), how soon the asset will likely be sold, the tax bracket of the legatee, whether the asset in question has some other way to avoid gain recognition upon sale (e.g., the personal residence), whether the asset is an item of inventory of the decedent (e.g., grain).²⁰

What must be filed? The executor must file a “Large Transfers Return” in accordance with I.R.C. §6018 if the estate value (other than cash) exceeds \$1.3 million. IRS had been working on a draft Form 8939, but pulled the form in late October. Whatever form is developed will require the listing of the property of the decedent, the decedent’s adjusted basis in the various items of property, the fair market value of the property, the character of the gain upon sale, whether the property was acquired by gift, and the amount of basis increase allocated to the various property interests of the decedent.

The “Large Transfers Return” is due when the decedent’s final income tax return is due. If that deadline is not met, the executor is subject to a \$10,000 fine. The executor must also provide the heirs with sufficient information concerning the decedent’s basis and holding period and the amount of any basis increase that the executor allocated to the decedent’s various assets. The executor is subject to a \$50 fine (per heir) for failing to provide such information.

The Future of the Estate Tax - The Real Question

While more estates would likely be impacted by the loss of stepped-up basis than would be impacted by the estate tax, the real question is whether the tax bill would be greater for the heirs if (and when) the inherited property is sold (as compared to what the tax burden for the estate would have been) *and* the reduced impact on the functioning of business as a result of estate tax repeal. Another key point is that with

an estate tax, payment of any estate tax is due within nine months after death which may be at a time that is particularly inconvenient for an ongoing family business or farming operation after the decedent’s death.²¹ This can be a particular problem for a small business or family farming operation where it is impractical to sell a fraction of the business to pay estate tax due to a lack of a recognizable market for non-control interests that are not actively traded.²² However, the capital gains tax can be timed and managed by the heirs to minimize interference to existing business operations.

Note: There is general agreement that carryover basis is not good tax policy as applied to estates. The loss of complete-stepped up basis for assets inherited in 2010 that are sold in 2010 will produce administrative and compliance issues. That will be particularly true for estates that lack good basis information.

Impact of the Estate Tax

Even though the federal estate tax impacts less than one percent of all estates (this is the projected impact for deaths in 2009), extending the estate tax became politicized in recent months.²³ Proponents of extending the tax have typically claimed that it’s just certain wealthy individuals that have been pushing for its elimination. While that may be true, such claims are typically not accompanied with a mention of data that indicates the estate tax’s negative impact on businesses and the economy. For example, a couple of recent studies have shown that the tax is a drag on the economy, and is particularly harsh on small businesses. One study concluded that full and permanent repeal of the estate tax would create 1.5 million jobs, increase the probability of hiring by 8.6 percent, increase payrolls by 2.6 percent, expand investment by 3 percent and reduce the jobless rate (as of February 2009) by .9 percent.²⁴ Another study found that the estate tax “impacts small firms disproportionately by encouraging well-capitalized companies to gobble-up smaller ones at the owner’s death” and promotes concentration of wealth by

preventing small businesses from being passed on to heirs.²⁵

Note: Proponents of extending the estate tax also typically fail to point out that not all countries have an estate tax. Those countries without an estate tax include Austria, Australia, New Zealand, Sweden, India, Virgin Islands, Gibraltar, Singapore and Russia. A reasonable question to ask is why these countries do not have an estate tax and the United States does.

Estate Tax Remnants Still Remain

In one sense, the estate tax is not completely gone for 2010. Even though the estate tax is repealed for deaths in 2010, those estates that have elected special use valuation, the qualified family-owned business deduction, or have elected to pay the estate tax in installments from pre-2010 deaths, the recapture rules will continue to apply in 2010 through the end of the applicable recapture period.

Planning Implications of Repeal

If the Congress does not enact legislation to deal with the estate tax in 2010, the estate tax will return for deaths in 2011 and thereafter. However, when it returns, the exemption will only be \$1 million (for generation skipping transfer tax (GSTT) purposes also) and the tax will have a top marginal rate of 55 percent (with a 5 percent surcharge applicable to adjusted taxable estates between \$10 million and \$17.184 million). Thus, for taxable estates exceeding \$17.184 million, the tax will be a flat 55 percent. The gift tax will return at a 45 percent rate.

