Puncturing the Paradigm - New Estate Planning and Drafting Considerations after the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")

By Richard L. Zinn

I. Introduction

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")[1] represents the Congressional answer to the Bush administration's promise to reduce income taxes and end the death tax. Although the death tax, in the form of the federal estate tax, was repealed by EGTRRA, full repeal will not occur until 2010. Prior to that time, estate tax rates will be incrementally reduced, and estate tax exemptions will be incrementally increased. Because of the so-called "Byrd Amendment,"[2] EGTRRA entirely disappears in 2011 and the law applicable on the date of EGTRRAs enactment returns.[3] Repeal thus has a Brigadoon existence-flourishing in 2010 and disappearing in 2011.

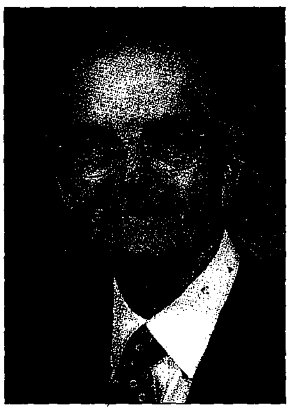

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Illustration 1

	Estate Tax		**Gift Tax**		**Generation Skipping Transfer Tax**	
	Exemption	**Max. Rate**	**Exemption**	**Max. Rate**	**Exemption**	**Max. Rate**
2002	$1,000,000	50%	$1,000,000	50%	$1,100,000	50%
2003	$1,000,000	49%	$1,000,000	49%	* $1,100,000	49%
2004	$1,500,000	48%	$1,000,000	48%	$1,500,000	48%
2005	$1,500,000	47%	$1,000,000	47%	$1,500,000	47%
2006	$2,000,000	46%	$1,000,000	46%	$2,000,000	46%
2007	$2,000,000	45%	$1,000,000	45%	$2,000,000	45%
2008	$2,000,000	45%	$1,000,000	45%	$2,000,000	45%
2009	$3,500,000	45%	$1,000,000	45%	$3,500,000	45%
2010	Repealed		$1,000,000	35%	Repealed	
2011	$1,000,000	55%	$1,000,000	55%	$1,000,000	55%

* 2003 GST exemption may increase by inflation index and, in 2011, the exemption probably will be the non-EGTRRA inflation-indexed exemption for 2011.

The incrementally reduced rates and increasing exemptions, as shown on Illustration 1, combined with the prospect of repeal, create a challenge to estate planners. This challenge is more daunting than that created by most tax legislation, in that planners are confronted with three potential planning periods: 2002 through 2009, the pre-repeal period, with increased exemptions and reduced rates; 2010, the repeal period; and 2011 and beyond, the post-repeal or repeal of repeal period, during which a carry-over basis regime will exist.[4] This Article presents preliminary considerations for planning and drafting

FOOTNOTES

1. Pub. L. No. 107-16, 115 Stat. 38 (2001).
2. 2 U.S.C. § 633(f)(2) (2000).
3. Section 901(a) of EGTRRA provides that the Act shall not apply to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010. After December 31, 2010, § 901(b) provides that "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."
4. Carryover basis rules were included in the Tax Reform Act of 1976, Pub. L. No. 94-455 § 2005, 90 Stat. 1520, 1872, codified at I.R.C. §1023 (Supp. III 1979). Because of the burdensome complexity in complying with carryover basis rules, §1023 was repealed in 1980 by Pub. L. No. 96-223, § 401, 94 Stat. 229, 299 (1980).

during these periods. It does not attempt to provide a detailed explanation of EGTRRA. Several excellent articles are available which provide such an explanation.[5]

II. Planning Guidelines

The following guidelines, while not inclusive, offer a starting point for approaching the estate planning and drafting challenges presented by EGTRRA:

A. We cannot ignore EGTRRA. We cannot assume that because EGTRRA is complex, and perhaps bad law, that it will disappear and that our comfortable planning principles and document forms will be suitable after all.

B. We should continue using most of the effective wealth transfer techniques that were in use prior to EGTRRA.

C. We must plan and draft for flexibility and change.

D. We must review all of our tax-driven formula provisions and survivorship presumptions.

E. We must review all tax-related definitions in estate planning documents.

F. We must be alert to the new generation-skipping transfer tax automatic exemption allocation rule in any document that may potentially have a generation-skipping transfer ("GST").

G. We must not prepare a gift tax return unless we have analyzed the gift for GST tax consequences, and determined whether we should elect out of the new automatic GST exemption allocation rules. If we are involved in the gift transaction, but we do not prepare the gift tax return, we should instruct the gift tax return preparer to undertake a similar analysis.

EGTRRA is law. Even though significant parts of EGTRRA may change before 2010, planning cannot be premised on the inevitability of such change.

III. We Cannot Ignore EGTRRA

EGTRRA is law. Even though significant parts of EGTRRA may change before 2010, planning cannot be premised on the inevitability of such change. To the contrary, our planning should recognize that the law, as currently in effect, requires conscious planning and drafting through the 2002, 2009, 2010, and 2011 planning periods. If, following an explanation of the planning alternatives, clients consciously decline to incur the cost and complexity of EGTRRA planning, that choice should be documented in correspondence to the client. Certainly, as estate planning documents are reviewed in the normal course of reviewing and updating those documents, EGTRRA issues should be addressed.

IV. Continue Wealth Transfer Planning

This Article is not intended to describe wealth-transfer techniques. EGTRRA should not, however, preclude the use of effective wealth-transfer techniques, but should probably accelerate the use of such techniques, particularly for larger estates. For estates that will likely be insulated from estate tax exposure because of increasing exemptions, at least through 2006, the use of wealth transfer techniques must be tempered by the non-tax consequences of their use. For example, an irrevocable life insurance trust for a couple whose combined assets, including the face value of life insurance, total $2 million should probably not be used unless there are non-tax benefits to be derived from such trusts. In larger estates, however, wealth transfer techniques, including the following, should be considered: annual exclusion gifts using the current $11,000 annual gift tax exclusion; §2503(e) tuition and medical expense gifts; irrevocable life insurance trusts, particularly flexible life insurance trusts with provisions that would permit access to cash values; Grantor Retained Annuity Trusts, particularly the so-called "zeroed out GRAT" following the *Walton* case;[6] sales to Intentionally Defective Grantor Trusts;[7] creation and fragmentation of family limited partnerships and limited liability companies;[8] and gifts using the full $1,000,000 exemption equivalent, as discussed more fully in Section XI of this Article. The use of many of these techniques will continue to require an analysis of basis issues, including the tension between estate tax reduction and the loss of basis step-up, and the possibility of a carry-over basis regime beginning in 2010.

