Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

Overview and Analysis

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B. **Unification of Estate and Gift Tax Exemptions**. The gift tax and estate tax exemptions, which have been separate since 2001, have been reunified under the 2010 Act, at the unified exemption amount of $5,000,000, and at a maximum tax rate of 35 percent, for the years 2011 and 2012. With unification of estate and gift tax exemptions, an individual is now able to make up to $5,000,000 of gifts during his or her lifetime, without paying any gift tax. However, any gift tax exemption used to make tax free lifetime gifts will, in effect, be deducted at death from the available estate tax exemption.

1. **Example of Unified Estate and Gift Tax Exemptions**. A Husband and Wife have assets of $12,000,000. $6,000,000 belongs to the Wife and $6,000,000 belongs to the Husband. The Husband predeceases his Wife in 2011, and leaves $5,000,000 to their children, and $1,000,000 to his Wife. The $5,000,000 bequest to the children fully uses and satisfies the Husband's estate tax exemption, and the $1,000,000 bequest to the Wife is exempt from estate tax because of the marital deduction. The Wife now has assets of $7,000,000. The Wife then makes $4,000,000 of lifetime gifts to her children. The $4,000,000 of lifetime gifts are less than her $5,000,000 gift tax exemption, resulting in no gift tax due. The Wife dies in 2012 with assets of $3,000,000. Her estate tax exemption is $5,000,000 minus the $4,000,000 of gift tax exemption used by her lifetime gifts, resulting in a $1,000,000 estate tax exemption. The Wife is left with a $2,000,000 taxable estate ($3,000,000 less $1,000,000 equals $2,000,000).

2. **Annual Gift Tax Exclusion.** The 2010 Act does not alter the current law regarding the federal annual gift tax exclusion, which for 2011 remains at $13,000. The federal annual gift tax exclusion refers to the amount of money or property that one individual can transfer to another individual, in a single year, without being subject to any gift tax or having to use any gift tax exemption. An individual can make a $13,000 gift to each of multiple donees without the need to file a gift tax return. The new $5,000,000 estate tax exemption, which may be $10,000,000 for spouses, as explained below under portability, may make annual exclusion gifts less important, or perhaps counterproductive. They may be less important because the increased exemption lessens the need for reducing one's estate to avoid the estate tax, and they may be counterproductive because the carryover basis for gifted property may eliminate a step-up in basis if the gifted asset had been held until the death of the donor.

3. **New Methodology Pertaining to Computing Tax on Prior Taxable Gifts.**

(a) **Estate Tax.** The computation of the estate tax takes into account prior taxable gifts, which are added to the amount of the taxable

C. **Generation-Skipping Transfer Tax Exemption.** The 2010 Act reintroduces the generation skipping transfer (GST) tax, after a one year hiatus (2010). The Act, in effect, repeals the 2010 repeal of the GST tax. The GST is retroactively introduced for 2010, with a $5,000,000 exemption and zero percent tax rate. For 2011 and 2012, the GST exemption is $5,000,000 and the maximum taxable rate is thirty-five percent (35%). The repeal of the 2010 repeal eliminated many uncertainties without creating a constitutional issue of retroactivity by providing a zero percent GST tax bracket for 2010. If, however, Congress fails to act with respect to the GST before January 1, 2013, the Internal Revenue Code will be applied and administered to generation-skipping transfers that take place after 2012 as if the 2001 Act ("EGTRRA") had never been enacted, thus creating even more uncertainties. Although uncertainty may exist after 2012, the 2010 Act provides certainty for generation-skipping transfers made in 2010 and those to be made in 2011 and 2012.

Planning Suggestion: Good planning probably dictates that if a client is willing and able, he or she should use the full $5,000,000 GST exemption as early in 2011 as possible. If a gift is made in early 2011, and GST tax exemption is allocated to gifted assets that produce an investment return, the investment return, together with the original value, will be protected from future GST tax. Moreover, unless Congress acts before January 1, 2013, the GST tax exemption is scheduled to revert to $1,000,000, indexed to inflation after 1998. Therefore, a GST tax exemption that is not allocated prior to 2013 may be lost.