For married couples, a common estate planning technique that has been utilized for many years with respect to potentially taxable estates is to utilize drafting language in will and trusts that eliminates federal estate tax upon the first spouse's death and minimizes estate tax upon the surviving spouse's death by dividing the first spouse's estate into two packages – (1) formula clause language that leaves the maximum amount of property to the surviving spouse in a

form that does not qualify for the marital deduction so as to fully utilize the deceased spouse's applicable exclusion against the estate tax (in other words, the clause language leaves the maximum amount of property to the surviving spouse in life estate form that eliminates estate tax in the first spouse's estate – typically referred to as the “bypass trust”²⁶; and (2) an outright gift to the surviving spouse (or a trust for the surviving spouse's benefit – known as the “marital trust”) of the balance of the estate (which passes tax free via the unlimited marital deduction).

Note: Some estate planners, especially when handling very large estates, utilize formula drafting language which has each spouse gift the spouse's GSTT exemption to a trust for the children (and, perhaps, grandchildren), with the balance of the estate passing either to the surviving spouse or the children.

Because of the use of formula clause language that is tied to the level of the exemption at the time of death to minimize tax over both spouse's estates (for example, typical drafting language may specify that the credit shelter amount (the “bypass trust” amount) is pegged as “the largest amount that can pass free of federal estate tax”), for deaths occurring while no estate tax exists a question will be raised as to the effect of any formula-derived gift. Will it fail because the formula clause language utilized refers to a non-existent tax (and/or exemption)? If so, the entire estate might pass to the surviving spouse.²⁷ That could create a problem on the surviving spouse's estate if the Congress re-enacts the estate tax. The surviving spouse's estate would be inadvertently “over-stuffed” resulting in a higher tax than would have been the case had the formula clause language worked as anticipated in the first estate. Another concern is that while all of the property may go to the surviving spouse, it may pass to the spouse in life estate form rather than outright. That will give the surviving spouse an income interest in the property for life, but not outright control. Will the income stream from the life estate property be enough for the surviving spouse? The answer

to that question depends on the age and lifestyle of the surviving spouse, among other things.

Note: For deaths in 2010, only those assets that pass outright to the surviving spouse or pass to the surviving spouse via a marital trust qualify for a basis increase. So, if the formula clause results in the assets of the first spouse passing entirely to the surviving spouse in life estate form, none of the assets would be eligible for a basis increase.²⁸

So, are there ways around the problem of the impact of repeal on present formula drafting language in wills and trusts? Maybe all that is necessary is that a codicil to an existing will be executed or that trust language be amended. But, clients must take action to update their plans – or practitioners should review existing client plans and take the initiative to get clients to make the necessary changes. However, some clients will want to delay doing anything, preferring instead to wait and see what, if anything, the Congress chooses to do. That could be a real client counseling issue. For clients that really need to have some estate planning done (for various reasons), here are some suggestions: (1) revise existing estate planning clause language to specify that if death occurs at a time when the federal estate tax is not in effect, a specified pecuniary amount will pass either outright or in trust for the children so as to reduce the amount passing to the surviving spouse; (2) alternatively, revise existing clause language to specify that if death occurs when there is no estate tax, all property passing to the surviving spouse is in trust with the spouse as beneficiary with the trust having language designed to minimize (or avoid) the impact of any estate tax that may be in effect at the surviving spouse's death; or (3) for GSTT planning purposes, revise existing clause language to specify that property that would have passed outright to children now passes in trust for their benefit – again to minimize or avoid the impact of a reinstated GSTT.²⁹

Note: Some states have taken legislative action that would treat decedents dying in 2010 as having died on December 31, 2009,

for purposes of construing formula clause and other tax-relevant language in wills and trusts.

But, in any event, estate planners should not lose sight of common planning techniques that are still in play. Such techniques include the use of annual exclusion gifts (presently \$13,000 per donee per year) – they should still be made (as well as other techniques that shift future asset value to later family generations) to keep the estate size manageable in the event the estate tax again becomes law.

