PROCEDURAL ISSUES FOR 2010 DECEDENTS UNDER THE 2010 ACT

By:

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I. **Introduction**

II. **The Basics of the 2010 Act as applied to Decedents Dying in 2010**

A. Section 301(a) repeals the amendments made by subtitle A (Repeal of the estate and GST taxes) and E (replacing section 1014 with carryover basis) of Title V of EGTRRA. Therefore, the estate and GST tax are retroactively reinstated for all decedents dying after December 31, 2009.

B. Estate tax and GST exemptions are $5 million.

C. Estate tax rate is 35%.

D. Section 302(c) provides that the applicable rate is 0% for all generation-skipping transfers (i.e., direct skips, taxable distributions and taxable terminations) made in 2010.

E. The gift tax exemption remains at $1 million, and the gift tax rate is 35% for gifts made during 2010. Sections 301(b) and 302(b) combine to reunify the gift and estate tax exemption for 2011 and 2012 (not 2010).

F. Section 301(c) permits an executor of a decedent dying during 2010 to make an election to apply the Code as though subtitle A and E of EGTRRA were not repealed by Section 301(a). This results in the executor electing into that application of the modified carryover basis rules of Code § 1022 instead of having the estate tax rules apply.

G. Section 301(d) extends the deadline for certain items for decedents dying between January 1, 2010 and December 16, 2010 (the date immediately prior to the date of enactment of the 2010 ACT), including filing the estate tax return and paying estate tax, to no earlier than 9 months after the date of enactment of the 2010 Act.

III. **Electing Out of the Estate Tax**

A. What does it mean?

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[1] I want to acknowledge the assistance of my associate, Brian M. Malec, in the preparation of this outline.

1. The amendments made by Section 301(a) of the 2010 Act, which repeal (i) the repeal of the estate tax and (ii) the modified carryover basis regime, do not apply. This results in the general application of the EGTRRA rules with respect to Chapter 11 (estate tax) for 2010 as they existed prior to the 2010 Act.

2. Section 1022 applies in lieu of section 1014 for purposes of determining the basis of property acquired from a decedent. The beneficiary generally receives a tacked holding period for the inherited assets, although the explicit language of section 1223 is arguably unclear as to whether a tacked holding period is available if the basis adjustment is allocated to increase the basis of an inherited asset to full fair market value. Further, section 1022 does not address whether the character of the gain or loss will remain the same in the hands of the beneficiary as it was in the hands of the decedent, although the legislative history of EGTRRA indicates that the character will remain the same.

3. Although not entirely clear from the language of the 2010 Act, the JCT Technical Explanation states that the intention of Congress is that the election will not impact the application of Chapter 13 (GST tax), which is retroactively reinstated for generation-skipping transfers made after December 31, 2009. Further, the applicable rate is zero for generation-skipping transfers made in 2010.

4. For purposes of Chapter 13, the decedent will be treated as the transferor under section 2652(a)(1) even if the election out of the estate tax is made. Prior to the 2010 Act, it was unclear whether a testamentary transfer from a 2010 decedent would be forever exempt from the GST tax because there was not a "transferor" (as such term is defined under section 2652(a)(1)) for such transfers since chapter 11 did not apply. Section 301(c) resolves this uncertainty by expressly providing that "For purposes of section 2652(a)(1) of such Code, the determination of whether any property subject to the tax imposed by such chapter 11 shall be made without regard to any election made under this subsection."

B. Procedures for Making the Election.

1. As of the date for submission of this outline, the Secretary has not issued any final form(s) or guidance as to how the election will be made. The IRS has released two drafts of Form 8939, Allocation of Increase in Basis for Property Acquired from a Decedent. The most recent draft (attached) was released on the date prior to the enactment of the 2010 Act and, therefore, does not make any reference to the election. At this point, it is unclear whether the Treasury will add the election to Form 8939, Form 706 or issue an entirely new form to make a valid election.

2. Only the decedent's executor can make the election. Section 301(c) of 2010 Act specifically defines the term "executor" by reference to section 2203 of the Code, which generally refers to the executor or administrator of the decedent's estate. However, if there is no executor appointed, qualified or acting within the US, then section 2203 expands the term "executor" to mean any person in actual or constructive possession of any property of the decedent, which may include the decedent's agents and representatives, safe-deposit companies, warehouse companies and other custodians of property, brokers holding, as collateral, securities belonging to the decedent, and debtors of the decedent in the US. Treas. Reg. § 20.2203-1.

    i. This opens the door to the potential for multiple executors with divergent interests if there is no probate opened in the local court. If parties will not agree as to whether an election should be made, consider having the local probate court appoint an executor (preferably an independent executor) even if full probate is not otherwise required.

3. The election, once made, is revocable only with the consent of the Secretary or the Secretary's delegate. Sec. 301(c) of 2010 Act. Note, however, the 2010 Act does not appear to mention any possibility of making the election after the due date if the executor initially proceeds under the estate tax rules and files an estate tax return, but later seeks to elect into the carryover basis regime. For example, if after filing the Form 706, additional assets are discovered or valuation disputes occur, the executor may want to make the election to avoid estate tax. It is unclear whether this may be possible.

C. Know your assets and basis.

1. Starting point - the basis of property acquired from a decedent is the lesser of (i) the adjusted basis of the decedent, or (ii) the fair market value of the property at the date of the decedent's death. I.R.C. § 1022(a).

