

**EFFECT OF ESTATE AND
GENERATION-SKIPPING TRANSFER TAX REPEAL
ON LIFETIME GIFT PLANNING
(OPPORTUNITIES AND PITFALLS)**

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- I. Law in 2009, 2010, and Beyond. The transfer tax law changes in 2010 and their return in 2011 to the law as it was in 2001 are as a result of The Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”).
- A. 2009
1. The gift tax exemption was \$1 million.
 2. The estate tax and generation-skipping transfer tax exemptions were \$3.5 million.
 3. The maximum rate for all three taxes was 45%.
 4. Property included in a decedent’s estate generally received a stepped-up cost basis.
- B. 2010
1. No estate tax for the first time since 1915.
 2. No generation-skipping tax for the first time since 1976.
 3. Top gift tax rate is 35%.
 4. The gift tax exemption remains \$1 million.
 5. Property owned by a decedent at the time of his/her death will not receive a stepped-up cost basis, except that the decedent’s executor can increase the basis of appreciated assets by \$1.3 million for transfers to anyone and by an additional \$3 million for qualified transfers to the decedent’s spouse.
- C. For 2011 and Beyond. In 2011, the federal estate, gift, and generation-skipping transfer tax rules will generally return to 2001 levels as follows:

1. The gift tax and estate tax exemptions will revert to \$1 million.
2. The generation-skipping transfer tax exemption will revert to \$1,340,000, indexed for inflation.
3. The maximum gift and estate tax rate will be 55% (with a possible 5% surcharge for large gifts and estates between \$10 million and \$17,184,000).
4. The maximum generation-skipping transfer tax rate will be 55%.
5. Property included in an estate will generally receive a stepped-up cost basis.
6. The estate and gift tax system will again be unified.
7. The state death tax credit under Section 2011 will be restored.
8. The 2001 Act also states that for estates of decedents dying, gifts made, or generation-skipping transfers after December 31, 2010, the 1986 Code shall apply as if the 2001 Act had never been enacted. As discussed in this outline, this language causes much confusion about the applicability of the changes that were in effect from 2001-2010 and whether they apply in 2011 and beyond.

II. Proposed Legislation

- A. The Byrd Rule. The reason all of the 2001 Act provisions “sunset” in 2011 is because the Byrd Rule. The Byrd Rule provides that tax cuts cannot cost the government revenue beyond the years covered by the budget reconciliation directive unless these costs are fully offset by other provisions in the bill or unless at least 60 senators vote for the legislation. Therefore, the 2001 Act sunsets in 2011, and all of the laws in effect in 2001 will again be in force. (See the attached article entitled Policy Basics: Introduction to the Federal Budget Process.)
- B. House of Representatives Action. On December 3, 2009, the House passed H.R. 4154 to permanently extend the 2009 transfer tax system (\$3.5 million exemption, 45% rate). Not one Republican voted for this legislation. The Republicans desire to see a \$5 million exemption and a 35% tax rate, and some bills have been introduced proposing those levels and rates.

- C. The Byrd Rule Round Two. The Byrd Rule again comes into play for legislation in 2010. Any “permanent” adoption of a transfer tax system that will decrease revenues as compared to the pre-2001 system will require 60 Senate votes.
- D. Senate Action. On January 20, the Senate placed H.R. 4154 on the Senate calendar. On January 28, the Senate passed legislation that included authority to exempt from the “pay as you go” rules a two-year (not permanent version like the House version) extension of the 2009 transfer tax exemption levels and rates. This may mean the Senate is willing to approve such a two-year extension of the 2009 system.

III. Chances of Retroactivity

- A. Common Law vs. Common Sense. Although it seems unfair (and is unfair), there is common law precedent for the retroactive application of a tax. There is a potential that legislation passed this year will purport to be retroactive to January 1. This attempt will undoubtedly be met with much litigation that may not be resolved for many years to come. All of the planning ideas discussed in this outline and in others may be for naught (and may actually result in more tax being paid or at least being paid earlier than anticipated) if the ultimate result is that legislation is retroactive to January 1. Certainly, the later we get in the year, the less likely retroactivity will be attempted.
- B. Wholly New Tax. In U.S. v. Carlton, 512 U.S. 26 (1994), the Supreme Court upheld the validity of retroactive legislation limiting the availability of an estate tax deduction for proceeds of sales of stock to employee stock-ownership plans to stock directly owned by the decedent immediately before death. The retroactive legislation was passed 14 months after its effective date. The Court stated that the December 1987 legislation fixing a mistake in prior legislation (October 1986) did not involve the “creation of a wholly new tax” and its period of retroactive effect covered a period “only slightly greater than one year.” In Untermeyer v. Anderson, 276 U.S. 440 (1928), the Supreme Court held that a gift tax could not be imposed upon the donor for gifts made while the legislation creating the gift tax was only a bill and was not yet law. In 2010, the question arises as to whether the estate and GST taxes would appear to be considered “wholly new taxes.” They were in existence in 2009, but they are not in existence in 2010. However, it would be difficult to argue that they are “wholly new.” Note that the Supreme Court resolved Carlton seven years after the issue arose. Assuming it would take that long to get to the Supreme Court, many estates of Decedent’s dying in 2010 would be “in limbo” for many years, perhaps until 2017 or later, causing many beneficiaries to wait a long time before estates are finally settled and distributed.

