We close this week with **Frank Berall's** comprehensive analysis of the Tax Reform Act of 2010. As members know, **Frank** is a **LISI Commentator Team Member**, and has previously provided members with commentary on the planning issues caused by the absence (until now) of estate and GST taxes in Estate Planning Newsletter #1705.

Frank S. Berall, principal of **Copp & Berall, LLP** and Senior Tax Consultant to **Andros, Floyd & Miller, P.C.**, both of Hartford, CT, is Chair of the newly revived Federal Tax Institute of New England. He was Co-chair (from 1977 through 2009) with Prof. Regis Campfield, of the Notre Dame Estate and Tax Planning Institute, is on the editorial boards of the Connecticut Bar Journal, the Connecticut Lawyer and Estate Planning, was a former Regent of the American College of Trust and Estate Counsel, a past Vice President of the International Academy of Estate and Trust Law, Co-chair of the Hartford Tax Institute's Advisory Council for 10 years, and has been a part-time faculty member at the Yale Law School, the University of Connecticut Law School and the University of Hartford's Graduate Tax Program.

Frank, a frequent speaker at many tax institutes, has published 133 articles, eight commentaries for Steve Leimberg's Estate Planning Newsletter, two articles on the Connecticut Bar Association's website, portions of 13 books, co-authored two Tax Management Portfolios and recently submitted a final draft of a portfolio on same-sex relationships. He has been recognized for his expertise in both trust and estate law as well as tax law in all 30 editions of the Best Lawyers in America, is one of the top 50 Connecticut Super Lawyers and the New York area's Best Lawyers.

Here is his commentary:

EXECUTIVE SUMMARY:

The 2010 tax act reinstated the estate and generation skipping transfer tax (hereafter GST) for 2010. They are retroactive to the beginning of 2010 and continue in effect for estates of decedents dying or generation skipping transfers made in 2011 or later years, had EGTRRAi not been enacted, but at lower rates and with higher exemptions. However, the extension and all changes in the 2010 Act expire again at the end of 2012, again leaving uncertainty as to the tax law applicable thereafter.ii

If they are eventually made permanent, they will dramatically change the way in which estate planning is conducted and the economics of the typical estate planning practice. If not, they will represent a two-year window during which several important estate planning opportunities will exist.

Estate planners must now evaluate all estate plans in light of the new tax rules, the increased exemptions and lowered rates, and other features of the new law. They must determine how to change existing estate plans to address the opportunities offered by these changes and the problems they create. This additional level of complexity will alter the use and features of most estate planning documents, render certain estate planning techniques irrelevant, while making others especially important. However, in determining whether and what planning changes to make, it is important to realize that all these changes expire at the end of 2012. There is no certainty that they will be extended beyond then. Thus, this makes dealing with them especially challenging.iii

COMMENT:

1. **Retroactivity of the transfer taxes was ameliorated somewhat by allowing an election to use carryover basis as an alternative**

While the estate and generation skipping transfer taxes were made retroactive for the entire year 2010, their problems have been eased to some extent by permitting an executor to elect either to pay estate tax or apply carryover basis to all of the estate's assets.iv

Since estates under $5 million, as well as those passing mostly to charity and some that pass most of their assets to a surviving spouse are estate tax free, their fiduciaries should not make an election to have carryover basis apply. Even where there is a relatively modest estate tax, carryover basis may be elected to obtain a stepped up basis for all the estate's assets. Furthermore, where the estate tax is fairly large, it may still be preferable than trying to solve the difficult challenges the election of carryover basis entails.

But in estates larger than $5 million, despite these problems, electing carryover basis may be the best solution. It avoids the estate tax. The election, on I.R.S. Form 8939, is due within nine months of death, unless the estate qualifies for a section 6163 hardship or a 6166 business interest extension (at an especially low interest rate). The date has obviously already passed for estates of most 2010 decedents.

For many estates over $5 million, the estate tax will probably be at a higher rate than any additional income tax on the sale of appreciated assets. Thus, only for a very small percentage of very wealthy 2010 decedents' estates will carryover basis be advantageous. In all cases, in the absence of an affirmative election to use carryover basis, the estate tax will apply.

Indexing for inflation will occur in $10,000 increments, but will not be rounded down to the next multiple of $10,000. Instead, it will be rounded to the nearest multiple of $10,000. This could result in rounding up. The inflation adjustment calculation must be repeated annually and refer to the consumer price index for the twelve months ending August 31, 2010. All annual calculations must be done by referring to this 2010 baseline and then rounding to the nearest multiple of $10,000. While the 2010 Act provides indexing only for 2012, at least, for this part of the law, Congress evidently contemplated extension of the 2011-2012 indexing rule before the end of 2012.

2. **The gift tax exemption and its rate remain respectively at $5 million and 35%**

On January 1, 2011, the gift tax rate became the same as that of the estate tax.v Thus, beginning in 2012, the gift tax exemption will be indexed for inflation, since it will identical to the indexed estate tax exemption. vi

A new, but unfortunately somewhat ambiguous section 2001(g)vii was added by section 302(d) of the 2010 Act. It was intended to conform the deduction for tax attributed to adjusted taxable gifts, when calculating the estate tax to the new gift and estate tax exemption and rates. However, this must be clarified by appropriate forms and instructions. Nonetheless, it appears well meaning and likely intended to avoid any subsequent "recapture" or "clawback" of a gift tax exemption with an increased estate tax. However, if the 2010 Act's rates and exemptions are made permanent, this will be academic.

3. The GST tax

Since the GST tax exemption and its rate are tied to and thus limited both to the applicable exclusion amount and the top rate of the estate tax, as they have been since 2004, with the change in the gift tax, both the estate and gift tax applicable exclusion amounts and the GST exemption are the same for the first time. The 2010 reinstatement of the estate tax again gives an applicable exclusion amount and thus a GST exemption of $5 million for 2010 inter vivos transfers.

For taxable distributions or terminations of a trust or for a direct skip gift in 2010, section 302(c) sets the 2010 GST tax rate at zero, regardless of inclusion ratios or any other calculations. The nine technical questions created by EGTRRA for 2010 and 2011 have been addressed by Code section 2664. The GST tax chapter "shall not apply to generation skipping transfers after December 31, 2009 [and the Code] shall be applied and administered to . . . [GST transfers after December 31, 2010] as if [section 2664] had never been enacted."

Thus, the GST tax chapter itself applies in 2010, without actually resulting in a GST tax, since the latter was set at zero for that year. This corrects the uncertainty caused by EGTRRA's repeal of the GST tax for 2010. Thus, although it was reinstated, its rate is zero. Beginning in 2011 and 2012 it equals the highest estate tax rate of 35%. Since the GST exemption is tied to the estate tax, the former has also been indexed for inflation, beginning in 2010.

For those estates (the majority) not electing carryover basis, the GST tax will have a rate on direct skips of zero and the exemption allocable to trusts created at death will be $5 million. However, for those estates electing carryover basis (probably only the largest ones and those with GST trusts), although the same result will occur, the analysis is much more complicated.

4. Due date and possible disclaimer problem

While the due date for a number of acts, including disclaimers is Monday, September 19, 2011, if the decedent died in 2010 before the December 17 enactment of the 2010 law, the nine-month rule for a valid disclaimer under Connecticut law and that of many other states, precludes a federal disclaimer from being valid, if it occurs after more than nine months, since a federal disclaimer must be valid under state law.

5. The $5 million estate tax exclusion and 35% maximum rate for both post 2011 gifts and estates

Decedents who died in 2010 or have already died in 2011 or will die later this year have a $5 million estate tax exclusion. This will be indexed for inflation for deaths after 2011. The maximum estate tax rate is 35%. Thus, the estate tax has been retroactively reinstated. The applicable exclusion for 2010 gifts was $1 million. The gift tax rate was 35%. For gifts after 2010, as already mentioned, the gift tax has been reunified with the estate tax with an applicable exclusion of $5 million and top rates of 35%.

