BETH SHAPIRO KAUFMAN

Happy New Year: Out With the Old, In With the ... Older!

Now that we have nearly survived the year 2010, it is time to look ahead to see what awaits us in 2011. The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) will sunset on 12/31/2010, and we will return to 2001 law, unless Congress acts before then to make changes. The time travel back to 2001 is sure to be painful and complicated.

For decedents who die after 2010, the top marginal estate and gift tax rate will be 55% (with a 5% surtax on estates between $10 million and $17 million to take away the benefits of the lower rates and the exemption amount). The applicable exemption amount will return to $1 million, producing one result for which attorneys have advocated: a return to a truly "unified" credit. Also returning will be the state death tax credit (although more than a few states have repealed their state death taxes) and step-up in basis at death.

The generation-skipping transfer (GST) tax will be assessed at a flat 55% rate, with an exemption of $1 million indexed to 2011 dollars (approximately $1.34 million). Other GST tax fixes from EGTRRA will fade out in the sunset. The statutory authorization for qualified severances will be gone, as will all of the changes to Sections 2632 and 2642 allowing for relief for missed exemption allocations, substantial compliance, automatic allocations, and qualified severances. (See Exhibit 1.)

While wealthy individuals will not like the estate and gift tax changes, at least they can understand them. The GST changes, stemming from the sunset provisions, create some very complex problems for 2011 and beyond.

A close look at the sunset

The problems with the GST tax in 2011 and beyond are created by the sunset provision in section 901(a) of EGTRRA, which states as follows: "All provisions of, and amendments made by, this Act shall not apply ... to generation skipping transfers after December 31, 2010." The mandate continues in section 901(b): "The Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted."

Consider the rest of this column a plea to Congress. Help us, Congress! We need answers.

Now you see it, now you don't

From 2001 to 2009, the exemption from GST tax gradually increased, reaching $3.5 million in 2009. Consider, for instance, the situation of a grandmother who used her entire $3.5 million of GST tax exemption in 2009 to fund a trust for her grandchildren. Now fast forward to 2011, where we are told that the Code should be applied and administered as if the provisions of EGTRRA had never been enacted. Does the grandmother's trust have a zero inclusion ratio for GST tax purposes? Theoretically the trust should have a zero inclusion ratio because the grandmother had $3.5 million of exemption available to her when she created, funded, and allocated exemption to the trust. However, if the sunset language is taken at face value and we are really to pretend that EGTRRA never existed, the grandmother's trust could not have a zero inclusion ratio. That the grandmother's trust continues to have a

BETH SHAPIRO KAUFMAN, of the District of Columbia and Maryland Bars, is a partner in the Washington, D.C., office of the law firm of Caplin & Drysdale, Chartered. She is also a Fellow of the American College of Trust and Estate Counsel, and has written and lectured extensively on estate planning.

zero inclusion ratio seems to be the "right" answer; otherwise, the existence of the higher exemption level in the intervening years would provide no benefit to taxpayers. Without guidance from Congress or the IRS, we cannot be certain of the answer in this situation.

For another example of "now you see it, now you don't," consider a deemed allocation made under Section 2632(c). Section 2632(c) is one of several helpful Code provisions enacted in 2001 to try to keep lawyers and accountants from making mistakes that are costly to the taxpayer. In this case, Section 2632(c) makes the assumption that if you have a fact pattern in which there is a very high likelihood that there will be a transfer to a skip person, the taxpayer would want to allocate exemption to that transfer. For the rare occasion in which the taxpayer does not prefer the automatic allocation, an opt-out provision is supplied.

A question arises for those who relied on the deemed allocation rules to allocate GST exemptions logically: What happens under the sunset rule when the deemed allocation rules are to be treated as if they had never been enacted? One would think that taxpayers should have the benefit of deemed allocations made in 2001 through 2009, but the sunset provision calls that conclusion into question.

Also, what about the hundreds (if not thousands) of taxpayers who paid hefty user fees to the IRS (and even larger fees to their attorneys or accountants) to obtain for them relief allowing them to make a late retroactive allocation of GST tax exemption under Section 2642(g)? Are the private letter rulings issued by the National Office of the IRS in those cases still binding on the IRS and useful to the taxpayers? Certainly they should be binding, but the sunset language could be read to make the relief vanish.

