ISSUES RAISED BY THE ONE-YEAR SUSPENSION OF THE ESTATE AND GST TAXES

(provided to congressional staff members by the Washington Affairs Committee of the American College of Trust and Estate Counsel)

February 22, 2010

The following is a summary of some of the technical issues raised by the one-year suspension of the federal estate and generation-skipping transfer ("GST") taxes as provided by the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 ("EGTRRA"). In general, the descriptions in this summary assume no changes in the current law, under which pre-2002 law returns in 2011. If Congress acts to change that, then all those descriptions should be interpreted accordingly, and references to 2010 should generally be read as referring to whatever gap period, if any, is left between 2009 law and the new law.

The members of ACTEC have considerable experience interpreting tax rules and making solutions work in the context of trusts and estates, and ACTEC stands available to provide technical assistance as desired on these and any other issues of interest to Congress.

GIFT TAX ISSUES

2010 Gifts in the Unified Tax System. ISSUE: If a donor makes taxable gifts during 2010, pays a gift tax at a rate of 35%, and dies after 2010, will the gift tax with respect to "adjusted taxable gifts" that is subtracted in the calculation of the estate tax under section 2001(b)(2) (line 7 of the estate tax return) be the 35% tax, or will it be the higher pre-2002 tax that "would have been payable" (see section 2001(b)(2)) if the 35% rate "had never been enacted" (see section 901(b) of EGTRRA)? (The latter approach would be consistent with the way the unified gift and estate tax system has operated since 1977, including the similar treatment section 2502(a)(2) gives to pre-1977 gifts.)

ISSUE: The same question could be asked with regard to gifts made during the years from 2002 through 2005, when the gift tax unified credit underEGTRRA was greater than under pre-EGTRRA law.

POSSIBLE ACTION: Clarify the answers to these questions, consistently with the overall policy judgments that Congress makes.

ISSUES REGARDING GENERATION-SKIPPING TRUSTS CREATED IN 2010

The creation of a generation-skipping trust during 2010 will not be subject to GST tax, even if, under 2009

law, it would have been treated as a "direct skip" and therefore a generation-skipping transfer. Almost every question about the GST tax treatment of such a trust after 2010, however, is unclear, as are many questions about the tax treatment of trusts created before 2010, largely because of the sweeping mandate in section 901(b) of EGTRRA that after December 31, 2010, "[t]he Internal Revenue Code of 1986 … shall be applied and administered to … transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted."

Allocation of GST Exemption. ISSUE: How can GST exemption be allocated to a trust created in 2010? For the most part, there are the same tax and non-tax reasons to create and fund a generation-skipping trust during 2010 as there were before 2010. And there certainly are the same reasons in 2010 to make additions to existing generation-skipping trusts, especially to permit the trustee to pay recurring trust obligations (such as the payment of premiums in the case of a life insurance trust). But there is no GST exemption to allocate in 2010; see sections 2631(c) and 2010(c). While a late allocation of GST exemption on January 1, 2011, is possible, a late allocation would be measured by the value of the trust assets at the time and therefore 2010 trusts would be treated differently from all other generation-skipping trusts without a self-evident policy reason for doing so. Because undersection 2664 the application of chapter 13 is suspended only with respect to "generation-skipping transfers" and the mere creation of a generation-skipping trust that is not a "direct skip" is not a "generation-skipping transfer," the deemed allocation rules of section 2632(c) theoretically appear to apply, except that there is no GST exemption in 2010 to be deemed allocated.

Generation-Skipping Assignment – "Move Down" Rule. ISSUE: In the case of a trust created exclusively for, say, the grantor's grandchildren and their descendants, will the "move down" rule of section 2653(a) apply to treat the trust as if the transferor were one generation above the generation of the trust's beneficiaries, so that those beneficiaries, the grandchildren of the grantor, will thereafter be non-skip persons? That would have been the result in 2009, because the creation and funding of the trust would have been a "direct skip" and therefore a "generation-skipping transfer" and the requirement of section 2653(a)(1) would have been met. In 2011, the Code is applied as ifsection 2664 "had never been enacted," suggesting that the "move down" rule might apply to define the skip persons after 2010, even though chapter 13 did not apply so as to impose a GST tax in 2010. But because this would in effect apply the "move down" rule to a direct skip – a generation-skipping transfer – in 2010, arguably in defiance of section 2664, the answer is unclear.