2. How much basis can be allocated?

    i. $1.3 million, but such amount may be increased by the sum of (i) any capital loss carryover under Section 1212(b), (ii) any net operating loss carryover under Section 172, and (iii) any losses that would have been allowable under Section 165 if the property acquired from the decedent had been sold at fair market value prior to death. I.R.C. §1022(b).

        a. The adjustment for Section 165 losses effectively permits basis to be shifted from depreciated investments to certain appreciated investments.

ii. Additional $3 million adjustment is available for “qualified spousal property”, which is defined as property transferred outright to the spouse or qualified terminable interest property. I.R.C. § 1022(c). Terminable interest property, such as a credit shelter trust for the benefit of spouse and children, is excluded. Further, note that citizenship of the spouse is not required to be entitled to the $3 million spousal basis adjustment.

iii. For nonresident, noncitizen decedents, the $1.3 million basis adjustment is reduced to $60,000, and it cannot be increased by the additional adjustments for 1212(b) capital loss carryovers, 165 inherent losses and 172 net operating losses. I.R.C. § 1022(b)(3). However, the $3 million spousal basis adjustment is available.

iv. The basis adjustment cannot be allocated to increase the basis of an asset beyond the fair market value of the asset *at the date of death* (not the date of distribution). Therefore, it is possible to create a loss for a beneficiary if the property depreciates during the administration period.

a. Assume decedent dies owning asset X which has a basis of $100 and a fair market value of $500 at date of death. If the asset depreciates during administration to $300, the executor can still allocate $400 of basis increase to the asset because there was $400 of appreciation on the date of death. Therefore, the beneficiary will take the property with $200 of built-in loss.

b. It could potentially be more beneficial to allocate the basis increase to create a loss in an asset rather than to reduce the gain on another appreciated asset if the loss to the beneficiary would result in a tax savings that is greater than the tax arising from the sale of other appreciated property, such as an ordinary loss asset versus a capital gain asset.

3. What property can basis be allocated to?

i. Property must be “owned” by the decedent at death <u>and</u> property must be “acquired from the decedent”.

ii. Definition of ownership is limited

a. For property owned as joint tenants with right of survivorship or tenants by the entirety, the decedent is treated as the owner of 50% if the surviving spouse was the only other tenant. If someone other than the decedent’s spouse is the surviving tenant, then the decedent is treated as the owner to the extent of the portion of the property

which is proportionate to the consideration furnished by the decedent, or, if the property was acquired gift, bequest, devise or inheritance, then the decedent is treated as the owner of a proportionate share based on the number of joint tenants with right of survivorship. I.R.C. § 1022(d)(1)(B)(i).

b. Decedent is treated as owning property held in a section 645 qualified revocable trust. I.R.C. § 1022(d)(1)(B)(ii). Qualified revocable trust is limited to those trusts which are treated under section 676 as owned by the decedent. I.R.C. § 645(b). For section 676 to apply, the power to revest title in the decedent must have been exercisable by the decedent or a nonadverse party. Therefore, self-settled irrevocable trusts may not qualify.

c. Decedent is not treated as owning any property by reason of holding a power of appointment over such property. I.R.C. § 1022(d)(1)(B)(iii). The statute does not distinguish between a general and limited power of appointment. Thus, it does not appear that basis increase can be allocated to property held in a QTIP or GPOA marital trust.

d. Property which represents the surviving spouse's one-half (1/2) share of community property is treated as owned by, and acquired from, the decedent if at least one-half (1/2) of the entire community interest in such property is otherwise treated as owned by, and acquired from, the decedent without regard to this clause. Therefore, the decedent's one-half (1/2) share and the surviving spouse's one-half (1/2) share are eligible for the $1.3 and $3 million basis adjustment. I.R.C. § 1022(d)(1)(B)(iv).

iii. Property is treated as being "acquired from the decedent" if such property:

a. Is acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent;

b. Is transferred by the decedent during lifetime to a section 645 qualified revocable trust, or to any other trust to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust; or

c. Passes by reason of death of the decedent without consideration. I.R.C. § 1022(e).

iv. It's unclear exactly what type of property falls within the category of "acquired from a decedent" but not "owned by a decedent".

v. Basis increase cannot be allocated to property acquired by the decedent by gift or bargain sale during the 3 year period ending on the date of the decedent's death. However, a gift from a spouse is specifically excepted unless the spouse acquired the gifted property during the 3 year period by gift or bargain sale. I.R.C. § 1022(d)(1)(C).

vi. Basis increase cannot be allocated to (i) stock or securities of a foreign personal holding company, (ii) stock of a DISC or former DISC, (iii) stock of a foreign investment company, or (iv) stock of a passive foreign investment company unless such company is a qualified electing fund. I.R.C. § 1022(d)(1)(D).

vii. Basis increase cannot be allocated to income in respect of a decedent (IRD). I.R.C. § 1022(f).

viii. Basis allocation may only be changed with the consent of the Secretary. I.R.C. § 1022(d)(3)(B).

4. Negative Basis Property

i. Liabilities in excess of basis are disregarded in determining (i) the adjusted basis of property in the hands of the beneficiary and (ii) whether gain is recognized on the acquisition of property from a decedent by the decedent's estate or a beneficiary other than a tax-exempt beneficiary, or from the decedent's estate by a beneficiary other than a tax-exempt beneficiary. I.R.C. § 1022(g). This generally prevents the recognition of gain on a distribution of encumbered property by a decedent or decedent's estate, but it does not protect the beneficiary from recognizing gain once the property is disposed of if the debt exceeds the basis of the beneficiary at the time of the disposition.

