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## *BLACK SWAN: COMPLIANCE AND PLANNING AFTER THE 2010 TAX ACT*

The Academy Awards season sparks an appropriate metaphor for estate planning and compliance considerations that arise under the 2010 Tax Act. The increase in the estate tax exemption allowance to $5 million, plus the new portability of the unused exemption allowance of the first spouse to die can enable up to $10 million of value to avoid estate tax! In addition, the estate tax rate has been reduced to 35%, the lowest since Calvin Coolidge was President.

How then do these numbers and tax law dramatically interweave with Peter Tchaikovsky's *Swan Lake* and the extraordinary performance by Natalie Portman in the 2010 motion picture release of *Black Swan*? Taxes can ravage a business or estate. Yet, which tax will create the greatest harm … income tax or estate tax? Which of these taxes will be an innocent bystander in the melodrama of succession of fortune or business?

Most decisions that save estate tax present income tax negatives. Valuation discounts reduce the amount of estate tax payable. However, the income tax basis adjustment will likely be lower as a result of the reduced estate tax value thereby creating the potential for additional capital gains tax and lower depreciation allowances. Exemption trusts can avoid estate tax on the death of the beneficiary yet allow for no income tax basis adjustment to fair market value on that beneficiary's death.

Natalie Portman's character epitomizes the conflict between the innocent virginal beauty of the white swan against the seductive sensuality and stealth of the black swan. In the estate planning context, a determination needs to be made to identify the tax system that will remain chaste and untouched and which system can rip out the financial heart of the estate. Whichever tax remains the least likely to be entangled and a threat to the financial affairs of a given estate is considered "chaste,"(the White Swan) in our metaphor.

Estate planners and clients can still be driven mad with the array of planning options and uncertainties inherent in the law. Yet, the bottom line endures … far greater estates will remain untouched and chaste to the estate tax system. What level of tax planning protection will the client need to secure a safe and healthy financial future for business and affairs of the estate?

### *Black and White Swans with 2010 Deaths*

The 2010 Tax Act re-imposes the estate tax for deaths in 2010 with a $5 million exemption and a 35% tax rate. At the same time, any estate can elect out of the estate tax system and into the modified carryover basis regime that had been enacted for 2010 under the prior 2001 Tax Act.

The modified carryover basis regime will be very attractive to large estates with deaths in 2010. The upside is no estate

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## BLACK SWAN: COMPLIANCE AND PLANNING AFTER THE 2010 TAX ACT

tax (the white swan). The downside will be basis rules equal to the lower of the pre-death adjusted basis or the fair market value of the interest, provided however, that increases are allowed to a limited extent to fair market value. The allowable increases include the following for a decedent's property:

(i) $1.3 million generally ($60,000 for a non-resident alien).

(ii) $3.0 million for property passing to a surviving spouse, including the surviving spouse's community property interest.

(iii) $250,000 for the decedent's principal residence.

(iv) Net operating loss carry-forward.

(v) Net capital loss carry-forward.

The executor makes the election to allocate on a Form 8939, which has not been published in final form and for which no instructions have yet been issued. Beware, however, if the court-appointed executor and the trustee of the living trust (with the assets) are not the same. The statute and legislative history is not clear on the resolution of disagreements for making the election.

No basis adjustment may be allocated to items of income in respect to a decedent (such as installment notes, bonuses, IRAs and retirement plans).

Electing into the modified carryover basis regime requires a timely filing of the Form 8939. The due date for this return is unclear at the time of this newsletter. Further guidance from the IRS is needed to coordinate the due date for the filing of this return with the decedent's income tax return or estate tax return due date.

### *Might There Exist a Gray Swan?*

Most of the time, it will be easy to determine which tax is the least worrisome swan or the more dangerous one. For example, estates (including the value of the taxable estate plus all taxable gifts … whether reported or not) of a value of less than $5 million will prefer to remain in the estate tax system and not elect into the modified carryover basis regime. Similarly, estates with values of greater than $9-$10 million, or more, will likely prefer to elect out of the estate tax system and to timely file the Form 8939.

However, some estates may be in a middle zone, "gray swans." Consider the following example:

Odette, a California resident, dies with an estate valued at $7 million with an adjusted basis of $1 million. The estate tax on $7 million would be $700,000 (35% of $2 million). Assuming that Odette is not survived by a spouse, the modified basis for her estate would be $2.3 million. If only a 15% capital gain applied to the $4.7 million difference ($7 million less $2.3 million), the capital gains tax would be $705,000.