Inclusion Ratio – Nontaxable Gift. ISSUE: In the case of a trust created for, say, *one* grandchild of the grantor, in such a manner that a gift of the annual gift tax exclusion amount (currently $13,000) meets the requirements of section 2642(c)(2), will the gift qualify as a "nontaxable gift" under section 2642(c)(1),

with an inclusion ratio of zero? This is similar to the previous issue, except that an affirmative application of chapter 13 (as in the case of the "move down" rule) is not needed in 2011 when section 2664 is treated as if it "had never been enacted." On the other hand, it still might be argued that application of the nontaxable gift rule itself to a section 2642(c)(1) "direct skip" in 2010 is as inconsistent with section 2664 as application of the "move down" rule to a section 2653(a) "generation-skipping transfer" in 2010.

Identification of Transferor – "Reverse QTIP" Election. ISSUE: Can a "reverse QTIP" election under section 2652(a)(3) be made for a transfer in 2010? Although section 2664 provides that chapter 13 "shall not apply" in 2010, it provides that only for "generation-skipping transfers," which the creation of a QTIP trust would not be. Moreover, in a subsequent year, when the identity of the transferor (which the reverse QTIP election determines) is relevant, section 2652(a)(3) will be applied as if section 2664 "had never been enacted."

ADDITIONAL ISSUE REGARDING TESTAMENTARY TRUSTS

Identification of Transferor and Skip Persons – Taxability of Trust.ISSUE: If a generation-skipping trust is created under the will or revocable trust of someone who dies in 2010, will it be subject to GST tax in the future? While this might be a surprising question, under section 2652(a)the "transferor" for purposes of the GST tax is defined as the decedent or donor with respect to whom the property transferred in trust is subject to estate or gift tax. If no estate tax applies (because the death is in 2010) and no gift tax applies (because this is a transfer at death, not by gift), the literal language of section 2652(a) does not identify a transferor for GST tax purposes. If there is no transferor, arguably there are no skip persons, because no one could ever be assigned to a generation two or more generations below the generation of the transferor.

This is not an anomaly that would necessarily be cured after 2010 when the suspension of the estate and GST taxes is treated as if it "had never been enacted," because under section 2652(a) the identification of the transferor, and thus skip persons, depends not on the design of the trust, but on the fact that the assets are "subject to the [estate] tax," which will never be true of the assets of a decedent who dies in 2010.

QUESTIONS PRESENTED BY ALL GENERATION-SKIPPING TRUSTS

Allocation of GST Exemption Increased by EGTRRA. If a grantor (or decedent) created and funded a generation-skipping trust during the years from 2004 through 2009 and the grantor (or executor) allocated GST exemption to the trust in excess of the $1 million exemption (indexed for inflation since 1999) that would have been applicable if the increases in the GST exemption in EGTRRA "had never been

enacted," will the GST exemption be under-allocated, so that the trust's inclusion ratio after 2010 will be greater than zero after all?

Deemed Allocations of GST Exemption Allowed by EGTRRA. If, during the years 2001 through 2009, a grantor created and funded a generation-skipping trust to which GST exemption was *deemed* allocated under section 2632(c), will the trust be exempt after 2010, when section 2632(c) will be treated as if it "had never been enacted"?

Late Allocations of GST Exemption Allowed by EGTRRA. If a grantor created and funded a generation-skipping trust before 2001, neglected to timely allocate GST exemption to it, but obtained a ruling from the Internal Revenue Service since 2001 under Notice 2001-50, 2001-2 C.B. 189, permitting an extension of time to make that allocation, will the grantor's late allocation be effective after 2010, when the statutory basis for such an extension of time, section 2632(d), will be treated as if it "had never been enacted"?

Qualified Severances Allowed by EGTRRA. If a generation-skipping trust is severed from 2001 through 2009 under the qualified severance rules ofsection 2642(a)(3), will the severance be respected after 2010 when section 2642(a)(3) is treated as if it "had never been enacted"? If not, will non-pro-rata distributions from the trusts be treated as a transfer between the trusts?