- C. Change in Tax Rate Only. There is also legal precedent for a retroactive change in the tax rate, creating speculation that the current 35% gift tax could revert to 45% causing many to pay more tax than they thought they would. In Quarty v. United States, 83 AFTR2d 99-597 (9th Cir. 1999), the court held that legislation imposing an increase in gift and estate tax rates from 50% to 53% and 55% signed August 10, 1993 was constitutionally retroactive to January 1, 1993.
- D. Choice of Law? There has been some discussion among lawmakers about allowing (in future legislation) estates in 2010 to elect which system would apply during any gap period—(i) the estate tax system similar to 2009 or (ii) the modified carryover basis regime currently in effect in 2010.

IV. Carryover Basis Regime; Potential Step Down in Basis

- A. Numbers of People Affected. It is estimated that the requirements resulting from the carryover basis regime will impact 70,000 estates whereas the estate tax with a \$3.5 million exemption level would have affected only 6,000 estates. So, the one year repeal is actually a detriment to many estates that would not have had a concern under the 2009 laws.
- B. Carryover Basis. Under Section 1022, the income tax basis of assets acquired from someone who dies in 2010 will not equal their estate tax values (as under prior law) but instead the cost basis will carryover to those who inherit the property. There is, however, some limited step up in basis available.
 - 1. An executor may allocate up to \$1.3 million to increase the basis of property passing to anyone up to the fair market value as of the decedent's date of death. This is not stepping up the basis for \$1.3 million worth of assets. This is an increase in basis by \$1.3 million. For example, if the decedent's basis in assets owned at death was \$7 million and those assets had a fair market value at death of \$8.5 million, the executor could allocate \$1.3 million of basis increase to those assets so that they would now have a basis of \$8.3 million (not the \$8.5 million basis they would have received prior to or post 2010).
 - 2. An executor may also allocate up to \$3 million to increase the basis of assets passing to the surviving spouse in a qualifying way such as outright or through a QTIP-type trust. This is in addition to the \$1.3 million increase in basis otherwise available.
- C. Step Down in Basis. Under the carryover basis regime, there is a limited step up in basis (as discussed immediately above). However, if the value at date of death is lower than the cost basis, there is a step down in basis. The original basis will

not remain. A new basis will be assigned at the lower date of death value. Section 1022(a) provides that the basis is the lesser of (i) the decedent's adjusted basis in the property or (ii) the fair market value of the property at the date of the decedent's death.

- D. Planning. Planning is important here to make sure that (i) the \$3 million basis increase is fully utilized for property passing to the surviving spouse in a qualified manner, (ii) the assets are ultimately not includible in the surviving spouse's estate, and (iii) there is flexibility in the estate plan to benefit not only the surviving spouse but also the children. This best result can be achieved through the utilization of QTIP type trusts, disclaimers, and credit-shelter/bypass type trusts.
- E. Community Property Eligible for Limited Step Up. Both decedent's one-half interest in the community property and the surviving spouse's one-half interest in the community property are eligible for the \$1.3 and \$3 million basis adjustments. Section 1022(d)(1)(B)(iv).
- F. Reporting to IRS. If a decedent dies in 2010 with carryover basis property (other than cash) exceeding \$1.3 million, the executor must file a return with the IRS. Section 6018(a) and Section 1022(b)(2)(B). (Note: For decedent's who are nonresidents and not citizens of the United States, the threshold amount is limited to \$60,000. For any amount over \$60,000, a return must be filed.) If the property other than cash is less than \$1.3 million, no return is required. The executor also must report any property acquired by the decedent within three years of death that is not treated as carryover basis property and which was not reported on a Form 709 gift tax return. Section 6018(b)(2). The form is to be filed with the decedent's income tax return for the year of death. Section 6075. An executor who is unable to make a complete carryover basis return must still file a return that includes a description of the property and the name of every person who holds a legal or beneficial interest in such property. The return must include the following information:
1. The name and tax identification number of the recipient of the property.
 2. An accurate description of the property.
 3. The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death.
 4. The decedent's holding period for the property.

5. Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income.
 6. The amount of the aggregate or spousal basis increase allocated to the property.
 7. Such other information as may be required by the Regulations.
- G. Reporting to Beneficiaries. The executor must also provide to every person listed on the return (other than the executor) (i) the name, address, and phone number of the person required to make the return and (ii) the information provided to the IRS with respect to the property acquired from, or passing from, the decedent to the person required to receive the statement.
- H. Potential Step Up after 2010 if 2001 Act “had never been enacted”? If a decedent dies in 2010 and the carryover basis regime is applicable, and a beneficiary in a later year sells an inherited asset, is there a stepped up basis to the date of death value in 2010? An argument could be made for that to be the case after 2010 if we are to treat the 2001 Act as if it “had never been enacted.” However, it seems unlikely that was the intended result.
- I. Penalties for Failure to Report.
1. The IRS will impose a \$10,000 penalty on an executor who fails to file the carryover basis return on time. Section 6716(a).
 2. Failure to report to beneficiaries or donees will result in a penalty of \$50 for each failure. Section 6716(b).
- J. What is the Gain Upon Funding a Pecuniary Bequest? When funding a pecuniary bequest under a will, the funding is treated as a taxable sale or exchange, and gains or losses may result. Treas. Reg. Section 1.661(a)-2(f)(1). The basis to be used in determining capital gain is the date of death value so the gain is the difference between that value and the date of distribution value. The 2001 Act provides that the basis for determining the gain is still determined using the date of death value as the basis, not the carryover basis the decedent had in the property. The basis of the property in the hands of the donee is then calculated to be the basis just before the funding (the lower of carryover basis or date of death value) increased by the amount of the gain recognized to the estate as a result of the funding. Section 1040(c).
- K. Record Keeping. Consider asking your clients to gather and maintain basis information now.

