

BUSINESS ENTITIES

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INTERVIEW

Lloyd Leva Plaine Interviewed by Jerald David August



Photograph by James W. Hill

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Lloyd Leva Plaine is in charge of the individual tax planning practice group at Sutherland Asbill & Brennan LLP (Washington, D.C. office). Lloyd is a frequent lecturer on gift tax, estate tax, income tax, and generation-skipping transfer tax and has written and published numerous articles in these areas. She co-authored a leading treatise on the generation-skipping transfer tax. She is active in the ABA and currently services on the ABA Tax Section Council, is a former Chair of the ABA's Real Property, Probate and Trust Law Section, and is a former Chair of the ABA Tax Section's Estate and Gift Taxes Committee.

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Q. Starting off, Lloyd, please tell us about your background and experience in the field of tax law and your areas of concentration.

A. I have been practicing in the area of estate planning and federal transfer taxation since joining Sutherland Asbill & Brennan's Washington, D.C. office in September 1975. I would describe the estate planning practice at Sutherland as tax, business, and estate planning. The practice involves lifetime tax and business planning for individuals, post-mortem income tax planning, and estate and trust administration. Although the focus of the practice is on estate planning, it is our belief that estate planning includes more than properly drafted wills and trust agreements. Therefore, we offer expertise in income tax, business, and estate planning for owners of closely held

businesses and people involved in real estate and international transactions. In addition, we work with clients to develop and implement lifetime gift, insurance, and charitable giving programs appropriate to their desires, needs, and resources. It is our goal to provide sound tax and business planning advice and create an estate plan that achieves the client's goals in a manner that minimizes the transfer taxes and the time and expense of estate administration. We assist clients in the integration of business planning techniques and estate planning by providing advice on the tax and non-tax issues attendant on the transfer of family businesses, including capital structure reorganizations, buy-sell arrangements, gift programs, and valuation issues.

Sutherland has represented numerous individuals and estates in disputes before the IRS concerning income, gift, estate, and generation-skipping transfer (GST) tax matters. In the course of these representations we have had significant experience in the area of asset valuation and whether property held in trusts or similar arrangements is subject to gift, GST, or estate tax.

Q. How was it that you became interested in specializing in federal transfer taxation? Are there other areas of the tax law that you are also substantially involved in?

A. I became interested in specializing in federal transfer taxation because of a number of factors. Growing up, my father, Marx Leva, and I frequently discussed matters relating to the economy and the stock market. I was interested in macroeconomics and majored in economics at the University of Pennsylvania, taking my major-related courses at the Wharton School. I worked at a stock brokerage firm two summers when I was going to college and learned about the economy from a different perspective. At law school, concentrating in tax law seemed to flow naturally from these interests. Taxation and estate planning and federal transfer taxation were of particular interest in part because of my desire to deal with individuals, their families, and businesses directly and to try to help them with their estate plans and assets including closely held businesses, and because of two excellent tax professors - Paul Dean and Peter Weidenbruch at Georgetown University Law Center.

Because I deal principally with individuals, their estate, trusts, and businesses, I frequently get involved with individual income tax questions. Income taxation of estates and trusts is a daily part of my practice. In planning for the formation and structuring of entities, and the operation and transfer and taxation of closely held businesses, I am fortunate to be able to draw on the wealth of tax expertise at Sutherland in the tax area in general and particularly in dealing with the taxation of Subchapter C corporations, Subchapter S corporations, partnerships, LLCs, pensions, and executive compensation matters. I also work closely with our corporate and real estate attorneys.

Q. For those of our readers who work primarily in income taxation, it would be helpful if you could briefly describe our transfer tax system prior to the enactment of EGTRRA in 2001 and address how the transfer tax impacts owners of closely held businesses.

A. Our federal transfer tax system both before and after EGTRRA basically involves the taxation of the transfer of property based on its fair market value. The gift and estate tax systems were unified before EGTRRA and will remain in many respects unified until 2010. The same tax rate schedule applies to both. The estate tax is based on the sum of the taxable estate and taxable gifts made after 1976 (other than gifts includable in the gross estate) reduced by gift tax that would have been payable under the rate schedule in effect at death on gifts made after 1976. The unified credit allowed against the gift tax and the estate tax is the same through 2003.

Specifically, the unified credit could be used to offset the gift tax and/or the estate tax. For example, in general, in 2000 and 2001 a U.S. resident could transfer (to someone other than a spouse or charity) by gift and/or at death property with a fair market value of \$675,000 ("the exemption equivalent") without owing any gift or estate tax. The exemption equivalent was scheduled to increase in stages to \$1 million for gifts made and deaths occurring in 2006. The gift tax or estate tax on the taxable transfer of \$675,000 of property would have been \$192,800, but because the unified credit was \$192,800, no gift or estate tax would have been due. The comparable amount that could be transferred free of taxes by a nonresident alien was (and remains after EGTRRA) \$60,000. There are additional credits against the estate tax including a credit for gift tax paid, a credit for state death taxes, a credit for tax on prior transfers, and a credit for foreign death taxes.

In addition, gifts and transfers at death, in an unlimited amount, can be made to or for the benefit of a U.S. citizen spouse if the transfer is made in a manner that qualifies for the gift or estate tax marital deduction. The result is tax deferral until the donee spouse makes a taxable gift or dies owning assets in excess of the donee spouse's exemption equivalent. Therefore, a U.S. citizen donee spouse, can, for example, spend his or her assets and then the tax deferral might result in no estate tax at the donee spouse's death. The marital deduction is also available for transfers to noncitizen spouses but lifetime transfers cannot exceed \$112,000 a year and have to be made outright or in a certain type of trust. Transfers at death to a noncitizen spouse—although unlimited in amount—have to be made in a certain form (to a qualified domestic trust) which basically ensures that the property that qualified for the marital deduction will be subject to estate tax later.