D. **Estate Tax Administration for 2010 Deaths and Transfers.** The 2010 Act permits the executor of the estate of a decedent who died in 2010 to select between (i) the new estate tax law applicable in 2011 and 2012, with an estate tax exemption of $5,000,000 and a tax rate of 35 percent, or (ii) the estate tax law of 2010, which provides for no estate tax. The new estate tax law for 2011 and 2012 with a $5,000,000 exemption and a tax rate of 35 percent is the default rule; that is, it applies without any affirmative action by the executor. The no estate tax law for 2010, however, requires an election to be applicable to the estate of a decedent who died in 2010. If the no estate tax law of 2010 alternative is selected, however, the executor will not be able to "step-up" the basis of the decedent's assets. Therefore, instead of the tax basis of an asset being its fair market value at the time of the decedent's death, the asset's basis will remain whatever the asset's basis was in the hands of the decedent. Capital gain or loss on the subsequent sale of the asset will therefore be determined by appreciation from the decedent's basis ("carryover") instead of the fair market value of the asset as of the date of death of the decedent. The estate's executor will, however, be given discretion to allocate $1,300,000 of "free basis" to any assets passing from the decedent. The executor can also allocate an additional $3,000,000 of free basis to assets passing to the surviving spouse.

(a) If the estate tax, rather than carryover basis, is elected, the size of the estate and thus the amount distributable to beneficiaries diminishes.

(b) If carryover basis is elected, the executor may allocate $1,300,000 of additional basis to the estate's assets and possibly an additional $3,000,000 of additional basis to assets passing to the surviving spouse. An executor faces a daunting challenge in making these allocations, particularly if a carefully drafted tax allocation clause is not included in the will or trust.

(c) A beneficiary entitled to a substantial specific pecuniary bequest, (e.g., $1,000,000) to which estate tax under the trust is not to be allocated, may not care what decision is made. However, the recipient of a section of farm land in which the decedent had a basis of $500 an acre with a date of death value of $4,000 an acre may care a great deal what decision is made. If estate tax is chosen and estate tax is allocated to the estate tax caused by the section of farm land, the beneficiary receives less. If estate tax is not chosen, the beneficiary receives a low $500 per acre or basis under the carryover basis regime with significant capital gains tax exposure in the future. In other words, the decision by the executor of an estate with assets over $5,000,000 (or at least over $4,000,000 if the $1,000,000 prior gift tax exemption has been used) to use the default rule by which the Federal Estate Tax will apply and carryover basis will not apply, causes a significant impact on how much value particular beneficiaries actually receive. Similarly, electing into the carryover basis regime, particularly if a portion of the $1,300,000 basis is not allocated to a transfer, may cause substantial future capital gains tax to the beneficiary.

(d) The tax character of the assets must be determined. Are the assets ordinary income property assets, or capital gain property assets? If carryover basis is elected, the character of the asset remains the same in the hands of the beneficiary as in the hands of the decedent.

(e) If a substantial part of the estate passes to the surviving spouse or under a disposition that qualifies for the marital deduction, allowing the estate tax to apply under the default rule and not making the carryover basis election may be preferable to having assets pass to a bypass or credit shelter trust with carryover basis. Although the assets passing to the bypass trust will be excluded from the estate tax at the time of the surviving spouse's death, and perhaps for a

Property, Trusts, and Estates has made comments submitted to the Internal Revenue Service that can be found on the website for that Section.

