Abstract - This paper describes the estate, gift and generation-skipping transfer (GST) tax reductions made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)\(^1\) and how estate planners are dealing with the challenges presented by the changes made by EGTRRA. EGTRRA affects decisions concerning the timing of taxable transfers, complicates the drafting of estate planning documents, creates the potential for controversy concerning the proper construction of wills and trusts, promotes harmful tax competition among the various states, and influences liquidity planning and charitable giving. Carryover basis presents special problems, especially for real estate developers, who rely on the adjustment to basis allowed at death to bail out of negative basis assets. In light of the uncertainty about what law will be in effect when a person dies, there is a premium on giving independent fiduciaries broad amendment and gifting powers.

SUMMARY OF TRANSFER TAX CHANGES MADE BY EGTRRA

EGTRRA phases out and temporarily repeals the estate and GST tax (but not the gift tax) by reducing rates, increasing the amount of unified credit that exempts an amount (the applicable credit amount (ACE)) from tax and increasing the GST tax exemption.\(^2\) In 2011, the pre-EGTRRA rules will apply except that the applicable credit amount for both gift and estate tax purposes and the GST tax exemption will be indexed for inflation.

Pre-EGTRRA, the maximum estate tax rate was 55 percent on estates of over $3 million and the unified credit shielded estates of $1 million or less from federal estate tax.\(^3\) The GST tax rate was a flat 55 percent, but the GST tax exemption shielded up to $1,120,000 from GST tax ($1,000,000 indexed for inflation).

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\(^2\) EGTRRA enacted IRC § 2210(b) providing that the estate tax will not apply to a person who dies in 2010 and § 2664 providing that Chapter 13 of the Code shall not apply to generation-skipping transfers that occur after December 31, 2009. However, § 901(b) of EGTRRA provides that all provisions of the Code shall be applied to persons dying after December 31, 2010 and to generation-skipping transfers made after December 31, 2010 as if the provisions of EGTRRA had never been enacted.

\(^3\) Pre-EGTRRA, the unified credit would not have shielded as much as $1 million from gift and estate tax until 2006 and EGTRRA accelerated the increase in the credit.
In 2007, the maximum rate for both estate and GST taxes is 45 percent. The unified credit shields estates of $2 million or less from federal estate tax. Once the estate exceeds $2 million, the maximum rate applies. The GST tax exemption also is $2 million. In 2009, the rate will not be changed but the unified credit will shield estates of $3.5 million or less from federal estate tax and the GST tax exemption also will be $3.5 million. In 2010, there will be no federal estate tax and no GST tax. In 2011, pre-EGTRRA rules will be applicable except that the applicable credit amounts and the GST tax exemption will be indexed for inflation.

Pre-EGTRRA, the gift and estate taxes were “unified” because a single graduated rate schedule applied to cumulative taxable transfers during life and at death. The same amount of unified credit reduced the tax on gifts and at death; to the extent the credit is used to shelter gifts from gift tax, the amount of credit available to shelter the estate from estate tax is reduced. Post-EGTRRA, it is still the case that the use of unified credit to shelter gifts from gift tax reduces the credit available to shelter estates from estate tax. However, the maximum amount of gifts that can be shielded from gift tax is $1 million and this amount is not being increased. Thus, an estate always will have some amount of unused available credit to reduce estate tax, regardless of the amount of taxable gifts the decedent made during his/her lifetime. The estate tax applicable credit amount can never be reduced by more than $1 million since this is the maximum applicable credit amount for gift tax purposes.

In 2010, when there is no estate or GST tax, there still will be gift tax. The rate will be 35 percent. Unless death is imminent, there will be a substantial advantage in making gifts in 2010 to avoid the cost of the restoration of higher gift and estate tax rates the following year. This is particularly true for gifts to grandchildren, which, if made in 2010, will avoid GST tax. In 2011, the pre-EGTRRA rules will be restored. The maximum gift tax rate will be 55 percent. The GST tax rate also will be 55 percent. The combined cost of gifts to grandchildren will be 140 percent calculated as follows.

### Table 1

<table>
<thead>
<tr>
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<th>Pre-EGTRRA</th>
<th>2007–8</th>
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<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate/GST tax rate</td>
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<td>45%</td>
<td>45%</td>
<td>0%</td>
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<tr>
<td>Gift tax rate</td>
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<td>45%</td>
<td>45%</td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td>Estate tax ACE</td>
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<td>$2 MM</td>
<td>$3.5 MM</td>
<td>0</td>
<td>$1 MM</td>
</tr>
<tr>
<td>GST tax exemption</td>
<td>$1 MM</td>
<td>$2 MM</td>
<td>$3.5 MM</td>
<td>0</td>
<td>$1 MM</td>
</tr>
<tr>
<td>Gift tax ACE</td>
<td>$1 MM</td>
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<td>$1 MM</td>
<td>$1 MM</td>
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</tr>
</tbody>
</table>

As shown on Table 1 above, the applicable credit amounts for estate and gift tax purposes are no longer the same and the GST tax exemption now substantially exceeds the amount a person can transfer by gift without gift tax consequences. This

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4 IRC § 2505.  
5 IRC § 2502.  
6 Gift tax is imposed on the GST tax. IRC § 2515.
creates an incentive for donors to find creative ways to take advantage of a donor’s GST tax exemption without incurring gift tax. Using the GST tax exemption as soon as possible allows increases in the value of the GST tax exempt property to avoid GST tax.

