THE TEXAS TAX LAWYER

Winter 2011
Vol. 38, No. 2
www.texastaxsection.org

2011

TO MOVE DIRECTLY TO AN ARTICLE CLICK ON THE TITLE

TABLE OF CONTENTS

Practitioner's Corner:

CHAIR'S MESSAGE

Greetings Tax Section Members,

We are a bit past the half-way mark for the fiscal year of the Tax Section and already a number of new initiatives have been put in place which I'll discuss below. First, though, please put the following events on your calendars:

- May 2, 2011 – Property Tax Conference, Austin, Texas
- June 9-10, 2011 – Texas Federal Tax Institute, San Antonio, Texas
- June 23-24, 2011 – Annual Meeting of the State Bar of Texas (including Tax Section Annual Meeting on June 24), San Antonio, Texas
- August 17-19, 2011 – Advanced Tax Law Course, Houston, Texas

Further details for these upcoming events will be posted on the Tax Section's website at www.texastaxsection.org.

It is with sadness that I report the passing of Charles O. Galvin, last year's recipient of the Outstanding Texas Tax Lawyer Award. Professor Galvin had a long and illustrious career both in private practice and as a member of the law faculty at Southern Methodist University which he joined in 1952, continuing his academic career into the twenty-first century. He was a leader in various tax policy debates that served as the foundation of the modern Internal Revenue Code. He will be greatly missed.

As for the new recipient of the Outstanding Texas Tax Lawyer Award, I am pleased to announce that the Tax Section Council has selected Stanley M. Johanson as the 2011 recipient of that award. This is the highest award that the Tax Section bestows as a recognition honoring recipients for their outstanding reputation, expertise and professionalism in the practice of tax law in Texas. Professor Johanson has been on the law faculty of the University of Texas School of Law since 1963 where he has taught thousands of students estate planning. He has won numerous awards over the years including the Treat Award for Excellence presented by the National College of Probate Judges and the endowed Massey Teaching Excellence Award at the University of Texas School of Law. In 2008, Professor Johanson was elected by the National Association of Estate Planning Councils to the Estate Planning Hall of Fame. His publications include Johanson's Texas Probate Code Annotated (2010—published annually); Gilbert's Law Summary on Wills (2002); Wills, Trusts & Estates (7th ed. 2005) (co-author; law school casebook adopted at over 120 American law schools). He is a member of the American Law Institute, American College of Tax Counsel, American College of Trust & Estate Counsel, and the International Academy of Trust and Estate Counsel. Congratulations to Professor Johanson.

With respect to recent Tax Section events, I'd first like to congratulate Andrius Kontrimas for yet another very successful International Tax Symposium. The 13th Annual Tax Symposium featured a number of nationally-renowned speakers and the Tax Section is working to post these presentations on the Section's 24/7 free on-line audio-video library. The current CLE Chair, Michael Threet, has undertaken a major initiative this year to stream-line the offerings of the 24/7 library so please stop by and check out the library at http://texastax.fastcle.com/store/provider/provider.php. As a member of the Tax Section, these State Bar of Texas accredited CLE audio-video presentations are free and accessible at any time from the convenience of your desktop computer.

And speaking of new technologies that could benefit your practice, don't forget to sign up for one or more listservs where you can interact with other members of the Tax Section. There are many different substantive areas to choose from including corporate tax, employee benefits, energy and natural resources, estate and gift, international tax, partnerships and real estate and many more. There's also a listserv for small firms and solos as well as a listserv dedicated to private practice issues, questions and referrals. For more information, please visit our website at http://www.texastaxsection.org/ListServ/Welcome/tabid/101/Default.aspx. If you're having trouble registering or logging in, please contact Brent Gardner at (214) 999-4585 or bgardner@gardere.com. Thanks once again to Brent and Andrius for spearheading this project and also for agreeing to head up the new Communications committee (along with Alyson Outenreath).

I would also like to thank Alyson for agreeing to oversee a special project with the Computer and Technology Section to develop a new iphone app for the Tax Section members. It is envisioned that this app would eventually be accessible from your blackberry, ipad, android phone, mac and pc. It would give you access to the Internal Revenue Code and other tax resources along with case annotations. If you have suggestions for Alyson regarding what tax resources to include on the app or have other comments or questions, please contact her at (214) 969-1741 or at Alyson.outenreath@tklaw.com. Also, if you would like to acquire the current app as prepared by the Computer and Technology Section please visit their website at http://www.sbot.org/. The app is available for free to all members of the Computer and Technology Section (there is a $25.00 annual membership fee). For a limited time only between now and May 31, 2011, any lawyer who is already a member of another section of the State Bar of Texas may join the Computer and Technology Section and receive a $10.00 rebate. The lawyer must send an email to council@sbot.org stating the lawyer's name, address and name of the other section to which the lawyer belongs.

Finally, the greatest benefit you can receive as a member of the Tax Section is to become involved with one or more of the Section's many activities. It's a great way to meet fellow tax professionals and make a lasting impact on the practice of tax law—both in Texas and nationally. Take a quick look at the Section's leadership roster on our website, identify a committee you are interested in joining, and call or email the committee chair. If you are not sure how to get involved, please contact me at (512) 536-5264 or at podaniel@fulbright.com. You will not only build and maintain a stronger Section but your personal practice will benefit as well. This is your section but it is only as strong as the time and effort you are able to devote to it. Thanks, and I look forward to finishing out a strong year with your help.

IN MEMORIAM: CHARLES O'NEILL GALVIN

Charles O. Galvin, Distinguished Professor *Emeritus* and former Dedman School of Law Dean at Southern Methodist University, died January 27. He was 91. In 2010, Dean Galvin received the Outstanding Texas Tax Lawyer Award from the State Bar of Texas Tax Section.