E. **Generation-Skipping Transfer Tax Issues for Decedents Who Died in 2010.** As previously discussed, the repeal of the GST Tax for 2010 was repealed by the 2010 Act. The Generation-Skipping Transfer Tax under Chapter 13 of the Code therefore applies to generation-skipping transfers made in 2010, for which there is a $5,000,000 exemption and a tax rate of zero percent. This interesting and unexpected legislative action solves a number of problems that existed for generation-skipping transfers during 2010 if there had been no generation-skipping transfer tax law during 2010. It also created several important opportunities that ended on December 31, 2010, including making taxable distributions or creating taxable terminations with respect to a non-exempt generation-skipping transfer trust that was created prior to 2010. Another important aspect of GST for 2010 deaths is that apparently an executor can allocate a decedent's GST exemption ($5,000,000 in 2010) even though an election is made out of the estate tax and into carryover basis.

Planning suggestion: Because the zero percent tax rate applied to 2010 generation-skipping transfers, an election under IRC 2632(b)(3) should be made to opt out of the automatic allocation of the GST exemption to any such transfer. In other words, avoid the automatic allocation of GST exemption in 2010 or the portion of the exemption allocated will be wasted.

1. The potential for similarly wasting a portion of a 2010 decedent's GST exemption would occur when such a decedent has provided for a direct skip at death. If the executor does not allocate the decedent's remaining GST exemption within the time required for filing the decedent's estate tax return, IRC Section 2632(a) provides for any remaining GST exemption to be automatically allocated to the direct skip made at death. Such an allocation would be wasteful because the GST tax rate for direct skips is zero.

2. Because of the zero percent GST tax rate for 2010 GST transfers, consideration should be given to the use of disclaimers that would enable a non-GST transfer to become a GST transfer, thus removing assets from the estate of one generation without estate tax or GST tax costs. The 2010 Act extended the time for making IRC Section 2518(b) disclaimers for 2010 decedents to nine months after the date of enactment of the Act. Although that date is September 17, 2011, questions remain whether a qualified disclaimer will occur because beneficiaries may have accepted benefits from the disclaimed property, and state law requires that disclaimers be made within nine months after the transfer. Thus, any

With portability, the unused portion of the Husband's estate tax exemption, equal to $4,000,000 (the DSUEA), will be added to the Wife's own estate tax exemption. Consequently, at the Wife's death, she will have $9,000,000 of assets, and both her own $5,000,000 exemption and the Husband's unused $4,000,000 exemption (unadjusted by inflation indexing, which is not applicable to the DSUEA), for a total $9,000,000 estate tax exemption. The Wife therefore will have a taxable estate of $0.00 dollars.

2. **Does Portability Provide Simplicity?**

(a) The answer is no, because portability seems to involve simply moving from one form of complexity to yet another.

(b) The complexity that portability solves is the need to use a bypass or credit shelter trust to avoid wasting the estate tax exemption at the death of the first spouse to die. Prior to portability, and using the current $5,000,000 exemption, if the spouses had a combined estate of $10,000,000, with each spouse having an estate of $5,000,000, in order to avoid wasting each spouse's $5,000,000 exemption, that exemption would need to be used at the time of the first death. If the estate had not been planned, or if the spouses opted for misguided simplicity, and if all assets passed directly to the survivor, the survivor would have an estate of $10,000,000, and, without portability, a taxable estate of $5,000,000. With careful planning, however, $5,000,000 in the estate of the first spouse to die would pass to a bypass or credit shelter trust which would not be included in the surviving spouse's estate. $5,000,000 would, therefore, be removed from the tax base.

In this example, if the estate of the first spouse to die consisted primarily of IRA or retirement plan assets, difficult decisions would occur as to whether those retirement assets should be protected from estate tax in the estate of the surviving spouse by causing those assets to pass to a bypass trust, or whether the IRA or retirement plan assets should pass directly to the surviving spouse who could roll the assets over into an IRA of his or her own, name new beneficiaries, and obtain a longer stretch-out period. Portability eliminates or greatly reduces the significance of this problem by preserving the IRA owner's unused estate tax exemption for use by his or her spouse, although the income and growth on the exempt amount during the surviving spouse's lifetime would not be protected from estate tax in the surviving spouse's estate.