EXHIBIT 1
Scheduled Changes in Transfer Tax Rules

	2009 Law	*2010 Law*	*2011 Law*
Exemption amount for gift tax	$1,000,000	$1,000,000	$1,000,000
Exemption amount for estate tax	$3,500,000	No estate tax	$1,000,000
Exemption amount for GST	$3,500,000	None (no GST tax)	$1,000,000 indexed (approx. $1,340,000)
Maximum rate	45%	35% (gift tax)	55%
Surtax on large estates?	No	No	Yes
State tax death credit?	No	No	Yes
State death tax deduction	Yes	No	No
DOD basis?	Yes	No	Yes
Relief provision in effect?	Yes	Yes	No

In a similar posture, are all of the qualified severances made pursuant to the authority granted in Section 2642(a)(3). Do those trusts remain severed after the sunset of EGTRRA? Again, they should be.

Summary of views

In my view, relief granted during the 2001 to 2010 period should remain valid. The relief provisions were in effect when the relief was granted. The taxpayer sought and took advantage of the relief provisions while they were the law. The sunset provision should not be construed to undo the laws that were in effect from 2001 to 2010; it should merely prohibit use of the relief provisions starting in 2011.

Gift tax issue

EGTRRA modified Section 2511(c) to cause some transfers that would not have been considered completed gifts prior in 2009 to be deemed to be completed gifts in 2010. Section 2511(c) provides that in 2010, transfers in trust are treated as completed gifts unless the trust is a grantor trust treated as owned by the donor or the donor's spouse for income tax purposes. While one can debate the wisdom of this provision as a substantive matter, the current issue is a question of the impact of the sunset provision. If a gift was treated as a completed gift under Section 2511(c) in 2010, is it still a completed gift in 2011 when the sunset rule tells us to pretend that EGTRRA never happened? If the answer to that question is yes, what happens in the year in which the grantor's (or the grantor's spouse's) power over the trust terminates and the gift becomes complete under current law? Does the donor owe a second gift tax on the same property? Clearly that is not a sensible answer, so either Congress or the IRS needs to provide some guidance on this issue.

Treatment of GST tax events occurring in 2010

Because the GST consequences of a transfer more often than not do not confine themselves to a single year, a series of 2010 issues carry over into 2011 and need congressional or IRS attention to be resolved.

Very little is clear about the consequences of generation-skipping transfers made in 2010. It is easy to summarize what seems clear:

- If a grandmother made an outright gift or bequest to her adult grandchild in 2010, the GST tax did not apply to that transfer.
- If an existing trust made a distribution to an individual who was a skip person in 2010, that too does not attract a GST tax.

Examples abound of what is not clear. As the following situations illustrate, we need more help from Congress and the IRS to sort all this out.

Direct skip in trust under a will in 2010. Suppose a grandmother died in 2010 (may she rest in peace) and under the terms of her will, a trust was created for the benefit of her grandchildren. Ordinarily, under pre-2010 law, we would have considered that to be a direct skip subject to the GST tax when the trust was funded. Then in later years, when distributions were made from that trust, no GST tax would apply because the treatment of the funding of the trust as a direct skip would have caused grandmother to be treated as being a member of the generation one above that of her grandchildren under Section 2653. Because of the Section 2653 "move-down rule," the distributions out of the trust in a later year would not be generation-skipping distributions, and no GST tax would apply at that time.

The lack of a GST tax in 2010, however, throws a few monkey wrenches into the statutory scheme. First of all, we typically look for a transferor under the Code to determine whether we have a generation-skipping transfer at all. The transferor is the person in whose estate the assets were taxed or who was the donor under the gift tax. Because the grandmother, in this example, died in 2010 when there was no estate tax, she does not fit the definition of a transferor. Second, the language of the sunset provision does not cure this absence, because even a broad reading of the sunset provision does not retroactively impose an estate tax on a 2010 decedent's estate. Thus applied literally, the EGTRRA provisions seem to provide that no GST tax can ever apply to a distribution from a trust created under the will of a 2010 decedent.

