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Estate Planning - Temporary Certainty

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Overview

In mid-December of 2010, the Congress passed and the President signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (Act).[1] The Act contains the most significant changes to transfer taxes (estate, gift and generation-skipping tax) in decades. The changes are so significant that standard estate planning techniques may no longer be necessary.

However, the changes are only for 2011 and 2012,[2] with no certainty at the present time as to what 2013 may bring. So, the uncertainty concerning the future of the estate tax that was present for much of 2010 is only removed through 2012.

Key Changes

Prior law. In 2009, the federal estate tax exemption was $3.5 million per decedent with excess amounts taxed at 45 percent.[3] The estate tax was repealed for deaths in 2010, and was scheduled to return for deaths in 2011 with only a $1 million exemption and a 55 percent rate. The income tax basis rule, which had allowed property included in a decedent's estate to receive an income tax basis in the hands of the heirs equal to the property's fair market value at death for deaths through 2009, was also changed for deaths in 2010.[4] For deaths in 2010, the so-called "stepped-up" basis rule was changed to a modified "carryover basis" rule. Under the rule, an heir's income tax basis in an inherited asset is the decedent's basis, but the estate's executor can increase that basis by up to $1.3 million (of fair market value, whichever is less) for property passing to someone other than the surviving spouse, and up to $3 million for property passing to the surviving spouse.

> **Note:** Both the $1.3 million basis increase and the qualified spousal basis increase can be allocated entirely to qualified spousal property.[5]

Income tax basis. The modified carryover basis rule is certainly applicable for assets inherited from a 2010 decedent that were also sold in 2010 and for which the estate's executor made an election out of the estate tax (the election is discussed later). But, the applicable income tax basis rule for assets inherited from a 2010 decedent's estate (where the executor made the election to not have the estate tax apply) is less clear. The uncertainty stems from the "sunset" provision contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[6] which enacted a modified carryover basis provision for deaths in 2010,[7] and stated that, beginning in 2011, the rules in effect before EGTRRA's enactment will apply as if EGTRRA had never been enacted.[8]

EGTRRA's sunset provision specifies as follows:

§901(a): "In General. All provisions of, and amendments made by, this Act shall not apply –

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

- (2) in the case of Title V, to estates of decedent's dying, gifts made, or generation skipping transfers, after December 31, 2010."[9]

§901(b):

- "(b) Application of certain laws. The Internal Revenue Code of 1986…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."

Based on a strict reading of §901(b), if a beneficiary of a 2010 decedent's estate sells an inherited asset in a year after 2010, the provision would appear to allow the heir to compute their income tax basis (for purposes of gain computation on the heir's post-2010 income tax return) in accordance with the date-of-death value rule of I.R.C. §1014.

> **Note:** The minimal amount of legislative history on the EGTRRA sunset provision indicates that the Congress did not intend to provide for a repeal of the federal estate tax in 2010 *and* allow beneficiaries of 2010 estates to receive a stepped-up basis for the inherited assets inherited from such an estate that are sold post-2010.

The basic drafting problem with the statutory language is that §901(a)(1) focus on "tax year" while §901(a)(2) focuses on the date the transfer at issue occurs. Because the two clauses are connected by "or," it is possible to read the provisions together and arrive at the conclusion that carry-over basis applies at any time an inherited asset is sold because the seller's receipt of the asset was derived from a "transfer" caused by a death in 2010. But, that would require one to ignore §901(b) of the sunset provision. The Congress included §901(b) in the EGTRRA sunset provision to reinforce the application of the "Byrd Rule" – a rule that, in its application, requires that the revenue impact of EGTRRA is the same post-2010 as it was before EGTRRA was enacted. Accordingly, §901(b) indicates that the same rules apply post-2010 to *all* Internal Revenue Code provisions. In other words, the sunset provision is a complete sunset of all EGTRRA provisions. To conclude otherwise by applying, for example, the modified carry-over basis rule of I.R.C. §1022 to post-2010 tax years would not result in revenue neutrality that is required by the "Byrd Rule."

In any event, the bottom line on EGTRRA's sunset provision as applied to the appropriate basis rule to apply to 2010 inherited assets that are sold post-2010 is that the matter remains unresolved at the present time. Indeed, well-respected estate planning attorneys, Blattmachr, Gans, Zaritsky and Zeydel, have stated, "…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."[10]

> **Note:** The IRS, in *Rev. Proc. 2011-41*, stated that I.R.C. §1022 applies to determine a legatee's basis in all property acquired from a 2010 decedent's estate where the election out of the estate tax is made regardless of when the property is sold. Unfortunately, the IRS did not provide any rationale as to how it reached its conclusion, and made the pronouncement in a Revenue Procedure, a very low level of IRS guidance that cannot be relied on as substantial authority

New Law

Effective January 1, 2010, the Act retroactively reinstates the estate tax with a top rate of 35 percent and a five million dollar exemption. But, executors of 2010 decedent's estates can choose whether to use the new rules or elect to use the 2010 rules that existed before the Act's enactment.