Dean Galvin, who was active at the national level, was dean of the law school from 1963 to 1978 and was a member of the faculty for over 30 years.

"Dean Galvin was one of the greatest deans in the history of the law school and one of the foremost tax professors of his time," said John B. Attanasio, Dean of SMU's Dedman School of Law. "This is a great loss for the law school, the university, and the entire community."

Introduction

Born in Wilmington, NC on September 29, 1919, his family moved to Dallas in 1921. Charley graduated from Highland Park High School, received his B.S. in Commerce from Southern Methodist University, an MBA and Juris Doctor from Northwestern University, Doctor of the Science of Law from Harvard, and honorary Doctor of Laws degrees from Capital University and SMU. Charley served four years in the United States Navy in the Pacific Theatre during World War II and was honorably discharged as a Lieutenant Commander. On June 29, 1946, he married Margaret "Peggy" Edna Gillespie of Brooklyn, NY at St. Patrick's Cathedral in NY. The couple lived in Dallas where they raised five children, Kathy, Pat, Paul, Charlie, and Liz. From 1947 to 1952, Charley practiced law with the Dallas firm of Leachman, Matthews, and Gardere. He was professor of law at SMU from 1952-1983 and Dean of the Law School from 1963-1978. Charley was also the Centennial Professor of Law, Vanderbilt University from 1983-1990, and thereafter Centennial Professor Emeritus. He also served as Executive in Residence, Vanderbilt, 1990-1994. Charley taught at the law schools of Michigan, Harvard, Duke, Pepperdine, Kansas, Texas as well as the Business Schools of Northwestern University and SMU. He was a Distinguished Professor of Law, Emeritus, SMU Law School and most recently was of counsel to the Dallas law firm, Haynes and Boone, LLP.

Charley was known as a highly-skilled technician, but he probably was best known for his career long devotion to questions of tax policy. Over many decades, Charley was an outstanding leader in tax policy debates. Several themes recurred throughout Charley's tax reform life: (1) a preference for a comprehensive tax base, (2) a desire to avoid "tax preferences" or "tax expenditures," (3) a preference for relying on market mechanisms to promote efficient allocation of economic resources, and (4) an ability to analyze, in a dispassionate manner, tax policy subjects that generated high passion as to some persons.

Career Accomplishments

Charley contributed to the growth and development of the tax law in many ways, the principal ones of which were: (1) his many impressive publications and (2) his distinguished leadership service to the tax policy and reform efforts of the organized bar. His early-in-life publications launched him on the path to outstanding leadership service to tax reform organizations.

Publications

The Galvin bibliography is long indeed. The following discussion will highlight only the most significant of his many writings. The stage was set for Charley's prominence in the tax law when, at a young age, he published an article in the Texas Law Review on percentage depletion. Charley recommended that percentage depletion be limited to the taxpayer's cost in the property, not a popular proposition from the perspective of the Texas oil and gas industry. As a relatively young SMU law professor in 1959, Charley (1) was a contributor to the 1959-60 Tax Reform Compendium, which was published by the U.S. House of Representatives Committee on Ways and Means, and (2) published in the Harvard Law Review an article on oil and gas taxation. These two publications constituted a substantial work that (1) contained an extensive historical development of the tax treatment of the oil and gas industry and (2) manifested Charley's familiarity with the oil and gas industry and the highly-technical legal relationships through which the industry conducted its activities.

Another impressive accomplishment in Charley's career occurred in 1967-68 and involved no less luminaries than Boris Bittker of Yale, Richard A. Musgrave of Harvard, and Joseph Pechman of the Brookings Institution. This is a highly incisive exchange as to the appropriate tax base and the proper treatment of various items under the Internal Revenue Code. Charley started his career writing about taxation of the oil and gas industry, but over his long career, he wrote about many other tax and related subjects, including the following: the history of the U.S. tax system, taxation of capital gains, depreciation, transfer taxation, integration of the corporate income tax with the individual income tax to reduce or eliminate the double taxation of distributed corporate earnings, the tax reform process, the comprehensive tax base, consumption based taxation, wills and trusts, the alternative minimum tax, critical tax theory, income tax realization of gains at death, indexation of the Internal Revenue Code, deductibility of non-business interest, value-added taxation, professional corporations, corporate taxation (including reorganizations), partnership taxation, tax-exempt organizations, private annuities, and international taxation.

Involvement in Institutional Tax Reform Efforts

Perhaps Charley's greatest accomplishments in the tax arena are reflected in his career-long participation in, and leadership of, formal tax reform efforts that resulted from his involvement with the Section of Taxation of the American Bar Association. In 1962, the ABA Section of Taxation appointed a "blue-ribbon" Committee on Substantive Tax Reform, with a membership of practitioners and academics, and Charley was asked to chair the Committee. The membership of the Committee included a powerful collection of tax talent: Robert Anthoine, Richard H. Appert (a one-time Chair of the ABA Tax Section); Mac Asbill, Jr. (a one-time Chair of the ABA Tax Section); Walter J. Blum (a noted academic at the University of Chicago and leading tax policy commentator); Norris Darrell (President of the American Law Institute from 1961-1976); Francis W. Hill; H. Cecil Kilpatrick; Charles C. Maclean, Jr. (a one-time Chair of the ABA Tax Section); Harry K. Mansfield (a one-time Chair of the ABA Tax Section); Lee I.

Park (a one-time Chair of the ABA Tax Section); Austin H. Peck; Charles D. Post; and David W. Richmond (a one-time Chair of the ABA Tax Section).

