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The federal estate, gift and generation skipping transfer taxes

Where are we now? And where are we going?

The Economic Growth Tax Relief Reconciliation Act of 2001 ("EGTRRA")[1] provided significant estate and gift tax relief through 2009. By 2009, the aggregate amount which could be transferred by a person during his lifetime by gifts in excess of the annual per donee exclusion (that's the amount a person can give to anyone each year – currently $13,000) increased to a maximum of $1 million and the combination of lifetime taxable gifts and transfers at death increased to a maximum of $3.5 million. In addition, the maximum unified estate and gift tax rate was reduced to 45%.

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EGTRRA also contained a provision by which both the estate tax and the generation skipping transfer ("GST") tax were repealed for tax years beginning after december 31, 2009. However, if nothing more were done, the law as it was prior to the enactment of EGTRRA would come back into existence beginning in 2011. (This "sunset provision" will be discussed in greater depth later.) When this was enacted, no one believed that repeal for 2010 would actually occur. Yet, the unthinkable has happened. The estate tax and the generation skipping transfer tax are repealed for persons dying during 2010. New York State has managed to avoid this result. When the NYS estate tax was repealed, it was replaced with what is referred to as a "pick-up" tax based upon the amount of the credit that would have been allowable for federal estate tax purposes if the decedent had died in 1998. Accordingly, repeal of the federal estate tax for 2010 has had no impact on nys estate tax.

Gift Tax Impact

The gift tax continued in 2010, but at a flat 35% tax rate on aggregate lifetime taxable gifts in excess of the gift tax applicable exclusion amount of $1.0 million. Reasons mentioned for keeping the gift tax system intact included (1) to provide a backstop against income tax abuse through tax-free transfers to relatives with lower income tax brackets, and (2) to provide a barrier to wholesale transfers in 2010 before the re-emergence of the estate and gst tax system in 2011 under the sunset provision.

Another change to the gift tax in 2010 is the addition of IRC §2511(c),[2] which applies to gifts after December 31, 2009. It provides that, except as provided in regulations, a transfer in trust is treated as a transfer by gift unless the trust is a wholly-owned grantor trust as to the donor or the donor's spouse (*i.e.*, a trust which contains certain provisions which make the income taxable to the grantor, even if he is not entitled to the income). This is a rather strange provision. Apparently, the purpose was to prevent an individual from making an "incomplete gift" to a non-grantor trust that avoids gift taxes but still takes advantage of the trust's lower income tax brackets. The impact of this provision could inadvertently be favorable for taxpayers. If a transfer to a grantor trust is not a taxable gift, one could create a trust which contains a provision mandating grantor trust treatment, but which does not contain any of the "strings" which pull a transfer in trust back into the grantor's estate for estate tax purposes. Accordingly, the transfer could avoid gift taxation as well as estate tax inclusion. This section will need a great deal of clarification by regulations.

Carryover Basis vs. Stepped-up Basis

Under the law prior to 2010, the basis of property acquired from a decedent was the fair market value of the property on the decedent's death. IRC §1014. For most people, this resulted in a "step-up" in basis, so that if the property were sold immediately, there would be no gain realized or recognized on the transfer. Under EGTRRA, this has been replaced with "carryover basis" under IRC §1022.

Under IRC §1022, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. IRC §1022(a)(2). There are two exceptions from the carryover basis provisions:

(1) To increase the basis of assets passing to anyone (including a surviving spouse), the executor can allocate up to $1.3 million increased by the following built-in losses:

• The sum of the amount of any capital loss carryover under IRC §1212(b), and the amount of any net operating loss carryover under IRC §172 which would, but for the decedent's death, have been carried from his last tax year to a later tax year of the decedent,

plus

• The sum of the amount of any losses that would have been allowable under IRC §165 to the decedent, if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death. (IRC §1022(b)(2)); and

(2) To increase the basis of assets passing to a surviving spouse either outright or in a QTIP trust, the executor can also allocate up to $3.0 million. These are increases to basis of $1.3 and $3.0 million, not assets having a value of $1.3 or $3.0 million, so the allocation process may get complicated.

Retroactive Effect

The most recent pronouncements by members of the senate finance committee have indicated that whatever new estate tax legislation is enacted, it will not be made retroactive. However, this cannot be guaranteed. A number of U.S. Supreme Court cases have upheld the constitutionality of retroactive changes to the transfer tax system. In *U.S. v. Carlton*,[3] retroactive legislation recasting the meaning of a newly enacted estate tax deduction was found to be constitutional. In the *Carlton* case, the Supreme Court rejected references to earlier decisions in which the court had refused to uphold retroactivity for the nation's first gift tax, noting the at

best such decisions were limited to situations involving the creation of a wholly new tax. *See, also, U.S. v. Hemme*.[4]

Some Supreme Court cases in the 1920's refused to uphold the retroactive effect of the gift tax, when it was instituted in 1924. However, in the *Hemme* case, those cases were essentially abandoned when the court noted that the principal objection to the statute was the absence of notice of the change in the law at the time the taxpayer made the gift. The gift tax was a new tax that was previously unknown both here and in europe and retroactive application was deemed inappropriate in a constitutional setting.