The gift tax will remain in effect in 2010. The circumstances surrounding the enactment of EGTRRA indicate that the reason for retaining the gift tax was to prevent donors from making gifts to lower bracket taxpayers to avoid income tax. The tax rate will be 35 percent and the applicable credit amount will be $1,000,000. This puts a cost on large gifts in 2010 to avoid GST tax, but gifts in 2010 may still be worthwhile due to the 20 percentage point increase on transfer tax rates if pre–EGTRRA law is restored.

Some of the revenue loss from reducing estate and GST tax rates and increasing the amounts shielded from those taxes was recouped by other EGTRRA changes such as replacing the state death tax credit with a deduction for state death taxes. “State death tax” refers to estate tax imposed by a state in an amount equal to the federal estate tax credit allowed by IRC § 2011 prior to its repeal. The maximum state death tax rate under IRC § 2011 is 16 percent. The repeal of IRC § 2011 had the effect of repealing state death taxes because the credit became zero, but about half of the states have “decoupled” the state estate tax in order to maintain their tax revenue despite the repeal of IRC § 2011. The maximum effective federal estate tax rate was not reduced materially by EGTRRA until actual repeal in 2010. Before EGTRRA the maximum effective federal estate tax rate was 39 percent (the maximum federal rate of 55 percent minus the maximum state death tax rate of 16 percent) and the 2007 maximum effective federal estate tax rate is 37.8 percent (the maximum federal rate of 45 percent minus the revenue cost of the state death tax deduction). For coupled states (states that impose no state estate tax), the federal share of revenue increased because the effective rate of estate tax increased from 39 percent to 45 percent. The maximum combined effective tax rate for persons dying in decoupled states—those that still impose state death tax—is about 54 percent (37.8 percent effective federal rate plus 16 percent state death tax rate). This is only one percentage point less than the 55 percent rate in effect pre–EGTRRA.

The repeal of the state death tax credit and decoupling by some states means that there are enormous potential savings from establishing domicile in a state that does not impose state death tax. For persons in the top bracket, the marginal saving is almost nine percent.

State death tax is avoided by not directly owning real estate in decoupled states. (Real estate is taxed in the state where the real estate is located even if the owner is domiciled in another state.) For example, owning real estate through a corporation or partnership may avoid state estate tax because the owner of stock or partnership interests owns intangible personal property that is taxable only in the state of domicile. Conversely, if a person is domiciled in a decoupled state and owns real estate in a state that imposes no state estate tax, it would be better to own the real estate directly.

Prior to EGTRRA, the state death tax was neutral because every state and the District of Columbia imposed a state death tax, it was fully creditable against federal estate tax and, if more than one state imposed the state death tax, the state death tax was apportioned proportionately. Where some states impose estate

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7 There are more appropriate and simpler ways to prevent gifts from allowing income tax evasion, such as deeming a gift to be an income recognition event.

8 IRC § 2058 replaced the credit allowed by IRC § 2011.
tax and others do not, there is a risk that the apportionment of state death tax will not operate fairly. There is a greater risk that more than one state may claim to be the domicile of a decedent, particularly where a change of domicile appears to be both tax motivated and incomplete (i.e., because the individual did not sufficiently sever ties with the state in which he or she was domiciled previously).

Under current law, the basis of most types of assets acquired from a decedent is adjusted to equal fair market value on date of death.\(^9\) This rule applies whether or not estate tax is due. For example, it applies both to smaller estates where no tax is due and to estates that pass to a surviving spouse and qualify for the unlimited marital deduction. In 2010, when the estate tax is repealed, only limited basis adjustments will apply. In general, the basis adjustment is capped at $1.3 million plus an additional $3 million for assets passing to a spouse or to a marital trust for the spouse.\(^10\)

The carryover basis rule creates a very difficult record keeping problem and a very significant burden for executors who are required to file returns with the IRS to report basis and basis adjustment allocations. It also creates administrative burdens for the IRS. The IRS will have little motivation to audit the information returns filed by executors because the returns generate zero revenue.

Note that for people who have “negative basis” assets, the carryover basis regime could be far more costly than the estate tax.

**EXAMPLE 2**

If the client has real estate worth $100,000,000 subject to a mortgage of $90,000,000 with a basis of $10,000,000 (due to depreciation deductions), the gain on a sale for fair market value would be $90,000,000 and the income tax on that at 25% would be $22,500,000. The cash generated would be $10,000,000, leaving a cash deficit of $12,500,000. Had the person died, assuming a 50% estate tax rate, the estate tax would have been $5,000,000.