An unlimited amount can be given or bequeathed to or for a charity in a manner that qualifies for the gift or estate tax charitable deduction.

In addition, annual gifts of present interests in property, up to \$11,000 a year (indexed for inflation) can be made to any number of donees a year. Further unlimited payments made *directly* to the provider of services for tuition only and medical care (unreimbursed by health insurance) are not considered to be gifts.

The gift tax system is "tax exclusive" meaning that for gifts made more than three years before the donor's death, there is no transfer tax paid on the money used to pay the gift tax. By contrast, gifts made within three years of death and the estate tax are tax inclusive, so that a transfer tax is paid on the very money used to pay the transfer tax. For example, if someone was in the 50% bracket and had \$1,500,000 available to make transfers and pay transfer tax, that person could give away \$1 million and pay \$500,000 of gift tax (if he or she lived more than three years after making the gift)—effectively a

33-1/3% rate on the \$1,500,000. On the other hand, if the gift was made within three years of death, the gift tax paid would be included in the gross estate. If the person had the same \$1,500,000 to use to make transfers at death and pay estate tax, and was in the 50% bracket, the estate tax would be \$750,000—so he or she could only make bequests of the remaining \$750,000—a 50% rate on the entire \$1,500,000. Therefore, it was beneficial before EGTRRA, and may still be in certain cases, to make taxable gifts if it is likely that the donor would live more than three years after the gift.

Section 303 affords the opportunity to have a distribution of property to a shareholder by a corporation in redemption of part or all of its stock where the stock is included in the gross estate to be treated as a distribution in full payment in exchange for the stock rather than as a dividend. This treatment is allowed (if certain requirements are met) for distributions equal to the total federal and state death taxes and funeral and administration expenses (allowable as estate tax deductions). There is a similar provision for redemption of stock for payment of the GST tax in certain situations.

Part of the planning with closely held businesses is to try to meet the liquidity problems at death caused not only by the imposition of the estate tax but also, in many cases, by the loss of the key person who had the credit relationship with the lender. Trying to meet liquidity needs is accomplished both by trying to reduce the estate tax and in trying to qualify, where appropriate, for valuation reduction, estate tax deductions, estate tax payment deferral, and the redemption provisions referred to above.

GST tax. The GST tax, in general, is imposed on transfers that skip a generation without being subject to gift or estate tax. Specifically, a gift to a grandchild would be subject to both gift and the GST tax because there is no transfer tax at the child's intervening generation. It is also imposed on the termination of a child's life estate in a trust if the property passes to or for the benefit of grandchildren without the imposition of a gift or estate tax at the child's generation. Each person has a GST exemption that he or she can allocate to property basically to exempt it from the GST tax. That exemption was \$1,060,000 in 2001 and is indexed for inflation such that it became \$1,100,000 in 2002 and \$1,120,000 in 2003. By allocating the GST exemption to a trust, an inclusion ratio is derived. For example, by timely allocating \$1,100,000 of the GST exemption to a \$1,100,000 gift made to a new trust, a "0" inclusion ratio is derived, and the trust is exempt from GST tax. If \$550,000 of the GST exemption were allocated, a "1/2" inclusion ratio would be derived, and if no GST exemption were allocated, a "1" inclusion ratio would be derived. Any GST of property is taxed by multiplying the amount of the GST by the maximum federal estate tax rate (for example 50%) and the inclusion ratio. To illustrate, if at the end of the child's life estate, \$500,000 of property passed to a grandchild outright or in further trust with a "1/2" inclusion ratio, there could be a \$125,000 tax ($\$500,000 \times .50 \times .50$).

One of the goals in GST tax planning is to try to allocate the GST exemption to derive a "0" inclusion ratio for an irrevocable trust containing assets that will appreciate and have the trust continue for as long as allowable under state law so that transfer tax can be avoided for multiple generations. Some states have no rule against perpetuities, so trusts in those states can continue without a time limit.

Lowering transfer taxes. In order to lower federal estate tax liability and decrease liquidity needs, it is important to try to reduce the value of the owner's interest in the business. This involves freezing (or decreasing) the value at the owner's level and shifting future business opportunities and future growth to the next generation with a minimum of transfer tax.

One way to do this is to reduce the ownership interest to a noncontrolling interest. A minority, noncontrolling interest in a closely held business is valued at a discount from the pro rata share of the business as a whole. Shifting or preserving income flow is another factor depending on the situation. In addition, deferring tax through the use of the marital deduction can be valuable. In the right case, using charitable vehicles to minimize transfer tax and benefit charity can also be beneficial. In order to decrease the owner's interest so he or she does not have a controlling interest (or if he or she has a controlling interest, so that he or she would not still have a large equity interest) at death, transfers can be made through outright gifts or gifts to trusts. Those gifts include using grantor retained annuity trusts (GRATs), charitable trusts, and sales to grantor trusts and perhaps recapitalizing, if advisable, into voting and nonvoting interests (so that transfers can be made of the nonvoting interests). If the business or real estate is not already in LLC, partnership, or corporate solution, it should be put in a limited liability entity to provide liability protection, centralized management, and ease of fractionalization. It is important that these steps be done with management and ownership succession planning in mind and not just to try to maximize discounts for lack of marketability and lack of control.

