

Repeal of the “Repeal” of the Estate Tax Under the 2001 Act
by the 2010 Act – Planning in 2011 and 2012
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The Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”) had been widely reported to “repeal” the federal estate tax. However, all of the provisions of the Act (including repeal of the estate tax) were temporary and would have expired (would have “sunsetting”), unless Congress provided otherwise prior to December 31, 2010. Accordingly, under the 2001 Act, after 2010, absent congressional action, the estate, gift and generation-skipping taxes were to be reinstated under prior law, so that the estate tax and the GST tax were repealed for only the twelve months of calendar year 2010.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“The 2010 Act”), enacted on 12/17/10, postpones that sunset for two years, until December 31, 2012, and introduces a number of new helpful transfer tax concepts.

The 2010 Act

Under the 2010 Act, the gift, estate, and GST rates and exemptions are reunified¹ at \$5 million per person (\$10 million per couple) and at a 35% top rate.² Beginning in 2012, the exemptions are indexed for inflation, to the nearest \$10,000. The repeal of the estate tax and GST tax for 2010 is itself repealed, but for decedents who died in 2010, the executor may choose to elect out of the estate tax/stepped-up basis regime and back into the no estate tax/modified carry-over basis regime of the 2001 Act.

All of these changes will themselves sunset at the end of 2012, and the rates and exemptions will – absent further Congressional action – revert to the pre-2001 Act rules of a \$1 million exemption and a 55% tax rate³ (with the GST exemption indexed for inflation, starting in 2003).⁴

Finally, the 2010 Act introduces – for estate tax but not GST tax purposes – the concept of portability of the exemption between spouses. Under this concept, the surviving spouse or his or her estate could use any unused estate tax exemption (but, again not the GST exemption)

¹ Only after 2010 for the gift tax exemption.

² For 2010, the GST rate is 0%.

³ As discussed below, plus a 5% surtax on larger estates.

⁴ The effect of that sunset, especially its effect on the GST provisions of the 2001 Act, is discussed below.

of his or her last deceased spouse (assuming the first decedent's estate timely filed an estate tax return which elected to allow it).⁵

The following grid summarizes these changes:

| | 2010 | 2011 | 2012 | 2013 |
|-------------------------|--------------------------|-------------|--------------------------|--------------------------|
| Maximum Estate Tax Rate | 35% ⁶ | 35% | 35% | 55% |
| GST Tax Rate | 0% | 35% | 35% | 55% |
| Maximum Gift Tax Rate | 35% | 35% | 35% | 55% |
| Estate Tax Exemption | \$5,000,000 ⁶ | \$5,000,000 | \$5,000,000 ⁷ | \$1,000,000 |
| Gift Tax Exemption | \$1,000,000 | \$5,000,000 | \$5,000,000 ⁷ | \$1,000,000 |
| GST Exemption | \$5,000,000 | \$5,000,000 | \$5,000,000 ⁷ | \$1,400,000 ⁸ |

The following is a summary of the law prior to the 2001 Act, the general impact of that Act on the estate, gift and generation-skipping tax systems over the last 10 years, as well as the impact of the 2010 law on the transfer tax system from 2010 through 2012 (when all of its provisions sunset, again, unless Congress acts prior to the end of 2012).

Pre-2001 Act Law

1. Generally.

Under pre-2001 Act law, a gift tax was imposed on lifetime transfers and an estate tax was imposed on transfers made at death. The gift and estate taxes were unified to provide that a graduated rate of tax applies to cumulative taxable transfers made by an individual during his or her lifetime and at death. The unified tax rates began at 18% and increased to 55% on cumulative taxable transfers over \$3 million.⁹

⁵ This only applies for predeceasing spouses who die after 2010, and there is no indexing of this exemption.

⁶ Unless the estate elects out of the estate tax regime.

⁷ This amount will be indexed for inflation.

⁸ The GST exemption is currently adjusted for inflation; this is a rough estimate.

⁹ In addition, a 5% surtax was imposed on cumulative taxable transfers between \$10 million and \$17,184,000, which had the effect of phasing out the graduated rates by subjecting these estates to a top marginal rate of 60%. Estates over \$17,184,000 were subject to a flat 55% rate.