No gain is realized at death under EGTRRA even though liabilities exceed basis (as in Example 2) unless the client leaves the real estate to charity, a foreign person, a governmental agency, or, to the extent provided in regulations, any person to whom property is transferred for a tax avoidance purpose.\(^11\) Suppose the property in Example 2 is worth $90,000,000 or less (less than the mortgage) and the property is left to a charity. Gain would be realized. But if the property is left to George W. Bush, absent regulations, he would be stuck with a liability and not an asset. What if the property is left to a person who has no net worth? How is the tax to be collected? Is this constitutional?

There seems to be a consensus that the carryover basis rule is a problem and will not take effect, but unless legislation is enacted, this will in fact be the law in 2010.

There are other miscellaneous changes made by EGTRRA that affect estate planners that will not be covered in this discussion. These include certain “relief” provisions for GST tax purposes such as automatic allocation of GST tax exemption to certain transfers, allowing trusts to be divided for GST tax purposes to make more efficient use of GST tax exemption and allowing retroactive allocation of GST tax exemption by a donor to certain trusts.

\(^9\) IRC § 1014. The basis is fair market value on the “alternate valuation date”—six months after death—where this date is used to determine estate tax.

\(^10\) IRC § 1022. Additional basis adjustments are allowed for loss carryforwards and unrealized losses.

\(^11\) IRC § 1022(g).
for descendants where a child of the donor
dies during the donor’s lifetime but before
the trust has terminated. These miscel-
naneous provisions also include expanded
tax benefits for conservation easements
and liberalized rules for deferred payment
of estate tax.

DEALING WITH THE EGTRRA
CHANGES

The long phaseout period and uncertain-
ties about whether repeal of the estate and
GST tax will be permanent, or will occur
at all, and concerns about carryover basis,
have created numerous problems for finan-
cial and estate planners and their clients.

Substantial tax savings may be achieved
by timing taxable transfers to occur in a
year in which the tax is not in effect or the
tax rate is lower and, conversely, accelerat-
ing transfers to occur in the most advantage-
ous years. While the timing of death is
not subject to control in most cases, the
timing of gifts and generation–skipping
transfers can be controlled. In addition,
the uncertain future of the estate tax
makes it more likely that clients will use
the marital deduction to defer all (rather
than merely some) of the estate tax until
the surviving spouse’s death.

However, delaying a taxable gift can be
costly. The effective gift tax rate is lower
than the estate tax rate. Although the
nominal rate is the same, the effective tax
rate is less because the tax base is different.
The estate tax is imposed on the value of
the taxable estate, including funds used
to pay estate tax, i.e., on a “tax inclusive”
basis. The gift tax is imposed on the value
of the gift, i.e., on a “tax exclusive” basis.
The savings are realized even when loss
of investment earnings on the gift tax
payments are considered, as the following
example shows.

EXAMPLE 3

Assume that an estate is $10 million, the
tax rate (for simplicity) is 50%, and there
is no available unified credit. The estate
tax is $5 million and the beneficiaries
net $5 million after tax. However, if the
donor who has a $10 million net worth
makes a $5 million taxable gift, the gift
tax (again using a 50% rate and assuming
no available credit) is only $2,500,000. If
the donor lives at least three more years
and all assets have appreciated by 40%,
the donees will have $7 million and the
donor will have (after making taxable
gifts and paying gift tax) an estate of $3.5
million (140% of $2.5 million). Upon the
donor’s death, half of the $3.5 million
will go to the government to pay estate
tax, leaving an additional $1.75 million
to the beneficiaries, who now have a total
of $8.75 million. Had no gift been made,
the donor would have died with an estate
of $14,000,000 and the children would
have received, after estate tax, $7,000,000.
Therefore, by making a gift, the children
receive an additional $1,750,000. This
is true despite the fact that investment
earnings on the amount used to pay gift
tax are not available to the family.

Despite these savings, many donors
do not make taxable gifts that incur gift
tax because they simply do not want to
write a check to the U.S. Treasury and
because they are less concerned about
additional amounts being due after their
death. As one client put it, “I won’t be
paying any estate tax, my children will
be paying the estate tax.” With the pros-
pect of repeal of the estate tax, there is an
additional disincentive to make taxable
gifts.

Postponing gifts also exposes apprecia-
tion in value to later gift or estate tax. In

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12 IRC §§ 2632 and 2642 enacted by §§ 561 and 562 of EGTRRA.
13 IRC § 2031(c) enacted by § 551 of EGTRRA.
14 IRC § 6166(b) enacted by § 571 of EGTRRA.
Example 3 above, the donor was able to avoid estate or gift tax on the $2,000,000 of appreciation that occurred after the gift was made. However, it is possible to make transfers that do not incur gift tax but still transfer appreciation to the donees. Moreover, sometimes the gifted assets decline, rather than appreciate, in value, which makes the gift a poor choice in hindsight. There are strategies that can be used that avoid this risk. The two most popular strategies for freezing values without paying gift tax are sales to “grantor trusts” and “grantor retained annuity trusts,” or “GRATs.” A detailed discussion of these strategies is beyond the scope of this paper, but a general explanation appears below.