Gap in ETIP as "Close" of ETIP. If, before 2010, a grantor created and funded a generation-skipping trust that would have been included in the grantor's gross estate, the grantor would have been prohibited under section 2642(f)(1) from allocating GST exemption to that trust "before the close of the estate tax inclusion period" ("ETIP"). Because there is no estate tax in 2010, has the ETIP now "closed," so that GST exemption can now be allocated? If so, although there apparently is no GST exemption to allocate in 2010, could a late allocation be made on January 1, 2011? By then the estate tax will apply again, so it appears that there will be a new ETIP, but the fact remains that the *first* ETIP will have closed. (section 2642(f)(1) refers to the close of "the" ETIP, while section 2642(f)(3) defines an ETIP as "any" period in which there would be estate inclusion, but section 2642 was probably not written with an interrupted ETIP in mind.)

POSSIBLE ACTION: Clarify the answers to all these GST tax questions. While the choice of clarification should reflect the overall policy judgments that Congress makes, it is likely that the most understandable and workable solution in most cases will be the solution that maintains the greatest possible continuity between the former GST tax and the reinstated GST tax and treats transfers in 2010 consistently with that continuity, except for the imposition of a 2010 GST tax.

SECTION 2511(c)

Section 2511(c) provides:

Treatment of Certain Transfers in Trust.—Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.

As a technical correction, section 411(g) of the Job Creation and Worker Assistance Act of 2002 (Public Law 107-147) inserted the words "transfer of property by gift" in lieu of the words "taxable gift under section 2503" included in EGTRRA. The practical significance of this technical correction is to clarify that the resulting gift is subject to reductions by reason of the annual exclusion and marital and charitable deductions in calculating the amount of taxable gifts.

ISSUE: Some have speculated that section 2511(c) means that a transfer to a trust treated as wholly owned by the grantor for income tax purposes is*never* a gift. That has led to the speculation that if the trust is designed to avoid any of the "string" provisions of sections 2036 through 2043 that would bring the value of the trust property into the transferor's gross estate, the property can eventually pass to the transferor's descendants or other beneficiaries without passing through either the gift tax or estate tax system. Notice 2010-19, 2010-7 I.R.B. ___, stated that that kind of speculation had "inaccurately interpreted section 2511(c)" and that the Service and Treasury intend to confirm that in regulations.

Others have asked how section 2511(c) might affect the treatment of other trusts, such as inter vivos charitable remainder trusts, that are not grantor trusts but historically have been given a settled treatment for tax purposes and have not been viewed as permitting the inappropriate shifting of income tax incidence.

Still others have never completely understood the role of section 2511(c) and aren't sure what questions to ask about it.

POSSIBLE ACTION: If section 2511(c) is not repealed or allowed to lapse, it appears that more clarification of its scope, meaning, and effect is needed, consistent with the policies Congress intends the statute to reflect.

NOTE: Because section 2511(c) by its terms is subject to limitation by regulations, more clarity might also be achieved administratively, as in Notice 2010-19, without legislation.

OTHER INCOME TAX ISSUES

Continuing Income Tax Exemption for Testamentary Charitable Remainder Trusts. Testamentary charitable remainder trusts created by a decedent dying in 2010 appear not to be exempt from income tax, because in the absence of an estate tax there will be no tax deduction, as required byReg. § 1.664-1(a)(1)(iii)(*a*). There is no indication in the legislative history that this was intended.

As an amendment "related to carryover basis," section 542(e)(4) of EGTRRA amended section 4947(1)(2)(A) to extend certain private foundation restrictions to split-interest trusts for which an income tax deduction is allowed under section 642(c) for amounts paid or permanently set aside by a trust or estate, but there is little elaboration in the legislative history. This will apply to most testamentary charitable lead trusts (for which an income tax deduction under section 642(c) will typically be allowed), but not to testamentary charitable remainder trusts, and it would not address the issue of *exemption* from income tax undersection 664 anyway.

POSSIBLE ACTION: Provide that a testamentary charitable remainder trust that meets the requirements of section 664(d) is exempt from income tax without regard to the requirement for a tax deduction. Alternatively, provide such a result if an estate tax deduction would have been allowable under the estate tax as in effect in 2009.

NOTE: Because this issue arises under the regulations, either result could also possibly be achieved administratively without legislation.

Application of Carryover Basis Beyond 2010. ISSUE: What is the basis after 2010 of property received from a decedent dying in 2010?