6. The $5 million GST exemption

The $5 million generation skipping transfer tax (hereafter GST) exemption is available for 2010 estates, regardless of whether their fiduciaries elect EGTRRA's 2010 zero estate tax or section 1022's carryover basis. But the GST tax exemption of the first decedent cannot be used at the second one's death if they were not married.viii However, whether or not an individual is married, thought should be given to how to interpret an instrument that makes a bequest or gift equal to the individual's unused GST exemption at death.

7. Charitable Trusts, Age Differences and GST tax

Using charitable remainder and charitable lead trusts are also possible for married opposite-sex partners. However, since unmarried partners or same-sex married partners are not related, if there is more than a 37 ½ year age difference between them, a generation-skipping transfer tax will be incurredix on a large transfer.x Thus, where an unmarried or same-sex married partner makes hisxi partner beneficiary of a generation skipping tax, since they are unrelated (that is, they are not lineal descendants of the other party's grandparent), they will be assigned to a generation on the basis of their date of birth.

If born within 12 ½ years of the date of the transferor's birth, the transferee will be assigned to the same generation as the transferor. If born more than 12 ½ years thereafter, but within 37 ½ years of the transferor's birth, she will be assigned to the first generation younger than the transferor. Subsequent generation assignments are similarly made on the basis of 25 year periods.xii Thus, same-sex partners unrelated by blood but married in those jurisdictions permitting same-sex marriage,xiii must be careful in trust planning, to avoid inadvertently becoming liable for the generation skipping transfer tax. However, since because of the Defense of Marriage Act and its wording, the United States Internal Revenue Code does not recognize same-sex marriages, this problem may be academic.xiv

8. Portability of the unified credit

The portion of the exemption (unified credit or exclusion) not used by a predeceased spouse is available to the survivor. To obtain portability, the latter's executor must make an affirmative election to use it on her timely filed estate tax return. This will toll the statute of limitations forever, but only to determine the amount of unused exemption, not to make any adjustments to the return itself. These are prevented by the regular statute of limitations. The first inflation index increase occurs, if at all, in 2012. It will affect the deceased spousal unused exclusion amount, under section 303(a) of the 2010 Act.

The executor must compute the amount of the deceased spousal unused exclusion and make an irrevocable election on a timely filed estate tax return. This is necessary to preserve the unused exclusion, even if the first spouse's estate does not exceed the exclusion. Regardless of the statute of limitations, that return may be examined to determine the correctness of the portability amount.

The gift tax applicable exclusion also benefits by an increase from the deceased spouse's unused exclusion amount. The gift tax credit is based on the applicable estate tax credit that would apply had the donor died during the calendar year in which a taxable gift was made.[xv] Thus, the surviving spouse should consider making gifts of property equal to the deceased spousal unused exclusion amount prior to death of a spouse from a subsequent marriage (or, if earlier, then before 2013 in light of the 2010 Act's sunset provisions).

Until Congress acts to make portability permanent, prudence requires an assumption that it will be made permanent. Therefore, such an election should be made at the death of the first spouse, unless the entire exemption is used then or it appears to be very unlikely that the survivor's estate will exceed the exemption. Since the smallest estates may have the most unused exemptions and therefore need to elect portability more than larger ones, this is not a simplification. However, if the combined estates of a couple are well underneath the exemption, there may be no reason to elect portability.

Portability could no more than double the exemption of a surviving spouse. It would be limited to the unused exemption of a survivor's last deceased spouse. Presumably a remarriage followed by a divorce would revive that status; thus, the "last such deceased spouse" need not be "the last spouse."[xvi]

While portability simplifies estate planning for some married couples, a credit shelter trust would still offer advantages, especially for larger estates. The advantages are professional management and asset protection for the surviving spouse's life, protecting the children's expectancy from diversion by her, especially where there are subsequent marriages and blended families or the surviving spouse remarries. Besides sheltering intervening growth and accumulated income from the estate tax, a credit shelter trust permits use of the predeceased spouse's GST exemption. Portability only applies to the gift and estate taxes.

But, many couples will find portability's simplicity and a second step up in basis for appreciated assets as their dominant consideration.xvii

9. The 1976-1980 controversy over carryover basis

The 1976 Tax Reform Actxviii introduced the controversial concept of carryover basis. This replaced "stepping up" or down the adjusted basis of property to its date of death or alternate valuation date value. A fresh start rule exempted prior appreciation, stepping up the basis of all property inherited after 1976 to its December 31, 1976 value. Carryover basis was so complicated that **Jonathan Blattmachr** wrote a book about it.xix

Tax professionals soon realized that it created major new difficulties in estate administration. Thus, a storm of protest arose from many professional groups. The Carter Administration and various "liberal" organizations tried to defend this significant change. They proposed a moratorium in 1978 followed by a "fix up." But the rapidly strengthening opposition's refusal to compromise and its insistence on repeal was overwhelming.

During a dialogue between panelistsxx and committee members at a 1979 House Ways and Means Committee hearing, it was apparent that those strongly favoring repeal; namely, the Republicans led by senior minority member, Barber Conable, and conservative Democrats, including Sam Gibbons, were far more articulate and convincing than Committee Chair, Al Ullman, and the handful of liberal Democrats favoring fix up. Retroactive repeal was enacted, but President Carter threatened to veto it. However, an oil supply crisis, causing skyrocketing gasoline prices, made a crude oil windfall profits tax a very important Administration priority. Carryover basis opponents attached its retroactive repeal to this veto-proof bill in 1980.xxi

10. As mentioned above, estates of 2010 decedents may choose either the recently resurrected carryover basis or pay an estate tax

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)xxii enacted a modified carryover basis provisions for 2010 deaths, gradually phased out the estate and GST taxes over the following eight years while repealing them for 2010 deaths. In 2011, all prior tax law provisionsxxiii apply, as if EGTRRA had never been enacted, xxiv except as changed by the 2010 Act.

Unlike the 1976 carryover basis law, which gave a fresh start, stepping up (or down) basis to its enactment date, EGTRRA did not have any fresh start rule. Appreciation that accrued prior to its enactment will be taxed. The absence of a fresh start rule makes determination of basis more difficult.

Section 1014(f)xxv makes section 1014(a)'s adjustment to basis, to the value at death or alternate valuation date, inapplicable to 2010 decedents' estates. However, persons who die after EGTRRA's 2011 expiration and thereafter are entitled to the basis adjustment previously allowed by section 1014, as though EGTRRA had never been enacted.

Accordingly, section 1022 treats property acquired from a 2010 decedent as if it had been transferred by gift, thus carrying over its basis. Although the legislative history of EGTRRA indicates that the nature of any gain or loss that would have been realized by the decedent's sale of inherited property also carries over to the decedent's estate, it is not clear that the statute itself supports this conclusion.

Although property is treated as received by gift, this does not determine the character of the donee's property or the character of the donee's gain. For example, property that was inventory in the hands of the donor may be a capital asset in the hands of the donee. Section 1221 does address the question of whether a work of art or literary composition acquired upon the death of the artist or author in 2010 is a capital asset in the transferee's hands.

Subsection 1221(a)(3)(C) provides that if the basis of the property is the same in whole or in part, as the transferor's basis, determined without regard to section 1022, then the asset is not a capital asset. Section 6018(c)(5) requires that executors of 2010 decedents file a return (presumably this will be on Form 8939, presently in a draft) disclosing whether the gain on the sale of the property would be treated as ordinary income. However, except for these provisions, the statute does not support the carryover of the character of property to the decedent's estate or beneficiaries.

Section 1221(11) treats gain on the sale of assets that acquired a new basis under section 1014 as long-term gain. During 2010, since section 1014 was not in effect, gains realized within 12 months of a decedent's death were short term, unless the decedent's holding period was "tacked" to the holding period of his estate or other recipient so that the property could be treated as being held for at least a year. Tacking is allowed when a person's basis is the same (in whole or in part) as the basis of the person from whom the asset was acquired.

If the limited basis adjustments allowed by EGTRRA are not allocated at all to an asset or if not allocated in an amount sufficient to increase the basis of the asset to fair market value on the date of the decedent's death, tacking should be allowed. This is because the basis will be the same (in whole or in part) as the decedent's basis. If the limited basis adjustments are allocated to increase the basis of an inherited asset to full fair market value, it is not clear whether tacking will be allowed.