That conclusion seems generous and perhaps unintended, but it is not unsupported (at least with respect to transfers to trusts that are themselves skip persons). Consider the purpose of the sunset provisions: They were intended to cut off the revenue loss from EGTRRA and make sure that EGTRRA had

no revenue impact after 2010. Where under pre-2010 law the GST tax would have applied to the direct skip to the trust at the time of grandmother's death, the sunset provision and literal terms of the law seem to work. The GST tax that has been avoided is one that would have been imposed in 2010 had the GST tax not been repealed for 2010. Therefore, this appears to be a revenue loss that was intended, and not some added benefit.

On the other hand, had the grandmother named both her children and her grandchildren as beneficiaries of her testamentary trust, the GST tax event would not have occurred in 2010, but rather in some later year or years when distributions were made from the trust to her grandchildren. If we treat that non-skip person trust as exempt from the GST tax, the federal fisc is losing revenue not in 2010, but in some later year. That result was supposed to be prevented by the sunset provision. Nevertheless, a literal reading of the statute would lead to the conclusion that the grandmother's testamentary trust has no transferor and thus cannot be subject to the GST tax. If Congress did not intend this result, remedial legislation is needed.

Direct skip in trust by gift in 2010. An inter vivos direct skip in trust produces a somewhat different problem. If the grandmother had only minor grandchildren, she might have been tempted in 2010 to create a trust for the benefit of those grandchildren while the GST tax was not in effect. While this trust might be identical to the testamentary trust for grandchildren described above, the statute applies differently to it. Unlike the estate tax, the gift tax was fully applicable in 2010. Thus, the grandmother's inter vivos trust has a transferor under the Code because the grandmother was the donor of a gift that was subject to the tax imposed by Chapter 12.

The question here is whether the move-down rule of Section 2653 applies. It should not apply in 2010 because the GST tax in its totality does not apply in 2010. What about in 2011, when we are supposed to read the Code "as if" EGTRRA never happened? A gift tax was paid with respect to grandmother's funding of the trust in 2010. Does the move-down rule then apply retroactively in 2011 to cause the grandmother to be treated as being only one generation above her grandchildren's generation?

Looking at this transaction through the revenue glasses, it is not offensive to say that a direct skip in trust in 2010 escapes the GST tax. After all, the taxable event should have been the transfer into the trust in 2010, and it was not taxed because the GST tax did not apply in 2010. The events occurring in later years would not be generation-skipping events absent EGTRRA, so no revenue is being lost in those years.

Other transfers in trust in 2010. An inter vivos transfer in trust for the benefit of children and grandchildren in 2010, however, is a different matter. In that situation, under normal application of the GST tax, there would not have been a taxable event in 2010. Rather, the event that would attract a GST tax would be the distribution out of the trust in a later year, a year in which the GST tax applied. Consequently, it does not seem offensive for the government to take the position that taxable distributions or taxable terminations from a generation-skipping trust funded by the grandmother in 2010 should be subject to GST tax in those later years.

Conclusion

Clearly, Congress needs to revisit the GST tax as soon as possible. Legislation is needed to clarify both the status of actions taken while EGTRRA was in effect and the consequences of the one-year repeal of the GST tax on transactions that have a continuing effect in later years. While this discussion has pointed out the revenue impact of various generation-skipping scenarios to support a particular result, Congress is unlikely to feel constrained by that analysis and could easily enact legislation to provide a different result. Thus, caution must be used in thinking that we really *know* much of anything about these issues, and we can only hope that Congress will provide some clarity in the near future.

One thing that can be said for 2010 and 2011 is that the state of the law has provided some very interesting work for estate planners. It has given us the opportunity to explore interesting questions with only hypothetical answers, and to plan in an uncertain environment. While we might enjoy this exercise on an intellectual level, a great disservice is being done to taxpayers who need real and dependable answers to their questions. Let us hope that those answers are forthcoming, and soon. ■