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2010: The Anatomy of a Train Wreck

I could not have been more wrong when I wrote these words for the June 2009 issue of ESTATE PLANNING:

> When Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 2010 seemed like a time in the distant future. EGTRRA contained the promise of a one year repeal of the estate tax, in 2010, followed by a reversion to prior law (with a $1 million exemption) in 2011. Now 2010 is nearly upon us, and Congress needs to act swiftly to avoid the train wreck that it put into play in 2001. All indications are that 2009 will be the year to stop the train.[1]

Alas, Congress did not stop the train. The House did its part, passing a bill to continue 2009 law regarding the estate, gift, and generation-skipping transfer (GST) tax through 2010 and beyond,[2] but the Senate did not take up the bill before the end of 2009. Thus, as I write this column, we have no estate or generation-skipping transfer tax in effect, and the gift tax applies at a low, flat 35% rate with a $1 million exemption. We also have the greatest uncertainty in estate planning that has existed in our lifetimes.

How did we get here?

The 2010 train wreck was placed on the tracks in 2001, when Congress passed EGTRRA and included a one-year repeal of the estate and GST taxes and introduction of a modified carryover basis regime in 2009, followed by a sunset provision that caused reversion to pre-EGTRRA law on 1/1/2011. As I said in my June 2009 column, no one expected that actually to occur; rather, everyone assumed that Congress would act sometime between 2001 and 2009 to enact a more rational law. Unfortunately, due to a combination of political and economic conditions, and in an act of what some commentators have called "congressional malpractice," Congress did not change the law, and the train wreck that was never supposed to occur did.

Where are we?

At least four major factors are complicating the estate planner's life right now. The most troubling issues are presented by the sunset provision itself. Section 901 of EGTRRA reads as follows:

> Sec. 901 Sunset of Provisions of Act
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> (a) In General. — All provisions of, and amendments made by, this Act shall not apply ... (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.
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> (b) Application of Certain Laws. — The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

To the extent that the estate, gift, and GST taxes apply once to a discrete situation, we can understand the meaning of the sunset provision. For example, if EGTRRA reduced the gift tax rate to 35% and EGTRRA does not apply to gifts after 2010, then the rate that applies to such gifts is 55%, the rate that was in effect prior to EGTRRA. Where the estate, gift, and GST taxes apply over a period of years, however, it is much less clear how to interpret paragraph (b) of the sunset provision.

It is the "as if the provisions and amendments described in subsection (a) had never been enacted" that is troubling. For example, consider a person who made a GST of $3.5 million to a trust in 2009 and used her entire exemption amount to shelter the transfer. Because the increase in the GST

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exemption amount is a provision of EGTRRA, is that trust fully covered by the exemption allocation after 2010? If we are really to act "as if" EGTRRA was never enacted, it seems that the trust would not be fully exempt any more.

The "as if" language also raises questions about the true application of the modified carryover basis rules. If a decedent dies in 2010 and the executor does not allocate basis to a particular asset, does that asset have a carryover basis after 2010? The language of the sunset provision would seem to regard the carryover basis rules "as if" they were never enacted. Does that mean basis would revert retroactively to step up? Clearly the sunset provision raises many unanswered questions.

A second troubling factor is carryover basis. Our only experience with a carryover basis regime at death is the ill-fated effort to enact such a regime in the late 1970s. The change was so disliked that it was repealed before it went into effect. In 2010, we have tumbled into carryover basis with no support or preparation. The IRS has not issued any guidance, the required tax returns do not exist, and the consequences are unknown. The age-old objection to carryover basis is that by the time taxpayers die, they do not know what the bases in their assets are. By providing for a new basis at death, the lack of record-keeping over a lifetime becomes inconsequential. In a carryover basis regime, that information becomes critical.

The particular modified carryover basis provisions of EGTRRA have their own peculiar problems. Problems include the authority of the executor to allocate basis, whether the executor is subject to any restrictions on how basis is allocated, and whether the estate plan is set up to maximize the ability to use both the general "free basis" and the spousal "free basis." Most wills simply are not drafted to accommodate the 2010 basis provisions. An executor who has to allocate basis without guidance either in the will or under state law may be risking liability no matter what decisions are made.

Third, formula clauses are a disaster in 2010. Any formula clause that makes reference to the unified credit amount, the applicable credit amount, or Section 2010 is suddenly undefined. Is the maximum amount that can pass free of estate tax under Section 2010 zero or the entire estate? With what should a GST trust be funded if the trust arrangement was supposed to maximize the decedent's use of his or her exemption in a year when no exemption is available?

Some states are attempting to remedy the situation by enacting statutes stating that formulas should be construed as if 2009 law were still in effect. Such a remedy, however, will not produce the best result for the heirs in many situations. For example, the family of a very wealthy individual may be better off if the credit shelter trust is funded with more than $3.5 million. If the marital bequest is in the form of a QTIP trust, it will not make much difference whether the amount passing to the credit shelter trust is maximized, whereas if the marital bequest is outright, it would be very important to maximize the funding of the credit shelter trust. In some situations, disclaimers can be used to achieve a better tax result, but other situations will be irreparable. What a mess!