Since EGTRRA was not extended after 2010, a basis adjustment may be available, even for property acquired from a 2010 decedent's estate, if the asset is sold after 2010. Section 902(b) of EGTRRA provides that the Internal Revenue Code shall be applied and administered to years, estates, gifts and transfers described in section 902(a) as if the provisions and amendments described therein had never been enacted. This provides that EGTRRA shall not apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2010. If the Code is applied to "years after 2010," as if EGTRRA had never been enacted, then assets acquired from the estate of a decedent who died in 2010 will acquire a date of death (stepped up or down) basis under section 1014.

a. The $1.3 Million Basis Increase

To ease application of the modified carryover basis system to small and medium-size estates, a "basic" basis increase of $1.3 million is allowed for the estate of any U.S. citizen or resident, up to fair market value.xxvi This adjustment is augmented by the sum of section 1212(b) capital losses and section 172 net operating loss carryovers. The net operating loss carry forward is the same amount that would have been carried over from the decedent's last taxable year to a later one, had he lived. The section 165 "built in" losses are calculated as if the decedent had sold the property at fair market value immediately before death. The additional adjustment for the decedent's "built-in losses" makes it unnecessary in most cases actually to sell assets to realize losses (so as to preserve them for the modified carryover basis system) prior to death.

Non-resident alien decedents are not treated as generously. Their initial basis increase will be limited to $60,000 and no additional adjustment will be allowed for unused built-in losses or loss carryovers.xxvii Hence, American taxpayers (and others) who inherit property from a foreign decedent will face more income tax, on average, on the disposition of that property than on inheritances from American decedents. Under prior law, the basis of property acquired from a foreign decedent, even though not subject to United States estate tax, was generally equal to its estate tax valuation date's fair market value. Thus, basis adjustments cannot cause an inherited asset's basis to exceed its date of death fair market value.

The rule treating transfers by a U.S. person to a foreign trust or estate as a sale or exchange is expanded to include transfers by a U.S. person or U.S. estate to a non-resident alien individual. The transferor's gain to be recognized is the excess of the transferred property's fair market value over its adjusted basis in his hands. The deemed sale does not apply to lifetime transfers to nonresident alien individuals.

Clarification by the I.R.S. is needed as to whether section's 1022 basis adjustments will be allowed to reduce gain, particularly where a sale or other taxable transfer occurs before allocations to basis adjustments have been made.

b. The $3 Million Spousal Basis Increase

In addition to the $1.3 million basis increase, the executor can also allocate up to $3 million to increase the basis of assets the surviving spouse receives, either outright or through a QTIP trust. The latter qualifies for the estate tax marital deduction (when there is an estate tax) only to the extent the executor elects qualification under section 2056(b)(7). No election is necessary for such a trust to have the $3 million basis increase allocated to it.

Many estate plans provide that if there is a surviving spouse and a direction that the estate be divided into two shares; one equal to the unused estate tax exemption equivalent and the balance to qualify for the estate tax marital deduction, the client's wish may appear to be that his estate passes entirely into the estate tax exemption equivalent share (usually a credit shelter trust for the surviving spouse's life), with its remainder to descendants.

If a 2010 decedent's fiduciary elects carryover basis, then without any estate tax, his entire estate (whether $5 million or $500 million) can pass estate tax free into the credit shelter trust. That could be how an instrument making the credit shelter trust/optimum marital deduction division will be construed. While the entire estate passes into the credit shelter trust, if the surviving spouse cannot benefit from the latter (e.g., it is exclusively for the benefit of the decedent's descendants from a prior marriage), the result seems harsh to the spouse.

c. QTIP trusts

Assuming this occurs and all surviving family members want it, or if the estate plan is revised to provide for that result, an important tax issue arises. Unless the credit shelter trust is QTIP, there may be insufficient Qualified Spousal Property for the executor to allocate the $3 million basis increase. On the other hand, suppose the instrument is either construed or revised to provide that the entire estate passes into a QTIP trust? If the 2010 estate elected not to pay estate tax, the maximum permissible amount of property to which the executor may allocate the $3 million basis increase will thus be available.

However, a QTIP trust limits other planning opportunities, such as transferring property to children free of gift tax or "splitting" income with the trust and/or descendants. This would normally be available if the credit shelter trustee has discretion either to accumulate or pay income or corpus to descendants, as well as to the spouse. Perhaps any disclaimed part of the QTIP trust would pass to such a discretionary credit shelter trust. Furthermore, even though there was a gift tax on all 2010 gifts, the spouse can make a section 2518 qualified disclaimer (which is not a taxable gift) and remain a beneficiary of any trust into which the disclaimed property passes.

Absent state law complications, a married property owner could leave his estate to a QTIP trust, qualifying for an estate tax marital deduction if the state has one, only to the extent elected by the executor. This qualification as such seems unimportant if the executor of a 2010 decedent elects not to pay federal estate tax. Since such a QTIP trust is Qualified Spousal Property, the executor may allocate the $3 million basis increase to it and the spouse may disclaim the entire QTIP trust, even exceeding the amount needed to receive the basis increase. The disclaimed assets will pass into a more flexible credit shelter trust.

Regardless of the QTIP trust's amount, no portion should be included in the surviving spouse's gross estate, even if she dies after 2010, when the estate tax was retroactively back in effect. Section 2044 taxes a QTIP trust in the spouse's gross estate if the trust avoided estate or gift tax because of the marital deduction.

While QTIP property falls into the carryover basis regime, it is denied the right to have a section 1022(b) or (c) basis increase. It would be helpful if the I.R.S. instructions to the carryover basis form (8939), required to be filed by 2010 estates electing carryover basis, would inform the executor whether to report basis information for QTIP property, general power of appointment property and other types of assets that cannot have their basis changed or whether these can be ignored for reporting purposes. As previously mentioned, this form will now be due no earlier than Monday, October 17, 2011.

For the estate of a married 2010 decedent electing carryover basis, there will be no estate tax. Presumably the executor of the first spouse to die may elect section 2056(b)(7) QTIP treatment and avoid estate tax. To the extent elected, the QTIP will be included in her gross estate. In the absence of an election to pay estate tax, a 2010 decedent's estate, the entire estate, other than a separate formula bequest to fully use the basis increase for Qualified Spousal Property, passes into the credit shelter trust, making reliance on the spouse's disclaimer unnecessary.

Qualified spousal property receives a $3 million basis increase (but not above its date of death fair market value).xxviii Qualified spousal property includes an outright transfer to a surviving spouse, unless it is a terminable interest. However, interests terminating because both spouses die in a common disaster are not considered terminable if the spouses do not die in a common disaster.

Qualified spousal property also includes qualified terminable interest property (QTIP).xxix This is defined identically to section 2056(b)(7)'s QTIP definition; namely, property "which passes from the decedent, and . . . in which the surviving spouse has a qualifying income interest for life . . . [being] entitled to all the income . . . [at least] annually . . . and no person has a power to appoint any part of the property to any person other than the surviving spouse."[xxx] For Louisiana, Puerto Rico and other decedents in civil law jurisdictions, a usufruct for life will qualify.[xxxi] However, unlike the federal estate tax requirement, no QTIP election is required for property to become qualified spousal property.

Nor does the latter include a charitable remainder trust of which the spouse is the only non-charitable beneficiary, because she is not entitled to all its income. The I.R.S.'s regulatory authority could treat both an annuity and such a trust as qualified spousal property.

Certain interests for which an estate tax marital deduction was available under prior law are not considered qualified spousal property. Thus, they are not eligible for the section 1022(c) $3 million spousal basis step up. For example, a section 2056(b)(5) general testamentary power of appointment marital deduction trust will not qualify if the spouse has a lifetime general power of appointment which may be exercised in favor of anyone other than the surviving spouse. Similarly, an "estate trust," whose remainder goes to the spouse's estate, without requiring any income payment to her would not be qualified spousal property.