Election for 2010 estates. Under the Act, for deaths in 2010, an executor can elect to utilize the prior 2010 rules.[11] If such an election is not made, the estate tax applies at a 35 percent rate on taxable amounts above $5 million.[12] Unfortunately, the Act is not clear as to *when* the election must be made. For sure, executors that make the election do not have to file a Form 706 (Federal Estate Tax Return) or pay federal estate tax until nine months after the Act's effective date (which would, in effect, be September 19, 2011). Under EGTRRA, a 2010 decedent's estate needed to make the income tax basis allocations by the due date of the decedent's income tax return via Form 8939 (which still has not been finalized) - typically April 17, 2011. But, a question existed as to whether that was the applicable deadline for making the election out of the estate tax for a 2010 death. All the Act says is that the election is irrevocable and that it is "to be made in such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide."[13] One possible interpretation of the statutory provision was that the deadline is nine months from date of enactment.

On February 16, 2011, IRS published guidance on the question.[14] At that time, IRS Form 8939 had not been finalized, and neither had IRS Publication 4895 (Tax Treatment of Property Acquired From a Decedent Dying in 2010). But, IRS did note that Form 8939 would not be due until at least 90 days after the finalization of Form 8939.[15] IRS also stated that guidance on how to make the election will be contained on the final Form 8939 and Publication 4895.[16]

> **Note:** The February 16 guidance left unanswered, however, the question of whether the election could be made on Form 8939 (IRS simply says that guidance on how to make the election will be on the form) or whether some other Form would have to be filed. This is an important question because if separate Forms were to be required, it is possible that different filing deadlines could apply to each form.

IRS provided additional clarification in Notice 2011-66 which was released on August 5, 2011.[17]

Here's a summary of Notice 2011-66:

- Form 8939, which had still not been finalized, would be due on Nov. 15, 2011.

- Form 8939 is the form to be used to both elect out of the estate tax *and* make the income tax basis allocations applicable for deaths in 2010.

- The election, once made, is irrevocable.

- If a filing has already been made purporting to make the election, it must be replaced with a Form 8939 filed by November 15, 2011.

- The filed Form 8939 must show the basis allocations for the assets in the estate.

- A recipient's basis in property is subject to adjustment upon examination by IRS of *any tax return* reporting a value dependent on the property's basis – including those situations where basis increase amounts have been allocated to property.

- If the election out of the estate tax is made, all of the decedent's property (except cash and IRD property) must be reported and valued on Form 8939, along with all appreciated property the decedent acquired (valued as of date-of-death) that was required to be included on Form 709 if the decedent acquired the property by gift or intervivos transfer for less than adequate and full consideration within three years of the decedent's death (except transfers from the decedent's spouse that weren't acquired by gift).

- If the executor has not been appointed, any person that is in actual or constructive possession of property acquired from the decedent may file Form 8939 for that property.

- For property held in trust, the trustee will file Form 8939 as the party in possession of the decedent's property (referred to as "statutory executor" via I.R.C. § 2203). If there is more than one trustee or party in possession and they cannot agree on allocations, they have 90 days after the filing deadline to decide on allocations. If an agreement cannot be reached, IRS will make the allocations.

- If IRS receives multiple Forms 8939 that collectively allocate more basis increase that what is available under the modified carry-over basis rule, IRS will issue a letter to each person filing an 8939. Each person that filed an 8939 must collectively sign and file a single restated Form 8939 within 90 days of receipt of the IRS letters. Otherwise, IRS will allocate the available basis increase at its discretion.

- Within 30 days after filing Form 8939, the executor must provide a statement to each recipient of property from the decedent's estate that was reported on the form containing the information required in I.R.C. §6018.

- A Form 8939 that is filed before November 15, 2011, may be revoked or amended by a subsequent and timely filed Form 8939.

- An estate tax return and a conditional Form 8939 cannot be filed. An executor might want to do this, for example, if an estate tax audit would result in an upward adjustment that causes the taxable estate value to exceed the exclusion amount available to the estate.

- IRS will not grant extensions of time to file Form 8939, unless:

    - I.R.C. §7508A applies;

    - The sole purpose is to allocate spousal basis increase, but only if Form 8939 had been timely filed and was complete when filed except for the allocation of the full amount of the spousal property basis increase to the eligible property reported on the form, and the amended Form 8939 is filed no later than 90 days after the date of the distribution of the qualified spousal property to basis increase is allocated;

    - An amended Form 8939 is filed on or before May 15, 2012 for any purpose except to make or revoke the election. In this situation, the executor must write "Filed Pursuant to Section 301.9100-2" at the top of the amended Form 8939;

    - An extension for relief has been filed in situations where the executor discovers more property that could receive a basis increase, and/or the fair market value of the property reported on Form 8939 is adjusted by IRS. Relief is not available to reduce a basis increase allocation; and

    - The executor is applying for an extension of time to file Form 8939.