From a gift tax planning standpoint the basic idea is to consider techniques that either take advantage of the repeal of the GSTT or the 35 percent gift tax rate. Such strategies might include using the \$1 million gift tax exemption to fund a “Crummey”-type trust for children and grandchildren.³⁰ If one believes that a higher gift tax rate will apply in the future, an aggressive gifting strategy could be utilized with the result that taxable gifts would be taxed at 35 percent rather than 45 percent. This strategy also dovetails with an estate tax minimization strategy if it is believed that the estate tax will return. Also, practitioners may want to consider the use of qualified terminable interest trusts (QTIP) to benefit a surviving spouse and allow the surviving spouse to adopt a “wait and see” approach as to whether a QTIP election should be made based on whether the estate tax is in existence.³¹

Future Legislative Attempts?

The pro-estate tax pundits and politicians have been pushing the idea that the Congress could try to retroactively restore the estate tax as of January 1, 2010.³² That may have been possible early in 2010, but not now (and probably not after February of 2010). Any attempt by the Congress to pass a retroactive reinstatement of the estate tax would trigger lawsuits. A retroactive reinstatement of the estate tax could be challenged as an unconstitutional violation of the Ex Post Facto Clause – i.e., it's unconstitutional to retroactively collect tax on the estates of people that died during the

timeframe that the tax was repealed, or upon trust terminations or distributions in that same timeframe.³³ However, the U.S. Supreme Court previously stated in *Carlton v. United States*³⁴, that a retroactive tax law is valid under the Constitution if (1) the government shows that the statute has a rational legislative purpose and is not arbitrary and irrational; and (2) the period of retroactivity is "modest."³⁵ However, there is caselaw indicating that the result might be different if the Supreme Court were to view the passage of a retroactive estate tax bill as a "wholly new" tax rather than as simply fixing something in an existing tax.³⁶ But, because the Congress allowed the estate tax to die, a retroactive "fix" would be a new tax - there is no estate tax law on the books at the present time. That is what could make a reinstatement of the estate tax retroactive to January 1, 2010, unconstitutional.³⁷

In early February 2010, an estate tax prepayment idea was floated by Senator Cantwell (D-WA) as a compromise between those Senators that don't want the estate tax rate to exceed 35 percent and the push by the Administration (and Senate Democratic leadership) for a 45 percent rate. Under the proposal, individuals with relatively large estates that might be subjected to estate tax if it is reenacted could essentially "prepay" estate taxes by placing assets in a "prepayment trust" during life with the trust assets taxed at a 35 percent rate. The tax could be paid over a five year period.³⁸

Conclusion

Perhaps the Congress will consider some type of compromise legislation by the end of 2010. But, that doesn't appear likely at the present time. Most likely, the Congress will deadlock on the estate tax issue during the lame-duck session.

Clearly, any debate concerning reenactment of the estate tax should involve discussions concerning whether the estate tax should be completely repealed with death-time basis restored and if not completely repealed, the estate tax rate, the structure of the tax rate (graduated, flat or stair-stepped), the amount of the estate tax

exemption, whether the estate and gift tax are to be unified, whether the estate tax exemption should be portable among spouses, and any applicable phase-ins (with respect to either the rate of tax, or the exemption amount).

In any event, practitioners should carefully counsel clients to maintain as much flexibility as possible in their tax and estate planning. The uncertainty over the future of the federal estate tax makes estate planning at the present time very difficult, and makes the review of present estate planning documents critical to make sure that they still carry out the client's intent for disposition of the assets at death.

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¹ In early 2009, the Administration had proposed making existing law (\$3.5 million estate tax exemption and 45% rate) applicable to transfer taxes (estate tax, gift tax and generation skipping transfer tax (GSTT)) permanent beginning in 2010. As the year progressed, the estate tax issue seemed to filter to the background behind spending legislation and, later, proposed health care legislation.

² The GSTT is separate from and in addition to the estate tax, and applies to transfers (outright or in trust) that skip generations (as defined by statute).

³ Provisions contained in the Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001 (Pub. L. No. 107-16, signed into law on June 7, 2001) specified that the federal estate tax exemption would gradually rise through 2009 combined with a gradual reduction in the estate tax rate. At the same time, the GSTT and gift tax rates would fall at the same pace. In 2010, the estate tax and GSTT would be repealed, but the gift tax would remain at a 35 percent rate on taxable gifts. Beginning with deaths after 2010, the estate tax and GSTT would return, but only with a \$1 million exemption and a 55 percent top rate. The Congress, since 2001, made numerous attempts to address the looming one-year repeal, and legislation did pass the House as early as 2006 that would have set the exemption at \$5 million with a date-of-death basis rule and a rate of 15 percent or 30 percent based on the size of the taxable estate. That

legislation would have been effective January 1, 2010, but the Senate never considered the bill.