5. Principal Residences

i. The $250,000 exclusion under section 121 on the sale of a principal residence is extended to estates, individuals who acquire the property from the decedent (within the meaning of section 1022) and a trust that was qualified revocable trust (as defined under section 645) immediately prior to the decedent's death, if the decedent used the residence as a primary residence for at least two of the five years prior to the sale. For purposes of satisfying the two year occupancy requirement, the decedent's occupancy period can be tacked to the occupancy period of the individual beneficiary.

ii. This exclusion is not allowed to a trust other than a section 645 qualified revocable trust. Therefore, a sale should be considered prior to funding a testamentary trust with the principal residence.

D. There are a multitude of factors for an executor to consider in determining whether the election should be made, including the following:

1. Basis of each asset;

2. Date of death value of each asset;

3. Projected value and earnings of each asset;

4. Tax character of gains, earnings and losses;

5. Projected holding period of each asset;

6. Present value of future income tax upon sale of assets vs. current payment of estate tax;

7. Identity of beneficiaries (any charities?);

8. Ability to allocate special ($1.3+ million) or spousal ($3 million) basis increases to assets;

9. Impact of election on formula clauses in testamentary instrument;

10. Estate tax apportionment among beneficiaries;

11. Potential for disagreement among beneficiaries in allocating special and spousal basis increases;

12. Future income and estate tax rates;

13. Domicile of beneficiaries and personal income tax information;

14. Impact of state estate tax, if applicable; and

15. Outstanding gift tax exposure for prior gifts and the potential impact of IRS valuation adjustments on estate tax and allocations of property between beneficiaries.

IV. **The executor has decided to make the election, now what?**

A. Section 6018 Return for Large Transfers at Death

1. Section 6018(b)(1) requires a return to be filed if the fair market value of all property (other than cash) acquired from a decedent exceeds the amount of the Section 1022(b)(2)(b) special basis increase (i.e., $1.3

million). For purposes of determining whether a return is required, the executor cannot consider capital loss carryovers, inherent losses, etc. Therefore, a return is apparently required to be filed even in the following circumstances:

i. The fair market value of the property acquired from a decedent totals $1.4 million, but the basis increase available to the executor is $1.8 million as a result of $500,000 of unrealized 165 losses and/or 1212(b) capital loss carryovers;

ii. The fair market value of the property is $2 million and all property is being transferred to spouse as qualified spousal property; and

iii. The fair market value of the property acquired from the decedent is $1.5 million, but basis cannot be allocated to any property because none of the assets have any unrealized appreciation or none of the property is treated as "owned" by the decedent under section 1022(d) (e.g., QTIP property).

2. Section 6018(b)(2) also requires a return to be filed for *appreciated* property acquired from a decedent if (i) such property was received by the decedent via a gift or bargain sale within 3 years of death (unless such property was received from a spouse), and (ii) such gift or bargain sale was required to be included on a gift tax return under section 6019. Note that appreciated property gifted to the decedent in the form of annual exclusion gifts would not trigger a filing requirement under section 6018(b)(2) because these gifts do not require the filing of a gift tax return under section 6019.

i. Since section 6018(b)(1) requires <u>all</u> assets acquired from a decedent to be reported on the return, regardless of whether an asset has built-in gain or loss and regardless of whether basis can be allocated to the asset, Section 6018(b)(2) does not appear to impose any additional filing burden if the executor is otherwise required to file a return under section 6018(b)(1). Section 6018(b)(2) appears to be relevant only in situations where the fair market value of all property acquired from the decedent does not exceed $1.3 million.

3. Section 6018(b)(3) requires a return to be filed for a nonresident noncitizen if the sum of the fair market value of (i) tangible property situated in the U.S. and (ii) other property acquired from a decedent by a U.S. person exceeds $60,000.

4. Form 8939 Allocation of Increase in Basis for Property Acquired from a Decedent was not yet finalized by the IRS at the time this outline was submitted. The draft form makes reference to instructions and Publication

4895, neither of which have been released. The language on the face of the draft Form is unclear and raises several issues:

i. Schedule A - Property Acquired by Surviving Spouse requests the completion of "a separate Schedule A for the surviving spouse and for any QTIP trust."

a. The reference to the preparation of a separate Schedule A for a QTIP trust suggests that a separate Schedule A should be completed if the QTIP trust is the recipient of property, not if property is being transferred from a QTIP trust as a result of the decedent's death.

ii. Schedule B - Property Acquired by Person Other Than Surviving Spouse requires a separate Schedule B to be completed for each recipient of property, including the decedent's estate.

a. Based on this language, it appears that the Schedule B filed for the decedent's estate should include any property that is sold by the estate during administration, whether or not any basis adjustment is allocated to such property.

iii. Part II of Schedules A and B bifurcates the reporting of property acquired from a decedent into property with a basis greater than fair market value at death, and property with a basis less than or equal to fair market value at death. Column 4(d) of Part II requests the executor to identify which assets are "ineligible property". Although it is not clear from the face of the draft Form, "ineligible property" is presumably a reference to property which is not qualified to receive an allocation of basis, such as terminable interest property. Therefore, <u>all</u> property acquired from a decedent must be listed under Part II of either Schedule A or Schedule B regardless of whether it has built-in loss, built-in gain, or no gain, and regardless of whether basis increase can be allocated to such asset.

a. This imposes a significant burden on the executor to determine the basis and fair market value of each and every asset. Section 6716(a) (described below) appears to impose a $10,000 penalty for <u>each</u> failure of the executor to furnish the information required to be reported to the IRS under section 6018. If the executor cannot utilize a significant portion of the basis adjustment due to the composition of the assets, it is possible that appraisal and other fees which are increased by this administrative burden could eliminate a significant portion or all of the benefit from the basis adjustment.

b. The reference in column 4(d) to “ineligible property” highlights the distinction between “property acquired from a decedent” and “property owned by the decedent” (see Section III.3.C above). All property acquired from the decedent must be reported in Part II, yet basis increase may be allocated only to property owned by the decedent.