V. Lifetime Planning Opportunities in 2010

- A. Outright Gifts at 35% Gift Tax Rate. Gifts can be made to anyone outright at a 35% gift tax rate, subject to the potential for a retroactive rate increase to 45%. The effective tax inclusive equivalent rate of a 35% gift tax is 25.9%. This is because the gift tax is exclusive of the gift. By way of example (ignoring exemption amounts), the tax on a \$100 gift would be \$35 and the tax would be paid from assets other than the \$100. If the \$135 total were included in the estate and only \$35 were due in tax, the result is an effective tax rate of 25.9%. In actuality, if \$135 were included in the estate at a 35% rate, the tax would be \$47.25 and only \$87.75 would pass to the donee. So, with the top estate tax rate of 55% (and even 60% in some cases) coming back into play in 2011, it is a compelling argument to make gifts now at the 35% rate (which is really an effective rate of 25.9%) as compared to a potential 55% estate tax.
- B. Outright Gifts to Grandchildren. Grandparents should consider making outright gifts to grandchildren during 2010. Gifts will not be subject to the GST tax and but will be subject to a 35% gift tax. However, if the gifts exceed the gift tax exemption amount of \$1 million and if any future legislation is retroactive, the gift tax rate could be increased to 45% on any amount of the gift over \$1 million. In addition, if the gift is over \$3.5 million and if the GST tax is made retroactive but keeps the 2009 exemption levels, GST tax would be owed for any amount of the gift over \$3.5 million. Remember that Section 2515 requires that the amount of the GST tax to be added to the amount of the gift in calculating the gift tax. This can result in total taxes (GST and gift) to be in excess of the actual gift (more than 110% of the gift).
- C. Creating Direct Skip Trusts in 2010
1. 2009 Example: Prior to 2010, if a grandparent created a trust for the benefit of a grandchild and did not allocate GST exemption, this was considered a direct skip, which would result in the payment of a GST tax upon the gift being made. However, all future distributions from the trust to the grandchild would not result in a GST tax. This is because the transferor (grandparent) is treated as moving down one generation to the child level for purposes of those distributions to the grandchild. Section 2653. If distributions were ever made to a great-grandchild, a GST tax would be incurred.
 2. 2010 Example: If the same trust were created in 2010, there would be no GST tax due upon the creation of the trust since there is no GST tax in 2010. However, in future years, the “drop-down” rule in 2653 may not be available since, in 2010 when the trust was created, Section 2653 did not

apply. Therefore, in future years, the grandparent would not “drop-down” and a GST tax would be due for each distribution to a grandchild. So taking advantage of a time when there is no GST tax may result in a GST tax in future years. It is unclear whether this would be the result or not. The argument for the application of the drop-down rule in 2011 or later would be that the suspension of the GST tax should be treated as if it “had never been enacted.” If that were the case, the transfer to the trust would be considered a direct skip and the drop down rule would apply. Because of the uncertainty surrounding whether the “drop-down” rule would apply to trusts created in 2010, it may make sense to not create direct skip trusts in 2010.

- D. Taxable Terminations and Taxable Distributions from Nonexempt Trusts in 2010. Trustees of trusts that are not exempt from GST tax should consider making taxable terminations or taxable distributions in 2010. These distributions would not be subject to the GST in 2010 since it does not apply in 2010. Such distributions would be taxable in later years. The risk in making taxable distributions in 2010 is the potential for a retroactive reenactment of the GST tax. Also, transfers from those trusts directly to beneficiaries will cause the assets to be includible in the estates of those beneficiaries and be subject to claims against those beneficiaries—two consequences that the trusts may have been designed to protect against. In addition, if it is contemplated that distributions from such trusts over the long-term would be made to non-skip persons (children, not grandchildren) or would be made directly to a school for tuition or to a provider of health care or health insurance for a beneficiary, those distributions would never be subject to the GST anyway. So if the trust may be used for such purposes, it may at least make sense to maintain the trust with assets sufficient for doing so.
- E. Inter Vivos QTIP Trusts. One spouse (donor spouse) establishes a QTIP trust for the other spouse (donee spouse) in 2010. A QTIP election is made to obtain the marital deduction so no gift tax is due. The assets will eventually be included in the donee spouse’s estate. At the donee spouse’s death, the donee will not be treated as the transferor for GST purposes if the donor spouse also makes a reverse QTIP election for GST tax purposes pursuant to 2652(a)(3). The reverse QTIP election can be made on an inter vivos gift in 2010 since Chapter 13 is not repealed in 2010—it just does not apply to any generation-skipping transfer in 2010. At the surviving spouse’s death, the assets remain in trust for the benefit of children and grandchildren. If future legislation allows for the “grandfathering” of GST trusts created during the gap period, distributions from the QTIP trust for grandchildren and more remote descendants would not be subject to the GST tax because of the reverse QTIP election made by the donor spouse.

F. Inter Vivos Marital Trusts (but QTIP Election Not Made).

1. Alternatively, if it does not look like the 45% gift tax rate will be retroactive and instead the 35% rate will apply, the donor spouse could decide not to elect QTIP treatment for the portion of the gift to a marital trust that he does not wish to qualify for the marital deduction. Instead, that portion of the trust will be subject to gift tax and will not be included in the donee spouse's estate. The QTIP election decision can be postponed until October 15, 2011 (the latest time to extend filing a gift tax return for 2010 gifts), allowing time to determine whether it makes sense to make an election, whether any legislation has been passed making the tax laws retroactive to January 1, 2010, and any other related issues that have arisen causing it to be clearer whether or not to elect QTIP treatment.
2. Can the terms of the non-QTIP elected trust be different from the terms of the QTIP trust for the portion of the trust for which the election is not made? For estates, Treasury Regulation Section 20.2056(b)-7(d)(3) provides that a qualifying income interest for life will not fail to be a qualifying income interest "because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse." This regulation is known as the Clayton regulation. Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992). This would mean that the non-QTIP portion could provide for terms similar to a bypass trust where the spouse and children are beneficiaries—not just the donee spouse and not requiring all the income to be distributed to such spouse.

