Estate Planners Alert,

WG&L Author Roundtable Discussion: Comments on Uncertainty

The WG&L Author Roundtable, chaired by renowned estate planning expert Howard M. Zaritsky, has, in the past, addressed select features of pending estate tax reform proposals. We all now know that permanent estate tax reform did not occur in 2009, nor was the pending repeal of the estate and generation-skipping transfer taxes postponed by an “extender” bill. Congress did what most practitioners thought was unimaginable—by its inaction, it allowed the temporary repeal of the estate tax and inapplicability of the generation-skipping transfer tax to occur, and permitted the carryover basis provisions to take effect for 2010. The days are now passing towards a return to pre-EGTRRA law in 2011. No one is certain what Congress will do next, leaving estate planning in 2010 fraught with uncertainties—and, sometimes, opportunities. So, most appropriately, this third installment of the Roundtable Commentaries on estate tax reform presents and shares some of its members' thoughts and reflections on this current period of uncertainty.

Other esteemed expert members of this Roundtable or prior Roundtables include Ronald D. Aucutt (partner in the law firm of McGuireWoods LLP), Kathryn G. Henkel (partner in the law firm of K & L Gates LLP), Lloyd Leva Plaine (partner in the law firm of Sutherland, Asbill & Brennan LLP), and Stephen A. Lind (Albert R. Abramson Distinguished Professor of Law at Hastings College of the Law).

Howard Zaritsky, consulting counsel:

A Year of Uncertainty

2010 is a year of estate planning uncertainty. We really only know very few things about the estate, gift, and GST taxes in 2010, and most of these facts are subject to possible retroactive changes by Congress.

First, the gift tax remains in effect with a $1 million exemption. That is certain. The top rate is 35%, but that is subject to the chance of retroactive legislative increase.

Second, there is no estate tax on estates of decedents who die in 2010, unless Congress retroactively reimposes the estate tax. Some congressional tax-writing staff members have stated that any retroactive reimposition of the estate and GST taxes would probably exempt estates of people who have died before the bill is introduced, but such statements are not reliable.

Third, there is no GST tax on taxable terminations, taxable distributions, and direct skip transfers made in 2010, subject also to retroactive reimposition of the GST tax by Congress. This will likely protect from tax most outright generation-skipping transfers, but it is unclear whether post-2010 distributions or terminations from a 2010 direct skip gift in trust will be subject to GST taxes. The sunset provisions of EGTRRA (Sec. 901) are just not clear on this issue, and some of the top minds in the field disagree on the correct interpretation.

The best estate planning tax advice we can give our clients for 2010 includes the following:

First, start collecting basis information. Carryover basis is now the law, though this, too, is subject to possible retroactive change. It is much easier for a client to gather this information than for his or her heirs to do so, and the effort will produce useful financial information even if the client lives past 2010 or carryover basis is retroactively repealed. At a minimum, the passwords for any computerized basis records should be provided to the future executor of a client's estate.

Second, be cautious about making inter vivos generation-skipping transfers in 2010. We do not know whether the GST tax will be retroactively reimposed, nor do we know what GST exemption would be available if it were. There appears to be no GST exemption available in 2010 under the present law. Therefore, advise a client that any generation-skipping transfer in 2010 involves a risk of possible GST tax imposition.

Third, pay 2010 premiums on generation-skipping insurance trusts by policy loans or grantor loans to the trust, rather than by actual gifts. There appears to be no GST exemption to allocate in 2010, and we do not know whether such transfers would adversely affect the trust's inclusion ratio after 2010.

Fourth, clients with taxable estates are likely to have far lower taxes if they die in 2010 than if they die after 2010. In a few rare cases, a client may have an element of choice in the date of death. 2010 may not be a true "throw momma from the train" year, but the law does suggest that mandatory "do not resuscitate orders" in a living will may not be the best tax planning. This is unpleasant to discuss with clients, but it is part of the job of an estate planner in 2010.