2. Applicable Exclusion Amount.

The Applicable Exclusion Amount (formerly the unified credit or exemption equivalent amount) effectively exempted up to \$675,000 of property from estate and gift tax. Prior to enactment of the Act, the Applicable Exclusion Amount was scheduled to increase in steps to \$1 million by 2006.

3. Basis of Property Received As A Gift or Bequest.

Generally, gain or loss for income tax purposes on the disposition of property is measured by the difference between the amount realized (i.e., the sales price) and the seller's basis in the property (i.e., the cost). Property received from a donor by a lifetime gift takes the lesser of the donor's basis of the property transferred or the fair market value at the time of the transfer ("carryover basis") in the hands of the donee.¹⁰ On the other hand, the basis of most property passing from a decedent's estate (other than retirement plans, IRAs and similar accounts, and other items of income in respect of a decedent) was traditionally the fair market value of the property on the date of the decedent's death¹¹ ("stepped-up basis"). Typically, therefore, the stepped-up basis of property inherited at death eliminated most, if not all, of the recognition of the built-in capital gain for income tax purposes on the subsequent disposition of inherited appreciated property.

4. Generation-Skipping Transfer Tax.

The generation-skipping transfer tax ("GST") had been a flat 55% tax imposed on either lifetime or deathtime transfers over the GST exemption, as indexed for inflation under prior law, made to individuals (or trusts for individuals) who are more than one generation removed from the transferor (e.g., a transfer from a grandparent to a grandchild or to a trust for a grandchild).

The 2001 Act

1. Estate, Gift and GST Rates.

The top estate, gift and GST tax rates were reduced as follows:

¹⁰ Adjusted for the portion of any gift tax paid attributable to gain in the asset gifted.

¹¹ Or on the alternate valuation date, if applicable.

| Calendar Year | Highest Marginal Estate, Gift & GST Tax Rates |
|---------------|--|
| 2001 | 55% |
| 2002 | 50% |
| 2003 | 49% |
| 2004 | 48% |
| 2005 | 47% |
| 2006 | 46% |
| 2007 | 45% |
| 2008 | 45% |
| 2009 | 45% |
| 2010 | top individual income tax rate (gift tax only) |
| 2011 + beyond | 55% ¹² |

2. Applicable Exclusion Amount & GST Exemption.

The 2001 Act increased the Applicable Exclusion Amount for deathtime transfers (the “Estate Exemption”) in steps to \$3.5 million in 2009. However, the Applicable Exclusion Amount for lifetime gifts (the “Gift Exemption”) increased to \$1 million in 2002 and remained there.¹³ In addition, the Act tied the GST Exemption to the Estate Exemption (although the GST Exemption may be allocated to lifetime transfers) beginning in 2004 until 2010. The estate and generation-skipping transfer taxes (but not the gift tax) were ultimately repealed for calendar year 2010. The following chart summarizes the various exemptions provided in the 2001 Act in each year.

¹² In addition, the 5% surtax described above was re-imposed on cumulative taxable transfers between \$10 million and \$17,184,000.

¹³ This “un-unifies” the transfer tax system for the first time since it was unified in 1976.

| Calendar Year | Estate Exemption | GST Exemption | Gift Exemption |
|---------------|------------------|---------------------------|----------------|
| 2001 | \$675,000 | \$1,060,000 | \$675,000 |
| 2002 | \$1 million | \$1,060,000 ¹⁴ | \$1 million |
| 2003 | \$1 million | \$1,060,000 ¹⁴ | \$1 million |
| 2004 | \$1.5 million | \$1.5 million | \$1 million |
| 2005 | \$1.5 million | \$1.5 million | \$1 million |
| 2006 | \$2 million | \$2 million | \$1 million |
| 2007 | \$2 million | \$2 million | \$1 million |
| 2008 | \$2 million | \$2 million | \$1 million |
| 2009 | \$3.5 million | \$3.5 million | \$1 million |
| 2010 | Repealed | Repealed | \$1 million |
| 2011 + beyond | \$1 million | \$1,060,000 ¹⁴ | \$1 million |

When the estate and GST taxes were to be re-enacted in 2011 and thereafter, the Applicable Exclusion Amount for gift and estate tax purposes reverted to its level under pre-2001 Act law - dropping from \$3.5 million to \$1 million; the GST Exemption would, however, continue to be indexed for inflation.

