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THE CONCLUSION OF THIS WASHINGTON REPORT.**

With time rapidly disappearing to enact either a temporary or permanent extension of the federal estate tax, it looks increasingly likely that there will be at least some period of time during 2010 when there will be no federal estate and generation-skipping transfer tax in effect. This Washington Report analyzes the changes to existing law that will occur during that period, what may be done to plan for repeal, and whether the tax may be reinstated retroactively to January 1, 2010.

THE WORLD UNDER REPEAL

As the result of changes adopted in the Economic Growth And Tax Relief Reconciliation Act of 2001 ("EGTRRA," P.L. 107-16), the federal estate and generation-skipping transfer (GST) taxes are scheduled to be repealed during 2010 and reinstated - with dramatically lower exemption levels and higher marginal rates - in 2011, when EGTRRA will "sunset." In general, the federal estate, gift and GST tax provisions during 2010 and 2011 will look like this:

2010

- Estate and GST Taxes Repealed.
- Gift Tax Exemption is \$1 Million.
- Highest Marginal Gift Tax Rate is equal to top individual income tax rate (35%, unless increased). Since the current marginal rate on gifts in excess of \$1 million (the gift tax exemption amount) is 41%, this likely will mean that gifts will be subject to a flat tax of 35%.

- Carryover Basis regime is instituted with \$1.3 Million per person exemption, plus \$3 million marital exemption (indexed for inflation).
- All transfers to trusts other than “grantor” trusts are treated as completed gifts.
- Distribution after 2020 from (and Terminations after 2009 by) Qualified Domestic Trusts (“QDOTs”) are no longer taxable.
- Additional tax for failure to extinguish a donor’s retained development rights in a qualified conservation easement (§ 2031(c)(5)); Acceleration of installment payments on disposition 50% or more of closely held business (§ 6166(g)); Recapture tax on ceasing to qualify for special use valuation (§ 2032A(c); and Recapture tax imposed on ceasing to qualify for the Qualified Family-Owned Business Interest (“QFOBI”) interest deduction (§ 2057(f)) all continue to apply after repeal.

2011 (“Sunset”)

- Estate and Gift Tax Exemption is \$1 Million.
- GST Exemption is \$1 Million (indexed for inflation above \$1.06 Million applicable in 2001).
- Highest Marginal Estate and Gift Tax Rate is 55%, plus 5% surcharge to phase out benefit of unified credit on estates with a value in excess of \$10 Million.
- Maximum State Death Tax Credit is 16%.
- QFOBI Deduction is restored.
- QDOT distribution and termination taxes are restored.

Carryover Basis

One of the most significant changes that will occur in a repeal environment is the institution of “carryover basis” on death. Upon full repeal of the estate tax in 2010, the current system, which provides, under Internal Revenue Code § 1014, a basis step-up to fair market value at death, will be replaced with a carryover basis system in which assets will receive a basis equal to the *lesser of* the basis of the property in the hands of the decedent or its fair market value on the date of death. Three rules applicable under the new régime should be noted:

- (i) Since § 1014 is repealed in 2010, the decedent’s estate and beneficiaries will be allowed to “tack” the decedent’s holding period only with respect to those assets having a basis determined by reference to the decedent’s basis. Thus, (i) assets that are “stepped up” under one of the basis allocation provisions described below, and (ii) assets having a fair market value that is less than the decedent’s basis must be held for one year prior to sale in order to get long term capital gain treatment in 2010;
- (ii) Depreciable real estate subject to recapture in the hands of the decedent will be subject to recapture when sold by the estate or beneficiaries; and
- (iii) Suspended passive losses that, under current law, are deductible at death only to the extent of the excess of the fair market value of the property in the hands of the transferee

exceeds its basis in the hands of the decedent immediately before death should, in most cases be deductible in full in 2010.