Other than QTIPs, terminable interests such as life estates, term of year legacies, annuities (except as provided in regulations), patents and copyrights will probably not qualify for the $3 million spousal property basis increase.[xxxii] But, a bond, note or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or term of years, will qualify.[xxxiii]

While allocation of the $3 million basis increase can be made to property received by a surviving spouse or QTIP trust, how can these assets be identified if the estate is still open and not all assets that could be distributed to the surviving spouse or QTIP trust have been distributed? For example, if the executor allocates the basis increase to $4 million in stock with a $1 million basis and the QTIP's share is at least equal to $4 million, if the executor allocates the $3 million basis adjustment to the stock and sells the stock before funding the QTIP, must the sales proceeds be allocated to the QTIP?

If the executor of a surviving spouse, who died in 2010 with a large estate and was beneficiary of a marital QTIP trust, elects carryover basis, instead of paying estate tax, neither section 1022 nor section 1014 seem to apply to the QTIP as property acquired from a decedent. The basis of the QTIP Trust assets thus remains that of those assets in the QTIP Trust immediately prior to death.   It would even be desirable if the assets happen to have built-in losses.

Suppose there is cash that could be distributed in satisfaction of the QTIP instead of the assets that have been sold and with respect to which all or part of the $3 million basis increase has been or it is claimed will be allocated? A similar problem was discovered in the 1976 carryover basis provisions by **Jonathan Blattmachr**. Although he could never figure out a perfect way to solve the issue, repeal of the 1976 carryover basis made it unnecessary for the I.R.S. to address it. However, that may be necessary now.

d.   Jointly Held Property

If property owned by a decedent includes jointly owned property, 50% of that held in joint tenancy with the surviving spouse as the only other joint tenant will be included in his estate.xxxiv Where there are additional tenants and the decedent furnished consideration, he will be treated as owner to the extent of his proportion in it.xxxv Where the decedent and someone other than his spouse acquired property by gift, bequest, devise or inheritance as joint tenants with right of survivorship, the decedent will be treated as owner to the extent of his fractional interest's value.xxxvi Where the decedent's interest in jointly held property was received by him as a gift, while the surviving joint tenant purchased his interest, there may be difficulties in proving contribution of the purchased property, as well as determining the contribution ratio for the joint property.xxxvii

e.   Effects on Foreign Spouses

The $3 million spousal basis increase applies to non-resident aliens and non-U.S. citizen surviving spouses' estates, regardless of the surviving spouse's citizenship or residency.xxxviii Unlike the estate tax law, where the estate tax marital deduction is permitted only for property passing to a qualified domestic trust or QDOT (described in section 2056A), a non-U.S. citizen surviving spouse may enjoy the basis increases under the modified carryover basis rules that a U.S. surviving spouse enjoy.

f.   Inflation Adjustments

When EGTRRA expired on December 31, 2010, Congress did not extend its carryover basis provisions in the 2010 Act.xxxix Inflation adjustments to the $1.3 aggregate increase from the 2009 base year will only be in $100,000 multiples. However, aggregate spousal basis increases of $3 million will be increased for inflation in $250,000 multiples. The $60,000 non-resident aliens' aggregate basis increase will be increased for inflation in $5,000 multiples, but cannot be increased by unused loss carryovers or built-in losses.xl

g. Other Problems

1. The "Owned by" and "Acquired from" Requirement

For property to receive a basis adjustment, it must be both owned by and acquired from the decedent. The "acquired from" requirement is broadly construed. It includes acquisitions by bequest, devise and inheritance, as well as property passing to his estate, from his revocable trust or any other trust he had the power to alter, amend or terminate and any other property passing from him because of his death, to the extent it passed without consideration.xli

However, the "owned by" requirement is given a narrower meaning. Assets held by a trust will satisfy the "owned by" requirement only if the trust is a qualified trust under section 645(b)(1) so it may, by election, be treated as part of the decedent's probate estate for income tax purposes. Property over which a decedent had a general power of appointment is not treated as his. Thus if he has the right to withdraw assets from a trust established by someone else, he will not be treated as owning them for section 1022 purposes.

It is at least arguable that assets owned in a trust treated as a grantor one for income tax purposes, of which the decedent was the grantor, will qualify for a basis adjustment. This is because it is the position of the I.R.S. that since such trust does not exist for income tax purposes; it is treated as owned by the grantor.xlii But the specific reference to section 645 trusts as meeting the "owned by" requirement implies that other grantor trusts do not meet the "owned by" requirement. This uncertainly may create some pressure for trustees either to make distributions to terminally ill beneficiaries or else to exercise withdrawal rights.

A surviving spouse's half share of any community propertyxliii is considered as having been owned by and acquired from the decedent, if at least half of her community interest is treated as owned by and acquired from the decedent, without regard to this provision. This rule is consistent with the benefit community property has enjoyed over jointly held property, in determining the basis of assets acquired from a decedent under section 1014.

2. Negative Basis Property.

Liabilities exceeding basis will be disregarded in determining a transferee's adjusted basis and whether gain is realized at death by the decedent or in a transfer to his estate or to any beneficiary other than a "tax exempt" one.xliv A beneficiary inheriting carryover basis property subject to a liability exceeding basis may incur tax on its subsequent disposition in an amount that could exceed its value. Thus, he should consider disclaiming it.xlv

If property subject to liabilities in excess of basis is left to a charity, a foreigner or any other person for tax avoidance purposes, gain is realized either by the decedent at death or by his estate, when the property is distributed. A distribution deduction would only shield the tax liability to the extent of the value of the property distributed. However, if it passes to a domestic trust without other assets, then collectability of the tax on the asset's eventual sale, subject to liabilities in excess of basis, is doubtful.

3. Property Received Within Three Years of Death

In general, property given to a decedent within three years of death will not qualify for a basis adjustment. However, transfers within three years of death from a spouse do qualify for a basis adjustment, unless the donor spouse acquired the property by gift from another person within the 3 year period.

4. Income in Respect of a Decedent

As under section 1014, no adjustment to basis is allowed for income in respect of a decedent ("IRD"). This is principally dealt with under section 691. It includes traditional IRAs, section 401(k)s and similar tax deferred retirement plans.

5. Satisfying Pecuniary Bequests with Carryover Basis Assets

Section 1040 provides that only post-death appreciation is recognized by an estate if a pecuniary bequest is satisfied with appreciated carryover basis property. To the extent provided in regulations, a similar rule will apply to trusts. Until then, revocable trusts should make a section 645 election to be treated and taxed as an estate. This will permit the trust to avoid gain recognition pursuant to section 1040 while the election is effect. Section

1040 seems to exempt IRD from being recognized when satisfying a pecuniary bequest, unless there has been an increase in value since death. This is based on a literal reading of the statute and may have been unintentional.

A beneficiary's basis will be the transferor's basis immediately prior to transfer, plus the gain recognized by the estate or trust on the transfer. Thus, selection of assets to fund pecuniary bequests will significantly affect the beneficiary's future income tax liability, potentially resulting in a significant gain at a later sale or other taxable disposition. A "boilerplate" provision allowing pecuniary bequests to be paid in cash or in kind and without regard to basis in the discretion of the executor could, under a carryover basis regime, distort a decedent's estate plan, such as where the decedent bequeathed a specific sum to an individual and intended that legatee to receive that amount without any inherent income tax liability.

6. Principal Residences

The $250,000 exclusion under section 121 on the sale of a principal residence will be extended to estates and heirs, if the residence was used by the decedent as such for two or more years during the five years before its sale. There can be tacking of the decedent's occupancy period to that of the individual beneficiary's in determining if the two-year rule is fulfilled, even if the residence was owned by a trust during the decedent's occupancy.xlvi However, this exclusion is allowed only to an estate or an individual beneficiary and not to a trust. Therefore, sales should be made before funding a testamentary trust. A revocable trust making a section 645 election to be taxed as an estate should also be able to use this exclusion while the election is in effect.