If an asset is received from a decedent who dies in 2010, the recipient's basis is a carryover basis, as modified under section 1022. Some have speculated that if that asset is sold after December 31, 2010, its basis will be the date-of-death value under section 1014, because, undersection 901(b) of EGTRRA, the Code, including section 1014, "shall be applied and administered to years … described in subsection (a) as if the provisions and amendments described in subsection (a) [includingsection 1022] had never been enacted." Others have noted that because section 542(f)(1) of EGTRRA describes the effective date of the carryover basis rules in terms of "decedents dying after December 31, 2009," not in terms of "years," section 901(b) leaves the 2010 basis intact beyond 2010.

POSSIBLE ACTION: If the carryover basis rules are not otherwise modified, clarify the application of section 901(b) to carryover basis.

ISSUES RELATING TO STATE LAW

Federal Respect for Constructions and Reformations Under State Law. Many estate planners are concerned about the interpretation of wills and trust instruments that include formulas based on estate and GST tax concepts that do not apply for federal tax purposes in 2010. These formulas typically arise in either (i) the division of an estate of a married decedent between a disposition that qualifies for the marital deduction and a "credit shelter" or "bypass" disposition that is exempt from estate tax by reason of the unified credit or (ii) the division of an estate of a single decedent or at the death of the surviving spouse between the next generation and a generation-skipping trust that is exempt from estate tax by reason of the GST exemption.

ISSUE: Will efforts to make these formulas work as contemplated be respected for federal tax purposes?

The federal tax concerns include, for example, the concern that if a formula that appears to leave everything to the surviving spouse is construed, reformed, or otherwise applied to direct the entire estate into a trust in which the spouse has only a life income interest, the spouse would be treated as making a present gift to remainder beneficiaries while retaining an interest that would subject the value of the trust assets to estate tax upon the spouse's death.

Some states are likely to pass remedial legislation providing

rules of construction (such as deeming the reference to federal law to be references to December 31, 2009, law),

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POSSIBLE ACTIONS:

Authorize or direct the Internal Revenue Service to respect the federal tax treatment that follows from actions taken under such state remedial legislation, even if, for example, the document itself is not ambiguous (under 2010 federal tax law) and/or there is no dispute among the parties about the appropriate resolution and/or the recipients may have had no enforceable rights absent the statute?

For cases where there is no state legislation, authorize or direct the Internal Revenue Service to respect the federal tax treatment that follows from a court order or a family settlement, again even if the document itself is not ambiguous and/or there is no dispute or enforceable rights?

NOTE: Because these issues are related to enforcement, they could also possibly be addressed administratively without legislation.

GENERAL COMMENTS ABOUT CHANGES IN THE LAW

Need for Other Provisions of EGTRRA To Be Made Permanent. Whatever action Congress eventually takes with respect to the core provisions ofEGTRRA – the repeal of the estate and GST taxes and the credit for state death taxes, the introduction of carryover basis, and the 2011 "sunset" – the other provisions of Title V of EGTRRA should be made permanent, unless Congress explicitly finds a policy reason not to.

These other provisions of EGTRRA are section 551 (relating to conservation easements), sections 561, 562, 563, and 564 (relating to the GST tax), and sections 571 and 572 (relating to the extension of time to pay estate tax under section 6166). (EGTRRA also has a section 581, but by its terms it applied only to claims for refund or credit filed before June 7, 2002.)

For example, the "Estate Tax and Extension of Tax Relief Act of 2006" (H.R. 5970, 109th Congress), which the House of Representatives passed on July 29, 2006, would *not* have removed the "sunset" of those miscellaneous items.

In the current Congress, Division A of H.R. 4154 (the "Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Act of 2009"), passed by the House of Representatives on December 3, 2009, and S. 722 (the "Taxpayer Certainty and Relief Act of 2009"), introduced by Senator Baucus on March 26, 2009, would remove the "sunset" of all those miscellaneous items and make those items permanent.

Consequences of Deferred Congressional Action. Unless Congress acts very early in 2010, it might be appropriate to consider actions to mitigate the effect of the passage of time on taxpayers and their advisors and permit them to respond to any changes or clarifications in the law, including

extending, without interest or penalty, the due dates of the federal estate tax return (which would have been due October 1, 2010, for the estates of decedents who died January 1, 2010) and the return required bysection 6018 relating to large transfers at death (which is due April 15, 2011, with respect to decedents who die in 2010), and

extending the time prescribed in section 2518(b)(2) for making qualified disclaimers, including transfer disclaimers under section 2518(c)(3)where necessary.