Note: In early Spring 2010, Thomson Reuters will publish *Practical Estate Planning in 2010,* authored by Howard Zaritsky, which will provide estate planners with practical advice and guidance on what can and should be done in this period of uncertainty. This book will describe and explain strategies that preserve the greatest flexibility to deal with the unknown future of the estate, generation-skipping, and gift taxes, and will also contain numerous sample forms to assist in implementing these strategies.

Ronald D. Aucutt, partner in the law firm of McGuireWoods LLP:

Estate Planning In Uncertain Times

Because Congress did not act in 2009 to preserve the federal estate and generation-skipping transfer ("GST") taxes in 2010, the federal estate and GST taxes have been repealed for one year, while the gift tax remains in place with a $1 million exemption and a 35% maximum rate, and a "modified carryover basis" regime has been implemented to generally deny a step-up in the basis of appreciated assets at death. Then, unless Congress acts, the estate, gift, and GST taxes as they existed before 2002 will be reinstated in 2011 with a 55% rate (with a 5% surcharge on estates or cumulative gifts between $10 million and $17.184 million), a $1 million exemption for lifetime and testamentary transfers, and a $1 million exemption from GST tax (indexed for inflation since 1999). Because of this changed and unpredictable environment, clients and their advisors now face significant uncertainty in planning the gratuitous transfer of assets given the current state of transfer tax exemptions and rates.

It is impossible in this time of increased polarization and partisanship in Congress to predict if and when Congress will act to eliminate the uncertainty and disparity in the transfer tax laws. If Congress acts, it is impossible to predict the effective date of the legislation, specifically whether the legislation will be retroactive to January 1, 2010 or effective as of the date of introduction or enactment. If Congress acts and the legislation is retroactive, there undoubtedly will be a constitutional challenge to the retroactive application of the legislation. Predicting the ultimate outcome of such a challenge is impossible.

Congressional action could involve any of the following possibilities: (1) Congress could enact transfer tax legislation, effective retroactively to January 1, 2010, and either extend the 2009 transfer tax rates and exemptions or enact new rates and exemptions; (2) Congress could enact transfer tax legislation, effective as of the date of enactment, introduction, or some other action, and either extend the 2009 transfer tax rates and exemptions or enact new rates and exemptions; or (3) Congress could continue the deadlock and not enact any legislation so the above transfer tax rates and exemptions will remain in place throughout 2010, and in 2011 and beyond, respectively.

Congress's inaction may mean that some estate plans no longer meet the client's objectives and goals. In particular, plans based on formulas or decisions tied to transfer taxes may be significantly impacted by the current state of flux. Also, many wealthy individuals have estate plans that use charitable gifts or techniques, such as charitable remainder trusts or charitable lead trusts that are designed to take advantage of the federal estate tax charitable deduction with the intention of lowering or eliminating the estate tax associated with a particular transfer. The changes in the estate tax rates and exemptions may affect both the original motivation for a particular vehicle or plan and the way a plan based on formulas works. Also, because of the repeal, there are other situations where a client's estate plan will no longer accomplish the client's estate planning objectives depending on when and how Congress acts. Accordingly, clients and their advisors should review their estate planning documents to determine whether changes are in order or necessary to accomplish the client's planning objectives. Also, clients should monitor activity in Congress to see if Congress quickly clears up this mess and thereby eliminates the need for changes.

Additionally, many wills and revocable trusts contain references to the Internal Revenue Code and use terminology tied to definitions and other provisions found in the transfer tax provisions of the Code. Many of the bequests under these documents are defined in terms of tax concepts. If the words and concepts used in a formula to define the size of a bequest are no longer an applicable part of the Code, do they have any meaning in interpreting and administering the estate?

Finally, if Congress fails to act quickly and there is a carryover basis regime for part or all of 2010, estate plans must be reviewed to make sure that adequate provisions have been or are made to take advantage of the adjustments available to reduce the impact on a decedent's estate because the appreciated assets it holds no longer receive a step-up in basis to the fair market value on the date of death.

Practitioners should be aware that the uncertain environment may also provide opportunity. For example, an individual planning on making taxable gifts in 2010 may pay less gift tax because of the 35% rate and transfer more assets to grandchildren because the GST tax has been repealed, depending on when and how Congress acts.