A grantor trust is a trust that is treated as owned by the grantor for income tax purposes. Such a trust may or may not be treated as owned by the grantor for gift and estate tax purposes because the rules of ownership are not the same for income tax purposes and for gift/estate tax purposes. If the trust is a grantor trust solely for income tax purposes, then the grantor can sell assets to the trust without realizing income in exchange for cash or a note or other property of equivalent value. Although the amount received is included in the grantor’s gross estate for estate tax purposes (along with any appreciation on those assets), appreciation in the value of the asset sold to the trust avoids gift and estate tax. Typically, the sale is for a promissory note issued by the trust that bears interest at the “applicable federal rate.” The applicable federal rate is based on the Treasury borrowing rate and obviously does not reflect the greater credit risk of a note issued by a trust that may not have sufficient assets to repay the note if the property declines in value. However, there is no imputed interest if the note bears interest at the applicable federal rate. If and when gift tax rates are reduced to 35 percent, the grantor may want to consider canceling the note. However, if the assets decline in value, the note still must be paid, and there may be gift tax consequences if the note is not paid.

A GRAT is similar to a sale to a grantor trust for a note except that the consideration received by the grantor in exchange for property conveyed to the GRAT is a term annuity. Under Treasury regulations, the annuity may be expressed as a percentage of the value of the property transferred to the trust as finally determined for gift tax purposes. This makes the annuity adjustable if the IRS values the property differently than the taxpayer does. As a result, there is little or no additional gift tax due as a result of a gift tax audit. If the present value of the annuity equals the value of the assets transferred to the GRAT, there is no gift on funding. Any appreciation benefits the remainder beneficiaries at no gift tax cost. If the assets decline in value, there will be no tax consequences.

Postponing gifts exposes the gift tax paid to estate tax. If the donor dies within three years of making a taxable gift, any gift tax paid is brought back into the estate and estate tax is imposed on the gift tax. If the donor had died within three years of making the gift, estate tax of $1,250,000 would have been imposed on $2,500,000 of the gift tax paid. The estate tax increase

15 IRC § 7872. If the note bears interest at the applicable federal rate, it should be valued at face. See, Estate of Frazee, 98 T.C. 554 (1992). (“Congress indicated that virtually all gift transactions involving the transfer of money or property would be valued using the current applicable federal rate. Sec. 7872(f)(2)(B). In so doing, Congress displaced the traditional fair market methodology of valuation of below–market loans by substituting a discounting methodology.”)


17 IRC § 2035(b).
of $1,250,000 eliminates some or all of the advantage of making gifts.18

Accelerating gifts can be advantageous. Accelerating gifts is particularly beneficial if the rate of gift tax drops to 35 percent or less, the GST tax is repealed and the estate and GST taxes are expected to be reinstated. Planners may recommend that a client consider authorizing gifts to be made on the client’s behalf if the donor is under a disability. As shown in Example 1 above, the combined gift and GST tax rate on a gift to a grandchild in 2011 is 140 percent. Had the gift been made in 2010, the rate would have been 35 percent.

Deathbed gifts are very beneficial for clients who live in decoupled states because deathbed gifts substantially reduce the state death tax. The state death tax is computed on the value of the estate — excluding prior gifts. Although the gift tax paid on gifts made within three years of death are added back to the estate, the gift itself is not. Many decoupled states do not impose gift tax. To preserve the benefit of a basis adjustment, high basis assets or loan proceeds should be used to fund deathbed gifts. Prior to the repeal of the state death tax credit, this type of planning was not necessary because the net cost of state death tax was always zero.

An attorney–in–fact (or agent) under a durable general power of attorney or a trustee under a revocable trust may be authorized to make gifts on the donor’s behalf, particularly if the tax rate falls to stated levels. Gifts made by an agent or trustee who is not authorized to make gifts are not effective for tax purposes, and such gifts are not authorized unless the governing instrument expressly authorizes gifts.

An irrevocable trust can be structured to control the timing of a generation–skipping transfer. The GST tax applies to three types of transfers: direct skips, taxable distributions and taxable terminations. A direct skip occurs when a gift or bequest is made to “skip persons” (such as grandchildren). A taxable distribution occurs when a distribution is made from a trust to skip persons. A taxable termination occurs when a trust ceases to have any beneficiary who is a nonskip person. For example, if a donor creates a trust for his son for life, remainder to the son’s children, a taxable termination occurs at the son’s death because at that point the trust’s only beneficiaries are the donor’s grandchildren.

The timing of direct skips and taxable distributions, like the timing of gifts, can be controlled. It is a bit more complicated, but not impossible, to control the timing of a taxable termination. By including at least one beneficiary who is a nonskip person (which could include a charity) it may be possible to postpone a taxable termination.19

Postponing a generation–skipping transfer clearly will be advantageous if the GST tax subsequently is repealed. However, if a generation–skipping transfer is postponed and the GST tax is not repealed, postponing the generation–skipping transfer could be costly. This is because the effective tax rate on direct skips is less than the effective tax rate on taxable distributions and taxable terminations. The difference is similar to the difference in the effective gift and estate tax rates. Although the nominal rate is the same, because the tax base is different, the effective tax rate for taxable distributions

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18 In addition, the basis adjustment allowed for bequests is not available for gifts. Instead, the donee takes the donor’s basis, adjusted for gift tax paid on the portion of the gift attributable to post–1976 value. IRC §1015. Occasionally, a gift is advantageous to avoid a step–down in basis.
19 A discretionary charitable interest will be disregarded and, thus, ineffective to avoid a taxable termination (where all other beneficiaries are skip persons). The IRS also has authority to disregard a nominal beneficial interest that is included merely to defer GST tax. Finally, if the trust creates “separate shares” for beneficiaries, a taxable termination would occur unless each separate share of the trust continued to have a nonskip person as a beneficiary.
and taxable terminations (like the estate tax) is higher. Both gift tax and the GST tax on direct skips are computed on a “tax exclusive” basis—the base on which the tax is computed does not include the amount of tax paid. The GST tax on taxable distribution and taxable terminations is determined on a tax inclusive basis.