7. No basis adjustment or credit is allowed for state and foreign death taxes

This is a particularly harsh consequence for U.S. citizens residing abroad. Not only may assets have to be sold to pay foreign death taxes without an income tax "credit" for the foreign death tax, but state death taxes may present the same problem.

h. Information Returns, Other Estate Administration Problems and Risks to Executors

As previously mentioned, an information return, Form 8939, in lieu of a United States estate tax return, is required to report large transfers at death.xlvii All property (other than cash) acquired from a decedent with a fair market value at death exceeding the $1.3 million aggregate basis increase (without increase for unused built-in losses and loss carryovers) will require the executor to file such a return to report large transfers at death.xlviii This filing requirement also applies to appreciated property acquired by the decedent within three years of death, for which the donor was required to file a gift tax return.xlix Basis increase allocations must be made by the executor on an asset by asset basis, on that return, for 2010 deaths. Allocation can be made to one or more shares or to an entire block of stock, but an asset's basis cannot be adjusted above its fair market value on date of death.

The return must report, to both the I.R.S. and the beneficiaries, the recipient's name and tax identification number (TIN), the property's accurate description, its adjusted basis in the decedent's hands, its fair market value at his death, his holding period, sufficient information to determine whether any gain on its sale is ordinary income, the amount of basis increase allocated to the property and any other information prescribed by not yet proposed regulations.

The return must be filed if the aggregate value of these assets (excluding cash) exceeds $1.3 million. If the executor cannot make a complete return, then every person holding any legal or beneficial interest in the property must file one.l For non-resident aliens' estates, the return requirement applies only to tangibles situated in the United States and other property acquired from that decedent by a U.S. person.

All return preparers must furnish a written statement to each beneficiary with the name, address and phone number of the person required to make the return and the information called for about the decedent's property passing to that person, no later than 30 days after the Form 8939 is filed.li Originally, these returns were required when the federal income tax return for the decedent's last taxable year was due to be filed. This would be April 15, 2011 or October 15, 2011, if extensions to file are requested. Even if they are not, the I.R.S. has evidently agreed that this Form 8939 will not be due until October 15, 2011. Since the latter is a Saturday, the due date will be Monday, October 17, 2011. (Thus, the I.R.S. has a long time before it must release its final Form 8939 and its instructions in final form.)

There is a $10,000 late filing penalty against the executor and a $500 penalty for each failure to furnish the section 6018(b)(2) information concerning certain gifts received by a decedent within three years of death. Furthermore, a $50 penalty will be imposed for failure to furnish statements to the recipients.lii A reasonable cause exception exists for failure to comply with these requirements.

i, Allocation of Basis Increases

Only the executor named in the will may allocate basis increases. Thus, the will should have had a provision authorizing the executor to make a discretionary allocation of the basis increase. (Most wills of 2010 decedents probably did not.) Under section 2203, absent an "executor or administrator appointed, qualified and acting . . . any person in actual or constructive possession of any property of the decedent" is the executor. There may be several such persons.

Absent an executor, disagreement may arise about who may exercise options and make basis elections. Thus, the will should be admitted to probate and an executor or, in the absence of a will, an administrator appointed to make the allocations.   If an executor who is a beneficiary can allocate the basis increases, both conflicts of interest and a question as to whether an executor-beneficiary may allocate basis increases to himself, under applicable state law, may arise. If so, there may be potential gift tax consequences to him if he does not act.

Since executors may be liable for asset allocation, individual family members may not wish to serve. Thus, they should either decline initially or else resign in favor of a corporate executor or co-executor. The the latter should be solely responsible for allocations, thus reducing conflict of interest problems among family members.

Administration of 2010 decedents’ estates will be complicated by allocation of basis adjustments. Determining optimum allocation may not be the fairest way of doing that under general fiduciary principles. The fairness of an allocation will probably be disputed and possibly litigated between beneficiaries. Even relatively small estates will have to appraise hard-to-value and not readily marketable assets.

The absence of some of the decedent’s pertinent records will require extra time and costs to reconstruct basis, particularly for jewelry, collections of stamps, coins, antiques, other collectibles, similar items of tangible personal property purchased in small quantities over the decedent's lifetime and even real estate improved while held by the decedent. The reporting requirements and handling disputes between beneficiaries over exemption allocations may increase the risk of surcharge actions, malpractice suits against attorneys for alleged mishandling of allocations or violations of fiduciary duties in making them. An executor who is also a beneficiary will have conflicts of interests in allocating potential basis increases and may be accused of violating his duty of loyalty to the estate.

It is quite likely that the I.R.S. will have enforcement problems. It is unclear if and when the return (Form 8939), upon which basis allocations and other information must be reported, will be audited or what penalties will apply if a valuation dispute occurs. If sales occur decades after a 2010 death, can the seller rely on the return's data? Until statutes of limitations run on income tax returns on which beneficiaries report the sale or other taxable disposition of property acquired from a decedent, the disclosures on the executor's information return (Form 8939) can apparently be questioned by the I.R.S., even many years after the estate was closed and the executor discharged, died or a bank executor is no longer in business.

j. Overall

As previously mentioned, the modified carryover basis rules that EGTRRA would have applied for purposes of determining the basis of property acquired from a 2010 decedent, have been repealed and the stepped up basis rule has been restored. Fiduciaries of 2010 decedents may elect either to apply the newly enacted retroactive 2010 estate tax and its usual basis step up (or down) rules, or have EGTRRA's 2010 carryover basis rules apply. If the latter election is made, a 2010 decedent's estate would not be subject to estate tax, but the basis of assets acquired from that decedent and any gain or loss on any future year's sale or disposition of the asset will be determined under section 1022's modified carryover basis rules.liii

Instead of a fresh start, as provided by the 1976 Act, section 1022(b)(2)(B) gives a basis increase of $1.3 million, augmented by sections' 1212(b) capital losses and 172 net operating loss carryovers. The latter would have been carried over from the decedent's last taxable year to a later one, had he lived. Section 165's "built in" losses are calculated as if the decedent had sold the property at fair market value immediately before death. The additional adjustment for the decedent's "built-in losses" makes it unnecessary in most cases to sell assets to realize losses (to preserve them for the modified carryover basis system) prior to death.

During 2010, gains realized within 12 months of death will be short term, unless the decedent's holding period is "tacked" to his estate's or that of other recipients. Tacking is allowed when a person's basis is the same (in whole or part) as the basis of the person from whom the asset was acquired. If the limited basis adjustments are allocated to increase the basis of an inherited asset to full fair market value, it is not clear whether tacking will be allowed.

QTIP assets do not get a basis step-up (or step-down) at the death of the surviving spouse if carryover basis is chosen. Thus, their basis remains at the amount it was before that death.liv

For 2010 decedents' estates electing carryover basis instead of paying estate tax, there is an aggregate basis increase of $1.3 million for estates of U.S. citizens and resident aliens.lv But, the survivor of an unmarried couple will not be entitled to this $3 million basis increase for qualified spousal property.lvi There are no provisions for surviving spouses of same-sex marriages, since the federal DOMA precludes recognition of them.

While there can be a total $4.3 million (plus unused losses) increase in the basis of the property transferred to a surviving spouse, neither the $1.3 million aggregate basis increase (including unused losses) nor the $3 million spousal basis increase can raise the basis of any property above its fair market value at death. Thus, the executor must determine which assets to use and to what extent to give each a basis increase. With insufficient appreciation to use these adjustments, the excess is lost.

If property subject to liabilities in excess of basis is left to a charity, a foreigner or, to the extent provided by regulations, to any other person for a tax avoidance purpose, gain is realized by either the decedent at death or by the estate when it distributes the property. A deduction for the distribution would only shield the tax liability to the extent of the value of the property distributed. However, if such property passes to a domestic trust without other assets, the collectability of the tax on the eventual sale of the asset subject to liabilities in excess of basis is doubtful.

k. Filing Deadlines

The filing deadline for estate and generation skipping tax returns of decedents dying prior to the December 17, 2010, enactment date of the 2010 tax law is September 17, 2011. But, since this is a Saturday, the deadline thus is Monday, September 19, 2011. Payment of the estate and GST tax and making of any section 2518(b) disclaimer of a property interest passing at the death of such a decedent are also due then. However, where a state's disclaimer law requires filing of a disclaimer with the probate court within nine months after death, the disclaimer may not be valid it if is filed later, despite it being permissible under federal tax law.

l. Unresolved Questions

1. While carryover basis will only have an impact on decedents who died in 2010 and whose estates elected carryover basis, will the basis of assets inherited in 2010 be adjusted to date of death fair market value, now that EGTRRA has expired and thus section 1014 applies to years after 2010 as if EGTRRA had never been enacted, i.e., as if this section had never ceased to apply?

