

# 2010 Tax Act *Impacts* Estate Planning

BY CHARLES D. "SKIP" FOX IV AND THOMAS W. ABENDROTH

On Friday, December 17, 2010, President Barack Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Act), which the Senate passed on December 15 and the House of Representatives passed late on December 16. This legislation to extend the so-called "Bush tax cuts" enacted in May 2001 by the Economic Growth and Tax Relief Reconciliation Act of 2001, and which otherwise would have sunset as of January 1, 2011, was the result of a compromise between President Obama and congressional leaders.

With the 2010 Tax Act, Congress not only extended the Bush tax cuts but also made significant changes to the estate, gift, and generation-skipping transfer (GST) tax laws for 2010, 2011, and 2012. This article will equip individuals and fiduciaries and their advisers to better understand the changed environment and the obstacles and opportunities it presents.

Following are the significant changes to the estate, gift, and GST taxes for 2010, 2011, and 2012:

- a reduction of the estate, gift, and GST tax rates to 35 percent
- an increase of the estate tax and GST tax exemptions to \$5 million
- an increase in the gift tax exemption to \$5 million for 2011 and 2012
- indexing of the estate tax, gift tax, and GST exemptions for 2012
- a reunification of the estate and gift tax exemptions so that an individual can give away during life or at death up to \$5 million for 2011 and 2012
- an introduction of the concept of portability, which permits the estate of the second spouse to die to take advantage of the unused \$5 million tax exemption of the first spouse to die for 2011 and 2012
- a reintroduction of the estate tax for all of 2010 with the \$5 million exemption and a 35 percent tax rate accompanied by an election for estates of 2010 decedents to opt out of the estate tax and into a modified carryover basis regime for appreciated assets
- a reintroduction of the GST for all of 2010 with a \$5 million exemption but a zero tax rate



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**Last Will**  
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DEPARTMENT OF REVENUE

INHERITANCE TAX RETURN  
RESIDENT DECEDENT

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## For decedents dying in 2011 and 2012, the estate tax exemption is \$5 million and the estate tax rate is 35 percent.

The 2010 Tax Act provision increasing the gift tax exemption from \$1 million to \$5 million will allow many to make far larger lifetime gifts in 2011 and 2012. The estates of 2010 decedents will now have to choose between the estate tax and a modified carryover basis. This will involve comparing the costs of paying the estate tax coupled with a step-up in basis for appreciated assets against analyzing the costs of electing out of the estate tax and taking a carryover basis for assets so that the recipients of appreciated property from the decedent's estate may pay higher capital gains tax. Applying the rules governing the GST tax can be complicated.

### The Estate Tax

While the sunset provisions of the 2001 tax act repealed the federal estate tax for decedents dying in 2010 in favor of a modified carryover basis regime, the 2010 Tax Act retroactively reinstated the estate tax for 2010 decedents. The estate tax exemption amount for 2010 is \$5 million and the estate tax rate is 35 percent.

However, an executor<sup>1</sup> of an estate of a decedent who died in 2010 may elect out of the estate tax regime and instead choose to subject the estate to the modified carryover basis rules imposed in 2010 under the 2001 tax act. This election must be an affirmative election made by the executor in an appropriate manner to be determined by the Internal Revenue Service. After the election is made, it is revocable only with the consent of the Secretary of the Treasury. Whether or not the election out of the estate tax would be appropriate for a particular estate is a complicated question based on myriad disparate factors and a consideration of fiduciary duties as discussed in more detail below.

For decedents dying in 2011 and 2012, the estate tax exemption is \$5 million and the estate tax rate is 35 percent. Significantly, the 2010 Tax Act reunifies the estate and gift tax regimes. Thus, the gift tax exemption and the estate tax exemption are no longer disconnected, but instead the \$5 million exemption applies for determining the transfer taxation of an individual's lifetime gifts and transfers at death.

Additionally, the 2010 Tax Act codified the concept of estate tax exemption "portability." Under the 2001 Tax Act and prior law, an individual's estate tax exemption amount was personal and nontransferable. Now, any remaining unused \$5 million exemption of a decedent who dies in 2011 or 2012 may, under certain circumstances, be used by the decedent's surviving spouse during his or her lifetime or upon the surviving spouse's subsequent death. So with portability, a surviving spouse's gift or estate tax exemption is equal to his or her remaining \$5 million exemption plus the decedent's unused exemption. Because of the reunification of the estate and gift tax, the surviving spouse's exemption may be applied to any transfer during life or at death. In order for the surviving spouse to use the decedent's unused exemption, the executor of the decedent's estate must make an affirmative election on a timely filed estate tax return, even if an estate tax return would not otherwise need to be filed.