By April of 1963, the Committee issued a substantial report, accompanied by a resolution that ultimately was adopted by the Board of Governors of the ABA on May 21, 1963. The resolution recited that "the federal income tax structure is unnecessarily complex and should undergo substantial revision in order to 1. broaden the tax base, 2. reduce the income tax rates, 3. simplify the technical provisions, 4. simplify administration, and 5. ease the burden of compliance ...." The Resolution approved by the ABA Board of Governors authorized continued inquiry and research by the Section of Taxation. It became evident, however, that a group of volunteer lawyers could not collect or analyze all the necessary and relevant statistical data. A full-time staff (including economists and computer technologists) and more substantial funding was required, and the American Bar Foundation joined in the project and provided the necessary funding for a "pilot" project involving the ground-breaking use of computers as a research tool with respect to income tax reform analysis. Arthur B. Willis, a prominent tax practitioner from Los Angeles, was appointed Project Director, and Charley was appointed Advisor. This project involved contact with the following luminaries in tax policy matters: Professor William Andrews of the Harvard Law School, Professor Boris Bittker of the Yale Law School, Professor Walter Blum of the University of Chicago Law School, Professor Earl Rolph of the Department of Economics of the University of California at Berkeley, Professor Joseph T. Sneed of the Stanford Law School (later to serve as Deputy United States Attorney General and Judge of the U.S. Court of Appeals for the Ninth Circuit), Gerard Brannon of the United States Treasury Department, Joseph A. Pechman of the Brookings Institution, George Sadowsky of the Brookings Institution, Herbert Stein of the Committee on Economic Development (later to serve as Chairman of the Council of Economic Advisors under President Nixon), and Randolph W. Thrower (who was to become Commissioner of the IRS) as a representative of the Section of Taxation. The efforts of the project resulted in the 1969 publication of STUDIES IN SUBSTANTIVE TAX REFORM.

The findings of the "pilot" project reflected in STUDIES IN SUBSTANTIVE TAX REFORM were carried forward by the Commission to Revise the Federal Tax Structure, which was supported by the Fund for Public Policy Research. The Fund for Public Policy Research was interested in studying and quantifying the so-called "dynamic" macro-economic consequences of a change in the tax law in terms of federal tax revenues and gross national product. The Commission to Revise included as members another impressive and powerful group of individuals including Charley and Arthur B. Willis, who carried over from the American Bar Foundation project. The Commission published REFORMING THE FEDERAL TAX STRUCTURE in 1973. The U.S. Treasury Department published BLUEPRINTS FOR BASIC TAX REFORM in 1977, and the conceptual underpinnings of BLUEPRINTS run directly to the two study groups with which Charley was associated and to subjects about which Charley had written.

Charley was also significantly involved with the American Law Institute ("ALI") regarding the transfer tax system. A. James Casner of the Harvard law faculty was appointed Reporter, and David Westfall and William D. Andrews, also of the Harvard law faculty, were appointed Assistant Reporters. Charley led (or was associated with) tax reform efforts that sought to bring greater rationality to our tax laws. Those efforts were viewed by some persons, however, as attacking important tax law provisions that were very valuable to the effected taxpayers. He personally was criticized, but he withstood those attacks and proceeded with his tasks.

Other Recognitions and Awards

Along the path of his career, Charlie testified before the House Ways and Means Committee and twice was appointed to the Advisory Group of the Commissioner of Internal Revenue (Commissioner Mortimer Caplin and Commissioner Randolph W. Thrower). He also acted as a consultant to the United States Treasury Department. He had been a long-time member of the ALI and the American College of Tax Counsel. He served as taxation editor of the Oil and Gas Reporter for more than 50 years (1953-2004), and he twice was presented the John Rogers Award by the Southwestern Legal Foundation (now the Center for American and International Law).

Conclusion

Charley lived (and guided many others) through periods of profound change to the U.S. federal tax system: the Great Depression and the New Deal, the Second World War and its aftermath, runaway inflation, burgeoning federal expenditures and deficits to support a wider array of social welfare support, the ebb and flow of the debates regarding the comprehensive income tax base and the consumption base, the ebb and flow of the debates regarding progressive versus flat/flatter rates, the declining significance of the federal income tax and the increasing significance of payroll taxes, and unification of the transfer tax system and addition of the generation-skipping transfer tax. He labored on through decades against considerable political inertia and notwithstanding some adverse comments that came his way.

Time and again, Charley's path of life intersected the paths of the tax greats of the day, persons who were, or were destined to be, prominent government tax officials or leaders on tax policy issues. Charley was destined for leadership in matters of tax policy, and his abilities and good works brought him into contact with the tax luminaries of his time. By virtue of his intellect, his interpersonal and leadership skills, and his industry, Charley became, one of those luminaries.

RETURN TO TABLE OF CONTENTS

FULBRIGHT RECEIVES ABA SECTION OF TAXATION JANET SPRAGENS PRO BONO AWARD

The American Bar Association (ABA) recently awarded Fulbright & Jaworski, LLP with the Janet Spragens Pro Bono Award for the numerous pro bono services that Fulbright's Tax Department has provided to the community.

Fulbright partner William Lee will accept the award on behalf of Fulbright at the ABA Section of Taxation's midyear meeting in Boca Raton on January 22, 2011.

Established in 2002, the ABA Section of Taxation Pro Bono Award was created to recognize providers of significant pro bono tax services. This is the first time that a law firm, rather than an individual tax practitioner, has been given this award.

Fulbright's pro bono tax services included support and services to the Tax Court Calendar Call Program in which Fulbright tax attorneys provided advice and counsel to pro se taxpayers at the U.S. Tax Court calendar calls. Fulbright tax attorneys also helped members of the armed forces with their estate planning documents and participated in the Low Income Tax Clinic.

