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ESTATE WISE PLANNING™

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2010 Transfer Tax Update

In view of the unprecedented confusion brought about in the waning hours of the 1st Session of the 101st Congress, this issue of *ESTATE WISE PLANNING™* addresses the state-of-affairs, so-to-speak, of the transfer tax system for the year 2010, assuming Senator Max Baucus, D-Montana and Chairman of the Senate Finance Committee, is unsuccessful in convincing his rancorous colleagues to retroactively reinstate the federal estate and generation-skipping transfer taxes to estates of decedents dying after December 31, 2009.

Federal Estate Tax Is Repealed: Know this: the federal estate and generation-skipping transfer taxes are repealed for the estates of decedents dying in the year 2010 [IRC §§ 2210(a) and 2664]. As discussed in the December 2009 issue of *ESTATE WISE PLANNING™* under *The Economic Growth and Tax Relief Reconciliation Act of 2001* (“2001 Tax Act”), these taxes are reinstated for estates of decedents dying **after** 2010 but with a \$1.0 million applicable exclusion amount (“exemption amount”) and a maximum estate tax rate of 55 percent. In other words, the law to be in effect **after** December 31, 2010, is the same law that was in effect **before** June 7, 2001 (the enactment date of the 2001 Tax Act).

Federal Gift Tax: The federal **gift tax** is **not repealed**; it remains in effect for gifts made in the year 2010 [IRC §§2210(a) and 2664 flush language and (d)]. The maximum lifetime federal gift tax exemption amount is \$1.0 million [IRC §2505(a)(1); the 2001 Tax Act, §§521(b), (e)(2)] with a maximum gift tax rate of 35 percent [IRC §2502(a)(1) and (2)]. Gifts to IRC Section 2503(c) minors trusts, gifts to IRC Section 2503(b) income trusts, and gifts to IRC Section 2503(b) Crummey trusts will continue to be viable estate planning strategies. Gifts to IRC Section 2502(b) income and Crummey trusts can be useful in situations where the beneficiary age twenty-one or older and the grantor (donor) of the trust wants to stretch the time the trust estate remains in the trust for the beneficiary (donee).

Federal Unlimited Gift Tax Marital Deduction: The unlimited **gift tax** marital deduction for lifetime gifts between heterosexual married spouses is not repealed for such gifts made in the year 2010 [IRC §2523(a)]. For calendar year 2010, the first \$134,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) is not included in the total amount of taxable gifts under IRC Sections 2503 and 2523(i)(2) made during that year [Rev. Proc. 2009-50, 2009-45 I.R.B. 1, §3.30(2)]. Heterosexual married spouses

may continue to use the unlimited gift tax marital deduction to balance the values of their respective estates. Doing so may be prudent estate planning, especially, if the federal estate tax exemption amount, beginning January 1, 2011, reverts to \$1.0 million with a maximum estate tax rate of 55 percent. In such case, the estate planning strategy of “equalizing” spouses’ estates in order to reduce the spouses’ respective estates to the lowest effective marginal estate tax bracket may be revisited.

Charitable Remainder Trusts: Five types of property (asset) transfers are not subject to federal gift tax: (1) transfers to political organizations [IRC §2522(a)(1)]; (2) **transfers to charitable organizations** [IRC §2522(a)(2)]; (3) gifts that qualify for the unlimited gift tax marital deduction [IRC §2523(a)]; (4) gifts that qualify for the gift tax annual exclusion [IRC §2503(b)]; and (5) gifts that qualify for the educational and medical expenses exclusion; *i.e.*, so-called “qualified transfer” gifts [IRC §2503(e)]. With regard to **transfers to charitable organizations**, “Notwithstanding any other provision of [IRC] section [2511] and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as **wholly owned by the donor or the donor’s spouse** under [the grantor trust rules of IRC sections 671 through 678]” [IRC §2511(c)].