2. Is the nature of a decedent's gain (e.g., ordinary income or capital gain) carried over? If the decedent was a dealer, will the estate have to treat the property as inventory rather than a capital asset? There is no definitive rule contained in section 1022 that says that the nature of the gain will remain the same in the hands of the inheritor as it was in the decedent's hands.

3. It should be noted that the legislative history of EGTRRA indicates that the character of the income to the decedent determines the character of the income to the estate or beneficiary who inherits the asset from the decedent. Specifically, "[t]he character of any gain or loss on the sale of an asset is also carried over with its basis. For example, depreciated real estate, which would have been subject to 'recapture' tax had it been sold by the decedent, will be subject to such recapture if sold by his estate."lviiThe statute, however, as mentioned, does not appear to include language that requires this result. For example, if the decedent was a dealer, is the inventory later sold by the decedent's estate ordinary income to the estate, as it would be to the decedent? Nothing in the statute mandates that result.

4. While it does not appear to have been intended, it seems that section 1040 excuses recognition of income as IRD, if used to satisfy a pecuniary bequest. Will this be allowed?lviii

11. Practical suggestions to advise a fiduciary whether to elect carryover basis

Consider the following:

- Compare the federal estate tax impact with step up with no federal estate tax with carryover basis, bearing in mind the lifetime use of the exemption;
- Sometimes carryover basis gives a higher basis (such as with QTIP and general power of appointment property and step down compared with pure carryover basis is not limited to date of death values);
- Consider the impact of the election on formula bequests and when this can be finally determined.
- If there is a state estate tax, what will be the impact of avoiding federal estate tax; for example, will there be no sections 2058 nor 691(c) deductions?
- Estimate the relative costs of administration, including difficulties of ascertaining basis in estates holding collectibles, antiques, real estate improved by a decedent, etc.;
- Consider the timing of the estate tax at the death of the surviving spouse and the time of the sale. This involves speculating on future federal and state tax rates.
- Bear in mind that if the estate has large amounts of assets consisting of income in respect of a decedent, these will not receive any step up or step down.
- Decide to pay the federal estate tax when the income tax savings, including the state's, will be greater; for example for negative basis property with inherent ordinary income or self-created artwork.
- To obtain a basis increase, the property must be both "owned by the decedent" and "acquired from the decedent." Thus, QTIPs are apparently excluded. But in some cases, this may be beneficial.
- For trusts over which control is held at death and transfers taking effect at death without consideration, since they meet the "acquired

from" but perhaps not the "owned by" tests, basis increases will evidently not apply to them.

- Whether basis increases apply to both halves of community property is questionable because the decedent's half is probably not considered qualified spousal property. There may be also some problems with jointly owned property and power of appointment or income in respect of a decedent from certain DISC and similar stock.lix

12. Tax Planning Techniques using GRITs and GRATs

a. Gratuitous transfers and gift splitting

Gift taxes apply to all gratuitous transfers. For 2010 gifts, it applied to those in excess of the $13,000 per donee annual exclusion between unmarried people. This included those transfers occurring upon termination of the relationship of unmarried cohabitants, such as gratuitous transfers by parties dissolving a civil union or a domestic partnership. The exemption for transfers made under a written separation agreement,lx if there is a final divorce within three years thereafter, does not apply, since civil unions and domestic partnershipslxi are not marriages. Thus, the IRS will probably not consider dissolution of one to be equivalent to a divorce from a conventional marriage. But, if there is adequate consideration or if the transfer is part of an agreement subject to court approval or ordered by a court, an exception might possibly be made.lxii

Married couples (if the donee spouse is a U.S. citizen) can make unlimited tax-free transfers between themselves.lxiii However, gratuitous transfers between unmarried people are taxable gifts. Splitting gifts by one unmarried partner to a third party, even if the latter is a child of one or both of them, is unavailable, since sections 2056, 2513, and 2523 only apply to spouses. Thus, there will be a federal estate tax on the entire taxable estate (gross estate less debts, funeral and administration expenses) in excess of the applicable exclusion.

b. GRITs and GRATs

A grantor retained interest trust (GRIT) and a grantor retained annuity trust (GRAT) can pass assets to a less wealthy unmarried partner at a reduced transfer cost, since the latter is not a I.R.C. Chapter 14 family member. This eliminated the use of GRITs, while adding strict requirements for GRATs for a remainder beneficiary who is a family member. However, because

Chapter 14 deals with transfers among traditional family members, other techniques formerly used before its enactment may still be used.

Family members do not include domestic partners, parties to a civil union, other unrelated parties and married same-sex couples, because none of them are considered married under the IRC. Thus, the advantageous GRIT and GRAT techniques may still be used by them. The grantor could retain all income from a trust for a fixed term with the remainder passing to the beneficiary. If the grantor dies before the term's end, the corpus is includible in his estate.lxiv Creation of the trust is a gift equal to the property's fair market value, less the retained income and any retained contingent reversionary interests. This combination could be significant, even if the prescribed I.R.S. interest rate is low.lxv

The GRIT's tax advantage is that if the accounting income's rate is lower than the U.S. Treasury's assumed section 7520 rate, there could be an overvaluation of the income interest. Thus, the remainder will be undervalued and a very low discounted value for gift tax purposes their might be obtained. Then, upon trust termination, the corpus (including appreciation) will pass transfer tax-free to the other partner. However, the I.R.S. has taken the position that the income beneficiary of a GRIT would be treated as making a gift, if the income is not sufficient. This is a concept which the I.R.S. never defined. The O'Reilly case,lxvi decided before enactment of section 7520, held the standard valuation tables could not be used.

Although the Obama Treasury indicated it wanted to restrict the use of GRITs and GRATs, particularly short-term ones, by requiring them to last for ten years, no such provision was in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.lxvii Therefore, since these proposals were never enacted, two-year rolling asset splitting GRITs and GRATs could still be considered. While their risk is small, it is probably not negligible. The I.R.S. once argued that because the annuity interest in a GRAT is measured by the applicable federal mid-term rates (essentially for more than three years), a GRIT or GRAT had to last at least that long.

Thus, despite the Treasury's proposal for a minimum ten year GRAT term with a remainder greater than zero, it is not certain if there is a minimum term and a minimum value for the remainder. A formula could be used, providing for the annuity to be paid for the longer of whatever term the drafter selects (e.g., two years, the minimum term required to be a qualified GRAT), with the remainder to be the greater of 1% of the value of the property contributed to the GRAT or the minimum value of the remainder required to have a qualified GRAT. lxviii

c. Inapplicability of Section 2702 to Transfer of Real property In Trust

While section 2702's prohibitions restrict family members in their use of personal residence trusts to specially restricted qualified ones (called QPRTs),lxix domestic partners, parties to a civil union and other unrelated parties are able to use personal residence trusts where sales may be made between the grantor and the trust holding his residence. The same should also be true for same-sex married couples. Thus, the grantor may purchase the residence from the trust just prior to the end of the term. The remainder beneficiaries receive the purchase price, without the grantor or the trust having to recognize gain or loss.lxx But, if after expiration of the term, the residence remains in the grantor trust, it can be rented from the trustee by the grantor without taxable rental income. Furthermore, if the grantor pays rent based on the fair market value of the residence, the latter will be excluded from his gross estate, since his economic enjoyment ceases upon the payment of rent.

d. Section 2704 Restrictions do not apply to Non-Family Arrangements

Domestic partners, parties to a civil union and others not related by blood or marriage may be considered natural objects of the transferor's bounty, and thus act like family members under section 2703. However, the restrictions of section 2704 should not apply to non-family arrangements, such as domestic partnerships and same-sex married couples. This will give an opportunity to obtain discounts by using partnerships, limited liability partnerships, limited liability corporations and other similar entities for people in such arrangements.

e. Life Insurance, Gifts, Payment Of Tuition And Medical Expenses

The use of life insurance, possibly by acquiring it with an irrevocable trust for the benefit of a spouse or a same-sex partner, and making annual exclusion gifts of $13,000lxxi in 2011, as well as gift tax-free payments of tuition and medical expenseslxxii should also be considered, as well as use of the applicable federal estate tax exclusion of $5 million in 2010 and 2011.