Estate Planning Effects and Strategies Under the "Tax Relief... Act of 2010"

February 2011
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

I. Brief Historical Background of TRA 2010

Republican leaders came to agreement with President Obama on December 6, 2010 to extend the "Bush income tax rates" for two years, not limited to just "middle class" taxpayers with less than $200,000 ($250,000 joint returns) and to extend unemployment benefits. Surprisingly, the agreement included extension of the estate tax for two years with a $5 million exemption and 35% rate (the exemption amount and rate urged by various Republican leaders over the last several years). (Apparently, the final "sticking points" in "making a deal" on the overall agreement were the estate tax provisions requested by Republican leaders and the renewal of "refundable tax credits" as urged by the Administration, and the final agreement came in meetings between Vice President Biden and Senate Minority Leader Mitch McConnell.)

Following discussions (and probably negotiations) with Congressional staffers about the details of the estate tax provisions and all of the other details of the broad agreement regarding taxes and unemployment insurance, the Senate Finance Committee released an amendment sponsored by Senators Harry Reid and Mitch McConnell containing the statutory language being considered by the Senate. The bill is an amendment of H.R. 4853 (which authorizes funding of the Airport and Airway Trust Fund), and proposes the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." (This proposal is referred to in this summary as "TRA 2010.")

The TRA 2010 proposal comes on the heels of a proposal by Senate Finance Committee Chair Max Baucus on December 2, 2010 of a Senate amendment of the same H.R. 4853, which amendment proposed the "Middle Class Tax Cut Act of 2010." That bill was defeated by the Senate on December 4, 2010, but of interest to the estate planning community are various estate and gift tax measures that were included in it. The following is a link to the "Baucus bill" containing the proposed Middle Class Tax Cut Act of 2010, a Summary of the proposal, and estimated budget effects of the proposal: http://finance.senate.gov/legislation/details/?id=bda915fc-5056-a032-5262-6a1899fee4e3. The following summary sometimes refers to differences between TRA 2010 and the "Baucus bill."

TRA 2010 was approved by the Senate on December 15 (by a vote of 81-19) and by the House on December 16 (by a vote of 277-148). President Obama signed the legislation on December 17, 2010 (the date of enactment). Text of the legislation is available at http://finance.senate.gov/legislation/details/?id=10874ed6-5056-a032-52cd-99708697eff0. Joint Committee on Taxation revenue estimates of the bill are available at http://op.bna.com/dt.nsf/r?Open=vmar-8bz3bn.

II. Title and Temporary Relief

A. Short Title. The "short" title is "Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010." [TRA 2010 § 1.] How's that for a *short* title?

B. Temporary Extension of Tax Relief. TRA 2010 generally provides various tax provisions that apply for just two years. This is accomplished first by extending the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") generally for two years, including the extension of the "Bush tax cuts" and the estate tax provisions. [TRA 2010 § 101(a) amends EGTRAA (effective as if enacted as part of EGTRRA in 2001) by amending section 901 of EGTRRA (the sunset provision) to extend the EGTRRA sunset to specified events occurring after December 31, 2012 (instead of December 31, 2010). Therefore, all of the provisions of EGTRRA generally are extended through 2012.]

In addition, TRA 2010 provides that the EGTRRA sunset provisions in section 901 of EGTRRA apply to all of the amendments in the title containing the estate and gift tax provisions. The effect is that the estate, gift and GST amendments made by TRA 2010 also sunset after 2012. [TRA 2010 § 304 says that section 901 of EGTRRA applies "to the amendments made by this title. "This title" refers to all of the "Temporary Estate Tax Relief" provisions in title III of TRA 2010), so the estate, gift and GST tax amendments made by TRA 2010 also sunset after 2012. The Senate amendment as originally proposed referred to "amendments made by this section," which was nonsensical. If that had not been changed, the transfer tax changes in TRA 2010 would have been permanent under a literal application of the statutory language. However, the word "section" was changed to "title" before the Senate and House vote. Interestingly, getting congressional approval for this important technical change was quite difficult.]

III. Brief Summary of Tax Provisions Other Than Estate, Gift and GST Tax Provisions

A. Income Tax Rates. Taxpayers at every income level would have the lower rates enacted in EGTRRA continued for two years. The top rate, on taxable income above $379,150, will stay at 35% instead of increasing to 39.6%. (Two-year cost: $186.8 billion)

B. Itemized Deductions. The personal exemption phase-out and itemized deduction limitation were both repealed for one year under EGTRRA. The repeal of both of these provisions is extended for an additional two years. This is important, for example, with respect to deductions available for large charitable contributions. Prior to the phase-out of the limitations on itemized deductions, the allowable total amount of itemized deductions was reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeded a threshold amount that was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80%. For high income taxpayers, reducing the otherwise allowable charitable deductions (as well as other itemized deductions) by as much as 80% is a substantial tax detriment. (Cost: $20.7 billion)

C. Capital Gains and Dividends Rates. Lower capital gains and dividend rates are extended for two years. The lower rates are: taxpayers below 25% bracket - 0%, taxpayers above 25% bracket - 15%. If those rates expire, the rates would become 10% and 20%, respectively, and dividends would be taxed as ordinary income. (Cost: $53.2 billion)

D. Social Security Tax Cut of 2%. All taxpayers, including self-employed individuals, have a one year reduction in the "social security payroll tax" of 2 percentage points in 2011. For individuals, the employee rate is reduced from 6.2% to 4.2% (the old age, survivors, and disability insurance tax on the taxable wage base ($106,800 in 2010)). The employer tax rate remains at 6.2%. For self-employed individuals, the rate is reduced from 12.4% to 10.4% for taxable years of individuals that begin in 2011. (Cost: $112 billion)

E. Alternative Minimum Tax. The AMT exemption amounts are increased to $47,450 ($72, 450 for joint returns) for 2010 and to $48,450 ($74,450 for joint returns) for 2011. (Over 20 million households are spared from tax increases averaging $3,900 as a result of this change.) (Cost: $136.7 billion)