This means that gifts to charitable remainder trusts (“CRTs”), which include charitable remainder annuity trusts and charitable remainder unitrusts, will be subject to gift tax under IRC Section 2501 [IRC §2511(c); 2001 Tax Act, §511(f)(3); §411(g)(1) of the *Job Creation and Worker Assistance Act of 2002*, Pub. L. No. 107-147, 107th Cong., 2d Sess. (9 March 2002), 116 Stat. 46; Notice 2010-19, 2010-7 IRB ___ (Feb. 16, 2010)], since CRTs are not “wholly owned” by the donor-grantor; that is, such trusts are not grantor trusts within the meaning of IRC section 671 [Rev. Rul. 77-285, 1977-2 C.B., ¶7 (“[Reg. §]1.664-1(a)(4) provides that, in order for a trust to be a charitable remainder trust, it must meet the definition of, and function exclusively as, a charitable remainder trust from the date or time of the creation of the trust. This section further provides that, solely for purposes of [IRC § 664] and the regulations thereunder, the trust will be deemed to be created at the earliest time that **neither the grantor nor any other person is treated as the owner of the entire trust under subpart E, part 1, subchapter J, chapter 1, subtitle A.**”); Reg. §1.671-1(d)]. Thus, a transfer of property to a non-wholly-owned grantor trust is a transfer by **gift of the entire interest** in the property [Notice 2010-19, 2010-7 IRB___ (Feb. 16, 2010)]. Accordingly, the donor’s \$1.0 million lifetime gift tax exemption amount will be reduced by the amount of the gift to a CRT [IRC §2505(a)(1)]. The gift tax on such gifts “shall be paid by the donor” [IRC §2502(c)]. In making gifts to CRTs, the estate owner must keep in mind how the reduction in the \$1.0 million gift tax exemption amount might affect noncharitable gifts to family members.

Step-up (Step-down) in Basis Repealed: Step-up (step-down) in basis of property in the hands of the decedent’s heirs or beneficiaries received from a decedent is replaced by **modified carry-over basis**. In effect, this means that accrued appreciation on the asset(s) included in the decedent’s gross estate may be subject to long-term capital gain tax when the heir or beneficiary sells the property. Since the enactment of the 2001 Tax Act (June 7, 2001), I have opined that modified carry-over basis would have the effect of broadening the income tax base. In other words, heirs and beneficiaries of decedents’ estates who would not have paid federal estate tax, because the value of such taxable estates would have been less than the federal estate tax exemption amount, may now have to pay capital gain tax when the asset(s) received from the decedent are sold by the heir or beneficiary. It seems that my prediction will be true, in that “North Dakota [Democrat] Representative Earl Pomeroy has said about 61,000 estates would have to pay capital gain taxes in 2010, versus about 6,000 affected by the current estate tax,” [Ryan J. Donnmyer, “Estate Tax to Expire Temporarily as Extension Dropped (Update 1),” Bloomberg.com, 12/17/2009] *i.e.*, the federal estate tax as in effect in 2009.

Modified carryover basis is the **lesser of**: (a) the adjusted basis of the decedent; or (b) the fair market value of the property at the date of the decedent’s death [IRC §1022(a)]—not the alternate valuation date. The decedent’s personal representative (executor/executrix) is allowed to increase (*i.e.*, step-up) the basis in assets owned by the decedent and acquired by the decedent’s heirs or beneficiaries [IRC §1022(d)(3)(A)]. Under this rule, each decedent’s estate generally is permitted to increase (*i.e.*, step-up) the basis of assets transferred by up to a total of **\$1.3 million** [IRC §1022(b)(2)(B)]. The \$1.3 million is increased by the amount of unused capital losses, net operating losses and certain *built-in* losses of the decedent [IRC §1022(b)(2)(C)]. In addition, the **basis of property transferred to a surviving spouse** can be increased by an **additional \$3.0 million** [IRC §1022(c)(2)(B)]. Thus, the basis of property transferred to a surviving spouse can be increased by a total of **\$4.3 million** [IRC §1022(c)(1)]. However, the additional \$3.0 million

adjustment to basis for property passing from the decedent spouse to the surviving spouse is only available if the property either **passes outright** to the surviving spouse or to the **trustee of a qualified terminable interest property (“QTIP”) trust** [IRC §1022(c)(3)]. Nonresident aliens (non-U.S. citizens not residents of the U.S.) will be allowed to increase the basis of property by up to \$60,000 [IRC §1022(b)(3)(A)]. **After** 2009, the \$60,000, \$1.3 million and \$3.0 million amounts are adjusted annually for inflation [IRC §1022(d)(4)]. Finally, under the 2001 Tax Act, IRC Section 1014 “shall not apply with respect to decedents dying after December 31, 2009” and the headline of IRC Section 1022 reads, “Treatment of Property Acquired From a Decedent Dying After December 31, 2009.” Nowhere in the 2001 Tax Act is it provided that IRC Section 1022 applies only to estates of decedents dying after December 31, 2009, and before January 1, 2011.