While this provision applies to QTIP elections in estates, it may not apply to QTIP elections made on lifetime gifts. The non-elected portion of a lifetime QTIP trust should continue to give the spouse a mandatory income interest and permit the surviving spouse alone to be a beneficiary during his or her lifetime. More troubling than the question of whether to modify the terms of the trust is the question of whether the interest for which the QTIP election is made can even qualify as a qualifying interest. Treasury Regulation Section 20.2056(b)-7(d)(3) states that "a qualifying interest for life that is contingent upon the executor's election [of QTIP treatment] will not fail to be a qualifying income interest for life because of such contingency. This regulation is not mirrored in the gift tax regulations. This raises the question of whether an income interest that is contingent on whether a QTIP election is made would qualify for the gift tax marital deduction even though such contingency would clearly not disqualify it for the estate tax marital deduction.

G. Spouse Likely to Die in 2010.

1. Example 1. If one spouse is likely to die this year, consider transferring most property to that spouse this year. At the spouse's death, have property flow into a marital trust for the benefit of the surviving spouse that (i) can take advantage of the \$3 million step up in basis for property that passes to the surviving spouse in a qualifying way and (ii) will not be includable in the surviving spouse's estate because no QTIP election will (or even can) be made. This will avoid estate tax not only at the first spouse's death, but also at the surviving spouse's death in later years.
2. Example 2. One spouse (W) is expected to die this year. Prior to W's death, the spouses partition community into equal separate property shares. W's will leaves her separate property into a qualifying marital trust for H. H transfers his separate property to an inter vivos QTIP for W. At H's subsequent death, the assets of neither trust are included in his estate. Unlike Example 1, however, H is not a beneficiary of half of the property for his remaining lifetime (the half he used to create the inter vivos QTIP trust for W).

H. Distributions from Existing QTIP Trusts or Other Marital Trusts. If a current client is the beneficiary of a trust that will be included in his estate at his death, consider having the trustee make permissible distributions to that beneficiary and then having the beneficiary make gifts to descendants (or to trusts for those descendants) at the 35% gift tax rate that may also avoid GST. Be certain (i) that the trustee has the authority under the trust instrument to make such distributions and (ii) you are not exposing the assets distributed to the creditors of the beneficiary. Also, be aware of the possibility of retroactivity to the 45% gift tax rate.

I. Use of Disclaimers to Buy Time. Example: A client makes a taxable gift to an inter vivos QTIP Trust with the following characteristics:

1. All income to Spouse payable annually.
2. Principal to Spouse for health, support, and maintenance.
3. Trust terminates at Spouse's death, at which time the remaining and unappointed trust estate is to be distributed as follows: 50% to charity, 25% to Son, and 25% to Daughter.

4. However, if the gift to the QTIP trust is disclaimed within the nine month disclaimer period, the gift is distributed as follows: 50% to Son and 50% to Daughter.

Because the inter vivos transfer to the QTIP trust was made when the gift tax rate was 35%, it does not matter that the disclaimer by the spouse came nine months later. The technique would lock in the 35% rate even if Congress later passed legislation prior to the disclaimer raising the rate back to 45% as of the date of the legislation. The law on the date of the gift is what would be controlling, not the law on the date of the disclaimer. This example assumes Congress does not impose a retroactive application of the 45% rate.

- J. Defined Value Clauses. With respect to all of the gifts outright or to trusts discussed above, a donor should consider whether to make such gifts by using a formula clause to define the value rather than by simply using a concrete number or value. The formula used should be based on the maximum amount that can be given without the imposition of a GST tax or without changing the GST inclusion ratio of a trust, taking into account the potential for any legislation that may make the GST tax retroactive to January 1, 2010. There is risk in using defined value clauses since by doing so, the donor is attempting to avoid the application of any transfer tax. By defining the gift to be “the greatest amount of such property” so as not to cause the payment of any gift tax (or GST tax), the taxpayer would “guarantee” that no transfer tax would be payable. The IRS in the past (and the courts) have found that such clauses are a violation of public policy. Whether they would be violations of public policy in this case is unknown, since what law will eventually be held to apply is also unknown.
- K. Gifts Contingent on Amount of Gift Tax or Application of GST Tax. A donor could attempt to make gifts contingent on the fact the current tax law (and rate) remain permanently effective as of the date of the gift. If the condition is not within the control of the donor, the gift may be considered a completed gift. If any future legislation makes retroactive changes, the gift would be reversed. Like the use of a defined value clause, there is no guarantee a contingent gift would be upheld.
- L. ILITs. The premium for insurance policies owned by life insurance trusts are typically paid by the trust after receiving annual exclusion gifts from the donors. In 2010, if annual exclusion gifts are made, GST exemption cannot be allocated to such gifts since Chapter 13 does not apply in 2010 and therefore there is no GST exemption to allocate. If the annual exclusion gifts are made, the trust runs the risk of being partially exempt and partially non-exempt, losing its wholly exempt status. However, the premium has to be paid. One solution is to have the trustee borrow the money necessary to pay the premium rather than receive gifts. In

order not to “lose” the annual exclusion gifts, another Crummey trust, with the original trust as the ultimate beneficiary, could be formed to receive those gifts. When everything settles out, those funds in the new trust could be transferred to the original trust and used to repay the loan. The other solution is simply to make gifts as usual to the trust and to do a late GST allocation in 2011 for the gifts in 2010, relying on the “as if had never been enacted” language of the 2001 Act.