(f) The chimera of simplicity is exposed when one considers the alternatives to relying on portability to solve what many consider to be one of the unnecessary complexities of estate planning; that is, using a bypass or credit shelter trust to avoid wasting the exemption of the first spouse to die. The issues in reaching such a decision are not simple and will be discussed in a later section of this outline.

3. **"Sunset" Provision.** According to the 2010 Act, portability of unused exemption between spouses will expire on December 31, 2012. If Congress does not act to extend portability beyond 2012, surviving spouses dying after 2012 will not be able to apply any portion of their previously deceased spouse's unused estate tax exemption to reduce their own estate tax liability.

4. **Portability is Not Indexed For Inflation.** The DSUEA computation begins with the basic exclusion amount and is not indexed for inflation. In other words, at the time of the death of the first spouse to die, the basic exclusion amount becomes fixed with no indexing. Because the basic exclusion amount is the starting point in determining DSUEA, DSUEA is similarly not indexed. The basic exclusion amount is, however, indexed prior to the death of the first spouse to die so that if as of January 1, 2011, the basic exclusion amount is $5,000,000, in 2012 it is indexed for inflation. Consequently, if the first spouse dies in 2012, the DSUEA may be more than $5,000,000.

5. **Statute of Limitations for DSUEA.** If form 706 is filed at the first death electing portability, the statute of limitations is tolled. Therefore, even a return is filed and a normal three-year statute of limitations exists, the return may be audited at any time in the future to determine whether the DSUEA was correctly calculated.

6. **Second Marriage.** At the death of a surviving spouse, portability is only available from his or her most recent deceased spouse. In other words, privity must exist between spouses. As a result, if a surviving spouse remarries, and subsequently the surviving spouse's second spouse dies, the surviving spouse's ability to use any portion of the first deceased spouse's unused exemption to reduce the surviving spouse's own estate tax liability, is lost. Similarly, if the husband dies and the wife remarries and dies before the new husband, the new husband is not entitled to any DSUEA from the first husband. Other issues pertaining to the DSUEA and a second marriage include the following:

There is a possibility, although unlikely, that W's estate would be taxable because her tentative tax base is $6,000,000, with a tentative tax of $2,100,000. The unified credit will cover $1,750,000 of this amount, so that the marginal tax on a taxable estate of $1,000,000 would be $350,000. Although this conclusion is far from doubt, and the factual situation far from common, either Congress through technical corrections or the Treasury Department through regulation will have to provide clarification. However, there has been some discussion among scholars that the "clawback" risk associated with remarrying is greater than the "clawback" risk associated with a future change in the gift exemption amount, as discussed in Article VI of this outline.

(c) There may be a market for DSUEA. Consider for example, the following E-Harmony add "wealthy widow, good health, seeking husband in poor health and with full DSUEA available." DSUEA may also be an impediment to a surviving spouse remarrying. For example, the surviving spouse who inherits a full $5,000,000 DSUEA may prefer not to remarry if the potential new spouse has few assets. The loss of a large DSUEA from the first deceased spouse may deter remarriage.

(d) After the first spouse dies, substantial portability benefits could be achieved by marrying a second spouse who has his or her full DSUEA. However, because the second spouse has a full DSUEA to offer, the second spouse probably does not have many assets, thus exposing the wealthier spouse to support obligations for the poorer spouse. Such a second marriage could also frustrate Medicaid planning for the poorer spouse.

(e) Premarital agreements, particularly between previously married couples, will need to ascertain the DSUEA of each spouse, and include representations of prior taxable gifts.

(f) The DSUEA received by a surviving spouse may be affected by state law, in that state death taxes may not recognize the DSUEA.

7. **<u>Application to Both Gift and Estate Tax.</u>** Portability applies to both the surviving spouse's gift tax and estate tax exemptions. As previously indicated, the 2010 Act seems to require, however, that the surviving spouse must use his or her own basic exclusion amount before using the DSUEA from a deceased spouse. Consequently, estate and gift tax calculations of a surviving spouse involve first applying that spouse's own

were repealed under EGTRRA for the year 2010. The 2010 Act extends the EGTRRA repeal of such phase-out provisions for the years 2011 and 2012.

