

The New (2010) Estate Tax Law and Its Implications for Estate Planning and Administration

Timothy S. Midura, C.P.A., J.D., LL.M.
Huck Bouma PC, Wheaton
www.TimothyMidura.com

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This presentation is responsive to the new federal estate tax law signed by the President on December 17, 2010 and the new Illinois estate law signed by the Governor on January 13, 2011. The goal is to briefly review the elements of the new law and then focus on surprises and unknowns and also on planning implications.

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- I. **Overview of 2010 Congressional Action Concerning Federal Estate, Gift, and Generation-Skipping Taxes.**
 - A. Effective December 17, 2010, the President signed into law **The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010**

(the “Act”). It will sunset after 2012. Congress will need to act again, otherwise the 2001 tax law with the \$1 million exemption will return on January 1, 2013.

B. For 2010:

1. The default rule is that there is estate tax retroactive to January 1, 2010. The estate tax basic exclusion amount is \$5,000,000 with a maximum rate of 35% and step-up in tax basis.
 - a. There is an option to elect carryover basis instead of estate tax (Form 8939 - due with the filing of the decedent’s final income tax return, unless administratively modified by IRS pronouncement).
 - (1) The default is an estate tax with a \$5,000,000 basic exclusion amount (and step-up in tax basis) . Alternatively there is an opt out for no estate tax and carryover tax basis (with the \$1,300,000 basis allocation plus \$3,000,000 more basis allocation for gifts to spouses).
 - (2) There is a credible conversation reported with a high senior IRS official that the Form 8939 filing deadline will be extended at least until October 15, 2011. The reported exact words were, “We expect Treasury guidance to give everyone an administrative extension of time to file Form 8939 at least until 10/15/2011.”
 - (a) October 15, 2011 is a Saturday so we can expect an administratively permitted filing date of October 17, 2011.
 - (3) The time and manner of making the election out of estate tax is not yet known.
 - (4) Draft Form 8939, as issued 12/16/10 (day before the new tax act), is full of problems, too many to list. Form 8939 will certainly be redone after the tax law and professional associations’ comments.
 - b. Estate tax returns (Form 706) are due by September 19, 2011.
 - (1) The Act provides for estate tax returns to be due within nine months from date of enactment. September 17, 2011 is a Saturday so the next business day is September 19, 2011.
 - (2) Deaths after December 17, 2010 will fall under the normal nine month rules.

- c. Disclaimers for testamentary gifts effective by death at any time in 2010 (prior to December 17, 2010) are due by September 19, 2011.
 - (1) Disclaimers for lifetime gifts are due within nine months from when the lifetime gift was made. The September 19, 2011 extension does not apply to lifetime gifts.
 - (2) Beware of independent state statutes with lesser periods of time. There is a need to comply with both federal and state requirements.
- 2. The gift tax basic exclusion amount is \$1,000,000 (no change) with a maximum rate of 35% (no change).
- 3. All the GST rules return for 2010, but the GST 2010 tax rate is zero.
 - a. Electing out of estate tax does not affect 2010 GST.

C. For 2011-2012:

- 1. The estate tax basic exclusion amount is \$5,000,000 with a maximum rate of 35%.
- 2. The gift tax basic exclusion amount is \$5,000,000 with a maximum rate of 35%.
- 3. “Portability.” Brand new is a “deceased spousal unused exclusion amount” (“DSUEA”) that permits a surviving spouse to later use the unused (estate and gift) basic exclusion amount of the predeceased spouse who dies in 2011 or 2012 (if the surviving spouse does not remarry).
 - a. The DSUEA could be lost if the surviving spouse remarries and is then “rewidowed.”
 - (1) Spouse 2 is predeceased by Spouse 1. Spouse 2 “inherits” Spouse 1’s DSUEA. Spouse 2 remarries Spouse 3. If Spouse 3 dies, Spouse 2 loses Spouse 1’s DSUEA and instead becomes eligible for Spouse 3’s DSUEA.
 - (a) The inherited DSUEAs assumes the respective executors of Spouse 1 and Spouse 3 file timely estate tax returns and assign the DSUEA to Spouse 2.

(b) If Spouse 3's executor does not file a timely filed estate tax return and assigns Spouse 3's DSUEA to Spouse 2, then Spouse 2 loses the DSUEA from both Spouse 1 and Spouse 2.

b. So the available basic exclusion amount of \$5,000,000 is also increased by any available DSUEA (as much as an additional \$5,000,000). So the total combined exclusions for a surviving spouse can be as much as \$10,000,000 for 2011 and 2012.

(1) Presently, this is available only if Spouse 1 dies in 2011 or 2012 and Spouse 2 either dies or totally uses the combined applicable exclusion amount by gift or death in 2011 or 2012. The DSUEA is scheduled to sunset in 2013.

(2) Since the basic exclusion amount (\$5,000,000) and the DSUEA are actually derived from credits. It's possible that the DSUEA does not have the same exemption amount effect – being a credit applied to a tax rate of 35%.

c. For a surviving spouse to receive the benefit of the predeceased spouse's unused exclusion amount, a timely estate tax return must be filed and the executor of the predeceased spouse irrevocably assign the predeceased spouse's unused exclusion amount to the surviving spouse.

(1) Practically, this means that an estate tax return will have to be timely filed for EVERY married person's estate in order to preserve the predeceased spouse's unused exclusion amount.

(a) My chief estate administration paralegal was ecstatic when hearing about portability because she thought estate tax returns would be substantially lessened. Then I told her that estate tax return preparation actually goes way up for every married decedent's estate due to the need to preserve the DSUEA.

4. The familiar 2009 step up in basis rules return.

D. For 2013 and After - The 2001 tax law is scheduled to return, which is the \$1,000,000 exclusion amount and a 55% maximum rate. The DSUEA is set to expire.