V. Planning and Drafting for Flexibility and Change

Standard drafting techniques such as marital or bypass trusts determined by formula must carefully be examined in each planning situation. Consideration must be given to the incrementally increasing credit shelter amount and the prospect of repeal. Formulae should also be reviewed to be certain that tax-driven provisions do not alter the client's desired economic distribution of assets. The possibility of a grantor's incapacity or unwillingness to incur the cost of several revisions may require drafting in the alternative for pre-repeal death, post-repeal death, and death following repeal of repeal.

5. *See* Jonathan G. Blattmachr & Lauren Y. Detzel, *Estate Planning Changes in the 2001 Tax Act—More Than You Can Count*, 95 J. TAX'N 74 (2001); James F. Gulecas & Alan S. Gassman, *Economic Grotwth and Tax Relief Reconciliation Act of 2001: Practical Estate Planning*, PRAC. TAX LAW., Dec. 2001, at 36; Charles F. Newland & Andrea C. Chomakos, *The 2001 Tax Act: Unchartered Waters for Estate Planners*, 2001 PROB. & PROP., Sept./Oct. 2001, at 32; Howard M. Zaritsky, *How Estate Tax "Repeal" Will Affect Your Estate Planning Practice*, ALI - ABA EST. PLAN. COURSE MAT'LS., Oct. 2001, at 6.

6. Carlyn S. McCaffrey, et al., *The Aftermath of Walton: The Rehabilitation of the Fixed-Term, Zeroed-Out GRAT*, 95 J. TAX'N 325 (2001).

7. Louis A. Mezzullo, *Freezing Techniques: Installment Sales to Grantor Trusts*, PROB & PROP., Jan./Feb. 2000, at 17; Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note - An End Run Around Chapter 14?*, 32 U. MIAMI INST. ON EST. PLAN. 15-1 (MB 1998).

8. Arthur D. Sederbaum, *Family Limited Partnerships: The Latest Cases*, DIG. TAX ARTICLES, Jan. 2002, at 11; Neil H. Weinberg, *Valuation Adjustments Applicable to Transfers of Family Business Interests*, 28 EST. PLAN.. 268 (2001); Dennis A. Webb, *Developing Valuation Discounts to Withstand Challenge*, 27 EST. PLAN. 214 (2000).

Consider, for example, the consequences of a typical drafting arrangement using a pre-residuary marital deduction trust and a residuary credit shelter trust determined by formula: The wife's assets are $3 million and the husband's assets are zero. In 2001, prior to EGTRRA, if the wife predeceased the husband, the marital trust would be in the amount of $2,325,000, and the credit shelter or by-pass would be in the amount of $675,000. In 2002, the marital trust would be $2 million and the credit shelter trust $1 million. In 2004, the marital trust would be $1.5 million and the credit shelter trust $1.5 million. In 2006, the marital trust would be $1 million and the credit shelter trust $2 million, and in 2009 the marital trust would be zero and the credit shelter trust $3 million, or the wife's entire estate. The consequences of the decreasing marital trust and the increasing credit shelter trust may differ significantly depending on whether the husband was the beneficiary of the credit shelter trust or whether the children or grandchildren were the beneficiaries. The consequences may also differ depending on how individual clients perceive and how attorneys explain the advantages and disadvantages of credit shelter trusts. A flexibly drafted credit shelter trust, in which the surviving spouse is the beneficiary with as much control as possible without creating a general power of appointment over the trust, will be perceived differently from a credit shelter trust in which the surviving spouse is subject to the whims of an independent and perhaps hostile trustee.

Over-qualifying marital deduction assets may be prevented by having the surviving spouse disclaim some of those assets into a credit shelter trust or to the children.

Ameliorating this potential mischief will require matching the clients' family and asset mix to one of several planning alternatives. Although other alternatives are available,[9] the following approaches should be considered as we offer planning recommendations to our clients:

A. Use of Disclaimers. Qualified Disclaimers under IRC § 2518[10] and K.S.A. 59-2291 to 2294, are friends of post-mortem planning. Their use may be involved in preventing over qualifying or under qualifying marital deduction assets. Over-qualifying marital deduction assets may be prevented by having the surviving spouse disclaim some of those assets into a credit shelter trust or to the children. Under-qualifying assets may require that the children disclaim in favor of the surviving spouse, thus qualifying the disclaimed assets for the marital deduction and avoiding unnecessary estate tax at the time of the first spouse's death. Disclaimers also are often used to deal with a client's disproportionally large retirement plans in order to fund the credit shelter trust[11] and to deal with situations in which a full credit shelter trust might not be appropriate in view of increasing exemptions.

EGTRRA makes disclaimers a more vital planning tool. Under a disclaimer arrangement, all of the grantor's assets would pass either outright to the surviving spouse or to a marital trust (which could be a withdrawal trust, a power of appointment trust, or perhaps a QTIP trust). The will or trust would provide, however, that if the surviving spouse disclaims, the disclaimed assets would pass to a credit shelter trust which could either be for the spouse's benefit, the benefit of the spouse and other family members, or only other family members to the exclusion of the spouse. The amount to be disclaimed would be determined by considering the following: the exemption level at the time of the first spouse's death; the separate assets owned by the surviving spouse; the surviving spouse's health; the potential exemption that would be available at the time of the surviving spouse's death; and an analysis of the extent to which assets owned by the predeceased spouse should be excluded from attracting estate tax in the surviving spouse's estate by disclaiming such assets into the credit shelter trust. In most instances, the credit shelter trust would name the surviving spouse as the trustee and provide the surviving spouse with an income interest and the right to receive principal distributions pursuant to an ascertainable standard.[12] So long as the trust contains no spray provisions or the right of the spouse to withdraw, other than pursuant to an ascertainable standard, a qualified disclaimer should occur and the disclaimed property in the credit shelter trust should escape tax at the time of the survivor's death.

The primary risks of the disclaimer arrangement are the following: (i) the surviving spouse's incapacity; (ii) the surviving spouse's reluctance to disclaim; (iii) the failure to disclaim within nine months because of oversight or inadvertence; and (iv) the requirement that the disclaimer be made within nine months, thus precluding the use of the potential fifteen month look-back period for the §2013 previously taxed property credit that might otherwise be available if a QTIP or contingent QTIP were used. These risks may, in part, be lessened by (a) substantial client education at the time the estate planning documents are discussed and executed, (b) ample warnings on the face of the estate planning documents and in client correspondence, and (c) the drafting attorney maintaining a separate list of all wills and trusts using disclaimer formats.

9. Ronald D. Aucutt, *An A-to-Z "To Do" List Following EGTRRA*, 28 Est. Plan. 606 (2001); Frank S. Berall et al., *Planning for Carryover Basis That Can Be/Should Be/Must Be Done Now*, 29 Est. Plan. 99 (2002). *See also* Gilecas & Gassman, *supra* note 5, at 43-49.

