Chapter 10: Estate Planning

Corrections were made to this material through January of 2012. No subsequent modifications were made.

On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Act)[1] became law. The Act prevented an income tax increase effective January 1, 2011. However, as applied to the federal estate tax, the Act constitutes a tax increase when compared to former 2010 law, and a tax decrease when compared to 2009 law. The Act contains the most significant changes to transfer taxes (estate, gift, and generation-skipping transfer tax (GSTT)) 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 as to what 2013 may bring. Consequently, the uncertainty concerning the future of the estate tax that occurred in 2010 is only postponed for two years.

As a tax professional, it is important to understand the changes. Clients look to their tax preparers as the first source of tax information. Asking the client if they have an estate plan — and then advising them to seek out their attorney and have a plan written or an existing plan updated — may be one of the most important things a tax preparer can do for their clients this year.

KEY ESTATE TAX CHANGES

OLD LAW

In 2009, the federal estate tax exemption was $3.5 million per decedent with excess amounts taxed at 45%.[3] The estate tax was repealed for deaths in 2010, and was scheduled to return for deaths in 2011 with only a $1 million exemption and a 55% top rate.

Through 2009, the income tax basis rule 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 (FMV) at the date of death. This is commonly referred to as "stepped-up" basis because it assumes that basis in an asset is lower than the FMV of the asset as of the owner's date of death. However, that may not always be the case, and the concept works both ways. Thus, if the FMV of an asset on the date of death is lower than the decedent's basis, the asset's basis is stepped down and the beneficiaries inherit the lower basis.

1. PL 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.

For deaths in 2010, the so-called "stepped-up" basis rule was changed to a modified "carryover basis" rule.[4] Under this rule, an heir's income tax basis in an inherited asset is the decedent's basis if the property's FMV on the date of death is greater than the decedent's basis. However, the estate's executor could increase that basis on an asset-by-asset basis by up to $1.3 million (or FMV as of the date of the decedent's death, whichever is less) for property passing to someone other than the surviving spouse. For property passing to the surviving spouse (or a qualifying trust created for the surviving spouse), the increase can be up to $3 million. Both the $1.3 million basis increase (termed the "general basis increase" which is the sum of the "aggregate basis increase" plus the "carryovers/unrealized losses increase") and the qualified spousal property basis increase can be allocated entirely to qualified spousal property. Thus, the basis of property transferred to a surviving spouse can be potentially increased by a total of $4.3 million.[5] The executor must file a "Large Transfers Return" (Form 8939) to allocate the basis increase amounts. If the FMV of an item of a decedent's property on the date of death is less than the decedent's basis, the basis is stepped down to the FMV on the date of death. This is not a change from prior law.

> **Note.** 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 (see discussion below). The basis rule is less clear if the inherited assets are sold **after** 2010. The law establishing the modified carryover basis rule for deaths in 2010 stated that none of its provisions applied to "any tax year beginning after 2010." Therefore, one possible interpretation of that language is that inherited assets sold **after** 2010 (the tax for which would be reported on a tax return for a tax year beginning after 2010) would be eligible for a complete stepped-up basis.[6] However, as indicated below, the IRS view is that the modified carryover basis rule applies to determine a recipient's basis in all property acquired from a decedent who died in 2010 and for which estate the executor makes the election out of the estate tax, when the property is sold during 2010, 2011, or any subsequent year.[7]

4. IRC §1022.

5. See the 2010 *University of Illinois Federal Tax Workbook* for a thorough explanation of the basis increase rules. This can be found on the accompanying CD.

6. See EGTRRA, Sec. 901(a)-(b). See also Blattmacher, Gans, Zaritsky and Zeydel, "The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010," *Journal of Taxation,* Feb. 2010. The authors note that EGTRRA contained rules designed to enforce the scope of what Congress could consider under the budget reconciliation process, and that one of those rules, known as the "Byrd rule," barred Congress from enacting tax provisions in a budget reconciliation bill that would reduce revenues beyond the years the reconciliation covers. According to the authors, a plain reading of Sec. 901(b) of EGTRRA provides that the Code should be administered in post-2010 years as if EGTRRA had never been enacted, thereby suggesting that income tax basis should be determined in 2011 and later years under IRC §1014 (FMV basis as of the date of the decedent's death). The authors note that it is possible to read Sec. 901 of EGTRRA in regards to a general intent of Congress to tie estate tax elimination with a modified carryover basis rule as Sec. 901 (a)(2) focuses on the date of death, date of gift, or date of the generation-skipping transfer, while Sec. 901(a)(1) specifies that EGTRRA does not apply to tax years after 2010. Thus, the provisions, in combination could be read to mean that IRC §1022 (the modified carryover basis rule) still applies post-2010 even if the asset is sold post-2010. The authors then note 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."

7. Rev. Proc. 2011-41, 2011-35 IRB 188.

NEW LAW[8]

Federal Estate Tax Reinstated

Effective January 1, 2010, the Act reinstates the estate tax with a top rate of 35% and a $5 million exemption for deaths through 2012. This is the default rule for 2010 deaths. The exemption is indexed for inflation beginning in 2012 in $10,000 increments and will be rounded to the nearest multiple of $10,000. The exemption is also portable.

> **Note.** The 35% rate takes effect at a level of $500,000. That means that the "progressive" rates apply only below $500,000.

Electing Out of the Federal Estate Tax and Into Modified Carryover Basis

The executor of a 2010 decedent's estate can elect out of the estate tax and apply the 2010 rules that existed before the Act's enactment. Once made, the election is irrevocable (unless the IRS consents to a revocation). The executor should ask for the tax professional's advice before making this important decision.

Recent IRS Guidance on the Election and Income Tax Basis

On August 5, 2011, the IRS issued Notice 2011-66[9] which provides additional clarity as well as confusion on the procedure to be used for opting out of the estate tax for 2010.

Notice 2011-66 specifies that Form 8939 will be used to both opt out of the estate tax for 2010 **and** to make the desired tax basis increase allocations. As of early August 2011, the IRS had not yet finalized this new form. Some of the items stated in the notice include the following.

- Previous filings for the purpose of making the election must be replaced with a Form 8939 filed by November 15, 2011.
- An election, once made, is irrevocable.
- If no executor has yet been appointed, anyone with actual or constructive possession of the decedent's property can file a Form 8939 in respect of that property.
- For property held in trust, the trustee files Form 8939 as the party in possession of the decedent's property (referred to as "statutory executor" via IRC §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, the IRS will make the allocations.
- If the IRS receives several Forms 8939 that collectively serve to allocate additional basis beyond the amount available, the IRS will send each filer a letter requesting a restated Form 8939 within 90 days.
- Each recipient of decedent property must receive a statement from the executor showing the basis adjustments. These statements must be forwarded within 30 days of filing the Form 8939.
- A Form 8939 filed before the November 15, 2011, deadline can be revoked or amended by a subsequent Form 8939 also filed before that deadline.
- The IRS grants extensions for Form 8939 only under limited circumstances.
- The election out of the estate tax does not negate the application of the GSTT to the estate.

The notice also provides guidance on the use of Forms 8939 and 709 and the GSTT (discussed later in this chapter).

8. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Act).
9. IRS Notice 2011-66, 2011-35 IRB 184.

However, significant confusion exists over the due date and finalization of Form 8939. Notice 2011-66 indicates that the due date for filing Form 8939 is November 15, 2011. However, as of early August 2011, the IRS's pace of activity in developing the new form, including substantial recent revisions, suggested a target finalization date of January 6, 2012.

In addition, the IRS stated in February 2011 that the new form would not be due until at least 90 days after its release. This would suggest a finalization date of August 15th for a November 15th due date. However, an August 15, 2011, finalization date appears unlikely. In addition, an August 15th finalization date would not allow sufficient time for submitting comments to the IRS as requested. Furthermore, the IRS has not provided a deadline for submitting comments.

In Rev. Proc. 2011-41,[10] the IRS provided the following clarifications concerning income tax basis for property received from a 2010 decedent's estate.

- The aggregate basis increase includes all unrealized losses in capital assets as of the decedent's death irrespective of any limitations on immediate deductibility that might apply for income tax purposes if the property were sold. That means that the amount of any unrealized losses is available to increase the basis of assets up to (potentially) FMV. Relatedly, the IRS said that a 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 were not 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 computed (presumably) by multiplying the decedent's separate loss carryover by the joint loss carryover.

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

- Unused passive losses can be added to the basis of the decedent's property. For community property, the surviving spouse's unused passive losses on such property can be added to the overall basis increase, although they are 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 for property depreciable in the decedent's hands, the character of the property remains the same in the recipient's hands. That character could, however, be impacted if the recipient changes the property's use. Property subject to depreciation recapture (IRC §§1245 or 1250) remains subject to potential recapture upon any eventual sale by the recipient. It is not possible to circumvent the rule by converting the property to personal use. If the property was depreciable by the decedent and is depreciable by the recipient, the recipient computes depreciation in the same manner as the decedent 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 considered "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. If that rule is satisfied, the property qualifies for a basis increase. In addition, such property could receive a "stepped-down" basis if its basis is less than its FMV as of the decedent's date of death. 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 of or distributed the property.

- The general basis increase for the estate of a nonresident who was not a U.S. citizen at the time of death is limited to $60,000. The limitation does not apply to the spousal property basis increase of $3 million. Therefore, qualified spousal property passing to a surviving spouse of a nonresident, non-citizen decedent is potentially eligible for a basis increase of up to $3,060,000.

10. Rev. Proc. 2011-41, 2011-35 IRB 188.

Also, on August 5, 2011, the IRS stated[11] that the IRC §1022 basis rule (modified carryover basis):

> *. . . 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 section 1022 election, when the property is sold during 2010, 2011 or any subsequent year, the recipient's (seller's) basis in the property is determined under section 1022 rather than under section 1014.*

Unfortunately, the IRS did not provide any rationale for its conclusion.

Portability

For deaths in 2011 and 2012, the estate tax exemption is portable. This means that any unused exemption amount at the death of the first spouse carries over to the surviving spouse and is added to the surviving spouse's $5 million exemption. Portability is a key feature of the law. It means that the combined exemption of both spouses is $10 million. There is no need for complicated estate planning to get the full benefit of the exemptions in the estates of both spouses.

There are limitations to this temporary rule, including a requirement that both spouses die after 2010 and before 2013. 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 has a credit associated with it.

> **Note.** This and other limitations are discussed more fully in the section "Impact of Portability."

Federal Gift Tax

Gift tax rules were not changed for 2010 — they remain with a **$1 million** exemption and a 35% rate on excess amounts. For 2011 and 2012, the new law establishes a **$5 million** estate, gift, and GSTT exemption. The tax rate is 35% on excess amounts. That means that the gift tax no longer has its own "unified credit" — it is the same as the estate tax unified credit and rates.[12]

If Congress had not acted, the gift tax rate would have reverted in 2011 to the 2001 rates — 41% for taxable gifts over $1 million and increasing to 55% for total gifts in excess of $3 million. Those who made gifts in 2010 with the belief that the law in 2011 would not be as favorable may consider rescinding those gifts. However, that may not be possible if rescission is sought after the tax year in which the gift was made.[13]

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The annual gift tax exclusion remains at $13,000 for gifts made in 2011. Married couples can elect to "split" gifts that they make by pooling their individual gift exemptions, to make gifts of up to $26,000 per recipient per year. If such an election is made, a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* must be filed. The Act retains the rule that allows unlimited gifts directly to an educational institution or medical care provider without incurring gift tax.[14]

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11. Ibid.

12. Act, Sec. 302(b)(1).

13. See, for example, Rev. Rul. 80-58, 1980-1, CB 181 (concept of rescission recognized when parties to the transaction restored to the original position before the transaction and rescission occurred in the same tax year as the transaction).

14. In *Lang v. Comm'r,* TC Memo 2010-286 (Dec. 30, 2010), the Tax Court ruled that a taxpayer could deduct medical expenses that were actually paid by the taxpayer's mother, who directly paid the medical care provider. The mother's payments were not subject to gift tax, and the daughter could claim the deduction because she was obligated to pay the expenses.

GSTT

Transfers that skip a generation (such as a transfer of a life estate to a child with the remainder interest to a grandchild) are subject to the GSTT. The GSTT applies to transfers involving three types of transactions.

1. **Transfers to skip persons —** individuals at least two generations after the transferor of the property transferred or a trust in which all beneficiaries are two generations after the grantor of the trust
2. **Transfers involving taxable terminations** — a transfer of an interest in a trust to a skip person
3. **Transfers involving taxable distributions —** a distribution from a trust to a skip person

Individuals who are descendants of the grandparents of either the transferor or a spouse of the transferor are assigned to generations on the basis of their place in the family tree. Any spouse or former spouse of the transferor or of any individual in the family tree is assigned to the generation of the family member to whom the person is married. Unrelated persons and those more remotely related are assigned to generations by date of birth. Anyone not more than 12½ years younger than the transferor is assigned to the transferor's generation. A person who is between 12½ and 37½ years younger than the transferor is assigned to the first generation below the transferor. Subsequent generations are assigned by additional 25-year intervals.

The Act also reinstates the GSTT for 2010. However, it provides a GSTT "holiday" by setting the GSTT rate at 0%. Consequently, transfers in 2010 could be made directly to skip persons or out of nonexempt GSTT trusts without any GSTT cost (and no allocation of the GSTT exemption). Future distributions from such trusts to the "skip" persons (who are not "skip" persons for 2010) are not subject to the GSTT.

> **Note.** Under the 2010 Act, IRC §2653(a) applies with the result that the transferor of the trust is "moved down" to the generation of the child of the transferor. Consequently, distributions from the trust to grandchildren are not subject to the GSTT.

Later distributions to descendants of such "skip" persons are subject to the GSTT unless the GSTT exemption is allocated. For 2010, the **$1 million** gift tax exemption limits the 2010 GSTT planning opportunity. For 2011 and 2012, the GSTT exemption is **$5 million,** but it is not portable. For 2011 and 2012, distributions to beneficiaries at the grandchild level (but not to beneficiaries of younger generations) will not be subject to the GSTT. In addition, the lack of portability of the GSTT exemption means that if the first spouse to die does not fully utilize the available GSTT exemption, it is lost.

For 2010, the GSTT exemption was available regardless of whether the executor made an election out of the estate tax. However, electing out of the estate tax for a 2010 decedent's estate may mean that the estate could not make a direct skip (because it was not subject to estate tax). That may affect the GSTT exemption allocation and other GSTT issues.

One area of uncertainty involves the GSTT provisions and whether they were intended to apply to a trust created in 2010 when the grantor also died in 2010. In that situation, a question exists as to whether the trust could receive a GSTT allocation only if the decedent's estate is subject to estate tax. If that is the case, an estate valued at more than $5 million may want to choose to be subject to estate tax so as to obtain the GSTT allocation.

> **Warning.** Because the Act is only an extension of the EGTRRA provisions for two years, if Congress fails to legislate, the "sunset" language (i.e., "…as if it had never been enacted") of EGTRRA will come back into play. The result could be a redetermination of the inclusion ratio for trusts that used either the additional GSTT exemption amounts exceeding $1 million or other GSTT planning tools that would cease to exist, possibly retroactively. The sunset language could also result in other provisions of Chapter 13 (GSTT provisions) that were added by EGTRRA no longer applying in determining the amount of GSTT payable on a post-2012 generation-skipping transfer.

> **Observation.** The Administration's FY 2012 budget proposal (which the U.S. Senate defeated by a 97-0 vote on May 25, 2011) included a GSTT tax exemption of $3.5 million and a limit on the GSTT tax exemption of trusts to 90 years.

The GSTT must be paid from the property constituting the generation-skipping transfer unless the will, trust, or other dispositive instrument **specifically directs** that the tax be paid from other property.[15] This requires careful drafting of the instrument creating the generation-skipping transfers so that the burden of the GSTT is allocated as planned. Clause language that directs the executor to pay the decedent's "just debts and taxes" is not a specific reference to the GSTT.

The following language is an example of how the payment of the GSTT can be properly addressed.