5. Executor is responsible for completing the return or filing the appropriate form. If the executor is unable to make a complete return as to any property acquired from or passing from the decedent, the executor must include in the return a description of the property and the name of every person holding a legal or beneficial interest in such property. Upon notice from the Secretary, such persons will then be required to prepare a similar return with respect to property received. I.R.C. § 6018(b)(4).

   i. If there is no executor appointed, qualified and serving in the U.S., section 7701(a)(47) provides that every person in actual or constructive possession of any property of the decedent is constituted an executor (Note: Although the definitions are identical, section 7701(a)(47) would technically apply to define the term “executor” rather than section 2203 for purposes of determining who shall file Form 8939. Section 2203 would not be effective if the election out of the estate tax is made). If multiple executors do not cooperate, this can easily result in an allocation of basis that is greater or less than the available amount. An executor is likely to be unaware of the actual amount of basis which may be allocated to the asset in its possession if it is not attuned to the other allocations that are being made. At the same time, an executor who is also a beneficiary may simply allocate basis to bring the property in its possession up to fair market value without concern for any other allocations being made. It’s unclear what the response will be from the IRS when the aggregate basis increase allocated by all executors is greater than the amount to which the decedent is entitled. Will the basis of each asset be reduced pro rata?

6. Changes to any allocation may be made only as provided by the Secretary. I.R.C. § 1022(d)(3)(B). However, guidance on making any changes to an allocation has yet to be issued.

7. I.R.C. § 6018 requires the following information to be included in the return: (i) the name and TIN of the recipient of such property; (ii) an accurate description of such property; (iii) the adjusted basis of such property in the hands of the decedent and its fair market value at death; (iv) the decedent’s holding period; sufficient information to determine whether any gain on the sale of the property would be ordinary income; (v) the amount of the special or spousal basis increase allocated to the

property; and (vi) any other information the Secretary requires by regulation.

8. The executor (and any other person required to make a return under I.R.C. §6018) must provide, within 30 days after filing the return, a written informational statement to each person whose name is set forth in the return showing the contact information for the executor and, with respect to the property acquired by such beneficiary from the decedent, (i) an accurate description of such property; (ii) the adjusted basis of such property in the hands of the decedent and its fair market value at death; (iii) the decedent's holding period; (iv) sufficient information to determine whether any gain on the sale of the property would be ordinary income; (v) the amount of the special or spousal basis increase allocated to the property. I.R.C. § 6018(e).

B. Section 6716 Penalties for Failure to File Information

1. The penalty for the failure to file the return and furnish the required information to the Secretary is $10,000 for each failure.

2. The penalty for the failure to furnish the written informational statement to each beneficiary is $50 for each such failure.

3. No penalty is imposed if failure is due to reasonable cause.

4. Any failure to file or furnish which is the result of the intentional disregard of the executor results in a penalty of 5% of the fair market value (as of the date of death) of the property with respect to which the information is required.

5. Note that these penalties are not based on any amount of tax owed.

C. The election may be reversed only with the consent of the Secretary or the Secretary's delegate. Section 301(c), 2010 Act.

D. Establishing the basis of assets

1. What documentation will the IRS require to establish the decedent's basis?

2. To what extent may the executor rely on basis records obtained from third parties without having to independently verify their accuracy?

3. What should the executor do if basis cannot be accurately determined?

E. Allocation of basis increase is made by executor on asset-by-asset basis.

1. Executor must be mindful of its fiduciary duties, including the duty to act impartially among the beneficiaries. If the will or trust does not provide a

sufficient exculpation clause to exonerate the fiduciary from liability relating to the allocation of basis, the executor must undertake steps to protect itself, including:

i. Appointing an independent executor solely to allocate the basis increases (if existing executor is also a beneficiary);

ii. Obtaining consents and releases from beneficiaries; or

iii. Obtaining approval of the probate court.

2. How anxious will an individual or trust company be to accept appointment as the independent fiduciary and assume responsibility for allocating the basis increase in a conflict situation?

F. Basis Allocation Strategies

1. Allocate to assets that are anticipated to be sold closest after decedent's death.

2. Allocate in the manner that results in the least total income tax which would be payable by the beneficiaries as a whole, considering the character of the gain and each beneficiary's income tax bracket.

3. Allocate to easy-to-value assets to avoid allocating too little basis if the IRS subsequently increases the reported date of death value on audit.

4. Allocate to assets passing to GST exempt trusts as opposed to assets passing to non-exempt trusts to avoid using exempt funds for the payment of income tax.

5. Allocate away from those beneficiaries with a short life expectancy, whose assets will likely receive a section 1014 stepped-up basis upon their subsequent death.

6. Allocate away from charitable beneficiaries who will be exempt from income tax on subsequent sale of assets.

7. Is it possible to make a formula allocation of the basis increase to avoid allocating too much or too little basis if the IRS adjusts the fair market value or basis of an asset?

i. Ex. "Decedent hereby allocates to asset X a fractional share of that certain basis increase available to decedent under section 1022(b) of the Code, the numerator of which is equal to the difference between the fair market value of such asset as finally determined for federal tax purposes and [the basis of the asset], and the

denominator of which is the total basis increase available to decedent under section 1022(b) of the Code."

ii. The complexity of a formula allocation appears to substantially increase as the number of assets to which basis is allocated increases.

