CHAPTER 7


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WENDY ANN WILKENFELD

Synopsis

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¶ 700 Scope of Article

This article is a description of selected provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, dealing with changes to the transfer tax system. It is not meant to include all gift, estate and generation-skipping transfer tax planning issues in light of the new law.

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1 The specimen language contained in this article is intended to be illustrative only. The authors make no representation as to the validity of any of the specific language contained in this article or as to the effectiveness of such language or any planning suggestions made by the article for tax or other purposes and the authors disclaim any liability arising from their use.

2 With appreciation to Christopher F. Tate, Esq. of Sutherland Asbill & Brennan LLP for his assistance with this article. Parts of the GST tax discussion in this article are drawn from a draft of an article that was published in the September 2001 issue of THE JOURNAL OF TAXATION, Vol. 95, No. 3 by the co-author of this article, Lloyd Leva Plaine of Sutherland Asbill & Brennan LLP, Washington, D.C.; Carol A. Harrington of McDermott, Will and Emery, Chicago, Illinois; Carlyn S. McCaffrey of Weil Gotshal and Manges, LLP, New York, New York; and Pam H. Schneider of Gadsden Schneider & Woodward LLP, King of Prussia and Philadelphia, Pennsylvania.
§ 701 107th (Current) Congress

§ 701.1 Legislative Proposal

A. In the House

H.R. 8 ("Death Tax Elimination Act of 2001" — Dunn/Tanner) ("New H.R. 8") was reported out of the House Ways and Means Committee on March 29, 2001, and passed by the House on April 4, 2001, by a vote of 274 to 154. It provided for a gradual reduction in the top marginal estate and gift tax rates with a total repeal of the estate, gift and generation-skipping transfer ("GST") taxes in 2011, i.e., for decedents dying and gifts and generation-skipping transfers after 2010. H.R. 8 would have replaced the unified credit with a unified exemption amount. Further, once the transfer taxes were repealed, it would have adopted a carryover basis system similar to that in the Act.

B. In the Senate

The Senate passed H.R. 1836 on May 23, 2001 by a 62-38 vote. It provided for a gradual reduction in the top marginal estate and gift tax rates with a total repeal of the estate and GST taxes in 2011, i.e., for decedents dying and GSTs after 2010. The Senate Bill would have increased the unified credit so that the exemption equivalent for the estate tax would have increased to $1,000,000 in 2002; $2,000,000 in 2004; $3,000,000 in 2005; $3,500,000 in 2009; and $4,000,000 in 2010. The gift tax exemption equivalent would have increased to $1,000,000 in 2002 and have stayed at that level. The gift tax top rate would have become 40% in 2011 — after repeal of the estate and the GST taxes.

The GST exemption would have equaled the estate tax exemption equivalent of the unified credit starting in 2004. Further, once the estate tax and the GST tax were repealed, it would have adopted a carryover basis system similar to that in the Act.

C. In Conference

After the Conferees worked out the Conference version of the bills, H.R. 1836, the House approved the package by a vote of 240-154 and the Senate by a vote of 58-33, both on Saturday, May 26. The President signed the

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3 Ways and Means ranking Democrat Rangel had offered an alternative to H.R. 8 that would have increased the current estate tax exclusion from $675,000 to $2,000,000 ($4,000,000 for married couples), effective January 1, 2001. His substitute would have also increased the exclusion every other year in $100,000 increments, ultimately reaching $2,500,000 for individuals ($5,000,000 for married couples) by 2010.

**¶ 701.2 Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001**

**A. Rate Reductions**

<table>
<thead>
<tr>
<th>Gifts Made in, Estates of Decedents Dying in and GSTs in</th>
<th>Top Marginal Estate and Gift Tax Rate and GST Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>50% (5% estate and gift tax surtax repealed)</td>
</tr>
<tr>
<td>2003</td>
<td>49%</td>
</tr>
<tr>
<td>2004</td>
<td>48%</td>
</tr>
<tr>
<td>2005</td>
<td>47%</td>
</tr>
<tr>
<td>2006</td>
<td>46%</td>
</tr>
<tr>
<td>2007</td>
<td>45%</td>
</tr>
<tr>
<td>2008</td>
<td>45%</td>
</tr>
<tr>
<td>2009</td>
<td>45%</td>
</tr>
</tbody>
</table>

The gift and estate taxes still use a unified rate schedule until 2010.

**B. “Repeal”**

In 2010 (i.e., for decedents dying and GSTs in 2010), the estate and GST taxes would be “repealed.” Technically, § 501 of the Act adds two new Code sections, § 2210 and § 2664, both titled “TERMINATION.” Section 2210 provides that Chapter 11 (the federal estate tax) (with the exception of the QDOT tax of § 2056A(b)(1)) “shall not apply to the estate of decedents dying after December 31, 2009.” Section 2664 provides that Chapter 13 (the federal GST tax) “shall not apply to generation-skipping transfers after December 31, 2009.” Therefore, although the heading of Act § 501 is
“REPEAL OF ESTATE AND GENERATION-SKIPPING TRANSFER TAXES,” technically the Code provisions of Chapter 11 and Chapter 13 remain in the Code, but “shall not apply . . . after December 31, 2009.” The fact that the provisions are still in the Code will be relevant in determining how to draft when referring to estate and GST tax provisions.\(^4\)

C. Applicable Credit/Exclusion Increases

The applicable exclusion amount (also referred to as the exemption equivalent of the unified credit), is increased to $1,000,000 by the Act for gifts made, and estates of decedents dying, in 2002. The amount stays at $1,000,000 for gifts made after 2001 but the amount increases, as set forth below, for the applicable exclusion amount for the estate tax. As under pre-Act law, the applicable exclusion amount used for gifts would reduce the applicable exclusion amount available (at death) for the estate tax. Specifically, if a donor had used the $1,000,000 gift tax applicable exclusion amount prior to his or her death in 2009, only $2,500,000 of the $3,500,000 applicable exclusion amount for the estate tax would be available.\(^5\)

\(^4\) This article uses the word “repealed” and the words “the tax no longer applies” or “the tax is not applicable” interchangeably — all are intended to have the same meaning.

\(^5\) § 2010(c). Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"). Unless otherwise indicated, all references to “Treas. Reg. §” are to sections of the regulations promulgated by the Treasury under the Code.
### Applicable exclusion amount

<table>
<thead>
<tr>
<th>Estates of decedents dying in</th>
<th>Applicable exclusion amount (exemption equivalent of the unified credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2003</td>
<td>1,000,000</td>
</tr>
<tr>
<td>2004</td>
<td>1,500,000</td>
</tr>
<tr>
<td>2005</td>
<td>1,500,000</td>
</tr>
<tr>
<td>2006</td>
<td>2,000,000</td>
</tr>
<tr>
<td>2007</td>
<td>2,000,000</td>
</tr>
<tr>
<td>2008</td>
<td>2,000,000</td>
</tr>
<tr>
<td>2009</td>
<td>3,500,000</td>
</tr>
</tbody>
</table>

### D. Gift Tax

The gift tax system would remain in place with a top marginal bracket in 2010 equal to 35%. Section 511(d) of the Act is entitled “MAXIMUM GIFT TAX RATE REDUCED TO MAXIMUM INDIVIDUAL TAX RATE AFTER 2009,” however, § 2502(a) (relating to the rate of the gift tax) just shows the maximum rate at 35% for gifts over $500,000 in 2010. There is no reference in the statute itself to the individual tax rate. The reason for keeping the gift tax was to back up the income tax system and to discourage gifts of appreciated assets to persons in lower income tax brackets or to non-resident aliens. Section 2511(c), added by the Act, treats transfers in trust after December 31, 2009, as taxable gifts unless the trust is treated as wholly owned by the donor or the donor’s spouse under subpart E of part 1 of subchapter J of chapter 1, i.e., sections 671–679 of the Code. This section attempts to align the completed gift rules with the grantor trust rules. Specifically, Congress did not want a taxpayer to be able to shift the taxation of property’s income to a taxpayer in a lower income tax bracket without being treated as having made a gift of the property. The Section may need technical correction — or explanatory legislative history — to clarify that it does not hurt exclusions from the gift tax under § 2503.
E. GST Exemption

The GST exemption for any calendar year after 2003 will be the same as the applicable exclusion amount for estates in the chart above. Before 2004, the GST exemption was not changed by the Act and stays indexed as it is under pre-Act law. The GST exemption for 2001 was $1,060,000, Rev. Proc. 2001-13, 2001-03 I.R.B. 337, and is $1,100,000 for 2002. Rev. Proc. 2001-59, 2001-52 I.R.B. 623. If the law reverts back to its pre-Act state in 2011, presumably the GST exemption will be the 2003 amount of the GST exemption indexed for inflation until 2011.

F. Old Law SPRINGS BACK Into Existence in 2011

Title IX of the Act, “Compliance with Congressional Budget Act” provides in § 901, “Sunset of Provisions of Act,” that “[a]ll provisions of, and amendments made by, this Act shall not apply . . . to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.” The Internal Revenue Code of 1986 SPRINGS BACK into place and is to be applied to estates, gifts and GSTs after December 31, 2010 as if the provisions and amendments made by the Act had never been amended. Congress may, among other possibilities, roll the sunset forward a year at a time, make the “repeal” permanent or stop the transition in a particular year — for example, when the estate tax applicable exclusion and the GST exemption are $2,000,000, when the gift tax applicable exclusion is $1,000,000, and when the estate, gift and GST tax rates are a flat 45%.

G. Basis

The adjustment in basis at death to estate tax value (hereinafter referred to as “step-up in basis”) that is in effect under current law, except as provided below, will be eliminated beginning with decedents dying after December 31, 2009. Property that does not meet one of the following criteria will have a “carryover basis” determined in a similar manner as the basis of property acquired by gift is determined under current law under § 1015. Therefore, in general, the property would receive a basis equal to

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6 § 2631(a) and § 2631(c).
7 Much of this discussion was drawn from the Official Committee Report of Estate Tax Repeal Bill, H. Rept. 107-37 (4/3/01) (“House Report”) if still relevant and The Conference Report to H.R. 1836, H. Rept. 107-84 (May 26, 2001) (“Conference Report”). It is interesting to note that the former report stated that the “staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Internal Revenue Code and that have ‘widespread applicability’ to individuals or small businesses.”
8 § 1022.
the lesser of the decedent’s adjusted basis or the fair market value of the property on the decedent’s death.

The executor can increase basis in several ways. The executor can increase basis in assets acquired from and owned by the decedent by $1,300,000. The $1,300,000 would be increased by any capital loss carryover under § 1212(b), the amount of any net operating loss carryover under § 172 which (but for the decedent’s death) would be carried from the decedent’s last taxable year to a later taxable year plus the sum of the amount of any losses that would have been allowable under § 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent’s death (“built-in” losses of the decedent).

The executor can increase basis of property acquired from and owned by the decedent that passes to a surviving spouse (“qualified spousal property”) by a total of an additional $3,000,000, if property:

(1) passed outright to a spouse with rules similar to those in § 2056(b)(i), e.g., it will not be qualified spousal property if on the lapse of time [other than the spouse’s death for a period not exceeding six months after the decedent’s death], on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, or

(2) passed as qualified terminable interest property (defined to mean property that passes from the decedent and the spouse has a qualifying income for life-entitlement to all the income payable annually or at more frequent intervals and no person has a power exercisable during the surviving spouse’s life to appoint the property to anyone other than the surviving spouse.)

Therefore, property in a marital deduction estate trust for the surviving spouse does not qualify for the $3,000,000 basis adjustment. Property in a general (testamentary) power of appointment marital trust should qualify, but only if it were drafted in a manner that also met the qualified terminable interest property rules.

The executor could, where there was a surviving spouse, increase the basis of assets passing to the surviving spouse by $4,300,000, or increase the basis of assets passing to the surviving spouse by $3,000,000 and increase the basis of assets passing to others by $1,300,000. Basis increase is allocated by the executor on an asset by asset basis (e.g., to a share or block of stock). The executor elects which assets receive the basis adjustment and the extent of increase. However, the adjustment cannot cause asset basis to exceed the fair market value of the asset. Under Section 1022 of the Code, nonresidents who are not U.S. citizens would be allowed to increase basis...
by up to $60,000. All of the basis increase amounts (i.e., $1,300,000, $3,000,000 and $60,000) for decedents dying after 2010 are indexed for inflation occurring after December 31, 2009.

Property acquired from the decedent is eligible for a basis increase. Property acquired from the decedent includes:

1. Property acquired by bequest, devise, or inheritance;
2. Property acquired by the decedent’s estate from the decedent;
3. Property transferred in trust by the decedent during his lifetime to a qualified revocable trust (as defined in § 645(b)(1));
4. Property transferred in trust by the decedent during his lifetime with respect to which the decedent has reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; and
5. Any other property passing from the decedent by reason of the decedent’s death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties).

Such property must be owned or treated as owned by the decedent at death. Ownership is defined narrowly and does not include all properties acquired from the decedent described in the paragraph above. For example, property in a QTIP trust at the death of the surviving spouse would not appear to be eligible for the surviving spouse’s estate’s $1,300,000 basis adjustment (unless the trustee had the authority to, and did, distribute the property out of the QTIP trust to the surviving spouse before death).

In the case of property held as joint tenants or tenants by the entireties with the surviving spouse, one-half of the property is treated as having been owned by the decedent and is thus eligible for the basis increase.

In the case of property held as joint tenants with right of survivorship with a person other than the surviving spouse, the portion of the property

9 Whenever this article refers to a “qualified revocable trust,” it refers to the definition in § 645(b)(1), i.e., “any trust (or portion thereof) which was treated under section 676 as owned by the decedent of the estate referred to . . . by reason of a power in the grantor (determined without regard to section 672(e)).” Section 676 provides that the grantor shall be treated as the owner of any portion of a trust, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both. However, that does not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under § 673 (the reversionary interest provision) if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.
attributable to the consideration furnished by the decedent is treated as having been owned by the decedent and will be eligible for a basis increase.

In the case of property held as joint tenants with right of survivorship with a person other than the surviving spouse, if the property was acquired by them by gift, bequest, devise or inheritance and their interests are not otherwise specified or fixed by law, the decedent shall be treated as the owner to the extent of the value of a fractional part — to be determined by dividing the value by the number of joint tenants.

The decedent also is treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a qualified revocable trust. The decedent also is treated as having owned the surviving spouse’s one-half share of community property (which will be eligible for a basis increase) if at least one-half of the whole of the community interest is treated as owned by, and acquired from, the decedent. The decedent shall not, however, be treated as owning any property solely by reason of holding a power of appointment with respect to such property (whether a special or general power of appointment). Therefore, property held in a § 2056(b)(5) general power marital deduction trust at the death of the surviving spouse would not appear to be eligible for the surviving spouse’s estate’s $1,300,000 basis adjustment. Presumably, if the surviving spouse exercised the general power in favor of his or her estate, the property would be eligible for the basis adjustment (but there are often non-tax reasons why that would not be desirable).

The following property would not be eligible for an adjustment to basis:

1. Property that was acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration during the three-year period ending on the date of the decedent’s death (other than from his or her spouse — unless the spouse had during such three-year period acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration). Query what if property was acquired for a dollar less than its fair market value;

2. Property that constitutes a right to receive income in respect of a decedent;

3. Stock or securities of a foreign personal holding company;

4. Stock of a domestic international sales corporation (or former domestic international sales corporation);

5. Stock of a foreign investment company; and

6. Stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).
Several provisions of the Act deal with the treatment of gains. The character of gain on the sale of property received from a decedent’s estate is treated the same as if the property had been acquired by gift. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent would be subject to recapture if sold by the heir.

Gain on the transfer of property by an executor of an estate in satisfaction of a pecuniary bequest is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent’s death (not the property’s carryover basis). Therefore, if a $20,000 cash legacy were funded with an asset worth $20,000 on the funding date in which the decedent had a $5,000 basis (to which no basis adjustment was allocated) and which had a $19,000 value on the date of death, the estate would recognize $1,000 of gain on funding, and the legatee would have a $6,000 basis in the asset. The Act states that these same rules will apply to trusts to the extent regulations are promulgated.\textsuperscript{10} In the interim, a § 645 election (i.e., an election to treat a qualified revocable trust as an estate) would need to be made to avoid such gain treatment for trusts. The Conference Report states “losses” also are not recognized. However, the Act is silent as to losses. Section 267(b)(13) allows losses for estates but not for revocable trusts. If a loss were at issue, a trust could make a § 645 election to be treated as an estate.

Gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent’s basis in that property. Similarly, no gain is recognized by the estate on the distribution of such property to a beneficiary of the estate (other than to a tax-exempt beneficiary) by reason of the liability. The section is silent with respect to revocable trusts — presumably a § 645 election would have to be made to get the same treatment for a revocable trust. A tax-exempt beneficiary is defined to include the United States, a state, a possession, an organization exempt from income tax, any foreign person or entity (within the meaning of § 168(h)(2) — e.g., a foreign government or organization and any person who is not a U.S. person), and to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance. Except with respect to a tax-exempt beneficiary, in determining whether gain is recognized and in determining the adjusted basis of such property, liabilities in excess of basis are disregarded.