In the event there shall be imposed upon the estate of either of my children the so-called 'generation skipping tax' under Chapter 13 of the Internal Revenue Code, my Trustee shall advance to the estate of such of my children such amount as is necessary to make payment of tax, from the share of this Trust of such deceased child, prior to the distribution of such Trust's share as hereinabove provided.

Failing to properly allocate the burden of the GSTT can result in significant and unexpected depletion of a portion of the decedent's estate.[16]

Tables

The tables on the following pages summarize the present status of transfer tax exemptions, rates, credits, and income tax basis rules as a result of EGTRRA and the Act.

15. IRC §2603(b).

16. See, for example, *Estate of Tubbs,* 21 Kan. App. 2d 395. 900 P.2d 865 (1995) (A federal estate tax return was filed with the GSTT exemption ratably allocated among remaindermen and specific bequests. The executor sought determination as to whether GSTT was to be paid from the residue of the estate or from the property that constituted the generation-skipping transfer. The will stated, "it is my will that all estate, inheritance and other death taxes. . . be paid from the residue of my estate, until my estate is closed." The court held that the clause did not specifically refer to the GSTT and that the specific reference rule did not apply to the allocation of the GSTT exemption. The GSTT property was nonresiduary property and the decedent's estate plan created $1,628,378 of transfers subject to the GSTT which, after allocation of a $1 million exemption, resulted in a GSTT of $345,608. The attorney later admitted to never having heard of the GSTT.); Ltr. Rul. 9731030 (May 5, 1997) (This letter ruling involved GSTT payable from property constituting the generation skips; the will did not specifically refer to the GSTT.

Overall Summary Table

YEAR	ESTATE TAX		GIFT TAX		GSTT		STATE DEATH TAX	BASIS ADJUSTMENTS
	Top Rate	Applicable Exclusion Amount	Top Rate	Applicable Exclusion Amount	Rate	Exemption	Credit-Deduction on Form 706	
2001	55%	$675,000	55%	$675,000	55%	$1.06 million	100% of credit	Step up
2002	50%	$1 million	50%	$1 million	50%	$1.1 million	75% of credit	Step up
2003	49%	$1 million	49%	$1 million	49%	$1.12 million	50% of credit	Step up
2004	48%	$1.5 million	48%	$1 million	48%	$1.5 million	25% of credit	Step up
2005	47%	$1.5 million	47%	$1 million	47%	$1.5 million	Deduction	Step up
2006	46%	$2 million	46%	$1 million	46%	$2 million	Deduction	Step up
2007	45%	$2 million	45%	$1 million	45%	$2 million	Deduction	Step up
2008	45%	$2 million	45%	$1 million	45%	$2 million	Deduction	Step up
2009	45%	$3.5 million	45%	$1 million	45%	$3.5 million	Deduction	Step up
2010	35% (or 0% if election made)	$5 million (or $0 if election made)	35%	$1 million	0%	$5 million	Deduction	Step up (or modified carryover by election)
2011	35%	$5 million (portable)	35%	$5 million	35%	$5 million	Deduction	Step up
2012	35%	$5 million (inflation adjusted and portable)	35%	$5 million (Inflation adjusted)	35%	$5 million	Deduction	Step up
2013 & After	55%	$1 million	55%	$1 million	55%	$1 million (plus inflation adjustment)	Credit	Step up

Estates and Gift Tax Rate Schedule for Transfers in 2011 and 2012

Amount Subject to Tax	Tentative Tax
Not over $10,000	18% of such amount
Over $10,000, but not over $20,000	$1,800, plus 20% of excess over $10,000
Over $20,000, but not over $40,000	$3,800, plus 22% of excess over $20,000
Over $40,000, but not over $60,000	$8,200, plus 24% of excess over $40,000
Over $60,000, but not over $80,000	$13,000, plus 26% of excess over $60,000
Over $80,000, but not over $100,000	$18,200, plus 28% of excess over $80,000
Over $100,000, but not over $150,000	$23,800, plus 30% of excess over $100,000
Over $150,000, but not over $250,000	$38,800, plus 32% of excess over $150,000
Over $250,000, but not over $500,000	$70,800, plus 34% of excess over $250,000
Over $500,000, but not over $750,000	$155,800, plus 35% of excess over $500,000

Corresponding Credit and Top Rate (Estate and Gift Tax)

Year	Estate Tax Applicable Exclusion Amount	Estate Tax Applicable Credit Amount	Estate Tax Top Rate	Gift Tax Lifetime Exemption	Gift Tax Applicable Credit Amount	Gift Tax Top Rate
2002	$1 million	$345,800	50%	$1 million	$345,800	50%
2003	$1 million	$345,800	49%	$1 million	$345,800	49%
2004	$1.5 million	$555,800	48%	$1 million	$345,800	48%
2005	$1.5 million	$555,800	47%	$1 million	$345,800	47%
2006	$2 million	$780,800	46%	$1 million	$345,800	46%
2007	$2 million	$780,800	45%	$1 million	$345,800	45%
2008	$2 million	$780,800	45%	$1 million	$345,800	45%
2009	$3.5 million	$1,455,800	45%	$1 million	$345,800	45%
2010	$5 million (or $0 if election made)	$1,730,800 (or $0 if election made)	35% (or 0% if election made)	$1 million	$345,800	35%
2011–2012	$5 million	$1,730,800	35%	$5 million	$1,730,800	35%

Disclaimers

The use of a disclaimer is another area where the tax advisor can help a client with tax planning. A disclaimer allows the heir of an estate to forgo an inheritance and pass it on to the next heir in line. Consequently, the situation is as if the original heir were already deceased at the time of the inheritance. The Act extends the timeframe for making a qualified disclaimer for decedents dying after 2009 and before December 17, 2010.[17] The extended timeframe is nine months (September 19, 2011) after December 17, 2010.

In general, the reason for the extension was the possibility that the retroactively reinstated estate tax would cause more (or less) of an estate to pass to a surviving spouse than the decedent intended. In such an instance, a disclaimer can be utilized to allow the family to fulfill the decedent's desires if the disclaimant has not accepted the property or the benefits of the property.[18]

> **Note.** This is an important point and raises a question about the risk of beneficiaries benefitting from property during the extended period which will taint the ability to disclaim. Relatedly, there could be an impact on creditor protection if a beneficiary disclaims to avoid a creditor and the disclaimer is valid under the Act but not state law.

A state may have a statute that sets a limit on the time to make a disclaimer. This is an important point because state law governs property rights. In some states, there may be a need for the legislature to pass a disclaimer "patch" statute to allow the relief set forth in the Act. In Iowa, however, a disclaimer that comports with IRC §2518 satisfies state law.[19] Illinois law is also the same.[20] However, under North Dakota law, for example, there is a 9-month time limit on disclaiming a present interest in property.[21] The same rule applies in South Dakota.[22]

State Death Taxes

Under the Act, the deduction for state death taxes is retained.[23] This retention is in lieu of the state death tax credit that was phased out beginning in 2002 and completely eliminated beginning in 2005, when it was changed to a deduction. This development led numerous states to let their estate taxes lapse or tie their state estate tax to the state death tax credit as it existed in 2001 or before. In states that retain a state estate tax, the exemption is typically less than the current $5 million exemption from federal estate tax. Therefore, at least for 2011 and 2012, the taxes triggered upon death are more likely to be at the state level than at the federal level.

- In those states that have tied the state tax to the federal credit, there is no state tax.
- In "decoupled" states, in which the state tax is tied to the federal credit that was in effect at some point before 2002, there is a state-level tax. Under IRC §2508, a deduction is allowed for the state tax in calculating the taxable estate, which typically results in an iterative calculation. However, in some states, state law does not allow a deduction for the state tax in calculating the state tax itself. That avoids the iterative calculation, but the effective state and federal tax rates will be changed.
- Some states decoupled their tax systems after 2001, not only from the federal credit for state death taxes, but also from the phased increases in the federal unified credit. The result is that the state exemption is less than the federal exemption.

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17. Act, Sec. 301(d), amending IRC §2518(b).
18. IRC §2518.
19. Iowa Code §633E.4.
20. See 755 ILCS 5/2-7.
21. NDCC §30.1-10.01.
22. See SD Cod. Laws §298A-2-801.
23. IRC §2058.

Decoupled State Death Tax Summary Table (with Top Rates Specified)[24]

States With a $5 Million Exemption	States With an Exemption of Less than $1 Million	States With an Exemption of $1 Million	States With an Exemption of $2 Million	States With an Exemption of $3.5 Million	States With an Inheritance Tax Only (Tax Assessed on Value of Specific Inherited Assets over an Exemption)	States With Both an Estate Tax and an Inheritance Tax
North Carolina (16% rate)	Ohio $338,333 (7% rate)	Maine (16% rate)	Connecticut (12% rate)	Delaware (16% rate)	Indiana (pick-up tax tied to federal state death tax credit); inheritance tax as separate tax (20% rate)	Maryland: $150 exemption from inheritance tax (10% rate; 16% for estate tax)
	New Jersey $675,000 (16% rate)	Maryland (16% rate)	Illinois (16% rate)	Hawaii (16% rate)	Iowa (pick-up tax tied to federal state death tax credit); inheritance tax on transfers to remote relatives and third parties (15% rate)	New Jersey No exemption from inheritance tax (16% rate for both inheritance tax and estate tax)
	Rhode Island $850,000 (16% rate)	Massachusetts (16% rate)	Vermont (**Note:** Exemption increased to $2,750,000 for deaths in 2011) (16% rate)		Kentucky (pick-up tax tied to federal state death tax credit); inheritance tax as separate tax (16% rate)	**Note:** In Maryland and New Jersey, state inheritance tax is subtracted from the value of the estate before the estate tax is calculated
		Minnesota[a] (16% rate)	Washington (19% rate)		Nebraska: 18% rate	
		New York (16% rate)			Pennsylvania: 15% rate	
		Oregon (16% rate)			Tennessee (pick-up tax tied to federal estate tax death tax credit); inheritance tax as separate tax (9.5% rate)	
		District of Columbia (16% rate)				

[a] For deaths after June 30, 2011, the first $4 million in qualified farm and small business property is exempt. For farm estates to be eligible for the exclusion, the farm must be either an agricultural homestead or vacant land that is contiguous to the homestead. The decedent must have owned the property for at least three years before death, and a member of the decedent's family must continue the farming business for at least three years after the decedent's death to avoid a recapture tax of 16%.

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Interim Changes and Adjustments

The Treasury, on an annual basis, updates certain transfer tax figures that are indexed for inflation. The following are the inflation-adjusted amounts for 2011 for certain transfer tax related items.

- Gift tax present interest annual exclusion: $13,000
- The 2% portion for purposes of installment payment of federal estate tax: $1.36 million
- Special use valuation maximum value reduction: $1.02 million
- Noncitizen spouse annual exclusion: $136,000

ELECTION FOR 2010 ESTATES

For deaths in 2010, an executor can elect to utilize the rules that were in effect before the Act's enactment.[25] Making this election results in no estate tax and a modified carryover basis for assets in the estate. If such an election is **not** made, the estate tax applies at a 35% rate on taxable amounts above $5 million. The Act retains the **deduction** for state-level death taxes. Under the Act, the deduction (for deaths in 2011 and 2012) reduces the amount of federal estate tax.

> **Observation.** According to IRS data, 16,000 federal estate tax returns were filed in 2009 when the exclusion was $3.5 million (and portability of the exclusion was not allowed). That amounts to approximately 0.6% of all decedents for 2009. The number (and percent of decedents) is expected to be lower in 2011 and 2012 due to the increase in the exemption to $5 million, irrespective of the fact that the exclusion is also portable.

Unfortunately, the Act is not clear as to **when** the election must be made. It is certain that executors who make the election do not have to file a Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, or pay federal estate tax. If the election is not made, any estate tax due must be paid via an estate tax return that is filed within nine months after December 17, 2010, for decedents dying during the period January 1, 2010, through December 16, 2010. Otherwise, estate tax is due nine months after the date of the decedent's death.

Under EGTRRA, a 2010 decedent's estate had to make the income tax basis allocations by the due date of the decedent's income tax return (April 17, 2011), using Form 8939, *Allocation of Increase in Basis for Property Acquired from a Decedent*. However, a question existed as to the deadline for electing out of the estate tax for a 2010 estate. The Act only indicates 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."[26] One possible interpretation of the statutory provision is that the deadline is nine months from the date of enactment, but that interpretation is not guaranteed.

> **Observation.** In Notice 2011-66,[27] the IRS stated that an estate tax return and a conditional Form 8939 cannot be filed. In addition, the IRS stated that it will grant extensions of time to file Form 8939 only in limited situations.

On August 5, 2011, the IRS stated that Form 8939 must be filed by November 15, 2011,[28] and that Form 8939 was to be used to opt out of the estate tax for a 2010 death **and** to make the desired income tax basis allocations.

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24. Practitioners are cautioned to research the current status of a particular state's estate tax law. The states not listed in this table have no state death tax.

25. Act, Sec. 301(c).

26. Ibid.

27. IRS Notice 2011-66, 2011-35 IRB 184.

28. Ibid.

BASIS INCREASE RULES AND FORM 8939

The tax advisor plays an important role in calculating modified carryover basis. They not only compute the allocation, they may also determine the basis of the assets held by the decedent. Because of prior gifting, it may be necessary to look back multiple generations in order to determine the current basis.

For clients who died in 2010, the executor must determine whether an election out of the estate tax should be made. If an election is made, the executor must prepare and file a carryover basis return (Form 8939). (A draft of the Form 8939 is shown later in this chapter.) As evidenced by the form, the basis of each of the decedent's assets must be listed and the date of death value reported. In addition, the executor must allocate and track the basis step-up amounts.

IRC §1022 Basis Rules

For 2010 deaths, IRC §1022 replaces IRC §1014 for purposes of determining the income tax basis of the decedent's property in the hands of the heirs.

Note. The 2010 *University of Illinois Federal Tax Workbook* (page 364) provides a discussion of the income tax basis rules for 2010 decedent's estates. This can be found on the accompanying CD.

The following is a summary of the rules that remain applicable after the passage of the Act **when the executor elects out of the application of the estate tax rules for a 2010 estate.**

- Property must be owned or treated as owned by the decedent at death in order to be eligible for a basis increase. For jointly owned property, this includes the portion the decedent is deemed to own under the rules similar to IRC §2040, and includes property held by a revocable trust and other property passing at the decedent's death without consideration.
- Property subject to a power of appointment is not treated as owned by the decedent by reason of the decedent holding the power. The provision appears to extend to powers created by third parties in favor of the decedent and powers created by the decedent's spouse.[29] Consequently, there is no basis increase available for property contained in a typical general power of appointment trust in the estate of the surviving spouse. However, powers retained by the decedent after the transfer to others can receive a basis increase. That would include a trust over which the decedent reserved the power to change beneficial enjoyment.[30]
- The $1.3 million nonspousal basis increase can be increased by capital loss carryovers under IRC §1212 and any net operating loss (NOL) carryover under IRC §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). Thus, a partial double benefit may flow from the carryover of NOLs. They may be taken as an income tax deduction on the joint return that the decedent and surviving spouse filed for the year in which death occurred.[31] It is also increased by any losses that would have been allowable under IRC §165 if the property acquired from the decedent had been sold at its FMV immediately before the decedent's death.

Note. When basis step-up amounts are allocated to eligible property, the result is known as the "aggregate basis increase." The allocations are shown on Form 8939. The IRS, in Rev. Proc. 2011-41, clarified that the aggregate basis increase includes all unrealized losses in capital assets as of the decedent's death. According to the IRS, this is the case irrespective of any limitations on immediate deductibility that might apply for income tax purposes if the property were sold. That means that the amount of any unrealized losses is available to increase the bases of assets up to (potentially) FMV.

29. IRC §1022(d)(1)(B)(ii).

30. IRC §1022(e)(2)(B).

31. IRC §6013(a)(3).

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 from an event that involved a different asset.