F. IRA Charitable Rollover. Among the tax extenders are the IRA Charitable Rollover provisions, which technically expired at the end of 2009. The IRA Charitable Rollover is extended for two years, through 2011, which allows individuals who are at least 70 ½ to transfer up to $100,000 per year directly to a qualified public charity (not a donor advised fund or supporting organization) without being treated as a taxable withdrawal from the

IRA. The transfer can be counted toward the required minimum distribution. The measure applies to all charitable distributions throughout 2010, and distributions made any time during 2010 or in January of 2011 can be counted toward the $100,000 limit for 2010. Individuals who have already taken their 2010 required minimum distributions cannot "undo" those distributions and instead make a charitable distribution to satisfy their 2010 required minimum distributions. (Cost: $979 million)

G. Deduction for State and Local Sales Taxes. The federal deduction for state and local sales taxes is extended for 2010 and 2011. (This is near and dear to residents of the nine states without state income taxes.) (Cost: $5.5 billion)

H. Estate, Gift and GST Tax Cost. The estate, gift and GST provisions are discussed in detail below. (Cost: $68.1 billion)

IV. General Summary of Estate, Gift and GST Tax Provisions

A. Estate, Gift and GST Tax Exemptions and Rates. TRA 2010 generally sets the estate, gift and GST exemption at $5.0 million, indexed from 2010 beginning in 2012, [TRA 2010 § 302(a)(1)] and sets the maximum rate at 35%. [TRA 2010 § 302(a)(2)]. The $5 million exemptions generally apply in 2010 [TRA § 302(f)], except that the gift exemption remains at $1.0 million for 2010 [TRA § 302(b)(1)(B)].

B. Estate Tax in 2010.

1. Default Rule — Estate Tax Applies in 2010. The estate tax applies to estates of decedents dying in 2010. As discussed above, the estate tax exemption in 2010 is $5.0 million and the rate is 35%. (For various issues discussed below, it is important to keep in mind that the *default* rule is that the estate tax applies in 2010.) This reenactment of the estate tax for 2010 is in a complicated section of TRA 2010 that sunsets certain provisions of EGTRRA as if they had never been enacted. TRA 2010 § 301(a) provides that "[e]ach provision of subtitle A or E of title V of [EGTRRA] is amended to read as such provision would read if such subtitle had never been enacted." Subtitle A contains I.R.C. § 2210, which says that Chapter 11 [containing the estate tax provisions] does not apply to decedents dying after 2009 (except as to certain distributions from QDOTs) and I.R.C. § 2664 (which says that Chapter 13 does not apply to GST transfers after 2009). Subtitle E contains the carryover basis provisions. The Code would be interpreted as if those provisions of EGTRRA (repealing the estate and GST tax and enacting carryover basis) had never been enacted. [TRA 2010 § 301(a).] The provision retroactively applies to decedents dying after and generation-skipping transfers after December 31, 2009. [TRA 2010 § 301(e).]

2. Carryover Basis Election for 2010 Decedents. Executors (within the meaning of I.R.C. § 2203) of estates of decedents who die in 2010 (all of 2010, not just decedents who die on or before the date of enactment, as provided in the Baucus bill) may elect to have the modified basis rules of I.R.C. § 1022 apply "with respect to property acquired or passing from the decedent" within the meaning of I.R.C. § 1014(b)) instead of the estate tax. [TRA 2010 § 301(c).]

Large estates (not covered by the $5 million exemption) that would otherwise have to pay substantial estate taxes will likely make this election. However, the executor will have to consider a variety of factors in making this decision, such as whether the election will change the amounts passing under formula bequests as discussed in section IX.A.1 and IX.B of this outline (including that the election will result in assets passing under the "alternate non-marital deduction manner" if the will contains a "Clayton marital trust"), the amount of estate tax payable currently vs. the gain that would be subject to income tax on a future sale of assets (keeping in mind that income tax rates may *exceed* estate tax rates), anticipated dates of sale, the character of the gain (for example, the Joint Committee on Taxation Technical Explanation says that "real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir"), anticipated state income taxes, anticipated cash needs of beneficiaries, whether depreciation can be used to derive current income tax benefits even without selling an asset, ability to allocate basis adjustments up to fair market value at the date of death for assets that will likely be sold in the near future, anticipated future capital gains rates (and ordinary income rates for "ordinary income property"), determination of which beneficiaries bear estate taxes and comparison to persons who bear income tax attributable to lack of basis step-up, whether aggressive positions would be taken on the estate tax return or have been taken on prior gift tax returns (and whether there is any question whether disclosures on gift tax returns satisfied the adequate disclosure regulations) that would be highlighted by filing an estate tax return, and weighing the present value of anticipated income tax costs against the current estate tax amount. Some rather subtle effects of making the election include: there will be no benefit of a deduction against federal estate taxes for the payment of state death taxes, there will be no § 691(c) deduction for estate taxes attributable to income in respect of a decedent property, there will be no ability to use a prior transfer credit under § 2013, the election may impact the ability to make a QTIP election for only state purposes, there will be a step-up (or step-down) in basis for *both* halves of community property if the carryover basis election is not made, and the election may impact the expenses and complexity of administering the estate (by making or not making the election).

If there is any possibility that the election may impact the amounts of bequests under the will, attempt to get consents of all of the parties or court approval of the election decision. (Equitable adjustments among the parties may be appropriate.) If the election benefits the executor personally, consider whether there are gift tax implications of the election. *See generally* Blattmachr, Heilborn & Gans, *Gifts by Fiduciaries by Tax Options and Elections*, 18 PROB. & PROP. 39 (Nov. Dec. 2004).

Practical Planning Pointer: The executor should carefully document and retain the analysis of the rationale for whatever decision is made regarding the carryover basis election.