Observations/Recommendations:

(1) For federal income tax reporting purposes, the carry-over basis rule applies to property owned by heterosexual married spouses owning property as joint tenants with right of survivorship (“JTWROS”) (including tenants by the entirety with right of survivorship) and single individuals owning property as JTWROS. For heterosexual married spouses, one-half the value of the property owned as JTWROS will be includable in the gross estate of the first spouse to die [IRC §2040(b)(1)]. The basis of the first decedent spouse’s one-half interest will be the lower of his or her adjusted basis or one-half the fair market value of the property on the date of the first decedent-spouse’s death [IRC §1022(d)(1)(B)(i)(I)]. In other words, the lower of either the decedent’s adjusted basis or one-half the fair market value of the property will *carry-over* to the surviving spouse. With respect to single individuals owning property as JTWROS, 100 percent of the fair market value of such property is includable in the gross estate of the first co-tenant to die, absent evidence of consideration paid by the surviving co-tenant(s) [IRC §§2040(a); 1022(d)(1)(B)(i)(II) and (III)].

(2) Heterosexual married spouses should review QTIP marital deduction trusts under their existing Last Wills and revocable living trusts to ensure that the trustee understands that such a subtrust is for the purpose of receiving property when the federal estate tax is in effect and when it is not in effect, so as to obtain for the surviving spouse the additional \$3.0 million adjustment to basis for property passing to a surviving spouse when the decedent spouse does not want his or her estate passing outright to the surviving spouse. In this regard, the decedent spouse **must** direct in his or her Last Will, revocable living trust, irrevocable life insurance trust, grantor retained annuity or unitrust, qualified residence or personal residence trust (in the “fail-safe” Article) that the property passing to the surviving spouse be allocated to a QTIP trust—not for estate tax marital deduction purposes (if the federal estate tax is not reinstated retroactively for estates of decedents whose deaths occur in the year 2010) but for the purposes of obtaining the additional \$3.0 million basis adjustment and for reducing or eliminating state inheritance and/or state estate tax.

(3) Taking into account our dysfunctional and broken Congress, estate owners would be well-advised to keep precise accurate records of the cost or adjusted basis in their assets so that, if, upon death in 2010, Congress has failed to reinstate the federal estate and generation-skipping transfer taxes and IRC Section 1014 (basis of property acquired from a decedent), a decedent estate owner’s heirs or beneficiaries will know exactly the adjusted basis and fair market value of the decedent’s assets; otherwise, the IRS will determine the basis as the lower of the decedent’s adjusted basis or the fair market value of the asset(s) as of the date of death. On the other hand, IRC Section 1014 may be reinstated; but breath-holding should not be attempted, as it may prove fatal. It is quite possible that Congress would reinstate the federal estate and generation-skipping transfer taxes but leave in-place IRC Section 1022 governing modified carry-over basis.

(4) The federal estate and generation-skipping transfer taxes were repealed by operation of the 2001 Tax Act [IRC §§2210(a); 2664 flush language and (d)]. So, in one sense, the failure of Congress was only in not reinstating that which was scheduled to be repealed before the scheduled repeal occurred. Though IRC Section 1014 was repealed by Title V, Section 541 of the 2001 Tax Act, one should not believe that, if the federal estate and generation-skipping transfer taxes are retroactively reinstated for the estates of decedents dying after 2009, such reinstatement will include reinstatement of IRC Section 1014. It may be argued that, by allowing, in effect, the provisions of Title

V of the 2001 Tax Act to expire, certain members of Congress knew full-well that more tax revenue would be collected in the form of capital gain tax than would be collected in federal estate and generation-skipping transfer taxes! Is it within the realm of possibility that Congress might reinstate the federal estate and generation-skipping transfer taxes but not IRC Section 1014— step-up/step-down in basis for assets acquired from a decedent? In contemplating such a possibility, remember, “property acquired from a decedent dying after December 31, 2009, **shall** be treated for purposes of this subtitle [Subtitle E of Title V of the 2001 Tax Act] as **transferred by gift...**” [IRC §1022(a)(1)] [Emphasis added]. Actions, or lack thereof, by Congress in the ensuing months should be most interesting.