III. PLANNING CHALLENGES IN 2011 AND 2012 UNDER THE ACT.

A. **Planning for Portability.** In addition to the planning suggestions made above in Paragraph I.D, planning for portability brings in to focus whether to use the "I Trust You Honey," arrangement or an arrangement involving a bypass trust, perhaps with a formula. Another arrangement which deserves careful consideration is a disclaimer format. An analysis of these arrangements requires determining what our clients really want in their estate planning. Their objectives generally are in this order of priority:

- to protect the survivor and the other family members
- to achieve simplicity
- to provide flexibility
- to avoid taxes

1. The "I Trust You Honey" arrangement coupled with portability, ensures a full step-up in basis at the time of the survivor's death, whereas assets in a bypass trust will not be stepped up at the time of the survivor's death. All appreciation between the time of the first death and the time of the second death, however, is removed from the survivor's estate.

2. This "I Trust You Honey" arrangement could take several forms:

   - joint tenancy
   - a simple will
   - beneficiary designation for IRA's, life insurance, and similar arrangements
   - TOD or POD accounts
   - joint revocable trusts, which generally are preferable to wills
   - stand-by joint revocable trusts

3. Although the simplicity of a "I Trust You Honey" arrangement is appealing, many reasons exist for the use of a trust or trusts for spouses.

time of the surviving spouse's death, but at the cost of an estate tax liability.

(d) **Allocation of GST Exemption.** A bypass trust permits the allocation of the $5,000,000 GST exemption to the trust, if the trust ultimately is to be distributed to skip persons (grandchildren or remote generations). Portability, however, does not apply to the $5,000,000 GST exemption. Consequently, if the $5,000,000 GST exemption is not to be lost, it must be used during either lifetime or at death.

(e) **Protection if Portability is Unavailable at Surviving Spouse's Death**. The current estate tax laws under the 2010 Act, which include portability, only exist for the years 2011 and 2012 and no one can reasonably predict what will occur after the expiration of that two-year period. If Congress takes no action, the exemption amount and tax rate will revert back to pre-Bush era levels, with no portability of exemption between spouses. A family with assets greater than $5,000,000 that fails to include a bypass trust arrangement in their joint estate plan, and instead relies on portability of unused exemption between spouses, could face serious estate tax consequences if portability is no longer available at the time of the surviving spouse's death.

(f) **Second Marriages**. The "I Trust You Honey" arrangement is generally not appropriate for second marriages or non-harmonious marriages.

B. **Neither Portability Nor a Bypass Trust is a Complete Panacea.** For reasons previously described, portability does not achieve the simplicity that might seem to exist after a superficial analysis. Similarly, a bypass trust creates its own set of problems, as follows:

1. In an era of exemption uncertainty, how is the amount passing to the bypass trust to be measured? If it is an amount equal to the applicable exclusion amount in 2011 and 2012, it will be funded with $5,000,000. As previously indicated, if it is described as a pecuniary sum, capital gain may exist on funding the bypass trust. Moreover, if the bypass trust is measured by the applicable exclusion amount, and that amount is $5,000,000, unless (i) the surviving spouse is entitled to all of the income from the bypass trust, (ii) it is a unitrust with an appropriate payout rate, or (iii) the surviving spouse is entitled to distributions of principal either based on an ascertainable standard if the surviving spouse is the trustee, or perhaps a discretionary standard if an independent trustee is named, the surviving

estate tax exemption amount, and the availability of portability of unused exemption between spouses, in deciding whether or not to fund a bypass trust in the estate of the first spouse to die. If, considering these factors, the surviving spouse decides that no Federal Estate Tax can reasonably be expected at the time of the surviving spouse's death, all of the property of the first spouse could pass outright to the surviving spouse or to a marital deduction trust over which the surviving spouse would have complete control. If, however, the survivor determines that estate taxes are probable in his or her estate, either due to the size of the combined estates compared to the estate tax exemption amount at the time of the first spouse's death or if portability is no longer available at the time of the first spouse's death, the survivor can disclaim all or a portion of the property passing to him or to her from the deceased spouse. The property disclaimed would then pass into a bypass trust, thus protecting that property from Federal Estate Tax in the survivor's estate.