Section 301(c) says the election is to be made "at such time and in such manner" as prescribed by the Secretary of the Treasury or his delegate (interestingly, not requiring regulations). The IRS may promulgate a new form to make this election. An IRS technical advisor has indicated informally that the election for reduced basis in lieu of paying estate tax will not be made on the decedent's final income tax return, but IRS officials are considering the possibility of having the election made simply by filing Form 8939 instead of filing Form 706.

In light of the fact that the statute extends the due date of the estate tax return for 2010 decedents who died before December 17, 2010 to no earlier than September 19, 2011, there will presumably be a similar due date for the election for the estate tax not to apply to the estate.

Practical Planning Pointer: Estates of decedents dying in 2010 with gross estates under $5 million would not be required to file an estate tax return under I.R.C. § 6018(a)(1), and there is nothing in TRA 2010 changing that result. Those estates will not make the carryover basis election, so those estates apparently will not have to file either an estate tax return or the carryover basis report that would apply under § 6018 to estates that make the carryover basis election. (There has been no official confirmation of this by the IRS, but it seems the clear answer under the statutory language.) For estates that are over $5 million and that may want to make the carryover basis election so that the estate tax will not apply, planners are quite anxious to find out exactly what must be filed and when in order to make sure that the estate tax does not apply. For estates of decedents who died earlier in 2010, there seems to be no necessity of filing an extension of time to file the estate tax return, because of the extended September 19, 2011 due date. (However some cautious planners may do so anyway.) Query whether a further discretionary six-month extension under I.R.C. § 6081(a) will be allowed?

The carryover basis election is described in TRA 2010 § 301(c). It is a complicated section, applying double and triple negatives.

> "Notwithstanding subsection (a) [which says that subtitle A or E of title V of EGTRAA are treated as having never been enacted], in the case of a decedent dying after December 31, 2009, and before January 1, 2011, the executor (within the meaning of section 2203 of the Internal Revenue Code of 1986) may elect to apply such Code as though the amendments made by subsection (a) do not apply with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code.)" TRA 2010 § 301(c).

Applying this language in steps:

- If this election is made, the amendments made by TRA 2010 § 301(a) do not apply. This involves a triple negative. The estate tax was repealed by I.R.C. § 2210 ("chapter 11 shall not apply…"), which was included in subtitle A of title V of EGTRRA, for decedents dying after 2009 (Negative 1-estate tax does *not* apply). The repeal of the estate tax is repealed, effective 1-1-2010, under TRA 2010 § 301(a) (as if subtitle A "had never been enacted") (Negative 2, negating Negative 1-so estate tax *does* apply). If the carryover basis election is made, the "repeal of the repeal" in TRA 2010 § 301(a) does not apply (Negative 3). This means that the estate tax does *not* apply. (Is your head swimming yet?)
- Similarly, carryover basis does apply under a similar stepped analysis if the election is made. Carryover basis was instituted under I.R.C. § 1022, as included in subtitle E of title V of EGTRRA for decedents dying after 2009. The carryover basis provisions are repealed, effective 1-1-2010, under TRA 2010 § 301(a) (as if subtitle E "had never been enacted"). If the carryover

basis election is made, the amendments in TRA 2010 § 301(a) do not apply, so the repeal of carryover basis is undone, so carryover basis *does* apply.

- The election (which undoes the "repeal of the repeal" of the estate tax and reinstitutes carryover basis) applies "*with respect to chapter 11 of such Code….*" This clause, perhaps among other things, means that the amendment in § 301(a) that repeals subtitle A of title V of EGTRRA, which contained I.R.C. § 2210 repealing the estate tax and § 2664 repealing the GST tax, does not apply with respect to chapter 11 (meaning that the estate tax *is* repealed), but does continue to apply with respect to the repeal of § 2664. Therefore, the repeal of the GST tax repeal is not undone. That is a technical correction of the similar provision in the Baucus bill.
- The election applies "with respect to property acquired or passing from such decedent (within the meaning of section 1014(b)…)." This is an obvious reference to carryover basis applying for property acquired or passing from the decedent. (It would seem that the provision could have referred just to property "acquired from such decedent" because I.R.C. § 1022(e), which remains in effect because subtitle E of title V of EGTRRA is not repealed as a result of the election, defines "property acquired from the decedent" as including property passing from the decedent by reason of death to the extent that it passes without consideration.)

If the carryover basis election is made, the last sentence of TRA 2010 § 301(c) adds that for purposes of I.R.C. § 2652(a)(1), "the determination of whether any property is subject to the tax imposed by such chapter 11 shall be made without regard to any election made under this subsection." Section 2652(a)(1) defines "transferor" for GST tax purposes as the last person who was subject to a transfer tax. This sentence means that for GST purposes the decedent is deemed to be subject to the estate tax and is therefore the "transferor" even though chapter 11 does not apply to the decedent in that circumstance. See section VIII.G of this outline for a discussion of this last sentence of TRA § 301(c).

3. <u>Extension of Time to File and Pay Estate Tax and GST Tax and to Make Disclaimers</u>.

   a. <u>Estate Tax</u>. The estate tax return and payment date of estate tax is extended to no earlier than nine months after the date of enactment. The extension applies to estates of decedents dying from January 1, 2010 to the day before the date of enactment (i.e., to December 16, 2010). (The extension in the Baucus bill was only for four months rather than nine months.) [TRA 2010 § 301(d).]