- The spousal property basis increase need not be in a qualified terminable interest property (QTIP) trust to qualify for the basis increase. The property must be "qualified spousal property,"[32] which does not include all property that qualifies for the marital deduction. For instance, property contained in a general power of appointment trust is not eligible.
- Property in a QTIP trust at the death of the **surviving spouse** is **not** eligible for the $1.3 million basis increase in the surviving spouse's estate.

> **Note.** There is no election necessary for purposes of the spousal basis increase rule. There is no provision for a partial QTIP election, and no ability to split the QTIP into two trusts.

- Gifted property received by a spouse within three years of death is ineligible for a basis increase.
- Property that is income in respect of a decedent (IRD) is not eligible for a basis increase.

> **Note.** This is the standard rule that has applied to IRD property. Therefore, the rule denies a basis increase to estates consisting primarily of qualified retirement plan benefits.

- 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 does not matter whether the executor allocates any basis increase amount to the subject proprty.

Establishing the Basis Increase. To establish the basis increase amounts, the executor must file a "Large Transfers" return (Form 8939).[33] If the decedent's estate value (other than cash) exceeds the basis increase amount ($1.3 million), the return reports the FMV of the decedent's property at the date of death and the amount of the basis increase allocated to items of the decedent's property under IRC §§1022(b) and (c).

> **Observation.** Presumably, the valuation penalties contained in IRC §6662 apply. That could affect the amount of valuation discounts attributable to minority and lack of marketability interests in closely-held businesses. Because the issue concerns income tax basis and not estate tax, the IRS will want to assert **lower** values and the taxpayer will want to assert **higher** values. However, audits do not occur until after the income tax return that reported the taxable event related to the inherited property is filed and selected for audit, which could be many years after the decedent's death.

Allocation of Basis. Fiduciary law requires that all allocations be made in a fair manner.[34] How is fairness determined? Should pro-rata allocations based on the relative FMV of the assets be used unless the dispositive instrument directs otherwise?[35] Can the allocation be directed and controlled by the decedent's will or trust? If so, that could provide some protection for the executor from claims made by disaffected beneficiaries. Other allocation questions involve how the allocation is applied when property passes by a contract beyond the executor's control, and whether an heir can be given the power to direct the executor in making the election. Currently, there is no guidance on these issues.

Form 8939. As of the date of publication of this workbook, the IRS has not finalized Form 8939 — the "Large Transfers" or "Carryover Basis" return. The most recent draft is dated August 24, 2011. Form 8939 shows the computation of the basis increase allocations, contains descriptions of the decedent's property, denotes the date of acquisition of the property by the decedent, the property's FMV at death, what the character of gain on the property would be upon sale, and whether the property is QTIP.

32. IRC §1022(c)(3).
33. The return must be filed in accordance with IRC §6018.
34. IRC §1022(d)(3).
35. Allocation is to be made on an asset-by-asset basis.

Form **8939**

Department of the Treasury
Internal Revenue Service

Allocation of Increase in Basis for Property Acquired From a Decedent

File separately. Do NOT file with Form 1040. See below for filing address.
To be filed for decedents dying after December 31, 2009, and before January 1, 2011.

OMB No. 1545-2203

2010

If this is an amended Form 8939, check here ▶ ☐ If filing this Form 8939 revokes a valid section 1022 election, check here ▶ ☐

Part 1—Decedent and Executor

1a Decedent's first (given) name and middle initial (and maiden name, if any)	**1b** Decedent's last (family) name	**2 Decedent's Social Security No.**
3 County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death	**4** ☐ Check if decedent was a nonresident and was not a citizen of the U.S. See instructions. If checked, enter nationality (citizenship)	**5** Date of death
6a Name of executor (see instructions)	**6b** Executor's address (number and street including apartment or suite number; city, town, or post office; state; and ZIP code) and phone number	
6c Executor's social security number (see instructions)	Phone no. ( )	

Part 2—Basis Allocation Computation

7 Marital status of the decedent at time of death:

☐ Married
☐ Widow or widower—Name, SSN, and date of death of deceased spouse ▶
☐ Single
☐ Legally separated
☐ Divorced—Date divorce decree became final ▶

8a Surviving spouse's name	**8b** Spouse's social security number

9 Individuals (other than the surviving spouse), trusts, estates, or other entities who acquired property from the estate (see instructions).

Name of individual, trust, estate, or other entity	Taxpayer identification number

10 Built-in loss (see instructions)	**10**	
11 Capital loss carryforward (see instructions)	**11**	
12 Net operating loss carryforward (see instructions)	**12**	
13 Enter the total amount of Basis Increase allocated to any property (see instructions)	**13**	
14 Enter the total amount of Spousal Property Basis Increase allocated to any property (see instructions)	**14**	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. I (executor) understand that if any other person files a Form 8939 or Form 706 (or Form 706-NA) with respect to this decedent or estate, that my name and address will be shared with such person, and I (executor) also hereby request the IRS share with me the name and address of any person who files a Form 8939 or Form 706 (or Form 706-NA) with respect to this decedent or estate. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Send Form 8939 (including accompanying schedules and statements) to: Internal Revenue Service, Estate & Gift Stop 824G, 201 W. Rivercenter Blvd., Covington, KY 41011

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions for this form. Cat. No. 37755W Form **8939** (2010)

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Form 8939 (2010)

Estate of:	Decedent's Social Security Number	Number of

SCHEDULE A—Disclosure of Property Acquired From the Decedent (and Recipient Statement)

Recipients of Schedule A: For more information and details on the information shown on this schedule, see the Instructions for Form 8939, Publication 4895, Tax Treatment of Property Acquired From a Decedent Dying in 2010, and *www.irs.gov/form8939.*

Complete a separate Schedule A for each recipient of property, including the decedent's estate. See instructions.

Part I General Information

1a Name of executor	**1b** Executor's address (number and street including apartment or suite number; city, town, or post office; state; and ZIP code) and phone number.
1c Executor's social security number	Phone no. ( )
2a Name of recipient	**2b** Recipient's taxpayer identification number (TIN)

Part II Property Information

3 For all property acquired from the decedent by the recipient named in line 2a the basis of which at the date of death is greater than or equal to its fair market value at the date of death, provide the following information. See instructions.

Item No.	**(a)** Description of property	**(b)** Date decedent acquired property	**(c)** Adjusted basis at death	**(d)** FMV at death	**(e)** Amount of gain that would be ordinary
Total from continuation schedules (or additional sheets) attached to this schedule					
3a Total for columns (c) and (d)					

(If more space is needed, attach the continuation schedule at the end of this Form)

4 For all property acquired from the decedent by the recipient named in line 2a the basis of which at the date of death is less than or equal to fair market value at the date of death, provide the following information. See instructions.

Item No.	**(a)** Description of property	**(b)** Date decedent acquired property	**(c)** Adjusted basis at death	**(d)** FMV at death	**(e)** Allocation of basis increase		**(f)** Amount of gain that would be ordinary
					(i) General basis increase	**(ii)** Spousal property basis increase	
Total from continuation schedules (or additional sheets) attached to this schedule							

Schedule A—Page 2

Form 8939 (2010) *(Make copies of this schedule before completing if you will need more than one schedule)*

Estate of:	**Decedent's Social Security Number**	**Number of**

SCHEDULE A, LINE 3
CONTINUATION SHEET

Item No.	**(a)** Description of the property	**(b)** Date decedent acquired property	**(c)** Adjusted basis at death	**(d)** FMV at death	**(e)** Ordinary gain
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Total for columns (c) and (d) (Carry forward to main schedule.)					

Form 8939 (2010) *(Make copies of this schedule before completing if you will need more than one schedule)*

Estate of:	**Decedent's Social Security Number**	**Number of**

SCHEDULE A, LINE 4
CONTINUATION SHEET

Item No.	(a) Description of property	(b) Date decedent acquired property	(c) Adjusted basis at death	(d) FMV at death	(e) Allocation of basis increase		(f) Amount of gain that would be ordinary
					(i) General basis increase	(ii) Spousal property basis increase	
Total for columns (e) (i) and (ii) (Carry forward to main schedule.)							

Form 8939 (2010)

Estate of:	Decedent's Social Security Number	Number of

Part 1. GST Exemption

1	Maximum allowable GST exemption	1	
2	Total GST exemption allocated by the decedent against decedent's lifetime transfers	2	
3	Total GST exemption allocated by the executor, using Form 709, against decedent's lifetime transfers	3	
4	GST exemption allocated on line 4 of Schedule R, Part 2	4	
5	GST exemption allocated on line 4 of Schedule(s) R-1	5	
6	Total GST exemption allocated to *inter vivos* transfers and direct skips (add lines 2–5)	6	
7	GST exemption available to allocate to trusts (subtract line 6 from line 1)	7	
8	Allocation of GST exemption to trusts (as defined for GST tax purposes):		

A Name of trust	B Trust's EIN (if any)	C GST exemption allocated on lines 2–5, above (see instructions)	D Additional GST exemption allocated (see instructions)	E Trust's inclusion ratio (optional—see instructions)
8D Total. May not exceed line 7, above		8D		

Schedule R—Page 3

10

Form 8939 (2010)

Estate of:	Decedent's Social Security Number

Part 2. Direct Skips

Name of skip person	Description of property interest transferred	Value

1	Total value of all property interests listed above	1	
2	State death taxes, and other charges borne by the property interests listed above	2	
3	Total tentative maximum direct skips (subtract line 2 from line 1)	3	
4	GST exemption allocated	4	

Schedule R—Page 4

SCHEDULE R-1 (Form 8939)

Department of the Treasury
Internal Revenue Service

Direct Skips From a Trust

Executor: File one copy with Form 8939 and send two copies to the fiduciary. Do not pay any tax. See instructions for details.
Fiduciary: See instructions for details.

Name of trust	**Trust's EIN**
Name and title of fiduciary	Name of decedent
Address of fiduciary (number and street)	Decedent's SSN
City, state, and ZIP code	Name of executor
Address of executor (number and street)	City, state, and ZIP code
Date of decedent's death	

Description of property interests subject to the direct skip		Value
1 Total value of all property interests listed above	1	
2 State taxes, state death taxes, and other charges borne by the property interests listed above	2	
3 Tentative maximum direct skip from trust (subtract line 2 from line 1)	3	
4 GST exemption allocated	4	
5 Subtract line 4 from line 3	5	

Schedule R-1—Page 36

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Note. The draft of Form 8939 released in August 2011 did not include a Schedule B, because there were no changes from the draft published in December of 2010. That Schedule B is shown below.

Form 8939 (2010)

Estate of:	Decedent's Social Security Number	Number of

SCHEDULE B—Property Acquired by Person Other Than Surviving Spouse

Recipients of Schedule B: For more information and details on the information shown on this schedule, see the Instructions to Form 8939, Publication 4895, Tax Treatment of Property Acquired from a Decedent Dying in 2010, and *www.irs.gov/form8939*.

Complete a separate Schedule B for each recipient of property, including the decedent's estate. See instructions.

Part I General Information

1a Name of executor	**1b** Executor's address (number and street including apartment or suite number; city, town, or post office; state; and ZIP code) and phone number.
1c Executor's social security number	Phone no. ( )
2a Name of recipient	**2b** Recipient's taxpayer identification number (TIN)

Part II Property Information

3 For all property acquired from the decedent by the recipient named in line 2a the basis of which at the date of death is greater than its fair market value at the date of death, provide the following information. See instructions.

Item No.	(a) Accurate description of the property	(b) Date decedent acquired the property (mm/dd/yyyy)	(c) Adjusted basis at death	(d) Fair market value at death	(e) Check if any gain would be ordinary (Attach statement)
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3a Total for columns (c) and (d)					

4 For all property acquired from the decedent by the recipient named in line 2a the basis of which at the date of death is less than or equal to fair market value at the date of death, provide the following information. See instructions.

Item No.	(a) Accurate description of the property	(b) Check if included on Schedule A. Attach statement. See instructions.	(c) Date decedent acquired the property (mm/dd/yyyy)	(d) Check if ineligible property. Attach statement. See instructions.	(e) Adjusted basis at death	(f) Fair market value at death	(g) Basis increase allocated to the property	(h) Amount of gain that would be ordinary (Attach statement)
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5 Add the amounts in line 4, column (g) . . . .

6 Enter the amount of basis increase allocated to property shown on this Schedule B and that was acquired by the decedent's estate and shown on the Schedule B for the decedent's estate. If this Schedule B is for the decedent's estate, enter zero . . . .

7 Enter the amount of basis increase allocated to property shown on this Schedule B and that was acquired by the surviving spouse and shown on Schedule A . . . .

8 Add lines 6 and 7 . . . .

9 Subtract line 8 from line 5 . . . .

Schedule B—Page 3

The following observations can be made concerning the draft Form 8939.

- While it was uncertain what disclosures were required with Form 8939, the IRS, in Rev. Proc. 2011-41, clarified that appraisals must be attached to support asset values in accordance with IRC §2031. Likewise, the IRS stated in Notice 2011-66 that other "supporting documents" must be attached as identified in the instructions to Form 8939 (which was not released at the time this chapter was written).
- There is no obvious place on Form 8939 to report community property, but the instructions to Form 8939 are anticipated to provide guidance.
- The IRS has informally stated that it would like to allow the spousal basis increase to be allocated to assets that are sold during estate administration if the proceeds are later distributed to the surviving spouse. However, the spousal basis increase only applies to outright spousal transfers or QTIP transferred to the spouse. Property sold during estate administration does not technically satisfy the statutory requirement. Although in Rev. Proc. 2011-41, the IRS explained that it would allow a spousal basis increase to be allocated to property sold before it is distributed if the executor certifies on Form 8939 that the net sale proceeds will be distributed to or for the benefit of the surviving spouse in a way that makes it qualified spousal property. The executor must attach each document that provides for a distribution to the surviving spouse to Form 8939.
- It is not presently known whether Form 8939 can be amended to address the distribution of property that occurs **after** its filing. However, the purpose of Form 8939 is to disclose the identity of the recipients of the decedent's property as of the date of filing. The decedent's estate is classified as the recipient of undistributed property as of the filing of Form 8939, so an amendment may not be required to report subsequent transfers or distributions. In Notice 2011-66, the IRS said that it would allow filing of an amended Form 8939 after November 15, 2011, only for the purpose of allocating the spousal basis increase. In order to amend Form 8939 after November 15, 2011, the original must have been timely filed and must have been complete at the time of filing.
- It would appear that property sold during estate administration or that remains undistributed by the deadline for filing Form 8939 should be entered on Schedule B with the estate listed as the recipient. A separate Schedule B must be completed for each beneficiary who receives assets from the estate.
- While the statute requires the executor to report the date the decedent acquired the property and its character, that information is irrelevant for property that has an income tax basis exceeding FMV. The draft Form 8939 requires (as does the statute) the inclusion of this information.
- The IRS specified in Notice 2011-66 that 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.
- The IRS has informally stated that split-interest property that results in a life estate to the surviving spouse and a remainder interest to others is reported at its full basis on both Schedules A and B because basis cannot be assigned under IRC §§1001 and 1014 until disposal of the life estate or remainder. There is a box on Schedule B labeled "check if included on Schedule A" that should be marked for such property.

Note. As of the date this book was published, the IRS was projecting January 6, 2012, as the date for finalizing Form 8939. However, the November 15, 2011, filing deadline assumes that Form 8939 was finalized by August 17, 2011.

EXECUTOR CHOICES — RULES OF THUMB

In some instances, the executor may have a difficult decision to make regarding whether to elect out of the estate tax for a 2010 estate. The executor may request the assistance of the tax advisor.

In general, for estates valued at $5 million or less, the executor will likely **not** want to elect out of the estate tax. In these situations, **not** electing out results in no estate tax due **and** the inherited assets receiving a stepped-up basis. However, for estates with values over $5 million, the executor may choose to elect out of the estate tax and use the modified carryover basis rule to limit the unrealized capital gains on the eventual sale of the assets.

> **Observation.** It appears likely that the capital gains tax rate will remain significantly below the estate tax rate. By timing when the capital gain tax applies, it is possible to use capital losses or loss carryforwards to offset gain.

