

Steeply Declining GRATs: Perhaps, the Best GRAT Ever

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Some Basic GRAT Concepts

Grantor Retained Annuity Trusts (GRATs), described in Code Sec. 2702(b), are successful in transmitting property out of a property owner's estate at no estate tax and no or minimal gift tax cost if the assets contributed to the trust grow at a rate greater than the so-called Section 7520 rate, which is published monthly by the IRS and is used to determine the value of the retained annuity in a GRAT and the value of its taxable remainder. Although not certain, it appears that the value of the remainder in a qualifying GRAT can be very small, such as .01 percent of the fair market value of the assets contributed to the trust if not zero.

Although again not certain, it seems that the annuity payment term of a GRAT may be as short as two years, at which time the annuity payments to the grantor/annuitant cease and anything remaining in the trust is transferred to or for the remainder beneficiaries, such as the grantor's children.

Because it is not certain how small the remainder may be or how short the annuity term may last, WTP has adopted a formula created by Diana Zeydel, Esq. of Greenberg Traurig in Miami. Essentially, it provides that the annuity must be at least sufficient to produce the desired remainder sought (such as one percent of the value of the property contributed to the trust) or such larger remainder that is necessary to have a qualified GRAT and the annuity term must be the longer of the term desired (such as two years) or such longer term necessary to have a qualified GRAT.

A drafter using WTP can implement the Zeydel Formula on the "Payments During Term" screen, by selecting either the "Fixed Payment Formula" or "Increased Payment Formula" choice under "Select How to Express Annuity" and then checking the box for "Use the Safe harbor GRAT Formula."

Short Term Increasing GRATs

Most practitioners agree that short term GRATs (such as ones for two years) are preferable to longer ones (such as those for terms longer than two years) for a number of reasons. One of those is that "good" investment performance (e.g., growth in excess of the Section 7520 rate) during the first two years of a GRAT is not diminished by "poor" performance later (e.g., decline during any GRAT period after the first two years of good performance). And a Monte Carlo simulation that

Jonathan and Diana presented with Robert Weiss at the 2007 Heckerling Institute verified that short term GRATs are preferable.

Also, most practitioners have the annuity payments increase from one year to the next. Reg. § 25.2702-3(b) provides that annual increases in annuity payments above 20% are disregarded for purposes of valuing the annuity interest retained by the grantor and, therefore, the value of the gift of the taxable remainder.

New "Science": Short GRAT *Declining* GRATs

Although it may seem counterintuitive, Diana and Jonathan have discovered that from both a theoretical perspective and Monte Carlo simulations that a steeply declining short term GRAT is better than a level payment or increasing one. The reason is that, if the performance in the first year is good (i.e., growth in excess of the section 7520 rate), the extra growth more likely can be "locked" in for the remainder beneficiaries by paying the grantor off almost in full at the end of the first year. And, if the performance in the first year is poor (e.g., a steep decline in the value of the assets contributed to the trust), all (or nearly all) of what is in the GRAT is returned to the grantor who can "re-GRAT" the assets returned (that is, create a new GRAT with the assets that have been returned as the first annuity payment). In fact, even if the performance in the first year is excellent, assets returned to the grantor as the first year annuity payment can be "re-GRATed" for the remainder beneficiaries. And although, as stated, the regulations effectively limit how much an annuity can increase from one year to the next, they do not limit how much it can decline.

Using the basic Zeydel Formula as a model, we have added another choice under "Select How to Express Annuity", which is "Declining annuity payments." If you make that selection, you will be asked to specify the percentage the first year annuity will be of the initial fair market value of the annuity contributed to the trust. For example, if it is a two year GRAT, you might provide that the first year annuity payment will be 90% of the initial fair market value of the assets contributed. Under the new "Zeydel" formula, the annuity payment for the first year will be the lesser of 90% or the largest percentage the annuity can be in the first year and be a qualified GRAT. The annuity payment for the next and final year of the GRAT will be determined by a word formula so the remainder will be the greater of (1) the size desired (e.g., .01 percent of the initial fair market value of the assets contributed to the trust) or (2) the minimum size a remainder may be in a qualified GRAT. (We recommend that the first year annuity payment not be specified to be greater than 90%.)

Summary and Conclusion

Both theory and Monte Carlo simulations suggest that a steeply declining GRAT is more likely to be successful in transmitting wealth than a level payment or increasing annuity payment GRAT. WTP now offers a steeply declining GRAT.

Gift Tax Safety Nets for Installment Sales to Grantor Trusts© 2008.
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Introduction

Estate planners have a number of tools available to them in planning for the transfer of assets that are expected to substantially appreciate in the future. One relatively common estate planning arrangement is for the grantor of a trust (where the trust is a "grantor trust" for income tax purposes) to sell assets to the trust. Commonly, a large part or all of the consideration for the sale is an installment note. For these purposes, we will refer to this as an "installment sale to a grantor trust" or "ISGT." See, generally, Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 Estate Planning 3 (Jan. 1996).

Wealth Transfer Planning™ includes a concept memo (SmartContent which will offer advice as to whether a particular client should consider making such a sale) and an interactive process for the preparation of documents. By their very nature, ISGT transactions involve a risk of being re-characterized as a part sale, part gift transaction. This article suggests several ideas on how that risk might be reduced. This article also outlines the changes that WTP, a part of Interactive Legal's "Legal Suite", is in the process of implementing to its Irrevocable Trust, along with new interactive questions and documents to help accomplish the goal of reducing such a gift tax risk.