G. Valuation issues

1. Does every asset need to be valued in order to prove that either (i) the basis is less than the fair market value at death, or (ii) the fair market value is less than the basis at death? The draft Form 8939 requires <u>all</u> property acquired from the decedent to be reported, regardless of whether the basis is greater or less than the fair market value at date of death and regardless of whether basis can or will be allocated to such asset.

i. Is it necessary to obtain a qualified appraisal for assets that have a documented basis if either (i) the fair market value of the asset is clearly in excess of the basis increase available to the decedent, or (ii) no basis increase will be allocated to such asset and the fair market value of such asset is clearly in excess of its basis?

ii. For example, assume a decedent owned a 25% interest in a closely-held business, the primary assets of which are several parcels of real estate. If the decedent's basis in the interest at date of death is $100,000 and the real estate is clearly worth at least $25 million, is the executor required to obtain a real estate appraisal for each parcel, and then obtain a business appraisal to document the fair market value of the decedent's interest? In lieu of a full appraisal, may an executor use tax assessor values for the real estate and apply excessive valuation discounts to show that the fair market value is clearly more than the sum of the decedent's basis and the available basis increase?

2. To what extent should discounts should be claimed? Whereas taxpayers sought to maximize discounts prior to carryover basis, they now benefit from taking lower discounts. The IRS is also in a similar position. The IRS may later review the discount(s) claimed by an executor on Form 8939 when reviewing discounts claimed on subsequent estate of gift transfers of the same asset. There is no statute of limitations with respect to values reported on Form 8939 and thus, the IRS is not bound by the values reported on Form 8939 for income tax purposes when a beneficiary later sells the asset.

H. Will/Trust Construction Issues

1. The reinstatement of the estate and GST tax does not resolve all of the ambiguities created by formula clauses which did not contemplate the

potential repeal of the estate tax because the executor can still elect out of the general application of the estate tax.

2. In states which enacted remedial legislation providing for a formula bequest to be construed under the estate tax laws that existed on December 31, 2009, should the estate tax exemption now be treated as $3.5 million or $5 million? Most of these state statutes contain a provision which provides that the statute will no longer apply as of the date the federal estate or GST tax becomes legally effective. The default rule under the 2010 Act is that the estate and GST tax applies as of January 1, 2010, which appears to eliminate the effect of these remedial statutes and result in a $5 million estate tax and GST exemption. However, it could be argued that making the election out of the estate tax means that the estate tax is not legally effective as of January 1, 2010. This interpretation would result in a $3.5 million estate tax exemption (pursuant to the state statute) rather than a $5 million estate tax exemption. The GST exemption would remain at $5 million regardless of whether the election is made.

3. In Florida and South Carolina, which enacted remedial legislation permitting fiduciaries and beneficiaries to bring a proceeding in probate court to construe the testator's intent in the event of an ambiguous formula clause, the existence of the election should be sufficient to create the ambiguity necessary to get into court to construe the decedent's intent.

4. The critical question is to what extent should the election impact the distribution of property under the governing instrument. In many documents, construing the formula as if chapter 11 does not apply will shift significant amounts of property, or even the entire estate, between beneficiaries. Property rights of beneficiaries are generally determined under state law, but decedents have typically defined these rights based on federal tax concepts in effect at the time of death. Is it possible that the election can still be made for federal tax purposes to avoid estate tax even if state law requires the beneficiary's shares to be defined based on the transfer tax concepts which are on the books for 2010?

5. If litigation is ongoing at the time the election is required to be made and requisite forms are required to be filed, what options may an executor have?

    i. Section 301(c) of the 2010 Act provides that the carryover basis election, once made, is revocable only with the consent of the Secretary. It does not address any potential for making the election if an executor initially files an estate tax return. Accordingly, should the executor always elect out of the estate tax and then seek to revoke the election, if necessary, at the conclusion of litigation?

V. **<u>What do I need to know if the executor decides not to make the election?</u>**

A. With a few exceptions, the 2010 Act did not change the procedure for preparing an estate tax return.

B. Exceptions

1. Due date for filing and paying any estate tax is extended to no earlier than nine (9) months after the date of enactment. Sec. 301(d)(1). This extension will not benefit the estate of any decedents dying between December 17, 2010 and December 31, 2010.

2. Generation-skipping transfers made in 2010 are subject to zero percent applicable rate.

VI. **GST Issues for 2010 Decedents**

A. Chapter 13 of the Code applies to generation-skipping transfers made in 2010, regardless of whether the election into modified carryover basis is made. However, the tax impact of such retroactivity is mitigated because the GST applicable rate is zero percent (0%) for all generation-skipping transfers (i.e., direct skips, taxable distributions and taxable terminations) occurring in 2010, whether by gift or as a result of the death of a testator.

1. Must look at when the generation-skipping transfer is deemed to actually occur. For a direct skip, the event which generally triggers the application of the GST tax occurs at the time the transfer is made or deemed to be made. For a taxable distribution, the event which triggers the application of the GST tax occurs at the time the distribution is made. For a taxable termination, the event which triggers the application of the GST tax occurs at the time the subject interest in property held in a trust terminates.

B. The application of Chapter 13 to decedents dying in 2010 means the "generation move-down rule" of IRC § 2653(a) applies. Accordingly, direct-skip transfers made in 2010 to a trust do not incur GST tax because the rate for such transfers in 2010 is zero, and distributions after 2010 from such trusts will not be subject to GST tax because the "generation move-down rule" applies to treat the direct-skip trust as if "the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer."

1. The application of section 2653(a) to a transfer to a direct-skip trust means that distributions in subsequent years which are made to a trust beneficiary who is one generation below the transferor will not be subject to GST tax. However, distributions to a lower generation beneficiary will still attract GST tax unless GST exemption is allocated.