When a gift is made, the donee will have the donor's basis, in general, whereas the basis of property owned at death through 2009 is its date of death value. Therefore, before deciding on a "gift plan," basis implications must be considered.

Establishing an irrevocable trust that purchases life insurance can be very helpful because, if done properly, the insurance proceeds will not be subject to income or estate tax. The proceeds can be used to make loans to, or to buy illiquid assets from, the decedent's estate or trusts, thereby providing a source of liquidity for the payment of estate tax, debts, and administration expenses.

A key part of planning with closely held businesses is being sure the operating and/or buy/sell agreements are drafted with the following in mind: operation of the business, ownership and management succession planning, cash flow considerations, liquidity concerns, disability planning, potential divorce, creditor protection, change in employment status, a potential sale of all or part of the business to a third party, creating a market for the interest, establishing value, providing a funding mechanism for redemption, and estate planning. The terms of the agreement will vary depending on the type of business, the goals of the owners, and the type of entity. For example, agreements involving S corporations need to have provisions to prevent the transfer of stock that would cause the corporation to lose its S status. Such agreements should provide for distributions equal to the income tax owed by the shareholders due to their status as S shareholders. The type of agreement—whether it is to be a cross purchase, an entity purchase, or a combination of the two—and how it will be funded will vary depending upon the type of business, type of entity, and goals of the owners.

Having properly drafted estate planning documents—including wills, trusts, durable powers of attorney for property management (in case of disability), and health care powers of attorney—is essential. Careful consideration should be given as to how to benefit children who are active in the business and children who are not—without disrupting the future operation of the business.

Trusts drafted for the ownership of interests in closely held businesses need to take into account potential conflicting interests among the beneficiaries, potential conflicting interests between the beneficiaries and the business, and the duties and the role of the fiduciary in the business. If an S corporation is involved, only certain types of trusts can be shareholders of S corporations.

Q. How did EGTRRA revise the transfer tax system? What are its present and long term impacts on estates of U.S. citizens and residents? What impact will EGTRRA have on owners of closely held businesses? And given the uncertainty of permanent repeal, and with due regard to the phase-in until 2010, how are estate planners advising their clients during this "schizophrenic" period? Are there drafting techniques and provisions that can be inserted into dispositive instruments that have the flexibility to adapt to the law at the time such instruments become effective so as to straddle the estate tax repeal issue?

A. EGTRRA made fundamental changes in the transfer tax systems including rate reductions, increases in the exemption equivalent of the unified credit, the deunification of the estate and gift tax, and the eventual repeal of the estate and GST tax for one year—2010.

The following chart sets forth the rate reductions made by EGTRRA:

Gifts Made in, Estates of Decedents Dying in, & GSTs in 2002	Top Marginal Estate & Gift Tax Rate & GST Tax Rate 50% (5% estate & gift tax surtax repealed)
2003	49%
2004	48%
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%

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

Repeal and spring-back. In 2010 (i.e., for decedents dying and GSTs in 2010), the estate and GST taxes are "repealed." Technically, it provides the estate tax "shall not apply to the estate of decedents dying after December 31, 2009" and the GST tax "shall not apply to generation-skipping transfers after December 31, 2009." The fact that the estate and GST tax provisions will remain in the Code is relevant when determining how to draft provisions that refer to the estate and GST taxes. The pre-EGTRRA law (i.e., the law in effect in June 2001) *springs back* into place and is to be applied to estates, gifts, and

GSTs after 12/31/10, as if the provisions and amendments made by EGTRRA had never been enacted.

Exemption equivalent. The exemption equivalent of the unified credit was increased to \$1 million by EGTRRA for gifts made, and estates of decedents dying, in 2002. The amount remains at \$1 million for gifts made after 2002, but the estate tax applicable exclusion amount increases as set forth in the table below for estates of decedents dying after 2003. As under pre-EGTRRA law, the applicable exclusion amount applied to gifts reduces the applicable exclusion amount available (at death) for the estate tax. For example, if a donor had used the \$1 million 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.

Estates of decedents dying in -----	Applicable exclusion amount (exemption equivalent of the unified credit) -----
2002	\$1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000

The GST exemption for any year after 2003 will be the same as the applicable exclusion amount.

The gift tax system in 2010 remains in place with a top marginal rate of 35%. The reason for retaining the gift tax was to back-up the income tax system and discourage gifts of appreciated assets to persons in lower income tax brackets or to non-resident aliens. Congress did not want a taxpayer to be able to shift the taxation of income to someone in a lower income tax bracket without the taxpayer being treated as having made a gift of the property.

Basis. The adjustment in basis to property acquired from a decedent to the estate tax value that is in effect under current law will, except as noted below, be eliminated beginning with decedents dying after 12/31/09. In general, under the new law, property acquired from a decedent after 2009 will receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property at the decedent's death.

After 2009, an executor can increase basis in assets acquired from and owned by the decedent by \$1,300,000. The \$1,300,000 is increased by any capital loss carryover under Section 1212(b), the amount of any net operating loss carryover under Section 172, which would (but for the decedent's death) be carried from the decedent's last tax year to a later tax year, plus the sum of the amount of any losses that would have been allowable under Section 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 by an additional \$3 million, if the property is acquired from and owned by the decedent and passes to a surviving spouse outright or in a qualified manner.