Some Background about ISGT's

A sale, even of appreciated property, by the grantor to a grantor trust is not, according to the IRS, subject to income tax. The grantor is treated as though he or she is "selling" the asset to himself or herself, which is not a taxable event for income tax purposes. See Rev. Rul. 85-13, 1985-1 CB 184.

Similarly, because (under Rev. Rul. 85-13) the existence of the trust is ignored and the grantor is treated as still owning the trust property, interest due or paid on the note from the trust to the grantor is also not subject to income tax. In a typical transaction, the note bears the applicable Federal rate (AFR) of interest, which is relatively low and often much lower than market rates of returns. Under Code Sec. 7872, charging at least AFR interest on indebtedness between family members prevents a gift from being made by the extension of credit.

If the property sold to the ISGT does grow at a rate greater than the note's AFR interest rate, value will accrue in favor of the trust, free of estate, gift and income tax. In addition, if the AFR thereafter drops, a new note carrying the lower (current) AFR may be substituted, generally with out adverse tax effects, for the "old" (higher AFR) note. See Blattmachr, Crawford and Madden, "How Low Can You Go? Some Consequences of

Substituting A Lower AFR Note for a Higher AFR Note," Journal of Taxation (June 2008).

Four Ways to Reduce the Risk of a Gift in an ISGT

WTP suggests the consideration of several strategies aimed at reducing the risk of a gift, or at least reducing the risk of a relatively large gift, in an ISGT.

Defined Formula Sales Price. In this context, the Internal Revenue Code defines a gift as occurring to the extent that the value of property transferred exceeds the value of the property received in exchange. Code Sec. 2512. Hence, if the fair market value, as finally determined for Federal gift tax purposes, of the asset or assets sold to the trust exceeds the amount the trust pays, the grantor will be treated as having made a gift to the trust. While the grantor might establish that the transaction was in the ordinary course of business within the meaning of Reg. § 25.2512-8, this is often challenging to do in a transaction between family members or entities on their behalf.

To reduce the risk of a gift occurring by having a sales price less than the sold property's fair market value, WTP will provide a purchase or buy-sell agreement under which the grantor will agree to sell and the grantor trust will agree to buy a fractional interest in certain identified property for a specified price set forth in the purchase agreement or determined by an appraiser selected by the grantor and the trustees of the trust after the purchase agreement is executed.

First, to avoid the risk of a penalty under Code Sec. 6662 if it turns out the value used to determine the purchase price is not "correct," the specified price set forth in the purchase agreement should be determined by an independent experienced appraiser. An alternative to the advance setting of the price by a qualified appraiser is to have the price determined by such an appraiser after the purchase agreement is signed. That way, neither of the parties knows when the agreement is signed what price will be, which some view as somewhat typical of what parties acting at arms' length would use to determine a price (as not infrequently occurs in arms' length buy-sell agreements among owners of a company).

In any event, the purchase agreement will provide that the portion, or fraction, of the asset(s) purchased will be the lesser of (1) the entire property (e.g., limited partnership units in a partnership, stock in a business or a tract of land) or (2) that fractional share of the property, the numerator of which is the specified price or value determined by the appraiser and the denominator of which is the fair market value, as finally determined for Federal gift tax purposes, of the entire property.

For example, assume limited partnership units are sold to the trust. The appraiser determines the value of all the units to be \$5,000,000. The trust will pay \$5,000,000, but in an attempt to reduce the risk of an unintentional gift, the purchase by the trust will be expressed as the lesser of (1) all of the grantor's limited partnership units or (2) that fractional share of the units, the numerator of which is \$5,000,000 and the denominator

of which is finally determined fair market value of the units. If the fair market value of the units is finally determined to be \$5,000,000 or less, the trust will have purchased all of the units. If the fair market value is finally determined to be \$6,000,000, the trust will have purchased 5/6ths of the units.

The viability of such a formula price clause is not certain. Logically, there seems to be no reason why it should not be respected for tax purposes. See McCaffrey & Kalik, "Using Valuation Clauses to Avoid Gift Taxes," 125 *Trusts & Estates* 47 (October 1986). The United States Tax Court in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g*, 120 TC 358 (2003), refused to honor a formula price clause, but it seems to be based upon the ground that the formula, as the court construed it, did not specify that the fair market value aspect of the formula would be *as finally determined for Federal gift tax purposes*. The Court of Appeals for the Fifth Circuit did honor the defined formula provision although the court noted that the IRS had abandoned on appeal certain of its "policy" arguments about why formula price clauses should not be respect for tax purposes.

Hence, although not certain, expressing the purchase as a fraction the numerator of which is the purchase price and the denominator of which is the property's fair market value as finally determined for Federal gift tax purposes should reduce the risk of a gift occurring by reason of the trust paying less than the full fair market value of what it purchases.

Defined Value Consideration. An alternative to having the trust purchase a fractional share of the property being sold by the grantor is to have the trust pay for the property using defined value consideration. In this approach, the consideration would be a fractional share of a marketable (easy to value) asset the trust owns. For example, the appraiser determines that the fair market value of the property that the grantor intends to sell to the trust is \$1,650,000. The trust then pays for that property by transferring to the grantor a fractional interest in an asset clearly worth more than the property the grantor is selling to the trust. For instance, assume that the appraiser is certain that it would be irrational to contend that the property, which the appraiser has determined to be worth \$1,650,000, is worth more than \$3 million. Hence, the trust will pay for the property with a marketable asset (e.g., a bond) having a current fair market value of at least \$3 million, and will transfer to the grantor "that fractional share of the bond, the numerator of which is \$1,650,000 and the denominator of which is the fair market value of the bond as of this date as finally determined for Federal gift tax purposes, and the parties agree that the bond will be divided into separate ownership by the grantor and the trust at any time at the direction either of them."