However, planning is not limited to deferring a taxable event, it is equally important to accelerate a generation-skipping transfer if the GST tax is repealed, particularly if repeal is temporary. In 2010, it will be very advantageous to distribute assets from trusts to skip person beneficiaries and avoid the GST tax on taxable distributions. By giving a fiduciary the power to amend the trust to exclude beneficiaries who are non-skip persons (even if they are excluded only temporarily), a taxable termination can be accelerated to occur in 2010 when the GST tax will be repealed. However, it is not clear whether the acceleration of a taxable termination that occurs in 2010 will be effective to avoid GST tax when the tax is restored. When a taxable termination occurs, the transferor “moves down” a generation to avoid the GST tax from applying to distributions from the trust to certain skip persons.20 For example, if a client creates a trust for his son and his son’s children, upon the son’s death, a taxable termination occurs. The client is reassigned to the son’s generation for GST tax purposes so that distributions to the client’s grandchildren that are made after the son’s death are not treated as taxable distributions. If the taxable termination occurs when the GST tax is not in effect, unless the generation move down rule applies, distributions to the client’s grandchildren after the GST tax is restored would be taxable distributions. It is not clear how the GST tax will apply if irrevocable trusts are established in 2010 when the GST tax is repealed, the GST tax later is restored and a distribution to a skip person is made from the trust after the GST tax is restored.

EXAMPLE 4

A client dies in 2010 when the estate and GST taxes are not in effect and leaves his $10 million estate to a trust for his descendants. In 2011, the GST tax is restored. Assume that the trustee distributes $2 million to grandchildren in 2011. This distribution would have been a taxable distribution under the GST tax rules had the trust been funded when the GST tax was in effect. However, because the trust was established when the GST tax was not in effect, it should be the correct result that the GST tax does not apply. There is no “transferor” for GST tax purposes if there was no taxable transfer when the trust was created at the client’s death.21 However, this construction of the law is uncertain. Clients may be better off leaving property outright to grandchildren to avoid this risk.

If the client funds the trust in Example 4 by a lifetime gift in 2010 rather than at death, it is likely that a distribution in 2011 would be a taxable distribution for GST tax purposes because the client would have made a transfer to the trust that was subject to gift tax. Therefore, there is a “transferor” so that there is no impediment to imposing the GST tax in 2011 when a taxable distribution occurs. However, will the client have zero GST tax exemption to allocate to the gift to the trust in 2010? If so, the client would be better off making the gift in 2009 when the GST tax exemption will be $3.5 million (even

20 IRC § 2653.
21 A threshold requirement for the GST tax is that there be a “transferor” who is defined in IRC § 2652 as the person subject to gift or estate tax when the transfer is made.
though the gift tax rate will be 45 percent in 2009 and 35 percent in 2010).

Clients should allocate the client’s GST tax exemption before the end of 2009 (when the GST exemption reaches its peak amount of $3.5 million). This can be done by making a taxable transfer of the amount of the client’s unused GST tax exemption. However, it may be possible to use the client’s GST tax exemption without incurring gift tax.

A client may make a “late allocation” of GST tax exemption to a trust that he previously funded. For example, if a client funded a trust with $600,000 that has grown in value to $3.5 million, and the client did not previously allocate GST tax exemption to the gift on a timely filed gift tax return, the client may later allocate GST tax exemption to the trust. However, before making late allocation, the client should determine that there is no basis for making the allocation retroactive.22

A late allocation of GST tax exemption may be appropriate because there are some gifts to which GST tax exemption cannot be allocated when the gift is made.

GST tax exemption may be allocated to a special type of trust called a “reverse QTIP” trust. This is a trust for a spouse that qualifies for the gift or estate tax marital deduction, so that there is no gift or estate tax when the trust is funded. GST tax exemption may be allocated to the trust if the donor or the estate makes a reverse QTIP election.24

It is not entirely clear how a trust to which GST tax exemption has been allocated will be treated when the GST tax exemption is later reduced. In Example 5 above, suppose that a taxable distribution occurs in 2011 when the GST tax exemption will be reduced to $1 million (indexed for inflation). The IRS may assert that the “extra” exemption allocated in 2009 is ineffective. To further protect against such an argument, it may be advisable to make a small taxable distribution from the trust in 2009 so that the statute of limitations begins to run on the IRS asserting that a smaller portion of the trust is exempt from GST tax.