The income tax exclusion of up to $250,000 of gain on the sale of a principal residence would be extended to estates and heirs and a trust

\textsuperscript{10} § 1040.
which immediately before death was a qualified revocable trust. If the
decedent’s estate or a person who acquired such property from the
decedent (within the meaning of § 1022) or the qualified revocable trust
sells the decedent’s principal residence, $250,000 of gain may be excluded
on the sale of the residence, provided the decedent used the property as
a principal residence for two or more years during the five-year period prior
to the sale. In addition, if an heir/beneficiary occupies the property as a
principal residence, the decedent’s period of occupancy of the property
as a principal residence may be added to the heir’s subsequent occupancy
in determining whether the property was occupied for two years as a
principal residence.

The present-law rule providing that transfers by a U.S. person to a foreign
trust or estate generally is treated as a sale or exchange is expanded. Under
the Act, transfers after 2009 by a U.S. person’s estate to a nonresident who
is not a U.S. citizen would be treated as a sale or exchange of the property
for an amount equal to the fair market value of the transferred property.
The amount of gain that must be recognized by the transferor is equal to
the excess of the fair market value of the property transferred over the
adjusted basis of such property in the hands of the transferor.

The Act imposes new reporting rules. For lifetime gifts, a donor required
to file a gift tax return under § 6019 would be required to furnish to each
person whose name is required to be set forth in the gift tax return a written
statement showing the following:

(1) the name, address, phone number of the donor, and
(2) the information specified in the gift tax return with respect to the
property received by the person (e.g., basis, a description of the
property, value of the property).

Such information is to be furnished not later than 30 days after the date
the gift tax return is filed.

For transfers at death of non-cash assets in excess of $1,300,000 (as
adjusted for inflation) and for appreciated property received by a decedent
within three years of death (which was ineligible for a basis adjustment due
to § 1022(d)(1)(C) — the three-year rule — if such property was required
to be reported on a gift tax return), the executor of the estate (or the
trustee of a revocable trust) would report to the IRS on a § 6018 return
(required to be filed with the decedent’s final income tax return or such
later date specified in regulations) the following information:

(1) the name and taxpayer identification number of the recipient of
the property;
(2) an accurate description of the property;
(3) the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death;

(4) the decedent’s holding period for the property;

(5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;

(6) the amount of basis increase allocated to the property under § 1022(b) or (c);

(7) any other information as the Treasury Secretary may prescribe; and

(8) if the executor is unable to make a complete return as to any property, the executor shall include in the § 6018 return a description of the property and the name of every person holding an interest therein.

Similar information (including the name, address, and phone number of the person making the return) would be required to be provided to recipients of such property within 30 days after the date the above return was filed.

There are also penalties for failure to file required information, as follows:

(1) Any person required to report to beneficiaries and donees under § 6018(e) or § 6019(b) shall pay a penalty of $50 for each failure to report such information to a beneficiary;

(2) Any person required to furnish any information under § 6018 who fails to do so would be liable for a penalty of $10,000 for the failure to report such information (or $500 in the case of a failure to furnish information in accordance with § 6018(b)(2)); and

(3) No penalty would be imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or a beneficiary under the proposal is due to intentional disregard of the rules, then the penalty would be five percent of the fair market value of the property for which reporting was required, determined at the date of the decedent’s death (for property passing at death) or determined at the time of gift (for a lifetime gift).

H. Generation-Skipping Transfer Tax

Several changes, mainly dealing with the allocation of GST exemption found at §§ 2631 and 2632 and the derivation of the inclusion ratio (§ 2642) were made by the Act. These changes were designed to make it less likely that taxpayers, tax planners and tax return preparers will make costly mistakes involving the use of the GST exemption and to help them
correct past errors. These provisions are effective immediately, many with retroactive effect. These provisions also are subject to the sunset provisions in 2011. The following description of those changes includes the stated “Reasons for Change” from the House Report.

1. Expanded Automatic Allocation of GST Exemption

According to the House Report, the “Committee recognizes that there are situations where a taxpayer would desire allocation of generation-skipping transfer tax exemption, yet the taxpayer had missed allocating generation-skipping transfer tax exemption to an indirect skip, e.g., because the taxpayer or the taxpayer’s advisor inadvertently omitted making the election on a timely-filed gift tax return or the taxpayer submitted a defective election. Thus, the Committee believes that automatic allocation is appropriate for transfers to a trust from which generation-skipping transfers are likely to occur.” It appears from this explanation that the drafters of the expanded automatic allocation rule did not intend for taxpayers routinely to ignore the GST exemption allocation issues when filing tax returns, but rather intended to make it less likely that an inadvertent failure to allocate will have dire tax consequences. However, to some extent, the expansion may have simply shifted the way in which inattention to the GST tax in the preparation of the tax return can harm taxpayers because the expansion may have made it more likely that an inadvertent failure to elect out of the expanded automatic GST exemption allocation rules will create problems. This is particularly likely to be the case in the early years as practitioners adjust to the new rules.

New § 2632(c) of the Act expands the automatic allocation rules, which previously applied only to direct skips, to apply also to “indirect skips,” a new defined term. As was the case prior to this expansion (with respect to the automatic allocation to direct skips), transferors can elect, on a timely-filed gift tax return for the year in which the transfer was made or deemed to have been made (or on such later date or dates as may be prescribed by the Treasury Secretary) not to have the automatic allocation rules apply to a transfer. An indirect skip subject to the estate tax inclusion period (ETIP) rules of § 2642(f) is deemed to have been made at the close of the ETIP. The fair market value of such transfer shall be the fair market value of the trust property at the close of the ETIP.

An indirect skip is a transfer to a “GST trust” that is subject to gift tax that is made after December 31, 2000 or subject to ETIP ending after that date. Any unused portion of such individual’s GST exemption would be allocated to the property transferred to the extent necessary to make the

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11 House Report, p. 35.
inclusion ratio for the property zero. The unused portion of an individual’s GST exemption is that portion of such exemption which has not previously been allocated by such individual, treated as allocated under § 2632(b) to an inter vivos direct skip occurring during or before the calendar year in which the indirect skip is made or treated as allocated under § 2632(c)(1) with respect to a prior indirect skip.

In order to determine whether the new rules apply to a particular transfer it is necessary to determine whether the trust meets the definition of a GST trust, another new defined term. A “GST trust” is defined broadly as a trust that could have a GST with respect to the transferor unless:

(i) the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons:
   (a) before that individual reaches 46 years of age (for example, the trust property passes to child when child reaches age 44), or
   (b) on or before one or more dates specified in the trust instrument that will occur before such individual attains 46 years of age (for example, child is now 40 and the trust property passes to child in 2004), or
   (c) upon the occurrence of an event that (in accordance with Treasury Regulations) may reasonably be expected to occur before the date that such individual attains age 46 (for example, child is now 20 and the trust property passes to child when the child finishes college);

(ii) the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the instrument (by name or by class) who is more than ten years older than such individuals;

(iii) the trust instrument provides for mandatory distribution of more than 25% of the trust corpus to the estate or estates of, or subjects such corpus to a general power of appointment held by, one or more such non-skip persons if one or more such non-skip person dies on or before a date or event described in (i) or (ii) above;

(iv) it is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;

(v) it is a charitable lead annuity trust, charitable remainder annuity trust, or a charitable remainder unitrust; or
(vi) it is a charitable lead unitrust ("CLUT") the noncharitable beneficiary of which is a non-skip person. Therefore, a CLUT the noncharitable beneficiary of which is a skip person will be a GST trust to which automatic allocations would be made unless an election were made to elect out of the provisions.

The provision puts the following gloss on this general definition: The value of transferred property is not considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the annual exclusion amount referred to in § 2503(b) with respect to any transferor. Note that this means that the existence of an annually lapsing withdrawal right (often referred to as a "Crummey power") held by a non-skip person, such as a spouse or child of the transferor, will not by itself prevent a trust from meeting the definition of a GST trust. However, the existence of a power that does not lapse in its entirety each year such that the amount that can be withdrawn, at least beginning in the second year of the trust, exceeds the annual exclusion amount (often referred to as a "hanging power") would likely prevent the trust from being a GST trust and therefore prevent the automatic allocation rules from applying to a transfer to it. The statute assumes that powers of appointment held by non-skip persons will not be exercised.

A problem with the statute is that the definition of GST trust is overinclusive. Neither the exception noted in paragraph (ii) above nor the one that is described in paragraph (i) applies to the following common type of trusts: (1) a trust that provides for a parent and his or her child or children until the parent’s death and then holds the trust property in further trust until the child reaches a specified age, with outright distribution thereafter or (2) an insurance trust that provides for distribution of the trust property on the later of the insured’s death or when the insured’s child reaches a specified age.

These types of trusts do not fit within the exception described in paragraph (i) because the death of an individual’s parent, in most instances, may not reasonably be expected to occur before the child reaches age 46. It does not fit within the exception described in paragraph (ii) because no portion of the trust property would be distributed to the child at the death of the parent unless the child had already reached the specified age.

Because these trusts are not described in either paragraph (i) or (ii), and assuming that none of the other exceptions apply, the trusts would be GST trusts and GST exemption would be allocated automatically. The oldest child’s attainment of the specified age could, if his or her share is
25% or more, cause the trust to shift from a GST trust to a non-GST trust at some point, and the automatic allocation would not apply to transfers to the trust that occur after that event.

Because most individuals outlive their parents and reach age 45, if the specified age is younger than age 46, it is likely that most transferors would not want to allocate GST exemption to the trust. When that is the case, and the trust is classified as a GST trust, the donor should elect out of the automatic allocation.

Further, if the insurance trust provided for the payment to the child at the later of the death of the insured and the insured’s surviving spouse, it is unclear whether the exception described in paragraph (ii) would apply because the death of more than one person who is more than ten years older would be involved. Therefore, it is likely that such a trust would be a GST trust, and the donor should elect out of automatic allocation.

The importance of making elections under this section is significant. These provisions were intended to be only default provisions. It will be extremely important, in most cases, for the transferor to elect out of the automatic allocation provisions, and then decide whether to make the allocation himself or herself. This is particularly important if (i) a late allocation is desirable because values had decreased since the time of the gift; or (ii) the trust’s GST potential is significantly less than that of other trusts in the estate plan.

In order to ease the administrative burden of annually electing out of the automatic allocation rules, transferors can elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust (“elected out trust”) and may elect to treat any trust as a GST trust with respect to any or all transfers made by the individual to such trust. It is unclear whether the elections are irrevocable; hopefully they are not. Certainly, if the transferor elects for a trust to be an “elected out trust,” he or she is free to allocate to the trust (or to transfers to the trust) at any time. The effect of the election to be an “elected out trust” is just that there will not be an automatic allocation to indirect skips to that trust. On the other hand, when an election is made to treat a trust as a GST trust, if the election is irrevocable, one may not be able to prevent automatic allocations to future indirect skip transfers to the trust. However, it seems likely the transferor could still use the provision that allows an election to have the automatic provision not apply to a particular transfer to a trust.\textsuperscript{12} Until the IRS indicates its view on this issue, the election probably should explicitly provide either that it is intended to apply only

\textsuperscript{12} § 2632(c)(A)(i).
for the current year or that it is intended to apply only until the transferor “elects out” of GST Trust treatment on a future Form 709.

Such elections are to be made on a timely filed gift tax return for the calendar year for which the election is to become effective.\(^{13}\) If such elections are to be made and the transferor has extended his or her income tax return due date, the box should be checked also to extend the gift tax return due date.

The provision applies to transfers subject to estate or gift tax made after December 31, 2000 and to estate tax inclusion periods or ETIPs ending after December 31, 2000.

2. New Retroactive Allocation of GST Exemption When Certain Beneficiaries Predecease Transferor

“A transferor likely will not allocate generation-skipping transfer tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor’s child unexpectedly dies such that the trust terminates in favor of the transferor’s grandchild, and generation-skipping transfer tax exemption had not been allocated to the trust, then generation-skipping transfer tax would be due even if the transferor had unused generation-skipping transfer tax exemption.”\(^{14}\)

One reason for this change, according to the House Report, is that the “Committee recognizes that when a transferor does not expect the second generation (e.g., the transferor’s child) to die before the termination of a trust, the transferor likely will not allocate generation-skipping transfer tax exemption to the transfer to the trust. If a transferor knew, however, that the transferor’s child might predecease the transferor and that there could be a taxable termination as a result thereof, the transferor likely would have allocated generation-skipping transfer tax exemption at the time of the transfer to the trust. The Committee believes it is appropriate to provide that when there is an unnatural order of death (e.g., when the second generation dies before the first generation transferor), the transferor can allocate generation-skipping transfer tax exemption retroactively to the date of the respective transfer to trust.”\(^{15}\)

Under new § 2632(d), a transferor can elect to make a retroactive allocation of his or her unused GST exemption to a previous transfer (or transfers on a chronological basis) in a trust, if a beneficiary of the trust

\(^{13}\) Notice 2001-50, 2001-34 I.R.B. 189.
\(^{14}\) Conference Report, p. 199.
\(^{15}\) House Report, p. 37, emphasis added.
(with an interest or future interest) is a lineal descendant of the grandparents of the transferor or of the grandparents of the transferor’s spouse or former spouse, who is in a lower generation than the transferor, i.e., a child, niece, nephew or child of a first cousin (first cousin once removed) of the transferor or the transferor’s spouse or former spouse, and if that beneficiary dies before the transferor. The allocation would be made on a timely filed gift tax return for the year of the non-skip person’s death. The amount of the transferor’s unused GST exemption is determined immediately before the non-skip person’s death. The allocation would be effective immediately before death of the non-skip person, but it would use the gift tax value — as though it had been a timely allocation.

This new rule applies to deaths of non-skip persons after December 31, 2000.

3. Certain Trust Severances Recognized and Inclusion Ratio Realignments Permitted

“Under Treas. Reg. 26.2654-1(b), a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ratio of one) only if (1) the trust is severed according to a direction in the governing instrument or (2) the trust is severed pursuant to the trustee’s discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Under current Treasury Regulations, however, a trustee cannot establish inclusion ratios of zero and one by severing a trust that is subject to the generation-skipping transfer tax after the trust has been created.”

One reason for this change, according to the House Report, is that “[c]omplexity can be reduced if a generation-skipping transfer trust is treated as two separate trusts for generation-skipping transfer tax purposes — one with an inclusion ratio of zero and one with an inclusion ratio of one. This result can be achieved by drafting complex documents in order to meet the specific requirements of severance. The Committee believes it is appropriate to make the rules regarding severance less burdensome and less complex.”

Under new § 2642(a)(3), the general rule is that a trust can be severed into multiple trusts if it is a “qualified severance.” The trusts resulting will

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16 This provision applies if the beneficiary is a descendant of a child or of a niece or nephew who is treated as being in the generation of the child or niece or nephew by reason of the predeceased parent rule of § 2651(e).
17 Conference Report, p. 200.
18 House Report, p. 38.
thereafter be treated as separate trusts for purposes of the GST tax. A qualified severance is “the division of a single trust and the creation (by any means available under the instrument or local law) of two or more trusts if (i) the single trust was divided on a fractional basis, and (ii) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.” A qualified severance is also “any other severance permitted under regulations prescribed by the Secretary.” Regulations are also to indicate the manner in which the qualified severance is to be reported.

The “succession of interests” language is drawn from Treas. Reg. § 26.2654-1(b)(ii)(A) which provides that “the terms of the new trusts [must] provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust.” The Preamble to the regulations provided as follows:

“The final regulations provide that the trusts resulting from the severance of a single testamentary trust need not be identical. Thus, if the trust provides income to spouse, remainder to child and grandchild, the trust may be severed to create two trusts, one with income to spouse, remainder to child and a second with income to spouse, remainder to grandchild. This result could be achieved through proper estate planning in any event. However, the regulations make it clear that the resulting trust must provide for the same succession of interests as provided for under the original trusts. Thus, a trust providing for an income interest to a child, with remainder to a grandchild, could not be divided into one trust for the child (equal in value to the child’s income interest) and another for the grandchild.” (Emphasis added.)

Under new § 2642(a)(3), an important and very helpful special rule applies when the undivided trust has an inclusion ratio other than one or zero. Under the special rule, a severance is a qualified severance only if it is divided into two trusts (one of which will have an inclusion ratio of one and the other of which will have an inclusion ratio of zero) so that the trust with the zero inclusion ratio receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. It is not clear what the result would be under the Code provision if the applicable fraction is exactly 50% because then both trusts would “receive a fractional share of the total value of all trust assets equal to the applicable fraction.” Hopefully regulations will allow the trustee to designate which trust receives which inclusion ratio under such a situation. This provision is effective immediately as it applies to severances made after December 31, 2000.

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4. Valuation Rules for Purposes of GST Exemption Allocations Clarified

One reason for this change, according to the House Report, is that the “Committee believes it is appropriate to clarify the valuation rules relating to timely and automatic allocations of generation-skipping transfer tax exemption.”