⁴ The \$13,000 present interest annual exclusion is also available for 2010 on a per-donee basis.

⁵ For assets that are gifted in 2010, the carry-over basis rule remains in effect.

⁶ I.R.C. §1014(a). Thus, only the post-death appreciation (if any) is subject to tax if and when the beneficiary sells the asset.

⁷ I.R.C. §1022.

⁸ I.R.C. §1022(d)(2)(B).

⁹ I.R.C. §1022(b)(2)(B). Estates of non-residents that are not U.S. citizens are entitled only a \$60,000 basis increase and no spousal property basis increase. I.R.C. §1022(b)(3)(A). Also, the \$1.3 million basis increase amount can be increased by any capital loss carryover under I.R.C. §1212, the amount of any net operating loss carryover under I.R.C. §172 that would be carried from a decedent's last tax year to a later year of the decedent (but for the decedent's death), and any losses that would have been allowable under I.R.C. §165 if the property acquired from the decedent had been sold at its fair market value immediately before the decedent's death. It is important to note that the basis increase amounts are without regard to the assets that generated the losses. Thus, basis can be increased for an asset by a loss generated by an event concerning a different asset. In addition, a double benefit can result from the carryover of an NOL – they can be taken as an income tax deduction on the joint return of the decedent and surviving spouse that is filed for the year of death. I.R.C. §6013(a)(3).

¹⁰ But, capital gain rates are significantly less than the 45 percent estate tax rate that was proposed in the legislation that the U.S. House voted on in late 2009.

¹¹ EGTRRA, in order to comply with the Congressional Budget Act of 1974, was required to sunset at the end of 2010. Specifically, the so-called "Byrd rule" was contained in that 1974 Act and bars the Congress from enacting tax legislation that has a negative revenue effect after the years covered by the relevant budget reconciliation process. The rule can be avoided, but it takes a Senate vote supermajority of 60. EGTRRA passed with less than 60 votes, so the "Byrd rule" applies to its provisions – that means no negative budget impact after 2010.

¹² EGTRRA, Sec. 901(a).

¹³ EGTRRA, Sec. 901(b).

¹⁴ *Id.* This point is further bolstered by Sec. 901(b) of EGTRRA which states that the Code "shall be applied and administered to years, estates, gifts, and

transfers [after December 31, 2010,] as if the provisions and amendments [of EGTRRA] had never been enacted."

¹⁵ Ron Aucutt, of McGuire, Woods has circulated an e-mail among the American College of Trust and Estate Counsel e-mail list espousing the "EGTRRA partial sunset" theory which is summarized herein.

¹⁶ It is highly unlikely that the drafters thought through this complicated mechanical statutory process in crafting the sunset language.

¹⁷ See also, Blattmacher, Gans, Zaritsky and Zeydel, *Journal of Taxation*, February 2010. They conclude, "The only thing that is clear is that we will not know the scope of EGTRRA's sunset provisions until Congress, a court, or perhaps Treasury through the issuance of Regulations, clarifies it.

¹⁸ The basis increase amounts are subject to inflation adjustments. The \$1.3 million can be increased in multiples of \$100,000 using 2009 as the base year, and the \$3 million amount can be increased in multiples of \$250,000 (with 2009 as the base year). There is also a \$60,000 aggregate basis increase for non-resident aliens which can be inflation adjusted in \$5,000 increments with 2009 serving as the base year. I.R.C. §1022(d)(4).

¹⁹ I.R.C. §1022(d)(1)(B)(iii). The provision would appear to extend to powers created by third parties in favor of the decedent and powers created by the spouse of the decedent. But, property subject to a power retained by the decedent after a transfer to others is eligible for a basis increase. I.R.C. §1022(e)(2)(B). Thus, a trust over which the decedent reserved the power to change the beneficial enjoyment is treated as property that is acquired from the decedent.

²⁰ The basis increase is important as to non-depreciable assets, but is very important as to inventory items such as zero basis calves or grain as well as I.R.C. §1245 depreciated equipment that would be subject to recapture tax upon sale or trade.