2. **When to Exercise a Disclaimer Trust**. Although the use of the disclaimer arrangement creates substantial flexibility and eliminates the need to use a formula to measure the amount passing to the bypass trust, great care must be taken to review the total estate at the time of the first death to determine if a disclaimer should be used. If at the time of the first death, the Federal Estate Tax exemption were $5,000,000 and the spouses' total assets were also $5,000,000, there would be little reason to fund a bypass trust other than to anticipate possible growth of assets following the first death. If substantial growth in the assets was expected, the survivor could elect to disclaim a portion of the property passing directly to him or to her, thereby causing such property to pass into a bypass trust, and thus be excluded from the survivor's Federal Estate Tax base at the time of the survivor's death. If, on the other hand, little growth was expected, or if the survivor anticipated using a substantial portion of the trust property for his or her support, there would be no reason to disclaim and thereby fund the bypass trust.

3. **Timing of a Disclaimer**. A disclaimer must be executed within nine months following the date of death of the first spouse to die.

4. **Operation of a Disclaimer Trust if Exercised**. If the surviving spouse exercises the disclaimer, as to either all or a part of the property that would otherwise pass outright to him or to her, or to a marital trust over which the survivor would have complete control, the disclaimed property will be held and administered under a disclaimer trust, which serves the same purpose as a bypass trust; that is, to prevent any of the trust property from being taxed at the time of the survivor's death. Whether the bypass trust is established by disclaimer or by the will or revocable trust of the first spouse

D. **A QTIP Trust Alternative.** Some of the potential problems of using the disclaimer arrangement can be avoided through the use of a QTIP trust. Under this arrangement, all of the assets of the first spouse to die would be left to a QTIP trust for the benefit of the surviving spouse. The trustee, or perhaps the executor, could then elect out of QTIP for that portion of the assets that should be protected from tax in the surviving spouse's estate. An arrangement comparable to a bypass trust then exists without depending on the decision of the surviving spouse to disclaim. Because under the QTIP arrangement the surviving spouse would not be entitled to withdraw all of the assets from the trust during his or her lifetime, and the distribution arrangements would be the same for both the elective and non-elective portions of the QTIP trust, there would be little incentive not to elect out of QTIP treatment to the extent necessary to protect assets from estate tax in the surviving spouse's estate.

IV. ESTATE PLANNING OPPORTUNITIES IN 2011 AND 2012.

A. **Gifts Using the $5,000,000 Exemption.** Clients who are in the position of making large gifts should be encouraged to do so, and not wait until late 2012. Because one of the primary purposes of gifting is to shift appreciation to the next generation, and perhaps to shift taxable income to a lower bracket taxpayer, the sooner a gift is made the more appreciation and taxable income can be shifted. Other issues to consider when making large gifts include the following:

1. The donor's basis must be considered, particularly if the donor has no estate tax exposure or only limited estate tax exposure. In those situations, paying only a small amount of estate tax might be preferable to the donee receiving the donor's low basis in the gifted assets.

2. Consider the consequences of Section 2032(a) or 6166 election potential if substantial gifts are made. The gifts may reduce the donor's estate in such a way that neither of those tax reduction or deferral provisions would be applicable.

3. Gifts using valuation and fractional interest discounts. Valuation discounts from minority interests and lack of marketability were not affected by the 2010 Act, although such discounts were, and still are, targeted by the Treasury for elimination or substantial modification. If a client faces estate tax exposure, even after portability, making gifts of minority interests in family entities should be emphasized, particularly in light of the new $5,000,000 gift tax exemption.

