

Momentous Changes in Estate Planning and Tax Law 2010 Starts with a Bang!

Samuel A. Donaldson
Professor & Director, Graduate Program in Taxation
University of Washington School of Law

Washington Planned Giving Council
January 11, 2010

Selected List of Internal Revenue Code Provisions that Expired at the End of 2009

§ 63(c)(1)	Additional standard deduction for state and local real property taxes
§ 164	State and local sales tax deduction
§ 170(b)(1)(E)(vi)	Contributions of capital gain real property for conservation purposes
§ 170(e)(3)(C)(iv)	Enhanced deduction for contributions of food inventory
§ 170(e)(3)(D)(iv)	Enhanced deduction for contributions of book inventory to public schools
§ 170(e)(6)(G)	Enhanced deduction for corporate contributions of computer equipment for educational purposes
§ 222	Deduction for tuition and related expenses.
§ 408(d)(8)	Tax-free distributions from IRAs for charitable purposes
§ 1367(a)	Basis adjustment to S corporation stock following charitable contribution
§§ 2001 – 2209	Federal estate tax
§§ 2601 – 2663	Generation-skipping transfer tax

New Code Provisions that Came to Life in 2010

- § 1022(a)(2) Basis of property acquired from decedent dying after 2009 is *lesser of* decedent's basis or FMV of property at decedent's death, but personal representative can allocate up to \$1.3 million (increased by unused losses and loss carryovers) of additional basis to assets (\$3 million of additional basis to assets passing to a surviving spouse)
- § 2511(c) Transfers in trust treated as gifts unless the grantor or the grantor's spouse is the deemed owner of the entire trust for income tax purposes

Hmm...

1. Does this apply to sales? If so, a sale to a nongrantor trust is a gift but a sale to a grantor trust is not!
2. Does this mean no transfer to a grantor trust is a gift? That's the

mother of all loopholes! (Probably not. Intent is to convert gifts to trusts that would otherwise be incomplete into completed gifts.)

What will happen with the federal estate tax?

- (1) Congress does nothing.
 - no federal estate tax or GST tax for 2010
 - both taxes re-emerge in 2011 with a \$1 million (inflation-adjusted) exemption and a 55% top rate
 - the deduction for qualified family-owned business interests returns, and the conservation easement exclusion disappears
 - “modified carryover basis” applies only to property of decedents dying in 2010
 - gift tax returns to 55% top rate
- (2) Senate passes HR 4154, makes it effective prospectively
 - permanent extension of the \$3.5 million exemption and 45% rate
- (3) Senate passes HR 4154, but legislation made retroactive to January 1, 2010
- (4) Congress enacts some other compromise package, effective prospectively
 - perhaps a \$5 million exemption and 35% rate
- (5) Congress enacts some other compromise package, retroactive to January 1, 2010

Can Congress retroactively reinstate the estate and GST taxes?

Untermeyer v. Anderson, 276 U.S. 440 (1928) -- Supreme Court invalidated retroactive application of the first federal gift tax

United States v. Carlton, 512 U.S. 26 (1994) -- Supreme Court unanimously upheld the retroactive validity of a 1987 amendment made to former § 2057(b), a provision enacted in 1986. The personal representative argued that the amendment violated due process, but the Court was not persuaded:

The due process standard to be applied to tax statutes with retroactive effect, therefore, is the same as that generally applicable to retroactive economic legislation: “Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches.... To be sure,... retroactive legislation does have to meet a burden not faced by legislation that has only future effects.... 'The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former'.... But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.” [quoting from *Pension Benefit Guaranty Corporation v. RA Gray & Co.*, 467 U.S. 717, 729-730 (1984)]

The *Carlton* Court concluded that the retroactive application of the amendment was constitutional because: (1) "Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary;" (2) "Congress acted promptly and established only a modest period of retroactivity;" and (3) "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." In distinguishing *Untermeyer* and other cases, the Court said:

Those cases were decided during an era characterized by exacting review of economic legislation under an approach that has long since been discarded. To the extent that their authority survives, they do not control here. *Untermeyer*, which involved the Nation's first gift tax, essentially [has] been limited to situations involving "the creation of a wholly new tax," and their "authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws." *United States v. Hemme*, 476 U.S. 558, 568 (1986). ... The amendment at issue here certainly is not properly characterized as a "wholly new tax," and its period of retroactive effect is limited.