3. Gift Tax.

The gift tax was not repealed by the 2001 Act; only the estate and generation-skipping transfer taxes were repealed for calendar year 2010. Prior to 2010, the gift tax rates for taxable gifts (those over annual exclusion gifts) were to be the same as the estate tax rates. Beginning in 2010, the top gift tax rate became the top marginal individual income tax rate as provided under the 2001 Act (35%). The gift exemption increased to \$1 million in 2002 and remained at that level through 2010. The annual exclusion and the other exclusions related to tuition and medical payments were unchanged by the 2001 Act.

The repeal of the estate and GST taxes for 2010, but not the gift tax, meant that all taxable gifts, including generation-skipping transfers made during lifetime, would generally still be subject to gift tax during the year of repeal and thereafter.

¹⁴ Plus any increases resulting from indexing for inflation.

4. Basis of Property Acquired From A Decedent.

In 2010, the concept of a stepped-up basis for assets¹⁵ received from a decedent ended, so that the property acquired from a decedent who died during that year in the hands of the transferee would have a basis equal to the lesser of the decedent's basis or fair market value at the time of death (i.e., carryover basis).

However, the 2001 Act allowed an executor to increase (i.e., step-up) the basis of those non-IRD assets selected by the executor which were owned by the decedent by up to \$1.3 million, and to increase the basis in assets owned by the decedent and transferred to his or her surviving spouse (or a QTIP trust for his or her benefit) by an additional \$3 million. Thus, the basis of property transferred to or in trust for a surviving spouse could be increased by a total of \$4.3 million.¹⁶

Attached Comparison Grid

The attached grid summarizes the major transfer tax provisions of pre-2001 Act law, the 2001 Act, and the 2010 Act.

¹⁵ As noted above, other than items of I.R.D., such as retirement plan assets.

¹⁶ This is referred to as a modified carry-over basis regime.

Estate, Gift and Generation-Skipping Tax Provisions Comparison Among
Pre-2001 Act Law, the 2001 Act, and the 2010 Act

| PROVISION | PRE-2001 ACT LAW | 2001 ACT | 2010 ACT |
|---|--|---|---|
| Estate tax rates | Graduated rates ranging from 18 to 55 percent. | Repealed rates in excess of 50 percent in 2002; 2003 through 2006, reduced rate by one percentage point per year; in 2007 through 2009, 45 percent maximum estate tax rate; tax repealed on January 1, 2010; pre-2001 Act rates reinstated in 2011. | Maximum rate of 35% Postpones reinstatement of pre-2001 Act rates until 2013 |
| Five-percent surtax | 5-percent surtax on transfers in excess of \$10,000,000 but not exceeding \$17,184,000. | Repealed the 5% surtax; effective for decedents dying after December 31, 2001; 5% surtax reinstated in 2011. | Postpones reinstatement until 2013 |
| Applicable Exclusion Amount (Unified Credit) | Unified credit equivalent amount in 2002 and 2003, \$700,000; in 2004, \$850,000; in 2005, \$950,000; in 2006 and thereafter \$1,000,000. | Increased Applicable Exclusion Amount in 2002 and 2003, to \$1 million; in 2004 and 2005, to \$1.5 million; in 2006 through 2008, to \$2 million; in 2009, to \$3.5 million; dropped to \$1 million in 2011. | Exemption of \$5 million per person/\$10 million per couple; indexed for inflation in 2012. Postpones reinstatement of pre-2001 Act exemption until 2013 |
| Provisions affecting small and family-owned business and farms | Special use valuation (reduced market value by \$750,000); family-owned business and farm deduction (allowed an additional \$675,000 deduction); and allowed installment payments at reduced interest rates. | Repealed family-owned business and farm provisions in 2004 (retained special use valuation and installment payment provisions). | |
| Basis of | Property passing from a | Effective January 1, 2010: property | Allow estates of decedents who |