No later than before the end of 2010, it is advisable to divide any trust that is only partially exempt from GST tax into separate trusts; one entirely exempt from the tax and one entirely subject to the GST tax. This is called a “qualified severance.” It is advisable to sever trusts in this manner so that the nonexempt trust can be used to benefit older generation beneficiaries and exempt trusts can be preserved for younger generation beneficiaries. After EGTRRA expires, it is not clear whether such severances will continue to be allowed.25

It is very common to use tax–driven formulas to define the portion of the

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EXAMPLE 5

A client established a five–year GRAT that ended in 2009. The remainder beneficiary is another trust. The remainder of the GRAT is $5 million. The client could not allocate GST tax exemption to the GRAT under the GST rules until the end of the annuity.23 However, when the annuity expires, the client may allocate his GST tax exemption to the remainder trust. There is no gift tax incurred at that time.

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22 The IRS has discretion to allow retroactive allocations. IRC § 2642(g)(1)(B). See Treas. Reg. § 301.9100–3 for procedures for relief. The usual grounds for relief is the failure of the return preparer to allocate exemption or a lawyer’s failure to properly advise the client of the need to allocate GST exemption.

23 IRC § 2642(f) provides that GST tax exemption cannot be allocated to a trust during the period of time that the assets are subject to being included in the donor’s gross estate for estate tax purposes. A GRAT is included in the grantor’s estate if the grantor dies before the expiration of the term of the grantor’s annuity. Thus, the grantor’s GST tax exemption cannot be allocated to the GRAT until the annuity expires.

24 IRC § 2652(a)(3).

25 IRC § 2642; §§ 562 and 901 of EGTRRA.
estate that is allocated to a beneficiary. This becomes more difficult when the tax principles that determine the amount passing under the formula change materially. Typically, formula clauses are used to divide an estate between the share that qualifies for the marital deduction (the “marital share”) and the portion sheltered from estate tax by the unified credit (the “credit shelter share”). These clauses are designed to defer all estate tax to the time of the surviving spouse’s death and to minimize the tax due at that time by taking full advantage of the unified credit of the spouse who dies first. The amounts of the formula bequests will change significantly as the amount sheltered by the unified credit changes and even more if and when the estate tax is repealed. How will such formula clauses be interpreted if they rely on estate tax principles and the estate tax is not in effect when the person dies?

**EXAMPLE 6**

A client dies with an estate of $5 million leaving his spouse “the minimum amount, if any, necessary to reduce federal estate tax to a minimum.” If the client dies in 2007, this amount will be $3 million, if he dies in 2009, this amount will be $1.5 million, and if he dies in 2010, this amount will be zero.

Suppose that the client’s will instead said that the children shall receive “the largest amount that can pass free of federal estate tax under my unified credit.”

If the client dies in 2007, the amount passing to the children in Example 6 will be $2 million, if he dies in 2009, this amount will be $3.5 million, and if he dies in 2010, it is not clear whether the amount will be $5 million or zero. This depends upon whether the clause is interpreted literally to be the amount sheltered by the unified credit (zero) or the amount that can pass free of tax for any reason (the entire estate).

Similarly, formula clauses are often used to define the amount that passes to or to trusts for grandchildren. The clause may be “the amount of my remaining GST tax exemption” or “the largest amount that can pass to my grandchildren without incurring GST tax.” In 2010, this amount could be either zero (the amount of the GST tax exemption) or the entire estate (the amount that can pass free of GST tax).

Formula clauses also may be necessary if death occurs when the estate tax is not in effect in order to take advantage of the additional basis adjustments allowed for property passing to a spouse or to a marital trust. If a client who dies in 2010 leaves his entire estate to a trust for the benefit of spouse and descendants, the additional $3 million basis adjustment will be lost because it is only available for assets that pass to the spouse or to a qualified marital trust for the sole benefit of the spouse.

Formula clauses also need to consider the state death tax in decoupled states. Some (but not all) decoupled states allow a marital trust to elect the marital deduction for state estate tax purposes even if the marital deduction is not elected for federal estate tax purposes. This means that the trust is taxable upon the surviving spouse’s death solely for state estate tax purposes.

**EXAMPLE 7**

Maryland is a “decoupled” state that imposes estate tax on amounts over $1 million but also allows a marital deduction to be elected solely for Maryland estate tax purposes. Suppose that the client dies in 2007 with an estate of $5 million. The client may divide the estate so that $1 million passes to the children or to a trust for the spouse and children, $1 million passes to a marital trust for which the Maryland but not the federal estate tax deduction is elected and $3 million passes either outright to the spouse or to a
marital trust for which the marital deduction is elected for both state and federal estate tax purposes. Upon the death of the surviving spouse, the marital trust for which a federal estate tax deduction was not elected will not be taxable for federal estate tax purposes (but will be taxable for state estate tax purposes).

Where a state–only marital deduction election is not allowed, the clients will have to choose whether to pay state estate tax in the estate of the first spouse to die and pay less estate tax when the survivor dies or to defer all estate tax (both state and federal) and face a potentially higher federal estate tax when the survivor dies. In general, for more modest estates, it is preferable to defer all tax because the increasing unified credit may shield the survivor’s estate from tax in any event (or the surviving spouse may consume enough of the estate so that no estate tax will be due). Conversely, in larger estates, it is almost always preferable to take full advantage of the federal unified credit.