VI. Other GST “what ifs” in 2011—2011 Sunset Consequences

- A. Late Allocations. If a late allocation of GST exemption to an existing GST trust was made during the period from 2001 to 2010 (as allowed by the 2001 Act), is that late allocation which is based on the date of gift value still valid and effective after 2010 (i.e., after the 2001 tax laws sunset)?
- B. Severances. If a trust that was not wholly exempt from GST was split in accordance with the qualified severance rules as permitted under the 2001 Act, and a taxable distribution occurs after 2010 from a trust that was severed to be wholly GST exempt, will such a distribution be considered only from that trust or will it be considered to be from the combined trust since the 2001 Act is to be treated as if it had never been enacted?
- C. Automatic Allocations. With the 2001 Act came the automatic allocation rules for GST purposes. The 2001 Act also states that for estates of decedents dying, gifts made, or generation-skipping transfers after December 31, 2010, the 1986 Code shall apply as if the 2001 Act had never been enacted. Could this mean that any allocation of GST exemption in excess of the amount that was available before 2001 (\$1 million) will no longer apply to any GST transfers after December 31, 2010? The Byrd Rule means that the tax law passed in 2001 cannot result in a revenue reduction after 2010. For this to be literally true, it is necessary to not allow the allocation for any amounts over the pre-2001 levels.
1. Example: 2009 GST Trust Created. D creates a lifetime generation-skipping trust in 2009 and fully funds it up to the level of GST exemption available at that time (\$3.5 million), and D allocates his GST exemption to that gift. Assume also that Congress fails to pass legislation this year and the 2001 law becomes applicable in 2011. Assume also that the \$1 million GST exemption available in 2001 is adjusted for inflation and is \$1.3 million in 2011. Beginning in 2011, what was a wholly exempt trust in 2009 now is not wholly exempt. Only 1.3/3.5 (37.1%) is exempt and 62.9% is non-exempt.
 2. Example: 2010 Trust Created. In 2010, there is no exemption to allocate. Perhaps if the GST tax is resurrected and retroactive, a late

allocation will be allowed. Currently, late allocations have to be done based on the value of the transfer as of the date of the late allocation, not the date of the original gift. Hopefully, Congress would provide some relief in the event of a resurrection of the GST tax as far as reporting and allocation requirements.

- D. Effect on Existing 2642(c) Trusts. 2642(c) trusts are Crummey trusts created by a grandparent for a single grandchild. No other person may be a beneficiary of the trust, and if the beneficiary dies while the trust is in existence, the assets will be includible in the beneficiary's gross estate. Gifts to the trusts qualify for the annual gift tax exclusion and satisfy the definition of a nontaxable gift, meaning the transfer has a zero inclusion ratio for GST tax purposes. The transfers to the trusts are considered direct skips, making the drop-down rule applicable so that future distributions from the trusts are not subject to the GST tax.

However, since transfers to a 2642(c) trust are generation-skipping transfers, and since Chapter 13 does not apply to generation-skipping transfers in 2010, the zero inclusion ratio rule does not apply. While this does not cause problems for transfers in 2010 since the GST tax does not apply in 2010. For 2011 and beyond, it is not clear if the drop-down rule in 2653(a) would apply. If the drop-down rule does not apply, distributions from the trust in 2011 and beyond would be subject to the GST tax at least to the portion of the trust that was non-exempt. So, the odd result would occur that because there is no GST tax in 2010, a GST tax would result in future years because of gifts made to such trusts in 2010. This result seems unfair and hopefully will be remedied by legislation.

For 2010 only, if possible, the donor should consider (i) making outright gifts to grandchildren rather than to 2642(c) trusts for them or (ii) not making gifts to grandchildren in 2010 at all. Gifts to custodian accounts are treated as gifts to trusts under the GST regulations, so custodian accounts are not a completely safe alternative.

In reality, however, annual exclusion gifts will likely continue to be made to custodian accounts or to 2642(c) trusts. However, for large direct skip gifts, clients should consider forming an LLC and making gifts to minors of membership interests in the LLC in order to maintain management capability.

VII. On the Horizon

- A. Loss of Discounts in Certain Family Limited Partnerships. The Obama administration desires to dramatically change the rules regarding valuation discounts associated with family limited partnerships that hold liquid assets and marketable securities (as opposed to an operating business). Any estate and gift

tax legislation that is adopted this year will likely contain these new limitations and restrictions. Even if the legislation does not contain restrictions on such valuation discounts, the IRS may issue regulations under Section 2704 that would create such restrictions.

- B. Loss of Short Term GRATS. On March 24, the House approved H.R. 4849, the “Small Business and Infrastructure Jobs Tax Act of 2010,” which would impose a minimum 10-year term for grantor retained annuity trusts (“GRATs”). GRATs allow taxpayers to structure a transfer of assets to another individual in such a way that substantial gift taxes may be avoided. A GRAT is generally an irrevocable trust in which the grantor retains an annuity interest and transfers a remainder interest to another individual. For gift tax purposes, in valuing the gift of the remainder interest to the beneficiaries of such a trust, current law allows taxpayers to deduct the value of the retained annuity interest from the value of the transferred assets. The value of the retained annuity interest is determined by computing the present value of the annuity at a statutory growth rate. If the property transferred to the trust appreciates in value at a rate that is greater than the statutory growth rate, the excess appreciation will be transferred tax free to the trust beneficiaries. One significant risk to this type of tax planning is that if the grantor dies during the trust term, the portion of the trust necessary to satisfy the annuity amount is included in the grantor’s gross estate for estate tax purposes. This generally eliminates the benefit of using a GRAT. As a result, taxpayers have created short-term GRATs to maximize their gift tax planning while minimizing the chances that they might die during the trust term. A minimum 10-year term for GRATs will significantly limit this type of planning. In connection with requiring a minimum 10-year term, the bill would also require that the value of the remainder interest must be greater than zero and that the annuity must not decrease during the first 10 years of the GRAT term. As a result, the bill would require taxpayers to take on a greater risk that they might die during the GRAT term in order to take advantage of the gift tax benefits of using a GRAT.