| | | | |
|--|--|---|--|
| property acquired from a decedent | decedent's estate generally took a stepped-up basis, meaning fair market value; unlimited deduction for transfers to a surviving spouse. | passing from a decedent's estate took carryover basis; estate may elect to step-up basis in \$1.3 million of assets; an additional \$3 million of property transferred to a surviving spouse may receive stepped up basis; step-up basis is reinstated in 2011. | died in 2010 to elect out of estate tax/stepped-up basis regime into no estate tax/modified carry-over basis regime. |
| Gift tax provisions | Annual exclusion of \$10,000 to each donee during the taxable year; exclusion of \$20,000 if spouse consents to split the gift with donor spouse; unified credit may be used during life to shelter transfers from gift tax. | Effective January 1, 2002, retained gift tax provisions, including annual exclusions, with reduction in the rates; credit increased to \$1 million for lifetime gifts effective January 1, 2002 and thereafter, including after 2009; as of January 1, 2010, rates set at highest individual income tax rate. | Gift exemption for 2010 remains at \$1 million; increases to \$5 million thereafter; indexed for inflation in 2012; maximum rate 35%. |
| Generation skipping transfer taxes | Imposed a 55-percent transfer tax on amounts in excess of \$1 million exemption for transfers to or for the benefit of a beneficiary one or more generation below that of the transferor. | Effective January 1, 2002, coordinated rates with the maximum estate tax rates; effective January 1, 2004, coordinated GST Exemption with deathtime Applicable Exclusion Amount; repealed tax after December 31, 2009; current rates and exemption reinstated in 2011. | GST exemption increased to \$5 million per transferor; indexed for inflation in 2012; GST rate for 2010 is 0%; thereafter is 35%. Postpones reinstatement of pre-2001 Act exemption (adjusted for inflation) until 2013 |
| Portability of Estate Tax Exemption | | | Allows surviving spouse to use unused estate tax (but not GST tax) exemption of last prior deceased spouse, if deceased spouse's estate elects; this exemption is not indexed. |

Planning During 2011 and 2012

Under the 2010 Act

1. Planning with the increased gift exemption(s).

- Clients who have not used any part of their lifetime gift exemptions could make gifts of up to \$5 million in 2011 or 2012; clients who have used their full \$1 million gift exemption could make an additional \$4 million gift in 2011 or 2012.
 - Subject to the discussion of what is called “claw back”, below.
- Even with the increased gift exemption, clients should continue to make annual exclusion gifts as well as gifts for education and medical expenses.
- Based on the way adjusted taxable gifts are calculated in completing a decedent’s estate tax return, for a decedent dying after 2012, if the exemption were to go back to \$1 million or \$3.5 million after 2012, technically the gift exemption used in 2011 or 2012 which exceeds the estate tax exemption available at death would be “clawed back”.
 - It has been suggested that such a claw back was not intended, and that there may either be a technical correction or an administrative rule eliminating it.
 - In any event, the donor would not be any worse off than if he or she had not made the gift of the increased exemption – only the difference between the exemptions would be clawed back; any appreciation on and income derived from the gift would continue to be outside the tax system.
- The use of the increased gift exemption during 2011 or 2012 should, accordingly, only be used to gift assets which have great appreciation potential and/or which generate substantial income (or, in a perfect world, both).
 - Which has always been true of lifetime gifts.
- The increased gift exemption(s) could be used to give economic substance to a proposed sale of assets or a loan to a trust perhaps eliminating the need for, or reducing the level of, beneficiary guarantees.
- Use of the increased gift exemption(s) during 2011 or 2012 should likely be made to grantor trusts, to increase the transfer tax leverage of the transaction – allowing the grantor to pay the income tax on trust income and gains without a gift, increasing the value of the trust and decreasing his or her remaining estate.

- Taking advantage of what has been called the “tax burn” of grantor trust planning.
- The 2010 Act did not change the rules with respect to discount planning or short-term GRATs, both of which are still viable planning options.
- Using the increased gift exemption to create a lifetime credit shelter trust for the less wealthy spouse could move the increased exemption plus appreciation out of both spouses estates and give the spouse/beneficiary access to the trust assets.
 - The donor’s indirect access to that trust’s assets would end at the donee spouse’s death or their divorce.
- Spouses creating such credit shelter trusts for each other would have to avoid the reciprocal trust doctrine (the outlines of which are sketchy, at best) in order for this planning to work for estate tax purposes.
 - In addition, it would have to be clear that each spouse used his or her own assets, not those derived from the other spouse, to create these trusts.