Under new § 2642(b)(1) and (b)(2), the value of property for purposes of determining the inclusion ratio in connection with timely and automatic allocations of GST exemption is its value as finally determined for gift tax purposes (with the meaning of § 2001(f)(2) — the gift tax finality rules) or estate tax purposes. The value for purposes of an allocation that is made at the end of an ETIP is its value at the end of the ETIP. This provision of the Act is a clarification rather than a change from prior law except that it refers to the new gift tax finality definition under § 2001(f) and it gives more guidance on ETIPs. This provision applies to transfers subject to estate tax or gift tax made after December 31, 2000.

5. 9100 Relief Mandated for Certain Missed Allocations and Elections

One reason for change, according to the House Report, is that the “Committee believes it is appropriate for the Treasury Secretary to grant extensions of time to make an election to allocate generation-skipping transfer tax exemption and to grant exceptions to the statutory time requirement in appropriate circumstances, e.g., when the taxpayer intended to allocate generation-skipping transfer tax exemption and the failure to timely allocate generation-skipping transfer tax exemption was inadvertent.”

Under new § 2642(g)(1), the Treasury Secretary is directed to grant extensions of time to allocate GST exemption or to elect out of an automatic lifetime allocation with respect to gifts or transfers at death without regard to whether any period of limitations has expired and to consider, in determining whether to grant an extension, “all relevant circumstances, including evidence of intent contained in the trust instrument or instruments of transfer and such other factors as the [Treasury] Secretary deems relevant.” In addition, the new provision explicitly states,

22 § 2642(g)(1)(A) explicitly requires the Secretary of the Treasury to “by regulation prescribe such circumstances and procedures under which such extensions of time will be granted . . . .” The reference in the text to the statute of limitations is not in the Code but can be found in the legislative history to the Act. See Conference Report at p. 202.
23 § 2642(g)(1)(B).
in terms clearly intended to evoke § 9100 relief, “[f]or purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.” In other words, § 2642(g)(1) appears to have two immediate consequences. First, it provides that the GST allocation and election in and out of automatic allocations are deemed to be regulatory elections for which § 9100 relief is currently available. The notice states that, in general, relief will be granted if “the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government.” Second, it authorizes the Secretary of the Treasury to write regulations expanding the reach of § 2642(g)(1) beyond the reach of the current § 9100 relief regulations. “If the relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.”

This change is in some ways retroactive in that it applies to requests for relief pending on, or filed after, December 31, 2000. In fact, the flush language of § 2642(g)(1)(A) explicitly requires the Secretary of the Treasury to include in its regulations “procedures for requesting comparable relief with respect to transfers made before the date of enactment.”

6. Substantial Compliance Rules Mandated

“Under present law, there is no statutory rule which provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or trust.”

One reason for the change, according to the House Report, is that the “Committee recognizes that the rules and regulations regarding the allocation of generation-skipping transfer tax exemption are complex. Thus, it is often difficult for taxpayers to comply with the technical requirements for making a proper election to allocate generation-skipping transfer tax exemption. The Committee therefore believes it is appropriate to provide that generation-skipping transfer tax exemption will be allocated when a taxpayer substantially complies with the rules and regulations for allocating generation-skipping transfer tax exemption.” No inference is

24 Id.
25 See Notice 2001-50, Internal Revenue Bulletin 2001-34, 189 (August 20, 2001) and discussed more fully in ¶ 702.4 below.
26 Conference Report, p. 292.
27 Conference Report, p. 203.
intended with respect to the availability of relief from late elections or the application of a rule of substantive compliance before such date.

Under new § 2642(g)(2), substantial compliance with the statutory and regulatory requirements for allocating GST exemption is sufficient to establish that GST exemption was allocated to a particular transfer or a particular trust. New § 2642(g)(2) explicitly states that “[a]n allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a particular transfer or trust shall be deemed to be an allocation of so much of the transferor’s unused GST exemption as produces the lowest possible inclusion ratio.” In addition, it directs that the Treasury is to consider “all relevant circumstances” to determine whether there has been substantial compliance, “including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant.”

This provision applies to transfers subject to estate and gift tax made after December 31, 2000.

The Service before the Act issued Letter Rulings finding substantial compliance in certain situations. For example, in PLR 199937026 the Service found substantial compliance even though Schedule R of the Form 706 was not completed, but the revocable trust attached to the Form 706 indicated how property was to be divided between trusts with a “1” and “0” inclusion ratio.29

1. QFOBI

The Qualified Family Owned Business deduction of § 2057 is repealed for estates of decedents dying after December 31, 2003.

J. Certain Tax Recapture Extending Past the Date for Repeal of the Estate Tax

Prior to repeal of the estate tax, many estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax. Because repeal of the estate tax would be effective for decedents dying after December 31, 2009, these estate tax recapture provisions would continue to apply.

Qualified Conservation Easements. A donor may have retained a development right in the conveyance of a conservation easement that qualified for the estate tax exclusion. Those with an interest in the land may later execute an agreement to extinguish the right. If an agreement to extinguish

29 See PLR 199909034 re substantial compliance and Form 709 and PLR 9534001 re substantial compliance and Form 706.
development rights is not entered into within the earlier of (1) two years after the date of the decedent’s death, or (2) the date of the sale of such land subject to the conservation easement, then those with an interest in the land are personally liable for an additional tax. This provision would be retained after repeal of the estate tax, which would ensure that those persons with an interest in the land who fail to execute the agreement remain liable for any additional tax which may be due after repeal.

**Special-Use Valuation.** Property may have qualified for special-use valuation prior to repeal of the estate tax. If such property ceases to qualify for special-use valuation, because, for example, an heir ceases to use the property in a qualified manner within 10 years of the decedent’s death, then the estate-tax benefit is required to be recaptured. The recapture provision would be retained after repeal of the estate tax, which would ensure that those estates that claimed this benefit before repeal of the estate tax would be subject to recapture if a disqualifying event occurs after repeal.

**Qualified Family-Owned Business Deduction.** Property may have qualified for the family-owned business deduction prior to repeal of the estate tax. If such property ceases to qualify for the family-owned business deduction, because, for example, an heir ceases to use the property in a qualified manner within 10 years of the decedent’s death, then the estate-tax benefit is required to be recaptured. The recapture provision would be retained after repeal of the estate tax, which would ensure that those estates that claimed this benefit before repeal of the estate tax would be subject to recapture if a disqualifying event occurs after repeal.

**Installment Payment of Estate Tax for Closely-Held Businesses.** The present-law installment payment rules would be retained so that those estates that entered into an installment payment arrangement prior to repeal of the estate tax would continue to make their payments past the date for repeal. If more than 50 percent of the value of the closely-held business is distributed, sold, exchanged, or otherwise disposed of, the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary. This rule would be retained after repeal of the estate tax, which would ensure that such dispositions that occur after repeal of the estate tax will continue to subject the estate to the unpaid portion of the tax upon notice and demand.

**QDOT.** Where the first spouse died before January 1, 2010, the QDOT tax with respect to the surviving spouse shall not apply:

1. Under § 2056A(b)(1)(A) to distributions made after December 31, 2020 from a QDOT before the death of a surviving spouse (Query why such a tax is imposed at all after 2009 — it seems unduly further to penalize noncitizen surviving spouses because technically under
the statutory language the estate tax paid at the death of the surviving spouse of a QDOT is the deferred tax payable with respect to the first spouse rather than a tax with respect to the surviving spouse. Further, if the sunset occurs in 2011, this provision would only be relevant in 2010 — after which the current QDOT provisions would return; or


K. Reduction in State Death Tax Credit: Deduction for State Death Taxes Paid

From 2002 through 2004, the state death tax credit allowable under present law is reduced as follows: In 2002, the state death tax credit is reduced by 25 percent (from present law amounts); in 2003, the state death tax credit is reduced by 50 percent (from present law amounts); and in 2004, the state death tax credit is reduced by 75 percent (from present law amounts). In 2005, the state death tax credit is repealed, after which there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent. Such state taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under § 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

This change basically means the reductions in the top marginal estate and gift and GST tax rate are paid for by the states losing their “pick-up” estate tax revenue. For example, a person today with a $3,500,000 taxable estate, although in the 55% top estate tax rate bracket, if he or she lives in a state with a pick-up estate tax would pay on the top dollar in the estate 9.6% to the state and 45.4% to the IRS. As the state death tax credit disappears in 2005, if the relevant state does not put in place an inheritance tax and does not have a state estate tax tied to the pre-2002 federal credit for state death taxes, the estate will be paying 0% to the state and a top rate of 47% to the IRS. Therefore, although the overall estate (federal and state) tax bracket has decreased from 55% to 47% for this estate, the federal rate on the top dollar in the estate has increased from 45.4% to 47%. Further, some states’ estate taxes are stated in terms of the federal credit for state death taxes as it existed in a year prior to 2002. In such a state,
the state estate tax would not decrease even though the federal state death tax credit decreased. Therefore, in some cases in some years, the combined estate tax paid to the IRS and the state could increase. For example, Virginia law provides the federal credit that is picked up by Virginia shall not “be less than the federal credit allowable by § 2011 of the Internal Revenue Code as it existed on January 1, 1978.”

Repeal of the federal estate tax and the intervening reduction in the state death tax credit and change to a deduction will result in an associated reduction in state death tax revenues, as many states have death taxes tied to the federal state death tax credit. States may enact new regimes or may “compete” with each other to enact taxpayer friendly regimes.

Some Planning Thoughts

(1) Taxpayers may plan to change domicile and/or to change the death tax situs of assets such as jewelry, art, etc.

(2) If an individual has real estate in New York, for example, but is domiciled in a state with a significantly smaller death tax, he or she could consider putting the real estate in an LLC if that would convert it to an asset with a situs in the state of their domicile. The law of both states would have to be checked to see if this would work and to be sure a double state death tax was not incurred.

(3) Taxpayers may bequeath more property to a surviving spouse to minimize the state death tax at the first spouse’s death and provide more time to plan to minimize the tax.

(4) A person domiciled in a state with a higher estate tax (and no offsetting federal credit) and no state gift tax might consider borrowing money to make death bed gifts. The federal transfer tax should be the same, but there should be no state death tax on the transfer. He or she would borrow to make the gift so the decedent would be able to keep assets so that the retained assets would receive a basis adjusted to date of death value under § 1014. Calculations should be done to determine if this makes sense in the particular case.

L. Excise Tax on Nonexempt Trusts

A split-interest trust would be subject to certain restrictions that are applicable to private foundations if an income tax charitable deduction, including an income tax charitable deduction by an estate or trust, was allowed with respect to transfers to the trust.31


31 § 4947.
M. Qualified Conservation Easement

The Act expands the availability of qualified conservation easements by eliminating the distance within which land must be situated from a metropolitan area, national park or wilderness area or from an Urban National Forest. Therefore, a qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. The Act clarifies that the date for determining easement compliance is the date on which the donation was made. The provisions are effective for estates of decedents dying after December 31, 2000.\footnote{32 § 2031(c).}

N. Expanded Availability of Estate Tax Installment Payments

The Act increases from 15 to 45 the number of partners in a partnership and shareholders in a corporation that is considered a closely-held business (if other requirements are met) and, therefore, eligible for installment payment of estate tax.

The Act expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. The Act provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years. No inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under present law.

The Act also clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be nonreadily tradable in order to qualify for installment payment of the estate tax. The Act also provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.\footnote{33 § 6166.}

These provisions are effective for decedents dying after December 31, 2001.
Planning in Uncertain Times

Long Transition Plus Scheduled Sunset Equals Complexity and Uncertainty

The long transition period of gradual tax reductions coupled with the scheduled sunset of the entire Act creates considerable uncertainty and adds substantial complexity to the estate planning process. With a nine-year transition, four or five future Congresses and one or two future presidents could be involved in fashioning the ultimate outcome. Predicting what that might be is risky at best.

A. Possible Congressional Action

Congress may decide to:

1. Leave the Act intact, with the result that repeal of the transfer tax system will go into effect in 2010, for one year only, with the law on the books in 2001 reinstated in 2011;

2. Leave the Act provisions unchanged through 2010 and "repeal the reinstatement" so that there will be no federal transfer tax on GSTs and decedents dying in 2010 and thereafter;

3. "Freeze" the Act provisions at some point along the transition period, but make the frozen provisions permanent (for example, a future Congress could decide to freeze the estate and GST tax changes at the level scheduled to be in effect in 2006, and increase the gift tax changes to be consistent with them, so that all three transfer taxes would have a flat 45% tax rate and an exemption or applicable exclusion amount of $2,000,000); or

4. Do something else altogether.

B. A Possible Approach to Planning

Planners as well as clients will frequently have strong views about whether or to what extent the changes made by the Act are likely to go into effect or be made permanent. There will be a great temptation to plan based on such views rather than for all contingencies, particularly as planning for all contingencies is likely to be difficult, expensive and without any guarantee that such planning will prove to be worthwhile. One approach, therefore, is for the estate planner to share his or her views with the client and have the client, not the estate planner, make the ultimate decision of the extent to which planning should take into account the scheduled changes, including ultimate repeal and/or reinstatement of the tax system as we now know it. If this approach is followed, the client should be
reminded that he or she could become incapacitated and therefore unable to change the estate plan even if circumstances warrant a change.

C. Possible Reactions

People who believe the transfer taxes will be reinstated may not be willing to incur the cost of revising their estate plans to prepare for the phase-in of repeal. Alternatively, some people may not engage in planning in the hope or belief that they will outlive the transition period and that repeal will occur and not sunset. In both cases, people could incur larger than necessary taxes. Some may revise their current health care powers so as to extend their lives by artificial means of support (when they would not have otherwise done so) so as to “outlive” the phase-out period but die before the pre-Act law springs back into existence. (Or, even more troubling, that a beneficiary/attorney-in-fact would use his or her power for such a result.)

¶ 702.2 Drafting

A. Flexibility

Estate planning documents may need to be drafted in the alternative to encompass situations where the testator dies before full phase-in of repeal, situations where the testator dies after full phase-in of repeal and situations where the testator dies after the pre-Act law springs back into existence. Further, documents should include the ability to distribute assets both outright and in further trust, as it is impossible to know what the future may hold for the family situation, assets, or the law. Consideration also should be given to survivorship clauses. There are many possibilities to consider.

1. Wills and Revocable Trusts

Should documents contain one part that is conditioned on the federal estate tax not being applicable at the date of death (or on the federal estate tax rate being less than or equal to x%) and another part conditioned on the federal estate tax still being applicable (or on the federal estate tax rate being greater than x%)? One should not draft to say if “I die after the federal estate tax is repealed” because it may be repealed in 2010, spring back in 2011 and death occurs in 2012 which is literally after the estate tax is repealed. (Further, care must be given to refer to repeal of the “federal estate tax” not just “death tax” or “estate tax” as state death taxes may be re instituted or may still be in place. Of course, there may be times when reference should also be made to state estate taxes.) Perhaps because the provisions of the estate tax and GST tax will still be in the Code (see
earlier discussion at ¶ 701.2[B] “Repeal”), in drafting one should instead draft “if I die when the federal estate tax is not applicable.” Wills (and revocable trusts) could provide for both scenarios.

If, at the testator’s death, the federal estate tax is not applicable or the marginal federal estate tax rate is less than $x\%$, then the dispositive provisions may be drafted in a fashion that does not provide for the marital deduction, charitable deduction, § 2032A special valuation rules, GST exemption, § 2057-QFOBI rules, etc. Further, if federal estate tax is no longer applicable, the plan would try to position assets in a manner 1) to utilize the $1,300,000 basis adjustment available at the decedent’s death, 2) if the decedent is married, to pass sufficient assets to the surviving spouse in a manner eligible to utilize the $3,000,000 basis adjustment at the decedent’s death and 3) to try to assure the surviving spouse will have sufficient assets owned in a manner eligible to use the surviving spouse’s $1,300,000 adjustment to basis at the surviving spouse’s later death.

If, at the testator’s death, the marginal federal estate tax rate is $x\%$ or more, then the dispositive provisions would be drafted in a fashion that would provide for the marital deduction, charitable deduction, § 2032A special valuation rules, GST exemption, § 2057 QFOBI (if it has not then been repealed) rules, etc.

Documents could provide for property to pass into a QTIP trust, and then if the independent executor does not make the QTIP election, the assets pass into another trust for the spouse and/or others. This would allow the independent executor to change the disposition of the property based on the state of the law. It would be important to exculpate the executor in the document. It might be preferable for a non-surviving spouse executor to have this power. Treas. Reg. § 20.2056(b)-7(d)(3) allows this under current law — without disallowing the marital deduction. The QTIP trust would have to be drafted carefully so that if the first spouse died when the federal estate tax was not applicable and when, therefore, there would be no QTIP election, there is a mechanism to move property to the other trusts. On the other hand, this would have to be drafted in a manner that would not interfere with marital deduction qualification if the first spouse died while the federal estate tax was applicable. Further, if the federal estate tax was not applicable, such a provision could prevent property passing into a QTIP trust from being eligible for the § 1022(c) $3,000,000 basis adjustment for qualified spousal property. The instrument could be drafted in two parts — one controlling if the testator died when the federal estate tax was applicable, and one controlling if the testator died when the federal estate tax was not applicable.