“ On or before the first Monday in February, the President submits to Congress a detailed budget request for the coming federal fiscal year, which begins on October 1.”

Updated December 1, 2009

The way Congress develops tax and spending legislation is guided by a set of specific procedures laid out in the Congressional Budget Act of 1974. The centerpiece of the Budget Act is the requirement that Congress each year develop a “budget resolution” setting aggregate limits on spending and targets for federal revenue. The limits set by the budget resolution, along with a companion “pay-as-you-go” rule, apply to all tax or spending legislation developed by individual committees as well as to any amendments offered on the House or Senate floor.

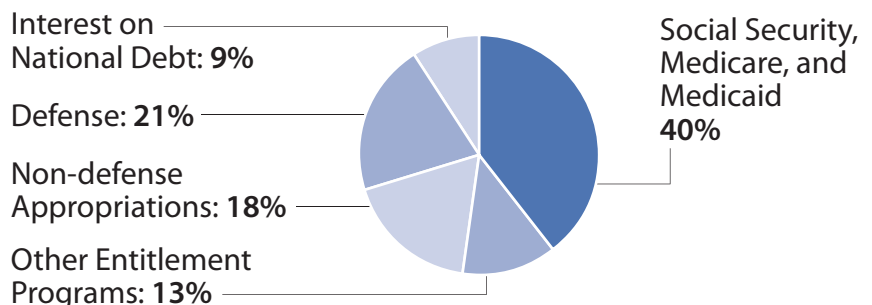
The following is an overview of the federal budget process, including:

- the President’s annual budget request, which kicks off the budget process;
- the congressional budget resolution — how it is developed and what it contains;
- how the terms of the budget resolution are enforced in the House and Senate; and
- budget “reconciliation,” a special procedure used in some years to facilitate the passage of spending and tax legislation.

Step One: The President’s Budget Request

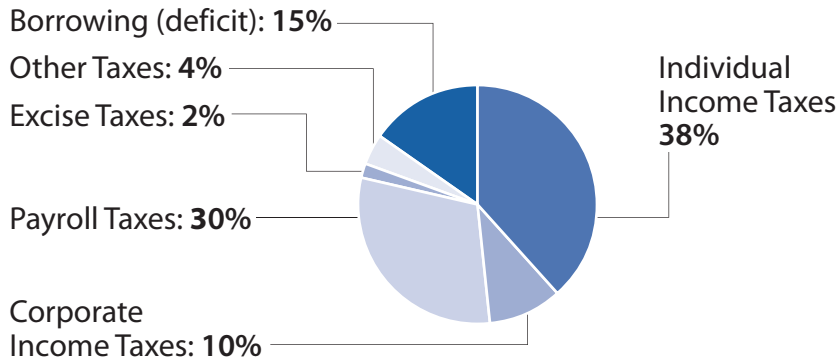
On or before the first Monday in February, the President submits to Congress a detailed budget request for the coming federal fiscal year, which begins on October 1. (In years where there is a change in administration, the budget is submitted later.) This budget request, developed by the President’s Office of Management and Budget (OMB), plays three important roles. First, it tells Congress what the President recommends for overall federal fiscal policy, as established by three main components: (1) how much money the federal government should spend on public purposes; (2) how much it should take in as tax revenues; and (3) how much of a deficit (or surplus) the federal government should run, which is simply the difference between (1) and (2).

Federal Spending, FY 2008



Source: Office of Management and Budget, April 2009

Financing the Federal Budget, FY 2008



Source: Office of Management and Budget, April 2009

Second, the budget request lays out the President’s relative priorities for federal programs — how much he believes should be spent on defense, agriculture, education, health, and so on. The President’s budget is very specific, and recommends funding levels for individual federal programs or small groups of programs called “budget accounts.” The budget typically sketches out fiscal policy and budget priorities not only for the coming year but for the next five years or more. It is also accompanied by historical tables that set out past budget figures.

The third role that the President’s budget plays is to signal to Congress what spending and tax policy changes the President recommends. The President does not need to propose legislative changes for those parts of the budget that are governed by permanent law if he feels none are necessary. Nearly all of the federal tax code is set in permanent law, and will not expire. Similarly, more than one-half of federal spending — including the three largest entitlement programs (Medicare, Medicaid, and Social Security) — is also permanently enacted. Interest paid on the national debt is also paid automatically, with no need for specific legislation. (There is, however, a separate “debt ceiling,” which limits how much the Treasury can borrow. The debt ceiling is raised as necessary through separate legislation.)

The President does have to ask for one type of spending each year:

- **Funding for “discretionary” or “appropriated” programs**, which fall under the jurisdiction of the House and Senate Appropriations Committees. Discretionary programs must have their funding renewed each year in order to continue operating. Almost all defense spending is discretionary, as are the budgets for K-12 education, health research, and housing, to name just a few examples. Altogether, discretionary programs make up about two-fifths of all federal spending. The President’s budget spells out how much funding he recommends for each discretionary program.

“ The budget request lays out the President’s relative priorities for federal programs — how much he believes should be spent on defense, agriculture, education, health, and so on.”

“After receiving the President’s budget request, Congress generally holds hearings to question Administration officials about their requests and then develops its own budget resolution.”