- The election out of the estate tax does not negate the application of the GSTT to the estate.

- The executor allocates the decedent's available GSTT exemption by attaching Schedule R of Form 8939 to the Form 8939 for the decedent's estate. If Form 8939 is timely filed, the allocation will be considered a timely allocation of the decedent's GST exemption under I.R.C. §2632.

- A 2010 transfer not in trust to a skip person is a direct skip to which the donor would not want to allocate GSTT exemption. Thus, the reporting of an intervivos direct skip in trust occurring in 2010 on a timely filed Form 709 will be an election out of the automatic allocation of GSTT exemption to that direct skip. Otherwise, an election out can be achieve by paying the GSTT with Form 709.

- The due date for filing a return reporting a direct skip, taxable distribution or taxable termination occurring January 1, 2010, through December 16, 2010 is September 19, 2011 (including extensions), unless a Schedule R that is attached to Form 8939 is required. That is due November 15, 2011.
- The due date for Filing Form 709 that does not report a GSTT transfer or that reports a GSTT transfer occurring on or after December 17, 2010, through December 31, 2010, is April 18, 2011, including extensions.
- The due date for filing Form 709 to elect to treat a trust as a GSTT trust or to allocate the GSTT exemption to a transfer occurring during 2010 was April 18, 2011, including extensions.

In the Notice, IRS said it was accepting comments concerning the guidance provided in the Notice, and that submitted comments will be available for public inspection and copying. However, no timeframe for submitting comments was provided.

Income Tax Basis Guidance. Also on August 5, IRS issued Revenue Procedure 2011-41.[18] In the Rev. Proc. IRS stated (with no statutory analysis) that for an estate for which the executor elects out of the estate tax via Form 8939, the I.R.C. §1022 basis rule "applies to determine a recipient's basis in all property acquired from that decedent, regardless of the year in which the property is sold or distributed. Accordingly, if property is acquired from the decedent who died in 2010 and the executor makes the election out of the estate tax and into modified carry-over basis, then when the property is sold during 2010, 2011 or any subsequent year, the recipient's (seller's) basis in the property is determined under I.R.C. §1022 rather than under I.R.C. §1014."

It's not surprising that the IRS would interpret the statute in that manner, but the IRS view set forth in the Revenue Procedure (which does not constitute substantial authority) does not preclude other interpretations of the statute.

In the Revenue Procedure, the IRS also answered some important previously unanswered questions by establishing several optional safe harbors as follows:

- When basis step-up amounts are allocated to eligible property, the result is known as the "aggregate basis increase." The allocations are shown on the Form 8939. The IRS clarified that the aggregate basis increase includes all unrealized losses in capital assets as of the decedent's death. That is the case, IRS said, irrespective of any limitations on immediate deductibility that might apply for income tax purposes if the property were to be sold.

  Note: Thus, the amount of any unrealized losses is available to increase the basis of assets up to (potentially) fair market value. Relatedly, basis increase is available (if a joint return is filed with the surviving spouse) for any unused NOLs or capital losses which would have been (but weren't because of the decedent's death) carried from the decedent's last taxable year to a later taxable year. The decedent's share of such losses is to be computed (presumably) by multiplying the decedent's separate loss carryover by the joint loss carryover.

- The holding period of property that is acquired from the decedent when an election out of the estate tax is made via Form 8939 includes the decedent's holding period. It doesn't matter whether the executor allocates any basis increase amount to the subject property. This will eliminate the possibility of short term capital gains and losses.

- Unused passive losses can be added to the basis of the decedent's property, and, for community property, the surviving spouse's unused passive losses on such property can also be added to the overall basis increase but are deemed to used last. If the executor does not use them to increase basis, the surviving spouse can use them in the future.

- For property used in the decedent's trade or business or property that was depreciable in the decedent's hands, the character of the property stays the same in the recipient's hands. That character could, however, be impacted if the recipient changes the property's use. But, in any event, property that was subject to depreciation recapture (I.R.C. §§1245 or 1250) remains subject to potential recapture upon any eventual sale by the recipient. An end-run around the rule is not achievable by converting the property to personal use. If the property would have been depreciable by the decedent and is depreciable by the recipient, the recipient computes depreciation in the same manner that the decedent did on whatever portion of the decedent's basis carries into the recipient's hands. Any basis increase amount is treated as a separate asset that is placed in service as of the date of the decedent's death.