GST tax. Several changes mainly pertaining to the allocation of the GST exemption and the derivation of the inclusion ratio, were made to the GST tax by EGTRRA. These changes were designed to make it less likely that taxpayers, tax planners, and tax return preparers will make costly mistakes relating to the allocation of the GST exemption and to assist in the correction of past and future errors.

QFOBI. The qualified family-owned business interest deduction would be repealed with respect to estates of decedents dying after 12/31/03.

Tax recapture extending past the date for repeal of the estate tax. Prior to repeal of the estate tax, many estates may claim estate tax benefits that, upon certain events, may trigger a recapture tax. Because repeal of the estate tax would be effective for decedents dying after 12/31/09, these estate tax recapture provisions would continue to apply after 2009.

Reduction in state death tax credit deduction for state death taxes paid. From 2002 through 2004, the state death tax credit allowable under pre-EGTRRA law is reduced as follows: In 2002, the state death tax credit was reduced by 25%; in 2003, the state death tax credit was reduced by 50%; and in 2004, the state death tax credit is reduced by 75%. In 2005, the state death tax credit is totally repealed, after which there will be a deduction (rather than a credit) 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.

Those estates that are subject to state estate tax regimes that are tied to the federal credit for state death taxes as it existed in a year prior to 2002 will not receive a state estate tax decrease, even though the federal state death tax credit will have decreased. Therefore, in some cases and in some years, the combined estate tax paid to the IRS and the state could increase. Many states have changed their state death taxes to tie them to the federal credit for state death taxes as it existed prior to 2002.

Taxpayers may plan to change domicile and/or the tax situs of tangible assets such as jewelry, art, etc., for state death tax purposes by, for example, putting real estate in a partnership so it is treated as intangible property. A taxpayer may bequeath more property to a surviving spouse to minimize the state death tax at the surviving spouse's death and provide more time to plan to minimize the tax—but this may be at the cost of more transfer tax at the death of the surviving spouse. A person domiciled in a state with a high estate tax (and no offsetting federal credit) and no state gift tax might consider borrowing money to make deathbed gifts. The federal transfer tax should be the same, but there should be no state death tax on the transfer. Borrowing property in order to make the gift enables the individual to keep assets, and the retained assets would, before 2010, receive a basis adjusted to date-of-death value. Calculations should be done to determine if this makes sense in each particular case.

Qualified conservation easement. EGTRRA 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 U.S. or its possessions.

Expanded availability of estate tax installment payments. EGTRRA 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.

Planning in uncertain times. The long transition period of gradual tax reductions, coupled with the scheduled sunset of EGTRRA, 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. Relying on a prediction of what that might be is risky at best.

One planning approach is to share views with the client and have the client 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 it existed prior to EGTRRA. If this approach is followed, and as with any estate plan, the client should be reminded that he or she could be incapacitated and would therefore be unable to change the estate plan even if circumstances warrant a change.

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. Alternately, some people may not engage in planning in the hope 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 of attorney 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-EGTRRA law springs back into existence. (Or, even more troubling, a beneficiary/attorney-in-fact might use his or her power for such a result.)

Drafting. Estate planning documents may need to be drafted in the alternative to encompass situations where the testator dies before the full phase-in of repeal, situations where the testator dies after the full-phase-in, and situations where the testator dies after the pre-EGTRRA law springs back into existence. It may be advisable for documents to allow the distribution of assets either outright or in further trust, as it is impossible to know what the future may hold for the family situation, assets, or the law.

One should not draft a will or a revocable trust to say "if I die after the federal estate tax is repealed" because if the tax is repealed in 2010 and springs back in 2011, then if death occurs in 2012, the death is literally after the estate tax is repealed. (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 reinstated or may still be in place. Of course, there may be times when reference should also be made to state estate taxes.) Because the provisions of the

estate and GST taxes will still remain in the Code when drafting, one could instead provide "if I die when the federal estate tax is not applicable."

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-EGTRRA law will need to be reviewed and in many cases revised, and estate plans may have to be updated 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. 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 disproportionate split of assets between marital bequests and bypass trusts and between trusts for children and GST exempt trusts principally for grandchildren.

Marital deduction. If a document is drafted with the bequest to the surviving spouse equal to 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 instead, a document is drafted with the applicable exclusion amount passing to one trust, with the rest of the property passing to a residuary marital deduction bequest for the surviving spouse, and the federal estate tax is no longer applicable, all the property would pass to the surviving spouse as part of the residuary marital bequest. Again, this may not be consistent with the intention of the testator.

During any transition period prior to the full phase-in of estate tax repeal, 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 three years after the gift, the gift tax paid would not be subject to transfer tax (as under current law). Alternatively, the recipient spouse may live until rates are lower, the estate tax applicable exclusion higher, or the estate tax 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 in the form of bequests to qualified terminal interest property 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 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 will have at the surviving spouse's death sufficient assets in his or her sole name.

With the applicable exclusion amount 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 (1) marital deduction bequest is a pecuniary reduce-to-zero bequest, and (2) at the death of the first spouse, \$4 million is to be distributed.