The President’s budget can also include:

- **Changes to “mandatory” or “entitlement” programs**, such as Social Security, Medicare, Medicaid, and certain other programs (including but not limited to food stamps, federal civilian and military retirement benefits, veterans’ disability benefits, and unemployment insurance) that are not controlled by annual appropriations. For example, when President Bush proposed adding a prescription drug benefit to Medicare, he had to show a corresponding increase in Medicare costs in his budget, relative to what Medicare would otherwise be projected to cost. Similarly, if the President were to propose a reduction in Medicaid payments to states, his budget would show lower Medicaid costs than projected under current law.
- **Changes to the tax code.** Any presidential proposal to increase or decrease taxes is reflected in a change in the amount of federal revenue that the President’s budget projects will be collected the next year or in future years, relative to what would otherwise be collected.

To summarize, the President’s budget must request a specific funding level for appropriated programs and may also request changes in tax and entitlement law.

Step Two: The Congressional Budget Resolution

After receiving the President’s budget request, Congress generally holds hearings to question Administration officials about their requests and then develops its own budget resolution. This work is done by the House and Senate Budget Committees, whose primary function is to draft the budget resolution. Once the committees are done, their budget resolutions go to the House and Senate floors, where they can be amended (by a majority vote). A House-Senate conference then resolves any differences, and a conference report is passed by both houses.

The budget resolution is a “concurrent” congressional resolution, not an ordinary bill, and therefore does not go to the President for his signature or veto. It also requires only a majority vote to pass, and its consideration is one of the few actions that cannot be filibustered in the Senate.

The budget resolution is supposed to be passed by April 15, but it often takes longer. Occasionally, Congress does not pass a budget resolution. If that happens, the previous year’s resolution, which is a multi-year plan, stays in effect.

- **What is in the budget resolution?** Unlike the President’s budget, which is very detailed, the congressional budget resolution is a very simple document. It consists of a set of numbers stating how much Congress is supposed to spend in each of 19 broad spending categories (known as budget “functions”) and how much total revenue the government will collect, for each of the next five or more years. (The Congressional Budget Act requires that the resolution cover a minimum of five years, though Congress sometimes chooses

a longer period, such as 10 years.) The difference between the two totals — the spending ceiling and the revenue floor — represents the deficit (or surplus) expected for each year.

- **How spending is defined: budget authority vs. outlays.** The spending totals in the budget resolution are stated in two different ways: the total amount of “budget authority” that is to be provided, and the estimated level of expenditures, or “outlays.” Budget authority is how much money Congress allows a federal agency to commit to spend; outlays are how much money actually flows out of the federal treasury in a given year. For example, a bill that appropriated \$50 million for building a bridge would provide \$50 million in budget authority in the same year, but the outlays might not reach \$50 million until the following year or even later, when the bridge actually is built.

Budget authority and outlays thus serve different purposes. Budget authority represents a limit on how much funding Congress will provide, and is generally what Congress focuses on in making most budgetary decisions. Outlays, because they represent actual cash flow, help determine the size of the overall deficit or surplus.

- **How committee spending limits get set: 302(a) allocations.** The report that accompanies the budget resolution includes a table called the “302(a) allocation.” This table takes the spending totals that are laid out by budget function in the budget resolution and distributes them by congressional committee instead. The House and Senate tables are slightly different from one another, since committee jurisdictions vary somewhat between the two chambers.

The Appropriations Committee receives a single 302(a) allocation for all of its programs. It then decides on its own how to divide this funding among its 12 subcommittees, creating what are known as 302(b) sub-allocations. The various committees with jurisdiction over mandatory programs each get an allocation that represents a total dollar limit on all of the legislation they produce that year.

The spending totals in the budget resolution do not apply to the “authorizing” legislation produced by most congressional committees. Authorizing legislation typically either changes the rules for a federal program or provides a limit on how much money can be appropriated for it. Unless it changes an entitlement program (such as Social Security or Medicare), authorizing legislation does not actually have a budgetary impact. For example, the education committees could produce legislation that authorizes a certain amount to be spent on the Title I education program for disadvantaged children. However, none of that money can be spent until the annual Labor-HHS-Education appropriations bill — which includes education spending — sets the actual dollar level for Title I funding for the year, which is frequently less than the authorized limit.

“ Budget authority is how much money Congress allows a federal agency to commit to spend; outlays are how much money actually flows out of the federal treasury in a given year.”

■ A single member of the House or Senate can block legislation that violates the terms of the budget resolution by raising a budget “point of order” against it on the floor.

Often the report accompanying the budget resolution contains language describing the assumptions behind it, including how much it envisions certain programs being cut or increased. These assumptions generally serve only as guidance to the other committees and are not binding on them. Sometimes, though, the budget resolution includes more complicated devices intended to ensure that particular programs receive a certain amount of funding. For example, the budget resolution could create a “reserve fund” that could be used only for a specific purpose.

The budget resolution can also include temporary or permanent changes to the congressional budget process. For example, the fiscal year 2007 budget resolution contained a provision reinstating the “pay-as-you-go rule” (PAYGO) in the Senate (see box: “The ‘Pay-As-You-Go’ Rule”).

Step Three: Enforcing the Terms of the Budget Resolution

The main enforcement mechanism that prevents Congress from passing legislation that violates the terms of the budget resolution is the ability of a single member of the House or the Senate to raise a budget “point of order” on the floor to block such legislation. In some recent years, this point of order has not been particularly important in the House because it can be waived there by a simple majority vote on a resolution developed by the leadership-appointed Rules Committee, which sets the conditions under which each bill will be considered on the floor.

However, the budget point of order is important in the Senate, where any legislation that exceeds a committee’s spending allocation — or cuts taxes below the level allowed in the budget resolution — is vulnerable to a budget point of order on the floor that requires *60 votes* to waive.