The post-repeal carryover basis rules are set forth in new § 1022, which contains the following provisions:

1. **Aggregate Basis Increase** The estate of each decedent will be allowed an “aggregate basis increase” in the amount of \$1.3 million (\$60,000 in the case of nonresident alien decedents), increased by the amount of the decedent’s built-in capital and net operating loss carryovers, and certain losses that would have been allowable under section 165 had the property been sold immediately prior to death. This amount will be indexed for inflation after 2010. The decedent's executor may allocate (on the return required under § 6018 for “large transfers at death”) the amount of the basis increase among assets owned by the decedent at death. Estate and gift tax returns will still be required in many cases post-repeal.
2. **Basis Increase for Property Acquired by Surviving Spouse** An additional \$3 million (which will be indexed for inflation) may be allocated to qualified marital deduction property inherited from a spouse. The surviving spouse need not be a U.S. citizen or resident for the property to be eligible for this allocation. Property eligible for the spousal basis step-up must be bequeathed to or inherited by the surviving spouse either outright or in the form of a qualifying income interest for life.
3. **Jointly-owned Property** Where property was owned jointly with a spouse, only that half of the property considered owned by the deceased spouse will be eligible for the basis step-up. If the property was owned jointly with a person other than the surviving spouse, the decedent is treated as the owner of that proportion of the property for which he furnished the consideration (thus creating a difficult “tracing” problem for assets, such as improved real property, for which it may be difficult to trace respective contributions of co-tenants).
4. **Community Property** In the case of community property, the surviving spouse’s one-half of the property also will be eligible for basis step-up (as under current law).
5. **Property Must Have been “Owned” by the Decedent** In order to be eligible for a basis increase, property must have been “owned” by the decedent on the date of his or her death. Property held by the decedent in a “qualified revocable trust,” (which refers only to domestic - *i.e.*, U.S. - trusts) will be treated as having been owned by the decedent for this purpose. However, property held by a surviving spouse in a “QTIP” trust, will not be treated as having been owned by the surviving spouse on the date of the surviving spouse’s death. Nor will the decedent be treated as owning property over which he or she held a power of appointment at death, property held as the beneficiary of an “estate” trust, or, in most cases, property that the decedent acquired for less than adequate consideration within 3 years of death. Property acquired by the decedent as a gift from his or her spouse within 3 years of death will be considered to be owned by the decedent, except where the spouse acquired the property by gift within the 3 year period.
6. **Property Ineligible for Step-Up** Property constituting “income in respect of a decedent” (IRD) will not be eligible for step-up. This rule is consistent with current law, and will principally affect property held in qualified retirement arrangements and individual retirement accounts. Stock of certain foreign entities also will not be

eligible for step-up. However, inherited art work or similar property created by the decedent will be reclassified as a capital asset eligible for the basis step-up.

7. **No Gain Recognition on Receipt of Property from a Decedent** A beneficiary, other than a tax-exempt beneficiary, will not recognize gain upon the receipt from a decedent's estate of property that has liabilities in excess of its basis -- *i.e.*, negative basis property. Situations in which gain will be recognized include the satisfaction of a pecuniary bequest with appreciated property (but only to the extent of appreciation in the value of the property occurring after the date of death) and transfers of property at death to nonresident alien individuals.
8. **No Increase In Basis Above Fair Market Value** Under no circumstances may an allocation of basis increase the basis of property in excess of its fair market value on the date of the decedent's death.

Transfers to Certain Trusts Treated as Taxable Gifts

Transfers to most "nongrantor" trusts will be treated as taxable gifts during repeal. This provision seeks to prevent income tax avoidance that might occur if a donor of property were able to shift the burden of income taxation on property transferred to a nongrantor trust in situations where that transfer is treated as "incomplete" under the gift tax rules. If, however, the transfer is eligible for the annual exclusion under § 2503(b) (through, *e.g.*, the use of "Crummey" withdrawal powers that are important to the implementation of most life insurance trusts), or the marital or charitable deductions, that exclusion, or those deductions, will continue to be available. A technical correction to EGTRRA, enacted as part of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), helps clarify this intent, although additional regulations probably will be required.

Ameliorative GST Provisions

EGTRRA's GST relief provisions, such as automatic allocations of GST exemption, relief from late allocations, and more generous trust severance rules will sunset along with the GST tax.

PLANNING FOR REPEAL

Many estate planners already have built into their documents contingencies for repeal, *e.g.*, through the use of disclaimer planning or "Clayton" QTIPs, *i.e.*, a QTIP trust in which the spouse's income interest is contingent on the election of QTIP treatment by the executor. *See Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992). The non-elected portion of the trust may pass either to a discretionary credit shelter trust or to children. However, many drafters may have used a "reduce to zero" formula to define the marital and credit shelter shares of an estate. Such a plan might result in the marital share of the estate being eliminated.