Estates of decedents dying in	Applicable exclusion amount (exemption equivalent of the credit for estate tax)	Marital Deduction Bequest	Non-marital Bequest(s) (e.g., Family or Bypass Trust)
2001	\$ 675,000	\$3,325,000	\$ 675,000
2002	1,000,000	3,000,000	1,000,000
2003	1,000,000	3,000,000	1,000,000
2004	1,500,000	2,500,000	1,500,000
2005	1,500,000	2,500,000	1,500,000
2006	2,000,000	2,000,000	2,000,000
2007	2,000,000	2,000,000	2,000,000
2008	2,000,000	2,000,000	2,000,000
2009	3,500,000	500,000	3,500,000
2010	Repeal estate & GST tax but not gift tax	0	4,000,000
2011	1,000,000	3,000,000	1,000,000

Since the increase in the exemption equivalent of the unified credit occurs in stages, it will be important to ensure that each spouse has sufficient assets in his or her sole name to use his or her exemption equivalent (and his or her GST exemption) during the transition period. For those estates where the increasing applicable exclusion amount or fact that the estate tax no longer applies results in too little property passing to the surviving spouse, it may be desirable (from a nontax perspective) to draft using formulas to cap the amount going to a family bypass trust. 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 reduce the amount of property passing to the family/bypass trust. In any event, while the estate tax is still applicable, it would be necessary to use a formula to assure that a sufficient amount of property qualifies for the marital deduction at the first death so that the estate tax is avoided—if that is the goal.

In the alternative, as discussed earlier, 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.

On the other hand, the instruments would have to be drafted in a manner that does not interfere with marital deduction qualification if the first spouse dies while the federal estate tax is applicable. The instrument could be drafted in two parts—one controlling if the testator dies when the federal estate tax is applicable and one controlling if the testator dies when the federal estate tax is not applicable.

In the alternative, property could pass to a QTIP trust 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, depending on how much the surviving spouse's own assets are worth, as the applicable exclusion amount increases, 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. Each case, of course, is different, and the facts must be examined.

GST tax. The following are points to consider with respect to drafting with formulas regarding the GST tax.

If a document is drafted with exempt trusts for the benefit of grandchildren and nonexempt trusts for the benefit of children, and if 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.

As the GST exemption increases, a formula bequest of the GST exemption to or for the benefit of skip persons increases from \$1,120,000 to \$3,500,000. If, on the other hand, the provision is drafted in a manner that refers to "the amount exempt from the GST tax," and 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 either.

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.) The document should be drafted, in most cases, so that children and grandchildren may be beneficiaries of both trusts.

The following chart illustrates the decrease in the children's share as the GST exemption increases where \$4 million (after estate tax) is being distributed under two types of formulas.

(1)	(2) GST exemption -----	(3) Children's Share -----	(4) "Amount equal to GST Exemption" (primarily for Grandchildren) -----	(5) "Amount exempt from GST tax" (primarily for Grandchildren) -----
2001	\$1,060,000	\$2,940,000	\$1,060,000	\$1,060,000
2002	1,100,000	2,900,000	1,100,000	1,100,000
2003	1,120,000	2,880,000	1,120,000	1,120,000
2004	1,500,000	2,500,000	1,500,000	1,500,000
2005	1,500,000	2,500,000	1,500,000	1,500,000
2006	2,000,000	2,000,000	2,000,000	2,000,000
2007	2,000,000	2,000,000	2,000,000	2,000,000
2008	2,000,000	2,000,000	2,000,000	2,000,000
2009	3,500,000	500,000	3,500,000	3,500,000
2010	Repeal estate & GST tax	4,000,000 /*/	0	4,000,000
2011	1,120,000 & index for inflation	2,880,000	1,120,000	1,120,000

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

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 reference sections are still in the Code but do not apply at a point in time, the section will not have been technically repealed but will have no effect.

The answer to this question will depend upon how the provision is drafted, how terms are defined in the instrument, how "Code" is defined, and whether discretion is given to the executor or trustee to use the definition in effect when the document was drafted or when the decedent died, or immediately before the provision was repealed.

Powers of attorney for property management. These 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, this will be done by prohibiting the attorney-in-fact from making gifts to himself or herself.

Deferring or eliminating transfer tax by making gifts. Many taxpayers will benefit from making gifts during the transition period and afterward so that future appreciation will be transferred. The gift would be made in a manner that will cause the value of the present gift to be relatively low. Often parents want to make transfers of property to their children during the parents' lives. Of course, the basis of the property given 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.

Gifts using the following techniques are made in order to minimize future transfer tax in uncertain times because (1) EGTRRA provides only one year of repeal of the estate tax before the prior estate tax law springs back, (2) the estate tax repeal may never occur, and (3) the donor may not live until repeal.

Annual exclusion/tuition/medical/applicable exclusion amount. Gifts should be made to utilize all of the available exclusions.

GRAT. A zeroed out GRAT can be used.

QPRT. A qualified personal residence trust can be used to transfer a residence with little tax. To achieve a very low gift value, an irrevocable QPRT may be created that will continue for a longer period. 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, the QPRT may not have been necessary. Also QPRTs are not as attractive in the current low interest environment.

Debt. Property, including limited partnership and LLC interests, can be sold to a grantor trust for a bona fide note. Bona fide loans can be made now, and if the gift tax rates are eventually reduced, the note could be given as a gift. There cannot be any prearrangement or agreement to make a later gift. Interest rates are currently at very low levels.

Limited partnerships and LLCs. Establishing limited partnerships and LLCs can enable the transferor to be in a position to fractionalize assets and make transfers now and as rates become lower, thereby shifting future appreciation. It is important to be sure the client is establishing the entities for reasons other than just tax minimization.

Specifically, the entities are valuable for limited liability, centralization of management, assisting with family relationships, and planning for management and ownership succession. A client should establish such an entity only if he or she will respect it as a separate entity and follow all the accounting and administrative requirements.