13. Real estate

If one cohabitant deeds real estate to the other, regardless of whether it is in any form of co-ownership or solely owned, in the absence of full and adequate consideration paid to the grantor, the latter will have made a taxable gift. The amount of this and any other gifts will be reduced by the donor's annual exclusion[lxxiii] and applicable credit equivalent, as well as the exclusion for certain tuition and medical expenses.[lxxiv]

Section 121's $250,000 exclusion on a principal residence's sale is extended to estates and heirs, if used by the decedent for two or more years during the five years before sale. There can be tacking of his occupancy period to that of the beneficiary, in determining if the two-year rule is fulfilled, even if the residence was owned by a trust during his occupancy.[lxxv] However, this exclusion is allowed only to estate or an individual beneficiary, not to a trust. Therefore, sales should be made before funding a testamentary trust. A revocable trust making a section 645 election to be taxed as an estate should also be able to use this exclusion, while the election is in effect.

14. State law problems

Prior to EGTRRA, most states, imposed a state estate tax equal to the amount of the federal credit allowable against the federal estate tax. This sponge tax was allowable under section 2011 for state death taxes paid. EGTRRA eliminated it (allowing a section 2058 deduction for payment of a state death tax).

Both residents and non-residents with real estate and/or tangibles in a state with an estate tax, will probably be taxable on them. Furthermore, a decedent's out-of-state tangible personal property may be taxed in both states, while non-residents who own real or tangible personal property may owe estate tax to the non-domiciliary state.

These states with estate taxes allowing a marital deduction will permit tax-free transfers outright to a surviving spouse. If the estate plan uses marital and non-marital trusts, state estate tax may be due on the non-marital trust after the first spouse's death. Some state estate taxes (such as that of Connecticut's), unlike the federal estate tax, may permit a married decedent's estate to elect to treat property as QTIP, solely for purposes of calculating that state's estate tax. This state QTIP election allows the state, as well as the federal estate tax (if elected for 2010), to be deferred until the surviving spouse's death.

If a state (like Connecticut) permits a marital deduction for a QTIP trust, even if no such election is made for federal estate tax purposes, those of its residents owning real or tangible personal property in a state not permitting a state-only QTIP election need to change their form of marital deduction, applicable only in that state, to some other qualifying one. This could be outright, a general power of appointment or an estate trust (one terminating in the surviving spouse's probate estate). Needless to say, this could complicate drafting, if extensive assets exist in a state without a state QTIP election.

However, while an outright devise or bequest of out of state real or tangible personal property is qualified spousal property, it is uncertain whether this is true of a general power of appointment marital deduction or estate trust. While an outright bequest is Qualified Spousal Property, a general power of appointment marital deduction or estate trust may not be qualified. Thus, if a married 2010 decedent used a general power of appointment or estate marital deduction trust, he probably should have made an outright formula bequest to his surviving spouse. Then, if his executor elected carryover basis, this would obtain full use of the $3 million additional basis increase for Qualified Spousal Property. As mentioned above, a QTIP trust is treated as Qualified Spousal Property and will qualify for the marital deduction for Connecticut death tax purposes under its state only QTIP election.

For clients with lifetime QTIP trusts "automatically" providing that if the grantor spouse survives the beneficiary spouse, the trust property will pass into a QTIP or a grantor trust, a state having state-only QTIP election could be made to avoid its estate tax on the trust's corpus. If not made, the property presumably would be subject to its estate tax.

<u>15. Conclusion</u>

The cost of administering the carryover basis rules both to the I.R.S. and taxpayers may exceed its revenues. Furthermore, despite the election to use carryover basis instead of paying a federal estate and GST tax, retroactive restoration of these taxes may lead to constitutional litigation by one or more estates of wealthy decedents' who died prior to the December 17, 2010 enactment of the estate and GST taxes. At least four multi-billionaires died during 2010, including New York Yankees owner George Steinbrenner. Cases dealing with the constitutionality of retroactive estate tax legislation have been mixed. Some earlier ones held such legislation unconstitutional while later ones sustained its constitutionality.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Frank Berall

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[i] P.L. 107-16, § 2210(a), enacted in 2001.

[ii] EGTRRA, The 2001 Economic Growth and Tax Relief Reconciliation Act, gradually raised the estate tax exemption equivalent to $3.5 million for 2009 deaths, abolished both the estate and GST taxes, left the gift tax in effect and enacted carryover basis for 2010 decedents. In 2011, EGTRRA expired and the pre-2001 tax law would have returned with a $1 million exemption and 45% top rate, but without carryover basis. However, § 101 of the 2010 Act changed EGTRRA's sunset date to December 31, 2012, striking the reference to December 31, 2010.

[iii] This paragraph has been edited and paraphrased from an article by Jonathan G. Blattmachr, Mitchell M. Gans, Howard M. Zaritsky, and Diana S.C. Zeydel.

[iv] Section 301(c) provides "[s]uch election shall be made at such time and in such manner as the [I.R.S. and Treasury] shall provide" and be irrevocable unless the I.R.S. consents otherwise.

[v] Section 302(b)(1) of the 2010 Act.

[vi] Also sometimes referred to as the applicable exclusion, the exemption equivalent to the credit or just the exemption.

[vii] All section references, unless otherwise indicated, are to the 1986 Internal Revenue Code.

[viii] This exemption is available for the surviving spouse of a married couple if a § 2652(a)(3) reverse QTIP (qualified terminable interest property) election is in the will or trust of the first spouse to die. Thus, since this cannot be predicted, a reverse QTIP election should be provided for in both spouses' instruments.

[ix] Section 2651(d).

[x] Portions of the material in item (7) on Charitable Trusts, Age Differences and the GST Tax are partially revised, updated, condensed and paraphrased from an article by Gail E. Cohen, Estate Planning for the Unique Needs of Unmarried Partners, 30 Estate Planning, No. 4, 188-191 (April 2003).

[xi] Author's note re use of gender terms: wherever the words "he", "his", "him", "man", "men" or comparable words or parts of words appear in this outline, they have been used solely for literary purposes in the interest of having a smooth reading text. They are meant to include all persons--whether male or female. The use of male nouns and pronouns to refer to or describe both the wealthier spouse and the first spouse to die and the use of female nouns and pronouns to refer to or describe the less wealthy spouse and surviving spouse has been done for the same reason. No discrimination is intended nor should any be inferred.

[xii] Section 2651(d).

[xiii] Same-sex marriage is permitted in Connecticut, Iowa, Massachusetts, New Hampshire, Vermont and the District of Columbia. It was permitted in California between June 15, 2008 and November 4, 2008. Outside the United States it is permitted in Belgium, Buenos Aires, Canada, the Netherlands, Mexico City, Norway, Portugal, Sweden, Spain and South Africa.

[xiv] There are two Massachusetts federal court cases holding the federal Defense of Marriage Act (DOMA) unconstitutional, that are on appeal to the First Circuit and one California federal court case overturning that state's Proposition 8, which amended the California Constitution to outlaw same-sex marriage. This is on appeal to the Ninth Circuit. Cases claiming DOMA unconstitutional are presently pending in the federal district courts for the Southern District of New York and the District of Connecticut which, regardless of their outcome, will probably be appealed to the Second Circuit. A Southern District of New York case has been filed for a refund of federal estate taxes paid by the executrix of her deceased same-sex partner's estate, where the parties had been validly married in Ontario.

[xv] Calculated under section 303(a) of the 2010 Act.

[xvi] For three examples, see explanation of the Joint Committee Staff.

[xvii] Some of the material in the analysis of portions of the provisions of the 2010 tax law, including portability of the unified credit have been condensed, revised and paraphrased from *Moving Forward (Two Years at a Time) With Estate Planning Under the 2010 Act* by Ronald D. Aucutt, of McGuire Woods, LLP, McLean, Virginia and Washington, DC (an outline updated through December 23, 2010).