II. Implications of the New Estate Tax Law.

A. In 2011 and 2012, the default position should be to file an estate tax return, Form 706, for each married person's decedent estate in order to preserve the deceased spousal unused exclusion amount (DSUEA).

1. If after full disclosure to the parties in interest a Form 706 is not to be filed for lack of size, waivers should be signed by the surviving spouse choosing not to file a Form 706 and forego preserving the DSUEA. However, if the surviving spouse is not the executor, then the executor probably has a fiduciary duty to file a Form 706 and make sure the DSUEA is preserved.
2. Note: Even a currently small estate may become larger later (i.e., invention, new business, inheritance, lottery, personal injury award, wrongful death award, etc.).
3. Reminder: The only way to preserve the DSUEA is by timely filing a Form 706 with an assignment of the DSUEA on the Form 706.
4. Since the DSUEA is set to expire in 2013, its lifetime usage in 2011 and 2012 might be considered.
5. DSUEA is more extensively covered by separate discussion below.

B. 2010 carryover basis.

1. Carryover basis holding period start date is not yet known.
2. Proving up basis with no records?
 - a. The IRS and some courts say basis is zero unless there are evidentiary records. This usually applies when the owner did not keep records.
 - b. When the donee does not have records, the donee is usually allowed to go back and recreate fair value when acquired by owner-grantor.
3. Basis increase can come from carryover losses and built in losses, as well as the application of the \$1.3 million and \$3 million.
4. The one and only definitive publication on carryover basis was written and published about 8 years ago by Jonathan Blattmachr. That will be mandatory reading for complicated carryover basis 2010 decedent's estates electing out of estate taxation.

C. Fiduciary duties and conflicts of 2010 election out of estate tax.

1. Tax sensitive formula driven gifts? Section 301 of the Act states estate tax law will not apply (the giving the \$5,000,000 estate tax exclusion). Therefore, arguably the credit shelter formula will be unlimited. What do fiduciary duties require?
2. Other states, such as Virginia, have statutes that provide 2009 estate tax law applies if there is no estate tax law in 2010. What applies? Unlimited? \$5,000,000? \$3,500,000?
 - a. Note: Construction statute states, such as Virginia, now have to amend their laws to conform to the new Act.
 - b. Florida's construction approach that permits determination of intent with parol evidence now appears to be the better model.
3. The fiduciary needs a provable process (assumptions and projections) of the determination electing in/out of 2010 estate tax. Use a checklist approach. Process should include interested parties.
 - a. Anticipate the need for a court construction or approval.
 - b. Consider family settlement agreement.
4. Fiduciary liability is the big inherent issue of the administering estates today.
 - a. What do you call a trustee who has discretion to make elections that affect different beneficiaries' expectancies? A **Defendant**.

D. Construction issues:

1. What is the "maximum" amount that avoids estate taxation?
 - a. \$5,000,000?
 - b. 2009 \$3,500,000 (like many state construction laws)?
 - c. Unlimited when electing out of 2010 estate tax?
 - (1) Note the Act provides the 2010 election out of estate tax means that there is no estate tax law.

2. Election in hands of fiduciary who is a beneficiary with significant swing consequences:
 - a. Fiduciary duties?
 - b. Possible general power of appointment?
 3. If in doubt on tax sensitive provisions, get ready now to go to court.
- E. If you predict exemptions are going down. Make gifts now. Use it or lose it (maybe).
1. Example: See spousal lifetime access trust below.
- F. Spousal Gift Splitting. Will there be more split gifting between spouses of second marriages with the other spouse's exclusion? Will "deals" have to be negotiated?
- G. 2011 and beyond: Credit shelter planning during the presumed first-to-die spouse's lifetime should still continue, and not rely on the DSUEA, because:
1. Potential loss of the DSUEA through remarriage or expiration in 2013.
 - a. The DSUEA is presently only available when one spouse dies in 2011 or 2012 and the surviving spouse gifts or dies in 2011 or 2012. The DSUEA is set to expire after December 31, 2012 and the 2001 \$1 million exemption law is scheduled to return.
 2. Removing appreciation from gross estate.
 3. Potential audit issues of predeceased spouse's estate tax return, Form 706, that remain open.
 - a. Note: The statute of limitations remains open for the IRS to audit the predeceased spouse's Form 706 for purposes of verifying the DSUEA.
 4. Creditor, remarriage, and third party influencer issues.
 - a. Discretionary spendthrift trusts provide protection.
 5. The DSUEA only carries forward for gift and estate tax planning, but not for generation-skipping tax planning. Therefore, any GST planning must be exploited during the first-to-die spouse's lifetime.
- H. The \$5 million GST exemption is applicable for 2010 even though an estate elects out of estate tax.

1. See footnote 53 of the Technical Explanation of the Revenue Provisions Contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 as prepared by the Staff of the Joint Committee on Taxation, “⁵³ The \$5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules.”
 - a. 2010 carryover basis election negates by specific reference only Chapter 11 (estate taxes) and is silent to Chapter 13 (GST), therefore GST applies, with exemptions, at a zero tax rate.
 2. This means that a GST exempt trust in an estate plan can be funded with the available GST exemption even though the estate elects out of estate taxation.
 3. An open issue then is, how to notify the IRS of the GST exemption allocation because an estate tax return, Form 706, will not be required?
 - a. Guidance from the IRS will be necessary.
 - b. I anticipate that the opt out form should have an attachment, signed by the (statutory) executor, making notification of such allocation.
 - (1) I believe we will have to October 17, 2011 to make this allocation (when I believe Form 8939 will be due). But this is yet to be determined.
- I. Zero rate for 2010 GST means disclaimers to create skips are very advantageous.
1. The “move down” rule is available in 2010 and, again, disclaimers are valuable uses of the zero GST rate.
 - a. The move down rule is the reassignment to a lower generation of the “skip person” status by not having a higher generation. For example: Grantor is G1. Grantor’s child is G2. Grantor’s grandchild is G3. Grandchild’s child is G4. Having G1’s 2010 gift to a direct skip trust by having G2 disclaim with a zero GST rate creates a move down so any distributions to G3 are no longer “skip” distributions or termination. G3 is assigned G2 status or G2 status is “moved down” to G3.