Taxable gifts. Although it may seem counterintuitive, even if the estate tax is repealed and is not reinstated, there still will be situations where it will be beneficial to pay a present gift tax. For example, assume that it is unlikely that a very elderly client will live until 2010 but it is likely he or she will live more than three years. If, in 2003, this client makes a taxable gift, the tax imposed at a marginal rate of 49% will, because of the tax

exclusivity of the gift tax, discussed above, effectively be a gift that is taxed at a marginal rate of slightly less than 33%. The gift also has the benefit of shifting future income and appreciation out of the client's estate. Of course, basis considerations must be taken into account. If he or she wants to transfer property into the hands of beneficiaries during his or her lifetime, taxable gifts may be necessary.

Q. Over the past several years, the question of whether the estate tax (or as the politically phrased "death" tax) should be repealed has become an important issue in Congress. As we all know, EGTRRA repeals the estate tax and GST tax but only for one year, i.e., for decedents dying in 2010. What do you believe led to the support that this legislation received in Congress when only a small percentage of American families fall within its grasp?

A. I believe, in general, that the Republicans did an excellent marketing job and the Democrats at first did not respond. By referring to the tax as the "death tax" and by getting *testimonials* from owners of small businesses, the Republicans caught the public eye and ear. Ironically, it is my understanding that under pre-EGTRRA law, many of those owners of small businesses could already have avoided all "death taxes" or at least have reduced them significantly with proper estate tax planning. The increases in the exemption equivalent of the unified credit to \$3,500,000 per taxpayer is a change that should be made if repeal is not made permanent. In that case, the percentage of estates subject to estate tax would be less than 1%. Also, the death tax was said to be double taxation, i.e., a tax on previously taxed property. Although that is true in some cases such as estate tax on previously taxed earnings, where the estate tax is imposed on appreciated assets, that appreciation has not been previously taxed, and therefore, there would not be a double tax.

Q. During the Congressional campaign last fall, President Bush affirmed that the first order of business when Congress reconvened in January was to make the estate tax repeal permanent and to further accelerate the planned increases in the exemption equivalent amount. While the Republicans now control both houses of Congress, what problems or obstacles are still in the path of permanent repeal?

A. The economy and the deficits potentially stand in the way of making repeal permanent. And while there is a budget resolution in place, it would take 60 votes in the Senate to make repeal permanent or absent a budget resolution, it would still take 60 votes to stop a filibuster.

Q. Are there compromise positions that can be agreed upon by the Republicans and Democrats? What about simply raising the exemption equivalent amount perhaps aided by an expansion of the qualified family business rule?

A. The Congress could decide to (1) leave EGTRRA 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, or change the reinstatement to

2013, so the repeal is in effect for three years; (2) leave the EGTRRA provisions unchanged through 2010 *and* "repeal the reinstatement" so that there will be no federal transfer tax on GSTs after 2009 or on decedents dying in 2010 or later; (3) "freeze" the EGTRRA provisions at some point during the transition period, and 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 amount of \$2 million); or (4) do something else altogether such as have an exemption amount of \$3,500,000 with an additional amount of family businesses allowed to pass free of estate tax.

Another proposal would allow the increase in the exemption equivalent amount but disallow lack of control discounts for family held businesses that do not conduct an active trade or business. Even if legislation is passed soon to make repeal permanent in 2010 (or earlier)—it is very possible a future Congress could repeal the repeal before 2010—or even after 2010 reinstate the transfer tax system after a "permanent" repeal takes effect.

Q. Assuming the death tax is permanently repealed, identify the "winners" and "losers" and those, perhaps, who will be largely unaffected. How are the states responding to the challenge of a sharp drop in revenues from estate tax repeal?

A. If the estate tax is permanently repealed and the carryover basis regime is put in place, the big winners are persons with estates that would otherwise have been subject to estate tax—except in those cases where the carryover basis causes additional capital gains tax in excess of the eliminated estate tax. For example, a couple dying in 2009, with property worth \$7 million and a \$1 million basis, could have avoided all estate tax and the assets would have received a basis equal to \$7 million. The same couple dying in 2010 would still avoid estate tax, but the assets could have a new adjusted basis of \$6,600,000 (i.e., \$1 million carryover basis + \$1,300,000 + \$1,300,000 + \$3 million basis adjustments) and, therefore, capital gain of \$400,000 would be recognized on a sale.

People would not need life insurance for estate tax but still would need it to meet other liquidity needs including those due to carryover basis and to fund buy out provisions. On the other hand, life insurance would become an even better product in a carryover basis regime because the proceeds are free of income tax.

Charities would probably be losers as some people would be less inclined to bequeath property to charity—but others, without the estate tax, would have more property available that they could bequeath to charity.

Spouses might receive less property through gifts and bequests—to the extent that assets were left to, or in trust for, spouses to defer estate tax. If carryover basis were in place, there would still be an incentive to bequeath property with \$3 million of appreciation to or for the benefit of a spouse to get the benefit of the basis adjustment at the death of the first spouse, and sufficient assets so the surviving spouse could utilize his or her own \$1,300,000 basis adjustment.

States are big losers, because the revenue sharing they received by virtue of the federal state death tax credit has been reduced and disappears as of 2005. As mentioned above, states are reacting in many cases by changing their state death taxes to tie them to the federal state death tax credit as it existed before 2002. Other states are trying to be taxpayer friendly and, therefore, will have no state death tax after 2004, and others constitutionally—such as Florida—cannot change their law to increase the state death tax, and, therefore, also will have no state death tax after 2004.