- For community property, the surviving spouse's one-half share is deemed to be "owned by and acquired from" the decedent for the purpose of the basis increase rule if at least one-half of the property is treated as "owned by and acquired from" the decedent. So, if that rule is satisfied, the property qualifies a basis increase. In addition, such property could receive a "stepped-down" basis if its basis is less than its fair market value as of the date of the decedent's death. Also, for community property, built-in losses on the surviving spouse's half of community property are eligible for a basis increase that the executor can allocate to other property.

- The executor can allocate basis to qualified property after the executor has disposed or distributed the property.

- Estates of non-resident, non-U.S. citizens are entitled to up to a $3 million spousal basis increase, but are limited to a general basis increase on non-spousal property of $60,000

New filing deadline. In September, IRS finalized Form 8939 and moved the filing deadline to January 17, 2012.[19] No statement or form has to be filed to have the new due date apply. Here are the key points of the September development:

- For deaths in 2010 where the estate's executor does not elect out of the estate tax, the filing deadline for Form 706 was September 19, 2011, for decedent's dying from January 1, 2010, through December 16, 2010.

- For deaths in 2010 where the estate's executor does not elect out of the estate tax, the filing deadline for Form 706 is nine months after death for decedent's dying December 17, 2010, through December 31, 2010.

- Executors of 2010 estates can obtain an automatic six-month extension of the Form 706 by filing Form 4768 on or before the due date for filing Form 706.

- The filing of Form 4768 does not lock the estate into filing a Form 706 for the estate. Instead, filing Form 4768 simply assures the executor of additional time to determine whether or not to elect out of the estate tax.

  Note: IRS also stated in Notice 2011-76 that late-payment and negligence penalty relief applies to recipients of property from a 2010 decedent's estate that sold the property in 2010, but did not properly report gain or loss because it was unknown at the time whether the estate property would be entitled to a full basis step-up or a modified carry-over basis. In such situations, if a recipient's tax liability is increased as shown on an amended return or otherwise because an election out of the estate tax has been made, reasonable cause and good faith is presumed and no penalty for failure to pay tax or the I.R.C. §6662(a) penalty will apply. "IRS Notice 2011-76" is to be written on the top of the amended return to show IRS that the recipient meets the reasonable cause requirement. *Notice 2011-76 is effective September 13, 2011.*

Gift Tax

Gift tax is not changed for 2010 – it remains in place with a $1 million exemption and a 35 percent rate on excess amounts. For 2011 and 2012, the new law establishes a $5 million estate, gift and generation-skipping transfer tax (GSTT) exemption. The tax rate is 35 percent on excess amounts. Also, for deaths in 2011 and 2012, the estate tax exemption is portable. That means that any unused amount of the exemption at the death of the first spouse carries over to the surviving spouse and is added to the surviving spouse's $5 million exemption.[20] That's a key feature of the law. It means that the combined exemption of both spouses is truly $10 million, without the need for complicated estate planning to get the full benefit of the exemptions in the estates of both spouses.

The Act also reinstates the GSTT for 2010, but provides a GSTT "holiday" by setting the GSTT rate at 0 percent. That means that transfers can be made directly to skip persons or out of non-exempt GSTT trusts without any GSTT cost (and no allocation of the GSTT exemption). But, there are practical limits – the GSTT exemption is $5 million, the $1 million gift tax exemption caps the 2010 GSTT planning opportunity, and the GSTT exemption for 2011 and 2012 is not portable.[21]

Disclaimers

The Act also extends the timeframe for making a qualified disclaimer for decedent's dying after 2009 and before December 17, 2010.[22] The extended timeframe extends to nine months after December 17, 2010 – the effective date of the Act.[23]

Executor Choices – Rules of Thumb

Because of the ability to apply the 2011-2012 rules (for the estate tax) to 2010 estates, an executor must consider several things in making an appropriate decision. In general, for estates valued at $5 million or less in net worth, the executor should not elect out of the retroactively reinstated estate tax for 2011-2012. The result would be no estate tax due, and the heirs would receive a stepped-up basis in the inherited assets.

For those estates with a taxable value of over $10 million, the executor would most likely want to elect to use the prior (2010) rules. That would result in no federal estate tax, but would also result in the application of the modified carryover basis rule.

For those estates valued between $5 million and $10 million, the executor will have to consider numerous factors to determine whether or not to elect out of the estate tax. The factors to be considered include the following:

- A comparison of the 35 percent estate tax rate to the potential income tax cost. In other words, will utilization of the 2010 rules allow the basis to be increased up to fair market value by virtue of the basis increase rules ($1.3 million for non-spousal property and $3 million for spousal property)?[24]

- Also, if an election out of the estate tax is made and income tax would result upon sale of the inherited assets, are strategies available for deferring the income tax?

- How likely is it that the inherited assets will be sold?