- b. Opportunity: In 2010, should a child disclaim from a trust to obtain a move down the skip person generation assignment? This creates a direct skip in 2010 with a zero GST rate.
 - (1) A 2011 disclaimer relating back to 2010 for a testamentary transfer can effect a 2010 GST skip at zero GST rate.
 - (2) The testamentary 2010 gift disclaimer period is extended to 9/19/11.
 - (a) Remember that the applicable state disclaimer law may provide a short period.
 - (3) A lifetime 2010 gift disclaimer period stays at nine months from date of gift (no extension).

- J. GST automatic allocation rules apply in 2010. Do elect out of direct skip automatic allocation and expressly allocate GST exemption to direct skips. Cannot rely on automatic allocation rules.
 - 1. *At the recent Heckerling Institute, this was repeatedly observed by many of the speakers – underscoring its importance.*

- K. Drafting now for the future? More usage of
 - 1. Highly discretionary distributions standards by independent trustee.
 - a. “Best interests.”
 - b. Lesser usage of “health, education, medical, and support” (HEMS) only standards.
 - 2. Independent third party amending powers.
 - 3. Decanting powers.
 - a. Permit transfer to new or another trust containing more appropriate discretions or powers (such as general power of appointment for basis step up purposes).
 - 4. Married client basic planning methodology:
 - a. Obtain marital deduction.
 - b. Keep estate tax planning an open option. For example, built in disclaimer trust.

- c. Be able to back out of any credit shelter trust to gain second step up in basis (if do not need estate tax shelter). Or, how do we get estate tax sheltered assets into the beneficiary's gross estate so there is a step-up in basis?
- (1) Best approach: "Best interests" distribution standard by independent trustee.
 - (2) Possible approach: What about having HEMS distribution standards if spouse is trustee, and flip to "best interests" if spouse names an independent distributions trustee?
 - (a) These trustees could act concurrently.
 - (3) Possible approach: Have provision to distribute into another trust (decant) that has a general power of appointment.
 - (4) Possible: Trust protector granting a general power of appointment.
 - (a) However, could have adverse implications for disclaimer.
 - i) Anticipate disclaimer issues and have all disclaimed property initially segregated (not commingled with non-disclaimer assets) to a 100% disclaimer trust.
 - ii) Draft any general power of appointment so it cannot apply to disclaimed property.
 - (b) It must be a truly independent act. Caution until further development.
- L. 2010 taxable gifts and buyer's remorse. Can 2010 taxable gifts be UNmade? – Those taxable gifts made when an anticipated 2011 55% tax rate and \$1 million exemption seemed imminent?
1. Mistake of fact or law calling for rescission?
 - a. Possible. Commentator's have split perspectives. Will be highly dependent on facts and applicable state law.

2. Disclaimer by donee and effect?
 - a. If disclaimed, does the property revert to the donor or go somewhere else?
 - b. Seems a more likely approach. "Acceptance" is probably a big practical issue.
 3. Answer is case specific and relies heavily on state law. Which jurisdiction? Donor? Donee? Other?
- M. 2010 may be the "Year of Disclaimers."
- N. Many commentators view the \$5-10 million estate will be the most difficult to plan.

III. **Estate Planning Has More Opportunities Than Ever!**

- A. The new \$5 million basic exclusion has not killed estate planning nor estate tax planning. It has made better and more sophisticated estate planning more vital than ever!
- B. With less tax evaporating an estate, it means that there is more wealth to plan for ... and also more wealth for family, creditors, and a divorcing spouse to fight over.
- C. Also, importantly, remember that Congress revisits estate taxes in two years and "What Congress Giveth, Congress May Taketh Away." So planning and locking in what you want is important before Congress can tell you again what it wants for you.
 1. We experienced in 2010 that law makers will not want to make tax law before an election. So we can expect a repeat of DECEMBER (2010) in 2012 after the presidential election. It is even more likely that January 1, 2013 will usher in the 2001 law \$1 million exemption with Congress taking action later in 2013.
- D. Estate tax planning now means more estate tax free wealth transfers later which can lock in benefits for planning towards spendthrifts, multiple marriages, creditors, divorces, and special needs, such as potential disability and Medicaid eligibility.
- E. Existing plans that have tax sensitive formula provisions have to be reviewed for interpretation, application and outcomes.

- F. Spousal Joint Revocable Trusts. Spouses with long-term, stable marriages with common children may find having an estate plan with a shared single joint trust now more attractive. This eliminates the complexities of choosing what assets go into which spouse's separate trust.
1. Commentators differ on advisability of joint trusts. There are continuing issues of contribution tracking, tax basis adjustments, dissolution of marriage effects, and the like.
- G. Surviving spouse marital trusts can be planned for more flexibility – thinking about smaller estates that are never contemplated to be estate taxable, say \$600,000 total assets with elderly retirees.
1. There can be a single highly discretionary marital trust (not qualifying for the marital deduction but within the \$5 million exclusion) with flexibility available through use of trustee discretions (independent trustee “best interests”), powers of appointment, and trust protectors. This provides the ultimate in creditor, remarriage, and third party influencer protection.
 - a. An independent trustee can be provided “best interests” standard of distribution to transfer assets to the surviving spouse if estate tax is not required and a second step-up in basis is desired.
 - b. Actually, my reference to “marital trust” merely connotes the trust is for the lifetime of the surviving spouse. It's actually more of “credit shelter” trust or “by-pass” trust. But the reference to “marital trust” is more of a warming feeling of intention.
 - c. Should there nevertheless be a formula fall back in the event of a taxable estate so a marital deduction trust is created?
 - (1) This brings us back to a classic A-B looking plan but having the document layout emphasize the B Trust as the “Marital Trust” (although not qualifying for the marital deduction) and the A Trust labeled something like the “Marital Deduction Trust” (actually qualifying for the marital deduction).
 2. See also “third layer” discussion below.