Matters would be worse if some of the gain is depreciation (such as on real estate, personal property, or other depreciable asset). Recapture rates can vary depending upon the year the property is acquired and use and type for the property. If $2 million of the $4.7 million gain arises from recapture taxed at the 28% rate, the tax on sale would be $905,000. State income taxes for those states that do not allow a step-up in basis at death when estate tax does not apply would also enter into the determination.

Accountants, fiduciaries, and attorneys will need to run the numbers to determine which tax will be most relevant. Also, consider when the property is likely to be sold in a taxable event.

### *Fiduciaries Beware*

Executors, trustees, and their advisors are presented with additional concerns. Wills and trusts are often drafted with certain bequests being estate-tax free while other shares of the estate bear the estate tax liability. On the other hand, an asset with basis less than value may be bequeathed to a beneficiary whose share does not bear estate tax. Unless the executor is mindful of the terms of the trust and tax results, the beneficiary may end up receiving a gift on which income tax is payable but no estate would have been payable had the estate remained subject to the estate tax system.

Fiduciaries are obligated to implement the trust and to be fair and impartial. On the other hand, "fairness" is often in the eye of the beholder ("Mirror mirror on the wall …") Litigation against fiduciaries can arise from differing perceptions.

In this setting, fiduciaries should consider notices of proposed action, agreements, or court orders relative to whether or not to elect out of the estate tax regime and with respect to the allocation of the basis adjustment allowance among assets.

### *Warning for Spouses!*

The $3 million basis adjustment increase appllies to property *distributed* to the spouse (outright or QTIP). Under the exact language of the statute, the $3 million allowance adjustment may not apply if property is sold before the Form 8939 is filed and spousal property is designated. Distribution of property may not be the same as distribution of proceeds.

### *Looking Forward: Deaths in 2011 and Beyond*

The most significant change in law for deaths arising in 2011 and 2012 is *portability* (i.e., transferability) of the deceased spousal unused exemption

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allowance ("DSUEA"). The DSUEA equals the estate tax exemption available in the estate of the deceased spouse reduced by adjusted taxable gifts and death transfers that utilize the deceased spouse's estate tax exemption allowance.

The estate tax exemption for decedent's dying in 2011 is $5 million. This exemption adjusts for inflation (based on the 2010 index) for the year 2012.

The DSUEA is only available if an election is made by the executor of the deceased spouse on a **timely filed** estate tax return for all the unused exemption to be available to the surviving spouse, subject to limitations for receipt of the DSUEA. Thus, the DSUEA is lost if a late estate tax return is filed, unless the IRS grants relief.

The DSUEA will be attractive to estates with unused estate tax exemptions regardless if estate tax is not payable and the estate is not very close to the normal filing requirements for estate tax returns.

**Example #1:** Harry dies with a $1 million estate, leaving it outright to his wife, Sally, age 55, who has an estate of $3 million. Sally will now have an allowable estate tax exemption allowance of $10 million (assuming no inflation adjustment), consisting of a $5 million exemption for both Harry and Sally. (Sally is more excited than had she just bitten into the best pastrami sandwich ever.)

**Example #2:** A few years later Sally is married to Tom. By this point in time, Sally's estate has grown to $7 million. Tom, however, predeceases Sally. He leaves his total exemption allowance of $5 million to the children of his first marriage. Since Sally's most recently deceased husband has no DSUEA, only Sally's $5 million exemption allowance remains. Lesson: If remarrying, choose a poor person with at least as much DSUEA available as the deceased spouse had and seek an agreement for its use.

**Example #3:** Same as example #1, except that Sally's estate has grown to $30 million. Sally is now in a position to make large gifts to her children. Sally can gift $10 million to her children (her gift tax exemption of $5 million plus the DSUEA from Harry) without paying gift tax.

Hopefully, the IRS will develop a form for a simplified filing for estates for whom filing requirements do not otherwise apply and to which the election for the DSUEA is desired.

*Limitations with the DSUEA*

The most significant benefit with a DSUEA arises from the fact that married couples do not need to create trusts simply to take advantage of the estate tax exemption allowance. Thus, credit shelter, by-pass or by whatever other name an estate tax exemption trust is called will more likely arise for other reasons … mainly non-tax but also tax related.

The most significant non-tax reason to use a trust for the benefit of a surviving spouse arises from the *Cinderella* line of cases (or human behavior). If you want to protect the ultimate inheritance of your children, leave your estate in trust for the spouse (or have a share go to the children). When property is left outright, the surviving spouse can do with that property whatever he or she wants. The children of the first spouse to die are not protected (à la *Cinderella)*.