- Is good income tax basis information available?
- What are the relative income tax brackets of the heirs?
- Who are the beneficiaries that will bear the estate tax?
- Are the beneficiaries the same persons that would bear the burden of the capital gains tax?
- What is the character of any gain that would be triggered on sale?
- What is the executor's degree of exposure to claims by unhappy beneficiaries?
- Is the surviving spouse involved? If so, it may be more beneficial to not make the election. This is particularly the case if the marital deduction can be used to avoid estate tax on the first spouse's death. A significant question then involves the anticipated size of the surviving spouse's estate and what the exemption will be at the time of the surviving spouse's death.

Portability Details

As noted above, a surviving spouse can use the remaining basic exclusion amount from the surviving spouse's previously deceased spouse. That means that, for married couples, the new exclusion amount is the basic exclusion amount plus the portable amount from the decedent's "last deceased spouse."[25] Portability only has application to estate tax – it doesn't apply to the GSTT. In addition, it is only available for deaths in 2011 or 2012.[26] Portability has no application for deaths in 2010.

Two key requirements. Two requirements must be satisfied for a surviving spouse's estate to be able to use the remaining unused exemption of the pre-deceased spouse:

- Because portability only applies for 2011 and 2012, *both* spouses must die before 2013, and;
- An election must be made in the estate of the first spouse to die to preserve the ability to utilize portability of any unused exemption amount in the surviving spouse's estate.[27]

Portability guidance. In late September, the IRS finalized the instructions for Form 706 for estates of decedents dying in 2011. The final instructions largely follow a prior draft, but do give additional insight into the portability of the deceased spousal unused exclusion amount (DSUEA). The instructions reiterate that the election to use the DSUEA in the estate of the surviving spouse in 2011 or 2012 is made by *timely* filing Form 706 in the first spouse's estate. If a Form 706 is filed in the first spouse's estate and the election is not desired, an attachment stating such can be attached to Form 706 or "No election under Section 2010(c)(5)" can be written at the top of the Form. Failure to file a Form 706 in the first spouse's estate (irrespective of whether any tax is due) results in no unused exclusion amount being available to the surviving spouse if the surviving spouse dies in 2011 or 2012. The instructions point out that at the death of the surviving spouse in 2011 or 2012, a copy of the predeceased spouse's Form 706 and calculation of the unused exclusion amount must be shown on page 1 of the surviving spouse's Form 706. The executor must also complete Part 4 of Form 706 and indicate on the Explanation line that the election was made in the first spouse's estate. If the surviving spouse had more than one spouse during life, the executor must list the names and Social Security numbers of each prior spouse and the reason for the termination of each prior marriage.

Timely filing? On September 29, 2011, the IRS issued Notice 2011-82.[28] In the Notice, IRS again pointed out that the portability election is to be made by filing a Form 706 in the estate of the first spouse to die for deaths in 2011. The IRS also stated that if an executor does not want to make the portability election that I.R.C. §2010(c)(5) provides for, the failure to timely file Form 706 will bar the making of the election. Indeed, I.R.C. §2010(c)(5) does specify that a portability election cannot be made if Form 706 is filed "after the time prescribed by law (including extensions) for filing such return."[29] But, that has no bearing on estates that are less than $5 million (for 2011 and 2012) where a filing requirement does not exist and, therefore, no timeframe is prescribed for by law to file Form 706. The Form 706 filing requirement and, hence, the timely filing rule contained in I.R.C. §6018, only applies when the gross estate of a citizen or resident exceeds $5 million (for 2011 and 2012).[30] In addition, the requirement that Form 706 be filed within nine months of death is contained in I.R.C. §6075 which, in turn, cross references the filing requirement rule for gross estates over $5 million by tying the requirement to a return "required by section 6018." So, the bottom line is that for the estate of the first spouse to die that is less than $5 million (for 2011 and 2012) a Form 706 is not required to be filed and there is no "time prescribed by law" to file Form 706, no timely filing requirement and, consequently, no time limitation that applies to the portability election in the first spouse's estate.

> **Note:** In IR 2012-24, IRS announced that it was extending the deadline for estates to file Form 706 in the estate of the first spouse to die to make the portability election with respect to the unused portion of the decedent's estate tax exemption. IRS stated that the extension only applies to estate of decedent's dying from January 1, 2011, through June 30, 2011. Also, IRS noted that an extension is available if the executor files form 4768 within 15 months of the decedent's date of death with the result that the estate would have 15 months from the date of death to make the portability election by filing Form 706. That's the case, IRS stated, even if the estate did not file Form 4768 before the nine-month filing deadline.

So what does all of this mean? Probably the best thing to do is that a Form 706 should be filed in all estates of the first spouse to die that are less than the $5 million filing requirement for the sole purpose of making the portability election. If that is not done, and it turns out that the unused amount of the exclusion in the first spouse's estate is needed in the surviving spouse's estate, the executor could formulate the argument set forth above that Form 706 was not required and can be filed at any time to preserve portability of the unused exclusion for the surviving spouse's estate. Until the IRS issues regulations that clarify the matter, it will remain unresolved.