3. There can be cascading marital trusts:
 - a. **First layer** can be a power to withdraw marital trust.
 - (1) This provides the most access to the surviving spouse, probate avoidance, but no tax planning or creditor protection.
 - b. The **second layer** can be funded by a predetermined fraction or amount or through a surviving spouse's disclaimer choice to a qualified terminable interest property (QTIP) marital trust.
 - (1) Here financial security is provided, with significant tax planning opportunities, and some creditor protection.
 - (2) An Illinois only QTIP election can be made to reduce Illinois estate tax payable on the first death due to the differential between the Federal \$5 million exclusion and the \$2 million Illinois exclusion.
 - (3) In order for the 2010 carryover basis spousal basis adjustment bonus of \$3 million, a trust for which there is no QTIP election but which would qualify for QTIP (a "qualifying trust"), should qualify for the \$3 million basis adjustment. IRC § 1022(c)(5).
 - (a) This can include a "credit shelter" trust that is a QTIPable.
 - (b) In other words, IRC § 1022(c)(5) has its own criteria of a qualifying trust for the \$3 million basis adjustment for a surviving spouse gift.

§ 1022(c)(5): Qualified terminable interest property - For purposes of this subsection -

(A) In general - The term "qualified terminable interest property" means property - (i) which passes from the decedent, and (ii) in which the surviving spouse has a qualifying income interest for life.

(B) Qualifying income interest for life - The surviving spouse has a qualifying income interest for life if - (i) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and (ii) no person has a power to appoint any part of the property to any person other than the surviving spouse. Clause (ii) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property

(regardless of whether the property from which the annuity is payable can be separately identified).

(C) Property includes interest therein - The term "property" includes an interest in property.

(D) Specific portion treated as separate property - A specific portion of property shall be treated as separate property. For purposes of the preceding sentence, the term "specific portion" only includes a portion determined on a fractional or percentage basis.

c. The **third layer** can be funded through a predetermined fraction or amount or the surviving spouse's disclaimer choice to a highly discretionary marital trust.

- (1) Here is the most creditor and third party influencer protection and flexibility is provided through trustee discretions and trust protector provisions.
- (2) An independent trustee can be provided "best interests" standard of distribution to transfer assets to the surviving spouse if estate tax is not required and a second step-up in basis is desired.
 - (a) Specifically permit distributions to other trusts (in existence or for the benefit of the beneficiary), such as those that might contain a general power of appointment to the beneficiary. A decanting provision.
 - (b) Permit the independent trustee or an independent trust protector to grant a testamentary general power of appointment.
 - i) Permit the severance of a trust into separate trusts prior to the grant of the testamentary power of appointment to control the taxability over assets.
 - ii) There could be a formula grant of a general power of appointment. But some commentators are not fans of formula general power of appointments that could be manipulated by the surviving spouse and argued to be a vested general power of appointment on the whole trust rather than a contingent power on only the formula (taxable) share.

- (3) Non-spouse beneficiaries can also be a part of the beneficiary class.

- H. Protective Child's Trust. Because of greater wealth potential, lifetime (or perpetuity, dynasty, or generation-skipping) trusts for the benefit of children can be highly advantageous. A lifetime child's trust will provide the ultimate in tax planning, creditor protection, and divorce and third party influencer defense. It can provide a great deal of flexibility through trustee discretions, powers of appointment, and trust protector provisions. It can pass to multiple generations with further direction and provisions by your child.
- I. Spousal Lifetime Access Trust (SLAT). One spouse can establish a trust during that first spouse's lifetime (not waiting for the first spouse's death) that completes a gift (for tax and creditor protection purposes), provides for the second spouse's financial security, and the first spouse inherently benefits from the trust because what is good for one spouse (beneficiary) is good for the other (grantor).
 1. SLAT with Loop Back. It may be possible for the grantor-spouse to give the beneficiary-spouse a testamentary special power of appointment that does not exclude the grantor-spouse as a future donee of the special power of appointment.
 - a. If this testamentary power of appointment is exercised in favor of a highly discretionary credit shelter like trust for the (grantor) surviving spouse, it can provide financial benefits, tax sheltering, and creditor protection.
 2. Extreme care must be taken not to violate the reciprocal trust doctrine should both spouses execute SLATs as grantors.
- J. Self Benefitted, Self Settled Trusts or Rainy Day Trusts. One can establish a completed gift self-settled (for one's own benefit) trust that provides tax planning and creditor protection. Because of the \$5 million basic exclusion amount, the funding of this protected self-settled trust can be very significant.
 1. Presently, such a trust is available only in states that permit "domestic asset protection" (DAPs) trusts. DAP states have repealed the inherent creditors rights in a self-settled trust and this creates the "magic" of having a Rainy Day Trust or DAP Trust be exempt from the grantor's creditors and also a completed gift and outside of the gross estate of the grantor, while the grantor is still a potential beneficiary.
 - a. DAP states include: Alaska, Delaware, Hawaii, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming.