   Practical Planning Pointer: The date of enactment is December 17, 2010, so the due date is extended to September 17, 2011, which falls on a Saturday, so the due date of estate tax returns for 2010 decedents is no earlier than September 19, 2011.

   b. <u>Carryover Basis Report</u>. Under current law, the carryover basis report under § 6018 is required to be filed with the decedent's final income tax return. I.R.C. § 6075(a). The due date for filing this report may also be deferred to nine months after the date of enactment. [TRA 2010 §

301(d)(1)(A).] EGTRRA amended § 6018 for decedents dying after 2009 to refer to a carryover basis information return instead of the estate tax return (because the estate tax does not apply under EGTRRA to decedents dying after 2009). That amendment to § 6018 (and the change to § 6075(a) regarding the due date of the carryover basis report) were in subtitle E of title V of EGTRRA, and TRA 2010 § 301(a) interprets the Code as if subtitle E had never been enacted. Therefore, the default rule under TRA 2010 is that § 6018 now refers to the estate tax return, not the carryover basis information report. However, if the carryover basis election is made, the amendment in § 301(a) does not apply as to the estate tax or carryover basis, so § 6018 continues to refer to the carryover basis report and not the estate tax return and § 6075(a) continues to require that the report be filed with the decedent's final income tax return. Section 301(d)(1)(A) extends the filing date of the estate tax return, but *not* the carryover basis report. While it refers to extending the due date for filing any return under § 6018 and while that will mean the carryover basis report if the carryover basis election is made under § 301(c) of TRA 2010, § 301(d)(1)(A) specifically says the extension applies to any return under § 6018 "as such section is in effect after the date of this enactment of this Act *without regard to any election under subsection (c)*." Therefore, this provision in § 301(d)(1)(A) of TRA 2010 does not override § 6075 regarding the due date of the carryover basis report.

An email message from Curtis L. Freeman (IRS Senior Technical Advisor, Tax Forms & Publications) to Carol Cantrell dated January 20, 2011 requests the ABA to "help spread the word that Form 8939 (nor anything else) is not filed with the decedent's final income tax return, but rather filed by itself." (This is despite the literal wording of § 6075(a) providing that "[t]he return required by section 6018 with respect to a decedent shall be filed *with* the return of tax imposed by chapter 1 for the decedent's last taxable year" [i.e., the decedent's final income tax return] (emphasis added).)

The IRS issued a draft of Form 8939 for comments on December 16, 2010. The draft form does not include instructions. The draft form does not contain any reference to an election provision (in light of the fact that the draft was prepared before TRA 2010 was enacted providing for the election). The form contemplates that the specific assets passing to each distributee (together with the carryover basis, value, holding period and basis adjustment allocation for each asset) will be listed on the form. (The form does not address what will happen if the executor has not paid all debts and expenses, paid all taxes and made final distributions of the assets to the beneficiaries by the time the form is due. Until all of that has happened, the executor cannot know what specific assets will pass to the respective beneficiaries.)

c. <u>Disclaimers</u>. The time for making any disclaimer under I.R.C. § 2518(b) for property passing by reason of the death of a decedent (who dies after 2009) is extended to nine months after the date of enactment. [TRA § 301(d)(1)(C).] (The Baucus bill applied the disclaimer extension, as well as the other extensions, only for 2010 decedents who die before the date of enactment and referred to an extension before the time of "receiving" a disclaimer rather than the time for "making" a disclaimer.) This opens up additional planning flexibility, in light of the dramatic change in estate tax treatment under TRA 2010. Concerns with being able to take advantage of this additional time include (1) that beneficiaries may have already accepted benefits, not realizing that the disclaimer period would be extended, and (2) state law requirements for disclaimers often refer to nine months after the transfer, so disclaimers during the extended time period may not satisfy the state law requirements. Query whether states will respond by amending their disclaimer statutes for decedents dying in 2010 before the date of enactment? Section 2518(c)(3) may provide a way for getting around a continuing state law 9-month limitation on disclaimers.

Section 2518(c)(3) provides that a transfer that does not qualify as a disclaimer under local law may still constitute a qualified disclaimer under federal law, as long as the disclaimer operates as a valid transfer under local law to the persons who would have received the property had it been a qualified disclaimer under local law.

The legislative history to § 2518(c)(3), passed in 1981, says that mere acts of receiving property to be able to make a transfer complying with the statute are not treated as acceptance that would preclude a disclaimer. "[T]he individual's direction of the transferor to the individual who would have taken under local law pursuant to an effective disclaimer will not be construed as acceptance of the property." H. Rept. 97-201, 1981-2 C.B. 352, 392. The Tax Court has made clear that §2518(c)(3) applies to a transfer made by the original beneficiary, not by the executor.

> "The transferor (i.e., the beneficiary) referred to in section 2518(c)(3) is not the same transferor of section 2518(b)(i.e., the estate or executor). Section 2518(c)(3) assumes that a transfer to the beneficiary has already occurred under local law because a disqualified disclaimer did not avoid the transfer. That beneficiary can still avoid the effects of the disqualified disclaimer by making a written transfer to the person who would have received the property (e.g., a surviving spouse) had the beneficiary made an effective disclaimer." *Bennett v. Commissioner*, 100 T.C. 42 (1993).

There must be a "written transfer" for § 2518(c)(3) to apply. Case law has held that a purported "disclaimer" that has no effect under state law does not satisfy the transfer requirement. *Bennett v. Commissioner*, 100 T.C. 42 (1993). In *Bennett*, purported disclaimers did not satisfy state law (among other things, they were not timely). The estate argued that the disclaimers satisfied §2518(c)(3), but the court disagreed because the beneficiaries did not make "actual written transfers of their interests in the Memorial Trust to the person who otherwise would have received those interests had the disclaimers been valid under local law." The court stated that §2518(c)(3) "should not be viewed as a catch-all provision to save defective or disqualified disclaimers" but that it applies when a "would be disclaimant makes an actual written transfer to the person who otherwise would have received the property had the disclaimer been valid under local law." The court quoted some of the legislative history:

> "In order to provide uniform treatment among States, the committee believes that where an individual timely transfers the property to the person who would have received the property had the transfer made an effective disclaimer under local law will be treated as an effective disclaimer for Federal estate and gift tax purposes provided the transferor has not accepted the interest or any of its benefits." H. Rept. 97-201, 1981-2 C.B. at 392.