Finally, the uncertainty of 2010 is paralyzing. We have unanswerable questions, and yet some clients wish to move forward with estate planning, and other clients are dying. It is a good time to make gifts—maybe the 35% rate will apply! It is decidedly not a good time to make GST gifts in trust (because there appears to be no GST exemption this year).

Wills can be written, but they are necessarily more complex than usual:

- Formula clauses must contain savings clauses.
- Even if the client would otherwise not prefer to use a marital trust, using a QTIP trust would offer more flexibility than outright marital bequests.
- Personal representatives should be given powers to deal with basis allocation, as well as any other tax elections that might arise.

For decedents dying this year, there are both opportunities and pitfalls. The issues are most acute where there is a surviving spouse. If the will provides for a QTIP trust, the answer is simple: do not make the QTIP election.[3] If the law is changed retroactively and an estate tax return is required to be filed, then the QTIP election would be made at that time. If the marital bequest is outright, however, one would like the surviving spouse to disclaim assets (so that they pass to children or grandchildren) and the "benefit" of dying in the year of repeal is not lost by putting all assets into the surviving spouse's estate. The problem there is with the uncertainty. Should disclaimers be prepared where there is a possibility that the estate tax could be retroactively restored? While there will always be some risk involved in that decision, it is advisable to put off that decision as long as possible to see what develops.

[1] Kaufman, "Estate Tax Legislation in 2009: Avoiding the Train Wreck," 36 ETPL 37 (June 2009) (footnotes omitted).

[2] See H.R. 4154 (passed by the House on 12/3/2009).

[3] In fact, it is probably not possible to make a QTIP election because no estate tax return is available on which to make the election.

Where might we go from here?
The way I see it, one of three things will have to happen:

- Congress will change 2010 law retroactively.
- Congress will change the law (either for the remaining portion of 2010 or for 2011 and beyond) without retroactivity.
- Congress will do nothing.

Here is a look at the ramifications of each of those possibilities.

Congress could act retroactively. The solution that leaves the fewest open questions would be for Congress to reinstate the estate and GST taxes retroactively to the beginning of 2010. That single act would resolve nearly all of the big questions for 2010. If the taxes were reinstated at their 2009 levels, the law would be seamless. The "as if" clause would be gone, carryover basis would be repealed (again) retroactively, formula clauses would work, and nearly all uncertainty would be gone.

Of course there is the problem of constitutionality. If the law is reinstated retroactively, a constitutional challenge will certainly occur. Prior challenges charged that a retroactive change in the tax laws is a violation of the due process clause. Most recently, in *Carlton*,[4] the Supreme Court upheld a retroactive change to the estate tax, denying a deduction for stock sold to an ESOP unless the stock was owned by the decedent on the date of death. The language in that decision would seem to permit almost any retroactive change in the tax law, but the facts in a case challenging retroactive imposition of an estate tax in 2010 would be significantly different from any prior case. Although the courts have repeatedly upheld retroactive rate changes,[5] the imposition of an estate tax in 2010 could be viewed as enactment of a "wholly new tax," which the Supreme Court in *Carlton* distinguished.

The worst aspect of congressional action to reinstate retroactively the estate and GST taxes is the uncertainty it would produce. The *Carlton* case took seven years to work its way through the court system. Any retroactive law imposed in 2010 would clearly be challenged by someone. If that challenge were to take seven years to reach a final determination, we would not know until 2017 whether the estate tax applied to early 2010 decedents. That uncertainty makes the retroactive reinstatement very unattractive.

The passage of time also works against retroactivity. While a retroactive law passed in January or February might have been begrudgingly tolerated, the longer Congress waits to act, the less receptive the public will be to a retroactive law. In fact, if we get to 10/1/2010—when the first estate tax return for a 2010 decedent ordinarily would be due—without congressional action, I think it will be virtually impossible for Congress to impose an estate tax retroactively.

Congress could act prospectively (and perhaps include an election). Congress could avoid a drawn-out and uncertainty-producing constitutional challenge by giving only prospective application to any law passed in 2010. While that action would leave uncertainty for the first part of 2010, it would otherwise raise revenue for the federal purse and address most of the uncertainty issues on a prospective basis. It would leave many GST questions unanswered, however, and require heirs of gap-period decedents to use carryover basis.

An alternative that Congress might embrace is to offer gap-period decedents the option to elect into the estate tax in exchange for resumption of a basis step up (or step down) to fair market value on the date of death. In fact, it would make sense to create a presumption in favor of application of the estate tax and allow people to elect to keep current law, because only the wealthiest of decedents' families would prefer carryover basis to the estate tax. It is unlikely that such an election would raise constitutional issues, so hopefully protracted litigation would be avoided.