Going forward in a repeal environment, some of these may include:

1. ***Review Plans.*** All formula bequests based on the existence of the federal estate tax should be reviewed.
2. ***Track Basis of Assets.*** Clients should be advised to keep records of the basis of assets - to the extent the basis can be determined - indefinitely, or, at a minimum, until it can be determined whether repeal will, in fact, occur. Unlike 1976 (the last attempt at enacting carryover basis) there is no "fresh start" to step up the basis of assets to 2010 values.

3. ***Empower Executor to Allocate Basis.*** Provisions should be added to existing estate planning documents giving the decedent's executor the power to allocate the decedent's aggregate basis increase among the assets includible in his or her gross estate, regardless of whether such assets pass under the will (*i.e.*, probate assets) or outside of the will (*i.e.*, non-probate assets). Executors should be indemnified and held harmless for making this allocation. Alternatively, specific direction should be given to allocate the basis step-up among assets. Such direction might include a direction to distribute low basis property to charity and/or a direction to allocate basis step-up first or ordinary income property, such as real estate subject to recapture.

4. ***Dispositive Scheme.*** Planners will want to recommend a "post-repeal" disposition that takes advantage of the client's available basis increase. This will be difficult because the increase does not refer to the absolute value of property eligible for the step-up, but to an addition to the basis of existing assets. Thus, a bequest to a QTIP trust of property having a *value* of \$3 million would utilize the marital basis step-up only if the property was (i) not cash, (ii) eligible for the step-up, and (iii) had a basis in the hands of the decedent of zero. In drafting, therefore, a bequest of property to a surviving spouse should, subject to independent counsel review, refer to, *e.g.*, "an amount of 'qualified spousal property' (within the meaning of § 1022(c)(3)) which, in the aggregate, has a basis that is equal to the amount of its fair market value on the date of my death, less the amount of the 'aggregate spousal property basis increase' (within the meaning of § 1022(c)(2)) available to my estate on the date of my death." A similar formula could be used to make a bequest to children that will utilize the decedent's \$1.3 million non-spousal basis step-up amount.

If repeal occurs, drafters should consider recommending the following disposition for sizeable estates:

- (i) \$3 million of basis increase in "qualified spousal property" to a QTIP trust;

- (ii) \$1.3 million of qualified property outright to the surviving spouse (so that the surviving spouse may take advantage of his or her own \$1.3 million basis step-up on death if he or she does not otherwise own sufficient property in his or her own name) (Alternatively, the trustee of a QTIP trust could be empowered to distribute to the surviving spouse an amount necessary to fund the \$1.3 million basis increase available to his or her estate); and

- (iii) the remainder in a discretionary "credit shelter" type generation-skipping trust to which the decedent's \$1.3 million "aggregate basis increase" may be allocated.

Perhaps the most feasible post-repeal plan will be a 100% QTIP disposition with the right in the surviving spouse to disclaim assets to a credit shelter-type trust in an amount sufficient to use the decedent's \$1.3 million basis allocation for non-spousal bequests. However, whether a § 2518 disclaimer will be effective for this purpose is an open question, since § 2518 is a transfer tax, and not an income tax, statute.

5. ***Life Insurance*** Life insurance (and life insurance trusts) should continue to have a place in estate planning even after repeal. In a carryover basis world, life insurance will be one of the few assets that is able to grow tax-free and which will not give rise to an income tax event after death. (§ 101) Further, the ability to fund many

insurance trusts in whole or in part with annual exclusion gifts provides the ultimate “leveraging” of the exclusion. This leveraging may be enhanced through the use of split-dollar (including private split-dollar) arrangements.

6. **Charitable Giving** EGTRRA made virtually no changes to the charitable deduction rules. While it is likely - although by no means certain - that testamentary charitable giving will decline as more estates are “liberated” from the certainty of having to pay estate tax, charitable giving as an income tax planning device will likely continue. In this regard charitable remainder trusts, because of their ability to eliminate the capital gains tax on appreciated assets, will be particularly important. In a post estate-tax world, charitable bequests of low basis assets may eliminate some of the downside of a carryover basis régime, as will *inter vivos* transfers of those assets to a CRT.
7. **Leverage Non-Gift Transfers** Certain techniques, such as grantor retained annuity trusts (“GRATs”), qualified personal residence trusts (“QPRTs”), sales to intentionally defective grantor trusts, self-canceling installment notes (“SCINs”), private annuity sales, and charitable lead trusts (“CLTs”) that transfer wealth but minimize or eliminate the gift tax may be especially useful in an environment where there continues to be a gift tax, but no estate or GST tax.