Q. Assuming estate and GST tax repeal is made permanent, it is noteworthy EGTRRA still retains the gift tax. Why did Congress act in this fashion and what particular problems will the retention of the gift tax have on owners of closely held businesses?

A. The original proposal had been to repeal all three transfer taxes—including the gift tax. However, the concern, in general, was that assets would be transferred abroad and parked in a manner that would avoid U.S. income tax on ordinary income and on capital gain from a sale and then later the property would be retransferred to the U.S. donor with a basis close to value. Further, there were concerns that gifts would be made to U.S. family members in lower income tax brackets than the donor—with the asset then being sold with less capital gains tax and reconveyed to the donor with a basis close to value.

I believe the income tax could receive the same protection even if the gift tax were repealed, by making changes in the income tax system aimed at such tax avoidance. The retention of the gift tax makes it hard to make transfers of ownership of closely held businesses and other assets to family members during life. I discussed earlier ways to make such transfers in a manner so that there would be little gift tax. However, there are many nontax-related reasons for transferring ownership that will be hampered. In case the federal estate tax were reinstated after repeal, it would obviously have been beneficial to make transfers before that happened. With an unpredictable future transfer tax system it may be better in many situations to put assets in irrevocable trusts for children and grandchildren. Because it is possible that the estate tax and GST tax could be reinstated, it would be preferable to keep property in trusts that hopefully should be exempt from a later reinstatement of the tax. Of course, there continue to be many nontax reasons for the creation of trusts including protecting beneficiaries from creditors, divorce, and themselves.

Q. The corollary to the repeal of the estate tax is that the basis of property acquired from a decedent will be a carryover basis with modifications, as set forth in Section 1022. An aggregate basis exemption is provided for \$1.3M to all beneficiaries, plus the decedent's carryover items and built-in losses, and a special \$3M exemption for spousal transfers. Still, IRD items cannot be allocated amounts under either exemption. How do you view the "modified" carryover basis rules in general? Would a "pure" carryover basis rule be preferable such as that contained in Section 1014? Is there yet another model

instead of modified carryover basis rules that could be put in place, such as a deemed realization event at death, that would be preferable?

A. As described above, the carryover basis rules are complex. It is very likely they will be changed before they are to become effective in 2010. The elimination of the "step-up in basis" at death will add record-keeping requirements and some potential uncertainty regarding the basis of particular assets. Taxpayers for whom appreciation in assets will exceed \$1,300,000 (at death) should start keeping good basis records for newly acquired assets and try to gather information for currently owned assets. (It is obviously easier for them to gather the information than it would be for their executor.) Having the executor determine which assets should receive the allocation of additional basis adds a degree of complexity to the regime. 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. In the case of an estate with assets with appreciation totaling less than the relevant basis adjustment amount, the new basis regime should not result in any added complexity.

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

Sales. 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 changes to the agreement and the sales price formula thereunder desirable—or making the purchase of life insurance by the decedent desirable to make up the difference to the seller.

Charitable deduction. Taxpayers may choose to make more lifetime gifts of appreciated property to charity to receive the benefit of the income tax deduction.

Sufficient assets owned by first spouse to die. It is advisable to position a couples' assets so that if they both live until the estate tax is repealed, there are sufficient assets at the death of the first spouse that will be treated as owned by that spouse to utilize the \$1,300,000 basis adjustment and the \$3 million basis adjustment

Surviving spouse. It will be important to assure that sufficient property passes to a surviving spouse or as QTIP property for the first spouse's estate to be able to take advantage of the \$3 million basis adjustment. It will also be important to assure that the surviving spouse has sufficient assets that are in the right ownership form to be able to use the \$1,300,000 basis adjustment at the surviving spouse's death.

Items of IRD are not eligible for a basis adjustment. Funding a pecuniary bequest with an IRD item accelerates the IRD.

\$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:

- (1) Should it be allocated proportionately among the nonspouse beneficiaries?
What about nonprobate assets?

- (2) Should it be allocated first to specific bequests and to assets that will be used to fund pecuniary bequests?
- (3) Should the executor be given guidance not to allocate it to assets passing to charity?
- (4) Should the executor be given guidance to allocate it first to assets that are likely to be sold (e.g., to fund bequests or to pay administration expenses or debts) and to allocate it to assets that, if sold, would not result in the realization of a long term capital gain but would result in ordinary income (and not to allocate it to assets that will be kept or which are not eligible for depreciation)?
- (5) 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?
- (6) The document should contain language exculpating the executor for decisions made in good faith, including the ability to allocate to nonprobate assets without liability.
- (7) Perhaps the document should allow the executor to allocate the adjustment to basis without regard to the original bases of the assets.

Pure carryover basis system. A pure carryover basis rule might be preferable with a fresh start and/or with a total amount of the "free basis" adjustment to be allocated by the executor or to be used by each beneficiary or for certain classes of assets (such as tangible and personal residences).

Deemed realization at death system. A system of deemed realization at death would still require knowledge of basis. Depending upon how it was structured and the basis adjustments, it could eliminate some of the complexities of the proposed system, but it would create liquidity problems similar to those caused by the estate tax.

Q. You have extensively written and lectured on the GST tax. While the complexity of the GST tax is an accepted fact, what are the problems practitioners have encountered with its application and what has Congress or the IRS done to try to make these provisions more "user friendly"?