Further, as discussed more below, disclaimers could be used more extensively to provide more flexibility.
Further, special powers of appointment could be used to provide more flexibility, being careful not to have powers that hurt marital or charitable deductions or QSST or ESBT status, or completed gifts.

It may be advisable to build into revocable trust instruments the power in someone (probably an independent trustee) to change the terms of the trust while the grantor is alive if the grantor becomes incapacitated (as defined in the instrument). This is a large power to give someone and should — if given — have some precatory language expressing the grantor’s intent to enable that person to make changes to the trust due to changes in the tax law, or other changed circumstances, etc. The instrument should be drafted carefully so as not to give the person a general power of appointment, i.e., he or she should not be able to increase property passing to himself or herself (except perhaps distributions subject to ascertainable standards). Under some states’ laws, this could be accomplished through a durable power of attorney that contains specific language allowing the change to such a trust. However, it will often be preferable to include the power explicitly in the trust instrument. It would be important to exculpate the person with this power (for acting and for failing to act) and to provide for removal of this person and appointment of a successor (using tax sensitive safeguards). Care must be taken that such a provision is drafted in a manner that does not result in adverse tax consequences — such as completed gifts (this may not be a problem and may be able to be prevented by providing a special testamentary power for the grantor in the revocable trust). Such a provision could increase risks of litigation.

It may be advisable to build into revocable trust instruments (that would become operative when the trust becomes irrevocable), the power in someone (probably an independent trustee) to change the terms of the trust. This could also be done in inter vivos irrevocable trusts. Again, this is a large power to give someone and should — if given — have some precatory language expressing the grantor’s intent to enable the person to make changes to the trust due to changes in the tax law, or other changed circumstances, etc. The instrument should be drafted carefully so as not to give the person a general power of appointment, i.e., he or she should not be able to increase property passing to himself or herself (except perhaps for distributions subject to ascertainable standards). This can also be done through a power in the trustee to appoint in further trust. Care must be taken to be sure such a power is drafted — while the federal estate tax is applicable — in a manner that does not disqualify a marital deduction, charitable deduction, QSST, ESBT, a disclaimer, completed gift status, or annual exclusions, etc. It would be important to exculpate the person with this power (for acting or for failing to act) and to provide for
the removal of this person and appointment of a successor (using tax sensitive safeguards). Such a provision could increase risks of litigation.

It will be important to grant trustees broad discretion to terminate trusts early and appoint property outright or in further trust — again being careful to be sure such a power is drafted — while there is a federal estate tax — so that it does not disqualify a marital deduction, charitable deduction, QSST, ESBT or completed gift status, or annual exclusions, etc. Of course, if the estate tax is later reinstated, it would have been preferable not to terminate the trust but to keep the property in generation-skipping trusts.

2. Irrevocable Trusts

Inter vivos irrevocable trusts should be drafted flexibly too.

They could contain different dispositions of assets depending upon whether full repeal occurs or is in effect. An independent trustee could have broader powers of distribution if full repeal occurred. For example, a trust that currently has a “1” inclusion ratio and is only to be for the benefit of nonskip persons could also be for the benefit of skip persons. Of course, there are many valid non-tax reasons to continue trusts, but added flexibility is important. Care must also be taken to ensure that the added provisions do not harm current planning, such as the marital deduction or charitable deduction. Spendthrift provisions could be omitted to allow later flexibility in assigning interests. Of course, in many cases, spendthrift provisions are very important and should not be omitted.

Trustees should have the power to disclaim certain powers and have that be binding on future trustees — as long as having such a power does not interfere with a planned deduction or trust status, etc.

In drafting, one needs to be careful not to cause a current gift to be incomplete or to cause inclusion in the grantor’s estate if the grantor dies when the transfer taxes are still in force. Could an independent trustee have the power to make discretionary distributions to the grantor after the estate tax is repealed (or if the top estate tax rate in the Code is less than or equal to x%)? There are several points to consider:

(1) Does the existence of such a provision cause a gift to be incomplete, i.e., under Treas. Reg. § 25.2511-2(b), has the grantor so parted with dominion and control as to leave him no power to change its disposition whether for his own benefit or for the benefit of another? If the donor reserves any power over the disposition of a transfer, the gift may be wholly incomplete or may be partially complete and partially incomplete, depending upon all the facts in a particular case.
(2) If the gift is complete, but the grantor is viewed as retaining an interest, how does §2702 apply?

(3) Does the existence of such a provision cause inclusion in the grantor’s estate if the grantor dies when the estate tax is still applicable (or if the top estate tax rate in the Code is more than $x\%$)?

(4) Does the existence of such a provision cause inclusion in the grantor’s estate if the grantor dies when the top estate tax rate in the Code is less than or equal to $x\%$?

(5) Under §2036(a)(1), one of the sections potentially applicable to this situation, a grantor may be treated as retaining possession or enjoyment of property or income therefrom where the interest is subject to a contingency beyond the decedent’s control that does not occur before his death — such as repeal of the estate tax. Although the regulations (Treas. Reg. §20.2036-1(b)(3)) specifically provide that such a contingency does not prevent inclusion under §2036(a)(2) (the right to designate who shall possess or enjoy property or the income therefrom), §2036(a)(2) is not relevant to this discussion. The regulations under the relevant section, §2036(a)(1), do not specifically address contingencies. However, Treas. Reg. §20.2036-1(b)(1)(ii) provides that the phrase “for any period not ascertainable without reference to his death” is illustrated by the following example:

**Example:** A decedent reserved the right to receive the income from transferred property after the death of another person who was in fact enjoying the income at the time of the decedent’s death. In such a case, the amount to be included in the decedent’s gross estate under this section does not include the value of the outstanding income interest of the other person. It may be noted that if the other person predeceased the decedent, the reservation by the decedent may be considered to be either for his life, or for a period which does not in fact end before his death.\(^{34}\)

The repeal of the estate tax or a reduced top estate tax bracket is a contingency analogous to the death of another person, thus arguably resulting in inclusion of the trust property in the grantor’s estate. However, the grantor is not retaining the use, possession, or right to the income or other enjoyment of the transfer and property. The grantor is a discretionary beneficiary. Nonetheless, property may still be includible in the grantor’s estate under §2036(a)(1)

\(^{34}\) See also Treas. Reg. §20.2036-1(a).
if: under relevant state law creditors of the grantor of such a trust could reach the trust assets; if the grantor were the trustee; if there were standards for distributions to the grantor that gave the grantor enforceable rights; or if there was an explicit or implicit agreement that the grantor would receive income.\textsuperscript{35}

(6) For purposes of § 2037, such a provision should not be treated as creating an interest transferred by the decedent of which “possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent.” Therefore, the trust property should not be includible in the grantor’s estate under § 2037.

(7) For purposes of § 2038, enjoyment of the property transferred should not be treated as subject at the date of death to change through the exercise of a power by the decedent (whether alone or with another person), and therefore includible in the decedent’s estate, if the power is “subject to a contingency beyond the decedent’s control which did not occur before his death” — such as the repeal of the estate tax.\textsuperscript{36} Section 2038 does not apply to a power held solely by a person other than the decedent (unless the decedent could remove that person and appoint himself\textsuperscript{37} or if the decedent could remove that person and appoint someone unrelated under § 672(c)).\textsuperscript{38} Therefore, subject to the creditor discussion below, the property should not be includible in the grantor’s estate under § 2038.

(8) For purposes of § 2041, a grantor should not be treated as though he had a general power of appointment, because “a power which by its terms is exercisable only upon the occurrence during the decedent’s lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent’s death.”\textsuperscript{39} Therefore, such a provision should not cause the property to be includible in the grantor’s estate under § 2041.

(9) Inclusion in the grantor’s estate would probably result if, under local law, creditors would have access to the trust assets. Specifically, as is explained in more detail below, to the extent creditors have access to the property in the trust, the transfer to the trust is not considered

\textsuperscript{35} See Tax Management Portfolio 50-5th discussions beginning on pages A-18 and A-23.
\textsuperscript{36} Treas. Reg. § 20.2038-1(b).
\textsuperscript{37} Treas. Reg. § 20.2038-1(a)(3).
\textsuperscript{38} Rev. Rul. 95-98.
\textsuperscript{39} Treas. Reg. § 20.2041-3(b).
to be a completed gift. The property would be includible in the
grantor’s estate under §§ 2036(a)(1) and 2038(a)(1).

Recent Alaska and Delaware statutes (among others) attempt to limit
access by creditors in certain situations.

On the other hand, under the Uniform Trust Code (2000), a grantor’s
creditors have the ability to reach whatever “can be distributed to or for
the settlor’s benefit.” (§ 505/Article 5). Further, under the Restatement
(Third) of Trusts § 60 cmt. f, where the settlor of a trust (regardless of
whether there is a spendthrift provision) is a discretionary beneficiary of
a trust, creditors of the grantor can reach the maximum amount the
trustee, in the proper exercise of fiduciary discretion, could pay to or apply
for the benefit of the settlor.

Under Revenue Ruling 77-378, 1977-2 C.B. 347, the Service held that
where income and principal were distributable in the complete discretion
of the trustee to the grantor of an irrevocable trust, the transfer was a
completed gift for purposes of Treas. Reg. § 25.2511-2 if, under state law,
neither creditors nor the grantor could reach any of the trust’s assets.
Under the relevant state statute, neither the grantor nor the creditors could
reach the assets, and thus the gift was ruled to be complete.

In Revenue Ruling 76-103, 1976-1 C.B. 293, the Service held that
where income and principal were distributable to the grantor of an irrevocable
trust in the complete discretion of the trustee, the transfer was not a
completed gift for purposes of Treas. Reg. § 25.2511-2 because, under the
relevant state law, the entire property of a discretionary trust could be
subjected to the claims of the grantor’s creditors whenever such claims may
arise. 40 The court concluded that the taxpayer could at any time obtain
the economic benefit of the trust income simply by borrowing and then
forcing creditors to look to her interest in the trust income for a source
of repayment. The ruling also provided that, under § 2038, if the donor
dies “before the gift becomes complete, the date of death value of the trust
corpus will be includible in the grantor’s gross estate, for Federal estate
tax purposes, under section 2038 of the Code because of the grantor’s
retained power to, in effect, terminate the trust by relegating the grantor’s
creditors to the entire property of the trust.”

In Outwin v. Commissioner, 76 T.C. 153 (1981), the grantor created four
irrevocable trusts of which he was the sole potential beneficiary during his
life. The trustee had absolute and uncontrolled discretion to distribute
income and principal to him; however, his spouse (who was the beneficiary

40 See Paolozzi, 23 T.C. 182 (1954), acq., 1962-1 C.B. 5 (holding that creditors could reach
income from trust property where income was distributable to the grantor in the trustee’s
discretion and the grantor was the sole potential income beneficiary).
of the trust after the death of the grantor) had to consent to the distributions or they would not be made. Under relevant state law (Massachusetts), creditors could reach the assets held in a discretionary trust for the settlor’s own benefit. The court concluded that, because the creditors could reach the assets, the petitioner failed to surrender dominion and control over the trust assets. The court noted that, under Treas. Reg. §§ 25.2511-2(c) and (e), a power in the grantor to revoke or alter a trust does not render the gift incomplete if the power is exercisable only in conjunction with a person having “a substantial adverse interest” in the trust. The court stated that while this may be true for gift tax purposes, it does not necessarily follow that the concept is relevant in determining the scope of creditors’ rights under state law with respect to assets in a discretionary trust for the grantor’s benefit.\footnote{76 T.C. 167.}

\footnote{76 T.C. 168, fn.5.}

The court noted that under Treas. Reg. §§ 25.2511-2(c) and (e), a power in the grantor to revoke or alter a trust does not render the gift incomplete if the power is exercisable only in conjunction with a person having “a substantial adverse interest” in the trust. The court stated that while this may be true for gift tax purposes, it does not necessarily follow that the concept is relevant in determining the scope of creditors’ rights under state law with respect to assets in a discretionary trust for the grantor’s benefit.\footnote{76 T.C. 167.}

The spouse’s consent/veto power would not shelter the property from creditors. Therefore, the court held the gift was incomplete. Further, the court stated that the grantor’s ability “to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the creditor’s gross estate under secs. 2036(a)(1) or 2038(a)(1).”\footnote{76 T.C. 168, fn.5.}

Although not a tax case, the Appellate Division of the Supreme Court of New York in \textit{Vanderbilt Credit Corp. v. Chase Manhattan Bank}, 473 N.Y.S.2d. 242 (1984), held that neither income nor principal of an irrevocable discretionary trust (with a spendthrift clause) was exempt from the claims of judgment creditors if the beneficiary was the grantor. The creditors could reach the maximum amount which the trustees could distribute to the grantor. This is true even if the trustee does not plan to make distributions to the beneficiary and the beneficiary cannot force him to make distributions. In contrast, in the \textit{Estate of German v. U.S.}, 7 Cl. Ct. 641 (1985), the Court of Claims held that, under Maryland law, creditors could not reach income and principal distributable, in the uncontrolled discretion of the trustee, to the grantor in the situation where prior consent to the distribution had to be given by the remainder beneficiary of the trust and a committee of nonbeneficiaries. The court noted that if the grantor chose to incur debts, her creditors could not attach or levy upon the trust assets to collect them.

Whether creditors can reach trust property is a question of relevant state law. Can a creditor reach property that, at the time, was not distributable by anyone to the grantor unless a contingency within the sole control of Congress (e.g., a change in the top estate tax rate under the Code or repeal of the estate tax) occurred? Relevant state law must be checked.
Could a non-fiduciary (other than grantor), such as grantor’s spouse (putting aside causing grantor trust status for income tax purposes), have a special inter vivos power to appoint trust property to the grantor’s parents’ lineal descendants (including the grantor) in the event of estate tax repeal? There are several points to consider:

1. Does the existence of such a provision cause a gift to be incomplete?
2. If the gift is complete but the grantor is viewed as retaining an interest, does § 2702 apply?
3. Does the existence of such a provision cause inclusion of the trust property in the grantor’s estate if the grantor dies before the elimination of the estate tax?
4. Because the grantor has no power over the trust property, the gift should be complete and the property should not be includible in the grantor’s estate — as long as there is no implicit or explicit agreement with the holder of the power regarding the exercise of such power and as long as the grantor does not have the right to remove the holder and name a successor who is related under § 672(c). However, if, under controlling state law, a creditor could reach the assets of the trust because of this power of appointment, the gift would not be complete and the property would be includible in the grantor’s estate. Treas. Reg. § 20.2038-1(a)(3) provides that § 2038 does not apply to a power held solely by a person other than the decedent. Treas. Reg. § 20.2036-1(b)(3) has similar provisions, but this regulation pertains to § 2036(a)(2). The regulations under the relevant section, § 2036(a)(1), do not directly address this issue, but see the discussion above about § 2036(a)(1) and the corresponding regulations.

B. Formulas

Existing revocable documents that contain formulas (such as for exempt and non-exempt trusts, the marital deduction, general powers of appointment, and charitable bequests) tied to pre-Act law will need to be reviewed and in many cases revised, and estate plans may have to be updated in order to preserve the plan during the transition period. Documents will need flexibility to accommodate changed definitions, inflation-based increases, and the phase-out of rates. Further, a formula dependent upon “the value as finally determined for federal estate tax purposes” or a variant thereof, will be problematic at a time when the federal estate tax is not applicable. Although current formulas may not lead to an increased estate or GST tax, depending upon the precise words used and what year the provisions are triggered, they may result in a dislocation in the asset splits between marital
bequests and bypass trusts and between trusts for children and GST exempt trusts principally for grandchildren.

1. Marital Deduction

There are numerous points to consider with respect to formula marital deduction bequests.

If a document is drafted with a reduce-to-zero pecuniary marital deduction bequest — *i.e.*, having the smallest amount necessary to lower the federal estate tax to zero — no property would pass under that clause to the surviving spouse once the federal estate tax is no longer applicable. This may not be consistent with the intention of the testator.

If a document is drafted with a reduce-to-zero pecuniary applicable exclusion bequest (leaving the nonmarital an amount equal to the applicable exclusion) with a residuary marital deduction bequest, if the federal estate tax is no longer applicable, all the property would pass to the residuary marital. This may not be consistent with the intention of the testator.

If a bequest for a spouse — whether pecuniary or residuary — provides that “the trustee shall not designate any asset as to which my estate would not be allowed a marital deduction,” no property would pass under that clause to the surviving spouse if the estate tax is no longer applicable. This language is necessary in order to qualify for the marital deduction, but if the estate tax and marital deduction are no longer applicable, this may not be consistent with the intention of the testator. Therefore, it may be desirable to change the bequest to provide “if the federal estate tax is applicable at my death, the trustee shall not designate any asset as to which my estate would not be allowed a marital deduction.”