Community Property Step-Up Basis Repealed: Property (real, tangible and intangible personal property) acquired by heterosexual married spouses during their marriage while domiciled in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington) is community property. The State of Wisconsin is a marital property state, but it does recognize the concept of community property between heterosexual married persons. In this regard, Wisconsin recognizes marital property as a form of community property [Wis. State. Ann. §766.001(2) (Loislaw 2001); Rev. Rul. 87-13, 1987-1 C.B. 20]. The State of Alaska recognizes community property by consent, in that it allows heterosexual married persons to classify their property as community property in a community property agreement [Alaska Stat. §34.77.060(a) (Loislaw 2001)]. Such property is deemed community property; *i.e.*, each spouse has an undivided one-half vested interest in the whole of the property acquired during the marriage. Prior to 2010, upon the death of the first spouse to die, while only one-half the value of the whole community property was includable in the first decedent spouse’s gross estate, both spouses’ (the decedent spouse and the surviving spouse) undivided one-half vested interest received a step-up (or step-down) basis to 100 percent of the fair market value of the property as of the date of the first decedent spouse’s death, or the alternate valuation date, in the hands of the surviving spouse [IRC §1014(b)(6)]. This step-up (step-down) in basis to 100 percent of the fair market value of the entire community property is no longer available [IRC §1014(f), which provides: “This section [meaning the entire section 1014] shall not apply with respect to decedents dying after December 31, 2009.”]. Thus, upon the death of the first spouse to die, only one-half the fair market value of the decedent spouse’s community property interest is includable in his or her gross estate (as it was prior to 2010); but now, the basis of such property in the hands of the surviving spouse is equal to the lower of the decedent spouse’s adjusted basis or the fair market value of one-half the value of the property on the date of the decedent spouse’s death (but not the alternate valuation date) [IRC §1022(a)(2)].

Principal Residence Exclusion: For decedents dying before January 1, 2010, if, upon death, a decedent’s principal residence was distributed to: (1) a credit shelter trust; (2) a qualified terminable interest property (“QTIP”) marital deduction trust; (3) a qualified domestic trust (“QDOT”); (4) a marital deduction estate trust; or (5) any other irrevocable trust, the IRC Section 121 exclusion of gain on sale of principal residence was not available to the beneficiary of such trust, even if the beneficiary was the trustee of the trust [Ltr. Rul. 200104005 (Sept. 11, 2000)]. Under the 2001 Tax Act, for estates of decedents dying **after** December 31, 2009, the exclusion applies “to property sold by a **trust**, which, immediately before the death of the decedent, was a qualified revocable trust [as defined in section 645(b)(1)] established by the decedent determined by taking into account the ownership and use by the decedent” [IRC §121(d)(9)(C), added by §542(c) of the 2001 Tax Act]. [Emphasis added] In this regard, the decedent’s period of occupancy of the property as a principal residence can be added to an heir’s (or beneficiary’s) subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence, regardless of whether the residence was owned by such trust during the decedent’s occupancy [Descriptions Contained in the Conference Committee Report on H.R. 1836, The Economic Growth and Tax Relief Reconciliation Bill of 2001, *Fed. Est. & Gift Tax Rep.* (CCH) ¶ 29,056, at 44,157 (May 30, 2001)]. Presumably, a surviving spouse, as a life estate beneficiary of a credit shelter trust (including a QTIP trust, QDOT or estate trust) created under the terms of a qualified revocable trust by the decedent spouse, will be eligible for the IRC Section 121 exclusion subject to the occupancy requirement of IRC Section 121(a) [Doug H. Moy, *Living Trusts: Third Edition*, John Wiley & Sons, Inc., Copyright © 2003 by Doug H. Moy. All rights reserved, at 181].