A surviving spouse may use only the unused exemption of his or her most recently deceased spouse. In other words, if a surviving spouse who has the use of the unused exemption of his or her predeceased spouse remarries and the second spouse also predeceases, the surviving spouse now may use only the unused exemption amount of his or her second spouse, if any, and the unused exemption of the first spouse to die is lost. The 2010 Tax Act directs the Internal Revenue Service to promulgate appropriate regulations regarding the new portability rules.

### Gift and GST Taxes

The 2010 Tax Act did not change the gift tax exemption for 2010, which remained at \$1 million. The gift tax rate applicable to taxable gifts in 2010 also remained at 35 percent. However, as noted above, starting on January 1, 2011, the gift tax exemption was unified with the estate tax exemption and is \$5 million. So for gifts made in 2010, the lifetime exemption amount was \$1 million, but the lifetime exemption amount for gifts in 2011 and 2012 is \$5 million. The gift tax rate for gifts made in 2011 and 2012 remained at 35 percent.

While the 2001 Tax Act eliminated the GST tax for transfers made in 2010, the 2010 Tax Act retroactively reinstated the GST tax with a \$5 million GST exemption, but confirmed that 2010 would indeed be a GST tax "holiday" by providing that the applicable rate for generation-skipping transfers would be zero in 2010. So in 2010, no GST taxes were imposed on direct skips or otherwise taxable distributions and terminations. In addition, the 2010 Tax Act made clear that certain subsequent distributions from trusts for the benefit of skip persons would not later be subject to GST tax pursuant to the "move-down" rule of Internal Revenue Code Section 2653(a).

For generation-skipping transfers made in 2011 and 2012, the GST exemption is \$5 million with a 35 percent tax rate. The \$5 million amount will be indexed for inflation beginning in 2012. Unlike the estate tax exemption, the GST exemption is not portable to surviving spouses.

### What's Not in the 2010 Tax Act

What is not in the 2010 Tax Act is as surprising as what actually appears in the legislation. Several of the transfer tax-related "revenue raisers" were not included in the 2010 Tax Act. This cannot be taken as a statement on the legislative priority of raising revenue; no revenue offsets are included in the 2010 Tax Act. While the absence of these revenue raisers in the 2010 Tax Act is generally considered favorable to taxpayers, many believe that some or all of the following may be taken up by a future Congress seeking to offset increasing budget deficits, permanent extensions of this or new tax regimes, or further spending.

### Minimum GRAT Term

A grantor-retained annuity trust (GRAT) has two components: an annuity interest that the grantor will retain and an interest that passes to selected beneficiaries (the remainder). The value of the gift or the remainder interest in the GRAT is measured when the trust is created, and it is calculated by subtracting the present value of the retained annuity interest from the value of

the property transferred to the trust. If the value of the annuity interest is very high, the value of the gift (that is, the value of the remainder transferred to the remainder beneficiaries) is very low. The key to the success of a GRAT is the assumption that the assets transferred into the GRAT will grow faster than the assumed growth rate that is prescribed by the Internal Revenue Service for calculating the value of the retained annuity (the Section 7520 rate).

If the grantor dies during the term of the GRAT, the assets transferred to the GRAT will be included in the grantor's estate and subject to estate tax. To avoid this mortality risk, an individual often creates a short-term GRAT (or a series of short-term GRATs) where the annuity interest is paid for two or three years. If the grantor survives the term and the assets outperform the Section 7520 rate, the appreciation in the assets of the GRAT passes to the remainder beneficiaries at a nominal gift tax cost.

An early attack on this technique took the form of rumors of Congressional plans to limit the attractiveness of GRATs by imposing a minimum gift tax value for the remainder, such as 10 percent. This effort coalesced in the Obama administration's revenue proposals for fiscal year 2010 and the Treasury's *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (the so-called "2009 greenbook") and was repeated in the 2010 greenbook for fiscal year 2011.