LIKELY RETROACTIVE RESTORATION OF THE ESTATE, GIFT AND GST TAX

Most planners anticipate that Congress, early next year, will move to re-instate some variation of the current transfer tax system (perhaps with slightly different rates and exemptions) with an effective date that is retroactive to January 1, 2010. Legal experts have speculated on the constitutionality of such a move. There is precedent, however.

In August 1993, President Clinton signed the Omnibus Budget Reconciliation Act (“OBRA”), which increased the highest federal estate and gift tax rates (then 50%) to 53% for transfers over \$2.5 million but less than \$3 million, and 55% for transfers over \$3 million. The OBRA tax rate increases were retroactively effective January 1, 1993. The estates of a number of decedents who died in the period between January and August 1993 sued to prevent the rate increase on the grounds that the retroactive increase was unconstitutional. The plaintiffs in each case variously alleged that OBRA’s retroactive imposition of the higher estate tax rate violated various constitutional provisions including the Apportionment Clause, the Separation of Powers Clause the Due Process Clause of the Fifth Amendment, or the Takings Clause under the Fifth Amendment, and contravened the prohibition against *ex post facto* laws. See *U.S. Bank, NA v. U.S.*, 74 F. Supp. 2d 934 (D. Neb. 1999); *NationsBank of Texas v. U.S.*, 44 Fed.Cl. 661 (Fed.Cl.1999); *Quarty v. U.S.*, 170 F.3d 961 (9th Cir.1999); and *Kane v. U.S.*, 942 F.Supp. 233, (E.D.Pa.1996), *aff’d without op.*, 118 F.3d 1576 (3d Cir.1997). See also, *United States v. Carlton*, 512 U.S. 26 (1994), in which the Supreme Court ruled that due process was not violated by retroactive application of amendment to federal estate tax statute limiting the availability of a deduction for proceeds of sales of stock to employee stock-ownership plans (ESOPs) to stock directly owned by decedent immediately before death.

There is a distinction, however, between retroactively changing the rates of a tax that is already in effect, and imposing a new tax retroactively. Some argue that, since the federal estate and GST taxes will have been repealed, however, briefly, their retroactive reinstatement would constitute the imposition of a “new” tax. This distinction resulted in rulings by the U.S. Supreme Court that the retroactive imposition of a tax on transfers made within three years - in “contemplation of” - death was unconstitutional because the statute was not allowed to reach back and tax a gift that was made and became completely vested long before enactment at a time when the tax burden could not have been foreseen, although the actual transfer occurred within the statutory period. See *Nichols v. Coolidge*, 274 U.S. 531 (1927); *Untermeyer v. Anderson*, 276 U.S. 440 (1928). Whether such an argument would be successful in a case where it is

widely anticipated that the tax will be reimposed is unclear. We can, however, almost certainly anticipate that the argument will be made.

RETURNS

Since federal estate tax returns are not due until 9 months after the date of a decedent's death, executors of estates of decedents dying on or after January 1, 2010 will be able to take into account the likely constitutionality (or unconstitutionality) of any retroactive reinstatement of the estate tax that occurs within the first 9 months of 2010. Some may take a return position that is consistent with repeal, while others may assume that any retroactive reinstatement of the estate tax is constitutional and file accordingly. The decision in either case is likely to be made in consultation with counsel who will have to assess the likelihood of success in arguing for the position that a retroactive tax is unconstitutional.

Likewise, gift tax returns for transfers made in early 2010 may not have to be filed until as late as October 2011 (with extensions), giving the donors time to consider certain elections (such as the QTIP election) and disclaimers that would, or would not, result in taxable gifts.

Furthermore, developments (including rulings and other publications by the Internal Revenue Service and the Treasury) during the period prior to the return filing date can be taken into account and may simplify potential relevant issues.

Throughout this Washington Report we have cautioned, with respect to various specific matters, that acting (whether by the client or his insurance advisors) should be undertaken only with the advice and judgment of legal counsel. We emphasize that such caveat is equally applicable to the entirety of this publication. We are not offering drafting or legal advice; we are merely attempting to give an appropriate background to help you think through your clients needs for ultimate referral to legal counsel.

We are all now beginning to swim in uncharted waters.

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