State Filing Requirement? Some states impose taxes at death. In these states, a question exists as to whether a state-level Form 706 must be filed if there was no requirement to file a federal Form 706 and the only reason a federal Form 706 was filed was to make the portability election. In Iowa, for example, the Department of Revenue has stated as follows:

> "The voluntary election to file a federal estate tax return does not create a requirement to file the IA 706."

Of course, there may be other reasons that ultimately require the filing of an IA Form 706 - such as some or all of the estate passing to persons other than exempt individuals. Practitioners should closely check state law to determine if a filing requirement applies independently of whether a federal Form 706 is required.

Portability and multiple marriages. As noted earlier, portability only applies to the unused exclusion of the decedent's *last deceased spouse*. One interpretation of that clause is that remarriage cuts off the right to use the prior spouse's exclusion. For example, if Jane is married to John and John dies, Jane's estate could utilize John's remaining exclusion. That much is certain. But, if Jane remarries Jack and Jane dies before Jack, this interpretation takes the position that her estate cannot use the remaining exclusion of John. So, if Jane has a potentially taxable estate, she needs to "marry-up" the exclusion ladder. Under a second interpretation, if Jane is married to John and John dies followed by Jane's remarriage to Jack, Jane can still use John's unused exemption if she dies before Jack because John is Jane's last deceased spouse. If Jack were to die before Jane, Jane could only use Jack's unused exemption, and could no longer use John's unused exemption.[31]

The second interpretation is correct, according to the statute.

Gifting Strategies

Basic points. For 2011-2012, gifting strategies will depend on an individual's net worth. If gifting is accomplished in conjunction with a *Crummey*-type demand power,[32] gifts probably should not be authorized for 2011 or 2012 if the donor's net worth is at or below $5 million. But, the unknown status of the law beginning in 2013 could impact the gifting strategy. Except for very high wealth persons, there really isn't much transfer tax-driven incentive to make gifts in 2011 or 2012.

Clawback? A provision in the Act (Sec. 302(d)) is intended to conform the deduction for tax attributed to adjusted taxable gifts in the calculation of the estate tax to the "recoupled" estate and gift tax exclusion and rate structure. The provision is probably intended to avoid a "clawback" of the gift tax exemption in the form of an increased estate tax.[33]

The whole matter of "clawback" involves the significant question of whether donors utilizing the $5 million (inflation adjusted) unified credit to offset taxable gifts will be subjected to estate tax on any of those gifted amounts at death if the estate tax exemption unified credit in effect at death is less than the credit amount used to offset taxable gifts during life.[34] It is not known at the present time what the interpretation of IRS will be concerning the issue.

Complicating the issue is that different (and reasonable) conclusions of the issue arising from the governing statutory provisions can be reached. "Clawback" involves the computation of the estate tax for a decedent's estate. Federal estate tax is computed as the amount of the "excess (if any) of a tentative tax computed under I.R.C. §2001(c) on the sum of the amount of the taxable estate, and the amount of the adjusted taxable gifts, over the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976."[35] So, the first step in computing a decedent's estate tax liability is to determine all of the taxable gifts that the decedent made during life and add those back into the decedent's taxable estate. On that amount a tentative tax is then computed. Because gift tax applies to taxable gifts that the decedent made during life, the decedent's estate tax can be reduced by the amount of those gift taxes. That means, then, that the more gift taxes that were paid during life, the decedent's estate receives a greater deduction.

> **Observation:** If the unified credit was lower when the decedent made taxable gifts, the estate tax deduction at death will be correspondingly higher.

The essence of the "clawback" issue is the appropriate unified credit amount that is to be applied to compute the amount of the gift tax deduction for the decedent's estate. Should the unified credit applicable amount in effect at the time the gifts were made be utilized to compute the offsetting credit against estate tax, or should the amount of the credit applicable in the year of the decedent's death be utilized? Clearly, with the dramatic increase in the unified credit since 2001, most decedent's in recent months that made taxable gifts in prior years did so when the unified credit was lower than at the time of death. As such, they would generally prefer to use the credit amount applicable when the gifts were made to get a larger estate tax deduction for the estate. But, it is on this point that the statute (I.R.C. §2001(b)(2) fails to define the year that applies in determining the appropriate unified credit computation. The IRS, however, has previously taken the position that it is the credit amount in the year the gift was made that applies. That's important, because, as noted above, this will result in a higher estate tax deduction at the time of death. But, that's only true if the gifts were made in prior years when the unified credit was lower than at the time of death.