During any transition period prior to full phase-in of estate tax repeal, gifts and bequests to spouses that qualify for the marital deduction afford an opportunity for the recipient spouse to make gifts so that if the spouse lived 3 years after the gift, the gift tax would not be subject to transfer tax (as under current law). Alternatively, the recipient spouse may live until rates are lower or the estate tax is no longer applicable, thus minimizing the overall tax liability — assuming the spring back is eliminated. It may be desirable to have many bequests to surviving spouses be into QTIP trusts. If the estate tax is not applicable at the first spouse’s death, it may be applicable at the surviving spouse’s death. There will probably be a good chance that property in a QTIP trust for which no marital deduction election was made (because the estate tax was not applicable at the first

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43 § 20.2056(b)-2.
spouse’s death), will not be subject to estate tax at the surviving spouse’s death. The trust should allow the trustee to distribute principal to the spouse for flexibility and to have the power to assure the surviving spouse has in his or her sole name (or other eligible form of ownership — but not in a QTIP) at death sufficient assets to use the basis adjustment of § 1022(b).

Provisions could be drafted so that disclaimers of bequests to nonspouses pass to the surviving spouse, thereby utilizing the marital deduction. There is then the potential (provided that there is no prearrangement or agreement) that, when rates are lower or the estate tax is no longer applicable, property can be transferred by the surviving spouse to the people who disclaimed.

With the exemption equivalent of the unified credit increasing from $675,000 to $3,500,000, the amount passing under a reduce-to-zero pecuniary marital deduction bequest will be decreased by $2,825,000. This may not be consistent with the intention of the testator.

The following chart illustrates the decreases in the marital deduction bequest as the applicable exclusion increases where the marital deduction bequest is a pecuniary reduce-to-zero bequest and at the death of the first spouse $4,000,000 is to be distributed.
Further, since the increase in the exemption equivalent of the unified credit is in stages, it will be important to be sure each spouse has enough assets in his or her sole name (or revocable trust, etc.) to use his or her exemption equivalent (and his or her GST exemption) during the transition. (Even if the estate tax is repealed at the death of the first spouse — as discussed more below — it is important to structure ownership of assets so they are eligible for the $1,300,000 and $3,000,000 basis adjustments at the death of the first spouse and the $1,300,000 basis adjustment at the death of the surviving spouse). It may be desirable to draft using formulas to cap the amount going to the family/bypass trust for those estates where the increasing exemption equivalent of the unified credit or the fact that the estate tax no longer applies provides too little for the surviving spouse. In other words, the will or revocable trust could provide that at least $x or $y% of the property would benefit the spouse. (This could be expressed as the greater of $x or $y% or the lesser of $x or $y% depending on the

<table>
<thead>
<tr>
<th>Estates of decedents dying in</th>
<th>Applicable exclusion amount (exemption equivalent of the unified credit) for estate tax</th>
<th>Marital Deduction</th>
<th>Family Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$675,000</td>
<td>$3,325,000</td>
<td>$675,000</td>
</tr>
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<td>3,000,000</td>
<td>1,000,000</td>
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</tr>
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<td>3,500,000</td>
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<td>Repeal estate and GST tax but not gift tax</td>
<td>0</td>
<td>4,000,000</td>
</tr>
<tr>
<td>2011</td>
<td>1,000,000</td>
<td>3,000,000</td>
<td>1,000,000</td>
</tr>
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</table>
client’s desires, and the dollar amounts could be tied to the CPI.) Of course, if the family/bypass trust has very generous terms for the benefit of the surviving spouse and especially if the surviving spouse is trustee of the family/bypass trust (or if the surviving spouse has sufficient assets of his or her own) it may not be necessary to assure that the amount of property passing to the family/bypass trust be reduced. In any event, while the estate tax is still applicable, it would be necessary to use a formula to assure a sufficient amount qualified for the marital deduction to avoid estate tax at the first death — if that were the goal.

“If the federal estate tax is applicable at my death, and if my spouse survives me, then I give, devise, and bequeath to the trustee hereinafter named an amount equal to the larger of (1) an amount equal to the greater of $x or y% of my gross estate after my gross estate is reduced by debts and claims allowable to my estate under Section 2053(a) of the Code, and (2) the smallest amount, if any, which, by virtue of being allowed as a marital deduction, would result in the least possible federal estate tax on my estate, after taking into account (i) the marital deduction allowed to my estate for all property which passes or has passed to my spouse under other provisions of this will or otherwise (based on the assumption that any election necessary to qualify property passing to a trust for my spouse not established by this will for the marital deduction under Section 2056(b)(7) of the Code will be made, even if in fact such election is not made), (ii) all other deductions and exclusions allowed to my estate, (iii) the applicable credit amount, (iv) adjusted taxable gifts, (v) the credit or deduction for state death taxes (but only to the extent that taking into account such credit or deduction does not incur or increase such state death taxes), and (vi) the credit for tax on prior transfers. For purposes of computing this amount, the executor shall assume that all distributions payable pursuant to the terms of the preceding Items of this will and applicable law at the time of my death have been satisfied in full. Such amount shall be held in trust, administered, and distributed in accordance with the provisions of Item Four, hereinafter referred to as the ‘Marital Trust.’ ”

The amount benefiting the spouse could be split in two parts — one that could be a pecuniary reduce-to-zero marital deduction (with sufficient property to avoid estate tax at the first death) and the second trust that was a trust primarily or exclusively for the spouse that would not be taxed at the death of the surviving spouse (even if the estate tax is still applicable). (If the first spouse dies when the federal estate tax is no longer applicable, it would be beneficial to have enough property pass outright to the spouse or as qualified terminable interest property to get the $3,000,000 basis adjustment.)
In other words, there could be three trusts — a marital trust, a nonmarital trust primarily for the surviving spouse and a bypass trust. Of course, a two-trust plan could work as long as the surviving spouse had sufficient assets or the spouse was a primary beneficiary of the family/bypass trust.

**For example,** if the decedent’s estate was $4,000,000

<table>
<thead>
<tr>
<th>Today — two trusts</th>
<th>2009 — two trusts</th>
<th>2009 — three trusts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marital Trust</td>
<td>Marital Trust</td>
<td>Marital Trust</td>
</tr>
<tr>
<td>$3,325,000</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>or</td>
<td>Nonmarital Trust</td>
<td>Primarily for Spouse</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Family Trust</td>
<td>Family Trust</td>
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</tr>
<tr>
<td>$675,000</td>
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“If the federal estate tax is applicable at my death, and if my spouse survives me, then I give, devise, and bequeath to the trustee hereinafter named an amount equal to the smallest amount, if any, which, by virtue of being allowed as a marital deduction, would result in the least possible federal estate tax on my estate, after taking into account (1) the marital deduction allowed to my estate for all property which passes or has passed to my spouse under other provisions of this will or otherwise (based on the assumption that any election necessary to qualify property passing to a trust for Sally not established by this will for the marital deduction under Section 2056(b)(7) of the Code will be made, even if in fact such election is not made), (2) all other deductions and exclusions allowed to my estate, (3) the applicable credit amount, (4) adjusted taxable gifts, (5) the credit or deduction for state death taxes (but only to the extent that taking into account such credit or deduction does not incur or increase such state death taxes), and (6) the credit for tax on prior transfers. For purposes of computing this amount, the executor shall assume that all distributions payable pursuant to the terms of the preceding Items of this will and applicable law at the time of my death have been satisfied in full. Such amount shall be held in trust, administered, and distributed in accordance with the provisions of Item Four, hereinafter referred to as the ‘Marital Trust.’ Such amount plus the amount described in clause (1) above shall be referred to as the ‘Spousal Amount.’ The greater of $x or $y% of my gross estate after my gross estate
is reduced by debts and claims against my estate allowable under Section 2053(a) of the Code shall be referred to as the 'Increased Amount.' If the Spousal Amount is less than the Increased Amount, then an amount equal to the difference between the Spousal Amount and the Increased Amount shall be held in trust as a separate trust from the Marital Trust, if any, and administered and distributed in accordance with the provisions of Item Five, and shall be hereinafter referred to as the 'Non-Marital Trust.'

As discussed earlier, in the alternative, property could pass into a QTIP trust drafted to provide that the portion of the trust with respect to which the executor does not make the QTIP election would pass into another trust for the surviving spouse and/or others. This would allow the executor to change the disposition of the property based on the state of the law. Treas. Reg. § 20.2056(b)-7(d)(3) allows this under current law — without disallowing the marital deduction. The QTIP trust would have to be drafted carefully so that if the first spouse died when the federal estate tax was not applicable and when, therefore, there would be no QTIP election, there is a mechanism to move property to the other trusts. However, if one wanted the QTIP to be able to utilize the first spouse’s $3,000,000 basis adjustment for property passing to a surviving spouse, the QTIP should not contain such a mechanism.

“If the QTIP election under Section 2056(b)(7) of the Code is made by my executor with respect to less than the entire Marital Trust, the executor shall divide the Marital Trust (in a manner consistent with Section 20.2056(b)-7(b)(2)(ii) of the Treasury Regulations if the federal estate tax is applicable) as to which such partial election was made into two separate trusts. The trust as to which the election was made shall be the Marital Trust, to be held, administered, and distributed in accordance with the provisions of Item Four. The trust as to which the election is not made shall be distributed to the trustee hereinafter named, to be held, administered, and distributed as part of the Family Trust in accordance with the provisions of Item Six.”

On the other hand, the instruments would have to be drafted in a manner that would not interfere with marital deduction qualification if the first spouse died while the federal estate tax was applicable. The instrument could be drafted in two parts — one controlling if the testator died when the federal estate tax was applicable (as above) and one controlling if the testator died when the federal estate tax was not applicable.
¶ 702.2 2002 INSTITUTE ON ESTATE PLANNING 7–44

“If my spouse survives me and if the federal estate tax is not applicable at my death, then I give, devise, and bequeath to the trustee hereinafter named an amount equal to the greater of $x or y% of my gross estate after my gross estate is reduced by debts and claims which would have been allowable to my estate under Section 2053(a) of the Code if the federal estate tax were still applicable. Such amount shall be held in trust, administered, and distributed in accordance with the provisions of Item Four, hereinafter referred to as the ‘Marital Trust.’”

In the alternative, property could pass to a QTIP and a partial QTIP election could be made. The trust could then be divided, but all the assets would stay in the trusts which would have identical terms. The problem with this approach is that the assets would only benefit the surviving spouse during his or her life and would mandate distribution of income to the spouse even from the portion of the trust with respect to which no QTIP election was made.

When analyzing the marital formula and how much goes into the bypass trust, it is important to recognize that, as the applicable exclusion amount increases (depending on how much the surviving spouse’s own assets are worth), more property may be passing to the family/bypass trust at the death of the first spouse than necessary to avoid estate tax at the death of the surviving spouse. If the surviving spouse has sufficient assets of his or her own — perhaps because the spouses have split their assets before the death of the first spouse, it may be sufficient to have the spouse as a discretionary beneficiary of the family/bypass trust. Each case, of course, is different, and the facts must be examined.

For example, if the first spouse dies in 2005 with an estate of $1,500,000, under a reduce to zero pecuniary marital deduction formula, all of the property would pass to the family/bypass trust. Further, more property may be passing to the family/bypass trust than necessary to avoid estate tax at the death of the surviving spouse, if the surviving spouse:

1. has $500,000 of her own assets but dies in 2006 when the exclusion amount is $2,000,000;

44 If there are no lineal descendants of either spouse from a prior marriage and the family is united, instead one may wish to use the following and rely on disclaimers to pass property to the Family Trust:

“If my spouse survives me and if the federal estate tax is not applicable at my death, then I give, devise, and bequeath all the rest and residue of my estate, of every kind and character, and wherever situated, including any lapsed, renounced, or void legacies, bequests, or devises, [but excluding/and including] any property over which I have a power of appointment, to the trustee hereinafter named to hold in trust, administer, and distribute in accordance with the provisions of Item Four, hereinafter referred to as the ‘Marital Trust.’”
(2) has $1,500,000 of her own assets but dies in 2009 when the exclusion amount is $3,500,000; or

(3) has $10,000,000 of her own assets but dies when the estate tax is no longer applicable (assuming the estate tax is still not applicable at the surviving spouse’s death).

In these cases, from an estate tax perspective, instead of having any property pass to the family/bypass trust, it could have all passed to the surviving spouse and not given rise to estate tax at the surviving spouse’s death. This makes planning very difficult when it is uncertain whether the applicable exclusion amount will ever reach scheduled amounts or whether the estate tax will cease to apply or will spring back in 2011 or at some later date.

In the alternative, while the estate tax applies and even if it is no longer applicable, all the assets could pass to the marital trust and disclaimers by the surviving spouse could be used to cause the assets to pass to a family/bypass trust or even first to a QTIP Trust and a second disclaimer could cause the assets to pass to a nonmarital trust primarily for the spouse and a third disclaimer could cause the assets to pass to the family/bypass trust. If the remainder beneficiaries of the various trusts are different (for example, children of different marriages), the surviving spouse may be less likely to make the disclaimer.

Even when the estate tax is no longer applicable, testators may still want property to be left in trust for spouses in order to provide spendthrift and creditor protection. However, because the property would not have to qualify for the marital deduction (remembering, however, that it would be beneficial to have enough property pass outright to the surviving spouse or as qualified terminable interest property to get the $3,000,000 basis adjustment if the first spouse dies while the federal estate tax is repealed), the testator could provide for additional trust beneficiaries during the spouse’s life. Further, there would be no mandatory income distribution requirement (except for the basis adjustment QTIP), which is often a burden on closely-held businesses. In addition, if the estate tax repeal was in effect at the first spouse’s death, the trust could, if desirable (which it may not be), provide that the surviving spouse would no longer be a beneficiary if the spouse remarried.

2. General Power of Appointment

If a document is drafted to specify who can be trustee or who can remove a trustee and appoint a successor trustee who is not related under § 672(c), the relevant clause may refer to § 2041. The meaning of such a provision
may be unclear if the estate tax is repealed; moreover, the prohibitions would be unnecessary except for income tax purposes.

3. Charity

Formula bequests to charity that are tied to reducing the estate tax may result in no property being distributed to charity. This result may not be consistent with the intention of the testator. A definition of a qualified charitable organization including reference to § 2055 perhaps should be modified to say if the federal estate tax is applicable. Formulas and definitions relating to charity must be reexamined to be sure they accomplish the desired results.

“The term ‘qualified charitable organization’ shall mean and include only an organization (i) which is described in Sections 170(c) and 2522(a) of the Code, and if the federal estate tax is applicable, in Section 2055(a), and (ii) which shall not, by any action or course of conduct, have so disqualified itself that any charitable deduction which (by reason of the nature of the purposes for which it was organized) would otherwise be available for federal income, gift or estate tax purposes, in respect of property passing to such organization, would be disallowed.”

4. GSTT

The following are points to consider with respect to formula drafting with respect to the generation-skipping transfer tax:

(i) If a document is drafted with exempt trusts for the benefit of grandchildren and nonexempt trusts for the benefit of children, and the GST tax is no longer applicable, then, depending upon how the document is drafted, all or none of the property may pass into the trust for grandchildren. This presumably is not consistent with the intention of the testator.

(ii) As the GST exemption increases, a formula bequest of the GST exemption to or for the benefit of skip persons increases from $1,100,000 to $3,500,000. This may not be consistent with the intention of the testator.

(iii) The document may need to be drafted to provide that at least $x or y% of the property would benefit children or skip persons — depending upon the client’s desires. (This could be expressed as the greater of $x or y% or the lesser of $x or y% depending on the client’s desires, and the dollar amounts could be tied to the CPI.)

(iv) If a document is drafted to create a pecuniary exempt trust by specifying that an amount equal to the transferor’s GST exemption
(currently $1,100,000) passes into an exempt trust, if the GST tax is no longer applicable, no property would pass into the exempt trust. This presumably is not consistent with the intention of the testator. On the other hand, if it is stated as “the amount exempt from the GST tax,” if the GST tax is no longer applicable, all the property would pass into the exempt trust. This presumably is not consistent with the intention of the testator.

The following chart illustrates the decrease in the children’s share as the GST exemption increases where $4,000,000 is being distributed under two types of formulas.
### ¶ 702.2

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*Children’s share is 0 in 2010 if the bequest to the trust primarily for grandchildren is stated to be the “amount exempt from GST tax,” as in Column (5) above.

**C. Definitions**

If provisions in a document are defined by reference to an Internal Revenue Code section, and if the section is repealed, what will be the effect on the provision in the document? If the sections are still in the Code (see earlier discussion in ¶ 701.2[B] “Repeal”) but do not apply at a point in time, technically, the section will not have been repealed — but it will have no effect. The answer to this question will depend upon how the provision
is drafted, how terms are defined in the instrument, and how “Code” is defined. The definitions below might be in a will or revocable trust. An irrevocable trust would substitute “the date this trust became irrevocable” for “the time of the execution of this will” and “in effect on the date on which the term or provision of this instrument is applicable” for “the date of my death.”

1. Current Definition

“‘Code’ means the Internal Revenue Code of 1986, as amended, and reference to any provision or section of that Code shall be deemed to refer to the provision or section of the federal tax law in effect on the date of my death that corresponds to the provision or section referred to that was in effect at the time of the execution of this will.”

2. New Definition

What if the above definition of “Code” were changed to the following?