Simple prospective reenactment of the estate and GST taxes, however, would not be sufficient. Taxpayers would still need guidance as to how to apply the law in 2010. Without this guidance, certainty cannot be obtained for 2010.

Bear in mind that many other provisions of EGTRRA are also expiring at the end of this calendar year.[6] Congress' appetite for fixing the estate tax will necessarily be tempered by economic and budgetary considerations. The current economic conditions will not allow for the continuation of all EGTRRA tax breaks, and the arguments for con-

[4] 512 U.S 26, 73 AFTR2d 94-2198 (1994).

[5] See, e.g., Darusmont, 449 U.S. 292, 47 AFTR2d 81-519 (1981); Nations Bank, 269 F.3d 1332, 88 AFTR2d 2001-6580 (CA-F.C., 2001).

[6] See discussion of other expiring provisions in Kaufman, "Budget and Taxes and Health Care. Oh My!," 36 ETPL 35 (December 2009).

tinuing those in the estate tax area may be comparatively weak.

Congress could do nothing. Given the economic conditions of our time, Congress has the clear option to do nothing. Let 2010 go, and bring back the estate and generation-skipping taxes on 1/1/2011 with a 55% marginal rate, a state death tax credit, and a $1 million exemption. While this option has been dismissed by commentators for years (along with the possibility that Congress would actually allow the estate tax to expire in 2010), at this point anything is possible.

Like the prospective fix, this option does not raise constitutional questions, but it also leaves unanswered all of the 2010 questions now on planners' minds. Even if Congress decided not to legislate on the estate tax, some guidance for 2010 would be required. Perhaps in that event, the IRS would step in to fill the void with regulations.

Allowing the law to revert to pre-EGTRRA provisions would also require someone to determine what the "as if" language of the sunset provision means. Of the three options outlined here, this is the one that actually relies on the "as if" language to reinstate prior law, and brings along with it all of the interpretive issues discussed above. While doing nothing is certainly an attractive option from an economic perspective, it is one that cries out for guidance and inevitably litigation.

Political considerations will also be important in determining which route Congress takes. On the one hand, the situation was ripe for compromise in 2009, when the Democrats could have avoided the one-year repeal by giving the Republicans a higher exemption level and lower rate for 2011 and beyond. As we move forward through 2010, the Democrats have less incentive to compromise, because the one-year repeal they had hoped to avoid has already occurred. With the approach of the mid-year elections in November, Congressmen will also be contemplating which course of action best furthers their campaign strategies. Not remedying the situation will allow the Republican candidates to argue that the reinstatement of a confiscatory estate tax in January 2011 is the fault of the Democrats, and allow the Democratic candidates to argue that the Republicans refused to compromise on the one-year repeal because they were protecting the wealthiest Americans. In other words, both sides may view inaction before the November elections as providing political opportunities.

What else is going on in Washington?

For the past two years, President Obama has included in his budget a proposal to require a minimum term of ten years for GRATs. Recently, that provision was picked up as one of the provisions to help "pay for" a jobs act.[7] H.R. 4849 passed the House on 3/24/2010, but has yet to be taken up by the Senate.

Even if H.R. 4849 does not pass in the Senate, the fact that the GRAT provision was used as a "pay for" in this bill is significant and provides reason to take much more seriously the possibility that restrictions on the use of GRATs could pass this year. In particular, the GRAT revenue raiser would seem to be a logical provision to include in whatever bill Congress passes (if any) with respect to the estate tax. Clients who are interested in short-term GRATs should consider funding them sooner rather than later. ■

[7] H.R. 4849, the Small Business and Infrastructure Jobs Tax Act of 2010.

ZARITSKY
(Continued from page 48)

tied to specified desired tax results (such as avoiding estate taxes at the decedent's death and minimizing taxes at the surviving spouse's death), in order to determine what the decedent would have wanted.[3] The Florida bills both provide that, in construing the governing instrument, the courts will consider the terms and purposes of the instrument, the facts and circumstances surrounding the creation of the instruments, and the testator's or settlor's probable intent. The courts may consider, in determining the probable intent behind the instrument, all relevant evidence, including any evidence that contradicts the apparent plain meaning of the governing instrument.

This approach is more likely to produce a favorable tax result than the Virginia plan, but it will require litigation in every case, delaying the division and distribution of the estate and increasing estate expenses. This litigation may be quite heavily contested in estates in which the interests of different beneficiaries are adverse. For example, a revocable trust that leaves a decedent's children an amount equal to the applicable exclusion amount and that leaves to the spouse the residue of the trust fund, may be construed without a serious contest when the spouse is the parent of the children and likely to leave them his or her own estate at death. On the other hand, where the spouse and the children do not at all get along, this dispute may be quite heated and expensive.