²¹ While the nine-month timeframe may not be sufficient time to raise the cash necessary to pay the estate tax liability, and insurance may not be practical for various reasons, it has been possible to make an election on the decedent's estate tax return to pay the tax in installments over (essentially) a fifteen-year period at a favorable interest rate. See I.R.C. §6166. However, numerous requirements must be satisfied to make the election and not all estates will qualify to make the election.

²² This point is commonly ignored by commentators that support the imposition of the estate tax. Such

commentators typically note (correctly) that the estate tax results in fewer than 1 percent of all estates having a tax liability, and (largely incorrectly) that business assets (such as a farm) don't have to be sold to pay the tax. Whether or not a farm (or other business assets) have to be sold to pay the estate tax is not the issue. The issue is the impact of the tax on the functioning of the business and the cost and other inefficiencies imposed by the planning and business structuring necessary to avoid the imposition of the tax, and whether the estate tax constitutes sound economic and social policy.

²³ The estate tax issue has been highly politically for a number of years. Numerous unsuccessful attempts had been made from 2002 through 2006 to fully repeal the federal estate tax.

²⁴ Eakin and Smith, "Changing Views of the Estate Tax: Implications for Legislative Options," American Family Business Institute, February 2009.

²⁵ Yakevlov, P. and A. Davies, 2009. "The Effect of Estate, Inheritance, and Gift Taxes on the Survival of Small Businesses: A Panel Data Analysis," *National Tax Journal*, under review. One of the basic conclusions of the study is that the estate tax results in smaller businesses being acquired by larger businesses. After a series of multiple acquisitions, a very large company can result.

²⁶ Also, the "bypass trust" property could pass outright to the decedent's children.

²⁷ Even more troublesome, perhaps, is that the property could pass to the decedent's children from a prior marriage. In addition, such formula clause language could inadvertently result in the complete defunding of charitable bequests.

²⁸ Another potential problem with of formula clause language can occur if the language results in the funding of the "bypass trust" with an amount that exceeds any state-level exemption. Some states still have an estate tax that would subject those excess amounts to tax. Those states presently with an estate tax are Connecticut, Delaware, Maine, Maryland, Minnesota, New York, Ohio, Oregon, Vermont and Washington. Also, the District of Columbia has an estate tax.

²⁹ Because the GSTT is also repealed for deaths after 2009, one consideration may be to make transfers to "skip" generations (e.g., grandchildren) in an amount that is less than the transferor's \$1 million gift tax exemption. As a hedge against reenactment of the estate tax and the GSTT, property could instead be placed in trust for the surviving spouse with the grandchildren designated as beneficiaries under

formula clause language that leaves the maximum amount to the grandchildren free of GSTT. Under this approach, however, the donor would need to make a qualified terminable interest property (QTIP) election on a timely filed gift tax return. Also, grandchildren could be named as remainder beneficiaries on various types of charitable trusts.

³⁰ See *Crummey v. Comr.*, 397 F.2d 82 (9th Cir. 1968).

³¹ See the text of footnote 13, *supra*.

³² Indeed, early in 2010, the Chairman of the Senate Finance Committee and the Chairman of the House Ways and Means Committee (the tax-writing committees in the Congress) have expressed their intent to extend the 2009 law for deaths after 2009, perhaps on a permanent basis and, perhaps, retroactive to January 1, 2010.

³³ Article I, Section 9 of the United States Constitution contains the Ex Post Facto Clause.

³⁴ 512 U.S. 24 (1994).

³⁵ The Court's opinion was unanimous, and the period of retroactivity was 14 months.

³⁶ The *Carlton* case involved closing a loophole on a retroactive basis to an *existing* estate tax.

³⁷ Also, 2010 is an election year and the more time that passes with the estate tax expired, not only does that bolster the argument that a retroactive reinstatement of the tax is unconstitutional, but it makes reinstatement of the tax much more politically difficult.

³⁸ As Joe Kristan has correctly noted on his blog (www.taxupdateblog.com), the current gift tax structure essentially accomplishes the same thing as the "prepayment trust." As Joe points out, "[T]he tax cost of gifting assets is lower than that of passing them on at death because the gift tax rate is imposed only on assets that reach the next generation; the estate tax is imposed on the whole estate, including the amount that has to go to the government to pay the tax."