When advising the executor to elect out of the estate tax, the decision should be based on an analysis of several factors. These factors include the following; however, no one factor is determinative.

- How does the 35% estate tax rate compare to the potential income tax cost on disposition of the inherited assets, factoring in the ability to increase basis ($1.3 million for nonspousal property and $3 million for spousal property)?[36]

> **Note.** The basis increase is important for nondepreciable assets. However, it is **critical** for inventory (such as zero basis calves or grain for a farmer/rancher) and IRC §1245 depreciated equipment that is subject to recapture when the property is exchanged or sold.

- If an election is made, and income tax would result upon sale of the inherited assets, are strategies available for deferring the income tax?
- Is income tax basis information available so that Form 8939 can be completed with relative ease and filed on time?
- Who are the beneficiaries that would bear the burden of any estate tax, and are they the same persons who would bear the burden of the capital gains tax that would be incurred on the sale of the assets if the election is made?
- What are the relative tax brackets of the recipients of the property?
- Are there certain items of property that are eligible for full or partial gain exclusion?
- What is the character of any gain that would be triggered on the sale of the inherited assets?

> **Observation.** It is likely that the beneficiaries will receive assets with varying proportions of **built-in gain.** Consequently, the particular tax situation of the beneficiary may also need to be considered along with how likely it is that the beneficiary will sell the asset and whether opportunities are available for exclusion of gain. For example, if the inherited asset is the decedent's home, the opportunity for exclusion of all of the gain attributable to the home may be available to the **beneficiary** under IRC §121.

36. The Act provides no guidance on the basis rule for 2010 estates when inherited assets are sold after 2010.

- How likely is it that the asset will be sold and the tax actually incurred?
- How is formula clause language (if any) in the decedent's will or trust that divides the assets between the marital and credit shelter shares (or trusts) to be interpreted?
- What is the executor's degree of exposure to claims by unhappy beneficiaries?
- Should an investment policy plan be prepared to guide the executor while holding estate funds?
- If the taxable estate value is only slightly over $5 million, what is the income tax basis of the estate's assets? Does achieving stepped-up basis treatment outweigh the potential capital gain that would be incurred upon sale of the assets?
- Is a surviving spouse involved? If so, perhaps the election should **not** be made if the marital deduction can be used to avoid estate tax upon the first spouse's death. Will the estate of the surviving spouse be large enough to incur estate tax by the use of marital deduction and bypass trusts?

Observation. Such a strategy has the risk of leaving too much property to the surviving spouse. At the present time, without congressional action, the federal estate tax exemption drops to $1 million beginning in 2013. However, if the decedent's estate plan leaves a substantial amount to charity, the strategy may be sound.

Note. If an executor chooses to elect out of the estate tax for a 2010 death, the election is irrevocable.[37] Because of the irrevocable nature of the election, the executor may want to obtain some sort of release from the court for protection from liability. Consideration may also need to be given to seeking court approval before making the election, but that raises other questions about the cost of the proceeding and the time involved.

Overall, an executor has important decisions to make and needs guidance in determining the proper approach. For some estates, the general rules of thumb may not apply based on the particular facts involved.

A larger concern for the executor may be how any election affects the estate's beneficiaries. While the election reduces the estate tax impact on the decedent's estate, that must be measured against the income tax impact of the loss of stepped-up basis on inherited assets in the hands of the beneficiaries.

Observation. If the election out of the estate tax is made for a 2010 estate, there may be no incentive to pay the executor's fee. Executor fees are a deductible expense for federal estate tax purposes. With no estate tax, the deduction is lost.

37. Act, Sec. 301.

PORTABILITY OF THE ESTATE AND GIFT TAX EXCLUSION

Under the Act, a surviving spouse can use the remaining exclusion amount from their deceased spouse. For married couples, the new exclusion amount is $5 million plus the portable amount from the decedent's "last deceased spouse."

> **Caution.** 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.

Portability only applies to federal estate tax. It does not apply to the various states' estate/inheritance tax or to the GSTT.

Portability of the unused portion of the estate tax exclusion of the first spouse to die only applies for deaths in 2011 or 2012. In order to add any unused exemption at the first spouse's death to the exemption of the surviving spouse, **both spouses** must die before 2013. Also, 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.[38] Portability is not automatic, and it could be difficult to apply in certain situations.

> **Caution.** For deaths in 2011 and 2012, practitioners should automatically make the election in the first spouse's estate in every situation in which the exemption has not been fully utilized or when it is likely that the value of the surviving spouse's estate will exceed the exemption. At the time this chapter was written, it was not known whether the Treasury would create an abbreviated Form 706 to use when the sole purpose of filing the form is to make the portability election.

The following examples are adapted from the Joint Committee on Taxation's Explanation of the portability provision[39] and provide additional insight as to congressional intent surrounding the portability provision.

Example 1. John died in 2011 with a $3 million taxable estate. John's estate executor elected on John's estate tax return to permit John's surviving spouse to use John's unused exclusion. As of John's death, Mary, his surviving spouse, made no taxable gifts. Thus, her exclusion is $7 million (her $5 million exclusion plus the $2 million unused exclusion from John's estate).

Example 2. Use the same facts as **Example 1,** except John made $1 million of taxable gifts before his death in 2011. Mary made no taxable gifts prior to John's death. Her exclusion is $6 million (her $5 million exclusion plus the $1 million unused exclusion from John's estate).

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38. Act, Sec. 303(a), amending IRC §2010(c). An important point is that an estate tax return must be filed so that the election can be made even if the estate is below the filing threshold. The election keeps the statute of limitations open forever on the predeceased spouse's estate tax return, but only for the sole purpose of determining the amount of the unused exemption. The normal statute of limitations bars any adjustments to the predeceased spouse's return after the statute expires.

39. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," Scheduled for Consideration by the United States Senate (JCX-55-10) (Dec. 10, 2010).

Example 3. Use the same facts as **Example 1.** Mary is lonely, so she marries Jack later in 2011. Jack dies in 2012. Before his death, Jack made $4 million of taxable gifts and has no taxable estate. Jack's estate executor makes the portability election on Jack's estate tax return to allow Mary to use Jack's unused exclusion amount.

Although the combined amount of unused exclusion of John and Jack is $3 million, only Jack's $1 million unused exclusion is available to Mary. The unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the **last deceased spouse** of the surviving spouse. Mary's applicable exclusion amount is $6 million, which she may use for lifetime gifts or for transfers at death (if she dies in 2012).

Note. As the examples illustrate, the amount of the unused spousal exclusion is also available to the surviving spouse for covering taxable gifts. Unfortunately, it is unknown (absent IRS guidance) how the use of the exemption for taxable gifts is accounted for if the surviving spouse remarries and survives the new spouse.

Example 4. Use the same facts as **Example 3,** except Mary dies before Jack. After John's death, Mary's applicable exclusion amount is $7 million. Mary did not make any taxable transfers before death and had a taxable estate of $3 million at the time of her death. Her executor made an election on her estate tax return to allow Jack to use Mary's unused $4 million exclusion. Jack's exclusion amount is now $9 million.

Caution. Based on the statute, the Committee's explanation is incorrect for **Example 4.** IRC §2010(c)(4)(B) specifies that the "deceased spousal unused exclusion amount" that is portable from (to use the names in the example) Mary to Jack is the excess of Mary's "basic exclusion amount" ($5 million) over the amount to which Mary's tentative tax is determined under IRC §2001(b)(1) ($3 million). Therefore, Mary's unused exclusion would be $2 million rather than $4 million, and Jack's exclusion would be $7 million.

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.

Example 5. Interpretation A. Jane is married to John and John dies. Jane remarries Jack and she dies before Jack. Jane's estate cannot use the remaining exclusion of John.

A different interpretation can lead to a different result.

Example 6. Interpretation B. Jane is married to John and John dies. Jane remarries Jack and she dies before Jack. Jane's estate can use John's unused exemption 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.

It would appear that interpretation B 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."[40]

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40. Ibid.

IMPACT OF PORTABILITY

It is important to remember that portability is only temporary, at least currently. Therefore, the standard credit shelter bypass trust arrangement for larger estates remains a good planning tool. Such a plan includes the following.

- Provides asset protection and management during the life of the surviving spouse
- Provides shelter from growth in value and accumulated income for estate tax purposes
- Allows use of the predeceased spouse's GSTT exemption
- Avoids a future spouse's rights to a statutory share
- Provides for minimization of state death taxes in those states with a death tax exemption lower than $5 million

For other clients, portability has the following potential advantages.

- Avoids splitting ownership of assets
- Allows the step up in basis for assets upon the death of the surviving spouse
- Avoids state estate tax for decedents that are residents of states that do not have a separate state estate tax

Example 7. Ralph and Alice are married and reside in a state where the state estate tax is calculated on the state credit using a $2 million exemption. They hold all assets in joint tenancy to avoid attorney fees and probate costs. Ralph and Alice are confident that their property will pass free of all death taxes. Ralph dies in 2011. Alice dies in 2012 leaving $4 million to their only child, Norton.

Question 7A. What are the estate tax consequences?

Answer 7A. On Ralph's death, there is no federal or state estate tax owed because the unlimited marital deduction applies to the joint tenancy transfer. Upon Alice's death in 2012, there is a $4 million tentative taxable estate. Under the federal estate tax portability provisions, Alice has her $5 million exclusion, plus Ralph's $5 million exclusion, for a total of $10 million. There is zero federal estate tax owed, and there is a stepped-up basis for the underlying assets.

However, for state estate tax purposes, Alice's estate owes tax. Because there is no portability of the state estate tax exclusion, the state estate tax at Alice's death on $4 million is over $250,000. If the couple had done proper planning for state estate tax, the outcome would be different. By dividing assets between spouses during their lifetimes and using a marital deduction/bypass trust estate plan, all state estate tax could have been avoided.

GIFTING STRATEGIES FOR 2011 AND 2012

For many, the gift tax exemption of $5 million ($10 million for a married couple) is sufficient to allow them to accomplish their estate planning objectives with simple outright gifts or gifts in trust if larger gifts are involved. Any appreciation in the gifted assets has no impact on the estate tax of the donor. In addition, any gift tax paid escapes estate tax if the donor survives for three years after the gift. This has the effect of reducing the 35% gift tax rate to an estate-tax equivalent rate of approximately 26%.

Observation. Because the GSTT exemption is also $5 million, such trusts can be GSTT trusts without any gift tax or GSTT paid.

BASIS IMPLICATIONS OF GIFTING

For purposes of determining the gain on gifted property, the income tax basis equals the donor's basis. Thus, for low-basis assets, consideration should be given to the potential estate tax saved by gifting the asset before death and the additional income tax on the capital gain that may be incurred if the donee sells the gifted property. Presently, the estate tax rate exceeds the capital gain rate, although the new Act narrows the differential. That differential has implications for gifting appreciated assets that are likely to be sold shortly after the donor's death.

Caution. Section 302(d) of the Act 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. Presently, the IRS has not provided guidance on the issue. Without guidance, and as long as the estate and gift tax exemption and rates remain nonpermanent, 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.

Gifting strategies for 2011–2012 depend on an individual's net worth. For persons with a net worth of $5 million or less, gifting is not necessary to bring the potential estate into a nontaxable position.

Note. There may be state death tax implications for those states that decouple. See the table earlier in this chapter for a list of states that decouple.

For these individuals, if a strategy of gifting was established under a *Crummey*-type demand power,[41] the strategy may need to be modified so that gifts are not authorized for 2011 or 2012. Not only is there no need for gifting to reduce the estate to a nontaxable position, but any gifted assets **will not** receive a stepped-up basis. If the assets remain in the estate and the taxable estate at death is $5 million or less (for 2011 and 2012), there will still be no federal estate tax **and** the assets included in the estate **will** receive a stepped-up basis.

Of course, the unknown status of the law beginning in 2013 could affect gifting strategies. Except for the very wealthy, there is no transfer tax incentive to make gifts in 2011 or 2012.

41. *Crummey* power is named after a 1968 federal court opinion (*Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968)) that allowed contributions to an irrevocable trust to qualify for the annual gift tax 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.

Charitable Gifts

It is possible that the enhanced federal estate tax exemption for 2010 through 2012 may dampen charitable giving. Those persons that already implemented testamentary charitable lead trusts as part of their estate plan to reduce the size of the taxable estates may now have an incentive to review their estate plan in light of the enhanced exclusion. This may be particularly true for clients with a potential taxable estate of between $1 and $5 million who feared, prior to the Act's enactment, that the estate tax exemption would fall to $1 million and consequently created a charitable lead trust to reduce the impact of the estate tax. If Congress does nothing to change the exemption, it will revert to $1 million for deaths beginning in 2013. In that case, the client's estate plan would need no revisions.

PLANNING IMPLICATIONS OF THE ACT

Note. The following discussion involves language to include in estate planning documents. Certain provisions have an effect on federal estate and gift tax liabilities. The actual drafting, modifying, or interpreting of the documents should be done by a licensed attorney.

STRATEGY FOR 2011 AND 2012

The Problem of Temporary Certainty

The temporary nature of the Act may result in clients being unwilling to make dramatic changes to existing estate plans. Planning situations for most married couples are simplified for 2011 and 2012 because combined spousal wealth is less than $5 million. Consequently, factors other than estate tax avoidance may drive the estate planning process. The same can be said for the use of trusts — nontax factors such as property preservation for children, property management, and protection for the surviving spouse may drive the decision to use a trust. Overall, it may be advisable for many clients to stay with existing marital deduction/bypass trust arrangements through 2012.

From the perspective of an estate planner, the focus necessarily shifts to client matters associated with estate planning concerns (such as financial and healthcare powers of attorney), asset protection planning (particularly for the possibility of long-term health care), financial planning, and income tax planning.

Determining Issues by Classifying Clients

It may be beneficial to think of 2011–2012 estate planning in terms of classifying clients according to their wealth. The wealthiest clients should view the Act as a golden opportunity for estate tax planning because of the uncertainty of the applicable estate planning rules beyond 2012. After 2012, the $5 million exemption and portability could continue, as well as valuation discounts and grantor-retained annuity trusts (GRATs). Alternatively, only a $1 million exemption could be enacted, along with a top rate of 55%, elimination of GRATs, and valuation discounts. Or, Congress could enact a different law that results in some middle ground, such as a $3.5 million exemption and a 45% rate. Because of the uncertainty, particularly for wealthy clients, aggressive planning may be warranted for 2011–2012.

For moderately wealthy clients, other concerns may dominate. These include the pitfalls of not planning, the limitations of portability, and the uncertainty of the law after 2012. Consideration should be given to state-level taxes associated with death (if any) and the impact of inflation on potential estate value.

For clients without an estate tax problem for 2011 or 2012, the focus shifts to income tax planning (maximizing income tax basis step up), planning residency and domicile for income tax and state death tax purposes, and family and personal matters involving health, family business succession, and asset protection. The planning mindset should take into account the possibility of only a $1 million exemption for deaths occurring after 2012.

Review of Estate Planning Documents

In General. Given the significant changes in the law, it is important that clients' wills and revocable trusts be reviewed to determine if pecuniary bequests, percentage allocations, and formula clauses will operate as desired upon death. If estate planning documents contain drafting language that refers to the Code, use Code definitions for transfer tax purposes, or otherwise use Code language to carry out bequests, the document may no longer describe the testator's intent. For example, if a bequest to a surviving spouse is defined by a formula tied to Code language, the size of that bequest may be altered by the Act. This is particularly a concern if the executor elects out of the estate tax for a 2010 death. In that instance, a clause that leaves a surviving spouse "the minimum amount needed to reduce the federal estate tax to zero" would result in nothing passing to the surviving spouse. Likewise, a beneficiary would receive everything under a provision that provides that the beneficiary receives "the maximum amount that can pass free of federal estate tax."

> **Observation.** Because many estate planners believed that the 1-year repeal of the federal estate tax in 2010 would never actually occur, it is likely that at least some estate planning documents for 2010 decedents do not address the possibility that the federal estate tax would not apply.