Because it is impossible to predict what Congress will do, clients and their advisors must exercise caution. If Congress enacts legislation retroactive to January 1, 2010, the retroactivity of which withstands constitutional challenge, the gift tax rate may not be 35%, but 45% or higher. Clients who do not want to pay the increased gift tax rate and are risk averse should not make taxable gifts on the assumption that Congress will not effectively change the law retroactively.

Additionally, a client may be able to use carefully designed techniques to take advantage of the possibility that the current transfer tax laws (35% gift tax rate and no GST tax) will be available during the early part or all of 2010 depending on congressional action but avoid or minimize the impact of retroactive changes. The techniques the client may want to consider could be directed toward: (1) taking advantage of the 35% gift tax rate but avoiding the 45% gift tax if there is retroactive legislation, and (2) taking advantage of repeal of the GST tax but avoiding retroactive legislation.

Flexibility is critical. To accommodate all of this uncertainty, estate planning documents, whether revocable or irrevocable, must include necessary and appropriate provisions to provide flexibility by enabling documents to be amended or other steps to be taken to achieve estate planning objectives while minimizing or eliminating exposure to transfer taxes, no matter what form those taxes may take in the future.

About retroactivity. One issue of great concern is whether, if Congress acts, the estate and GST taxes could be reinstated retroactively to January 1, 2010. Questions have been raised about whether a retroactive tax, even one that was retroactive for a very short period of time, would pass muster under the United States Constitution. Instinctively, retroactive legislation is unfair and inappropriate and, therefore, must be unconstitutional. Courts, however, have been more tolerant, leaving the constitutional issues very much in doubt. But even if the outcome of a constitutional challenge would be hard to predict, it seems virtually certain that someone would challenge almost any period of retroactivity, calling the tax law into question while litigation and appeals, maybe all the way to the Supreme Court, are ongoing. Because lawmakers are undoubtedly aware of that possibility, perhaps all that can be said is that those in Congress who seek such legislation will seek it quickly, and that the longer it takes to resolve differences the less likely it is that Congress will invite the constitutional fight by making any change retroactive.

Note: The above is excerpted from “Estate Planning In Uncertain Times: The Impact of The Repeal of The Estate Tax and What You Need to Consider” (January 1, 2010), a white paper prepared by the Private Wealth Services Group of McGuireWoods LLP, including Ronald D. Aucutt, partner in the law firm of McGuireWoods LLP. Copyright © 2010 by McGuireWoods LLP. All rights reserved.

The complete white paper is available from the McGuireWoods website at: http://www.mcguirewoods.com/estatetax.

Lloyd Leva Plaine, partner in the law firm of Sutherland, Asbill & Brennan LLP:

A Unique Level and Quality of Uncertainty For GST Tax

A. The GST Tax and 2010. The GST tax has not been repealed for 2010. Code Sec. 2664 provides that “this chapter [meaning Chapter 13 which contains the Code sections of the generation-skipping transfer tax system] shall not apply to *generation-skipping transfers* after December 31, 2009.” (Emphasis added) This is different than the broader provision for the federal estate tax, which renders the Code provisions in Chapter 11 meaningless for decedents dying in 2010. Code Sec. 2210(a) states:

> IN GENERAL—except as provided in subsection (b) [which deals only with Qualified Domestic Trusts, i.e., marital deduction trusts for non-citizen surviving spouses], this chapter [meaning Chapter 11 which contains the Code sections of the estate tax system] shall not apply to the estates of decedents dying after December 31, 2009.

Thus, many of the GST tax sections are still applicable in 2010; however, they do not apply to generation-skipping transfers occurring in 2010. This is relevant, among other reasons, because (i) trusts created in years before 2010, (ii) trusts created by gifts in 2010, (iii) trusts created before 2010 to which gifts are made in 2010, (iv) trusts funded in 2010 with generation-skipping transfers from pre-existing non-exempt trusts, and (v) depending upon how and if the Sunset provisions are applied, trusts containing property that was not subject to estate tax at the death of decedent in 2010 (but that would have been so subject had the estate tax then been applicable) will often give rise to generation-skipping transfers occurring after 2010 when the GST tax again applies to generation-skipping transfers. These future generation-skipping transfers may be affected by actions taken in 2010 by trustees or transferors under the still relevant sections of the GST tax system, Chapter 13 of the Code.