Under current law, the estate tax unified credit falls to $1 million beginning in 2013. Thus, for post-2012 decedents that made taxable gifts in prior years when the exemption was much larger, the IRS position would result in a relatively lower estate tax deduction. That's the essence of "clawback" – it would "recapture" some of the benefit of the higher exemption applicable pre-death years. But, as noted earlier, the sunset provisions of EGTRRA specify that the EGTRRA provisions (including the $5 million amount of the unified credit) are deemed to have never existed beginning in 2013. Thus, a strict application of the statutory language eliminates the application of "clawback" for post-2012 estates.[36] But, the Form 706 instructions also take the position that the unified credit amount to be used in the gift tax computation on the estate tax return is to be the credit amount at the time the gift. However, the Treasury issued regulations in June of 2012 on the portability of the estate tax exclusion.[37] While these regulations do not directly apply to the gift tax clawback issue, they do relate to how to compute the amount of prior gifts subject to gift tax in pre-death years for portability purposes. An example contained in the regulations seems to indicate that the focus of the IRS with respect to gift tax computations as applied to the unified credit is on the credit amount in the year of gift rather than the year of death.[38] Other than that example, the regulations can be viewed as supporting the point that clawback will be a non-issue for post 2012 deaths if the exemption decreases."

Planning For High Net-Worth Individuals

The Act provides a tremendous opportunity for individuals with high net-worth to accomplish some significant estate planning if death would occur in 2011 or 2012. Such persons can utilize a $5 million exemption ($10 million over both spouses (if applicable) with portability of any unused exemption if a surviving spouse remains. Grantor retained annuity trusts remain available as does valuation discounting. The $5 million exemption applies to both taxable gifts made during life or can be reserved to offset estate tax at death. But, the law is not permanent. So, it's very limited window of opportunity to accomplish some significant transfers at little-to-no tax cost. But, that scenario appears unlikely at the present time. What appears more likely is that the estate tax exemption will be extended at its present level (adjusted for inflation) or will be repealed in its entirety (while gift tax will remain). The President's proposal to reduce the exemption equivalent to $3,500,000 ((and raise the top rate by nearly 30 percent) would be particularly onerous for small businesses and farms/ranches. Under current law the $5,120,000 exemption can be leveraged with planning techniques to allow the transfer of about $8 million per decedent. The President's proposal would eliminate a significant leveraging technique (valuation discounting) with the result that an exemption worth approximately $8 million in reality would only be worth $3.5 million.

Even if the unified credit exemption were to decrease post-2012 and clawback were to be asserted, there are still benefits to the making of large gifts before the end of 2012. Then enhanced level of the unified credit exemption allows gifts to GSTT trusts to be more highly leveraged, and appreciation in asset value can be shifted to others. But, gifting in 2012 should not be overdone. Unless there is a significant change in U.S. economic policy coupled with a repeal of the recently enacted health care law, more assets and wealth will be needed during retirement years to pay for rising living and health care costs.

Summary

The estate planning "ballgame" has certainly changed for 2011 and 2012. Practitioners will need to change their approach with clients. There will be less emphasis on estate tax and charitable planning and more emphasis on retirement, succession, financial and income tax planning. For high net worth clients, the new rules provide a two-year window of opportunity to accomplish asset protection planning on a large-scale basis. There certainly is some danger presented if no planning is done for clients of moderate wealth. For instance, if death occurs and the surviving spouse remarries, a limit on portability of the exclusion may apply. Also, in some states, state estate/inheritance tax may remain a concern.

Consideration may need to be given as to whether existing plans should be changed.

Historically, for spouses, the strategy has been to divide spousal assets equally between the spouses. While that may no longer be necessary due to portability of the exclusion, the fact that portability only applies if both spouses die in 2011 or 2012 and that portability may be limited if a spouse remarries may indicate that existing plans shouldn't be dramatically changed.

Nevertheless, now may be a good time to review all existing wills and trusts, and existing formula clause language that is keyed to estate tax figures. In any event, maximum flexibility should be maintained - 2013 and its uncertainty is looming.[39] If the Congress does nothing before 2013, the estate tax will be pegged at a rate of 55 percent on taxable amounts above $1 million beginning in 2013.

Also, approximately one-half of the states levy either and estate tax or an inheritance tax at death. Planning remains necessary to account for those state-level taxes.

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[1] Pub. L. No. 111-312.

[2] Act, Sec. 301(a).

[3] Under legislation enacted in 2001 (the legislation containing the provision is commonly referred to as EGTRRA), the estate tax exemption increased over time while the estate tax rate declined over the same timeframe. For deaths in 2010, the estate tax was repealed.

[4] I.R.C. §1022.

[5] To make the allocation, Form 8939 must be filed.

[6] Enacted June 7, 2001.

[7] I.R.C. §1022.

[8] Section 902(b) of EGTRRA.

[9] Title V of EGTRRA deals with the estate, gift, GST taxes and related income (such as the modified carry-over basis rule of I.R.C. §1022).

[10] "The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010," Journal of Taxation, Feb. 2010.