A. The allocation of the GST exemption is complex. Many costly mistakes in the allocation have been made. Several changes, mainly pertaining to the allocation of the GST exemption and the derivation of the inclusion ratio, were made by EGTRRA. These changes were designed to make it less likely that taxpayers, tax planners, and tax return preparers would make mistakes relating to the allocation of the GST exemption and to assist in the correction of past errors. These provisions are effective now, many with retroactive effect; however, these provisions also are subject to the sunset provisions in 2011.

EGTRRA expands the automatic allocation rules, which previously applied only to direct skips, to apply also to "indirect skips," a newly defined term. An "indirect skip" is a transfer subject to gift tax that is made to a "GST trust" and (1) made after 12/31/00, or (2) is subject to an estate tax inclusion period ending after that date. As was the case prior to EGTRRA (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) not to have the automatic allocation rules apply to a transfer.

These provisions were only intended to be default provisions. There are problems with these provisions because the definition of GST trust is too broad, so they would automatically allocate the GST exemption to some trusts to which one would not want to have it allocated. It is extremely important, in most cases, for the transferor to be able to *elect out* of the automatic allocation provisions and decide whether to allocate the GST exemption. This is particularly important if a late allocation is desirable because values have decreased since the time of the gift; or the trust's GST potential is significantly less than that of other trusts in the estate plan.

New retroactive allocation of the GST exemption when certain beneficiaries predecease transferor. A transferor likely will not allocate the GST exemption to a trust that the transferor expects will benefit only non-skip persons, such as a child. However, if the transferor's child unexpectedly dies before the end of a trust (for example, a trust designed to end and be distributed to child at age 35), such that the trust terminates in favor of the transferor's grandchild, and the GST exemption had not been allocated to the trust, then GST tax would be due even if the transferor had an unused GST exemption.

If a transferor knew, however, that his or her child might predecease the transferor and that as a result there could be a GST, the transferor likely would have allocated the GST exemption at the time of the transfer to the trust. Therefore, where there is an unnatural order of death (e.g., when the second generation dies before the first generation transferor), the transferor can allocate the GST exemption if any is available retroactively to the date immediately before the child's death using the value at the time of the transfer to the trust.

Certain trust severances recognized and inclusion ratio realignments permitted. Under 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 in very limited circumstances including if the trust which is included in the transferor's estate 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 "0" and "1" by severing a trust that is subject to the GST tax after the trust has been created.

Complexity can be reduced if a GST trust is treated as two separate trusts for GST tax purposes—one with an inclusion ratio of "0" and one with an inclusion ratio of "1". This result can be achieved by drafting complex documents in order to meet the specific requirements of severance. The changes made by EGTRRA make the rules regarding severance less burdensome and less complex.

The new general rule is that a trust can be severed into multiple trusts if the severance is a "qualified severance." The resulting trusts will 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 governing instrument or under local law) of two or more trusts if—the single trust was divided on a fractional basis, *and* 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."

Another qualified severance rule applies when the undivided trust has an inclusion ratio other than "1" or "0".

Regulatory relief mandated for certain missed allocations and elections. The Treasury Secretary is directed to grant extensions of time to make an election to allocate the GST exemption and to grant exceptions to the statutory time requirements in appropriate circumstances, e.g., when the taxpayer intended to allocate GST, the failure timely to allocate was inadvertent. Basically, this was an expansion of Reg. 301.9100-3 relief under which the Treasury has the authority to grant extensions of time to make certain tax elections. Before EGTRRA, the IRS had taken the position that it could not grant extensions of time to allocate the GST exemption. Since EGTRRA and the issuance of Notice 2001-50, 2001-2 CB 189, the IRS has issued many private letter rulings granting extensions of time to make timely allocations of the GST exemption (where the taxpayer acted reasonably and in good faith and granting relief did not prejudice the interest of the government). If the relief is granted, the gift tax or estate tax value of the transfer to the trust would be used for determining the GST exemption allocation.

Substantial compliance rules mandated. Under prior law, there was no statutory rule that provided that substantial compliance with the statutory and regulatory requirements for allocating the GST exemption would suffice to establish that the GST exemption was allocated to a particular transfer or trust. Therefore, a provision was added providing that the GST exemption will be allocated when a taxpayer substantially complies with the rules and regulations for allocating the GST exemption.

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.

Deferral. 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. Building in and using special powers of appointment may also be beneficial in deferring a GST until the GST tax no longer applies.

Dynasty trusts. Even if the 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 reintroduction 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 but 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 distribute 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. A 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.

2010—Who is the transferor? In the unlikely event that the EGTRRA changes to the Code remain in effect through 2011, a number of questions arise with respect to trusts and GSTs established in 2010. Specifically, if a trust is established in 2010 on the death of a transferor whose estate is not subject to estate tax by reason of the "repeal," the trust 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 Section 2652(a) and 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.

Gift. In contrast, an inter vivos generation-skipping trust established in 2010 when the GST tax is not in effect would probably not be protected from the GST tax with respect to a GST 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.

Terminations. It is not clear how a trust should be treated for GST tax purposes after 2010 if, in 2010, an event occurs that would have been a taxable termination if the event 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. 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.

Q. Finally Lloyd, gaze into your crystal ball and tell our readers your predictions as to the short and long term outcomes of the debate before Congress concerning the repeal of the "death" tax.

A. Unfortunately, everyone's crystal ball is a bit hazy. I am advising clients about the various possible scenarios. I am telling clients that it is likely that whatever is drafted today will need to be changed because there are too many possibilities. We are drafting flexibly—and trying to provide room for changes in the law—but that is a very difficult task when you do not know what the changes will be.

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