The use of a defined value consideration certainly appears to reduce the risk of a part sale, part gift transaction. However, other consequences should be considered. First, no AFR note is being used in the sale. Using an AFR note produces an additional advantage if the property sold grows at a rate greater than the AFR. Of course, if the parties do not think the property will grow, at least over a reasonable time, at a rate greater than the AFR, then the issue of whether to make the sale for an installment note should be

reevaluated. Second, in order to accomplish the above described defined value consideration strategy, the trust must already have a marketable asset with a value well in excess of the appraised value of the property being sold to the trust by the grantor. In many cases, the trust will not have such an asset. Of course, the trust could borrow cash from the grantor, at the AFR, and use the borrowed cash to buy such a marketable asset. That would also permit the trust to "leverage" on the growth of the marketable asset purchased above the AFR (to the extent not transferred to the grantor in exchange for the property being sold by the grantor to the trust).

We believe that this strategy will be used infrequently in actual practice, and thus WTP does not currently offer such a defined value consideration provision but it seems that it would not be difficult for a skilled drafter and planner to implement it.

Division of Any Part Sale, Part Gift Transaction into Complete and Incomplete Portions. As discussed above, the sale by the grantor to the trust could result in a deemed gift. For example, if the sales price is lower than the transferred asset's fair market value, the grantor will likely be treated by the IRS as having made a gift of the value difference. Additionally, a gift might be deemed to occur for other reasons.

To reduce the risk of a relatively significant gift being made, the trust can provide that any gift resulting from the sale will be divided into two parts. Ninety percent (90%) of such gift will be added to a trust for the benefit of the grantor and, as a result of the terms of that trust, will be an incomplete gift. Thus that 90% portion should not be subject to gift tax, although estate tax inclusion likely would occur as to that portion. The other 10% of any such gift will be added to the Lifetime Trust under the Irrevocable Trust with respect to which the gift would be complete.

While some might think that the entire 100% of any such gift should pass to the "incomplete gift" trust, the split into complete and incomplete gifts is to reduce the risk of the IRS contending that the incomplete portion should be ignored under *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944).

The IRS apparently reads that case as holding that any action to prevent the imposition of gift tax by formula or condition will be ignored. *Cf.* TAM 200245053 (not precedent). Instead, the trust agreement we suggest uses a different approach: any gift made after a specified date (which should be a date after the initial funding of the trust and prior to the date of the sale) is divided automatically into the 90% and 10% portions. Hence, any gift arising by reason of the sale would be subject to the above described 90% / 10% division. Although not certain, it seems that such a division, because it occurs automatically when the transfer is made and is not based upon any condition or formula, should not be subject to a "Procter" objection.

In any event, to reduce the risk of any significant taxable gift occurring by the sale to the trust by the grantor, the drafter will specify a date that will be (1) after the initial funding of the trust will occur (so all of the initial funding will be added exclusively to the Lifetime Trust created under the Irrevocable Trust and will constitute a completed

gift) and (2) before the sale will occur. The Irrevocable Trust will provide that any gift, made by any means, including by a bargain sale, after the date the drafter specifies, and whether complete or not, will be divided into the 90% and 10% portions, with the 10% portion also added to the Lifetime Trust and with the 90% portion added to a trust under the Irrevocable Trust for the benefit of the grantor that should not be a completed gift.

For example, if it is anticipated that the initial funding will be on March 1, 2009 and the sale will be on November 1, 2009, the date specified might be April 1, 2009. Hence, any gift made to the trust after April 1, 2009 (such as by a bargain sale) would be divided into the 90%/10% portions with the 90% portion going into the incomplete gift trust and 10% into the Lifetime Trust (which should render the 10% portion a completed gift). The goal, of course, is that only 10% of the gift element made in the bargain sale should be a taxable gift (and potentially subject to gift tax).

Disclaimer of Gift Element. One of the ways that a gift may be prevented from occurring after a transfer is made is if the beneficiary makes a qualified disclaimer of the property transferred under Code Sec. 2518. That section provides that if the beneficiary disclaims a transfer within nine months and certain other conditions are met, the property will be treated as though it never was transferred.

Although the IRS took the position in *Estate of Christiansen v. Commissioner*, 130 T.C. No. 1 (2008), that qualified disclaimers under Code Sec. 2518 may not be implemented in certain ways to achieve a particular specific result (e.g., the IRS position that it is against public policy to allow a disclaimer which, by a tax-driven word formula, would be a disincentive to the IRS upon audit because, for example, increases in the value of assets on audit would increase, dollar for dollar, the charitable deduction), the Tax Court rejected that position. Hence, it seems that if the principal beneficiary of a trust disclaims property transferred to the Irrevocable Trust and, if a result of the disclaimer, the property reverts to the grantor, then no gift should be deemed made.

Therefore, WTP will have the Irrevocable Trust provide, if a sale will made to it by the grantor, that, if the individual identified as the Principal Beneficiary disclaims any gift made to the trust, the property will revert to the grantor. This provision should allow the identified Principal Beneficiary to make a disclaimer under Code Sec. 2518 with respect to any portion of the property sold to the trust that would constitute a gift and, as a result, should prevent any portion of the transfer from constituting a gift because it will revert to the grantor/seller.