10. All further section references are to the Internal Revenue Code of 1986, as amended.

11. *See* generally Natalie B. Choate, Life and Death Planning for Retirement Benefits, Ch. 8 (4th ed. 2002) (discussing the use of disclaimers of retirement and insurance benefits in estate planning).

12. An ascertainable standard, as defined in I.R.C. § 2041(b)(1)(A), prevents the surviving spouse, as trustee, from having a general power of appointment over the credit shelter trust.

QTIP elections permit the executor to control both the amount that will qualify for the marital deduction and the amount that will pass into a non-elected portion which will escape tax in the surviving spouse's estate.

The disclaimer format is appealing to clients, particularly when described as a "Surviving Spouse's Selection Trust," emphasizing the surviving spouse's control over whether, and the extent to which, the credit shelter trust will be funded. If the marital trust gives to the surviving spouse an inter vivos withdrawal right, the surviving spouse can disclaim into the credit shelter trust and withdraw all the remaining assets from the marital trust even before funding, resulting in only two trusts (the surviving spouse's revocable trust and the credit shelter trust) rather than three. This arrangement reduces fees if a corporate trustee is involved, and reduces complexity if a surviving spouse is the trustee.

The risk of the surviving spouse's incapacity may be addressed by drafting powers of attorney that clearly and unambiguously give the attorney-in-fact the authority to disclaim. Similar authority should extend to executors in wills so that a disclaimer could be used if the surviving spouse dies within nine months from the date of the predeceased spouse's death. If a disclaimer is used, one must carefully comply with K.S.A. 59-2291 to 2294, and I.R.C.§2518. Included within the §2518 requirements are prohibitions against the disclaimant accepting any interest or benefits from the disclaimed property or having the power to direct the ultimate disposition of the disclaimed property. If, therefore, the disclaimed property passes into a credit shelter or disclaimer trust, the surviving spouse cannot have a limited power of appointment over the disclaimed property.[13]

B. Use of QTIP Trusts. QTIP elections permit the executor to control both the amount that will qualify for the marital deduction and the amount that will pass into a non-elected portion which will escape tax in the surviving spouse's estate.[14] The non-elected portion may roughly be comparable to a bypass or credit shelter trust for the surviving spouse. QTIP's can be designed in one of several ways:

1. The *Clayton*[15] or contingent QTIP approach, now sanctioned by Treas. Reg. §20.2056(b), directs the non-elected portion to persons other than the surviving spouse, or does not provide the surviving spouse with a mandatory income right from the non-elected portion. Because of the availability of the new automatic six-month extension for filing an estate tax return,[16] the contingent QTIP approach may provide the personal representative with up to fifteen months within which to determine whether to make the QTIP election. Therefore, even though the client may not want his or her spouse to receive property, even in a QTIP arrangement, a contingent QTIP allows an election to be made if the surviving spouse dies within fifteen months following the first death. If the surviving spouse lives for the full fifteen month period, the QTIP election would not be made and the property would pass, for example, to a trust for children or to other persons, possibly to the complete exclusion of the surviving spouse. If, however, the surviving spouse dies within fifteen months following the first death, the executor of the estate of the first spouse to die might make the QTIP election so that, to the extent of the property subject to such election, the survivor's full unified credit could be absorbed or the QTIP property taxed in a lower bracket than if it were part of the estate of the first spouse to die. The surviving spouse should not be the personal representative if a contingent QTIP trust election might be made because making the QTIP election, particularly a *Clayton* or contingent QTIP election, may shift the beneficial ownership of property. Therefore, if the surviving spouse is the personal representative, he or she would possess the power to shift property away from himself or herself by making the QTIP election, and a possible taxable gift would occur.

Even though the contingent QTIP arrangement has potential benefits, it has two significant disadvantages. First, the contingent QTIP eliminates the opportunity for the §2013 credit for tax on prior transfers for unelected property, because unelected property will be disposed of in a way which is not qualified for QTIP treatment. Second, the personal representative has significant authority to alter beneficial interests in property if the surviving spouse is not a beneficiary of the non-elected portion.

2. If the surviving spouse is to receive income, or both income and principal (limited to an ascertainable standard), from the elected and non-elected portions of the QTIP trust, the size of the non-elected portion could be determined by considering the exemption level at the time of the first death and the executor's analysis of the extent to which assets owned by the predeceased spouse should be excluded from potential tax in the survivor's estate as a part of the non-elected portion.

3. A separate marital trust could be established in addition to the QTIP trust from which the surviving spouse would have a right of withdrawal for the purpose of making gifts.[17] Sufficient assets would, however, be directed to the QTIP trust (probably by formula) to be certain that a full credit shelter amount would be available for the non-elected portion.

13. Treas. Reg. § 25.2518-2(e) (2001). A surviving spouse may, however, disclaim an interest in property even if that property passes into a trust for the benefit of the surviving spouse. I.R.C. §2518(b)(4)(A) (1994).

14. I.R.C. § 2056(b)(7) (Supp. V. 1999).

15. *See Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992) (recognizing the deductibility of the contingent QTIP trust).

16. Treas. Reg. § 20.6081-1(b) (2001).

17. Under I.R.C. § 2056(b)(7)(ii)(II), if the surviving spouse has a lifetime power to direct trust property to anyone other than the surviving spouse, QTIP treatment will be denied.

4. A five and five power[18] should be considered to give the surviving spouse greater withdrawal rights over the non-elected portion than would otherwise be permitted if only an ascertainable standard were used. A five and five power should also be considered even if a standard bypass or credit shelter trust is used so that if the exemption level increases to cause the credit shelter amount to be unnecessary in the surviving spouse's estate, or if repeal actually occurs, the surviving spouse could more rapidly deplete the credit shelter trust. In addition, if he or she were also given an ascertainable standard right of withdrawal, the credit shelter trust could be depleted even more rapidly. The risk of giving the surviving spouse the ability to deplete the credit shelter trust, even pursuant to an ascertainable standard, is that the surviving spouse may deplete the trust without regard to tax consequences, thus causing assets to be taxed in the surviving spouse's estate that would not have been taxed if the surviving spouse did not have the power of invasion.

5. Another, non-EGTRRA generated benefit of QTIP's is that, if properly structured, interests in family entities such as limited partnerships and limited liability companies passing to QTIP trusts can, at the time of the survivor's death, receive additional valuation discounts.[19]

C. "Not to Exceed" Approach. This approach uses traditional formulae, but with language stating that the credit shelter or bypass trust is not to exceed a certain pecuniary amount or fractional share of the estate. The use of the "not to exceed" approach presupposes that a credit shelter trust may impose a burden on the surviving spouse that would not otherwise occur if he or she received the property outright or in a non-QTIP marital trust.

The use of the "not to exceed" approach presupposes that a credit shelter trust may impose a burden on the surviving spouse that would not otherwise occur if he or she received the property outright or in a non-QTIP marital trust.