The 2009 and 2010 greenbook proposals focused on the term of the GRAT rather than the value of the gift and would have required the GRAT to have a minimum 10-year term. The proposal was estimated to raise \$3.25 billion in revenue over 10 years in the 2009 greenbook and \$2.959 billion over 10 years in the 2010 greenbook. Throughout 2010, various forms of the greenbook proposal were included in incarnations of transfer tax reform legislation before enactment of the 2010 Tax Act (H.R. 4849, H.R. 5486, H.R. 4899, S. 3533, and H.R. 5764). The estimated revenue would have been used to offset the permanent or temporary extension of estate tax relief.

The greenbook proposals attempt to introduce a heightened downside risk—the grantor's mortality—into a technique with little downside risk. Simply put, a longer-term GRAT increases the likelihood that assets will be included in the grantor's estate and subject to the estate tax.

A short-term GRAT has been a successful technique for capturing the upside of asset volatility. If the proposal to introduce a minimum term for a GRAT is resurrected, the ability to transfer appreciation to future generations with a GRAT still exists. Planners, however, will have to customize GRAT terms to reflect traits of the assets transferred into the trusts by using, for example, a level-term GRAT or a GRAT in which the annuity increases in some years but not others (or increases at different rates in different years).

### Attack on Discounts

Beginning with proposals during the Reagan administration and then late in the Clinton administration, limits on valuation discounts for interests in family-owned entities have been considered as a means of raising revenue. A 1999 proposal would have eliminated valuation discounts for interests in any

entity that was not an active business. Under the 1999 proposal, entities that held "readily marketable assets" or "nonbusiness assets" could not have been valued at a discount for transfer tax purposes.

In a 2005 report, "Options to Improve Tax Compliance and Reform Tax Expenditures," the Joint Committee on Taxation (JCT) continued the attack on valuation discounts, responding to "the frequent use of family limited partnerships ('FLPs') and LLCs to create minority and marketability discounts," claiming in essence that families were manufacturing discounts for transfer tax purposes.<sup>2</sup> The JCT proposed reducing the effectiveness of these discounts by applying aggregation rules (for the transferor and the transferee) to limit the discount in certain intra-family transfers.

The 2009 and 2010 greenbooks picked up where these efforts left off and proposed raising revenue by curbing techniques designed to reduce the transfer tax value of assets but not the economic benefit of the assets in the hands of the owners. Under Internal Revenue Code Section 2704(b), certain "applicable restrictions" that would otherwise justify valuation discounts (such as limitations on the ability to liquidate the entity) are ignored for transfer tax purposes in intra-family transfers. The Obama administration's proposal would have created a more durable category of disregarded restrictions under Internal Revenue Code Section 2704(b) and may have included limitations on liquidation, management, distributions, access to information, and transferability. The disregarded restrictions under this proposal would significantly limit the marketability discounts that are commonly used in valuing interests in family-owned entities.

The proposal was estimated to increase tax revenue by \$19.038 billion over 10 years in the 2009 greenbook and \$18.667 billion over 10 years in the 2010 greenbook. Of all the pay-for proposals, limitations on valuation discounts would generate the most revenue for the Treasury. Moreover, the limitations would adversely affect many common "estate freeze" techniques, including gifts and sales to trusts of interests in family-owned entities.

The proposal to limit valuation discounts made only one serious appearance in the tax debate during 2010. The Pomeroy Bill (H.R. 436) called for a separate valuation of business and nonbusiness assets in an intra-family transfer (returning to the Clinton era), causing many taxpayers, advisers, and business valuation experts to fear the end of the valuation discount era was near.

Despite these fears, the 2010 Tax Act contains no provisions regarding valuation discounts. But because of the amount of revenue estimated to be raised by limiting valuation discounts, a budget-conscious Congress may again consider some form of limitation on valuation discounts for intra-family transfers. Individuals and their advisers should consider using techniques that take advantage of valuation discounts for transfers of interests in family entities while they are still viable.

### Consistency in Basis

The 2010 Tax Act reinstated the estate tax and with it, the "step-up" in basis for assets included in the estate. This has also resurrected the debate over consistency in basis reporting.

Because the estate tax exemption has been increased to \$5 million, some will conclude that the “middle-class tax relief” objectives of estate tax reform for family farmers and ranchers have been met.

The basis of property acquired from a decedent is “the fair market value of the property at the date of the decedent’s death,” with appropriate adjustments if the alternate valuation date is used. It is possible for the beneficiary of property acquired from a decedent to claim, for income tax purposes, that the value of the asset reported by the decedent’s estate was too low, and that the beneficiary’s basis is therefore greater than the estate tax value. These claims are often made after the statute of limitations has run out on the estate tax return, and thus the beneficiary would recognize less gain and pay lower capital gains tax upon sale of the property.