Reinstating the estate tax and the GST tax retroactively would not appear to prejudice a decedent, as it could hardly be claimed that he or she intentionally died in reliance upon the fact that these taxes were not in effect on the date of death. However, as the year moves forward, the executors of estates and trustees of revocable trusts who were required to make distributions could argue that they relied upon the absence of such taxes in paying bequests without holding back sufficient funds to satisfy potential tax liabilities in the event of reinstatement of these taxes.

Another possible issue is whether a retroactive increase in the gift tax from 35% to 45% (or even higher) is constitutional. Relying on the *Carlton* case, courts have upheld the constitutionality of retroactive gift and estate tax rate increases. For example, in *Quarty v. United States*,[5] an increase in gift and estate tax rates from 50% to 53% (and later 55%), signed on August 10, 1993, retroactive to January 1, 1993, was held constitutional where the decedent died on January 12, 1993 having made taxable gifts earlier in that year.

If the estate and GST taxes are reenacted retroactively to January 1, no doubt there will be numerous lawsuits over the constitutionality of the provision, which probably will ultimately be resolved by the U.S. Supreme Court after years of litigation in the lower courts.

Pending and Proposed Legislation

During the summer of 2010, senate finance committee members Jon Kyl (R-AZ) and Blanche Lincoln (D-AR) working with committee chair Max Baucus (D-MT) and ranking minority member Charles Grassley (R-IA) attempted to move forward estate tax legislation. an agreement was reached based upon a $5 million exclusion and 35% top rate. Unfortunately, these discussions came to naught. The democratic senate caucus declined to provide tax relief for the "wealthy" and, absent a majority of democrats in favor, the democratic leadership would not permit the bill to be brought out of committee, even though a majority of the senate as a whole had indicated a willingness to support it. It is anticipated that estate tax reform will be brought up again in early September, 2010, as part of the discussions concerning extending the expiring provisions under the income tax law.

During 2010, the house of representatives did manage to pass the small business jobs tax relief act of 2010[6] which contains a provision requiring a minimum 10-year term for grantor retained annuity trusts. The bill is now been referred to the senate finance committee. Other estate tax reform proposals have been suggested during the last several years, including the possibility of portability of the estate and gift tax exemptions between spouses and the possibility of unification of the gift tax exemption with the estate and GST tax exemptions. Legislative discussions may include some of those reform measures as well.

What Happens If Nothing Happens?

The simple answer to the question posed is that all the changes under EGTRRA go away. Unfortunately, it is not that easy. section 901(a) of EGTRRA contains the general "sunset provision" with respect to the changes made by the law and provides, in pertinent part, as follows:

> a. In General. All provisions of, and amendments made by, this act shall not apply – ... (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

Following sunset, all rates in effect in 2001 (which provided for a top rate of 55% on taxable estates in excess of $3 million), including the 5% surtax on taxable estates in excess of $10 million to phase out the benefits of the unified credit and the graduated rates, will apply. The applicable exclusion amount will be $1 million (as was scheduled to commence beginning in 2006 under the pre-EGTRRA law) for both estate and gift taxes. The GST exemption will be $1 million indexed for inflation since 1997.

Various other changes made in EGTRRA would also be eliminated when the estate tax returns in 2011. Among these would be changing the deduction for state death taxes on the federal estate tax return back to a credit.

Impact of the Section 901(b) "Sunset Provision"

The more significant (and inscrutable) of the "sunset provisions" is contained in section 901(b) of EGTRRA, which reads as follows:

> b. application of certain laws. the internal revenue code of 1986 and the employee retirement income security act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

The senate version of EGTRRA originally included section 901(a) but not 901(b). There is no discussion in the conference report of the reasons for adding the "had never been enacted" language of section 901(b).

An example of uncertainty created by the "had never been enacted" provision involves carryover basis. If a decedent dies in 2010, during which the carryover basis rules of IRC §1022 apply, and if a beneficiary sells an appreciated asset received from the estate in 2012, is the beneficiary's basis stepped up to the date of death value in 2010 or do the carryover basis rules apply? If EGTRRA had never been enacted, the beneficiary's basis would have been a stepped up basis under IRC §1014.

At this point, absent new legislation (and possibly even with such legislation), we will be left with even more questions than those which currently face us. Suffice it to say, reversion to pre-EGTRRA law will not go as smoothly as some would have us think.

(Further congressional action may have occurred subsequent to the submission of this article for publication.)

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1. Public Law 107-16 (2001)
2. All references herein to "IRC" are to the Internal Revenue Code of 1986, as amended.
3. 512 U.S. 26 (1994)
4. 476 U.S. 558 (1986)
5. 170 F.3d. 961 (9th Cir. 1999)
6. H.R. 5486

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