C. Allocation of GST exemption

1. The automatic allocation rules of I.R.C. § 2632(e) provide that any GST exemption which has not been allocated by the filing deadline for the estate tax return shall be deemed to be allocated first to direct skips occurring at death, and second, pro rata to trusts for which such decedent will be treated as the transferor and from which a taxable distribution or taxable termination might occur after death.

2. To avoid wasting GST exemption for transfers arising from a decedent's death in 2010, be sure to affirmatively allocate the decedent's GST exemption to indirect skips (and away from direct skips) for which the event triggering the application of the GST tax will occur in subsequent years when distributions are made or the trust terminates. In contrast to the automatic allocation rules for inter vivos transfers, there is no election out of the automatic allocation rules for transfers on death. Instead, an executor needs to specifically allocate the decedent's GST exemption. I.R.C. § 2632(e)

3. Although a direct skip transfer to a trust from a decedent dying in 2010 will be subject to the zero percent GST applicable rate, it is still possible that future distributions from the trust may be subject to GST tax. For example, a transfer to a trust for the benefit of grandchildren and great-grandchildren will be treated as a direct skip because the only persons having an interest under section 2652(c) in the trust are skip persons, and thus, the trust is a skip person. However, distributions from the trust to great-grandchildren will still be taxable distributions subject to GST tax because the great-grandchildren will be deemed to be two generations below the decedent/transferor (after the application of the generation move-down rule under section 2653(a)). Therefore, depending on the testamentary plan of the decedent, it may still be prudent to allocate GST exemption to a transfer to a trust which is a direct-skip.

4. The executor should also consider making late allocations of the remaining exemption to transfers previously made in trust by the decedent during his lifetime. A late allocation must be filed by the due date of the decedent's estate tax return and the late allocation will be effective as of the date of filing the late allocation. Treas. Reg. § 26.2632-1(d)(1).

D. Using qualified disclaimers to take advantage of zero percent applicable rate for generation-skipping transfers occurring in 2010.

1. A transfer which occurs as a result of a qualified disclaimer relates back to the date of death of the decedent and should be subject to the GST tax rules in effect for the year of the decedent's death. See Treas. Reg. § 25.2518-1(b). Accordingly, a disclaimer may be made in 2011 to trigger the zero percent GST applicable rate for property passing from a decedent dying in 2010. The goal is to convert a transfer which is not a generation-

skipping transfer into a direct-skip to avoid one generation of estate or GST tax.

i. *Example*: Assume surviving spouse dies in 2010 resulting in the termination of a Marital GPOA Trust (which is not exempt from GST tax) created upon the death of the first spouse. If the remainder of the GPOA Trust provides that unappointed property will be divided into per stirpital shares for descendants, then one or more children may disclaim a portion or all of their interest in the remainder within the appropriate time period after death in order to have the trust property pass to the disclaimant's grandchildren free of GST tax. Treas. Reg. § 25.2518-2(c)(5), Ex. 2. Since the trust property is not otherwise exempt from GST tax, the estate or GST tax which would have been due upon the child's death if the disclaimer was not made is avoided. This can be done regardless of whether the property remains in trust for the grandchildren or is paid outright and regardless of whether the executor elects out of the application of the estate tax (although basis increase likely cannot be allocated to the trust property since property subject to a power of appointment is not treated as owned by the decedent for purposes of section 1022. I.R.C. § 1022(d)(1)(B)(iii)).

ii. *Example:* Assume a pot trust is created upon D's death for the benefit of children and grandchildren in excess of D's remaining GST exemption. If the children do not disclaim their interests, then the testamentary transfer to the trust will not be a generation-skipping transfer in 2010 and subsequent distributions from the trust to grandchildren will be subject to GST tax. If the children disclaim their interests in the trust, the trust will become a skip person and the testamentary transfer to the trust will be a direct-skip subject to the zero percent GST applicable rate. Thereafter, distributions to grandchildren will not be not subject to GST tax.

iii. Disclaimers can be used to shift property to great-grandchildren as well. Even though more than one generation is skipped, it can still result in a direct-skip subject to the zero percent applicable rate. See I.R.C. § 2612

2. 2010 Act has extended time period for making qualified disclaimers to 9 months following date of enactment of 2010 Act. This means that beneficiaries generally have until September 17, 2011 to make a qualified disclaimer (unless otherwise restricted by state law).

i. This extension may be problematic in those states which impose a time limitation within which a disclaimer must be executed to be effective for state law purposes. Such states may or may not amend their statutes to comport with the extension under the 2010

Act. Commentators have suggested that if a disclaimer will not comply with state law, it may still constitute a qualified disclaimer under Federal law if the disclaimer complies with Section 2518(c)(3). In this situation, the disclaimer should contain language which validly transfers the disclaimed property under state law to the person(s) who would have received such property had the transferor made a qualified disclaimer.

ii. Some states, such as Florida, contain an overriding provision which effectively provides that any disclaimer which is a qualified disclaimer under Section 2518 of the Code shall also be effective for state law purposes.

3. A disclaimer will not be qualified if the beneficiary has accepted any of the benefits from his or her bequest. Accordingly, if there is any potential for a disclaimer, special care must be taken to ensure that such beneficiary does not undertake any action with respect to the property which may constitute acceptance.

E. Filing a GST return to report a generation-skipping transfer for a 2010 decedent or the allocation of GST exemption by a 2010 decedent.

1. Assuming that a Form 706 will not be required to be filed if the carryover basis election is made, it leaves open the question of how generation-skipping transfers and allocations of GST exemption will be reported.