A few portions of the material on sunset data, GST tax and portability have been condensed and edited from portions of an outline presented by Professor Elaine Hightower Gagliardi at the ABA midyear Tax Section meeting in Boca Raton, Florida on January 22, 2011. Several other parts were condensed from an annual report on current developments in individual, corporate, partnership and estate and gift taxation presented at the ABA Tax Section's January 22, 2011 meeting by Professors Ira B. Shepard, Daniel L. Simmons and Elaine Hightower Gagliardi in a program chaired by Professor Martin J. McMahon.

[xviii] P.L. 94-455.

[xix] McGrath & Blattmachr, *Carryover Basis Under the 1976 Tax Reform Act* (Journal of Taxation 1977).

[xx] Among proponents were former Commissioner of Internal Revenue, Donald C. Alexander, former Deputy Assistant Secretary of the Treasury, John Nolan, and distinguished tax attorney, James Lewis, who had previously served as a somewhat lower level in the Treasury. All three were former Chairs of the American Bar Association's Tax Section. Among opponents, representing the American College of Probate Counsel (now the American College of Trust and Estate Counsel) as a Regent and its Estate and Gift Tax Committee Chair, was Frank S. Berall (the author of this material).

[xxi] It was signed to the great disappointment of Tax Legislative Counsel to the Treasury, Harry (Hank) Gutman and Presidential Adviser Stu Eisenstat.

[xxii] Enacted June 7, 2001.

[xxiii] Section 901(a)(2) of EGTRRA.

[xxiv] Section 902(b) of EGTRRA.

[xxv] Added by EGTRRA, § 542.

[xxvi] Section 1022(b)(2)(B).

[xxvii] Section 1022(b)(3).

[xxviii] Section 1022(c).

[xxix] Section 1022(c)(5).

[xxx] Section 1022(c)(5)(D) treats a specific portion as separate property, limiting that former term to a portion determined on a fractional or percentage basis.

[xxxi] Section 1022(c)(5)(B)(i).

[xxxii] Section 1022(c)(4)(B).

[xxxiii] *Id.*

[xxxiv] Section 1022(d)(1)(B)(i)(I).

[xxxv] Section 1022(d)(1)(B)(i)(II).

[xxxvi] Section 1022(d)(1)(B)(i)(III).

[xxxvii] *Id.*

[xxxviii] Kaufman, *The Estate and Gift Tax: Implications of the 2001 Tax Act,* Tax Analysts Special Report, Tax Notes, P. 949, 952, August 13, 2001.

[xxxix] P.L. 107-16. *See also* §§ 1022(b)(3) and (d)(4). This adjustment for inflation seems irrelevant, since carryover basis expired December 31, 2010.

[xl] Sections 1022(b)(3) and (d)(4).

[xli] P.L. 107-37 and §§ 1041(b)(2) and (3).

[xlii] Rev. Rul. 85-13, 1985-1 C.B. 142.

[xliii] Residents of common law states who lived in a Community Property jurisdiction (Arizona, California, Idaho, Louisiana, Nevada, Washington, Wisconsin, most Latin American and many central and southern European countries) while married, probably have community property.

[xliv] Section 1022(g).

[xlv] As a general rule, disclaimed property passes to alternate takers. These may eventually be the takers in default under the intestate laws of the decedent’s domicile. If all individual takers disclaim, then the decedent may have to recognize the gain as of time of his death.

[xlvi] Conference Committee Report (H.R. CONF. REP. No. 107-84), hereafter H.R. 107-84. The report refers to the beneficiary as an "heir," which could be limited to an intestate beneficiary, but this was probably not the intent.

[xlvii] See section 6018.

[xlviii] As specified in § 6018(c).

[xlix] Section 6018(b)(2).

[l] Section 6018(b)(4).

[li] Section 6018(e).

[lii] Sections 6716(b) and 6019(b).

[liii] For a detailed discussion of EGTRRA's carryover basis provisions, see Berall, Harrison, Blattmachr and Detzel, *Planning for Carryover Basis That Can Be/Should Be/Must Be Done Now*, 29 Estate Planning 99 (No. 3, March 2002). A more recent analysis by the same authors is cited in note 64, *supra*.

[liv] Some of the above material is from edited observations (by this author) made in the January 6, 2011 ACTEC Practice Listserve by Terry Tuthill of Cummings & Lockwood, Greenwich, CT, Howard Zaritsky of Rapidan, Va., Jonathan G. Blattmachr of Milbank, Tweed, Holley & McCloy, New York, N.Y. and Donald O. Jansen of the University of Texas System, Austin, Texas.

[lv] Section 1022(b)(2)(B).

[lvi] Section 1022(c).

[lvii] H.R. 107.37.

[lviii] Much of the carryover basis material in this article is an updated revision of a second article on that subject by Berall, Harrison, Blattmachr and Detzel, *Carryover Basis: A Discredited Concept in Estate Planning*, which appeared in 37 Estate Planning 3 (No. 4, April 2010).

[lix] The above material on Practical Suggestions has been condensed and edited from slides prepared by Jonathan G. Blattmachr for a presentation to the Fiduciary Income Tax Committee of the American Bar Association's Tax Section in Boca Raton, Florida on January 22, 2011.

[lx] Section 2516.

[lxi] While same-sex marriage is not available in most states, same-sex couples may enter into domestic partnerships in California, Calif. Fam. Code Div. 2.5 Part 1, § 297; execute designated beneficiary agreements in Colorado, Col. Rev. Stat. § 14-2-104(1)(3); enter a domestic partnership registry in Florida's Broward Co. Dom. P. Act of 1999, Ordinance 199-03, Art. VIII, § 16 ½-150 providing health and other benefits for domestic partners, in Hawaii, they may register as reciprocal beneficiaries, 31 Haw. § 572 C4-5 and become domestic partners under Maryland statutes D.R.S. 6-101. While Nevada Constitution, Article 1, Section 21 has a DOMA, Nevada Revised Statutes Chapter 122A, adopted in 2009 and effective on October 1, 2010 (originally introduced as Senate Bill 283), recognizes domestic partnerships and allows unmarried individuals to receive some of the same benefits and protections under law as married couples; domestic partnerships are available in Oregon, 11 Ore. Rev. Stat. Ann. Ch. 106, §§ 1-9; Washington, Wash. Rev. Code § 26.04.020(1)(c); and Wisconsin under 2009 Wisconsin Act 28 (June 30, 2009).

[lxii] See *Harris v. Com'r*, 340 U.S. 106 (1950) and *Com'r v. Converse*, 163 F.2d 131 (2d Cir. 1947).

[lxiii] Section 2523.

[lxiv] Under § 2036(a).

[lxv] Section 7520's Treasury tables are used to compute the interest.

[lxvi] *O'Reilly v. Commissioner*, 95 T.C. 646 (1990) held actuarial tables of gift tax Reg. § 25.2523-5(f), used to value gifts in trust when the retained interest reflected a much lower income yield than the assumed 10% table yield, could not be used for a GRIT.

[lxvii] P.L. 111-312.

[lxviii] This formula was developed by Diana Zeydel of Greenberg Taurig E.A., Miami, Florida, co-author, with Jonathan Blattmachr and Georgianna Slade, both of Milbank, Tweed, Hadley & McCloy, New York, N.Y, of the BNA Tax Management Portfolio, 835-2nd, Partial Interests—GRATs, GRUTs, QPRTs (Section 2702). The formula language itself is set forth in the GRAT forms published in *Wealth Transfer Planning,* a document assembly system published by *Interactive Legal*, of which Jonathan Blattmachr is co-developer.

[lxix] QPRT is an acronym for a Qualified Personal Residence Trust.

[lxx] Rev. Rul. 85-13, 1985-1 C.B. 184.

[lxxi] Section 2503(b).

[lxxii] Section 2503(e).

[lxxiii] $13,000 in 2010 and 2011.

[lxxiv] Section 2503(e).

[lxxv] The Conference Committee Report (H.R. CONF. REP. 107-84), referred to the beneficiary as an "heir." This could be limited to an intestate beneficiary, but was probably not intended.