A separate marital trust could be funded with the excess of the amount shielded from federal estate tax by the unified credit over the amount shielded from state estate tax. If an election is made to qualify the trust for the federal and state estate tax marital deductions, the federal election may be void because it does not reduce federal estate tax. If so, the trust should avoid federal estate tax when the survivor dies. However, state tax authorities may argue that the election also is void for state estate tax purposes.

It is not clear what will happen in states that do not allow a state–only marital deduction election if the federal estate tax is repealed. If assets are bequeathed outright to the spouse or to a trust that would qualify for the marital deduction even without an election (e.g., a general power of appointment trust or an estate trust), the marital deduction is assured. On the other hand, if the assets instead are bequeathed to a QTIP trust for which the federal estate tax marital deduction is not elected, no federal estate tax will be due if and when the tax is restored.

Of course, many of these issues can be avoided by not using formula bequests and letting the tax burden fall as it may. This is most often feasible in very large estates, where the formulas produce minimal benefits and the estate has the liquidity to pay the tax due. However, if no federal marital deduction is available because the estate tax is not in effect, will a marital deduction be allowed for state estate tax purposes?

Special care is necessary if the marital and credit shelter shares benefit different people so that the effect of the formula could impose hardship or lead to litigation. Where the credit shelter share also benefits the spouse (as the beneficiary of a “bypass trust,” for example) this is less likely to be a problem. (A bypass trust is a trust that benefits the spouse but is not included in the spouse’s estate upon his/her death, i.e., the trust “bypasses” the surviving spouse’s estate.)

The complexities of formula clauses may be mitigated by “disclaimer planning.” This involves leaving property to

27 A general power of appointment trust is one that pays all income to the spouse and gives the spouse the unlimited power to designate who takes the remaining principal at his or her death. An estate trust is a trust that pays the remaining principal to the surviving spouse’s estate at death. Both qualify for the marital deduction. By contrast, in a QTIP trust, the surviving spouse is entitled to all income but need not be given the right to designate who takes the remaining principal upon his or her death. The ability to control the disposition of the remaining principal is especially desirable in situations where there are children from a prior marriage whose inheritance needs to be protected. A QTIP trust qualifies for the marital deduction only if an election is made.
a spouse or to a marital trust for a spouse and relying on the survivor making a “qualified disclaimer” to redirect assets to a bypass trust. A qualified disclaimer is a refusal to accept property, which, if made in accordance with certain rules, is treated as if the property passed from the decedent directly to the person who becomes entitled to receive the property as a result of a disclaimer, i.e., the person making the disclaimer is not treated as if he/she received the property and made a gift of the property to the person entitled to receive it.\textsuperscript{28} In general, a qualified disclaimer must be made within nine months of death, before the person making the disclaimer accepted any benefit and the disclaimed property must pass without direction on the part of the person making the disclaimer. Unless the person making the disclaimer is the spouse, the person making the disclaimer may not retain any beneficial interest in the disclaimed property.

\textbf{EXAMPLE 8}

A client will leaves all assets to his wife but provides that to the extent that the wife disclaims, the disclaimed property passes to a marital trust, and if the spouse disclaims all or any portion of the marital trust, the disclaimed amount passes to a bypass trust, and if the spouse disclaims any portion of the bypass trust, the disclaimed amount passes to the children, and if the children disclaim, any disclaimed amount passes to the grandchildren.

Obviously this type of planning places considerable reliance on family members to make the most appropriate decisions. This is not always realistic.

Formula clauses also may be mitigated by leaving all assets to a marital trust that qualifies for the marital deduction only to the extent the deduction is elected. The principal of the trust remaining at the survivor’s death is taxable only to the extent the marital deduction is elected. This type of trust is called a “qualified terminable interest property trust” or “QTIP trust.”\textsuperscript{29} The trust may provide that to the extent an election is not made, the assets pass to a bypass trust.\textsuperscript{30} A QTIP trust is very useful to avoid tax if the estate tax is not in effect when the client dies but is restored before the surviving spouse dies. Because the marital deduction obviously would not be elected (at least for federal estate tax purposes) if that tax is not in effect, the trust also will not be included in the survivor’s estate upon his/her death. A QTIP trust also will qualify for the additional $3 million basis adjustment under the carryover basis regime because the same criteria apply.

Uncertainty about what law will be applicable when the client dies has encouraged drafting for greater flexibility. For example, independent trustees or trust advisors or protectors may be granted broad powers concerning trust distributions and/or amendments. Such powers could be exercised, for example, to accelerate a taxable distribution for GST tax purposes or to make a large distribution to a beneficiary to enable the beneficiary to engage in further estate planning strategies or qualify for a basis adjustment at his/her death. Beneficiaries may be given limited powers of appointment to direct assets to other persons or other trusts either during their lifetime or at death, in order to alter the disposition of assets.