Formula Clause Language. As noted above, a common estate planning approach for a married couple facing the possibility of at least some estate tax upon the death of either of them has been for the estate of one spouse to be split into a marital trust and a credit shelter (bypass) trust. To implement this estate planning technique, the couple's property is typically retitled, if necessary, to roughly balance the estates so that the order of death of the spouses becomes immaterial from an estate tax standpoint. This necessarily requires the severance of joint tenancy property. Estate "balancing" between the spouses is critical when combined spousal wealth is between $5 million and $10 million. The trust is split in accordance with a formula which causes the credit shelter trust to be funded with the deceased spouse's unused exemption, and the marital trust to be funded with the balance of the estate.

The typical formula would fund the bypass trust first by means of a fraction set forth in the drafting language.

Common language may be as follows.

> *. . . the largest value of the trust assets that can pass free of federal estate tax by reason of the unified credit . . .*

However, this clause produces an amount of zero if the federal estate tax does not apply. If the words "by reason of the unified credit" were omitted, the formula would apply to all of the trust assets.

Other drafting language creates and funds the marital trust first by stating, for example:

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

In either event, if no federal estate tax applies, the clause causes nothing to pass to the surviving spouse in the marital trust.

> **Observation.** The same problem with formula clause language applies to many charitable bequests that are phrased in terms of a percentage of the "adjusted gross estate" or that establish a floor or ceiling based on the extent of the "adjusted gross estate."

Examining Existing Documents for "Repeal Language." Some attorneys anticipated the repeal of the federal estate tax by including so-called "repeal language" in estate planning documents. Such language generally follows certain common forms. For example, such language could be stated as follows.

> *. . . however, if at my death the federal estate tax does not exist or does not apply to my estate, all such assets shall constitute the bypass trust.*

That language should successfully account for the nonexistence of the federal estate tax at death. In addition, the language works well if the surviving spouse is the sole income beneficiary of both the marital and the bypass trust and can receive discretionary principal distributions. However, if the bypass trust is intended to be for the benefit of the couple's children and not the surviving spouse, the language leaves nothing for the surviving spouse. That, in turn, triggers the surviving spouse's right to take an elective forced share of the first spouse's estate, in accordance with state law.

Another form of "repeal language" may read:

> *. . . if the federal estate tax has been repealed.*

The current problem with this language is that Congress retroactively **reinstated** the federal estate tax to the beginning of 2010 with the ability to elect out of the estate tax. In other words, the estate tax was repealed by statute due to the 1-year sunset contained in EGTRRA but was then reinstated retroactively with the ability to elect out of the estate tax. What is currently unknown is whether an election out of application of the estate tax is construed as "repeal" for purposes of such a clause.

Other estate planning documents may contain language that ties the amount of property included in the marital trust to the unified credit. One such common drafting clause may read as follows.

> *. . . a fractional share of the trust assets, the numerator of which is the largest value of the trust assets that can pass free of federal estate tax by reason of the unified credit (a.k.a. the "applicable credit amount") . . .*

That language, if the executor elected out of the estate tax for a 2010 death, results in nothing passing to the bypass trust.

Alternatively, the following language results in **all** of the decedent's assets passing to the bypass trust:

> *. . . to the bypass trust the largest pecuniary amount which will produce the least federal estate tax payable by reason of my death . . .*

Observation. It is important to examine all estate planning documents for a clear understanding of the implications of drafting language if such language were to become operative in either 2011 or 2012, if the federal estate tax were again repealed at some point in the future, or if the federal estate tax exemption reverts to $1 million beginning in 2013.

The standard marital deduction formula clause that funds the bypass trust with the maximum amount of property resulting in the least amount of federal estate tax will fund the bypass trust with $5 million of property for deaths in 2011 and 2012. **Consideration should be given to the use of a partial QTIP** for state death tax purposes if the decedent is domiciled in a state with an estate tax exemption that is less than $5 million. This will also provide flexibility against the uncertainly of the estate tax exemption for deaths after 2012. Under such a plan, the residue of the decedent's estate (to the extent the assets qualify for the marital deduction) would pass to a single (divisible) QTIP marital deduction trust for the benefit of the surviving spouse. Through the use of a partial QTIP election, the decedent's fiduciary can then determine how much of the QTIP trust property is qualified for the marital deduction.

Note. With a 6-month extension to file the decedent's federal estate tax return, the decedent's fiduciary may have up to 15 months to determine the appropriate partial QTIP election amount.

A decedent's intent may be to benefit the surviving spouse for life, but they may also want more post-death flexibility than is available under an outright bequest to the surviving spouse. A single QTIP trust that is subject to a partial QTIP election is useful in this situation. With an outright bequest, the surviving spouse has only nine months to disclaim some or all of the marital bequest. Another benefit of the partial QTIP approach is that the surviving spouse's income interest is in a partial QTIP trust. When the surviving spouse receives a mandatory income interest in the nonelected (divided) QTIP trust, it may provide the surviving spouse's estate with a credit for previously taxed property.[42] To implement this estate planning technique, the couple's property is typically retitled, if necessary, to roughly balance the estates so that the order of death of the spouses becomes immaterial from an estate tax standpoint. This necessarily requires the severance of joint tenancy property. Estate "balancing" between the spouses is critical when combined spousal wealth is between $5 million and $10 million. A partial QTIP election that leaves less than the full applicable exclusion amount to the nonmarital trust may also be helpful to minimize the risk associated with the uncertainty of the estate tax exemption after 2012.

Savings, Defined Value, and Disclaimer Clauses. In light of the possibility of estate tax repeal in recent years (either outright repeal or by election), some estate planners utilize drafting language that not only accounts for that possibility, but also accounts for the uncertainty in the valuation of transferred property and challenges that might be brought by the IRS. On the valuation issue, such language is particularly important if the estate planning instruments fund various shares of the estate in accordance with formula clause language (or a fixed fraction) tied to an exemption amount. A subsequent change in valuation can negatively affect those shares with a resulting unfavorable tax result.

A savings clause is commonly used for marital deduction formulas. An example of a savings clause follows.

> *My Trustee shall segregate and add to the Bypass Trust all assets that are not included in my gross estate, and such assets shall not be subject to the fractional division described in this Article.*

With such language in a will or trust when there is no estate tax, there obviously is no "gross estate" and no assets to include in the "gross estate." That means all the assets are allocated to the bypass trust. If that outcome is objectionable, the clause can be combined with the use of a post-death disclaimer by the surviving spouse to carve out the appropriate size of the marital and nonmarital shares.

> **Observation.** The same result is obtained by means of drafting language specifying that property not qualifying for the marital deduction shall not be allocated to the marital trust but instead shall be allocated to the bypass trust.

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A defined value clause is used in the dispositive instrument to overcome valuation issues that can arise post-death. Such a clause sets forth a specific amount of property tied to the applicable exemption and can be used for estate tax or gift tax purposes. While the IRS objects to defined value clauses (often on public policy grounds) because the clauses frustrate the IRS valuation challenges on audit, the courts have ruled favorably on these clauses in recent years.

The first case to deal with the IRS public policy arguments was *Procter*.[43] In this case, the drafting language specified that if any federal court of last resort determined that any part of the transfer at issue was subject to gift tax, the gift portion "shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from any trust hereby created." The court ruled that the clause imposed an impermissible condition subsequent on the transfer in violation of public policy.

> **Note.** A disclaimer clause can be used for the same purpose and effect.

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42. IRC §2013.

43. *Procter v. Comm'r,* 142 F.2d 824 (4th Cir. 1944), *cert. den.,* 323 U.S. 756 (1944).

In *McCord*,[44] the U.S. 5th Circuit Court of Appeals gave full effect to a defined value gift clause that the Tax Court had voided because the formula used in the clause defined the gift based on its "fair market value" rather than its "fair market value as finally determined for federal gift tax purposes."

In *Christiansen*,[45] the U.S. 8th Circuit Court of Appeals affirmed the Tax Court in a case involving a disclaimer clause. The heir (the decedent's daughter) executed a partial disclaimer which resulted in an amount of the decedent's assets that exceeded a pre-established value passing to charity. The impact of the disclaimer was to shield the estate against a valuation challenge by the IRS that would result in an enhanced estate tax liability. In that event, any additional amount would pass to the charity and generate an enhanced charitable deduction for the estate. On audit, the IRS enhanced the decedent's assets by approximately 50%, and the estate claimed an enhanced charitable deduction due to the disclaimer clause. The IRS disagreed, but the court upheld the clause on the basis that the gift was neither contingent at the time of death nor violated public policy.

In *Petter*,[46] the Tax Court upheld a defined value gift tax clause (a.k.a. a "gift over" clause) and again rejected the IRS's policy-based arguments. Via a part-gift or part-sale transaction, the taxpayer transferred her interests in an LLC to intentionally defective grantor trusts. The amount transferred was keyed to maximize the taxpayer's unused applicable exclusion amount, with the excess passing to charity. The transfers were reported on the taxpayer's gift tax return. On audit, the IRS adjusted the value of the gifts upward and took the position that the defined value clause was invalid on public policy grounds. The court distinguished the *Procter* decision and stated that formula clauses like the one at issue should not be declared against public policy in all situations.

Note. The U.S. 9th Circuit Court of Appeals affirmed *Petter* on appeal.[47] The IRS abandoned its public policy argument and the court disagreed with the valuation arguments of the IRS. The court noted that the gifts to the charity were effective as soon as the transfer documents were executed and the LLC units were delivered. As such, any later valuation change by the IRS did not mean that the charities would receive any additional LLC units. The court also held that the language "value as finally determined for gift tax purposes" contained in IRC §2001(f)(2) did not apply for gift tax purposes.

In *Hendrix*,[48] the Tax Court again approved transfers with "defined value" formula provisions to limit gift tax exposure from the transfers. The court concluded that a transfer of closely-held stock in a gift or sale transaction to family trusts and a gift to a foundation under coordinated formula provisions was at arm's length and was not contrary to public policy. The defined value clause at issue allocated stock between the family trusts and the foundation based on values determined by the IRS using a willing buyer and willing seller test. The Tax Court believed the transactions were entered into at arm's length and that there was no collusion between the donors and the foundation.

Note. *Hendrix* is appealable to the 5th Circuit and, if the case is appealed, it is possible that the court could expand upon its prior opinion in *McCord*.

44. *McCord v. Comm'r,* 461 F.3d 614 (5th Cir. 2006), *rev'g.,* in part, 120 TC 358 (2003).

45. *Christiansen v. Comm'r,* 586 F.3d 1061 (8th Cir. 2009), *aff'g.,* 130 TC 1 (2008).

46. *Petter, et al. v. Comm'r,* TC Memo 2009-280 (Dec. 7, 2009).

47. *Estate of Petter v. Comm'r,* No. 71854, 2011 U.S. App. LEXIS 16098 (9th Cir. Aug 4, 2011).

48. *Hendrix v. Comm'r,* TC Memo 2011-133 (Jun. 15, 2011).

Impact of State Law. As noted above, formula clauses can have extremely different meanings depending on whether the federal estate tax applies to the estate. Depending on the situation, the impact of the clause could result in a disposition that is contrary to what the decedent intended and could lead to litigation. To address this potential problem in 2010, 19 states along with the District of Columbia enacted legislation designed to interpret estate plans.[49] The legislation constitutes a default rule of construction for formula clauses that do not expressly contemplate estate tax repeal. Under most of the state statutes, the decedent is presumed to have died in 2009 with a $3.5 million exemption. However, some of the statutes specify that they do not apply if the federal estate tax (or the GSTT) became effective before January 1, 2011. Consequently, while the estate tax under the Act became effective before January 1, it is not clear how that type of statute is construed if an election **out** of the estate tax is filed for a 2010 decedent's estate.

> **Note.** Some state statutes require that a judicial proceeding to construe a formula disposition must be brought within a certain timeframe from the date of the decedent's death.

The "Over-Stuffed" Credit Shelter Trust. A common clause that historically was used to split the credit shelter and marital shares and may still be found in older estate planning documents follows.

> *To my trustee . . . that fraction of my residuary estate of which the numerator shall be a sum equal to the largest amount, after taking into account all allowable credits and all property passing in a manner resulting in a reduction of the federal estate tax unified credit available to my estate, that can pass free of federal estate tax and the denominator of which shall be the total value of my residuary estate.*
>
> *For the purpose of establishing such fraction the values finally fixed in the federal estate tax proceeding in my estate shall control.*
>
> *The residue of my estate after the satisfaction of the above devise, I devise to my spouse; provided that, any property otherwise passing under this subparagraph which shall be effectively disclaimed or renounced by my spouse under the provisions of the governing state law or the Internal Revenue Code shall pass under the provisions of paragraph . . . "*

While the above language typically worked well with federal estate tax exemption levels much lower than the current $5 million amount, the language can result in an "over-stuffed" credit shelter trust under current law.

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Example 8. John and Mary are married. They had a combined spousal wealth of $3 million in 2001 when the exclusion from the estate tax was $1 million. As part of the estate planning process, they retitled their assets and balanced the value between them to eliminate problems associated with the order of their deaths.

John dies first with an estate of $1.5 million when the estate tax exclusion is $1 million. The clause language results in $1 million passing to the bypass trust and $500,000 passing outright to Mary in the marital trust created by the residuary language. Upon Mary's death, when the estate tax exclusion is $1 million, her estate consists of her separate $1.5 million (assuming unchanged asset values) and the $500,000 passing outright to her under the terms of John's will. With a $1 million exclusion, only $1 million is subject to the federal estate tax at Mary's death.

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49. The states are Delaware, Florida, Georgia, Idaho, Indiana, Maryland, Michigan, Minnesota, Nebraska, New York, North Carolina, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Virginia, Washington, and Wisconsin.

Example 9. Use the same facts as **Example 8,** except the estate tax exclusion is $5 million. The clause language results in John's entire estate passing to the bypass trust, and nothing passing outright to Mary as part of the marital trust. Although the couple's estate value is not large enough to trigger an estate tax problem, it would be better to have some property included in Mary's estate so it could receive a stepped-up basis. With a $5 million exclusion, all John's property could be left outright to Mary and added to her separate property. Mary's estate would still not be subject to federal estate tax.

Note. The temporary nature of the $5 million exclusion and the possibility of state estate tax having a lower exemption must always be kept in mind.

There are solutions to the problem outlined above.

- The surviving spouse can be given a power of appointment over trust assets.
- The surviving spouse could execute a qualified disclaimer over some of the assets.
- A partial QTIP could be utilized.
- An independent trustee can be given broad discretionary power coupled with a direction that the trustee exercise the power to reduce overall taxes.

Reminder. If Congress does nothing, the estate tax exemption falls to $1 million for deaths beginning in 2013. Therefore, some clients may not want to change existing wills and/or trusts that contain the above language. In those situations, practitioners have an ethical duty to explain the impact of such language to the client if death were to occur in 2011 or 2012.

GSTT PLANNING FOR WEALTHY INDIVIDUALS

The Act represents an opportunity for wealthy individuals to accomplish significant estate planning. For estate tax purposes, these taxpayers can utilize a $5 million exemption. The combined amount is $10 million for both spouses (if applicable) with portability of any unused exemption if a surviving spouse remains. The reunification of the credit for both estate and gift tax purposes has important implications. For instance, a person who previously made taxable gifts of $1 million consistent with the prior gift tax exclusion could make up to $4 million of additional gifts without incurring gift tax.

Note. Although discussed during debate of the House bill and included in the administration's budget proposals for the prior two years, no limits on existing techniques to achieve valuation discounts, such as grantor-retained annuity trusts (GRATs) and family limited partnerships (FLPs) were enacted as part of the Act.[50] However, there were several legislative proposals during 2010 that would have imposed a minimum term on GRATs. Limiting the timeframe of a GRAT would hamper the ability to use a GRAT to transfer asset appreciation away from the grantor. It would also increase the likelihood that the grantor would die during the term of the GRAT.