WTP also will be offering a form of disclaimer under which the Principal Beneficiary of the trust may make the disclaimer.

Alternative to Sale by Grantor: Sale by Grantor's Spouse

An alternative to the grantor selling assets to a grantor trust that the grantor creates is to have the spouse of the grantor sell the assets to a trust of which the spouse is a beneficiary but not the grantor. The trust for the spouse may be worded so the sale

should not result in the spouse being deemed to make a gift because the trust would be structured so even a direct gift by the spouse to the trust would not be complete under the principles set forth in Reg. § 25.2511-2. For example, if the selling spouse is the only beneficiary of the trust for life (or is a beneficiary with the power to veto distributions to others during his or her lifetime) and holds a special power of appointment exercisable at death, any gift by that spouse to that trust by any means (including a bargain sale) would not be subject to gift tax because the gift would be incomplete. And as long as there is no gift by the selling spouse, no part of the trust should be included in his or her gross estate because he or she is not the grantor of the trust.

On the other hand, if the sale transaction does involve some type of gratuitous transfer (such as where the asset is sold for less than its fair market value), the gratuitous portion of the transfer should not be a completed gift. As a result, no taxable gift should be deemed to have occurred and therefore no gift tax should be payable. However, in that case, some portion of the trust may be included in the decedent's estate under Code Sec. 2036(a)(2) and/or 2038 (and *see, also*, Code Sec. 2043). WTP will default certain answers to the Irrevocable Trust form so that any gift made by the spouse by a sale to the trust should be an incomplete gift.

A sale by the spouse of the grantor to the trust is treated as a sale by that spouse to the grantor, because the existence of the trust is ignored under Rev. Rul. 85-13. Since the selling spouse is treated as selling the asset to his or her spouse (the grantor of the trust), and since sales between spouse are not subject to income tax, there should be no income tax on the sale. Code Sec. 1041.

However, Code Sec. 1041 does not completely foreclose all income tax effects of transactions between spouses. For example, if the trust pays the selling spouse (who is not the grantor) for the purchased property by issuing an interest bearing note, the interest paid or imputed will be included in the gross income of the grantor and be deductible by the grantor's spouse to the extent specified in Code Sec. 163. As long as the asset purchased from the trust is an investment asset, the interest should be investment interest, deductible by the selling spouse to the extent of investment income. If the grantor and the grantor's spouse file a joint income tax return, the income from the interest and the deduction for it likely will "cancel" out.

Nonetheless, there will be other consequences. For example, the adjusted gross income of the couple will increase, potentially leading to other consequences on a joint income tax return. For example, increasing the adjusted gross income raises the threshold in deducting charitable contributions under Code Sec. 170. On the other hand, it may increase the amount of certain itemized deductions that will be reduced under Code Sec. 68. Thus, even though the sale by the spouse of the grantor, combined with a special power of appointment, should foreclose any deemed taxable gift, all additional consequences should be considered.

Further, state and local income tax consequences should be considered. For instance, in some jurisdictions, certain itemized deductions (including that for investment interest paid) may be disallowed or limited.

In any case, even if the spouse will make the sale, the purchase (buy-sell) agreement between that spouse and the grantor trust will provide for a defined formula purchase price.

Summary and Conclusions

An ISGT may be a very effective estate tax planning strategy. There is, however, a risk that the IRS may claim a gift has been made by such a sale. To reduce that risk, WTP is modifying its irrevocable trust form (the trust to which the sale is made), the goal being to reduce the risk of a large inadvertent gift. In addition, WTP will be offering a purchase (buy-sell) agreement incorporating a formula defined purchase price. Such a formula approach should further reduce the risk of an inadvertent gift by reason of the ISGT. Finally, WTP will be offering a disclaimer and renunciation form by which the purchasing trust's Principal Beneficiary may disclaim any gift made to the trust as a consequence of the sale to the trust by the grantor.

Thinking About the **IMPOSSIBLE** for 2010 No Estate Tax and Carryover Basis

By Jonathan G. Blattmachr and Michael L. Graham

Under current law, the federal estate tax will be eliminated for the year 2010. The income tax "step-up" in basis rule for most property included in a decedent's estate also is eliminated for that year. Rather, the decedent's basis "carries over" to those who succeed to the property subject to special rules. Although many, if not most, estate planners thought the chance of zero estate tax with carryover basis for one year was extremely unlikely—perhaps, even less likely than permanent repeal and carryover basis—it may be that 2010 will be known as the one year without estate tax.

It seems appropriate to think about that possibility in planning now. Perhaps certain clients (such as those who own property with liabilities in excess of income tax basis or what is called "negative basis" property) should be warned about the prospects of carryover basis. It also seems sensible to consider the carryover basis issues for many married clients who just might die in that year with a surviving spouse. This article will focus on how certain estate planning documents (wills and revocable trusts, for example) might be structured in light of the possibility of a year without estate tax.

How Big Is the Formula Marital Deduction If There Is No Marital Deduction?