If clients are concerned that a credit shelter trust impinges on the surviving spouse's enjoyment of the property, which would clearly be the case if the credit shelter trust were to benefit only children or grandchildren, the not to exceed arrangement should be considered. It might be considered in situations in which the incrementally increasing exemptions will prevent estate tax in both spouses' estates. For example, if in 2004 the spouses' combined estates are $2.0 million and there is little appreciation potential, a pecuniary or fractional formula could be used to establish a ceiling for the credit shelter trust. Such a formula, in this $2.0 million example, might be as follows:

> The Trustee shall distribute to the Client Family Trust (credit shelter trust) the lesser of $500,000 or the largest value of Grantor's remaining trust property that can pass without increasing the federal estate and Kansas estate tax liability of Grantor's estate. In determining such largest value, the Trustee shall consider all transfers of assets included in the Grantor's gross estate for federal estate tax purposes and all of Grantor's adjusted tax gifts.

Presuming that in 2004 the largest value of the remaining trust property that can pass into a credit shelter trust without incurring tax would be $1.5 million, the credit shelter trust is capped at $500,000 because that $500,000, combined with the remaining property, whether owned by the surviving spouse or passing to the surviving spouse, will be $1.5 million, and the surviving spouse's $1.5 million exemption will not be exceeded. If a pecuniary formula is used, care should be taken to avoid taxable gain upon funding. While the estate tax is extant, formulae should be used to assure that a sufficient amount qualifies the marital deduction to avoid estate tax at the first death.

The problem with the "not to exceed" arrangement is that the survivor's estate may grow dramatically and unexpectedly. For example, the surviving spouse may receive an inheritance or have assets that unexpectedly appreciate in value. Formulae could perhaps be drafted to achieve the goal of avoiding too much of the asset value of the first spouse to die passing into a credit shelter trust without causing federal estate tax at the second death because of unexpected growth in the survivor's estate. To achieve this result, a disclaimer or QTIP arrangement may be preferable to a "not to exceed" formula because of the ability to decide how much to direct to the credit shelter or non elected portion within nine months (perhaps fifteen months) following the first death.

As a variation of the not to exceed arrangement, three trusts might be created: (i) a marital trust; (ii) a non-marital trust primarily for the surviving spouse; and (iii) a credit shelter or bypass trust. For example, in 2009, when the exemption is $3.5 million, a $4.0 million estate might be allocated as follows: $1.5 million to the marital trust; $2.0 million to a non-marital trust for the surviving spouse; and $1.5 million to a family trust for the children. If the surviving spouse were the primary beneficiary of the family trust, only two trusts might result; the marital trust in the amount of $1.5 million, and a family trust in the amount of $3.5 million.

18. A Five-and-Five power gives a beneficiary the right to withdraw the greater of $5,000 or five percent of the aggregate value of the trust assets. So long as the right does not exceed the greater of $5,000 or five percent, the lapse of the power is not considered to be a release of a power of appointment and therefore a taxable gift. I.R.C. § 2514(e) (1994).

19. *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996); *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999); *Estate of Lopes v. Comm'r*, 78 T.C.M. (CCH) 46 (1999); *Estate of Nowell v. Comm'r*, No. 1999-15, T.C.M. (RIA) 99,015 (1999) (acq.), *action on dec.*, 1999-6 (1999).

D. Drafting "In the Alternative." The most complex approach to address planning uncertainty involves drafting in the alternative depending on whether the estate tax is applicable at the date of death or whether the estate tax exemption is equal to or greater than a certain amount. Care should be given to avoiding such language as "in the event of my death after federal estate tax repeal" because the estate tax may be repealed in 2010, repeal repealed in 2011, and death occur thereafter. The estate tax would literally have been repealed, but would still be applicable and disastrous consequences could result. Alternative drafting might involve different scenarios if the federal estate tax is applicable. For example, the document might provide that if the exemption is $2 million or more, no credit shelter trust will be established, and all of the assets will pass to the surviving spouse. This arrangement lacks flexibility, however, in that it fails to provide to the surviving spouse or the personal representative of the estate of the first spouse to die with the second chance look that is available under the disclaimer and QTIP arrangements.

> ***Present formulae that generally measure the credit shelter amount by the exemption equivalent will, unless revised, result in the credit shelter share increasing and the marital share decreasing as the exemption equivalent increases.***

Drafting in the alternative might also involve different provisions if the federal estate tax is applicable or inapplicable at the time of death. If the federal estate tax is no longer applicable, provisions pertaining to the marital deduction, generation-skipping transfer tax exemptions, §2032, §2057 and similar provisions would no longer be needed. Moreover, if the federal estate tax is not applicable at the time of death, the marital deduction trust would not be required and the document might be drafted to require assets that otherwise would have been placed in the marital trust to pass to the credit shelter trust. If the estate tax reappears, and assuming a credit shelter trust remains protected from the estate tax, what would otherwise be taxable to the surviving spouse's estate as a part of the marital trust would not be subject to estate tax. Such drafting must, however, consider the carry-over basis rule that requires the additional three million dollar spousal adjustment to be available only if the property passing to the surviving spouse is outright or in a QTIP arrangement.

E. Continued use of Present Formulae - Expanding the Credit Shelter Share and Shrinking the Marital Share. Present formulae that generally measure the credit shelter amount by the exemption equivalent will, unless revised, result in the credit shelter share increasing and the marital share decreasing as the exemption equivalent increases. Notwithstanding a general initial bias against an expanded credit shelter share and a shrunken marital share, such a result may be salutary. Whether the result is salutary will depend on several factors, not the least of which is whether the credit shelter trust is flexible and gives the surviving spouse substantial control over the credit shelter trust. Principal distributions based on an ascertainable standard, even supplemented by five-and-five power, may not provide adequate control and ensure maximum flexibility to the survivor, particularly if clients have young children who might not be included within the distribution provisions of the credit shelter trust. The surviving spouse might feel extreme displeasure if the credit shelter trust is not available for college expenses for his or her children, particularly if the increasing exemption makes the potential for estate tax in the survivors's estate unlikely.

Consequently, as the credit shelter expands and the marital share shrinks, consideration should be given to increasing the surviving spouse's control over the credit shelter trust through flexible drafting arrangements. Such control can be assured by giving the surviving spouse the power to appoint an independent person who in turn can appoint an independent trustee.[20] Neither the independent person nor the independent trustee may be subordinate to the surviving spouse and both must meet the criteria for an unrelated and non-subordinate party under § 672(c). In this manner, the independent trustee can be clothed with the authority to make fully discretionary distributions to the surviving spouse and others, and if necessary because of changed circumstances (such as the elimination of the estate tax), distribute the entire credit shelter trust to the surviving spouse. The liberalized credit shelter trust may be preferable to a disclaimer trust in that the surviving spouse can have a limited power of appointment over the credit shelter trust but not over a trust funded through the surviving spouse's disclaimer.