Observations:

1. IRC Section 121(d)(9) provides that, “The exclusion under this section shall apply to property sold by— (A) the *estate* of a decedent, (B) any individual who acquired such property from the decedent (within the meaning of section 1022), and (C) a *trust*, which, immediately before the death of the decedent, was a *qualified revocable trust* [as defined in section 645(b)(1)] established by the decedent.” (Emphasis added) Notice that no provision is made for a *testamentary trust*. Presumably, the exclusion is not available to an individual taxpayer, as beneficiary of a testamentary life estate trust (*i.e.*, a trust established by the decedent’s Last Will), except perhaps to the extent of the beneficiary’s five-or-five power over the trust principal of which the principal residence is a part [See *supra* Priv. Ltr. Rul. 200104005]. If this presumption is correct, then, the revocable living trust clearly has an advantage over a testamentary trust of which any part or all of the decedent’s principal residence is part of the trust estate [Moy, *Living Trusts: Third Edition*, at 181].

2. Under the 2001 Tax Act, after 2009, property passing to a general power of appointment marital deduction trust under IRC Section 2056(b)(5) will not be eligible for additional basis increase in excess of \$1.3 million up to scheduled maximum \$4.3 million amount for a surviving spouse. In this regard, only *qualified spousal property* will qualify for the additional \$3 million basis adjustment. *Qualified spousal property* is *qualified terminable interest property*, as that term is defined for purposes of the QTIP trust [IRC §1022(c)(3)(B), (5); IRC §2056(b)(7)(B)]. Accordingly, it is unlikely that spouses will direct their respective interests in their principal residence to a general power of appointment marital deduction trust, because property allocated to such trust will not be eligible for additional basis increase for property acquired by a surviving spouse, even though such a trust would be a life estate trust for the surviving spouse [Moy, *Living Trusts: Third Edition*, at 181].

Question of the Month: What should I do if I sell or get rid of property that has already been transferred to the trustee of my revocable living trust? **Answer:** (1) The trustor can delete the property described on the applicable schedule attached to the end of the trust agreement by simply drawing a line through the description, dating the deletion and making a notation regarding the disposition of the property; for example, “property sold; proceeds used to acquire (description of property acquired);” or (2) The trustor can create a revised schedule. If the deleted property is replaced with other property, a description of the replacement property can be added to the applicable schedule affecting that property.

AFR: The **January 2010** Applicable Federal Rate, under IRC Section 7520, for determining the present value of an annuity, an interest for life or a term of years or a remainder or reversionary interest is **3.0 percent** [Rev. Rul. 2010-01, 2010-2 I.R.B.1, Table 5]. The **February 2010** AFR is **3.4 percent** [Rev. Rul. 2010-06, 2010-6 I.R.B.1, Table 5]. This bodes well for the grantor retained annuity trust (GRAT), charitable lead annuity trust (CLAT), charitable transfer of remainder interest in residence or farm and private annuities but not well for the qualified personal residence trust (QPRT), grantor retained income trust (GRIT) and charitable remainder annuity trust (CRAT). Lower AFRs have no impact on grantor retained unitrust (GRUT), charitable remainder unitrust (CRUT), charitable lead trust (CLT) and pooled income funds. **Note:** In the case of transfers to a CRAT for which the *valuation date* is **after** April 30, 1999, if an election is made under IRC Section 7520 and Treasury Regulation Section 1.7520-2(b) to compute the present value of the charitable interest by use of the interest rate component for **either of the two months preceding the month** in which the transfer is made, the month so selected is the *valuation date* for purposes of determining the interest rate (*i.e.*, the AFR) and mortality tables [Treas. Reg. § 1.664-2(c) (Jan. 5, 2001)]. In other words, one may choose the lowest AFR of either of the two months preceding the month the CRAT is funded in order to obtain the maximum tax deduction for the present value of the remainder interest.

ERRATA: In the December 2009 issue, the January 2010 AFR was incorrectly reported as 3.2 percent; it should have been 3.0 percent. Also, the Rev. Rul. citation was incorrect; please see corrected citation above. The Publisher regrets and apologizes for the error.

[**Note:** Section 6110(k)(3) of the Code provides that letter rulings may not be used or cited as precedent; however, they may be cited as authority].

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Available by order at most book stores for \$39.95: Moy, Doug H., *Living Trusts, Third Edition*. John Wiley & Sons, Inc., 2003. Or visit www.wiley.com. In the upper right-hand corner, enter: Doug Moy (and then click on "Search").

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Nancy Shurtz, *Estate Planning*, July 2004, Vol. 31/No.7, p. 357.

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