Usually, the estate plan for a married person who wants to maximize the use of his or her unified credit (or federal estate tax exemption) provides for his or her estate to be divided into two broad shares: one equal to the amount of

the federal estate tax exemption and the balance in a form qualifying for the estate tax marital deduction. Generally, there are three broad ways to effect this division: (1) make the amount of the federal exemption a fixed sum of money, (2) make the amount of the marital deduction a fixed sum of money, or (3) make each a fractional share. In each case, a word formula is used to define at least one of them. Sometimes, it defines the federal exemption—and although there are several variants, all essentially say to determine the maximum taxable estate the married person could have at death without paying federal estate tax on account of the unified credit (and, perhaps, other credits). Other times, it defines the amount of the marital deduction. Again, there are several ways to phrase it, but essentially it says to determine the minimum amount necessary as the federal estate tax marital deduction in order to reduce the federal estate tax to zero. Experience teaches that defining either the federal exemption or the marital deduction that way works "just fine" for estate tax purposes.

But just what does either word formula produce if no federal estate tax is in effect when someone dies? If there is no federal estate tax, what is the maximum *taxable* estate one can have without increasing his or her federal estate tax? The concept makes no sense because there will no longer be a taxable estate. Alternatively, what is the minimum marital deduction necessary to reduce the federal estate tax to zero when there is no marital deduction or federal estate tax? Again, the concept makes no sense if there is no marital deduction. One can imagine, in a case in which the spouse of a second marriage succeeds to the marital deduction amount and the children from a prior marriage of the decedent succeed to the exemption amount, that the widow(er) and the children would take diametrically different positions over what each receives.

Even if there is no dispute among the surviving family members (they all agree everything passes under the disposition of the exemption share, for example), the IRS may not agree. And it will have an interest in the outcome in at least two ways. First, it is likely that the exemption share will pass into a trust, and the income earned thereon will not necessarily be taxed to the surviving spouse or to other fam-

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ily members. If the property passes to the surviving spouse (or to a marital deduction trust), the income will be taxed to the surviving spouse (except trust income allocated to corpus and not distributed). Second, the IRS will have a keen interest in the surviving spouse receiving more because the survivor likely will die in a later year when there is an estate tax. Certainly, some practitioners will contend that whatever the result, it can be resolved post-death by a disclaimer. For example, they will contend that the whole estate can pass under the federal exemption disposition by having the widow(er) disclaim any marital deduction disposition under section 2518 of the Internal Revenue Code of 1986 as amended ("Code"). But if the proper construction is that there is no such disposition (that is, everything passes into the marital deduction share if the decedent's spouse survives and nothing passes as part of the federal exemption disposition), the disclaimer will not produce the desired result. In any case, experience indicates that many a surviving spouse is reluctant to disclaim.

Perhaps the judges who will decide this issue will be consistent. But most would agree that a better choice is to let the clients decide. There seem to be two broad choices. One choice is to provide that, in the event there is no federal estate tax in effect when the first spouse dies, the entire estate passes under the marital deduction disposition and rely on the surviving spouse disclaiming that disposition if it "makes sense" to do so. But, as indicated above, and as Prof. Jeffrey Pennell has observed, "[A]mong the world's greatest lies are: (1) 'The check is in the mail'; (2) 'I'm from the government and I want to help you'; and (3) 'Of course I'll disclaim if it will save taxes.'" Tax Mgt. Portfolio No. 843-2d: Estate Tax Marital Deduction, at I.E.3, n.55.

An alternative is to direct that the entire estate passes under the disposition of the exemption amount. In such a case, it no doubt makes sense to ensure that the surviving spouse is a beneficiary of that trust, either entitled to income or eligible to receive income

and corpus. The widow(er) might be given the right to demand property from that trust for his or her health, education, maintenance, and support (although in some states this may subject the trust assets to the claims of creditors of the surviving spouse; see *In re Flood*, 219 N.Y.L.J. No. 4, at 32, col. 3, Mar. 1998, aff'd, 691 N.Y.S.2d 354 (N.Y. App. Div. 1999)). In addition, the survivor could be granted the right to direct where the trust is to pass on his or her death, and the trustee may be authorized to consider the needs of the



surviving spouse as more important than those of other beneficiaries, including remainder beneficiaries.

One more complication: the decedent's estate may still be subject to state estate tax even if there is no federal tax. Hence, the practitioner must decide if the "traditional" division between an exemption share and a marital deduction share should be used to take advantage of the state exemption and to avoid state death tax (by also using the state estate tax marital deduction). Some practitioners likely will decide that it is preferable to pay a relatively small state estate tax (by having the entire estate of the spouse dying in 2010 passing into an estate tax exemption or credit shelter trust) than potentially increasing the estate of the surviving spouse who is likely to die after the federal estate tax has come back into effect.

In any case, when the married client decides that his or her entire estate (except for specific or dollar bequests,

perhaps) should pass as would the federal exemption (into a so-called credit shelter or bypass trust, for example), the following fractional share language might be considered (if using a pecuniary formula, similar changes should be made). Also, the bracketed language in italics would be added if reference should be made to state estate tax if there is no federal estate tax in effect:

A. If my spouse survives me, I give a fractional share of my estate as determined after payment of transfer taxes, expenses and any other pre-residuary gift, the numerator of which shall be equal to my Estate Tax Exemption and the denominator of which shall be equal to the value, as finally determined for Federal estate tax purposes, [(or, if there is no Federal estate tax in effect at the time of my death, as finally determined for death tax purposes under the law of the state of my domicile)] of my estate as so determined to the Trustee of the Credit Shelter Trust under this Will, to be disposed of under the terms of that trust.