50. The administration has proposed that a GRAT have a minimum of 10 years and that a GRAT's remainder interest have a value greater than zero. If enacted, the proposal would increase the gift tax cost of creating a GRAT and could significantly reduce a GRAT's potential transfer tax benefits by increasing the risk of the grantor's death during the GRAT's term.

The GSTT is largely limited to use for married couples with a net worth of $10 million or more (for 2011–2012). For estate plans that only provide for outright distributions to a surviving spouse and children alive at the death of the first spouse, there typically are no GSTT issues. However, many estate plans are complicated, and the possibility of other dispositions could create a GSTT issue. Clearly, **the GSTT must be considered whenever a lifetime or testamentary transfer is made in trust for one or more of the transferor's grandchildren.** When the grandparent's interest in the trust ends and there is a distribution of property to a grandchild, to more remote descendants, or to unrelated persons that are significantly younger than the grantor, a GSTT taxable termination occurs.

The GSTT is not likely a concern for estates for which the anticipated tax value is less than the decedent's available GSTT exemption. This assumes the value is based on the anticipated value of the estate at the time of the estate owner's death at some point in the future, and the anticipated transfer tax system in place at the time of death. Married couples with combined spousal wealth expected to be under the available GSTT exemption (combined) at death could have a GSTT problem unless planning is utilized to avoid the GSTT.

OTHER STRATEGIES FOR WEALTHY CLIENTS

The Act did not make changes to numerous sophisticated tax planning strategies. Several of these strategies are described next.

Charitable Planning

While the enhanced exemption for 2011 and 2012 may cause a decline in tax-motivated charitable giving, wealthy clients may still find charitable giving an essential part of their estate plan. Charitable giving can be used as part of a strategy to decrease the potential taxable estate upon death.

Charitable IRAs. The Act extends through 2011 the ability of a traditional IRA owner who is at least 70½ years old to transfer to a qualifying charity up to $100,000 per year by direct gift through the IRA trustee. The amount transferred is not included in the taxpayer's income for tax purposes but counts toward satisfying the taxpayer's annual required minimum distribution. If a married couple has a separate account for each spouse, the limit applies separately to each spouse. The transfer to the charity is subject to the normal rules for qualification as a charitable deduction. Also, in states that use the federal definition of "income," the gift is excluded from income for state law purposes.

> **Note.** See Chapter 5, Retirement, for more information regarding the use of IRA distributions for charitable contributions.

Charitable Lead Annuity Trust (CLAT). A CLAT is an irrevocable trust that pays one or more charities a specified annuity payment for a fixed term. At the end of the term, any remaining assets in the CLAT pass to the remainder noncharitable beneficiaries. The annuity paid to the charity is stated as a fixed percentage of the initial value of the assets transferred to the CLAT and is established by a formula so that the discounted present value of the annuity absorbs almost the entire value of the assets transferred to the CLAT. During the CLAT's term, the charity receives the entire amount of the initial transfer to the CLAT, plus interest at the applicable federal rate (AFR) (120% of the mid-term rate).

If the CLAT is drafted as a nongrantor trust, the grantor does not receive an income tax deduction on the transfer of the assets to the CLAT. The CLAT is subject to income tax and is entitled to a charitable deduction for the payment of the annuity to the charity that is not subject to the percentage limitations that apply to individuals.

If the CLAT is drafted as a grantor trust, the grantor may be entitled to a charitable deduction for the discounted present value of the charitable annuity. Any unused portion of the charitable deduction can be carried forward for up to five years. Likewise, grantor trust treatment requires the grantor to report the CLAT's income on the grantor's tax return each year of the CLAT's term. The grantor will not be able to claim a charitable deduction for annuity payments to the charity.

If the grantor dies during the CLAT's term, the assets in the CLAT are not taxed in the grantor's estate. The grantor does not retain any interests in the transferred asset. The initial income tax deduction that the grantor takes is recaptured, and the CLAT continues as a separate taxpayer. A charitable deduction is allowed to the CLAT for each annuity payment paid to the charity.

Other Planning Strategies

Dynasty Trusts (GSTT Trusts). A planning technique that also involves GSTT planning is the dynasty trust concept. A dynasty trust allows wealthy taxpayers to provide for multiple generations of descendants. The trust is structured to last the maximum term permitted by state law, allow trust assets to avoid transfer taxes for the trust's term, and provide asset protection. The trust is an irrevocable trust. However, the beneficiaries can access the trust principal based on trust language allowing for the distribution of income or principal based on need (known as an ascertainable standard). A dynasty trust also typically includes a "spendthrift" provision designed to protect the trust assets from actions of the beneficiaries, former spouses, creditors, and legal action. The beneficiaries do not own the trust assets. Instead, the trust assets are controlled by a trustee and are not subject to creditors' claims or actions of the beneficiaries.

Because the initial funding of the trust is designed to take advantage of the grantor's transfer tax exemption amount ($5 million for 2011 and 2012) without gift tax complications, the enhanced amount of the exemption for 2011 and 2012 provides a window of opportunity to fund a dynasty trust to a greater extent without gift tax complications.

Once funded, and if structured properly, the trust assets can pass from generation to generation without incurring estate tax or GSTT.

The classic example of the use of a dynasty trust to avoid all of these problems involves the Kennedy family. Family patriarch, Joe Kennedy (1888–1969), never gave or left any assets to his children outright. Everything was transferred in trust, and each child had a separate trust. When each child reached a certain age, each could serve as co-trustee over their respective share. At an older age, each child could choose their own co-trustees to serve along with the child. The strategy worked well. When Ted Kennedy was sued for wrongful death, all his wealth was protected from creditors and the decedent's estate settled for his liability insurance coverage of approximately $300,000. The dynasty trusts also specified that the trust assets could not be reached by former spouses of the beneficiaries. That provision has proven beneficial given the multiple marital problems that occurred in the family chain, with the most recent being the separation of a grandchild and her spouse announced on May 9, 2011. Similarly, spouses of family members were not entitled to any of the Kennedy family wealth upon the death of a trust beneficiary. Instead, the property stayed in trust for the couple's children. Also, the trust assets avoided probate and the associated public scrutiny.

> **Example 10.** A grantor funded a dynasty trust in 2009 with $3.5 million of property when the applicable exclusion was $3.5 million. With an assumed net investment return (after distribution to beneficiaries) of 3%, the trust property will be worth $50 million after 90 years. If the trust is funded with the full exclusion amount of $5 million in 2011 or 2012, that same trust will have assets worth $71.5 million. For married couples, the initial $5 million investment can be doubled to $10 million without gift tax consequences.
>
> A dynasty trust funded with $1 million will grow to approximately $19 million after four generations, assuming a 3% annual distribution to the beneficiaries. By comparison, if the initial $1 million were taxed at each generation, the trust assets would grow to slightly less than $2 million after four generations.

The maximum trust term is tied to a particular state's rule against perpetuities. The rule against perpetuities states, "No interest is good unless it vests no later than 21 years after some life in being at the creation of the interest."[51] Vesting is when a right in property is legally recognized and cannot be taken away by a third party. Initially, every state followed the common-law rule and prohibited a trust from lasting longer than 21 years after the death of the last beneficiary alive at the time the trust was created. However, the rule against perpetuities has been modified or abolished in numerous states. Presently, 22 states have either modified or abolished the historic rule against perpetuities.[52] Trusts established in those states can benefit from the repealed or modified rule.[53] Consequently, it is important to include a provision in the trust that allows the trustee to move the trust to another jurisdiction if local law changes and becomes less favorable (particularly those regarding taxation) to the trust.

> **Caution.** The Administration's 2012 budget proposal (which was defeated 97-0 in the Senate on May 25, 2011) includes a provision that would limit dynasty trusts to 90 years.

While the grantor's unified estate and gift tax exemption (for 2011 and 2012) is automatically allocated to the transfer of property to the trust, the grantor must elect to allocate the GSTT exemption to transfers. Access to trust assets by the beneficiaries is limited by the terms of the trust and can be as broad or narrow as the grantor desires.

Broad Powers. Provisions giving beneficiaries broad powers include the following.

- Naming the beneficiary as trustee
- Providing the right to all income and the right to consume principal limited by ascertainable standards associated with health, education, maintenance, and support[54]

Some dynasty trusts give the beneficiary additional control by granting a special (or limited) testamentary power of appointment to name successive beneficiaries. If the beneficiary can exercise the power in their own favor or in favor of either their creditors, their estate, or creditors of their estate, the value of the assets subject to the power will be included in the beneficiary's estate unless the power is limited by an ascertainable standard.

Restricted Powers. If restricting the power of a beneficiary is desired, an independent trustee can be named and given the sole discretion over distributions coupled with a spendthrift provision. Such provisions give the trustee full authority to determine whether to distribute income or principal to the beneficiary as the trustee deems appropriate. Such a spendthrift provision can also be beneficial to preserve assets in the event of the beneficiary's need for long-term health care and the need to protect assets from being depleted while paying for long-term care.[55]

> **Observation.** Clearly, the greater the restrictions on a beneficiary's ability to access trust property and income, the less likely creditors can access the trust property.

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51. John Chipman Gray & Roland Gray. Section 201. *The Rule against Perpetuities* (4th ed., 1942) OCLC 173841.

52. Practitioners must determine the rule in place for the relevant jurisdiction.

53. Typically, what is required to establish a trust in a particular state is the use of a trustee from that state and the transfer of custody of some or all of the assets to that state. It is critical to establish sufficient "minimum contacts" with the state.

54. IRC §2041.

55. See, for example, *Biagetti v. Rhode Island Department of Human Services,* No. PC 09-7370, 2011 R.I. Super. LEXIS 32 (Super. Ct. R.I. Feb. 25, 2011). The settlor of a trust did not qualify for Medicaid because the trust was a countable resource given that it was a support trust rather than a spendthrift trust. The trust terms indicated that the trustee had to first provide for settlor's well-being during settlor's lifetime.

Many dynasty trusts also include a provision for what is called a "trust protector." A trust protector is a third party that is given the ability to change the trustee, if necessary, and amend the trust's provisions. The purpose of a trust protector is to add flexibility to the trust and allow the grantor to delegate power to another individual for dealing with unanticipated future events.

> **Note.** Only Alaska, Delaware, Idaho, South Dakota, and Wyoming recognize the dual existence of the trustee and the trust protector.

The powers of the trust protector are defined by the terms of the trust and can take many forms. In general, the trust protector is given the power to:

- Remove or replace the trustee,
- Alter the administrative and investment powers of the trustee,
- Change the trust's situs,
- Resolve disputes between co-trustees or disputes arising between the trustee and/or beneficiaries,
- Control spending above a specified amount,
- Veto distributions to the beneficiaries,
- Sue and defend lawsuits against the trust assets,
- Terminate the trust, and
- Amend the trust to reflect tax or other legal changes that affect trust administration.

> **Observation.** As a practical matter, the trust protector should not be a family member, related to the family, or a beneficiary. The trust protector and the trustee should be independent of each other and should be able to act in the long-term interest of the beneficiaries. Many dynasty trusts that designate a trust protector also include a provision naming a successor trust protector to serve in the event that the initial trust protector is unable to serve or fails to qualify.

A dynasty trust can be either a grantor or nongrantor trust. If it is structured as a grantor trust, the grantor is taxed on trust income. However, the grantor's obligation to pay income tax on the trust income is not an additional gift to the trust's beneficiaries.[56] In addition, if the trust is a nongrantor trust and the assets incur a loss, the loss is deductible if the **collective efforts** of the trust's fiduciaries, employees, and agents satisfy the material participation test.[57] Although the IRS believes that only the activity of the fiduciaries counts toward the material participation test for purposes of the passive loss rules,[58] that position has been judicially rejected. In one court case, the portion of IRC §469 (passive loss rules) applicable to closely-held C corporations (other than personal service corporations) links material participation with the exclusion of active businesses from the at-risk rules under IRC §465(c)(7). Those rules attribute the activity of employees to the entity. Similarly, under IRC §469(a)(2)(A), a trust is an entity and, like a corporation, looks to the activity of employees and agents to conduct its business.[59] If a dynasty trust is coupled with annual demand powers (*Crummey* powers) so that gifts to it qualify for the present interest annual gift tax exclusion, the beneficiaries are taxed on trust income and their collective activities are taken into account for purposes of the passive loss rules.

56. Rev. Rul. 2004-64, 2004-27 IRB 7.

57. The IRS has never developed regulations governing material participation by trusts and estates, and existing regulations apply only to individuals. See Temp. Treas. Reg. §1.469-5T.

58. See TAM 200733023 (Aug. 17, 2008); Ltr. Rul. 201029014 (Apr. 7, 2010).

59. *Mattie K. Carter Trust v. U.S.,* 256 F.Supp.2d (N.D. Tex. 2003).

GRATs. A grantor-retained annuity trust (GRAT) is a form of an irrevocable trust authorized under the Code.[60] It is commonly used to make large gifts to family members without the grantor incurring gift tax. An "applicable family member" is a person who is either the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor. Siblings, nephews and nieces, and unrelated "significant others" do not qualify as applicable family members.[61] GRATs also allow the grantor to retain the income from the transferred assets for a period of years or until death. The grantor establishes the GRAT by transferring property to the trust. The grantor retains the right to a fixed annuity for a term of years. The annuity can be structured to return the entire initial gift amount plus interest equal to 120% of the mid-term AFR to the grantor. This rate is called the "§7520 rate." Assets that fund the GRAT are expected to appreciate over the GRAT's term, and may consist of cash, stocks, mutual funds, real estate, or any other investment or income-producing property. For a GRAT to be successful, the total return on assets transferred to the GRAT must exceed the **§7520 rate**. If the total return on the assets contained in the GRAT is less than or equal to the AFR, the entire GRAT property is returned to the grantor at no cost except that related to creating the GRAT and any loss in value in the GRAT assets.

> **Observation.** The lower the AFR, the more likely it is that the GRAT will outperform the §7520 rate. This outcome results in greater excess appreciation in investment assets transferred to the beneficiaries.

At the end of the fixed period (or the donor's death, if earlier) any remaining value in the trust passes to the designated family member beneficiary(ies) as an outright gift or in trust without any transfer taxes. If the grantor does not survive the term of the GRAT, the remaining trust assets at the time of death are included in the grantor's estate where they are potentially subject to federal estate tax.

When the GRAT is established, a "gift value" of the remainder interest is calculated. The gift value is established as equal to the initial contribution to the GRAT, plus a theoretical amount of interest earned on the principal, minus the annuity payments that would be made through the end of the term. This computation involves, in essence, subtracting the present value of the annual annuity payments to the grantor from the FMV of the assets transferred to the GRAT. The theoretical rate of interest is determined by the Treasury regulations.[62] Because the annuity can be structured so that its value absorbs almost all of the value of the assets transferred to the GRAT, the remainder interest's present value can be low (practically zero) and the value of the taxable gift will be nominal.[63]

60. IRC §2702(b).

61. IRC §§2702(a)(1) and 2701(e)(2).

62. Treas. Regs. §§25.2702-3(b) and (d).

63. See, for example, *Walton v. Comm'r,* 115 TC 589 (2000), *acq.,* Notice 2003-72, 2003-44 IRB 15. The court upheld the grantor's zero valuation of gifts of remainder interests to beneficiaries of two GRATs upon the expiration of the GRATs' terms; all income and principal had been distributed to the grantor in accordance with the annuity payments.

Example 11. Steve is 60 years old. In July 2011, he creates and funds an irrevocable trust (the GRAT) with $1 million when the §7520 rate is 2.4%. Steve retains the right to receive an annual annuity of $100,000 for 10 years under the terms of the trust. At the end of 10 years, the remainder of the trust property passes to Steve's children. The value of Steve's retained annuity interest to receive a $100,000 annuity for 10 years using the §7520 rate of 2.4% is $879,750.