2. Planning with increased lifetime GST exemption(s).

- Unlike the use of the increased gift exemption during 2011 or 2012, use of the increased lifetime GST exemption would not be subject to claw back.
- To further increase the transfer tax leverage of using the increased gift exemption during 2011 and 2012, consider making gifts of the increased gift and GST exemptions into long-term, inter-generational “dynasty” trusts.
- In addition to keeping the property out of the transfer tax system for an extended period of time (perhaps forever), keeping the gifts in trust will provide creditor and spousal claim protection – protection from creditors and predators – as well as investment management and protection for the beneficiaries, for the trust’s extended term.
- If loans, rather than gifts, were made in 2010 to GST trusts (because until the 2010 Act, there was no GST exemption to allocate), a gift of the increased exemptions could allow the trust to partially or fully repay them.

3. Reviewing existing estate planning documents because of the increased estate and GST exemption(s).

- Because the increase in the estate and GST exemption(s) are only in effect for two years, absent further Congressional action, not all client estate plans will need to be reviewed and amended to reflect those higher exemptions.
- However, there are some situations where existing documents will need to be reviewed and likely amended, including those where the increased exemption(s) will distort the client's plan, such as:
 - Formula-driven plans for a married couple where, if one client were to die in 2011 or 2012, funding a credit shelter trust with \$5 million might leave the surviving spouse less outright than he or she would be comfortable with.
 - Formula-driven plans where gifts to grandchildren or trusts for their benefit will be over-funded, reducing the amount going to a surviving spouse or to children.
 - Formula-driven plans for a married couple, such as in second marriage situations, where the credit shelter trust was for the benefit of children by a prior marriage which could disinherit the surviving spouse.
 - Formula specific bequests of the estate or GST exemption, which will distort the client's plan.
- Wills or trusts which leave everything to the surviving spouse or which use disclaimer plans, which leave everything to the surviving spouse but allow him or her to disclaim any or all of the gift into a credit shelter trust for his or her benefit, would seem not to require review because of the increased exemption(s).
 - These dispositions would add flexibility to the plan, to be able to respond to future changes in the transfer tax system (which might occur as early as 2013).
 - Similarly, a bequest to a "one lung" trust which would qualify as a QTIP (if a total or partial QTIP election were made for it) could add flexibility to the plan, without requiring an outright bequest to the surviving spouse.

4. Planning for the possible use of portability of the estate tax exemption.

- While portability has been touted as one of the attractive benefits of the 2010 Act, there are a number of reasons why it may prove not to be helpful in many situations.
- For example:

- The portable exemption is not indexed for inflation, which favors credit shelter trust planning.
- Relying on the portable exemption does not guard against the estate tax on appreciation of assets received by the surviving spouse, which favors using credit shelter trust planning.
- Surviving spouses who remarry will have to plan carefully to determine the impact of remarriage on the available portable exemption. The surviving spouse has an incentive to make taxable gifts of the portable exemption of the first spouse, to assure its use, before using his or her own exemptions (assuming there is an ordering rule).
- Conversely, a widow or widower whose previous spouse used the entire portable exemption can gain a tax advantage by marrying a second spouse who has not used his or her portable exemption, provided the new spouse dies first.
- The sunset provision of TRA provides that portability will disappear after 2012, and the costs of portability may not be sustainable. For decedents dying in 2011 and 2012, the use of a credit shelter trust will be a more certain way to lock in the benefit of the new \$5 million applicable exclusion amount.
- The inability to preserve the first spouse's unused GST exemption favors the use of credit shelter trust planning (applying the decedent spouse's GST exemption to that trust, assuming that it benefits skip persons).
- The portability concept strongly encourages the filing of federal estate tax returns for all married decedents dying on or after January 1, 2011, in order to preserve the availability of the portable exemption. In fact, there appears to be no reason (other than costs) not to do so, even if the surviving spouse is less wealthy.
 - The executor must (i) file an estate tax return on a timely basis, including extensions (a late filed return will not suffice), (ii) on that return compute the amount of the available portable exemption, and (iii) make an irrevocable election that such amount may be taken into account.
 - The IRS is charged with issuing regulations to implement the portability feature. By analogy to the complexity of making QTIP elections, it would appear that the portability election will be a source of problems.
- On the other hand, while portability might not be planned for, where both spouses die in 2011 or 2012, it may be useful for a number of reasons, including:

- The surviving spouse could use the pre-deceased spouse's unused estate tax exemption to make lifetime gifts.
- If the first spouse to die has no estate or a small estate, the portable exemption would be worth more than a credit shelter trust.
- There will be a stepped-up basis for the heirs of the surviving spouse for all of his or her assets, including those covered by the exemption from the pre-deceased spouse.

5. Planning with the increased lifetime exemption(s) to "fix" existing gifts, sales, loans, etc.

- One possible use of gifting the increased gift and GST exemptions may be to "fix" existing broken insurance or estate planning transactions, such as:
 - Under-water split-dollar arrangements;
 - Under-water private premium financing transactions; or
 - Installment sales to intentional grantor trusts, where the asset failed to appreciate or to generate enough cash to make the required payments; GRATs which didn't work for the same reason can't be "fixed", since they can't be added to.
- Where split-dollar or private premium financing arrangements were created without a "exit strategy" to allow the advances or loans to be repaid during the insured's lifetime, use of increased gift and GST exemptions could create side-funds as the exit strategy.
- Even if the split-dollar or premium financing arrangement or the installment sale is not under-water, having the lender or seller forgive all or part of the loan, advance, or note would simplify the transaction (although the forgiveness of interest due in premium financing would be a gift of that interest and would be subject to a penalty).
- If an installment sale relied on guarantees to give the transaction substance, a gift of the increased exemption to the purchasing trust may allow the guarantees to be released or at least reduced.

6. Insurance planning with the increased lifetime exemption(s).

- Being able to transfer the increased gift and GST exemptions into a revocable life insurance trust will eliminate the need for more complex transactions, such as split-dollar or private premium financing to fund large premiums.
- Transferring the increased exemptions into an ILIT in 2011 or 2012 would allow the trustee to either purchase a single premium policy (which would be a modified endowment contract) or to invest the gift and pay premiums as they became due out of the trust's investment account.
- As noted above, the increased gift and GST exemptions may be useful in "fixing" old insurance transactions that have gone upside down.

Effect of the Scheduled Sunset of the 2001 Act in 2013

Under the "as if it never enacted" rule of the 2001 Act, the following provisions enacted as part of EGTRRA would be repealed retroactively (as if never enacted) after 2012, because the 2010 Act merely postponed the repeal of these provisions for two years:

- The deduction for state death taxes, although the credit, which was phased out after 2004, would be reinstated.
- The expansion of the estate tax rule for conservations easements.
- The following (helpful) provisions dealing with the GST tax:
 - Deemed allocations of the GST exemption to lifetime transfers to GST Trusts.
 - Qualified severances of trusts.
 - Expansion of the predeceased ancestor rule to nephews and nieces.
 - Retroactive allocations to a trust when a beneficiary has died before the transferor.
 - Modification of certain valuation rules.
 - Relief provisions allowing for extensions of time and allocations of the GST exemption if there was substantial compliance (Section 9100 relief).
- The following provisions dealing with Section 6166:
 - Increase in the number of partners or shareholders from 15 to 45 for purposes of Section 6166.
 - Expansion of its availability to qualifying lending and finance businesses.
 - Expansion of to allow subsidiaries to have publicly traded stock.

- The QFOBI deduction would be reinstated; the maximum deduction would be \$300,000 – the maximum deductible amount of \$1,300,000, reduced by the estate tax exemption of \$1,000,000.

Treating EGTRRA as if it had never been enacted beginning in 2013 means that all of its helpful GST provisions (which clients and practitioners have relied on since 2001) will disappear, retroactively; what do/what should/what can practitioners do thereafter for trusts that had been severed under those rules, trusts that had relied on automatic allocation of GST exemption, or trusts that had been granted Section 9100 relief?