An expanded credit shelter trust will also provide the non-tax benefits of creditor protection and protection from second marriages. This protection seems particularly appropriate if the spouses have divided their estates in a roughly equal manner. Even if substantially all of the assets of the first spouse to die passed to the credit shelter trust, the surviving spouse retains his or her individual ownership of one-half of the assets. The assets of the first spouse to die would, therefore, be protected from the surviving spouse's creditors and subsequent marriages. Expanding the credit shelter trust may offer a hedge against Congressional unpredictability, exemption tinkering, and repeal of repeal. If, for example, Congress should freeze the exemption at $1.5 million in 2004, estate tax exposure could result in a situation in which each spouse has an estate of $1,000,000, one spouse dies in 2003, and the surviving spouse, through a disclaimer or QTIP election, directs only $500,000 to the credit shelter trust

20. Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust*, 33 Real Prop. Prob. & Tr. J. 1, 23-25 (1998).

in anticipation of the exemption reaching $2 million in 2006. If, however, Congress freezes the exemption at $1.5 million, the surviving spouse (assuming no appreciation value of his or her estate) will have $500,000 exposed to estate tax at the time of his or her death. Similarly, estate tax exposure could result if repeal occurs but the estate tax subsequently returns, as is presently scheduled to happen in 2011. If a credit shelter trust had been established, the assets in that trust would probably be free from estate tax during a subsequent estate tax regime. If, however, a credit shelter trust had not been used because of repeal or the prospect of repeal, and all of the assets passed to the survivor, repeal of repeal would expose all of the assets above an uncertain exemption to estate tax in the surviving spouse's estate.

One risk in maximizing the credit shelter amount even through flexible drafting, is that if repeal occurs and carry-over basis becomes law, the assets in the credit shelter trust would not qualify for the spousal $3 million-adjustment to basis, which would have occurred if the assets had been placed in a QTIP trust. However, placing assets in a QTIP trust in anticipation of repeal in order to qualify for the $3 million spousal basis adjustment assumes that, following repeal, a QTIP trust established prior to repeal will not be subject to tax in the surviving spouse's death after repeal.

An adaptation to the traditional credit shelter trust – marital trust formulae might include language in the marital trust that the surviving spouse should receive distributions equal to the combined income from both the marital trust and the credit shelter trust, and no distributions would be made from the credit shelter trust until such time as the marital trust was exhausted. In this manner, the marital trust, which would be taxable in the surviving spouse's estate, would be reduced and the credit shelter trust, which would not be taxable in the surviving spouse's estate would be increased. This arrangement presupposes that the surviving spouse will consume the additional distributions from the marital trust rather than investing those distributions in a way that would cause them to be taxed in the surviving spouse's estate.

Pre-residuary pecuniary credit shelter formulae could create an unexpected result in a post-repeal regime if the formula refers to the "maximum amount necessary to reduce the estate tax to zero," and there is no estate tax.

VI. Other Considerations in Drafting for Flexibility

Although drafting flexibly and avoiding tax-driven formulae from misdirecting beneficial interests in property were planning considerations prior to EGTRRA, the uncertainties spawned by EGTRRA necessitate consideration of newer and less comfortable planning approaches. Among them are the following:

A. Consideration should be given to allowing a trustee or trust protector to change the terms of a revocable trust following death, at which time the trust becomes irrevocable. Language may be precatory, expressing the grantor's intent to avoid estate tax to the greatest extent possible, and if no estate tax is applicable, to benefit the surviving spouse to the greatest extent possible. Any right to change trust terms must, however, avoid inadvertently creating a terminal interest, thus causing property not to qualify for the marital deduction. Moreover, any powers granted must not give the powerholder the ability to benefit himself or herself, unless ascertainable standards are used.

B. Similar language may be used in a revocable trust to take into account the grantor's possible incapacity. Thus, if changes in the tax law occur that frustrate or otherwise are not consistent with the grantor's stated intention, the trustee, an attorney-in-fact, or a trust protector can revise the trust if the grantor is incapacitated.

C. A trustee or trust protector might be given the power to terminate a trust, particularly a credit shelter trust, prior to the stated termination date. Similar powers are used in many documents today if the size of a trust decreases so that it is no longer economically prudent to continue its existence, or if the purposes of the trust have been fulfilled. If such a power is given, however, the drafter must be particularly attentive in order to avoid disqualification of the marital deduction, charitable deduction, qualified subchapter S trust ("QSST"), electing small business trust ("ESBT"), and similar arrangements. Any such language must also focus on the possibility of repeal of repeal. The power of termination could be in the form of a limited power of appointment.

D. If creditor protection is not overly important, trusts without spendthrift provisions may enhance flexibility. A beneficiary with a vested remainder interest could, therefore, sell that interest for estate planning purposes or make a gift of the interest.

VII. Revising Current Formulae and Document Language

A. Reduce to zero formulae may continue to be useful during the phase-in period prior to repeal. If, however, repeal occurs and the client has not changed his or her estate planning documents prior to repeal, a reduce to zero formula could prevent any assets passing to the marital share. During the phase-in period, the reduce to zero formula may substantially overfund the credit shelter share, thus depriving the surviving spouse of a substantial part of the predeceased spouse's property, particularly if the credit shelter passes to children or grandchildren. If the surviving spouse is a beneficiary of the credit shelter trust, over funding that trust may be beneficial if the trust has been flexibly drafted to give to the surviving spouse substantial control over the trust property without creating a general power of appointment in the surviving spouse. *See* Section V.E., *supra*.

B. Pre-residuary pecuniary credit shelter formulae could create an unexpected result in a post-repeal regime if the formula refers to the "maximum amount necessary to reduce the estate tax to zero," and there is no estate tax. In that situation, the credit shelter amount might not be funded and all assets would pass to the marital trust, potentially subjecting those assets to tax in the surviving spouse's estate in the event the estate tax is reinstated. Language might, therefore, be considered that would provide for the determination of the pecuniary credit shelter amount in the same manner as if the federal estate tax were in effect at the time of the grantor's death. Preresiduary pecuniary credit shelter formulae could also create untoward consequences prior to repeal because a larger and larger share of the estate will pass to the pecuniary credit shelter trust. Therefore, if most or all of the assets in the estate will pass to the credit shelter trust because of the growing exemption, avoiding taxable gain on funding the credit shelter trust will be difficult. Such taxable gain could result when appreciated assets are used to satisfy the pecuniary share obligation. Thus, if all of the assets in the estate must be used to fund the pecuniary credit shelter amount, gain will be recognized if assets that have appreciated since the date of death are transferred to the credit shelter trust. Similarly, gain could be recognized if the estate has an installment contract that is transferred to the credit shelter trust. In that situation, all of the gain that would otherwise have been recognized as income in respect of a decedent over the installment payment period may, under §453B, be accelerated and recognized in the year the installment obligation was transferred to the credit shelter trust.