“(a) ‘Code’ refers to the Internal Revenue Code of 1986, as amended, and reference to any provision or section of that Code shall be deemed to refer to the provision or section of the federal tax law, in effect on the date of my death, that corresponds to the provision or section referred to that was in effect at the time of the execution of this instrument. Notwithstanding the provisions of the previous sentence, if there is no provision or section of the federal tax law at the date of my death that corresponds to such provision or section, and if the federal estate tax is not applicable (as defined in Paragraph (b) of this Item) at my death, then [for the purpose of determining the amount of property that passes under a provision of this instrument and/or for any other purpose(s), even if not for all purposes or references to a provision or section of the federal tax law, a reference to a provision or section of the federal tax law shall nevertheless be deemed to refer to the provision or section that was in effect at the time of the execution of this instrument or the provision that was in effect immediately before the tax law became inapplicable, if the independent executor or non-beneficiary trustee, in his sole discretion, determines that such result or results is more consistent with my intention.] 45 The provisions of the previous sentence shall not apply if their inclusion in this instrument

45 In place of bracketed language, you may instead wish to use:

“such provision or term shall be interpreted by the independent executor or nonbeneficiary trustee in such manner as such independent executor or nonbeneficiary trustee considers advisable keeping in mind the general scheme of distribution of this instrument and the purposes for which any trusts created herein are being established.”
would cause any property passing under this instrument that would otherwise qualify for the federal estate tax, marital deduction, charitable deduction, special use valuation or Qualified Family Owned Business deduction or a qualified disclaimer, to fail to qualify. The independent executor or nonbeneficiary trustee shall not bear any liability for any action taken or nonaction or any decision made by such person in good faith pursuant to the power granted to him under the terms of the second sentence of this paragraph.

“(b) For purposes of this instrument, the federal estate tax shall be ‘applicable’ at a person’s death if the federal estate tax of Subtitle B, Chapter 11 of the Code (Sections 2001, et seq.) is then applicable and a federal estate, federal inheritance, or other federal transfer (other than a generation-skipping transfer tax) tax is imposed on such person’s assets on account of his or her death and otherwise shall not be applicable.

“(c) The term ‘non-beneficiary trustee’ refers to a trustee of a trust created hereunder who is not a beneficiary of such trust to whom distributions may be made from such trust (if such person were not serving as trustee) while such trustee is serving as trustee.

“(d) The term ‘independent executor’ refers to an executor who has no beneficial interest, vested or contingent, in the assets of the estate or the income or the principal of any trust created under this instrument, and who is not the spouse, parent, descendant, or ancestor of a person with such an interest.”

3. Alternate Suggestions

In the alternative, an independent executor could be given the discretion in the language in brackets in the last footnote. In both cases, the executor or trustee should be allowed such a power only if he or she is unrelated. Certainly the grantor, as trustee, of an irrevocable trust should not have such a power. In an irrevocable trust the definition of Code should be tailored to the trust in question and, if relevant, should include the following additional safeguards:

“The provisions of the previous sentence shall not apply if their inclusion in this instrument would cause any property passing under this instrument that would otherwise not be includible in my gross estate for federal estate tax purposes to be includible in my gross estate or that would cause a transfer that would otherwise be a completed gift — not to be treated as a completed gift.”

D. Reforming Irrevocable Trusts

If the federal estate and GST taxes are repealed, steps would have to be taken to reform irrevocable documents that contain definitions,
formulas or provisions that would either be meaningless or contrary to the grantor’s intent if the transfer tax were repealed. It might be desirable to reform a restrictive marital deduction trust that only allowed distributions for “support” to allow broader distributions to the spouse so transfers could be made to the spouse and then by the spouse to children. It might be desirable to reform a trust to delete a spendthrift provision to build in flexibility to allow assignments of trust interests. Of course, in many cases it may not be desirable to remove spendthrift protection.

E. Powers of Attorney for Property Management

These documents should be examined to determine if the client wants them to be revised to allow the attorney-in-fact to make larger gifts and in some cases (if allowable under state law), to create or amend a revocable trust. The power of attorney should be drafted to avoid causing inclusion of the property in the estate of the attorney-in-fact while there is a transfer tax and to avoid a gift by the attorney-in-fact, in most cases, by not allowing the attorney-in-fact to make gifts to himself or herself.

F. Powers of Attorney for Health Care and Living Will

These documents should be examined to determine if the client wants them to be revised to allow flexibility to take transfer tax consequences into account.

¶ 702.3 Planning

A. Deferring or Eliminating Transfer Tax-Making Gifts

Many taxpayers will benefit from making gifts during the transition period and afterward in a manner that will cause the value of the present gift to be relatively low, so that future appreciation will be transferred. Further, often parents want to make transfers of property to their children during the parents’ lives. (Of course, basis will also need to be considered including the fact that the new basis adjustments that will be applicable to estates of decedents dying in 2010 will not be available to gifts.) Of course, any action taken to lower the value of property in an estate, will also mean — after the estate tax no longer applies, if there is carryover basis — there is less appreciation to which to allocate the basis adjustments. This should not be a problem where there is sufficient appreciation in the estate to use the basis adjustments. However, if using these gift devices lowers the estate values and shifts appreciation away from the estate, so that the estate no longer has sufficient appreciated assets to use the basis adjustment, query whether the gifts were very beneficial. Presumably, the gifts were made in order to minimize future transfer tax because (1) the Act provides
only one year of repeal of the estate tax before the present estate tax springs back, (2) the estate tax repeal may never occur and (3) the donor may not live until repeal. Therefore, it would in many cases, make sense to do this planning — but the potential of not having sufficient appreciated assets available to use the adjustment can be discussed with the client. The donees will have a carryover basis in the property they were given and, therefore, there may be more capital gains tax for the donee to pay upon a sale of the property than if the donor had kept the asset, died when repeal was in existence and had assets appreciate which did not exceed the basis adjustments. Too many ifs!

1. **Annual Exclusion/Tuition/Medical/Applicable Exclusion Amount**

   Gifts should be made to utilize all of the available exclusions.

2. **GRATs**

   A zeroed out GRAT can be used. Amounts the grantor has received from the trust can later be given to the remaindermen when the tax rates are lowered or passed at death if the estate tax no longer applies.

3. **QPRTs**

   A QPRT can be used to transfer the residence with little tax — but to achieve a very low gift, an irrevocable trust may be created for a longer period than may have been necessary if the estate tax is repealed (and does not come back into existence), and if the grantor lives until the estate tax no longer applies. This needs to be discussed with the client.

4. **Debt**

   If property, including limited partnership and LLC interests, is sold to a grantor trust for a bona fide note before gift tax rates are lowered, the note could be given as a gift when the rates are later lowered, but there cannot be any prearrangement or agreement to make a later gift. The note could be a self-canceling installment note.

5. **Debt**

   Bona fide loans can be made now, and if the gift tax rates are later lower, the note could be given as a gift, but there cannot be any prearrangement or agreement to make a later gift.
6. Partnerships and LLCs

Establishing partnerships and LLCs can enable the transferor to be in a position to fractionalize assets and make transfers as rates become lower, thereby shifting appreciation.

7. Taxable Gifts

Although it may seem counterintuitive, even if the estate tax is repealed and does not spring back, there will still be situations where it will be beneficial to pay a present gift tax. Specifically, with a very elderly client who it is believed will not live until 2010 but will live more than three years, making a taxable gift at a 50% bracket, for example in 2002, due to the tax exclusivity of the gift tax will effectively be a 33-1/3% bracket. It also has the benefit of shifting future income and appreciation out of the donor’s estate. Of course, basis considerations must be taken into account. Further, you need to explain the risks to the client, *i.e.*, what if he or she lives until 2010 or repeal is accelerated. Further, if the donor wants to get assets in the hands of beneficiaries during life, in some cases taxable gifts may be necessary.

8. § 2511(c)

One would need to be careful to avoid new § 2511(c) which for certain transfers in trust made after 2009 would cause gift treatment even though under pre-Act law there would have been no gift. Section 2511(c) added by the Act treats transfers in trust as taxable gifts unless the trust is treated as wholly owned by the donor or the donor’s spouse under subpart E of part 1 of subchapter J of chapter 1, *i.e.*, §§ 671-679 of the Code.

B. Spendthrift Clauses

Drafting trusts without spendthrift provisions in order to allow a trust beneficiary (for example, a beneficiary with a vested remainder interest) to make a gift of his or her interest can provide flexibility — if creditor protection is not important.46

C. Carryover Basis

Once carryover basis is in place in 2010 (and before the sunset of the Act):

46 However, see discussion of the potential GST tax effects of such a transfer in Harrington, Plaine, and Zaritsky, *Generation-Skipping Transfer Tax*, Chapter 9, (Warren, Gorham and Lamont/RIA 2nd edition 2001) (PLR 200107015).
1. **Effect of Elimination of Step-Up In Basis**

The elimination of the “step-up in basis” at death (except as elected by the executor) will add record-keeping requirements and some potential uncertainty regarding the basis of particular assets. Clients whose assets will exceed $1,300,000 (at death) should start keeping good basis records for newly acquired assets and try to gather information as to currently owned assets. It is obviously easier for them to gather the information than for their executor. However, the change to the basis rules means that property transferred by gift and property transferred at death will be subject to many of the same rules (except to the extent the executor makes an election with respect to such property).

2. **Complexity**

Having the executor determine which assets should receive the allocation of additional basis adds a degree of complexity to the regime, but this arguably is offset to some extent by the elimination of other complex areas of the estate and GST tax regime. Further, an estate where the total assets are worth less than the relevant adjustment should not add complexity.

The ability of the executor to determine which assets receive an increased basis raises potential fiduciary liability concerns and the possibility of more disputes among beneficiaries.

With transfers to the surviving spouse, tying the $3,000,000 to transfers that are either outright or qualified terminable interest property adds further complexity.

3. **Income Tax Planning**

A taxpayer may find it advantageous to transfer property to lower income tax bracket persons using, for example, the gift tax annual exclusion, so as to reduce income tax liability.

With carryover basis in place, post-death sales that were planned to be free of income tax, for example under buy-sell agreements, may now give rise to an income tax to the seller — perhaps making some change to the agreement and the sales price formula therefore desirable — or making the purchase of life insurance by the decedent desirable to make up the difference to the seller.

4. **Charitable Deduction**

Taxpayers may choose to make more gifts of appreciated property to charity during life to get the benefit of the income tax deduction.
5. $1,300,000 and $3,000,000 Adjustments

It is important to recognize in drafting, and in planning to use the $1,300,000 and $3,000,000 basis adjustments, that these numbers (as indexed for inflation and as adjusted for NOLs, etc.), do not refer to value — they refer to basis adjustment. Specifically, it is not sufficient to provide that $3,000,000 of assets pass to a QTIP trust. One really needs assets with $3,000,000 of appreciation. The $3,000,000 (as is true of the $1,300,000) increases the basis from the carryover basis and that increase cannot cause the basis to exceed the date of death value of an asset. For example, if 1,000 shares of X stock is worth $4,500,000 on the date of death and has a $1,500,000 carryover basis, if it is bequeathed to the spouse or to a QTIP trust for the spouse, the executor can allocate the $3,000,000 basis adjustment to that stock. This can cause a conflict, because other beneficiaries might prefer to have the most appreciated property pass to the spouse to use the $3,000,000 with the least amount of assets, but the spouse may want less appreciated assets so it takes a larger amount of assets to use the $3,000,000 basis adjustment.

6. QTIP

If QTIP trusts are used to qualify property for the $3,000,000 basis adjustment, they should be drafted to allow distribution of principal to provide flexibility for later transfers to the surviving spouse including to assure the surviving spouse had enough assets in his or her sole name (or other eligible form of ownership — but not in a QTIP) to use the $1,300,000 basis adjustment at the death of the surviving spouse.

7. Sufficient Assets Owned by First Spouse to Die

It is advisable to position a couple’s assets so that if they both live until the estate tax is repealed, at the death of the first spouse, there are sufficient assets that will be treated as owned by that spouse under § 1022(d) to utilize the $1,300,000 basis adjustment and the $3,000,000 basis adjustment so that assets available for the surviving spouse have bases increased as much as possible. Even though a couple’s combined assets are below the amount that can pass free of estate tax, i.e., one exclusion amount, or even if there is no federal estate tax, this is still desirable. Gifts made to a dying spouse by the other spouse, even if within three years of death, are still eligible for the adjustments — as long as the donor spouse had not received them as a gift during that period. Therefore, the title readjustment could be done at any time before the first spouse dies. This can be done even if the assets are bequeathed by the dying spouse back to the donor spouse. However, it is preferable not to wait until death bed planning is necessary, as that
often does not get done and is emotionally painful to do. Of course, durable powers of attorney for property management allowing these sorts of gifts between spouses would also be helpful.

8. Spouse

It would be important to assure that sufficient property passes to a surviving spouse or as qualified terminable interest property for the first spouse’s estate to take advantage of the $3,000,000 basis adjustment. It would also be important to assure that the surviving spouse has sufficient assets and in the right ownership form to use the $1,300,000 basis adjustment at the surviving spouse’s death. As stated earlier, although a QTIP trust can be used to obtain the first spouse’s basis adjustment, property in the QTIP at the death of the surviving spouse will not qualify as property owned by the surviving spouse, for the surviving spouse’s estate’s basis adjustments — unless the property is distributed from the QTIP to the surviving spouse before death. Should the executor be given guidance to allocate assets that will produce the largest or smallest possible amount for the spouse? Items of I.R.D. are not eligible for a basis adjustment. Where should they be directed — bearing in mind that funding a pecuniary bequest with an I.R.D. item accelerates the I.R.D.?

9. $1,300,000 Adjustment

Query whether guidance (not direction) should be given to the executor as to how to allocate the $1,300,000 adjustment to basis:

(i) Should it be allocated proportionately among the nonspouse beneficiaries — what about nonprobate assets?

(ii) Should it be allocated first to specific bequests and assets to fund pecuniary bequests?

(iii) Should the executor be given guidance not to allocate it to assets passing to charity?

(iv) Should the executor be given guidance to allocate it first to assets that are likely to be sold, for example, to fund bequests or pay administration expenses or debts, and to assets that if sold would not cause a long term capital gain but would cause ordinary income and not to allocate it to assets that will be kept or which are not eligible for depreciation?

(v) Should the executor be given guidance to allocate assets that will produce the largest or smallest possible amount of property for the nonspouse beneficiaries collectively?
The document should contain language exculpating the executor for decisions made in good faith, including the ability to allocate to nonprobate assets without liability.

Perhaps the document should allow the executor to allocate assets without regard to basis.

¶ 702.4 Generation-Skipping Transfer Tax Planning

The GST tax changes contained in the Act and discussed above will have an immediate and significant effect on (i) the ability of advisors to rectify problems arising from past mistakes or unforeseen events, (ii) tax return preparation and (iii) fundamental estate planning decisions. This portion of the article discusses ways in which the approaches of advisors to these issues should be modified by reason of the legislation.

A. Fixing Problems

Three of the technical provisions discussed above will make it possible to solve previously unsolvable GST exemption allocation problems and will make it easier or more certain to solve others: (1) the severance provision, (2) the substantial compliance provision and (3) the § 9100 relief provision. In addition another of the technical provisions, the retroactive allocation provision will allow practitioners to “fix” GST tax problems arising from a beneficiary in a younger generation unexpectedly predeceasing the transferor.

B. Trust Severance

In some cases, a problem arising from a failure correctly to allocate GST exemption can be solved without seeking IRS approval, by a qualified severance under new § 2642(a)(3). This will generally be the case if inadvertence resulted in a trust with an inclusion ratio between zero and one that allows discretionary distributions to be made to skip persons and non-skip persons or that provides that upon a specified event, such as the death of a non-skip person, distribution must be made to both skip persons and non-skip persons, in specified percentages or subject to an expandable power of appointment.

Consider a trust with a 20% inclusion ratio payable on C’s death 80% to GC and 20% to charity. Under new § 2642(a)(3)(B)(ii), as long as state law authorizes the division (whether by reason of a statute, court action, or the governing instrument), the trustee can sever the trust into two trusts (reflecting the 20% inclusion ratio, or more precisely the 80% applicable fraction) and the 80% trust will have an inclusion ratio of zero and the
20% trust will have an inclusion ratio of one. Importantly, because of the “succession of interests” language discussed above, as long as state law permits, the trust severance can provide that the 80% trust with the zero inclusion ratio is payable to GC on C’s death and the 20% one inclusion ratio trust is payable to the charity at that time. This will produce the desired result discussed earlier, resulting in a potentially substantial tax savings.

The trust severance provisions of § 2642(a)(3) are consistent with the legislative history of the GST tax. The regulations under § 2654, to the extent they do not respect trust severances that are respected under state law, are inconsistent with that legislative history. The separate share regulations will need to be changed in light of the new section. Example 8 under Treas. Reg. § 26.2654-1(a)(5) will need to be changed to provide that if the division is a qualified severance into separate trusts they will be recognized as separate trusts for GST tax.

### C. Substantial Compliance

The substantial compliance provision should allow many past and future attempts at allocating GST exemption to be treated as successful if sufficient intent was evident and/or information was given on the return. The government is to consider all relevant circumstances including evidence of intent contained in the trust document or instrument of transfer and such other factors as the Secretary deems relevant — presumably such things as contemporaneous letters from or to advisors or transferors, indications on relevant Forms 709 and 706, etc.