2. Generally, the individual who is liable for the GST tax is required to file the return. For a direct-skip, this means the executor of the decedent's estate. For a taxable distribution, the trustee is responsible for filing Form 706GS(D-1) with the IRS and the distributee, and the distributee of a taxable distribution is responsible for reporting a taxable distribution and paying GST tax by filing Form 706GS(D). For a taxable termination, the trustee is responsible for filing Form 706GS(T) with the IRS and paying the GST tax. Treas. Reg. § 26.2662-1. Forms 706GS(D), 706GS(D-1) and 706GS(T) are generally due by April 15th of the year following the calendar year of the taxable distribution or taxable termination, but Section 301(d)(2) of the 2010 Act extended the due date for all returns required under section 2662 of the Code to no earlier than 9 months after the date of enactment.

i. The instructions for Form 706GS(D-1) state that a trustee is required to file such Form for each skip person to whom a distribution is made even if the inclusion ratio applicable to the distribution is zero. Thus, a trustee will likely still be required to file this form for distributions made in 2010 which are subject to the zero percent applicable rate.

ii. The instructions for Form 706GS(D) state that a distributee does not need to file such Form if the inclusion ratio for the distributing trust is reported as zero by the trustee on the Form 706GS(D-1). Additionally, if a Form 706GS(D) is otherwise required, a distributee is not required to report any distributions which have a zero inclusion ratio. For taxable distributions made in 2010, the inclusion ratio applicable to the distribution does not need to be zero to avoid GST tax because the applicable rate (not the inclusion ratio) is deemed to be zero. Accordingly, it is currently unclear whether a distributee will be required to file Form 706GS(D) if the inclusion ratio applicable to a taxable distribution is greater than zero since no GST tax will be due.

iii. Direct skip transfers occurring at death are ordinarily reported on Schedule R or R-1 of Form 706. Does this mean the IRS will require a Form 706 to be filed to report a direct-skip transfer or allocation of GST exemption even if the carryover basis election is made?

VII. **Relevant Procedural Deadlines**

A. For decedents dying between January 1, 2010 and December 16, 2010 (the date prior to the date of enactment of the 2010 ACT), the 2010 Act extends the deadline for the following items to no earlier than 9 months after the date of enactment of the 2010 Act (i.e., September 17, 2011):

1. Filing the estate tax return and paying estate tax;

2. Filing any election required on the estate tax return;

3. Filing Form 8939 (carryover basis);

4. Disclaiming an interest in property received from a decedent;

   i. Need to be careful that the disclaimant has not received and does not receive any benefit from the disclaimed property prior to executing the disclaimer.

   ii. Note that some states (other than Florida) impose a time period for a disclaimer to be effective for state law purposes which may be less than the extension granted by the 2010 Act. Florida law does not impose any time limitations and, in fact, contains a general provision that any disclaimer which is qualified for federal tax purposes is also qualified for state law purposes.

5. Filing any return under section 2662 of the Code to report an inter vivos or testamentary generation-skipping transfer; and

6. Making any election on a return to report an inter vivos or testamentary generation-skipping transfer.

B. Note: 9 months from the date of enactment of the 2010 Act is Saturday, September 17, 2011. Therefore, the actual due date for the above actions (other than making a qualified disclaimer) is September 19, 2011.

C. Section 6075(a) provides that Form 8939 shall be filed with the decedent's final income tax return. Thus, although the 2010 Act extends the filing date for the Form 8939 to no earlier than September 19, 2011, it is possible to extend the filing deadline to October 15, 2011 if a 6 month extension is obtained for filing the decedent's final income tax return.

VIII. Looking Ahead: Procedural Issues for Portability in 2011 and 2012

A. Section 303(a) of the 2010 Act provides that the executor of the first deceased spouse must file a timely estate tax return and make an election to permit the surviving spouse to utilize the unused exemption.

1. Unlike Section 301(a), which addresses the carryover basis election, Section 303(a) does not make an explicit reference to Section 2203 for purposes of defining the term "executor". Notwithstanding, the election for portability is included under Section 2010(c) and Chapter 11 of the Code and, therefore, Section 2203 would presumably apply.

2. In the absence of a court appointed executor, Section 2203 defines "executor" as "any person in actual or constructive possession of any property of the decedent." If there is no executor appointed, then a surviving spouse who possesses any property of the deceased spouse, regardless of value, would be free to prepare and file the estate tax return and make the portability election.

B. The requirement that an estate tax return for the predeceased spouse be prepared and filed in order to make the election raises several issues because the surviving spouse is not always the executor of the deceased spouse's estate, especially in second marriage situations where the deceased spouse has children from a prior marriage.

1. The portable exemption benefits the surviving spouse, the beneficiaries of the surviving spouse's estate, and the remainder beneficiaries of a QTIP trust created upon the death of the first spouse. If none of these individuals are serving as executor, then what incentive does the executor have to complete an estate tax return?

i. May the executor accept a fee paid directly from the surviving spouse in order to prepare and file the return? It would seem unfair to charge the estate for the additional compensation that is

owed to the executor for the preparation of the return if any estate beneficiaries will not realize a benefit from the filing of a return.