C. Language that requires only assets qualifying for the marital deduction to be used to fund marital gifts should be reviewed. If repeal occurs, there will be no marital deduction, and the possibility exists that such bequests could not be funded or that a reformation action would be necessary.

D. Formula GST gifts using the grantor's remaining GST exemption may create the following untoward consequences:

1. If no GST tax exists, there will be no gift without reformation.

2. As the GST exemption increases, clients should be apprised that the amount passing in to a GST trust will grow with the exemption, and, for example, in 2009 may be $3.5 million. This may not be consistent with a client's wishes, particularly, if the GST amount passes into further trusts for grandchildren, to the exclusion of children.

Moreover, as the exemption increases, unequal asset ownership may result in over funding the credit shelter amount, particularly if formulae have not been changed.

E. All wills and trusts must be reviewed for references to terms, such as the federal estate tax, marital deduction, generation-skipping transfer tax, and similar terms that may control dispositive provisions but that may not be applicable if repeal occurs.

F. Tax apportionment clauses must be reviewed. Such a review is essential notwithstanding EGTRRA because of the new Kansas Estate Tax Apportionment Act.

VIII. Asset Allocation Between Spouses

The principle of asset equalization will continue to be important after EGTRRA because as the exemption amount increases, the bypass benefits of each spouse owning assets equal to the exemption amount will also increase. Moreover, as the exemption increases, unequal asset ownership may result in over funding the credit shelter amount, particularly if formulae have not been changed.

Current formulae that are intended to achieve equalization at the time of the first death should, however, be examined. Such formulae could require tax at the time of the first death even though at the time of the second death the exemption will have increased and, perhaps, repeal will have occurred. Any plan that contemplates paying estate tax at the time of the first death should be reviewed and probably changed.

Presumptions of survivorship should also be reviewed to prevent pyramiding assets into the surviving spouse's estate or preventing the full use of both spouses' credit shelter amounts. For example:

A. Husband and wife each has assets of $2.0 million and the exemption is $1.5 million. Neither spouse's trust should provide for a presumption that the other spouse survives in the event of a simultaneous death. Rather, each trust should provide that in the event of a simultaneous death the other is presumed not to have survived, which would be the result under the Kansas Uniform Simultaneous Death Act. A presumption of survivorship in either trust could cause $500,000 of assets being subject to estate tax in the other spouse's estate, a result that would not have occurred if the Uniform Simultaneous Death Act had applied.

B. The wife's assets are $3.0 million and husband's assets are $1.0 million. The exemption is $1.5 million and husband dies five months after wife's death. A six-month survival requirement under these facts would create unnecessary tax and would waste $500,000 of the surviving spouse's exemption. Thus, to the extent either spouse has assets less than the exemption, a six-month survival requirement may create additional tax if the spouse whose assets are less than the exemption survives. In this example if the wife's trust had not included the six-month survival requirement, the $1.5 million marital share would have passed to the husband and a $1.5 million credit shelter share would have passed to the credit shelter trust. The husband's estate would, therefore, become $2.5 million, and his full $1.5 million exemption would be available at the time of his death. This example would also dictate consideration of the surviving spouse's executor disclaiming a portion of the marital share in order to equalize estate tax brackets. Furthermore, if there is an actual expectation that the surviving spouse may not live for six months following the death of the first spouse, a QTIP arrangement should be used to maximize the previously taxed property credit under § 2013.

IX. Examine Tax Related Definitions in Estate Planning Documents

The tax driven formula that measures the gift to the grandchildren by the generation-skipping transfer tax exemption is tax driven and may, unless changed, cause much more property to pass to the grandchildren than the grantor intended.

Most estate planning documents drafted for potentially taxable estates contain many tax-related definitions. The possibility of estate tax repeal necessitates a review of the applicability of such definitions during the pre-repeal, repeal, and post repeal periods. Such a review might include the following:

A. Assuming permanent repeal, substantial uncertainty exists as to the effect of repeal on references to specific Code sections that may no longer exist. If those sections remain in the Code, but the estate tax has been repealed, are those sections still effective? Moreover, the reference to "repeal" may be troublesome if repeal is repealed. All references in documents pertaining to powers of appointment should also be reviewed. For example, in a post-repeal era, is an ascertainable standard limitation under §2041 needed, or does the usual tax-driven ascertainable standard language reflect the client's desired non-tax motivated standard for distributions?

B. Should the definition of "Code" be changed from its current reference "The Internal Revenue Code of 1986, as amended"? A suggested substitute would be to "the applicable provisions or sections of the Federal Tax Law in effect on the date of grantor's or testator's death that corresponds to the provision or section referred to that was in effect at the time of the execution of the document."[21]

C. The trustee or executor could be given discretion to change dispositions tied to specific, but inapplicable code sections. Even in a post-repeal era, however, such powers could create income tax problems under the grantor trust rules.

D. Care must be given to the use of the term "death tax" because of the differences in the federal estate tax and state death taxes, the latter of which may become more significant than the former.

X. Generation-Skipping Transfer Tax Considerations

EGTRRA presents several significant generation-skipping transfer(GST) tax issues. Those issues may be divided into two main categories. First are issues resulting from the increased generation-skipping transfer tax exemption, and second are issues resulting from EGTRRA changes that are generally intended to make the generation-skipping transfer tax more "user friendly."

The potential mischief created by the increased exemptions arises primarily from the use of tax-driven formulae in which wealthy persons may choose to make testamentary gifts to grandchildren measured by that person's generation-skipping transfer tax exemption. For example, the grantor has an estate of $4,000,000 and wishes to leave his or her maximum generation-skipping transfer tax exemption to her grandchildren. Pre-EGTRRA drafting would measure the amount of the grandchildrens' gift as an amount equal to the grantor's then remaining GST exemption. Consequently, in 2002, the amount left to the grandchildren, probably in trust, would be $1,100,000, and $2,900,000 would be left to the children. Because of the increasing GST exemption, however, in 2004 the grandchildren's trust would be $1.5 million and the children's trust $2.5 million. In 2006, the grandchildrens' trust would be $2.0 million and the children's trust $2.0 million, and in 2009, the grandchildren's trust would be $3.5 million and the children's trust $500,000. The tax driven formula that measures the gift to the grandchildren by the generation-skipping transfer tax exemption is tax driven and may, unless changed, cause much more property to pass to the grandchildren than the grantor intended. Problems may also occur if a GST trust is defined by the grantor's remaining GST exemption and the GST tax is no longer applicable. In that situation, the GST trust could be denied the receipt of any property.