4. Although the generous $5,000,000 exemption ($10,000,000 for spouses) should motivate wealthy persons to make substantial gifts, most persons, regardless of their wealth, are concerned that they may not have enough for

(d) Other potential uses of the new gift tax exemption.

(i) **Irrevocable Life Insurance Trusts.** Irrevocable life insurance trusts should continue to be an important estate planning arrangement. The increased gift tax exemptions should enable larger amounts to be gifted to the trust to pay premiums and thus ensure that the insurance proceeds will not be includable in the insured's estate for Federal Estate Tax purposes.

(ii) **Family Business Succession Planning**. Family business succession planning through gifts of interests in family businesses should be emphasized during the two-year period in which both the gift tax and generation-skipping transfer tax exemptions have been increased to $5,000,000 per person, or $10,000,000 for married persons.

(iii) **Intentionally Defective Grantor Trusts**. Such sophisticated planning techniques as sales to intentionally defective grantor trusts are even more advantageous because of the increased gift tax exemption. Such trusts combined with substantial life insurance purchases can dramatically increase family wealth that can be passed estate or GST free to subsequent generations without any estate tax consequences. Grantor trusts are particularly effective tax planning vehicles because the grantor pays tax on the trust income, thus creating a non-taxable indirect gift to the trust's beneficiaries.

(iv) **Loans That Have Been Made to Children Might be Forgiven.** Such loans often become substantial because few principal payments are usually made, even though they are established at low interest rates under the Applicable Federal Rate structure. Because interest cannot be forgiven without being taxed to the donor, forgiven interest is treated as if paid to the donor and gifted back to the donee (continuously accruing interest becomes a problem). Consequently, forgiving the loans and eliminating future interest accruals could be an effective use of the increased exemption.

V. PUNCTURING THE PARADIGM - ESTATE PLANNING AFTER THE 2010 ACT.

A. **The New Paradigm.** In 2001 the author published an article in the Kansas Bar Journal pertaining to EGTRRA, the 2001 tax Act. The article was entitled, "Puncturing the Paradigm." The 2010 Act further punctured the estate planning paradigm, particularly because we have only a two-year duration of the new rules. The new paradigm, if one can be identified, is drafting for flexibility. Flexible drafting should include the following considerations:

1. The current and probable future effective tax rates and exemption amounts.

2. Residency and the possibility of changing residency, including changing the situs of the trust.

3. Income, capital gain, dividend, and other income related taxes must be considered, as discussed in Article II of this outline. The new 3.8% Medicare tax on unearned income is one of those taxes.

4. Asset protection is an essential ingredient of estate planning. Failure to consider asset protection may be malpractice.

5. Planning for special needs clients and family members.

6. Coordinating with other professionals, including financial planners, insurance advisors, CPAs, trust officers, and other professionals.

7. Trust drafting must consider investment strategies available to the trustee, and consider whether the prudent investor rule, as modeled on Modern Portfolio Theory, should be broadened, limited, or otherwise modified. The client's investment goals must be determined.

8. Uncertainty, which is now the new normal, must somehow be built in to our document drafting. Can our documents be stress tested to withstand an exemption of $1,000,000, $3,500,000, $5,000,000, or a total repeal of the estate tax? Do they recognize the existence of portability and that portability may not continue after 2012?

9. Drafting tax allocation clauses will become even more precarious. If, for example, clawback occurs and the estate of a person who has made a $5,000,000 gift when the exemption is $5,000,0000 finds that the estate tax exemption has been reduced to $1,000,000 and estate tax is due, who pays the estate tax, particularly if the gift was to someone other than the residuary beneficiaries of the donor's estate?

16. Dispositive provisions should consider permitting the trustee to invest for total return. Often a unitrust can be used effectively for this purpose.

17. Be creative in granting both lifetime and testamentary powers of appointment.

18. Understand and use grantor trusts, particularly when the grantor is willing to pay income tax on income he or she does not receive.