2. Does the executor of the first deceased spouse always have a fiduciary duty to file an estate tax return and elect to transfer the unused exemption to the surviving spouse, even if the total assets of the surviving spouse do not currently approach the estate tax exemption? What is the potential liability of the executor if he or she fails to file the estate tax return and make the portability election?

    i. Who has a cause of action? Does the surviving spouse (or the estate of the surviving spouse) have a cause of action against the executor of the first deceased spouse if an estate tax return is not filed and the unused exemption is not transferred to the surviving spouse? Do any other individuals, such as the beneficiaries of the surviving spouse's estate, have a cause of action?

    ii. When does the cause of action arise? Does a cause of action arise once the executor of the first deceased spouse fails to file an estate tax return and make the portability election, or does the cause of action arise upon the death of the surviving spouse? If the cause of action arises upon the failure of the executor to make the portability election, then the beneficiaries of the surviving spouse's estate cannot have a cause of action because those beneficiaries can be changed at any time.

    iii. What is the measure of damages? It appears that damages cannot be calculated until the surviving spouse dies and the tax savings are calculable (does SS have a duty to mitigate by engaging in future estate planning?) If the cause of action, however, arises once the executor of the first deceased spouse fails to make the portability election, then damages would be purely speculative at that point. In that case, one may argue that it is possible to calculate the future tax savings based on factors such as (i) projected asset appreciation, (ii) the remaining life expectancy of the surviving spouse, (iii) valuation tables, (iv) present value concepts, (v) the tax rates and estate tax exemption that (under current law) will be in effect at the end of the surviving spouse's life expectancy, but any calculation such as this could result in a substantial windfall to the surviving spouse because the calculation would not account for any changes in the estate tax rate and exemption (which have never decreased) and it assumes that no future estate planning will be done to lower assets of the surviving spouse below the available exemption.

3. Who should pay for the cost of preparing the estate tax return for the first deceased spouse if a return would not otherwise have been filed?

i. The executor's foremost duty is to the estate of the first deceased spouse and the beneficiaries of such estate. Although the surviving spouse is likely to be a beneficiary of the first deceased spouse's estate, this may not always be the case. For example, the surviving spouse may have previously waived (by prenuptial or postnuptial agreement, or otherwise) his or her right to an interest in the estate of the first deceased spouse. If the surviving spouse is not a beneficiary, how does an executor justify using estate assets to pay for the expense of filing an estate tax return since neither the estate nor the beneficiaries of the estate are receiving any material benefit? Alternatively, if the surviving spouse is a beneficiary, is it fair or prudent to charge any portion of the cost of preparing the estate tax return to those beneficiaries who are not receiving any benefit?

ii. The portability election clearly has value to the surviving spouse. If the surviving spouse pays for the cost of filing the estate tax return or any additional amount requested by the executor, is this a taxable transaction or transfer? Has the surviving spouse made a gift to the beneficiaries of the estate? Alternatively, should the amount received from the surviving spouse be treated as gross income to the estate or executor? If so, what is the character of this income?

iii. Filing an estate tax return may cause the IRS to audit prior gifts by the decedent and valuations reported on the estate tax return when these issues would not otherwise have been in front of the IRS.

a. Although the surviving spouse would be harmed by a successful IRS challenge in the form of a reduction in the unused credit transferred to such spouse, the estate will be responsible for the costs incurred in defending the audit and any estate or gift tax arising therefrom.

b. The executor is filing the estate tax return for the primary or sole benefit of the surviving spouse. Therefore, the executor should seek to protect the shares of the remaining beneficiaries. For example, the executor could agree to file the return only if (i) the costs arising from the audit are charged to the share of the surviving spouse, or (ii) the surviving spouse agrees to indemnify the estate for the costs arising from an IRS audit.

iv. The portability election may become a valuable negotiating chip for the executor when dealing with a surviving spouse who is challenging the will or trust of the predeceased spouse. For example, assume the deceased spouse has a $1 million estate and

the surviving spouse is seeking to set aside the will so that the entire estate will pass to the surviving spouse by intestacy. If the executor does not have a fiduciary obligation to file an estate tax return and make the portability election, would the surviving spouse relinquish his or her challenge if the executor agreed to make the portability election and transfer the $4 million of unused exemption to the surviving spouse? From a pure numbers standpoint, the surviving spouse would receive a $1.4 million benefit (assuming a 35% estate/gift tax rate) if the $4 million of unused exemption became available to the surviving spouse. However, the surviving spouse would only receive a net benefit of $650,000 (assuming a 35% estate/gift tax rate) if the surviving spouse succeeded in his or her challenge of the will. In a situation such as this, the executor should even be able to get the surviving spouse to pay for the costs of preparation.

4. If the executor chooses to prepare the estate tax return, it is in the best interests of the executor to treat the return as if it was a taxable estate and prepare the return as complete as possible to avoid potential fiduciary liability. The executor should avoid underestimating the importance of an accurate and complete return.

    i. The IRS has an unlimited period to challenge the amount of the unused exemption transferred to the surviving spouse. Section 303(a), 2010 Act. Thus, a challenge is more likely to occur on the death of the surviving spouse, which may be many years later. Accurate valuations and documentation are substantially more difficult to obtain if they are not prepared contemporaneously with the filing of the return.

    ii. Prior to filing, the executor should have the beneficiary or beneficiaries who are requesting the filing of the estate tax return review and consent to the positions taken therein. Additionally, the fiduciary should seek a release of liability from such beneficiary or beneficiaries who may have standing to sue for errors in the return.

C. Planning to minimize potential complications arising from the portability election.

1. The portability election should be addressed in the decedent's Will or Trust.

    i. Provide exoneration provisions for the executor in exercising discretion to make or not make the election and in preparing the estate tax return.

ii. Provide direction as to whether an estate tax return is required to be prepared and the portability election made, subject to limited exceptions.

iii. Authorize the executor to pay or not pay the costs of a return depending on who requests the election to be made. Further, the executor can be given the authority to charge the costs of preparation to the surviving spouse.

iv. How much discretion should the executor retain to deal with the specific circumstances existing at death yet minimize the potential for conflicts which may arise surrounding whether the election will be made?

2. Include provisions in prenuptial / postnuptial agreement regarding whether the portability election will be made upon the death of the first spouse.