The second set of GST issues created by EGTRRA involves several Code changes intended to reduce the number of precarious traps in GST planning and implementation. Although post-EGTRRA traps remain, they are slightly less precarious but continue to require careful planning, particularly in allocating the GST exemption. As described in Section I, *supra*, the GST exemption increases from its current $1,100,000 by annual cost of living increases until 2004, at which time it unifies with the estate tax exemption equivalent of $1,500,000, and continues to move in tandem with the exemption equivalent through 2009. Because the proper allocation of the GST exemption can mean the difference between the imposition the GST tax or no GST tax, or can greatly reduce the amount of GST tax, and because of concern that allocation errors were common and potentially costly, both attorneys and accountants urged Congress to make the GST tax allocation procedures more user friendly. Whether EGTRRA accomplished that result remains an open question. What is not an open question, however, is that the GST rules continue to be exceedingly complex and anyone preparing a document with generation-skipping transfers or preparing a gift tax return involving a transfer that may potentially result in a generation-skipping transfer must fully be cognizant of the GST rules and how EGTRRA changes those rules. Several

21. Lloyd Leva Plaine & Wendy Ann Wilkenfeld, *Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues After Enactment of the Economical Growth and Tax Relief Reconciliation Act of 2001*, 27 ACTEC J. 119 (2001).

excellent sources[22] provide a thorough analysis of EGTRRA's GST changes and drafting suggestions to reflect those changes in estate planning documents.

Several gift tax planning opportunities exist during the phase-in period. Included among these opportunities is the use of the full increased lifetime exemption of $1.0 million dollars that becomes available after January 1, 2002.

XI. Gift Tax Planning

A. EGTRRA Disunifies Estate and Gift Taxes.

As of January 1, 2004, the lifetime gift tax exemption is frozen at $1.0 million and the estate tax exemption is increased to $1.5 million. The unified credit, therefore, is disunified after December 31, 2003. Even if estate tax repeal occurs, the gift tax remains with a top marginal bracket in 2010 of thirty-five percent. The thirty-five percent rate is based on the maximum individual income tax rate at that time. The statute does not specifically refer to the individual tax rate, but rather specifies a thirty-five percent tax rate. The gift tax is retained to protect the income tax by avoiding income shifting through asset transfers to lower income family members, thereby reducing aggregate family income tax liability. The $10,000.00 ($11,000 in 2002) per donee annual exclusion, indexed to inflation, will continue.

B. Gift Planning.

1. Several gift tax planning opportunities exist during the phase-in period. Included among these opportunities is the use of the full increased lifetime exemption of $1.0 million dollars that becomes available after January 1, 2002. Because the $1.0 million dollar exemption is frozen following January 1, 2002, the earlier gifts are made using the exemption, the greater the appreciation that can be removed from the donor's estate. Any gifting decision should, however, consider basis in selecting assets to gift. Basis considerations now involve determining whether various gift devices that lower estate values and shift appreciation may also preclude adequate appreciation to make the $1.3 and $3.0 million basis adjustments if death occurs following 2009. Because of the uncertainty of repeal and concomitant carryover basis, this analysis should, however, be secondary to the goal of shifting appreciation. Clients who have made taxable gifts prior to 2002 should be cautioned that they do not have a full $325,000 of exemption equivalent available, which would be the case if prior gifts had equaled or been less than the 2001 exemption equivalent of $675,000. A full $325,000 is not available because that amount is based on the tax (before the credit is applied) on gifts between $675,000 and $1,000,000, rather than the tax on gifts that are in excess of the prior $675,000 exemption equivalent. Consequently, clients should not be told that in all instances they have $325,000 of available exemption remaining.

2. Leveraged Gifts Should be Preferred. Leveraged gifts could include the following: (a) gifts of interests in family LLC's and LLP's using valuation discount principles; (b) gifts of life insurance; and (c) GRATS, particularly zeroed out GRATS, in which payments to the grantor, although subject to possible estate tax in the grantor's estate, should benefit from increasing exemptions and perhaps estate tax repeal.

3. Installment sales to intentionally defective grantor trusts should be considered. Not only can substantial leverage be achieved in such sales, but the note to the grantor can be forgiven as gift tax rates are lowered. SCIN'S (self-canceling installment notes) should also be considered.

4. Forgiveness of indebtedness may also be an advantageous wealth-transfer device. Testamentary forgiveness of indebtedness incurred in either an intra-family loan or an installment sale would be effective if the obligee dies following estate tax repeal. This arrangement must, however, be structured to avoid a gift being made at the time the debt was incurred because the sale was not bonafide or there was no intention to collect the debt.

XII. Carryover Basis Planning

Because the purpose of this Article is to provide preliminary planning and drafting considerations following EGTRRA (to be tested by time, trial, and error) only a general summary of the carryover basis rules will be provided. Those rules are found in new §1022, and establish basis rules for property acquired from decedents dying after December 31, 2009. Pursuant to §1022(a)(2), the basis of property acquired from a decedent after December 31, 2009, shall be the lesser of the adjusted basis of the property in the hands of the decedent or the fair market value of the property at the date of the decedent's death. The step-down in basis for loss assets is thus preserved, while the step-up in basis for appreciated assets is denied. Such denial is mitigated, however, by the basis increase permitted under §1022(b). Under that Section, the executor can allocate to specific assets acquired from a decedent a basis increase of $1.3 million, but such increase cannot increase the basis above the fair market value of the specific assets at the time of the decedent's death. For example, on the date of death the decedent owned improved real estate with an adjusted basis of $500,000 and a fair market value of $1.8 million. The executor can allocate the full $1.3 million basis increase to the real estate. If the adjusted basis were $500,000 and the fair market value $1.6 million, the executor could only allocate $1.1 million to the real estate.

A surviving spouse is entitled to an additional $3 million of basis increase. The $3 million basis increase is avail-

22. *See, e.g.*, Harrington, McCaffrey, Plaine & Schneider, *Generation-Skipping Transfer Tax Planning after the 2001 Tax Act: Mostly Good News*, 95 Journal of Taxation 143 (2001); Herrington, Plaine & Zaritsky, Generation-Skipping Tax (2nd ed.2001).

able, however, only with respect to "qualified spousal property." Qualified spousal property is limited by §1022(c) to property transferred outright to the surviving spouse or qualified terminable interest property. Thus, even after repeal of the estate tax, QTIP concepts will remain to test whether the $3 million basis increase is available for property acquired by a surviving spouse.

The $1.3 million basis increase can be further increased by any of the decedent's unused capital losses and net operating loss. No adjustment is allowed, however, for §691 assets that are considered income in respect of a decedent. Consequently, no basis increase will be allocable to qualified retirement plan assets, installment contracts, deferred compensation, and other assets that are considered income in respect of a decedent.

The uncertainty of estate tax repeal and the history of carryover basis (remember 1976) should cause estate planners to consider the extent to which they should draft documents and charge clients for carryover basis planning. Estate planners may, however, wish to consider the following:

A. Clients should be encouraged to maintain good basis records. There is no reason to believe that today's clients maintain better basis records than clients of 1976.