Three estate/GST - tax related limitations also arise from the use of outright bequests, rather than exemption trusts, to protect the estate tax exclusion allowance:

First, the DSUEA from the first spouse to die does not increase in value with inflation. If the $5 million DSUEA grows in value to $8 million by the time of the death of the widow, the $8 million value is used to determine the estate tax of the surviving spouse. The loss of an estate *freeze* (removal of value from the beneficiary's estate) with the DSUEA will hurt for estate tax purposes if investments exceed inflation (assuming the inflation adjustment remains in the law for the surviving spouse).

Second, use of the exemption trust as a separate valuation entity is lost. Thus, minority interest discounts and fractional interest discounts may be harder to achieve.

Third, the deceased spouse's GST exemption cannot be allocated to the DSUEA transfer of the surviving spouse (unless the property is left in a QTIP trust for the surviving spouse and a reverse QTIP election is made).

*What Would Natalie Say?*

Pirouetting before our swans, the ultimate issue may rest with the transfer tax (capital gains under income tax versus estate tax/GST tax) that the client and planner classify as the black swan or white swan. If the income tax system is considered the greater threat, then a credit shelter trust may be less desirable. Instead, an outright bequest may be preferred. If the deceased wants to provide for his spouse, protect his children, receive an income tax basis increase in the estate of the surviving spouse and preserve the DSUEA, property can be left in a trust for the surviving spouse in a manner that can qualify for a marital QTIP election. Yes, it will still be necessary to administer a trust and file income tax returns for a trust during the widow's lifetime. However, protection of the children's remainder interest is important … at least when it comes to protecting loved ones down the road or in a blended family situation.

Natalie Portman's character like the QTIP election approach because it provides up to 15 months after the death of the deceased spouse to determine whether a QTIP election will be made. This added time can be secured with an extension to file the estate tax return. This extension of time can reduce stress in determining which tax is our black swan.

*Creating Time to Identify the Black Swan*

In addition to the use of a trust that could either qualify for a marital deduction QTIP election or to which

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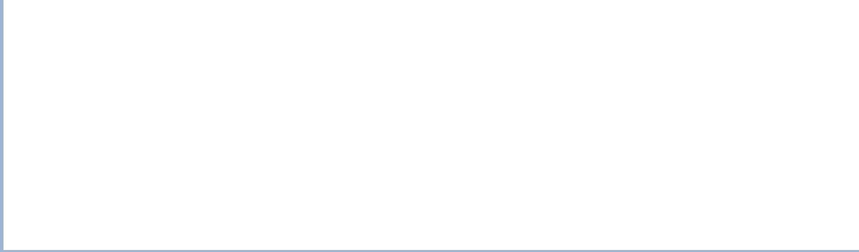



OTHER DEVELOPMENTS

Notwithstanding the dedication of this newsletter to an overview of the 2010 Tax Act, several other recent developments merit attention:

1. The Supreme Court decision in *Mayo Foundation v. U.S.* (1/11/11) makes more likely the upholding by the courts of Treasury Regulation issued after hearing when the statute is ambiguous (which most are to some extent) and the regulations are not materially inconsistent with the statute. This decision, and earlier decisions that followed *Standard Oil, Inc. v. National Resources Defense Council, Inc.*, make more likely the upholding of Treasury Regulations regarding the deduction of claims, liabilities and administrative expense deductions for a decedent's estate. However, estates in the Fifth, Tenth and Eleventh Circuit Courts (which include Florida, Texas, and Colorado) among other states may have strong policy arguments to overturn the regulations on policy grounds and the standard of *Mayo Foundation*. The case is not lost even in the Ninth Circuit although the battle will be more uphill and fact dependent.

2. *Adler v. Comr.*, T.C. Memo 2011-28: A deed included a provision that allowed the decedent to continue to control gifted property. As a result, the gift of Carmel property was returned to the gross estate as a retained interest under Code Sec. 2036. The result is not surprising. When gifts are made, a change of position is required and the donor cannot, directly or indirectly, retain control or benefit of what he/she gifted.

3. Tax Court Judge Mark V. Holmes, John Schooler (the managing estate and gift tax appeals officer for the Western United States), and Keith Schiller discussed several recent developments at the CalCPA Foundation's Advanced Estate Planning Institute.The following are a few highlights:

(a) Unfunded trusts can present problems, including potential loss of estate tax exemption allowances. Trusts should be funded before the surviving spouse dies and creditor claims timely filed if funding does not occur. While the Hurford case did not raise viable defense points timely to this issue, the issue remains in any event. Make your best deal in audit or appeals. Each side has real litigation risks.

(b) IRS Appeals is seeking greater uniformity with issue treatment across the country. This is one of John Schooler's principle goals.