2. To date, the IRS has not ruled positively or negatively on the estate tax exclusion of DAP trusts. Commentators believe if the facts do not obviously put the grantor-beneficiary in a first place usage position, the IRS will be hard pressed to be successful in a gross estate inclusion argument – thus a perspective use of rainy day (only) trust.
- K. Non-taxable estate with poorly structured or operated FLP or family LLC: Consider voluntarily having § 2036 inclusion apply to “defective” FLPs and get step up in basis on assets within the FLP.
- L. IMPORTANT: EVERY ESTATE PLAN SHOULD NOW BE REVISITED AND THE NEWEST OPPORTUNITIES EVALUATED!
- M. *There are more planning opportunities than ever!*

IV. **Deceased Spousal Unused Exemption Amount - DSUEA – More Detail.**

- A. This outline section provides more explanation on the brand new estate and gift tax concept of the Deceased Spousal Unused Exemption Amount (“DSUEA”) installed by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “Act”).
- B. The estate tax is reduced by an amount called the Unified Credit. The Unified Credit is equal to the amount of tax that the estate would incur if the taxable estate were exactly equal to an amount called the Applicable Exclusion Amount (AEA). It is the AEA that is often thought of as the exemption amount or exemption equivalent. For decedents dying after 2010, the AEA for estate and gift tax purposes is generally \$5,000,000.
- C. The Act establishes a new rule that the AEA can be increased for a surviving spouse by the predeceased spouse’s unused AEA. This is commonly referred to as “portability.”
1. Portability means any or all of the \$5 million AEA not used by the estate of a predeceased spouse may now be transferred to a surviving spouse by making an election on a timely filed estate tax return. This new rule is effective for decedents dying and gifts made after December 31, 2010. The carryover is called the “Deceased Spousal Unused Exclusion Amount” (DSUEA).
 2. The DSUEA addition to the surviving spouse’s AEA will reduce gift and estate taxes of the surviving spouse.
 3. Notable is that the DSUEA, however, does not apply to generation-skipping tax (GST) transfers.

- a. Implication: Use of both spouses AEA for GST planning will have to ignore available DSUEA and specifically plan for use by the lifetime and testamentary usage of the first-spouse-to-die (the presumed predeceased spouse).
 - (1) Appropriately structured disclaimer trust could be a solution.
 - b. Act § 302(b)(2) expressly changes the definition of the GST exemption in IRC section 2631(c) by deleting the words “the applicable exclusion amount” and substituting “the basic exclusion amount”. This indicates clear Congressional intent that the Portability rules are not available for GST purposes.
- D. DSUEA is scheduled to expire after December 31, 2012, along with the rest of the Act’s tax provisions.
 - 1. Implication: Until this is a permanent law feature, use of a credit shelter trust is advisable.
 - a. Appropriately structured disclaimer trust could be a solution.
- E. This makes it possible for a married couple to transfer (in 2011 and 2012) up to \$10 million free of estate and gift taxes to their intended donees and beneficiaries. Before portability was enacted, a surviving spouse could not utilize any part of the unused AEA of a predeceased spouse.
- F. The AEA is now defined as the sum of (1) the “Basic Exclusion Amount” and (2) the DSUEA. The Basic Exclusion Amount is the \$5 million amount that we used to call the AEA before the law change.
 - 1. The DSUEA is the difference between the decedent’s last predeceased spouse’s Base Exclusion Amount and the taxable estate of that last predeceased spouse.
 - a. Congress was worried about stacking up unused exclusion amounts of more than one predeceased spouse, so it limited the DSUEA to the amount equal to the decedent’s Base Amount.
 - (1) Since the AEA under the Act is comprised of two components (the Basic Exclusion Amount, plus the DSUEA) and the definition of DSUEA itself references only the Basic Exclusion Amount, the portion that is effectively excluded from the definition is the DSUEA of that person’s previously deceased spouse. This has the

result of preventing any DSUEA that the Spouse 2 has available from the predeceased Spouse 1 from carrying over (upon Spouse 2's death) to Spouse 3.

G. The Joint Committee Report on the Act contains several examples:

1. **Example 1.** Assume that Husband 1 dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.
2. **Example 2.** Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made \$4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is \$3 million (\$2 million for Husband 1 and \$1 million for Husband 2), only Husband 2's \$1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount (\$5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's \$1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Questions: What happens in Example 2 if Husband 2's estate makes no election? Is the DSUEA reduced to zero – wife losing the DSUEA from both Husband 1 and Husband 2?

And what happens if Wife in example 2 uses up all of the augmented AEA in making lifetime gifts before Husband 2 dies? Does the gift tax increase retroactively? Is there an additional tax to pay on Wife's death (a "claw back")?

Here's the third and last example appearing in the Joint Committee reports:

3. **Example 3.** Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of \$3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is \$4 million (Wife's \$7 million applicable exclusion amount less her \$3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by \$4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.
 - a. So complex that even the Joint Committee Report writers don't get it right. Example 3 in the Joint Committee Report incorrectly

references the AEA, rather than just the Basic Exclusion Amount as provided in IRC § 2010(c)(4)(B)(i)). See underline in immediately preceding paragraph.

- H. Ordering. Presently, we do not know the ordering usage of the DSUEA. If a lifetime gift is given by the surviving spouse, is his or her basic exclusion amount used first or is the available DSUEA?
1. This will have to be tracked, particularly in regard to lifetime gifts and multiple marriages that ended in death. What is his and hers? What is available and when for gift, estate, and GST (GST not applicable to DSUEA) purposes?
- I. Tracking. Any available DSUEA must be tracked. Estate planning data collection questionnaires should now include a question covering any such availability. The estate tax return, Form 706, for the predeceased spouse is especially important to be permanently preserved.
1. Because the DSUEA does not apply to GST, taxpayers and their return preparers will now have to track separately the gift and estate tax AEA versus GST AEA.
- J. Election on a Timely Filed Estate Tax Return. The first step in preserving the opportunity to use a DSUEA is that (1) a timely estate tax return must be filed and (2) an election must be made in order to port the unused AEA from the predeceased spouse to the surviving spouse. Both of these acts are required in order to effectively vest the surviving spouse in the DSUEA.
- K. Extended Statute of Limitations to Review the Calculated DSUEA. In order to protect the integrity of proper determination of the calculated DSUEA, the time for auditing the estate tax return that contains the election is extended indefinitely.
1. As a practical matter, that extension to audit will be limited by the statute of limitations on assessment and collection applicable to the deceased spouse's estate that receives the DSUEA. The language of the extended statute of limitations appears to limit the audit extension period to the determination of the DSUEA. Therefore it should not be possible to assess estate taxes against the predeceased spouse's estate after the "normal" time for assessing and collecting tax has expired. This should also leave unchanged the length of time for transferee liability exposure.
- L. Strategic Use of Taxable Gifts and Filing Gift Tax Returns. Making taxable gifts, using the DSUEA, and filing gift tax returns seems to assure the DSUEA use and its evidentiary tracking. Because of the liberal drafting of the tax law, for now it's being assumed that a gift tax return will use the DSUEA first before the surviving spouse's basic exclusion amount. If a surviving spouse (Spouse 2) remarries (to