B. Definition of Transferor. Definitions in the GST tax system are essential to the application of the GST tax. The definition of "transferor" is fundamental because, among other things, the generation assignments of the transferees are set with reference to the transferor. If none of the transferees (including remainder beneficiaries of a trust) is more than one generation below that of the transferor, no generation-skipping transfer can occur. Although, under current law, the GST tax does not apply to generation-skipping transfers in 2010, assuming it will apply to generation-skipping transfers occurring after 2010, identifying the transferor is the pivotal first step.

Generally, the transferor, under Code Sec. 2652(a) , is the individual with respect to whom property was most recently subject to federal estate or gift tax. Status as a transferor is not dependent on there being an actual transfer of property for local property law purposes, as long as the transfer is "subject to federal gift tax, or estate tax." Reg. § 26.2652-1(a)(2) provides that:

> a transfer is subject to Federal gift tax if a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits). A transfer is subject to Federal estate tax if the value of the property is includible in the decedent's gross estate as determined under section 2031 or section 2103.

Because there is still a federal gift tax, for gifts made in 2010, the donor is the transferor. Therefore, once the GST tax system is again applicable to generation-skipping transfers (after 2010—or sooner depending on changes to the law), if the 2010 gift was made to a trust, generation-skipping transfers from such a trust will be subject to the GST tax system. However, if a decedent dies in 2010 when the federal estate tax is not applicable to his estate (absent a retroactive change in the law), the property that *would have been subject to estate tax* in a year in which the estate tax was applicable, would not be subject to estate tax in 2010. Therefore, because there appears to be no "transferor" for GST tax purposes, transfers by such decedent through his will or revocable trust to a trust should be treated as resulting in a trust later transfers from which (even when the GST tax system once again applies to generation-skipping transfers) should be outside the GST tax system. Such transfers should be analogous to property transferred to irrevocable trusts prior to or on September 25, 1985, which is grandfathered from the GST tax. However, if the Sunset provisions (described later) came into effect, they provide that, for decedents dying after 2010 and generation-skipping transfers after 2010, the estate tax and GST tax are to be applied as though Code Sec. 2210 and Code Sec. 2264 never applied. This could mean that, for generation-skipping transfers after 2010, such transfers would be treated as though there had been an estate tax in 2010, and, therefore, there would be a transferor and such property would be subject to the GST system.

C. Sunset Provisions. EGTRRA also included the following Sunset provisions (quoted below), which have created a great deal of additional uncertainty—especially with respect to the application of the GST tax:

> SEC 901. SUNSET OF PROVISIONS ACT.
>
> (a) IN GENERAL — All provisions of, and amendments made by, this Act shall not apply —
>
> (1) to taxable, plan, or limitation years beginning after December 31, 2010, or
>
> (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.
>
> (b) APPLICATION OF CERTAIN LAWS — The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) *had never been enacted.* (Emphasis added)

D. Uncertainty as to the Application of the GST Tax System. A unique level and quality of uncertainty as to the application of the GST tax system is created due to the combination of the following: (i) the uncertainty as to what future action Congress may take and what its effective date will be; (ii) Code Sec. 2664, which provides that Chapter 13 does not apply to generation-skipping transfers after 2009, and (iii) the Sunset provisions (quoted above) that for estates of decedents dying after 2010, gifts made after 2010, and generation-skipping transfers after 2010, provide that the Code “shall be applied and administered” to estates of persons dying after 2010 and generation-skipping transfers after 2010 “as if the provisions and amendments” made by EGTRRA “*had never been enacted.*” (Emphasis added) There are at least the following four possible scenarios with respect to how the GST tax system will be applied. There are many uncertainties, and the following is the author's current analysis of the possible scenarios:

Scenario 1: Congress could enact a law that is retroactive so it applies to gifts made after 2009, estates of decedents dying after 2009, and generation-skipping transfers after 2009. In that case, Code Sec. 2664 and the Sunset provisions should be irrelevant. The result should be that the gift, estate, and GST tax system in place in 2009 would continue to apply without interruption—but with whatever changes to Chapter 13 that are made by the new law, e.g., an increase in the GST exemption.