(c) Estate tax return filing will sink dramatically with the increase in the estate tax exemption allowance. The author anticipates about 5,000 taxable estate tax returns for the entire nation. About 18% come from California with Florida second at approximately 9%. The IRS increased hiring. IRS audit percentages increase, including with first spouse deaths. The author also anticipates that if the IRS will ever conduct fiduciary income tax return audits, including trust funding, with any focus, now would most likely be the time.

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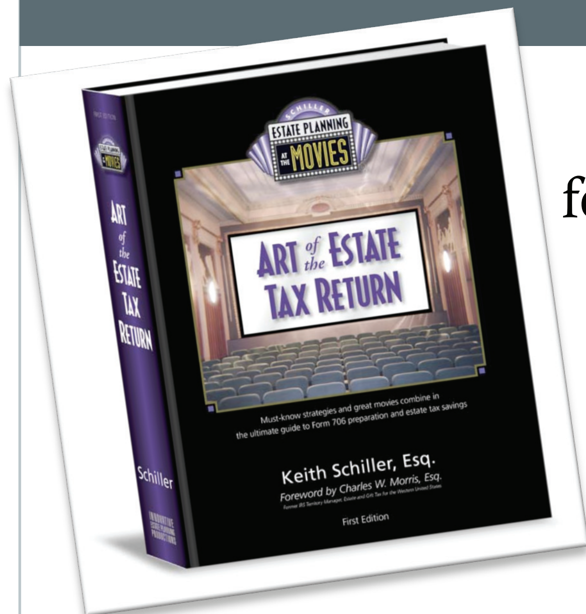


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no election would be made (thus using estate tax exemption amount), other strategies exist to build in flexibility into the estate plan. These strategies buy time before a decision is made to utilize a trust or to classify a trust as exempt or non-exempt:

- If the surviving spouse will be receiving the estate outright, include a disclaimer trust as a fallback alternative. The surviving spouse can elect to disclaim the outright benefit and receive all, or part, of the outright share in trust. The spouse can receive income and, in addition, principal for need under an appropriate standard. However, the surviving spouse cannot change distribution of the trust on death.
- Appoint an independent trust "protector" with the authority to grant powers or limit rights in prescribed manners. For example, the trust protector could be authorized to create a general power of appointment that would make a trust estate taxable, if that would save overall taxes when the surviving spouse dies. The protector is a non-fiduciary who will determine which tax system is the black swan or chaste white swan. As a caution, general powers of appointment can create additional creditor rights, whether exercised or not. See, Calif. Prob. Code Secs. 611 and 682. (a)
- Contingent general powers of appointment (i.e., those that arise only in the event of certain conditions, such as the value of an estate), provide an apparently attractive alternative. However, their bona fides are subject to a test that may be difficult to satisfy. ***Kurz v. Commissioner,*** 101 TC 44 (1993), ***aff'd*** 68 F.3d 1027 (7th Cir. 1995).

### Major Gifting and Sales to Family Members

The black swan for clients of major wealth remains the estate tax and GST tax. However, a perfect storm of interest rates, gift tax exemption, and favorable valuation rules conspire to trim the features from the injurious swan.

The gift tax exemption allowance has been increased to a record high of $5 million. For many years, the gift tax has existed as a means of supporting the income tax system. In other words, if the wealthy wanted their loved ones to receive more income, the gift tax would arise when significant assets were transferred. The increase in the exemption significantly changes that equation. A married couple can make taxable gifts of $10 million, assuming no prior taxable gifts. This $10 million gift not only removes the post-gift growth from the estate of the donors. It also moves the income from that investment base to the loved ones. For example, a 4% return,shifts $400,000 a year in income.

At the same time, the IRS rates for loans, including installment sales, is near record lows. This $10 million exemption allowance can be used to support truly large sales … even up to $100 million if properly structured. The net income from the assets sold may exceed the required payments on the loan.

**Aside: In one of the great ironies, the IRS argues that sales made in which the income is sufficient to satisfy the note payment are evidence of a non-business purpose with a retained interest. Yet, the lending of money at lower rates than the return on the investment has been a principle of sound banking for centuries. Of course, the banking industry has forgotten that rule from time to time ... such as the savings and loan disaster of the 1980s or the recent mess with mortgage-backed securities. Ideally, sound estate planning principles can embrace traditional prudence while reflecting a respected transaction.**

Finally, rules pertaining to discount valuations and intentionally defective grantor trust sales enable these sales transactions, and their income tax benefits, to blend in the shifting of massive wealth to loved ones with little or no estate or gift tax. We conclude in this respect with an instance in which the income tax and estate tax systems can blend in which each system resembles as closely as possible the desired white swan.

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