[11] Act, Sec. 301(c).

[12] The Act also changes the previous credit (for deaths through 2009) for state-level taxes associated with death to a deduction. The former credit reduced federal estate tax (dollar-for-dollar) for state death taxes paid up to a 16 percent rate. In essence, the federal government was subsidizing the state-level taxation of decedent's estates. Under the Act, the deduction (for deaths in 2011 and 2012) reduces the amount of federal estate tax by only a percentage.

[13] Act, Sec. 301(c).

[14] See www.irs.gov/form8939.

[15] That means that April 17, 2011, will most definitely *not* be the deadline.

[16] IRS also points out that Form 8939 is not to be filed with the decedent's final income tax return, nor is the election to be made on the decedent's final income tax return.

[17] 2011 I.R.B. LEXIS 432.

[18] Rev. Proc. 2011-41, 2011 IRB LEXIS 432.

[19] IRS Notice 2011-76.

[20] Thus, the exclusion (formerly known as the "applicable exclusion amount") is the "basic exclusion amount" plus the portable amount. The exclusion of $5 million correlates to a credit of $1,730,800. Similarly, the portable amount would have a credit associated with it.

[21] But, 2011-2012 distributions to beneficiaries at the grandchild level (but not to beneficiaries of younger generations) will not be subject to the GSTT.

[22] Act, Sec. 301(d), *amending* I.R.C. §2518(b).

[23] But remember, a state may have a disclaimer statute that sets a limit on the time to make a disclaimer. That's an important point because state law governs property rights. So, in some states, there may be a need for the legislature to pass a disclaimer "patch" statute to allow the relief the Act attempts to allow. In Iowa, however, a disclaimer that comports with I.R.C. §2518 satisfies state law. Iowa Code §633E.4.

[24] The Act doesn't provide any guidance on the basis rule for 2010 estates where inherited assets are sold after 2010.

[25] This has serious implications for drafting. One question involves the impact of formula clause language that refers to the "applicable exclusion amount." Also, some powers of attorney contain language that authorizes the gifting of the principal's property up to "the applicable exclusion amount." The Act raises a question as to the meaning of that language.

[26] If the executor elects to use the 2011-2012 rules for a 2010 death, portability does not apply. It is not available retroactive to the beginning of 2010.

[27] Act, Sec. 303(a), *amending* I.R.C. §2010(c). Also, IRS can readjust the available unused exclusion amount of the first spouse to die, even though the statute of limitations for examining the estate tax return has expired.

[28] 2011-42, I.R.B. 516

[29] I.R.C. §2010(c)(5) states that a portability election is to be made on an estate tax return within "the time prescribed by law (including extensions)."
[30] I.R.C. §6018 contains the filing requirement for the gross estate of a citizen or resident that exceeds $5 million.
[31] It would appear that the second interpretation is correct. Being married to a new spouse with a new exemption still permits the use of the last spouse's exemption because the statute refers not to the last spouse, but the "last such deceased spouse."
[32]A *Crummey* power is named after a 1968 federal court opinion (*Crummey v. Comr.,397 F.2d 82 (9th Cir. 1968)*) that allowed contributions to an irrevocable trust to qualify for the gift tax annual exclusion because the beneficiaries (typically the donor's grandchildren) are given an unrestricted right for a specified period of time. The *Crummey* power has become a standard estate planning tool, the benefits of which increase through leveraging the annual exclusion to maximize the amount of gift tax-free transfers to an irrevocable trust
[33] Without guidance from the IRS on the issue, and as long as the estate and gift tax exemption and rates remain non-permanent, there is some risk in making gifts in 2011 and 2012 if the donor dies in 2013 or later and the estate tax exclusion is less than $5 million.
[34] If the Congress fails to take action on the estate tax during 2012 with the prospect of only a $1 million exemption looming, practitioners may be tempted to suggest to clients with potentially taxable estates to make gifts to pair-down the size of the estate in an attempt to minimize the impact of estate tax on the estate. If the IRS asserts clawback, such a strategy will have little tax benefit to these clients.
[35] I.R.C. §2001(b).
[36] Another statutory argument against "clawback" exists. I.R.C. §2001(b)(2) states that the tax rates in effect at the time of death apply to the computation of the gift tax computation.
[37] T.D. 9593 (June 15, 2012).
[38] Treas. Regs. §§20.2010-2T(c)(2) and (c)(5), Example 2.
[39] It also is probably not a wise idea to cancel insurance policies on the belief that no estate tax will be due upon death. Liquidity needs may still remain, and state-level taxes associated with death apply in some states. Also, it is uncertain what the estate tax rules will be beginning in 2013. There are four possibilities: (1) existing law expires and the estate tax exemption falls to $1 million and the top rate is 55 percent; (2) current law is extended or made permanent; (3) some sort of compromise is reached; or (4) the federal estate tax is repealed.