Scenario 2: Congress could enact a law that is not retroactive but that is effective at some future date—for the sake of discussion, say November 1, 2010—that puts back in place the estate tax for persons dying after October 2010 and makes the GST tax apply to generation-skipping transfers after October 2010. Implications:

> (a) In such case, there would have been a period of time (January 1, 2010, through October 31, 2010) (“a GAP”) when, although the gift tax was applicable, estates of persons dying were not subject to estate tax and generation-skipping transfers were not subject to GST tax. This would make the Sunset provisions inapplicable and irrelevant. Of course, it is not known what other possible changes could be made to the transfer tax system by such possible future legislation.
> (b) With respect to gifts made during the GAP, because there was a gift tax, the donor is the transferor under Code Sec. 2652(a). Therefore, trusts created by

such gifts should be in the GST tax system so that generation-skipping transfers occurring after October 31, 2010, with respect to such trusts should be subject to the GST tax system.
(c) With respect to generation-skipping transfers occurring during the GAP, although no GST tax would be imposed on the transfer if the transfer was to a trust, the trust should be in the GST tax system and generation-skipping transfers after October 31, 2010, with respect to such trusts should be subject to the GST tax system.
(d) On the other hand, property that would have been subject to the estate tax had the decedent died before 2010 would not be subject to estate tax if the decedent died during the GAP. Accordingly, there should be no transferor under Code Sec. 2652(a) for purposes of the GST tax. Therefore, such property, for example, if it passed to a trust under the decedent's will or revocable trust, should not (for reasons explained earlier) be in the GST tax system even when the GST tax system is, in the future, applicable to generation-skipping transfers after the effective date of the new law. As stated above, if instead the Sunset provisions come into effect, it is possible that the decedent will be treated as the transferor in which case the GST tax system would be applicable to such trust.

Scenario 3: Congress does not enact a law and the Sunset provisions come into effect. This would also create a GAP for all of 2010, when the estate tax did not apply to the estates of decedents dying in 2010 and the GST tax did not apply to generation-skipping transfers in 2010. If the Sunset provisions come into effect, for generation-skipping transfers after 2010, it is as though Code Sec. 2210 and Code Sec. 2664 did not apply in 2010. Although that would not change the estate or GST taxation in 2010, it is possible that the estate and the GST tax system would be treated as having applied to decedents who died in 2010 and to generation-skipping transfers and other transfers to trusts that occurred in 2010 for purposes of applying the GST tax system after 2010 to trusts and generation-skipping transfers after 2010.

Scenario 4: Congress could enact a law and put back in place the estate tax and GST tax, for example, say effective November 1, 2010, that is not retroactive and that applies to gifts after October 2010, estates of person dying after October 2010, and generation-skipping transfers occurring after October 2010. Although it is highly unlikely, they could provide that gifts made in 2010 but before November 2010, and any property originating from the estate of someone dying in 2010 but before November 2010, and any generation-skipping transfers to further trusts in 2010 but before November 2010 would be grandfathered from the GST tax.

Basically, unless they later violated the grandfathering rules, such transfers and trusts created by such transfers would be outside the GST system. This application of this grandfathering to trusts created from 2010 gifts and from 2010 generation-skipping transfers to trusts is highly unlikely and will be referred to as “grandfathering.”

As explained earlier, however, even if there is a GAP and no express grandfathering, at least if the Sunset provisions do not come into effect, it is likely that transfers from an estate of a person dying in 2010 (before the effective date of new legislation) when the estate tax was not applicable (and trusts resulting from such transfers) should be outside the GST tax system as there should be no transferor for GST tax purposes, and, therefore, they should be effectively grandfathered from the GST tax.

© 2010 Thomson Reuters/RIA. All rights reserved.