In the following definition of "Estate Tax Exemption," the first bracketed phrase in italics should be included if you wish to take state death taxes into account in a "decoupled" state, but this may result in a relatively small state death tax savings at the death of the first spouse, as compared to a substantially overall higher federal estate tax at the death of the surviving spouse. The second and third bracketed phrases in italics should be included if reference should be made to state estate tax if there is no federal estate tax in effect:

B. My "Estate Tax Exemption" means the largest amount that can pass to the Credit Shelter Trust without increasing the Federal estate tax [and without increasing the state death tax] due by reason of my death, [or, if I

die when there is no Federal estate tax, without increasing my state of domicile's death tax if my state of domicile's death tax law permits an unlimited exemption or deduction for transfers to a surviving spouse and an exemption or credit against the state death tax regardless of the person to whom property passes,] and shall mean my entire estate, to the extent not effectively disposed of by the provisions of this Will preceding this gift, if there is no Federal estate tax [and, under the law of the state of my domicile, if there is no state death tax] in effect at the time of my death.

Carryover Basis Matters

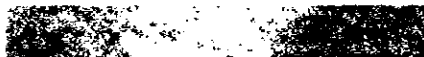
For persons dying in 2010 (whether or not married), some consideration ought to be given to the carryover basis rules. Those rules are found in Code § 1022, which is to become effective if the currently enacted estate tax repeal rule is not changed before 2010.

Under Code § 1022, the basis of assets acquired from a decedent will not equal their estate tax values for any year that no federal estate tax is in effect. During that time, the decedent's basis will "carry over" to those who succeed to the property on the decedent's death (although in no event can the basis exceed its fair market value at death).

There are exceptions and special rules. Under one of these, the executor/personal representative may allocate up to \$1.3 million to increase the basis of assets up to their fair market value. (The \$1.3 million amount is increased by certain pre-death losses of the decedent. Different thresholds apply for a noncitizen, nondomiciliary of the United States.) For example, assume a decedent owns a piece of real estate worth \$5 million on her death for which her basis is \$800,000. Under Code § 1022, the decedent's \$800,000 basis would remain the basis in the real estate when she dies. The executor/personal representative may increase the basis of the land to \$2.2 million by allocating the entire \$1.3 million basis increase to that asset.

Authorize Executor/PR to Allocate to Nonprobate Assets

Because the executor is a fiduciary under the decedent's will and has no direct authority or responsibility for nonprobate assets, it may be that a beneficiary under the will would contend that the executor must allocate, to the extent possible, the \$1.3 million basis increase to probate assets. In that event, the beneficiary would also undoubtedly contend that an executor who allocates basis to property outside the probate estate, without specific



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authorization, would be subject to removal, surcharge, or loss of commissions. Hence, it may be best to provide expressly in the client's will that the executor/personal representative may allocate part or all of the \$1.3 million basis increase allowed under Code § 1022 to any asset or assets in the decedent's gross estate including those passing outside of the will. Of course, this provision must be contained in the will as it is the executor who makes the allocation (and not, for example, the trustee of any revocable trust created by the property owner, even if such a trust is the principal estate planning document used to transmit wealth when the property owner dies). The following is a sample provision that might be inserted in a will so the executor/personal representative is expressly authorized to allocate any basis increase (including the \$3 million spousal basis increase discussed below) to nonprobate property.

Adjustments to Basis. I authorize my Executor/Personal Representative, in the exercise of sole and absolute discretion, to make any adjustment to basis authorized by law, including but not limited to increasing the basis of any property included in my gross estate, whether or not passing under my will, by allocating any amount by which the basis of assets may be increased. My Executor/Personal Representative shall be under no duty and shall not be required to allocate basis increase exclusively, primarily or at all to assets passing under this instrument as opposed to other property included in my gross estate. I waive any such duty that otherwise would exist. Any such allocation shall not cause my Executor/Personal Representative to be liable to any person or to be subject to removal or forfeiture of commissions or other compensation.

Authorize Executor/PR to Allocate to Own Assets

Whether or not the executor/personal representative is authorized to allocate the \$1.3 million basis increase allowed under Code § 1022 to any asset or assets in the decedent's gross estate including those passing outside of the will, the question arises about whether the executor/personal representative may allocate basis to property the fiduciary is "inheriting" individually or as a trustee, as opposed to being required to allocate all or a pro rata portion of the basis step-up to property others receive. Hence, it may be appropriate for the property owner's will to provide expressly that the executor/personal representative may or may not allocate that basis increase to assets that the executor/personal representative is receiving. A sample provision permitting that might be written as follows:

My Executor may elect, in the exercise of sole and absolute discretion and without permission of any court or other authority, to allocate basis increase to one or more of all assets that any Executor receives or in which the Executor has a personal

interest to the partial or total exclusion of other assets with respect to which the election could be made. Any such allocation shall not cause my Executor to be liable to any person or to be subject to removal or forfeiture of commissions or other compensation.