The value of the remainder interest is $120,250. The value of the remainder interest must be reported as a gift in July 2011 for gift tax purposes. If the trust assets are invested in growth stocks that appreciate 5% annually, the value of the underlying trust property held in the GRAT at the end of 10 years would be $371,105. If Steve lives for 10 years, the GRAT allows $250,855 to pass free of estate taxes ($371,105 – $120,250). If Steve dies during the 10 years, a portion of the trust property is included in Steve's taxable estate.[64]

Observation. If a GRAT is funded with highly volatile assets, it is possible that the actual interest earned on the assets will be substantially higher than the IRS's theoretical interest. In that event, the value remaining in the GRAT at the end of the term (or the grantor's death, if earlier) may still be large, even though the initial IRS calculation suggests that it should have been zero. The remaining value, however, still escapes gift tax.

A GRAT is treated as a grantor trust for income tax purposes. Thus, the grantor pays income tax on trust income. Because the trust grows income tax free, the payment of taxes by the grantor constitutes a tax-free gift to the beneficiaries.

Note. Grantor trusts are **not** subject to the passive activity loss rules.[65] Instead, the grantor is personally subject to the rules, and it is the grantor's material participation that is the key.[66]

Ideally, a GRAT should be funded with property that is predicted to appreciate in value at a rate exceeding the §7520 rate. While a longer-term GRAT locks in the interest rate, if investment return is expected to fluctuate, a series of short-term GRATs (known as "rolling GRATS") may be a better approach. Any asset that has not increased in value can be rolled out of one GRAT and into another one.

A disadvantage of a GRAT is that a grantor's GSTT exemption (presently $5 million) may not be allocated until the end of the initial term of the trust.[67] The opportunity to leverage the GSTT exemption so that post-transfer appreciation is free of GSTT is not allowed with a GRAT. The GSTT allocation is made to the amount passing to the remainder beneficiaries of the trust when the retained interest ends.

Qualified Personal Residence Trust (QPRT). Under IRC §2702, a taxpayer who transfers a remainder interest in the taxpayer's personal residence to someone else (most likely the taxpayer's child or children) and who retains a life estate makes a gift of the actuarial value of the remainder interest for gift tax purposes.

A common mistake is the assumption that the only way that the gift would be limited to the actuarial value of the remainder interest (rather than being equal to the value of 100% of the property) would be if a QPRT satisfying the requirements of Treas. Reg. §25.2702-5 were utilized. That assumption is incorrect based on the applicable statute.

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64. Treas. Regs. §§20.2036-1(c)(2)(i) and (iii), Example 2 (illustrating GRAT).

65. Temp. Treas. Reg. §1.469-5T(b)(2).

66. See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 242, note 33, 100th Cong., 1st Sess. (1987).

67. IRC §2642(f).

The value of any retained interest is treated as being zero as provided in IRC §§2702(a)(1) and (2). However, IRC §2702(a)(3)(A)(ii) specifies that this rule does not apply if a transfer ". . . involves the transfer of an interest in a trust, all the property of which consists of a residence to be used as a personal residence by persons holding term interests in such trusts." IRC §2702(c)(1) states that for purposes of IRC §2702, "The transfer of an interest in property to which there is one or more term interests shall be treated as a transfer of an interest in a trust." Under IRC §2702(c)(3)(A), a "term interest" is defined as "a life interest in property." Thus, the transfer of a remainder interest in the transferor's home coupled with a retained life estate is within the exception of IRC §2702(a)(3)(A)(ii), and is excluded from the rules of IRC §§2702(a)(1) and (2). Consequently, the actuarial value of the retained life estate is deducted from the total value of the property that is transferred, resulting in a gift of only the actuarial value of the remainder interest.

The retained life estate, however, causes inclusion of the value of the real estate in the gross estate at the time of the holder's death.[68] To avoid inclusion in the holder's gross estate, while **simultaneously** creating a gift of only the remainder interest, a QPRT must be utilized.

> **Note.** In Ltr. Rul. 200919002,[69] the IRS stated that a simultaneous sale of a remainder interest in a residence coupled with the transfer of the residence to a QPRT does not violate IRC §2702. Therefore, no gift tax is triggered on the sale of the remainder interest, and it is likely that the transfer can be utilized in conjunction with a retained life estate and not cause the value of the life estate to be included in the decedent's gross estate at death. The retained life estate need not be a term of years. The IRS did not specifically rule on the estate tax angle of the technique, but it is difficult to see how IRC §2036 would come into play. The federal courts are split on the issue. For clients worried about triggering estate tax, the traditional QPRT can be utilized with a term of years retained interest. The ruling will also likely lead practitioners to use a single QPRT for a married couple.

In essence, a QPRT is utilized to transfer a personal residence (or vacation home) to designated beneficiaries upon the termination of the trust. The value of the residence is removed from the owner's estate at a reduced gift tax value. However, until the trust terminates, the owner of the residence continues to own the residence, live in it, and pay real estate taxes and insurance on the residence.

Upon creation of the QPRT, the transferor is deemed to have made a gift to the trust beneficiaries. Because the transferor retains the right to use the residence for the QPRT's term, the value of the gift is less than the residence's FMV as of the transfer date. In this regard, the QPRT allows the leveraging of the transferor's applicable gift tax exemption. Additionally, the transfer to the beneficiaries upon expiration of the trust is not subject to estate or gift tax. The value of the gift is calculated based on the transferor's age at the time of the creation of the QPRT, interest rates during the month of the transfer, and the term of the trust.

> **Note.** Because the original purchase price of the residence plus improvements is transferred to the beneficiaries, if the beneficiaries sell the home upon expiration of the trust, capital gain tax may be incurred to the extent the gain exceeds the gain exclusion provision of IRC §121 — currently up to $250,000 on a single taxpayer's return.

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68. IRC §2036(a)(1).

69. Ltr. Rul. 200919002 (Dec. 23, 2008).

To get the maximum benefit from a QPRT, the homeowner should own and live in the home until the end of the trust's term. If the house is sold after being placed in a QPRT but before the end of the trust's term, the sale proceeds may not be permissible for the QPRT to hold because of limitations on the amount of cash in the QPRT. The sale proceeds should be reinvested in another property. Alternatively, the homeowner could choose to receive the proceeds of the sale in a lump sum or over a period of time, diminishing the amount passing to the QPRT's beneficiaries.

Upon termination of the QPRT and transfer of the residence to the beneficiaries, the original homeowner is no longer the owner and typically rents the home from the beneficiaries.[70] If the homeowner dies **before** the end of the QPRT's term, the value of the home is included in the homeowner's estate. Nevertheless, the ultimate transfer of the home to the beneficiaries is not subject to gift tax. However, the Tax Court ruled that the value of a multi-million dollar residence in a QPRT was **not** included in the transferor's estate when the QPRT terminated six months **before** the transferor's death.[71] The Tax Court determined that the parties had agreed that the transferor would pay fair market rent for the residence after the QPRT terminated and that the rental payments would begin by the end of the calendar year in which the QPRT expired. The evidence also convinced the Tax Court that an implied agreement or understanding did not exist under which the transferor would retain an interest in the residence for life without paying rent. Specifically, the transferor had agreed to pay rent and, after the QPRT expired, the transferor had tried to determine the amount of the rent. The only reason that the lease and rent payments were not executed was because the transferor died unexpectedly. As a result, the Tax Court reasoned that the value of the residence was not included in the transferor's estate.

Family Limited Partnerships. Another tool for minimizing transfer tax is the family limited partnership (FLP). The principal objective of an FLP is to carry on a closely-held business when management and control are important. FLPs have nontax advantages, but a significant tax advantage is the transfer of present value as well as future appreciation with reduced transfer tax.

Typically, for many closely-held family businesses, the parents contribute most of the partnership assets in exchange for general and limited partnership interests. The nature of the partnership interest affects the value of the partnership interest, as does state law and whether the transfer creates merely an assignee interest with the assignee becoming a partner only upon the consent of the other partners. Provisions in the partnership agreement that restrict liquidation and transfer of the partnership interest can result in significant discounts from the underlying partnership asset value. An assignee interest is one that gives the holder the right to income from the interest but not ownership of the interest.

In a 2009 case,[72] the court allowed a 47.51% discount for the decedent's minority interest in an FLP even though the FLP was not funded until one year after the decedent's death. Under state (Texas) law, the owner's intent of making an asset the partnership's property causes the asset to be partnership property. Thus, even though no action was taken to fund the partnership until the year after the decedent's death, the partnership existed and the valuation discount was allowable. A significant nontax reason for the transfer of assets to the FLP existed — "to consolidate and protect family assets for management purposes and to make it easier for those assets to pass from generation to generation." The decedent and spouse had a combined net worth of $350 million.

The IRS continues to litigate lack of marketability and lack of control discounts claimed by FLPs, primarily under IRC §2036. Careful FLP planning must be utilized to ensure that all valuations are supported by excellent appraisals, all formalities are followed, and the transferor's personal assets are kept outside the entity. If personal assets are placed in the FLP, payment should be made to the entity for their use.[73]

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70. The rental income is subject to income tax in the hands of the beneficiaries.

71. *Estate of Riese v. Comm'r,* TC Memo 2011-60 (Mar. 15, 2011).

72. *Keller, et al. v. U.S.,* No. V-02-62, 2009 U.S. Dist. LEXIS 73789 (S.D. Tex. Aug. 20, 2009).

73. See, for example, *Estate of Jorgensen v. Comm'r,* No. 09-73250, 2011 U.S. App. LEXIS 9203 (9th Cir. May 4, 2011), *aff'g.,* TC Memo 2009-66. The estate included assets transferred to an FLP. The decedent retained control over the assets and retained economic benefits and control over the property. The transfers did not involve a bona fide sale for full consideration. The FLP paid over $200,000 of the decedent's estate taxes from FLP funds, which indicated an implicit agreement that the transferor would retain enjoyment of the transferred property.

It is critical to have a legitimate and significant nontax reason for creating an FLP. The transferor of assets must pay close attention to formalities when creating and funding the FLP. These formalities can include the following.

- Making cash distributions proportionate to partnership interests
- Keeping a minute book
- Not commingling partnership assets with personal assets or using them for personal purposes
- Complying with the partnership agreement with respect to partnership actions
- Holding an annual meeting
- Ensuring that FLP income is deposited into FLP accounts
- Paying FMV for the use of any (and all) FLP assets
- Ensuring the general partner demonstrates respect for fiduciary duties
- Paying the general partner a management fee
- Keeping the limited partners out of management of the FLP operations

> **Note.** The Administration's last few budget proposals have contained a provision that would result in disregarding certain restrictions on interests in family-controlled entities. The result would be higher valuations of such interests and increased transfer tax costs.

Intentionally Defective Grantor Trust (IDGT). For wealthy clients who own a family business and who desire to pass the business on to the next generation, one strategy might include an installment sale to an IDGT. The enhanced estate and gift tax exemption for 2011 and 2012 makes an IDGT a more powerful tool for those businesses that have sufficient cash flow to make the installment payments. Coupled with valuation discounts for the business interests (minority and lack of marketability), the IDGT can be an effective strategy.

> **Note.** The terms of the installment note can be drafted so that payments fluctuate over time to match expected cash flows from the business. Likewise, provision can be made for interest-only payments for a period of time followed by a balloon payment of principal.

An IDGT is an irrevocable trust that, if carefully drafted, is treated as a grantor trust for income tax purposes even though transfers to the trust are complete for transfer tax purposes. Accordingly, tax on trust income is paid by the grantor and the beneficiaries ultimately receive the trust property income tax-free. Additionally, under the grantor trust rules, an installment sale to the trust is treated as a sale to the grantor with the result that there is no liability for capital gains tax or other income tax on the installment payments that are received.

> **Note.** Grantor trusts are **not** subject to the passive activity loss rules.[74] Instead, the grantor is personally subject to the rules, and it is the grantor's material participation that is the key.[75]

74. Temp. Treas. Reg. §1.469-5T(b)(2).

75. See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 242, note 33, 100th Cong., 1st Sess. (1987).

To avoid an IRS challenge that the sale transaction involves a disguised gift, the trust must have sufficient assets so that an installment sale of the business in exchange for a promissory note would be considered commercially reasonable. Typically, that requirement is satisfied by gifting "seed money" that is cash or marketable securities to the trust. A suggested minimum gift is 10% of the value of the assets being sold to the trust. While the gift is subject to gift tax, the enhanced $5 million exclusion minimizes (or eliminates) the tax on the gift.

Observation. The installment note must provide for a reasonable rate of interest and other commercially reasonable terms to ensure that the note is deemed to represent a legitimate debt.

Due to present economic conditions, some family businesses may be valued relatively low. When the depressed business value is combined with the enhanced transfer tax exemption, a gift or sale to an IDGT may be an effective tool in gaining leverage for transferring the business interests to subsequent family generations.

The following is an example of the basic structure of an IDGT transaction.

Example 12. In 1970, Tom established a business that became very successful over the years. In 2008, the business was valued at approximately $65–70 million. Due to the recent economic downturn, Tom's expert appraisers valued the business in 2011 at $50 million.

As part of Tom's business succession plan and to decrease his taxable estate, Tom wants to transfer 50% of the business (a $25 million transfer) to his children. Tom hires a valuation expert who produces a report justifying a valuation discount of 40% for the transferred interest. This results in the transfer of $25 million worth of business interests, valued at $15 million after the valuation discount. Tom gifts marketable securities to an IDGT worth $2.5 million (greater than 10% of the value of the assets being sold to the trust). The gift is completely gift-tax free in 2011 or 2012. Tom then sells stock to the IDGT for $15 million in exchange for an installment note with an interest rate charged at the AFR mid-term rate for the month in which the transaction occurred. As a result, Tom removed 50% of the business value from his estate. The trust owns the other half of the company and receives any future appreciation.

The benefits of an IDGT include the following.

- The business owner continues to retain some level of control over the business.
- There is no sale for income tax purposes.
- The current value of the transferred business interests and the future income on those interests are removed from the owner's taxable estate.
- The grantor pays tax on trust income, which creates tax-free gifts to the beneficiaries.
- Unlike a GRAT, if the business owner dies during the term of the IDGT, the business interests are **not** included in the owner's estate. Only the present value of any unpaid installments are included in the owner's estate.
- Unlike a GRAT, the IDGT can use the AFR rate of interest instead of the §7520 rate (which is 120% of the federal mid-term rate).
- Unlike a GRAT, the GSTT exemption can be allocated to an IDGT when the original gift is made rather than when the grantor's retained interest ends in the GRAT.

There are risks to using an IDGT. Unlike the GRAT, which is authorized by IRC §2702, a sale to an IDGT has no such statutory authorization and uncertainty remains about the tax consequences if the grantor dies during the term of the IDGT. In a letter ruling, the IRS was critical of the rule that results in no taxable gain when the grantor makes an installment sale to a grantor trust.[76] The ruling involved an installment sale of stock to trusts that were grantor trusts. The sales were held to be nontaxable and the trusts took the respective sellers' basis in stock. The ruling was conditioned on the status of notes as debt and not equity. The IRS also stated that "we are expressing no opinion regarding the application of section 2036 to the transaction."

OTHER ESTATE PLANNING ASPECTS OF THE ACT

Powers of Attorney

For 2011 and 2012, gift provisions in existing financial powers of attorney may need to be modified. Practitioners may want to consider the following when reviewing powers of attorney.

- Consider eliminating any provision that allows the agent to make gifts if the estate is not large enough to incur federal estate tax with a $5 million exemption.
- Consider the need to expand existing powers and rights to allow the agent to create and fund a trust in the event a grantor becomes incompetent **and** the exemption drops to $1 million and the top estate tax rate rises to 55%.
- Consider the potential for an inflation of asset value in connection with existing gifting provisions, and the possibility of state death taxes.

Prenuptial Agreements

The possibility of portability of the exclusion should be addressed in prenuptial agreements, along with the intended use of the exclusion. Undoubtedly, many prenuptial agreements included formula clause language that was not addressed in 2009 or early 2010 to deal with the possibility, and then the actuality, of repeal. Such language must be examined to determine whether the $5 million exclusion is consistent with the intent of the formula clause.