Appropriations bills (or amendments to them) must fit within the 302(a) allocation given to the Appropriations Committee as well as the Committee-determined 302(b) sub-allocation for the coming fiscal year. Tax or entitlement bills (or any amendments offered to them) must fit within the budget resolution’s spending limit for the relevant committee or within the revenue floor, both in the first year *and* over the total multi-year period covered by the budget resolution. The cost of a tax or entitlement bill is determined (or “scored”) by the Budget Committees, nearly always by relying on the nonpartisan Congressional Budget Office, which measures the bill against a budgetary “baseline” that projects entitlement spending or tax receipts under current law.

The Budget “Reconciliation” Process

From time to time, Congress makes use of a special procedure outlined in the Congressional Budget Act known as “reconciliation.” This procedure was originally designed as a deficit-reduction tool, to force committees to produce spending cuts or tax increases called for in the budget resolution. However, it was used to enact tax cuts several times during the George W. Bush Administration, thereby increasing projected deficits. This practice has since been barred, by House and Senate rules adopted in 2006 at the same time as the PAYGO rule.

The “Pay-As-You-Go” or “PAYGO” Rule

Independent of the Congressional Budget Act, the House and Senate each have a rule requiring that all entitlement increases and tax cuts be fully offset. For example, a bill that increases Medicare spending would have to be paid for by cutting somewhere else in Medicare or another entitlement program, by raising revenues, or by a combination of the two. The rule does not apply to discretionary spending, which is limited by the allocations set in the annual budget resolution.

If legislation providing for new tax cuts or entitlement increases is not paid for, the “PAYGO” rule gives any senator the power to raise a point of order against the bill, which can only be waived by the vote of *60 senators*. In the House, any Member can raise a point of order, and there is no opportunity to vote to waive the PAYGO requirement — the bill is automatically defeated, unless the leadership-appointed Rules Committee has decided in advance to waive PAYGO as part of the broader measure (referred to as a rule) setting the terms of debate on the bill as a whole and the House has agreed to that rule.

PAYGO is an additional requirement, separate and apart from the terms of the budget resolution. A bill that cuts taxes or increases entitlement spending without an offset would violate the PAYGO rule *even if* the budget resolution had assumed the enactment of tax cuts or entitlement increases and allocated the necessary amounts to the relevant committees. (The PAYGO rule does not directly apply to the budget resolution itself or amendments to it, however.)

In order to satisfy the House and Senate PAYGO rules, a bill must be paid for over the first six years (including the current year), and over the first 11 years (including the current year). The Senate PAYGO rule does not consider the impact of a bill on Social Security and other “off-budget” items, whereas the House PAYGO rule applies to the “unified budget,” which includes Social Security.

- Originally designed as a deficit-reduction tool, reconciliation was used to enact tax cuts several times during the George W. Bush Administration, thereby increasing projected deficits.

- **What is a reconciliation bill?** A reconciliation bill is a single piece of legislation that typically includes multiple provisions (generally developed by several committees) all of which affect the federal budget — whether on the mandatory spending side, the tax side, or both. A reconciliation bill, like the budget resolution, cannot be filibustered on the Senate floor, so it only requires a majority vote to pass.

■ The PAYGO

("pay-as-you-go") rule helps ensure that tax cuts and entitlement increases are paid for, and do not add to the deficit.

- **How does the reconciliation process work?** If Congress decides to use the reconciliation process, language known as a "reconciliation directive" must be included in the budget resolution. The reconciliation directive instructs a committee to produce legislation by a specific date that meets certain spending or tax targets. (If they fail to produce this legislation, the Budget Committee Chair generally has the right to offer floor amendments to meet the reconciliation targets for them, a threat which usually produces compliance with the directive.) The Budget Committee then packages all of these bills together into one bill that goes to the floor for an up-or-down vote, with only limited opportunity for amendment. After the House and Senate resolve the differences between their competing bills, a final conference report is considered on the floor of each house and then goes to the President for his signature or veto.
- **Constraints on reconciliation: the "Byrd rule."** While reconciliation enables Congress to bundle together several different provisions affecting a broad range of programs, it faces one major constraint: the "Byrd rule," named after Senator Byrd of West Virginia. This Senate rule makes any provision of (or amendment to) the reconciliation bill that is deemed "extraneous" to the purpose of amending entitlement or tax law vulnerable to a point of order. If a point of order is raised under the Byrd rule, the offending provision is automatically stripped from the bill unless at least 60 senators vote to waive the rule. This makes it difficult, for example, to include any policy changes in the reconciliation bill unless they have direct fiscal implications. Under this rule, authorizations of discretionary appropriations are not allowed, nor are changes to civil rights or employment law, for example. Changes to Social Security also are not permitted under the Byrd rule.

In addition, the Byrd rule bars any entitlement increases or tax cuts that cost money beyond the five (or more) years covered by the reconciliation directive, unless these "out-year" costs are fully offset by other provisions in the bill. This is one reason that Congress made the 2001 tax cuts expire after ten years, rather than making them permanent.

In short, the annual federal budget process begins with a detailed proposal from the President in February; Congress next develops a blueprint called a budget resolution that sets limits on how much each committee can spend (or reduce revenues) over the course of the year; and the terms of the budget resolution are then enforced against individual appropriations, entitlement bills, and tax bills on the House and Senate floors. In addition, Congress sometimes uses a special procedure called "reconciliation" to facilitate the passage of deficit reduction legislation or other major entitlement or tax legislation. Finally, a companion PAYGO rule helps ensure that tax cuts and entitlement increases are paid for and do not add to the deficit.