It is very common to make bequests charity to reduce estate tax since amounts

\textsuperscript{28} IRC §2518.
\textsuperscript{29} IRC § 2056(b)(7).
\textsuperscript{30} Treas. Reg. § 20.2056(b)–7(d)(3)(i). These types of QTIP trusts are referred to as “Clayton QTIPs” after the first case in which the technique was upheld. \textit{Estate of Clayton v. Commissioner}, 976 F2d 1486 (5th Cir. 1992).
left to charity are deductible. If a client dies in 2010 when the estate tax is repealed, charitable bequests will not be necessary to reduce estate tax. Where there is a philanthropic objective, the client may be better off leaving assets to a discretionary trust for the benefit of the family and charity. Trust distributions made to charity will provide deductions for income tax purposes that may benefit the family.

A charitable remainder trust funded from the estate of a person who died when the estate tax is repealed may not qualify as a tax exempt charitable remainder trust. If no estate tax was in effect at the client’s death, no deduction would be allowed for the bequest to the trust. A charitable remainder trust is not qualified unless a deduction is allowed on funding. This is significant because a qualified charitable remainder trust is exempt from income tax. Particularly if carryover basis takes effect, a charitable remainder trust will be a useful income tax saving mechanism because the trust can sell appreciated assets and the trust will not be taxable on the gain.

Planning is advisable to assure that cash can be raised to pay the expected estate tax liability. The most common way to do this is to purchase life insurance. Because of uncertainty about the future of the estate tax, clients are not sure how much insurance they will need. Another way to provide liquidity is to enter into buy–sell agreements so that interests in closely held businesses can be liquidated, usually by a sale to the entity or other equity owners. Such sales will not be necessary for liquidity purposes if the estate tax is repealed. In addition, sales may cause gain to be recognized if the client dies when carryover basis rules are in effect. Under current law, sales do not cause gain to be realized because the asset is usually sold for its value for estate tax purposes, and a new basis is acquired at death. Of course, there may be other reasons to sell at death.

If the carryover basis rules take effect, life insurance may continue to be very popular. Because investment income on assets held under a life insurance contract are not taxable to the owner, and the cash proceeds of a life insurance policy are excluded from income, investing through a life insurance policy avoids the tax cost of carryover basis. If there is no estate tax, the life insurance policies can be held directly by the insured without adverse tax consequences. Therefore, virtually unlimited amounts can be invested in policies provided only that there be a sufficient mortality component to meet the definition of life insurance contract. Under current law, the gift tax imposes a practical limitation on funding large policies to provide liquidity for estate taxes. Because the policies usually are owned by an irrevocable trust in order to avoid exposing the proceeds of insurance to estate tax, gift tax must be paid on amounts used to fund the trust.

The basis adjustments allowed at death under current law discourage lifetime sales of highly appreciated assets. One positive feature of carryover basis is that this incentive to postpone sales is eliminated.

The substantial increase in the unified credit makes it more difficult for spouses to take full advantage of both their credits regardless of who dies first. Complex structures are being used to try to allow all property to be included in the estate of the first spouse to die so that no credit is wasted, but the tax consequences of these structures are uncertain.

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31 IRC § 2055.
32 IRC § 664.
33 IRC § 101.
34 IRC § 7702.
EXAMPLE 9

Clients have $5 million of jointly held assets. To take advantage of the $3.5 million credit in 2009, they fund a joint revocable trust that gives each of them the power to revoke as to assets each contributed and gives the spouse who dies first a general power of appointment over that portion of the assets in the trust equal to the applicable credit amount. In default of appointment, the applicable credit amount passes to a bypass trust for the benefit of the surviving spouse. If one spouse dies in 2009, the bypass trust would be funded with $3.5 million and $1.5 million would remain in the revocable trust subject to withdrawal by the surviving spouse (and, therefore, the $1.5 million would qualify for the marital deduction). The survivor’s taxable estate would be $1.5 million, which is likely to be less than the amount that will be sheltered from estate tax by the unified credit allowable at his or her death.

I believe that the plan in Example 9 is flawed, but the IRS has issued several favorable private letter rulings allowing this strategy.35

CONCLUSION

EGTRRA creates a number of challenging estate planning problems. In general, it is difficult to draft effective and tax efficient wills and trusts when you do not know what law will be in effect when the estate plan “matures.” To protect against problems, a popular strategy is to grant broad discretionary powers, including amendment powers, to fiduciaries. If beneficiaries are given broad powers, there could be adverse tax consequences for them. Therefore, the powers are usually granted only to independent or disinterested fiduciaries.

Drafting for flexibility increases the cost of preparing estate planning instruments, the cost of administration and the risk of controversy where the beneficiaries disagree as to the appropriate course of action taken by the independent fiduciary. Clearly the public would be better served if there were greater stability and predictability in the transfer tax law.

35 PLRs 200604028, 200403094, 200210051, 200101021. My problem with these techniques is that a gift is made from the surviving spouse to the deceased spouse’s estate, which may not qualify for the gift tax marital deduction because the gift is not made to a spouse, but to a deceased spouse’s estate. Only the taxpayer to whom a PLR is issued is entitled to rely on it. If the IRS were to issue a revenue ruling approving this strategy, then all taxpayers would be entitled to rely on it.