Spouse 3), uses the predeceased spouse's (Spouse 1) DSUEA for lifetime gifting, and Spouse 3 dies with the effect of replacing Spouse 1's DSUEA with Spouse 3's DSUEA, it does not seem logical that the "over use" of Spouse 1's DSUEA will need to be recaptured ("claw back") – arguing for aggressive lifetime gift use of the first predeceased spouse's DSUEA should the surviving spouse remarry.

- M. Estate Tax Returns for All Predeceased Spouses? Because the financial fortune of a surviving spouse cannot be predicted (new businesses can thrive, intellectual property become very valuable, lottery won, personal injury award, wrongful death award to the estate), even a small estate probably should file an estate tax return and make the DSUEA election in order to preserve its use. Therefore, expect that every married person's decedent's estate should file an estate tax return.
- N. Preemptive Drafting for the DSUEA. Who wants to pay for estate tax return preparation that seems wasteful or for the benefit of the family of a second spouse (thinking multiple marriage situations)? It might be appropriate to have the first spouse (the presumed predeceased spouse) settle preparation and cost issues by including a will provision saying whether the executor will (a) never, (b) sometimes, or (c) always file an estate tax return and make the DSUEA election. The will might include exculpatory language to hold the executor harmless from acting or failing to act. Alternatively, the will could provide that the executor will notify the surviving spouse of the potential election and that the executor will make the election or not as the surviving spouse may direct. In other words, the will could put the surviving spouse in charge of whether the executor will make the election.
1. If the will has no provision regarding the election, the executor could nevertheless seek the surviving spouse's direction. If the surviving spouse wants the election, there could be some negotiation and written agreement about who will bear the costs and responsibilities. If the surviving spouse doesn't want the election, the executor could ask the surviving spouse to sign off and hold the executor harmless in an agreement binding on the estate of the surviving spouse, including heirs and devisees.
 2. It seems likely that without direction, the DSUEA is potentially so valuable that it might be deemed an inherent breach of fiduciary duty to the surviving spouse and derivative beneficiaries for not preserving the DSUEA.
- O. Estate Tax Return Extensions. Whatever method is used to decide, the estate tax return filing due date of the predeceased spouse should always be extended in order to provide the maximum amount of time to make that decision, gather return filing information, file the return, and make the election.

1. If the estate plan contains a QTIP marital trust, the extension of time also permits additional time for post-mortem planning via the QTIP election.
- P. Claw Back. If exemptions decrease and gifts of up to \$5 million were made, will there be a claw back of gifts in excess of the (whatever) new estate tax exemption?
1. The issues arise from the way the current Form 706 worksheets work. They would generate an estate tax on the lifetime gifts.
 2. How to collect tax when there is no estate? From whom? It's not collectible!?
 - a. Certainly the gift-donee cannot be obligated (as transferee liability) to pay subsequent estate tax!?
 3. There is a marital deduction problem due to an interrelated calculation (claw back tax [non-deductible] reducing the marital deduction).
 4. Should there be an donee agreement or will or trust provision allocating any adverse tax consequences?
 5. This is an open issue / unknown. It's presently a speculation of issue by professions estate planners. It is theoretical, but presumed not to be probable.
 - a. Caution dictates disclosure of potential to clients.
- Q. Avoid the DSUEA Mess. Credit shelter trust planning is the best way for the presumed predeceased spouse to control his or her use of his or her AEA and also the potential waste of it due to the potential remarriage of his or her surviving spouse or Congress not extending it after 2012. It will also preserve the exemption for GST purposes if the trust is so designed.
1. Tension with second basis step-up.
- R. QTIP Marital Trust Even More Important. Using the maximum federal AEA will potentially bring a cost of incurring state death tax that has a lower state exemption. QTIP type trusts with reverse elections could be a response. But QTIP trusts have much less beneficiary, discretionary distribution, and creditor protection flexibility. However, QTIP trusts can also be implemented for optimal use for GST planning through reverse elections. Carving out marital QTIP trusts into sub-trusts with various elections may be the future norm.
1. See below for discussion of planning for differing state death tax exemptions. For example, Illinois estate tax exemption is \$2 million

dollars ... differing significantly from the potential of a surviving spouse having an AEA of up to \$10,000,000 (\$5,000,000 basic exclusion amount plus the \$5,000,000 DSUEA).

- a. Since the basic exclusion amount (\$5,000,000) and the DSUEA are actually derived from credits. It's possible that the DSUEA does not have the same exemption amount effect – being a credit applied to a tax rate of 35%.

S. Social Implications. If a surviving spouse (“Spouse 2”) has inherited DSUEA of some significance from predeceased Spouse 1, will he or she consider it a significant disadvantage to remarry someone (“Spouse 3”) of wealth who, if the new Spouse 3 predeceases, loses the DSUEA from Spouse 1? Will there be nuptial negotiations and consideration paid for the potential of the loss of one’s DSUEA?