B. Fiduciaries should be given the authority to allocate the $1.3 million and $3.0 million basis adjustments. Exculpation provisions will also be important. If the fiduciary is a family member, consider giving basis adjustment discretion to an independent fiduciary to avoid inadvertent gifts (remember, the gift tax remains).

C. Depending on client tolerance, consider discussing different approaches to allocating the basis adjustment. Should it be allocated on a pro rata basis similar to equitable apportionment? This approach would allocate the basis increase in the ratio that the percentage of unrealized appreciation in each asset bears to the unrealized appreciation in all assets in the trust or estate.

Because the state death tax credit will be phased out after December 31, 2001, and will be replaced in 2005 by a deduction, states will bear a significant part of the cost of the federal estate tax exemption increases and rate reductions.

D. In second marriages, will the surviving spouse receive the full $4.3 million adjustment or should $1.3 million basis adjustment be allocated to the children?

E. How will basis adjustments be allocated among specific beneficiaries and residuary beneficiaries?

F. If the basis adjustment is allocated to ambiguously valued assets, and such assets are revalued after the §6019 return (the return to report carryover basis) is filed, gain may have been improperly determined during the period between the date of death and the final determination of value. If the basis adjustment is allocated to unambiguously valued assets, similar uncertainty will not exist.

G. Should formulae be used to ensure that the surviving spouse will have at least $1.3 million of assets at the time of his or her subsequent death?

H. If, in a carryover basis regime, the full $4.3 million basis adjustment is allocated to the surviving spouse, can the surviving spouse sell the adjusted basis assets, convert such assets to cash, and, effect a step up with respect to the full $4.3 million?

I. In a carryover basis regime, §1022(d)(I)(C)(ii) provides that gifts made to a terminally ill spouse by the other spouse, apparently even within three years of death, are still eligible for the $3.0 million basis adjustment so long as the other spouse did not receive such assets as a gift during the three-year period. Such asset shifting could, therefore, be done at any time before the death of the first spouse to die. Durable powers of attorney could also permit gifts between spouses, not only for possible carryover basis positioning, but also for estate equalization and for utilizing the increasing exemption amounts.

J. If the surviving spouse is to receive the $3.0 million basis adjustment, the assets passing to him or to her must either be outright or in a QTIP arrangement. Although the QTIP arrangement will qualify a basis adjustment for the full $3.0 million at the time of the first death, assets in the QTIP trust will not qualify for the $1.3 million basis adjustment at the time of the surviving spouse's death. The surviving spouse should, therefore, have assets independent of the QTIP trust to assure that at his or her death, the full $1.3 million basis adjustment will be available.

XIII. State Death Tax Issues

Because the state death tax credit will be phased out after December 31, 2001, and will be replaced in 2005 by a deduction, states will bear a significant part of the cost of the federal estate tax exemption increases and rate reductions. For states that have a pick-up tax tied to the federal estate tax credit for state death taxes (and not as of a particular date), 2005 will bring a significant revenue loss. Some states having a pick-up tax, including, perhaps, Kansas, may not have a revenue loss if the state's death tax is either a separate estate tax or is tied to the federal state death tax credit as of a particular date, rather than generally to the federal state death tax credit. The situation in Kansas is interesting and unexpected, and has been thoroughly explored by Timothy P. Sullivan and Stuart T. Weaver in an excellent article found in the November/December 2002 issue of the Kansas Bar Journal.[23] Few states will be spared the uncertainty caused by EGTRRA's phase out of the state death tax credit. For those states that do not tie the state death tax credit to a particular date, as does Kansas, federal estate tax may actually increase between 2001 and 2006, notwithstand-

23. O'Sullivan and Weaver, 2002 *Kansas Death Tax Legislation: An Emperor in Need of Clothes*, J. Kan. Bar Assn. 19 (November/December 2002)

ing increased exemptions and reduced rates. For example, in 2005, an estate of $3.5 million will pay nothing to a pick-up tax state, and a top rate of forty-seven percent (47%) to the Internal Revenue Service.

Perhaps we should also recognize that those uncertainties and complexities provide the not unpleasant prospect of more and challenging work for estate planners. If it weren't difficult, we would'nt be needed. Perhaps, therefore, we should say, "Thank you, Senator Byrd."

XIV. Retirement Plans

As retirement plans grow in relative size to all assets in an estate, problems continue in how to fund the credit shelter trust with retirement plan assets. This problem will be exacerbated by the increased exemptions through 2009. Disclaimer arrangements will still be important as will QTIP formats. In the disclaimer arrangement, the spouse is named primary beneficiary and a disclaimer trust that meets the "look through rules" for establishing a designated beneficiary under Treas. Reg. §1-401(a)(9)-4 is named as the contingent beneficiary. This arrangement permits the surviving spouse to determine whether all or a portion of the retirement plan assets should be rolled over into a spousal IRA, and, to the extent that assets are not rolled over, the excess can be disclaimed into a disclaimer bypass trust.

XV. EGTRRA Effects on Surviving Spouses

Because of the increased exemptions, the wealthier spouse in a second marriage may have little incentive to provide a QTIP trust for his or her surviving spouse. Thus, if in 2006 a husband's assets total $2.0 million, he might desire to leave all of his assets, estate tax free, to his children, and therefore not provide for the surviving spouse as would be the case if his estate were subject to tax if he did not use a QTIP. Prenuptial agreements will, therefore, become even more important as exemptions increase and if repeal becomes permanent.

Some spousal protection exists even in a post-repeal regime because of the $3.0 million basis adjustment. Even though the surviving spouse would have only $1.3 million of basis adjustment of his or her own, if the surviving spouse sells QTIP assets distributed to her or to him as a part of the $3.0 million basis adjustment, and replaces those assets with cash or high basis assets, children of the first spouse to die will ultimately benefit.

The increased gift tax exemption to $1.0 million may provide an opportunity for second spouses to join with his or her spouse in making substantial gifts or to "sell" a portion of his or her exemption to the wealthier spouse. With prior lower exemptions, a second spouse may have been concerned that because of appreciation, he or she would be subject to tax at the time of his or her death. However, with the increased exemptions, the likelihood of estate tax may be reduced, thus providing an incentive for the spouse with the fewer assets to join with his or her spouse in making large gifts.

XVI. Conclusion

The planning and drafting suggestions made in this Article are untested by trial and error. As we experience the reality of EGTRRA, tested and refined suggestions will no doubt be made. Continuing with the old planning paradigm, however, while waiting for such suggestions to be made, ignores EGTRRA's presence. We must, therefore, respond in our planning and drafting to the uncertainties and complexities EGTRRA presents. Perhaps we should also recognize that those uncertainties and complexities provide the not unpleasant prospect of more and challenging work for estate planners. If it weren't difficult, we would'nt be needed. Perhaps, therefore, we should say, "Thank you, Senator Byrd."