An ancillary issue is that if, under the will or governing law, the executor has the discretion to allocate the basis increase to assets he or she is receiving, the fiduciary who does not do so might be treated as making a taxable gift, bestowing a tax benefit away from himself or herself to another. Of course, that issue arises for other tax options and elections as well. See generally J. Blattmachr, M. Gans & S. Heilborn, *Gifts by Fiduciaries by Tax Options and Elections*, Prob. & Prop., Nov./Dec. 2004, at 39. A sample provision that might be inserted in an instrument to attempt to avoid having a fiduciary be deemed to have made a gift by the manner in which a tax election or option is exercised (or not exercised) might read something like the following:

No individual fiduciary hereunder shall participate in any decision with respect to any tax election or option, under Federal, state or local law that could enlarge, diminish or shift his or her beneficial interest hereunder from or to the beneficial interest hereunder of another person. Any such tax election or option shall be made only by a fiduciary or fiduciaries that do not have a beneficial interest hereunder or whose beneficial interest could not be enlarged, diminished or shifted by the election or option. If the only fiduciary or fiduciaries who otherwise could exercise such tax election or option hold beneficial interests hereunder that could be so enlarged, diminished or shifted, another individual or a bank or trust company (but not an individual, bank or trust company that is related or subordinate within the meaning of Code Sec. 672(c) to any acting fiduciary hereunder) shall be appointed by

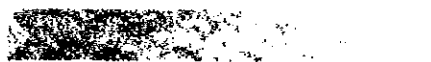
the fiduciary or fiduciaries by an acknowledged instrument delivered to the person so appointed and the fiduciary so appointed shall alone exercise any such election or option.

Make Bequest to Use Spousal Basis Increase

In addition to the \$1.3 million basis increase the executor/personal representative may allocate to assets, that fiduciary is authorized to allocate up to \$3 million to increase the basis of assets that are received by the property owner's surviving spouse or a QTIP (qualified terminable interest property) trust. For example, assume that the decedent bequeaths a piece of real estate worth \$5 million to her husband.



There is a "tie in" here between the estate tax repeal and the carryover basis that ought to be considered for several married persons who might die in 2010.



Also assume that her basis in the property was \$800,000. Under Code § 1022, the decedent's \$800,000 basis would remain the basis in the real estate when she dies, and is inherited by her husband. The executor/personal representative, however, may increase the basis of the land to \$3.8 million, by allocating the entire \$3 million spousal property basis increase to that asset.

There is a "tie in" here between the estate tax repeal and the carryover basis that ought to be considered for several married persons who might die in 2010. As indicated above, it may well be that a will or revocable trust that provides for an "optimum" marital deduction (that is, the part of the estate equal to the federal estate tax

exemption passes one way and the balance qualifies for the marital deduction) will be construed as having all the property pass as part of the federal exemption share such as to a "credit shelter trust." Unless that trust just happens to be in the form of a QTIP trust, there may well be insufficient assets in the decedent's estate to be able fully to use the special \$3 million spousal property basis increase. And it is unlikely that a disclaimer even by all the beneficiaries of the credit shelter trust will save the day—the disclaimed assets may not pass to the marital deduction disposition because that disposition never could come into effect based on the construction of the instrument. (Maybe, just maybe, if the disclaimed property passes into intestacy and the surviving spouse is the only heir-at-law or all other heirs disclaim—a complicated matter to say the least—it will pass to that spouse and there will be property to which the \$3 million spousal property basis increase may be allocated.)

One simple way to ensure there is enough property to which the special \$3 million spousal basis increase can be allocated is to bequeath all assets to the surviving spouse. As indicated above, however, a married property owner may not want to have his or her entire estate pass to the surviving spouse for several reasons. One reason is that if the estate tax is reenacted by the time the surviving spouse dies, assets the survivor has inherited outright presumably would be included in the survivor's gross estate for federal estate tax purposes. Hence, the married property owner may want his or her entire estate to pass into a trust that will not be included in the gross estate but from which the surviving spouse may benefit. For several reasons (including creditor protection for the surviving spouse and to permit maximum income shifting among surviving family members), the married property owner may want the assets placed in a trust from which the trustee may distribute property to the surviving spouse or to the property owner's descendants. But such a trust is not the type to which any portion of the special spouse \$3 million spousal property basis increase may be allocated. Hence, an

outright bequest either to the spouse or to a QTIP trust (from which all income must be paid to the spouse for life) must be created to be able to make that allocation.

Outright or QTIP Trust?

An initial question is whether, in making such a disposition to ensure use of the \$3 million spousal basis increase, the disposition should pass outright to the surviving spouse or to a QTIP trust. It is at least arguable that a QTIP trust is preferable. One reason relates to estate tax inclusion when the surviving spouse dies. Certainly, anything he or she inherits will be in his or her estate when he or she later dies (and the estate tax is likely back in effect). But the QTIP trust may not be so included. At least under current law, that QTIP trust created by a married person while no federal estate tax is in effect would not be included in the estate of the surviving spouse. Although a QTIP trust is included under Code § 2044 in the estate of the spouse for whom it was created, that section applies only if the spouse who created it got the benefit of an estate or gift tax marital deduction. Because there would have been no estate tax in effect when it was created, it should not be included in the estate of the surviving spouse. Therefore, using a QTIP may be the better choice to take advantage of the \$3 million spousal property basis increase.

How Much Must Pass to Use the \$3 Million Spousal Basis Increase?