Life Insurance

Some clients may be tempted to cancel life insurance policies that were intended to cover tax liability associated with death. This action may be premature. The possibility of the exclusion returning to $1 million in 2013 exists, and some decedents' estates will incur state tax liability. In addition, it would be important to consider whether a client could replace a canceled policy if it becomes necessary or desirable. For most clients, it may be more likely that a restructuring of the client's existing life insurance program for 2011 and 2012 is needed.

Another strategy may be to gift high cash value policies to an irrevocable life insurance trust that the prior $1 million gift tax exclusion and limited *Crummey* powers made impractical.

76. Ltr. Rul. 9535026 (May 31, 1995).

FIDUCIARY INCOME TAX FOR ESTATES/TRUSTS — HELPFUL ITEMS

For 2010–2012, certain fiduciary income tax issues should be kept in mind. The following list contains helpful information that should be considered.

- For 2010, a qualified disability trust is entitled to an exemption of up to $3,650 and is not subject to a phaseout.
- Form 8855, *Election To Treat a Qualified Revocable Trust as Part of an Estate,* can be filed to treat a qualified revocable trust as part of an estate. If there is an estate executor, both the trustee and the executor must agree to the election. The executor must file Form 1041 by the due date, and the trustee must timely provide the executor with information needed to prepare the return for the combined entity on behalf of the trust. If there is no executor for the estate, the trustee of the revocable trust files Form 8855. The instructions are not clear whether the Form 8855 is filed separately or with the Form 1041 for the combined entity. It is also unclear whether Form 8855 is filed for each tax year or in just the initial tax year.
- The election to deduct state and local sales tax instead of state and local income tax has been extended through the 2011 tax year.
- Form 1041-V, *Payment Voucher,* is now used to include information about the tax remittance of the balance due on Form 1041. Use of the Form 1041-V is optional, but the IRS encourages taxpayers to use it if payment is made by check or money order.
- When an amended return is filed for an NOL carryback, the IRS requests that "NOL Carryback" be written at the top of the first page.
- On page 1 of the Form 1041 instructions, a section entitled "Reminder" is included. There is a single item in this section that states, "Review a copy of the trust instrument (including any amendments) or the will, if any, before preparing an estate's or trust's return."

Note. It is important that trust agreements be reviewed periodically to ensure the fiduciary income tax returns are being prepared correctly. Upon review of the trust agreement, practitioners should review dispositive provisions with respect to distributions of principal and income. Ages of beneficiaries and when they are entitled to receive trust corpus should be noted. If trust corpus is retained in the trust after a beneficiary becomes entitled to it, the trust may inadvertently be converted from a simple or complex trust to a grantor trust.

- For an estate, Form 1041 must be filed if the estate has gross income for the tax year of $600 or more or has a beneficiary who is a nonresident alien.
- For a trust, Form 1041 must be filed if the trust has any taxable income for the tax year, gross income (irrespective of whether it is taxable or not) of $600 or more, or a beneficiary who is a nonresident alien.
- If all or any portion of the trust is a grantor trust, the trust (or portion thereof) must follow special reporting requirements.
- The taxable year of a trust is the calendar year (except that tax-exempt trusts and charitable trusts can elect otherwise). An estate may elect a fiscal yearend.[77]

77. IRC §§441(e) and 644(a).

- While a trust generally cannot pass a loss to its beneficiaries, **depreciation may be passed separately from rental income** and cause the trust (or estate) to, in essence, pass a net loss.[78]

> **Note.** For additional information on fiduciary accounting income, see the 2010 *University of Illinois Federal Tax Workbook,* Chapter 7, pp. 262–263. This can be found on the accompanying CD.

- Under IRC §645, the executor of an estate and the trustee of a "qualified revocable trust" may elect to have the trust treated and taxed as part of the estate for income tax purposes for all of the estate's taxable years ending after the date of death and before the "applicable date." Once made, the election is irrevocable. For 2010 estates that fund a pecuniary bequest with assets having a carryover basis, and that elect out of the estate tax, only post-death appreciation is recognized if the pecuniary bequest is satisfied with those assets.[79] There is a similar rule for trusts "to the extent provided in Regulations…" There are no regulations on the matter, so it may be wise to make the IRC §645 election for estates/trusts for 2010 deaths if the trust may be distributing assets in satisfaction of pecuniary bequests. The election allows a trust to be treated as an estate with the result that the trust can avoid gain recognition under IRC §1040(a) while the election is in effect. Without the election, the trust may have to realize gain (all unrealized gain, not just post-death gain) when property in kind is used to satisfy a pecuniary bequest.

PLANNING SUMMARY

Estate planning is a whole new "ball game" for 2011 and 2012. This means that practitioners must change their approach with clients. The following is a summary of the planning challenges for 2011 and 2012.

1. There is less emphasis on estate tax and charitable planning and more emphasis on retirement, succession, financial, and income tax planning.
2. For wealthy clients, the new rules provide a 2-year window of opportunity to accomplish asset protection planning on a large scale.
3. There is some risk 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.
4. In some states, state estate/inheritance tax may remain a concern.
5. Consideration should be given as to whether to change existing plans. Historically, the strategy was to divide spousal assets equally. Even with the portability of the estate exclusion, individuals may not want to make dramatic changes because:
    a. Portability only applies if both spouses die in 2011 or 2012, and
    b. That portability may be limited if a spouse remarries.
6. It may be a good time to review all existing wills and trusts and existing formula clause language that is keyed to estate tax figures.
7. Maximum flexibility should be maintained — 2013 and its uncertainty looms. If Congress does not act before 2013, the estate tax rate jumps to 55% on taxable amounts above $1 million.

78. Rev. Rul. 74-71, 1974-1 CB 158.

79. IRC §1040(a).

SPECIAL USE VALUATION

Note. This section is limited to addressing the more important planning implications of estates in which a special use valuation election may be desirable or has been utilized. It is not intended as a comprehensive discussion of a very lengthy and detailed topic.

OVERVIEW

Normally, property included in a decedent's estate is valued for estate tax purposes at its FMV as of the decedent's date of death. However, the executor may elect to have real property devoted to farming or ranching (or other closely-held businesses) valued at its special use or "use" value rather than its FMV.[80] Special use value is determined by one of two separate valuation methods — the rent capitalization approach,[81] or the 5-factor formula approach.[82]

The **rent capitalization approach** is the most commonly used approach. It involves utilizing the average annual gross cash rent per acre less property tax on comparable land for the last five full calendar years before the decedent's death. The result is then divided by the average annual effective Farm Credit Bank interest rate for the last five years (which is specified annually by the IRS). For deaths in 2011, the election cannot reduce the gross estate by more than $1.02 million.

Example 13. John died in 2011 with a taxable estate valued at $8.25 million. John's estate included 750 acres of Illinois farmland with an FMV of $5 million at the date of death ($6,667 per acre). The executor located tracts comparable to the land in John's estate and determined that the comparable tracts cash rented for an average of $300 per acre. Also, the property tax on the comparable tracts averaged $25 per acre. Illinois is located in the AgriBank District, and the IRS-specified interest rate for purposes of IRC §2032A for deaths in 2011 is 6.12%. According to the rent capitalization approach, the special use value of the farmland in John's estate is computed as follows.

$$\frac{\$300 - \$25}{.0612} = \$4{,}493$$

The election results in the 750 acres being valued at $4,493 per acre in John's estate, or $3,369,750. However, for deaths in 2011, the aggregate reduction in value via the election is limited to $1.02 million. That means that the 750 acres are valued in John's estate for tax purposes at $3,980,000 ($5 million – 1.02 million).

Numerous requirements must be satisfied by the decedent before death and at the time of death for the executor to make a special valuation election in the decedent's estate. In addition, the family member heirs of the decedent (known as qualified heirs) must satisfy certain requirements associated with the elected land for 10 years after the date of the decedent's death to avoid paying back the estate taxes saved by making the election.[83]

Note. IRC §2032A(c)(7)(E) refers to "member of the family of such spouse or descendant" which, in turn, refers to the definition of member of the family at IRC §2032A(e)(2), which includes spouses and descendants of an individual, or a parent of such individual, and their spouses. This means that members of the family of a particular qualified heir include the heir's siblings and the children of the siblings. This is an important point for the post-death qualification requirements, particularly for leases of elected land by a qualified heir.

80. IRC §2032A.
81. IRC §2032A(e)(7).
82. IRC §2032A(e)(8).
83. IRC §2032A(c).

SPECIAL USE VALUATION ELECTION PLANNING[84]

While it is not possible to anticipate all possible future events that can affect planning, there are some general observations that can be made when a special use valuation election might be utilized in a decedent's estate.

- Pre-death cash leases are permissible to family members only.
- Post death, cash leases are prohibited.[85] There is one statutory exception that permits lineal descendants of the decedent to cash lease elected land to family members of the lineal descendant.[86]
- Because of the potential for ineligibility to make the election and the possibility of recapture during the 10-year period after the decedent's death, it is important to avoid having farmland or other closely-held business interests owned in undivided interests with persons who are not heirs.
- In conjunction with the preceding point, it is also important to avoid creating undivided interests by will or trust to the qualified heirs. The goal is to allow each qualified heir to independently make decisions about the election and any later disposition of the elected property.
- It is advisable to avoid creating successive interests in land that could be subject to the election if eliminating the possibility of recapture on the death of the first successive owner is desired.
- The election should be made on the least amount of land necessary to satisfy the election requirement and, to the extent possible, on the land least likely to be sold in the 10-year period after the decedent's death.
- If possible, the election should be restricted to bare land.
- It is advisable not to make the election applicable to oil, gas, mineral, or wind energy rights that may be associated with elected land.[87]

Observation. In a current Texas court case, the IRS takes the position that the execution of a wind energy lease on elected land by the heirs during the recapture period constitutes a disqualifying disposition. Consequently, the recapture tax applies to **all** the elected property rather than just the portion of the elected property that was actually removed from cattle grazing. Subsequent negotiations between the heirs and the IRS resulted in the IRS asserting recapture tax on only the land that was actually removed from cattle grazing. At the time this book was published, this case had not been decided.

- To the extent possible, limit the amount of elected property passing to a financially unstable heir.

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84. As previously noted, the election is available for closely-held businesses other than farming and ranching operations. However, the discussion that follows is restricted to farm and ranch estates.

85. If an heir has the option to cash lease or crop-share elected land and their choice of the type of rental arrangement results in their being at production risk on their return, the lease arrangement is not per se disqualified as a cash lease (Ltr. Ruls. 201129016–201129020 (Apr. 6, 2011)). Under the facts of these rulings, the lease arrangements at issue were not within the scope of IRC §2032A(c)(7)(E) because some lessees were not "members of the family" for purposes of IRC §2032A and, therefore, not lineal descendants of the decedent. The facts involved a family farming operation that attempted to comply with the "spirit" of the law. Congress's intent in IRC §2032A was to preserve family farming operations.

86. IRC §2032A(c)(7)(E).

87. By specifically excepting such rights, there is no future question about whether the development or sale of such rights is excluded from the possibility of recapture.

Events that have recapture implications include the following.

- Mortgaging elected property does not trigger recapture tax if the mortgage proceeds are used to improve the property.[88]
- A qualified heir's sale of elected land to reduce debt associated with the business is a recapture-triggering event.[89]
- Selling land subject to an election to repay a mortgage debt triggers recapture tax.[90]
- If foreclosure proceedings are brought against the elected land held by a qualified heir, recapture is not triggered.[91]
- If the qualified heir files bankruptcy, merely transferring title on the elected property to the bankruptcy trustee is not a recapture-triggering event.[92]
- If the trustee makes a taxable disposition of the elected property, recapture is triggered to the bankruptcy estate.
- If the trustee subsequently abandons the property, it is possible that the recapture tax could be trapped in the bankruptcy estate.

Note. Whether the rules governing the discharge of taxes apply to the debtor's contingent recapture tax liability remains unknown.

GSTT Implications

While it may be desirable to use special use valuation in conjunction with GSTT planning concepts, complications can arise. For instance, the election can only be made for direct skips and does not apply to taxable terminations or taxable distributions.[93] For GSTT trusts, the life beneficiary could be given a general power of appointment over the qualified property so that it is not subject to the GSTT. If the amount of property in the GSTT trust exceeds the GSTT exemption, the life beneficiary could use the power of appointment for the excess amount and thereby make the excess amount eligible for the election when the trust terminates.

Marital Deduction Planning

When a special use valuation election is made in the estate of the first spouse to die, multiple issues can arise concerning the marital deduction clauses included in wills and trusts. A related issue involves the computation of the marital deduction property passing to the surviving spouse. The pecuniary marital lead date of funding FMV is the best formula.[94] In general, pecuniary credit shelter/residual marital bequest clauses may not be desirable in estates planning to make a special use value election. For example, funding the credit shelter trust at FMV fails to shelter the amount of the value reduction from estate taxation in the surviving spouse's estate. However, standard language tends to make specific reference to the unified credit and may "lock in" the amount at the applicable exclusion amount.

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88. IRC §6324A(d)(3). The IRS raised the issue in a case in which the proceeds were not necessarily going to be used to improve the property, but the issue was dismissed before trial. *In re Druse,* 82 B.R. 1013 (Bankr. D. Neb. 1988).

89. Rev. Rul. 89-4, 1989-1 CB 767.

90. *In re Morgan,* 90-1 (CCH) ¶60,005 (Bankr. E.D. Okla. 1990). A sheriff's sale was an involuntary conversion that triggered recapture. The qualified heir was personally liable for recapture tax even though the IRS did not assert its lien at the sheriff's sale.

91. TAM 9333002 (Apr. 20, 1993). While naked title had passed, all redemption rights and rights to reacquire property after notification of offer to purchase by a third party must expire before the transfer is deemed to occur.

92. IRC §1398(f)(2).

93. IRC §2624(b).

94. Robert M. Bellatti and Shari L. West, *Estate Planning for Farms and Other Qualfied Family-Owned Businesses Under Section 2032A and 2057* (Warren, Gorham & Lamont, 1999).

The actual amount that a surviving spouse receives under a pecuniary formula depends upon how the pecuniary amount is funded. If it is funded at the (lower) special use value, the surviving spouse receives more property than if funding occurred at FMV. This could lead to an overfunding of the marital deduction, which could cause a larger taxable estate at the death of the surviving spouse. The IRS and the Tax Court have addressed this issue. The IRS clarifies that any value that is **not** included in the gross estate (because of a special use valuation election, for example) is **not** eligible for the marital deduction. As a result, the marital deduction amount resulting from a specific bequest or a residuary transfer is limited to the special use value of the property.[95] Similarly, the Tax Court has ruled that the special use value must be used to compute the marital deduction.[96] However, a federal district court held that the IRS could not require that a marital trust be funded with shares of corporate stock based on the value utilized for special use valuation purposes.[97] The corporation owned farmland and the special use valuation election was made for the stock representing the value of the land. The trustee had the sole discretion to determine the number of stock shares that passed to the marital trust for the surviving spouse and funded the trust with the number of shares of corporate stock based on the corporate property's (land) FMV. The court ruled that the trustee used the correct approach to value the corporate stock.

Gift Tax

If a special use valuation election results in an increase of the inheritance for some heirs and a decrease in the inheritance for others compared to what their respective inheritances would have been without the election, no gift occurs.[98] The rationale for the rule is that any change in the amount of the bequest is deemed as constituting property that passed from the decedent. Similarly, when a special use value election reduces the marital share and increases the residuary, there is no taxable gift to the residuary beneficiary.

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95. Ltr. Rul. 8422011 (Feb. 8, 1984).

96. *Estate of Evers v. Comm'r,* TC Memo 1989-292 (Jun. 15, 1989) (Gross estate value of elected farmland reported at the special use value, but FMV was used in computing the marital deduction; the court ruled that IRC §2032A(a) required that the special use value is to be used for all purposes of Chapter 11 (estate and gift tax provisions)).

97. *Simpson v. U.S.,* 92-2 U.S. Tax. Cas. (CCH) 60,118 (D. N.M. 1992).

98. TAM 8943004 (Jul. 17, 1989).