VI. "CLAWBACK" RISK FOR GIFTS MADE IN 2011 AND 2012.

A. **Description of Risk**. As discussed in Section III of this outline, there are many estate planning opportunities associated with making large gifts in 2011 and 2012 to take advantage of the $5,000,000 unified estate and gift tax exemptions. However, because the estate tax provisions of the 2010 Act "sunset" after 2012, there is a risk that the estate and gift tax exemption amounts could be significantly less than $5,000,000 at the time of the decedent's death. As a result, any gifts made by the decedent during 2011 or 2012 have the potential to "clawback" and be taxed at the time of the decedent's death.

B. **Example of "Clawback Risk"**. In 2011, an individual with assets of $6,000,000 gifts $5,000,000 to an irrevocable trust. No gift tax is due because the entire gift amount is equal to the individual's unified estate and gift tax exemption amount ($5,000,000 in 2011 and 2012). Congress fails to extend the estate tax provisions of the 2010 Act and subsequently the estate and gift tax exemptions "sunset" on December 31, 2012. As a result, the estate and gift tax exemptions revert back to $1,000,000. The individual then dies in 2013 with assets of $1,000,000. Under IRC Section 2001(b)(1), when computing a decedent's estate tax liability, lifetime gifts are added to the taxable assets held at death to derive a gross taxable amount. In this example, the individual's gross taxable amount is $6,000,000 ($5,000,000 plus $1,000,000 equals $6,000,000). The gross taxable amount of $6,000,000 is then reduced by the 2013 estate tax exemption amount of $1,000,000. The resulting $5,000,000 is then multiplied by the 2013 estate tax rate of 55%, which equals $2,750,000 of estate tax. However, after the estate tax is computed, it is reduced under IRC Section 2001(b)(2), by the amount of gift tax that would have been payable at the time the gift was made. In this example, no gift tax would have been payable at the time the gift was made because the gift was made in 2011 when the gift tax exemption amount was $5,000,000. As a result, the entire $2,750,000 of estate tax is due. This amount of estate tax could result in extraordinary hardship for the beneficiaries of the decedent's estate who are only entitled to inherit the $1,000,000 of assets remaining in the decedent's estate at death, especially if such beneficiaries are not the same beneficiaries who received the benefit of the lifetime gift.

1. The current law (2011 and 2012) becomes permanent.

2. Gridlock occurs, as happened in 2010, and 2001 returns with a $1,000,000 exemption and a fifty-five percent top estate tax bracket.

3. Gridlock occurs and 2001 returns with a $1,000,000 exemption and a fifty-five percent top estate tax bracket. Congress, however, fixes this problem in 2013 by making the current law permanent, with a January 1, 2013 effective date.

4. The estate tax is completely repealed.

5. We continue to have a series of biennial extenders which, as with most other important Congressional decisions, involves kicking the can down the road.

B. **The Future of Estate Planning.** Although estate tax planning may become less significant than in the past, so long as there is an estate tax, planning will be needed, although for fewer and fewer clients. Estate planning, however, is not just tax planning. The planner will need to continue navigating family dynamics, exploring business succession planning needs, analyzing residency issues, assisting clients with asset protection, working with financial planners and other advisors, dealing with special needs arrangements, assisting clients with charitable planning, working with life insurance professionals to structure appropriate insurance plans to meet the client's and the client's family's needs, income tax planning, planning for the elderly and their unique needs, coordinating business planning with estate planning, and being a trusted advisor to clients. In other words, there is a lot left even if the estate tax is repealed. Unfortunately, many of these important planning areas may be overlooked as the mass media and other "consumer advocates" recommend to clients that they can either handle their own estate planning or look to the planner whose services are at the lowest cost, perhaps through internet forms. The $5,000,000 exemption and portability both exacerbate the problem of persons not seeking appropriate planning under the belief that they are not wealthy or that they no longer have the need for planning. As professionals, we have the obligation of providing services customized to the client's needs, and structuring our practices so that we can deliver those services at a reasonable cost.

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