The disposition to or for the spouse to which the executor/personal representative is to allocate the \$3 million spousal property basis increase may be structured in several ways. It is important to realize that it is a \$3 million *increase in basis* and *not* just an allocation to \$3 million *worth of assets* to which the allocation applies. An example may help to illustrate this principle. Assume a married woman dies in 2010 when there is no federal estate tax. She bequeathed her husband stock worth \$3 million in which her basis was \$1.4 million, a piece of land worth \$2 million in which her basis was \$100,000, and a painting worth \$4 million of which her basis was \$1 million. The inherent gain in the assets are (1) \$1.6 million in the

stock, (2) \$1.9 million in the land, and (3) \$3 million in the painting. Suppose the executor wants to increase the basis in the stock to its \$3 million fair market value. The executor would not allocate the entire \$3 million basis increase to the stock even though it is worth \$3 million, but would allocate only \$1.6 million. The carryover basis of \$1.4 million plus the allocation of an additional \$1.6 million of basis to the stock will increase its basis to \$3 million, its fair market value when the property owner died. (Note again that the executor cannot allocate more to an asset than will increase its basis to its fair market value at the decedent's death). The executor will allocate the balance of the \$3 million spousal basis increase (such balance being \$1.4 million) to the other assets. For example, the executor might allocate this balance to the painting, bringing its basis up from \$1 million to \$2.4 million. Alternatively, the executor might allocate the entire \$3 million basis increase to the painting, bringing its basis up from \$1 million to its full fair market value of \$4 million.

Ways to Structure the Marital Bequest

There seem to be two principal ways to structure the bequest to the spouse or a QTIP trust. One is to minimize the amount that will be transferred to the spouse or the marital trust. The other is to maximize income tax savings. Here is an illustrative comparison. A married man dies with two assets. One is a \$4 million vacant parcel of land in which his basis is \$1 million. The inherent profit in the land is long-term capital gain. The other asset is a commercial building worth \$10 million with a basis of \$7 million on which he has taken accelerated depreciation for tax purposes. A portion of the inherent profit in the building will be taxed at higher than the 15% long-term capital gains tax rate. Both assets have inherent untaxed profit of \$3 million, but the gain in the vacant land will face a lower tax than will the commercial building. So allocating the \$3 million spousal basis increase to the commercial real estate will save more income tax, but it may put more in the

spouse's estate (although, as mentioned, any asset given to a QTIP trust while the carryover basis rules are in effect should not be included in the estate of the surviving spouse, at least as the law is now written).

Clients need to decide whether their principal goal is to minimize what the surviving spouse receives (or will be paid to a QTIP trust for the survivor) while still being able to use the entire \$3 million spousal property basis increase, or to minimize potential income taxes even if it means the survivor (or the QTIP trust) will receive more. Here is a sample provision that might be considered to minimize what the surviving spouse receives to fully use the basis increase allowed for qualified spousal property:

Qualified Spousal Property Gift. If I die when there is no Federal estate tax in effect, I give to the Trustee of the QTIP trust hereunder the lesser of (i) all carryover basis property passing hereunder and not disposed of by the foregoing provisions of this instrument, or (ii) those assets, not effectively disposed of by the foregoing provisions of this instrument, having the lowest combined value as of my date of death as finally determined for Federal tax purposes to which my Executor may allocate the entire basis increase allowable, after reducing such basis increase allowable, as of my date of death under Code Sec. 1022(c), by the basis increase that could be allocated to any other assets otherwise constituting qualified spousal property and otherwise passing to my Spouse or a qualified terminable interest property trust within the meaning of Code Sec. 1022(c), whether under this instrument or otherwise. The purpose of this gift is to take maximum advantage of the basis increase allowed under Code Sec. 1022(c) if I die when the carryover basis rules are in effect, but minimize the amount of property passing to the qualified terminable interest property trust and I direct that this provision be construed to achieve that result. For purposes of this paragraph, the term "carryover

basis property" means property with respect to which the additional basis increase under Code Sec. 1022(c) could be made if it were acquired by my Spouse.

And here is a sample provision that might be considered to maximize income tax saving through the use of the basis increase allowed for spousal property:

Qualified Spousal Property Gift. If I die when there is no Federal estate tax in effect, I give to the Trustee of the QTIP trust hereunder the lesser of (i) all carryover basis property passing hereunder and not disposed of by the foregoing provisions of this instrument, or (ii) those assets not effectively disposed of by the foregoing provisions of this instrument, having the lowest combined value as of my date of death as finally deter-

mined for Federal tax purposes that would produce the greatest income tax (taking into account the nature of the inherent gain) if sold for such value to which my Executor may allocate the entire basis increase allowable, after reducing such basis increase allowable as of my date of death under Code Sec. 1022(c) by the amount that could be allocated to any other assets otherwise constituting qualified spousal property and otherwise passing to my Spouse or a qualified terminable interest property trust within the meaning of Code Sec. 1022(c). The purpose of this gift is to reduce potential income taxes attributable to inherent gain in carryover basis property passing hereunder while attempting to minimize the amount of property passing to the qualified terminable interest property trust and I direct that this provision be construed to achieve that result. For purposes of this paragraph, the term "carryover basis property" means property with respect to which the additional basis increase under Code Sec. 1022(c) could be made if it were acquired by my Spouse.

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Summary

Although most would probably place the chances at less than 50% that the year 2010 will bring a repeal of federal estate tax and its companion carryover basis, it is far from impossible. It seems prudent to plan for repeal of federal estate tax and carryover basis now by having a decedent's estate planning documents structured to maximize flexibility and savings. In addition, married clients need to decide how much should pass into a nonmarital deduction trust and how much, if any, should pass to (or in a QTIP trust for) the surviving spouse. Although from an overall perspective it seems appropriate to minimize what the survivor inherits if there is no estate tax, the carryover basis provisions suggest a sizable disposition to the spouse (or, perhaps, better yet, to a QTIP trust) to take advantage of the \$3 million spousal increase in basis rule under Code § 1022. Also, executors/personal representatives should be specifically authorized to make such allocations of basis increase as they think best. ■