What Doesn't Change: The Washington State Estate Tax

Washington imposes an estate tax that is independent of the federal estate tax, so the Washington state estate tax clearly applies to estates with decedents dying in 2010.

Basic elements of the Washington tax:

- \$2 million exemption
- "Washington-only" QTIP election is possible, but must still meet basic requirements for marital deduction (income payable only to spouse at least annually, etc.)
- Return due nine months after the decedent's death
- Tax computed using the Washington taxable estate and Table W (below).
- "Washington taxable estate" = federal taxable estate minus \$2 million and minus the value of real and tangible personal property qualifying for the farm deduction

Table W - Computation of Washington Estate Tax

If Washington Taxable Estate		The Amount of Tax Equals		Of Washington Taxable Estate Value Greater Than
Is at Least	But Less Than	Initial Tax Amount	Plus Tax Rate %	
\$0	\$1,000,000	\$0	10.00%	\$0
\$1,000,000	\$2,000,000	\$100,000	14.00%	\$1,000,000
\$2,000,000	\$3,000,000	\$240,000	15.00%	\$2,000,000
\$3,000,000	\$4,000,000	\$390,000	16.00%	\$3,000,000
\$4,000,000	\$6,000,000	\$550,000	17.00%	\$4,000,000
\$6,000,000	\$7,000,000	\$890,000	18.00%	\$6,000,000
\$7,000,000	\$9,000,000	\$1,070,000	18.50%	\$7,000,000
Above \$9,000,000		\$1,440,000	19.00%	Above \$9,000,000

Possible Planning Options for Early 2010

1. Create dynasty trusts when there is no GST tax.

CAUTION → If the GST tax is reinstated, no guarantee that trust created now would be grandfathered from the “new” tax.

2. Make distributions from (or terminate) dynasty trusts when there is no GST tax.

CAUTION → If the GST tax is reinstated, no guarantee that any distributions would be grandfathered.

3. Make gifts directly to grandchildren (formerly direct skips).

CAUTION → GST tax may be restored and made retroactive to January 1 (possibly solve through formula clause that limits the amount of the gift to the maximum amount that can be transferred currently without imposition of any GST tax and without changing the GST inclusion ratio of any trust, taking into account any future changes to the GST tax made retroactively).

4. Make taxable gifts now while the 35% rate is in effect.

CAUTION → If Congress reinstates the 45% rate, no guarantee that gift made today would be grandfathered from a subsequent rate increase made retroactive.

5. Make discounted wealth transfers now, if you anticipate that legislation in 2010 will impose significant restrictions on valuation discounts.

6. Distribute amounts from a QTIP trust to surviving spouse and have spouse make gifts to children and/or grandchildren while the 35% rate is in effect.

CAUTION → See above concerns regarding retroactivity and grandfathering.

7. Revisit the wills of clients that might soon die. Do the dispositive provisions still make sense in a world without an estate tax?

EXAMPLE → If a credit shelter trust is funded with the maximum amount that can pass free of estate tax, all will go to the credit shelter trust. If the surviving spouse is not a beneficiary of the credit shelter trust, the surviving spouse gets nothing and that will likely provoke a fight in court.

Planning Opportunity for CLATs

Usually we don't draft CLATs naming grandchildren as the remainder beneficiaries because of the ETIP rules. But in early 2010, there is no “estate tax inclusion period,” so this could be a good time to set up a CLAT that benefits grandchildren.

Bob Keebler, Steve Bigge, and Mike Jones suggest setting up a CLAT that names the grandchildren as remainder beneficiaries and the children as contingent beneficiaries. That way, if the GST tax is revived and made retroactive, the grandchildren can disclaim their interests and cause the remainder to pass to the children, avoiding the GST tax altogether.