1. Engineering usage of Spouse 1’s DSUEA to Benefit Spouse 3: Assuming Spouse 2 is widowed with substantial unused basic exclusion amount and Spouse 2 has inherited substantial DSUEA from her predeceased Spouse 1: New wealthy husband, Spouse 3, could gift a portion of his assets to his new wife, Spouse 2, sometime prior to her death, in order to allow either her (during her lifetime) or her estate (after her death) to transfer assets to Spouse 3’s children, thus utilizing her FIRST husband’s, Spouse 1, unused exemption for the benefit of Spouse 3 and his children.
 - a. There is risk if the NEW husband Spouse 3, were to die before the wife Spouse 2, she would lose any portability from her first husband Spouse 1 (therefore potentially incurring either gift or estate tax), might not have any DSEUA available from Spouse 3, and thus she might be more motivated to keep some or all of the assets that the second husband, Spouse 3, gave to her.
 - b. There are more complications based and the financial fortunes of the spouses, order of deaths, potential future changes in tax laws (such as sunset of DSUEA, “claw back,” or merely a reduced exemption), etc. that makes the discussion more complex and in need of study.
2. Because the DSUEA means as much as \$1,750,000 gift or estate tax savings (\$5,000,000 x .35 estate tax rate) to the inheritors, children-inheritors may have their own perspectives on whether a new marriage is worth \$1,750,000 to them. What influences might be asserted for the potential costs of \$1,750,000 for remarriage?
 - a. Since the basic exclusion amount (\$5,000,000) and the DSUEA are actually derived from credits. It's possible that the DSUEA does

not have the same exemption amount effect – being a credit applied to a tax rate of 35%.

3. Marry for Love or Trafficking in a DSUEA Market? Might someone now prefer marriage to an older and poorer person to gain a DSUEA? Might Internet dating now have a new question ... “What is your unused Application Exclusion Amount?” What about arranged marriages with terminally ill persons with compensation for his or her DSUEA? Might there be situations where there is “plug pulling” in order to lock in a DSUEA? There are no anti-trafficking provisions for DSUEA. And those romantic prenuptial agreements may be contracting terms for assuring timely filing of the estate tax return and making the DSUEA election. Let’s start the negotiations for what is the DSUEA worth in the matrimonial relationship? Practically, it’s worth as much as \$1,750,000.

a. Since the basic exclusion amount (\$5,000,000) and the DSUEA are actually derived from credits. It’s possible that the DSUEA does not have the same exemption amount effect – being a credit applied to a tax rate of 35%.

4. Black widow estate tax planning? *Shiver.*

T. Communicate to clients about portability. It’s a “myth” as to the DSUEA’s answer to married or widowed person’s tax planning.

V. **Illinois Estate Tax.**

A. Illinois followed the Federal 2010 estate tax sunset. So there is no Illinois estate tax for 2010 (notwithstanding the Federal estate tax retroactive reinstatement for 2010).

B. On January 13, 2011 signed into law is a reinstatement of Illinois estate tax for deaths after 2010. So, effective January 1, 2011, Illinois has estate tax with a \$2,000,000 exemption. This is the same law that was in effect in 2009.

C. More technically, the Illinois estate tax is equal to the full amount of the state tax death tax credit that would have been allowed under the Internal Revenue Code in effect on December 31, 2001 but limiting the exclusion amount to \$2 million.

D. Effective September 8, 2009, Illinois permits Illinois only QTIP trust elections for qualifying a trust for Illinois only marital deduction.

E. Decoupling: Many states, like Illinois, have “decoupled” their death taxes from the federal death tax system. State death tax planning has taken on more importance.

1. Drafting change from the two trust (A-B) plan to the decoupled three trust (A-B-C [QTIP qualifying]) plan.
2. The Federal exemption is \$5 million (or \$10,000,000 with the DSUEA) and the Illinois exemption is \$2 million.
 - a. Therefore, a “bypass” trust funded with \$5,000,000 federal basic exclusion amount will still incur Illinois estate tax of \$352,000 (after the \$2,000,000 Illinois estate tax exemption).
 - (1) The additional Illinois estate tax is even greater if the estate has federal applicable exclusion amount by way of the DSUEA.
 - (a) The Illinois estate tax on a \$10,000,000 taxable estate is approximately \$927,000.
 - (2) These are the “premature” Illinois estate tax costs for fully funding a federal oriented credit shelter trust.
3. QTIP (qualified terminable interest property) or QTIPable trusts have taken on more significance versus spray or accumulation trusts.
 - a. One can have a QTIP(able) marital trust initially funded with \$7,000,000 and segregated to:
 - (1) Non-elected Federal and Illinois QTIP: \$2,000,000 exemption for Illinois estate tax, Federal estate tax, and GST.
 - (2) Non-elected Federal QTIP: \$3,000,000 exempt for Federal estate tax and GST, with an Illinois only QTIP election.
 - (3) Elected Federal and Illinois QTIP of \$2,000,000.

VI. Summary of Estate Planning Practice Implications.

- A. Disclaimers. 2010 transactions by death or gift should be immediately reviewed for disclaimer opportunities.
 1. Remember: “Acceptance” spoils the ability to disclaim.
 2. Remember: Some states may have a disclaimer period shorter than that permitted under the 2010 Act (9/19/11 for 2010 testamentary transfers).