It is not clear whether the IRS will view this provision as mandating a more liberal view of the substantial compliance doctrine than it was applying prior to the enactment of § 2642(g)(2).

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47 Whether court action or approval is required will depend on state law and the governing instrument. Often it will not be required.

48 Of course, the example conveniently posits a case where the applicable fraction is exactly equal to the portion of the trust payable to skip persons. Even if this is not the case, benefits can be derived from qualified severances. For example, if only 60% of the trust were payable to GC and the balance to charity, the 80% zero inclusion ratio trust could be structured to be payable 75% [60%/80%] to GC and 25% to charity and the 20% one inclusion ratio trust could be structured to provide that the full amount pass to charity. Further, if consistent with state law and if the numbers are large enough to warrant it, the zero inclusion ratio trust might be further divided into a subsequent qualified severance, with both resulting trusts having an inclusion ratio of zero so that the charity’s share and the GC’s share can be invested differently. The example is also convenient in that the applicable fraction did not need to be rounded. In many cases Treas. Reg. § 26.2642-1(a), requiring that the applicable fraction is to be rounded to the nearest one-thousandth (.001) will apply. Care should be taken to use the rounded fraction in making the division. This could be a trap, particularly where the applicable fraction can easily be expressed in terms of a fraction (e.g., one-third).
Although the IRS has issued at least one private Letter Ruling (PLR 199937026) using language in a trust document attached to an estate tax return (where no allocation had been made on the estate tax return) to find that a personal representative complied with the GST allocation rules, no such ruling has been issued in the gift tax area. The rather strong language in the new Code provision as well as the legislative history referring to an evidence of intent “contained in the trust instrument or instrument of transfer” might encourage the IRS to issue such rulings in the gift tax area as well. However, such a ruling may be unnecessary as 9100-type relief is even more likely to be available in such a situation.

D. 9100 Relief

If GST exemption inadvertently was not timely allocated or was allocated incorrectly or an election was not made, 9100 relief through a private Letter Ruling (which is granted only in the discretion of the IRS) would allow many mistakes to be corrected retroactively as though the allocation had been made properly and timely. This provision should be extremely helpful in eliminating the significant unanticipated and unnecessary GST tax that can result from such mistakes where such GST tax could have been avoided altogether if GST exemption had been timely and properly allocated. The Conference Report states “No inference is intended with respect to the availability of relief from late elections prior to the effective date of the provision.”

Although § 2642(g)(1) indicates the Treasury Secretary is to prescribe by regulation the circumstances and procedures for relief for late and missed and erroneous allocations and elections dealing with the allocation, the Service recently issued Notice 2001-50, 2001-34 I.R.B. 189, stating that rulings may be granted under Treas. Reg. § 301.9100-3 because § 2642(g)(1) specifically provides that “[f]or purposes of determining whether to grant relief under this paragraph the time for making the allocation or election shall be treated as if not expressly prescribed by statute,” thereby vitiating the IRS’s reason for not entertaining such requests.

Notice 2001-50 concludes as follows:

Therefore, taxpayers may seek an extension of time to make an allocation described in section 2642(b)(1) or (b)(2) or an election described in section 2632(b)(5) or (c)(5) under the provisions of section 301.9100-3.

In general, under section 301.9100-3, relief will be granted if the taxpayer establishes to the satisfaction of the Commissioner that the taxpayer

acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. Taxpayers requesting relief should follow the procedures for requesting a private Letter Ruling under section 301.9100 contained in section 5.02 of Rev. Proc. 2001-1 (or its successor), 2001-1 I.R.B. 1, 28.

Treas. Reg. § 301.9100-3(b) sets out five circumstances, any one of which is sufficient, under which the taxpayer will be deemed to have acted reasonably and in good faith:

1. The taxpayer’s application for relief is made prior to discovery of the missing election or application for relief by the IRS.
2. The taxpayer inadvertently failed to make the election because of certain intervening events beyond the taxpayer’s control.
3. The taxpayer failed to make the election, because after exercising reasonable diligence (taking into account the taxpayer’s experience and the complexity of the return or issue), the taxpayer was unaware of the necessity of the election.
4. The taxpayer reasonably relied on the written advice of the IRS.
5. The taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make or advise the taxpayer to make the election or application for relief. Not all reliance, however, will be deemed to be reasonable. The taxpayer will not be considered to have reasonably relied upon a tax professional if the taxpayer knew or should have known that the tax professional was not competent to render advice on the election, or the taxpayer knew or should have known that the tax professional was not aware of all relevant facts.

Regardless of whether the application for relief is made before or after discovery by the IRS, there are two circumstances applicable to GST exemption allocation issues under which the taxpayer will not be considered to have acted reasonably and in good faith, and therefore would be ineligible for relief. First, no taxpayer will be deemed to have acted reasonably and in good faith if the taxpayer was fully informed of the required election and related tax consequences and chose not to file the election. Second, a taxpayer will not be considered to have acted reasonably and in good faith if the taxpayer “uses hindsight” in requesting relief. The

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\[50\] Much of the portion of this article dealing with 9100 relief is drawn (with permission) from an article by Douglas L. Siegler, Esq., Sutherland Asbill and Brennan LLP, entitled “When Bad Things Happen to Good People: Section 9100 Relief for Late Tax Election,” 32 University of Miami Heckerling Institute on Estate Planning (1998), Ch. 12.
regulations make clear that, absent strong proof that the decision to seek § 9100 relief did not involve hindsight, when specific facts have changed since the original due date of the election that make an election advantageous to a taxpayer, the IRS will not ordinarily grant relief.

Treas. Reg. § 301.9100-3(c) describes the two circumstances under which the interests of the government are deemed to be prejudiced. First, such prejudice arises if granting relief “would result in a taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money).” If the tax consequences of the election affect more than one taxpayer, the determination of whether the interests of the government are prejudiced must be made by looking at the tax liability of all the affected taxpayers, in the aggregate.

Second, the interests of the government will ordinarily be prejudiced when the tax year in which the regulatory election should have been made, or any tax year affected by the election had it been made timely, are closed by the statute of limitations before the taxpayer’s receipt of a ruling granting § 9100 relief. However, the IRS may nevertheless grant relief to the taxpayer in such circumstances if an independent auditor, not involved with the failure to make the election in a timely fashion, certifies that the interests of the government will not be prejudiced by virtue of a decreased tax liability outlined above.

Further, the rules may be more liberal in this area as the legislative history of new § 2642(g)(1) indicates that extensions of time are to be granted without regard to whether any period of limitation has expired.51

Procedural Requirements for Granting of Discretionary Relief. Treas. Reg. § 301.9100-3(c) sets out numerous procedural requirements that must be complied with when requesting discretionary relief. The purpose of these requirements is to provide written evidence that the taxpayer acted reasonably and in good faith and that the interests of the government will not be prejudiced. This information includes:

1) Information concerning when the applicable return, form or document used to make the election was required to be filed and when it was actually filed (and the taxpayer must submit a copy of any documents referring to the election).

2) Disclosure of any IRS examination of any return for the tax year in which the election should have been made or which would be affected by a timely made election, whether by a District Director or Appeals Officer, or any Federal judicial proceeding involving the

return (and the IRS must be notified if an examination of any such return is opened while the request for Section 9100 relief is pending).

(3) The sworn affidavit of the taxpayer (or his or her representative with respect to tax matters) must set out in detail the events that led to the failure to make a valid regulatory election and the discovery of the failure. It must also describe the engagement of any qualified tax professional, the responsibilities of the professional and the extent of the taxpayer’s reliance on the professional.52

(4) Sworn affidavits from individuals having knowledge or information about the events that led to the failure to make a valid regulatory election and to the discovery of the failure. In this connection, affidavits must be submitted by the taxpayer’s tax return preparer, any individual (including an employee of the taxpayer) who made a substantial contribution to the return, any other accountant or attorney, knowledgeable in tax matters, who advised the taxpayer in connection with the election.53

In addition, because the regulations make clear that the request for § 9100 relief does not suspend the statute of limitations, the IRS may, as a condition to granting the requested relief, require the taxpayer to consent to an extension of the statute of limitations for the assessment of taxes in accordance with § 6501(c)(4) for the tax year in which the election should have been made and all tax years affected by a timely made election.54

A transferor who has made a late election during life (described in § 2642(b)(3)) should be treated no worse than a transferor who had not yet attempted to cure the missed or flawed allocation. Specifically, the intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant should be considered. These other factors should include contemporaneous letters from or to advisors or transferors, indications on relevant Form 709s, and other such evidence of intent. In any case where relief is granted “then the gift tax or estate tax value of the transfer to the trust would be used for determining

52 Treas. Reg. § 301.9100-3(e)(2). This affidavit must describe the engagement and the responsibilities of the professional, as well as the advice that the professional provided to the taxpayer. In addition, each affidavit must include the name, current address, and taxpayer identification number of the affiant and must be signed and accompanied by a dated declaration stating that, under penalties of perjury, the facts in the request are true and include all relevant facts to the best of the affiant’s knowledge and belief. Treas. Reg. §§ 301.9100-3(e)(2) (last sentence) and (e)(3) (last sentence).
53 Treas. Reg. § 301.9100-3(e)(3). These affidavits must also meet the requirements discussed in note 52, supra.
54 Treas. Reg. § 301.9100-3(d)(2).
generation-skipping transfer tax exemption allocation.”\(^{55}\)
Because the relief allocation should be treated as creating the inclusion ratio as of the date of the gift, \(i.e.,\) as though the allocation was timely made, any late allocation should be treated as void. This is because when the late allocation was made the inclusion ratio, in light of the relief granted, should be zero. Therefore, the late allocation should be void because under Treas. Reg. § 26.2632-1(b)(2)(i) (except with respect to a CLAT) “an allocation of GST exemption to a trust is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust.”

At an October 30 AICPA meeting, James F. Hogan, Esq., the Senior Technician Reviewer of Branch 9 of Passthroughs and Special Industries in the IRS Chief Counsel’s office (one of two branches that handles most of the estate, gift and GST tax private Letter Ruling requests), is reported to have said that 9100 relief will be granted liberally and that the IRS will be looking for decent indicia of the intent to make an allocation. Further, in discussing a ruling request in which the taxpayer’s new accountant who upon discovering an error made three years before by a prior accountant had the taxpayer make a late allocation, Hogan was reported to have said (without committing how the IRS would rule) that he thought the IRS would grant relief in that situation as otherwise it would be unfair to penalize the individual who was trying to do the right thing.

The relief provision and the Notice apply to requests pending on, or filed after, December 31, 2000. The provision is extremely important because it is available without regard to the date on which the missed or erroneous allocation was made and without regard to whether a period of limitations has expired,\(^{56}\) although of course, in each case relief will only be granted if the IRS in its discretion determines a favorable ruling should be issued.

**Regulations Also Provide Automatic Relief—6-Month Extensions.** An automatic extension of 6 months from the due date of the return, excluding extensions, is granted within which to make regulatory or statutory elections whose deadlines are prescribed to be the due date of the return or the due date of the return including extensions.\(^{57}\) In order to qualify for this relief, the taxpayer must have timely filed the return for the year the election should have been made. In addition, the taxpayer must take the corrective action described below within the 6-month extension period.

**Required Corrective Action.** Corrective action under the automatic 6-month extensions requires the taxpayer to file an original or amended

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\(^{57}\) Treas. Reg. § 301.9100-2(b).
return for the year the statutory or regulatory election should have been made, and attach the appropriate form or statement for making the election. Where the election is not required to be filed with the return, the taxpayer must take the steps required to file the election in accordance with the statute, the regulations published in the Federal Register, or the revenue ruling, revenue procedure, notice or announcement published in the Internal Revenue Bulletin.\(^{58}\)

The Regulations make clear that the taxpayer making the election under the automatic extension provisions, as well as all affected taxpayers, must file their tax returns in a manner that is consistent with the election and comply with all other requirements for making the election for both the year the election should have been made and for all affected years. Failure to do so is grounds for the IRS to invalidate the election.\(^{59}\)

**Procedural Requirements Associated with Automatic Extensions.** Any return, statement of election, or other form of filing that must be made to obtain automatic extensions must contain the statement “FILED PURSUANT TO § 301.9100-2” written across the top. The filing must be sent to the same address that the filing to make the election would have been sent had it been done in a timely fashion.\(^{60}\) In addition, the Regulations make clear that no request for a private Letter Ruling is required for an automatic extension, and, therefore, no user fees need to be paid by a taxpayer taking corrective action.\(^{61}\)

**Letter Rulings and Automatic Extensions.** The IRS has indicated, in limited circumstances, that the automatic 6-month extension provided under the regulations described above, may be available to extend the time within which to allocate GST exemption. In PLR 9718020 (January 30, 1997), the decedent’s executor filed a timely estate tax return, properly electing QTIP treatment for an exempt and a nonexempt marital trust. Schedule R, however, was not filed with the return, thereby precluding the reverse QTIP election and allocation of decedent’s GST exemption to the exempt marital trust. Within 6 months of the due date of the return, the executor filed a Schedule R, made the reverse QTIP election, and allocated the decedent’s GST exemption to a credit shelter trust and to the exempt marital trust. The ruling granted an extension of time within which to make the reverse QTIP election. In addition, the ruling concluded that the provisions governing allocation of GST exemption under § 2632(a) are eligible for the automatic 6-month extension provided under Treas. Reg.

\(^{58}\) Treas. Reg. § 301.9100-2(c).

\(^{59}\) Id.

\(^{60}\) Treas. Reg. § 301.9100-2(d).

\(^{61}\) Id.
§ 301.9100-2, and that, because the estate had taken the proper corrective action, the allocation on the late filed Schedule R would be effective.

E. Retroactive Allocation When Certain Beneficiaries Predecease Transferor

When a beneficiary of a trust to which no GST exemption was allocated dies before the transferor and is an individual to whom § 2632(d) applies, it may be possible to avoid an otherwise applicable GST tax without the allocation of an inordinate amount of GST exemption by reason of the new retroactive allocation provision of § 2632(d). Care must be taken to comply with the requirements of new § 2632(d), including the requirement that the return retroactively allocating exemption be filed by the due date for a gift tax return for the year of the beneficiary’s death. It also may be necessary to sever the trust after the allocation to get maximum benefit from the allocation. Section 2632(d) provides “the transferor may make an allocation of any of such transferor’s unused GST exemption to any previous transfer or transfers to the trust.” The use of this provision can best be understood by an example.

Example. Assume T created a trust providing that in the trustee’s discretion income is to be paid to T’s spouse, S or accumulated and that on the death of the survivor of S and T, the trust is to terminate and pass outright to T’s descendants who survive the survivor of S and T, per stirpes, and that at the time the trust was created T had four children. Further assume T funded the trust with $600,000 and that no GST exemption was allocated to the trust. Now assume that D, one of T’s children, died before T, survived by children (grandchildren of T) at a time when the trust had grown to $1,000,000. Prior to § 2632(d), T would have needed to allocate $1,000,000 of GST exemption to the trust to avoid GST tax on the portion of the trust passing to D’s children on the death of the survivor of S and T. However, under § 2632(d), T can avoid GST tax by allocating $150,000 of GST exemption to the trust, as long as T has that much unused GST exemption, immediately before D’s death. T would need to do the following:

1. File a timely gift tax return for the year of D’s death and allocate $150,000 to the trust. This should result in a 75% inclusion ratio for the trust immediately before D’s death.

2. Thereafter, divide the trust in a qualified severance under new § 2642(a)(3)(B)(ii) into two trusts, one of which has 25% of the

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62 As stated above, this provision applies to a child, niece, nephew or a child of a first cousin of the transferor or the transferor’s spouse or former spouse or a descendant of a child, niece or nephew who is treated as being in the child’s generation by reason of the predeceased parent rule of § 2651(e).
value (or $250,000 if the value is unchanged from D’s death until the time of severance) and an inclusion ratio of zero (because it is funded with a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust before the severance) and the other of which has an inclusion ratio of one.

(3) The qualified severance will need to provide for the same succession of interests as the original trust. Therefore, it should (i) provide that any discretionary income distribution to S must be paid 25% from the 25% zero inclusion ratio trust, (ii) name D’s descendants who survive S, per stirpes (and only if none survive T’s other descendants) as the remainder beneficiary of that trust, and (iii) name D’s other surviving descendants, per stirpes as the remainder beneficiaries of the 75% one inclusion ratio trust.

The provision raises certain questions that will need to be resolved by regulation or technical correction. For example, it is unclear how this new section would apply if the child died during the reserved interest of a GRAT. Specifically, it is not clear how it would interrelate with the ETIP rules of § 2642(f) that provide an allocation to an ETIP is not effective until the end of the ETIP and is to use the fair market value of the property at the end of the ETIP. One wonders, furthermore, whether this relief is available if the transferor predeceases the non-skip person, but the non-skip person dies no later than 90 days after the transferor by analogy to Treas. Reg. § 26.2612-1(a)(2), under which the predeceased ancestor exemption is available when a “living descendant who dies no later than 90 days after the subject transfer is treated as having predeceased the transferor to the extent that either the governing instrument or applicable local law provides that such individual shall be treated as predeceasing the transferor.”