The 2005 JCT report first addressed the issue of consistency in basis reporting in a systematic way, proposing that a beneficiary would be required to use an income tax basis equal to the estate tax value. The proposal called for a basis report to be filed with the IRS and delivered to the beneficiary setting forth the basis of property received by the beneficiary.

The 2009 and 2010 greenbooks addressed consistency in basis as a potential source of revenue to offset some temporary or permanent tax relief. It was expected to increase tax revenue by \$1.87 billion over 10 years in the 2009 greenbook and \$2.103 billion over 10 years in the 2010 greenbook. In subsequent comments, the JCT approved the greenbook proposal and addressed the general need for consistency in reporting across the tax system and the specific need for more realistic determinations of value on estate tax returns.<sup>3</sup>

Consistency in basis reporting appeared in the estate tax reform debate in 2010, most notably in the Responsible Estate Tax Act (S. 3533 and H.R. 5764), but was not included in the 2010 Tax Act. Because of the policy reasons behind the proposal (i.e., consistency) and the need for revenue offsets, this proposal may resurface in future debates and legislative proposals. All proposals supporting consistency in basis have included broad authority for the Treasury to issue regulations to implement the rules and would have broad impact on estate and income tax reporting.

### Benefits to Farmers

Throughout the estate tax reform debate over the last decade, legislators looked to provide political context, and garner political support, for estate tax reform proposals. The Senate Finance Committee, most notably Senators Baucus and Conrad, tried to couch the estate tax reform debate in terms of middle-class tax relief, singling out America’s family farmers and ranchers as deserving of relief.

The many incarnations of estate tax reform legislation have set forth targeted relief for family farms, including an estate tax exemption for the value of farmland so long as it was held by a

qualified heir (S. 3664), and an increase in the reduction of value under the special use valuation provisions of Internal Revenue Code Section 2032A (currently limited to \$1 million) to the applicable exclusion amount (S.722 and S. 3533, H.R. 5764).

Because the estate tax exemption has been increased to \$5 million, some will conclude that the “middle-class tax relief” objectives of estate tax reform for family farmers and ranchers have been met. Therefore, further action on these farm exemptions will not be as urgent and may not occur.

### Sunsetting

The uncertainty surrounding the estate tax during the last decade has been driven largely by Section 901 of the 2001 tax act—the sunset provisions. That section provides as follows:

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.

The 2010 Tax Act does nothing to solve the concerns with these sunset provisions. It simply replaces “December 31, 2010” with “December 31, 2012,” and invites continued speculation and confusion. Absent meaningful reform or legislation in the next two years, individuals and fiduciaries and their advisers will be in the same position in 2012 as they were in 2010: all of the tax changes will expire on December 31, 2012, and after that date the tax law “shall be applied . . . as if the provisions and amendments [of the 2001 tax act and the 2010 Tax Act] had never been enacted.” The estate tax exemptions, rates, and other provisions are scheduled to return to pre-2001 levels, reaffirming the need for flexibility in estate planning documents. ■

### Endnotes

<sup>1</sup>The term “executor” is defined in Internal Revenue Code Section 2203. <sup>2</sup>Available at [www.house.gov/jct/s-2-05.pdf](http://www.house.gov/jct/s-2-05.pdf).

<sup>3</sup>“Description of Revenue Provisions in President’s Fiscal Year 2010 Budget Proposal, Part One: Individual Income Tax, Estate and Gift Tax Provisions,” Joint Committee on Taxation (Sept. 9, 2009).

*This article is based upon the White Paper prepared by the McGuireWoods LLP entitled “The 2010 Tax Act’s Impact on Estate Planning and Administration: Making Sense Out of the Confusion,” which was issued on January 12, 2011.*

### ABOUT THE AUTHORS

**CHARLES D. “SKIP” FOX IV** of McGuireWoods LLP in Charlottesville, Va., can be reached at (434) 977-2500 or via e-mail at [cfox@mcguirewoods.com](mailto:cfox@mcguirewoods.com).

**THOMAS W. ABENDROTH** of Schiff Hardin LLP in Chicago, can be reached at (312) 258-5501 or via e-mail at [tabendroth@schiffhardin.com](mailto:tabendroth@schiffhardin.com).