- B. 2010 Decedent Estate Elections. The election out of estate tax for a 2010 decedent's administration must be reviewed.
- C. 2010 Generation-Skipping Tax ("GST") Planning. For 2010 gifts and decedent's estates, the use of the zero GST rate should be reviewed.
1. The GST "move down" rule is available for 2010, providing opportunities to arrange by disclaimer benefits a lower generation, which should be explored.
 2. Elect out of the GST automatic allocation rules where there is a direct skip and make a specific allocation of GST exemption to the direct skip.
- D. 2010 GST Exemption Still Available With Carryover Basis. Even if there is a 2010 election out of estate tax towards carryover basis, the \$5 million GST exemption is still available to fund GST exempt (zero inclusion ratio) trusts. Documents must be reviewed and trust funding planned to capitalize on this opportunity.
- E. Portability – DSUEA.
1. Specific planning must be done affirmatively in order to best capitalize on portability.
 2. Portability characteristics must be affirmatively tracked.
 3. Estate planning questionnaires should ask for DSUEA information.
 4. Portability might need to be negotiated between spouses and wills and trusts written to specifically handle portability usage, assignment of benefits, allocation of costs for administration (i.e., preparation of the estate tax return), and even compensation.
 - a. Portability has a value of up to \$1,750,000 (the 35% estate tax rate times \$5,000,000). \$1,750,000 is enough for people to fight over.
 5. Advise clients on the possibility of the "claw back" if lifetime gift usage of portability is used and later the DSUEA is lost or the future exclusion is decreased.
 6. Educate clients that portability is more of a placebo in that it really does not deliver what it promises in its advertising. Plan assuming portability will not be available.

- F. 2011 and 2012 Estate Tax Returns for Every Married Person's Estate. Plan on educating about and filing estate tax returns for every married decedent's estate in order to preserve DSUEA.
1. Who will be blamed for the DSUEA loss? If a DSUEA preserving estate tax return is not prepared, then the lawyer must take steps not to be later blamed for the DSUEA loss.
- G. More Estate Tax Returns Filing for Extensions. Filing for extension of time to file estate tax returns becomes more important to evaluate opportunities of QTIP elections and DSUEA.
- H. New Tax Laws Expire in Two Years. The new Federal transfer tax laws, with their benefits, expire at the end of 2012. Therefore, 2011 and 2012 are years to take advantages of the benefits. *What Congress Given, Congress Can Taketh Away!*
- I. Old Dogs, Still Good Dogs. Important in the Act is also what did not change, was left in tact, and is still on our preferred technique list, despite the IRS cries of foul. Use of family limited partners and limited liability companies, qualified personal residence trusts, sales to intentionally defective grantor trusts, discounting, grantor retained annuity trusts, and more are still very alive.
- J. Second Marriages. Second marriage situations have become more complex and must have even better analysis and implementation. DSUEA!
- K. Credit Shelter Trusts. The use and design of the "credit shelter trust" or "by-pass trust" is more important than ever. The design considerations should be more thoughtful.
- L. Highly Discretionary Trusts. The use and design of highly discretionary distributions trusts becomes more important.
- M. Trust protectors continually become more important for purposes of flexibility and adjustment.
- N. Protective Trusts. The use of trusts that provide protections for spouses, children, grandchildren, and other loved ones from taxes, creditors, divorce, and third party influences becomes more important.
1. With less estate tax, there is more wealth to fight over.
- O. Spousal Lifetime Access Trust (SLAT). Having one spouse establish an irrevocable gift trust for the lifetime benefit of the other spouse provides tax locked in benefits, creditor protection, and other benefits.

1. Through a special power of appointment, it may be possible to provide a contingent loop back to the donor spouse should the donee spouse predecease.
- P. Cascading Marital Trusts. We now operate in a very unstable transfer tax and estate planning environment. A possible solution for married individuals is the use of multiple marital trusts. Each different marital trust can be designed for unique characteristics. The funding of each trust can be decided later by the surviving spouse by having assets selectively cascade into the appropriate pockets. Plan and draft today, but decide later.
1. One way or another, most trusts that benefit any spouse must be revisited. Even “credit shelter trusts” need to consider that the Federal exemption is \$5,000,000 and the Illinois exemption is only \$2,000,000. See Illinois Estate Tax, below.
 2. QTIP marital trusts grow in importance for the potential to make various tax elections (i.e., estate tax, GST, state estate tax differences, DSUEA implications).
- Q. Joint Trusts. In appropriate circumstances, the two separate trusts held by husband and wife can be combined into a single “joint” trust. This simplifies titling and funding. It follows a pattern that brings comfort to many and that is holding everything together.
- R. Self-Settled Domestic Asset Protection (DAP) Trusts or Rainy Day Trusts. With the larger gift tax exemption, a significant trust can be established for the benefit of the grantor (also for the grantor’s loved ones) that is beyond the reach of creditors and the tax man.
- S. Double Step Up in Tax Basis. If the estate tax is not an issue at the beneficiary’s death, pre-plan the technique and ability for a second step up in the tax basis of assets in the second-to-die beneficiary’s estate (i.e., “best interests” distribution standard or trust protector grant of general power of appointment).
- T. Tax Sensitive Formulae. It is very common to have formulae that are tax sensitive. All such formulae need to be reviewed for impact and outcome.
1. Court Construction: More wills and trusts will need court construction or family settlement agreements to settle the application of tax sensitive funding provisions.
- U. 2010 Taxable Gifts. Some people made taxable gifts in 2010 that created gift taxes because of a fear of 2011 bringing a \$1 million exemption and 55% Federal estate tax rate. No one expected what this new law provides. So some 2010 donors may have remorse of now having to pay gift tax although a larger 2011 gift

exemption is available. Rescission or disclaimers might be a way to unwind those 2010 gifts.

- V. Illinois Estate Tax. With a \$5 million Federal exemption and a \$2,000,000 Illinois exemption, there could be a premature Illinois estate tax required payment of up to \$352,000. If the DSUEA is in play, the premature Illinois estate tax required payment could be as much as \$927,000. Planning is necessary. The Illinois only QTIP election should be evaluated for integration.
 - W. Fight! Remember, with less tax, there is more wealth to be fought over by family, divorcing spouses, creditors, and even non-taxing government agencies (such as for Medicaid eligibility).
- VII. **Lock and Load**. As much as things have changed, things are still the same. Planning is essential. There are great opportunities that can be capitalized if not foreclosed by more tax law changes, death, disability, and the like. There are some fundamental approaches that now should be revisited and refined while the “sun shines.”
- VIII. **Thank you Congress!?**

~ end ~