In planning an inter vivos irrevocable trust to be distributable to a child at age 35, it would seem advisable to include a power in an independent trustee to grant the child a general testamentary power of appointment (not an automatic grant of a general power). Specifically, if the child dies before 35, the retroactive allocation cannot be used if the transferor is deceased or if the transferor is alive but has no available GST exemption immediately before the non-skip person’s death. If the trustee grants the general power, query whether the retroactive allocation can be used. The retroactive allocation is effective immediately before the child’s death and if the child had a general power at that time, it would seem the allocation would be ineffective as the regulations provide at Treas. Reg. § 26.2632-1(b)(2) that an allocation is “void if the allocation is made with respect

63 § 2651(e).
to a trust that has no GST potential with respect to the transferor making the allocation, at the time of the allocation." If the child has a general power, there will not be GST potential. Consider whether the trustee should be directed to use the power to grant a general testamentary power only if the transferor was deceased — or if the transferor was alive only after the transferor had no remaining GST exemption. (This latter test requires communication and with the GST exemption increasing, this may be hard to deal with.) However, the trustee could presumably draft the grant of the general power by formula and make it by its terms effective only when the transferor was deceased or at a time when the transferor had no GST exemption available.

F. Compliance

The expansion of the automatic allocation rules as well as the retroactive allocation rule will have a substantial effect on tax return preparation in future years.

Automatic Allocation to Indirect Skips. The Act’s provision regarding automatic allocation of GST exemption to lifetime transfers to trusts that are not direct skips can be very helpful. However, it is important for this not to be a trap itself. The provision contains a mechanism allowing taxpayers to elect into and out of the automatic allocation for a particular transfer and/or for all transfers by a transferor to a particular trust. Irrevocable trusts to which periodic additions are made and irrevocable trusts that were subject to the ETIP rules of § 2642(f) should be reviewed to see whether transfers to the trust or a termination of all or part of the ETIP would (or would not) trigger an automatic allocation so that an election out of (or into) the automatic rule or an actual allocation is desired.

This is particularly true in early 2002, as it is possible that a 2001 addition was made to an older trust to which the decision was made not to allocate GST exemption (or to allocate exemption only on a late return) but to which the new provision would cause an automatic allocation to apply.

ETIPs may be particularly problematic because they may terminate in favor of a trust that meets the definition of a GST trust even though there was never an intention to allocate GST exemption to it. This issue becomes more complicated if an individual remainder beneficiary assigned his or her interest to a trust that would meet the definition of a GST trust.

Further, in drafting new trusts, consideration should be given to intentionally meeting (or not meeting) the definition of a “GST trust” and what allocations to make.
It will often be desirable to include language in the trust or the instrument of transfer, if any, to indicate whether or not the trust is intended to be exempt from GST tax. However, it is important to be aware that the taxpayer might want to change his or her mind. However, to elect into and out of the automatic allocation of GST exemption, a timely Form 709 needs to be filed — language in the document itself is not sufficient (§ 2632(c)) although it should help with substantial compliance or a § 9100 request. Consider the following language:

“I intend this trust to have a zero inclusion ratio within the meaning of § 2642 of the Internal Revenue Code. I further intend this provision to constitute an allocation of GST exemption on any return to which this trust document is attached (i) to any transfers to this trust made in the year for which such return is filed (ii) in the amount of GST exemption as defined in § 2631 of the Internal Revenue Code necessary to achieve this result, unless this provision is overridden on the face of the return (including any attachments thereto) by explicit reference to this provision.” (Query whether to include the last phrase.)

The substantial compliance rule needs to be considered. A similar problem could exist by reason of the substantial compliance provision. If a trust document is attached to a tax return (as required whenever transfers to a trust are reported on the return) and no allocation of GST exemption is intended with respect to the return (or a late allocation is desirable because no GST has occurred at the time of the return and the value of trust property has declined substantially), it would be advisable to review the trust document to make sure that there is no language that should be overridden in the document or the return in order to prevent the substantial compliance doctrine from applying.

Practice Pointer. Put simply, by reason of the expanded automatic allocation rules and the substantial compliance provision, it is prudent always to indicate on the relevant Form 709 or 706 whether a GST allocation is intended and, if so, whether a zero inclusion ratio is intended (or that no allocation is intended).

Beware of the deadlines for a retroactive allocation. As is discussed above, to take advantage of the special rule allowing retroactive allocations by reason of a beneficiary predeceasing the transferor, a timely gift tax return must be filed for the year of death of the predeceasing beneficiary. The tax return preparer may not be aware that a death has occurred and may need to ask specific questions to determine whether benefit of this provision is available and, if so, whether it is desired.
G. Structuring Estate Plans

It is obvious that the scheduled reduction in transfer tax rates, the substantial scheduled increase in the estate and GST tax exemptions as well as the more modest increase (or acceleration of the increase) in the gift tax exemption, and the scheduled repeal of the estate and GST tax (and carryover basis) will require changing the approach to GST planning in certain ways. Less obvious is the substantial impact the severance provision is likely to have on such planning. The severance provision will not only simplify drafting, but it will also expand the types of trusts to which one might wish to allocate GST exemption.


The use of downstream divisions that are respected for GST tax purposes will be very valuable in planning for new trusts. It is important to include provisions in new documents allowing severances in a manner that meets the qualified severance requirements, especially if controlling state law does not permit such severances, or only permits them with court approval.

Possible language authorizing such divisions is as follows:

“The trustees may without court approval at any time and from time to time, divide any trust hereunder into two or more separate trusts (based on the fair market value of the trust assets at the time of the division). In addition, if any trust for any reason (such as separate fractional or stirpital dispositions) is severable into distinct shares, the trustees may hold such distinct shares (or any portions thereof) as separate trusts. The terms of each of the new trusts may differ from the original trust but shall in the aggregate provide each of the beneficiaries with the same succession of interests as the original trust, except that any terms of the trust before severance that would affect qualification of the trust for any federal tax deduction, exclusion, election, exemption, or other special federal tax status must remain identical in each of the separate trusts created.”

Discretionary severances will be helpful in allowing executors and trustees to react to the increasing estate and GST exemptions particularly if enough flexibility is built into documents in the form of powers of appointment and trustee powers to accumulate income or distribute principal to allow GST exempt and non-exempt trusts created through severances on identical terms to be administered separately.

In planning new trusts for which a GST allocation is initially considered undesirable, because, for example, all trust property is to pass to children as long as they survive to a stated age or period, to which they are expected
to survive, it is possible to minimize the amount of GST exemption that would have to be allocated if one of several children dies prematurely survived by issue, as long as a significant generation-skipping transfer does not occur before the necessary allocation and severance can occur. Trusts can be drafted to provide that at the transferor’s death if a child had predeceased him or her the property could be held in a spray trust for deceased child’s spouse or the other children in addition to the deceased child’s descendants for a period of time — for example, six months. During this six months, GST exemption could be allocated to the trust. Then the trust could be divided in a qualified severance, so that the portion for the deceased child’s lineals would have a zero inclusion ratio and the portion passing to the other children would have a one inclusion ratio. This approach could be valuable with trusts (including an insurance trust if a child predeceases the transferor) if the retroactive allocation was not made, whether because the transferor predeceased the child, the due date is missed, or because the beneficiary is not in a close enough relationship to the transferor.

The qualified severance provision may make it desirable in certain situations to allocate GST exemption to trusts previously thought to be “off-limits” to GST allocations because it was not possible to ensure that the trust would have an inclusion ratio of zero. It should now be possible to allocate GST exemption to such trusts relying on the qualified severance provision to derive the desired inclusion ratio. For example, a long term trust (so that a GST does not occur immediately at the end of the ETIP) following a very successful GRAT might be a perfect receptacle for GST exemption, particularly when (or if) the GST exemption exceeds the gift tax exemption. The same can be true for qualified personal residence trusts and CLATs. For example, clients who were planning to allocate GST exemption to a testamentary charitable lead unitrust might want to use a CLAT instead, as long as the trust was not intended to have no or a very small estate tax value net of the charitable deduction. If this approach is used, it is crucial that any GST with respect to the trust will not occur immediately on the termination of the lead interest because there needs to be time to sever the trust before it occurs.

Section 2642(a)(3) also recognizes a “qualified severance” into multiple trusts when the inclusion ratio of the trust before the severance is zero or “1.” In the above situations, the qualified severance could be done and then GST exemption could be allocated — as long as the severance itself did not give rise to the GST. If there were non-skip persons in each trust after the severance (with interests that were not disregarded under Treas. Reg. § 26.2612-1(e)(2)(ii) after the severance) there should not be a GST. A qualified severance of a trust with a zero inclusion ratio could be helpful
if property with a one inclusion ratio were about to be added to such a
trust and no GST exemption would be allocated with respect to the
additional property. Presumably, a qualified severance could be done so
that one trust held the old property with a zero inclusion ratio and one
trust held the new property with the one inclusion ratio.

It would seem that a qualified severance would be effective when it was
made — but perhaps by analogy the approach in Treas. Reg. § 26.2654-
1(b)(2) would be adopted so that if the severance process had started and
been reported to the IRS, the trust would be treated as severed upon the
earlier of when the severance occurs or when the reporting was filed. Treas.
Reg. § 26.2654-1(b)(2) recognizes certain severances at death, even though
the severance was not yet complete when the Form 706 is filed, although
if a court proceeding was necessary it has to have been commenced and
court papers are to be filed with the Form 706.

If an allocation and severance that caused a GST were done the same
day — it would seem that the allocation should be treated as preceding

I. Drafting Trusts With a View to the Substantial Compliance Rules

In light of the new 9100 relief, substantial compliance and automatic
allocation provisions, it would be helpful to indicate in new documents that
a trust is intended to be exempt. However, it is important to be aware that
the taxpayer might want to change his or her mind. For example, lifetime
trusts intended to be GST exempt might contain language similar to the
following:

“I intend this trust to have a zero inclusion ratio within the meaning
of § 2642 of the Internal Revenue Code. I further intend this provision
to constitute an allocation of GST exemption on any return to which
this trust document is attached (i) to any transfers to this trust made
in the year for which such return is filed (ii) in the amount of GST
exemption as defined in § 2631 of the Internal Revenue Code necessary
to achieve this result, unless this provision is overridden on the face of
the return (including any attachments thereto) by explicit reference to
this provision.”

Further, it is important to indicate in the instrument of transfer and on
the Form 709 or Form 706 that the intent is (or is not) to derive a zero
inclusion ratio.

J. General Planning for Possible Repeal of the GST Tax

In light of the scheduled reduction in rates, increase in the GST
exemption and one-year repeal of the GST tax (and the possibility that
these benefits will be expanded, accelerated, frozen or cancelled), flexibility in planning is crucial.

Setting up spray trusts for children (rather than stirpital trusts), may allow deferral of the GST tax until the rates are lower or until the GST tax no longer applies. Similarly, provided that their interests will be respected for GST tax purposes, having non-skip persons (including charities) as beneficiaries (with interests in the trust) may allow deferral of the GST tax until the rates are lower or the GST tax no longer applies. Further building in and using special powers of appointment may also be beneficial to defer a GST until the GST tax no longer applies.

Even if GST tax no longer applies, very long term or dynasty trusts are likely to still be attractive to many clients because of a desire (1) to provide creditor and spendthrift protection for their children and (2) to protect against the re-introduction of the GST tax or the estate tax on the theory that effective date protection would likely be granted to such trusts. In addition, if the GST tax and the estate tax no longer apply, and do not spring back into existence and the gift tax remains in existence, the dynasty trust can be used to benefit multiple generations without a gift tax. Specifically, instead of distributing property outright to a child, who would incur a gift tax if the child then made a gift to his or her child, the trustee could direct the distribution directly to the child’s child without a gift tax. The trust should be drafted flexibly and give the trustee broad distribution powers — including the ability to distribute into further trust — and could give special powers of appointment to beneficiaries. Charity could be included as a beneficiary for added flexibility. Property also could be distributed from the trust to a beneficiary who did not have sufficient assets to use the basis adjustments.

K. 2010

In the unlikely event that the Act’s changes to the Code remain in effect through 2011, a trust established on the death of a transferor who dies in 2010 whose estate is not subject to estate tax by reason of the “repeal” should not become subject to GST tax when that tax, along with the estate tax, springs back in 2011. In order for the GST tax to apply to a transfer, a transferor must be identified and individual recipients, whether actual or potential, direct or through trusts, must be assigned to generations by reference to the transferor. Under § 2652(a) and Treas. Reg. § 26.2652-1(a), if a transfer is not subject to estate or gift tax, no transferor can be determined, and, as a result, the GST tax cannot apply.\(^{64}\)

\(^{64}\) This analysis appears to have been applied by the Secretary in Treas. Reg. § 26.2663-2, which involves the applicability of the GST tax to transfers by non-resident aliens.
On the other hand, an inter vivos generation-skipping trust established in 2010 when the generation-skipping transfer tax is not in effect would probably not be protected from the GST tax as to generation-skipping transfers that occur after the GST tax is restored. There would be a transferor of such trust because the gift tax will be in effect in 2010.

It is not clear how a trust should be treated for GST tax purposes after 2010 if, in 2010, it has an event that would have been a taxable termination if it had occurred in a year in which the GST tax applied. Normally, when a taxable termination occurs, for purposes of applying the GST tax to future transfers, the generation-assignment of the transferor moves down at least one generation. The move occurs to prevent the application of additional GST tax when trust property passes to the generation below the generation assignment of the person whose terminated interest caused the taxable termination.\(^65\) If, however, the taxable termination occurs in a year when the GST tax does not apply, the IRS might take the position that the generational move-down rule is not available to protect future transfers.

### 702.5 Life Insurance Planning

#### A. Life Insurance

Establishing an irrevocable life insurance trust to purchase term life insurance to cover a death during the transition period may be beneficial, as long as the insurance is convertible to a continuing policy in case the repeal is postponed or never occurs or occurs and the estate tax springs back. Using a universal life policy may give added flexibility.

#### B. Liquidity

With less federal estate tax, there should in some cases be less liquidity concerns. However, there will be higher income tax due to carryover basis. Further, in the business context, liquidity will continue to be important especially recognizing that when a key man dies often outside dollar sources of liquidity (dependent upon the reputation or relationships of the key man) often become less available.

#### C. Basis

Insurance is also attractive because the inside build up is not subject to income tax and the death proceeds are free of income tax. This effectively is a step-up in basis at death. This can be especially beneficial if death occurs after 2009, as the other assets of the estate are subject to carryover basis.

\(^65\) § 2653.
¶ 702.6 Charitable Planning

A. CLTs

Creating charitable lead trusts to leverage gifts and shift future appreciation may still be beneficial during a transition period (provided that there is a desire to benefit charity), but calculations will need to be done at various gift tax rates to see at what point such transfers cease to be desirable. However, CLTs are irrevocable and may not be what the grantor wants, especially because to have a small up front gift, the trust would have to exist beyond 2009. This needs to be discussed with the client.

B. CRTs

Creating charitable remainder trusts with appreciated low income assets if the annuity or unitrust payable to the donor and then to the donor’s children (with the remainder to charity) could be advantageous if the estate tax were repealed at the time the grantor’s interest ended. The grantor would retain the ability to change the children’s interest through his or her will so the establishment of the CRT would not be a taxable gift. The children’s interest would be in the grantor’s estate — if not cancelled — but if the estate tax was not then applicable, there would not be an estate tax. Of course, if the estate tax were then applicable, making the children’s interest revocable might not have been a good idea if the assets appreciated between the time the trust was established and the donor died. It might have been preferable to have a taxable gift at the time the trust was created. On the other hand, because the children’s interest can be revoked, the grantor could revoke the interest if the estate tax was then applicable and there would be no estate tax. Presumably, this approach would be followed if the donor intended only to have the interest pass to the children if the estate tax was not applicable and, therefore, if that is the case, the donor’s will should from the time the CRT was established contain such a revocation provision dependent upon the applicability of the estate tax.

C. Basis

When carryover basis replaces the step-up in basis at death, it will be beneficial to allocate low basis assets to charitable bequests.

D. Bequest Recipients

Currently, it is advantageous to bequeath property to a spouse and then have the spouse give the property to charity. The decedent gets an estate

tax marital deduction, and the spouse obtains an income tax charitable
deduction. If the estate tax no longer applies, the decedent can bequeath
the property to a nonspouse who can then give property to charity and
obtain an income tax charitable deduction.

E. Lifetime Gifts

Once there is no estate tax, it will be more beneficial to give assets
(epecially highly appreciated assets) to charity (including charitable
remainder trusts) during life to receive an income tax charitable deduction
— as there will be no estate tax deduction.

¶ 702.7 Retirement Plans

Retirement plans would continue to be subject to income tax but would
not be subject to estate or GST tax if those taxes were no longer applicable.
Many employees would probably choose to change the beneficiary in light
of this change in taxation, e.g., to take advantage of potentially lower
income tax rates at younger generations.
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