Section 2518(c)(3) requires a written transfer of the person's "entire" interest in the property disclaimed. There is no law as to what that means (and no regulations have been issued regarding § 2518(c)(3)). The legislative history is scant as to the meaning of this requirement:

> "A transferor will not be considered a transfer of the entire interest in the property if, by reason of the transfer, some or all of the beneficial enjoyment in the property returns to the transferor or the transferor has any period after the transfer to control the beneficial enjoyment from the property." H. Rept. 97-201, 1981-2 C.B. at 392.

It is not clear whether that means that the person's entire interest in a particular "severable" interest (such as the income interest) must be disclaimed or whether literally the entire interest in the property must be disclaimed. Alternatively, is it sufficient for a person to disclaim her entire interest in an undivided one-half interest in Blackacre, or must her entire interest in Blackacre be transferred?

If the disclaimant lives in one of the few states that has a state gift tax, an issue with making transfers that qualify as disclaimers under § 2518(c)(3) is that a state gift tax will apply to the transfer, if it is not a transfer that constitutes a disclaimer under state law.

Practical Planning Pointer: If a transfer is intended as a qualified disclaimer under § 2518(c)(3) even though it does not meet the requirements under state law for a disclaimer, recite in the deed or other transfer document that the transfer is intended as a qualified disclaimer for federal tax purposes and that the assets are passing to the same persons who would have received the property had the transferor made a valid disclaimer.

Extended Due Date: The extended disclaimer period runs until September 19, 2011 for 2010 decedents who die before December 17, 2010. Presumably the "holiday" rule under I.R.C. § 7503 will apply because it refers to the day "prescribed under authority of the internal revenue laws for performing any act;" it is not limited just to tax returns. (For decedents who die on or after December 17, the 9-month period will run as usual, which will be sometime on or after September 17, 2011.)

d. GST Tax Returns. The date for filing any return under § 2662 to report a "generation-skipping transfer" made in 2010 before the date of enactment (i.e., before December 17) is extended to no earlier than 9 months after the date of enactment (or September 17, 2011, which is a Saturday, so the extended due date would be no earlier than September 19, 2011). [TRA § 301(d)(2).]

Practical Impact: For generation-skipping transfers (i.e., direct skips, taxable distributions or taxable terminations), the due date for reporting the transaction on an appropriate return is extended to no earlier than September 19, 2011. (The GST transfer would be reported on the form, but the GST tax rate would be zero. Query whether there is any penalty for failing to file the return on time if the penalty is based on the amount of unpaid tax?) The time for filing a timely return to make a timely allocation of GST exemption to a direct skip or to make a timely election out of automatic allocation to a direct skip would be extended to September 19, 2011. (For a lifetime direct skip that would be reported on a gift tax return, if the income tax return is extended, the extended due date (October 17, 2011) would be past the September 19 date in any event.)

Practical Planning Pointer: While the time to file GST returns to report "generation-skipping transfers" (i.e., direct skips, taxable distributions or taxable terminations, § 2611(a)) that occur before December 17, 2010 is extended, there does not appear to be an extension of time for filing a return to make timely allocations of GST exemption (or elect out of automatic allocations) for "indirect skip" transfers to trusts that are not direct skips.

e. Applicability of Extensions. The extension period for filing returns and paying estate taxes and for making disclaimers applies to estates of decedents dying in 2010 and before the date of enactment (December 17, 2010). Similarly, the extended due dates for GST returns applies for a generation-skipping transfers made in 2010 before the date of enactment. [TRA 2010 § 301(d).]

C. Portability. The executor of a deceased spouse's estate may transfer any unused estate exemption to the surviving spouse. [TRA 2010 § 303.]

1. Estate Tax Exclusion Amount Definition Change. The portability concept is accomplished by amending § 2010(c) to provide that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" ($5.0 million, indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount." [§ 2010(c)(2), as amended by TRA § 302(a).]

2. Deceased Spousal Unused Exclusion Amount. The "deceased spousal unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in new § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under section § 2001(b)(1)").

The first item limits the unused exclusion to the amount of the basic exclusion amount. Therefore, if the estate tax exclusion amount decreases by the time of the surviving spouse's death, the lower basic exclusion amount would be the limit on the unused exclusion of the predeceased spouse that could be used by the surviving spouse.

The second item is the last deceased spouse's remaining unused exemption amount. Observe that it is strictly defined as the predeceased spouse's basic exclusion amount less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a privity requirement (discussed below in section IV.C.6 of this outline).

3. <u>Statute of Limitations on Review of Predeceased Spouse's Estate to Determine Unused Exclusion Amount</u>. Notwithstanding the statute of limitations on assessing estate or gift taxes for the predeceased spouse, the IRS may examine the return of a predeceased spouse at any time for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. I.R.C. § 2010(c)(5)(B), as amended by TRA 2010 § 303(a).

4. <u>Must be Timely Filed Estate Tax Return and Election for Predeceased Spouse's Estate</u>. The Act continues the position of prior portability bills that the executor of the first spouse's estate must file an estate tax return on a timely basis and make an election to permit the surviving spouse to utilize the unused exemption. § 2010(c)(5)(A), as amended by TRA 2010 § 303(a). (Therefore, even small estates of married persons must consider whether to file an estate tax return for the first deceased spouse's estate.)

5. <u>Only Last Deceased Spouse's Unused Exclusion Amount Applies</u>. Only the most recent deceased spouse's unused exemption may be used by the surviving spouse (this is different from prior portability legislative proposals). I.R.C. § 2010(c)(5)(B)(i), as amended. An explanation of TRA 2010 by the Joint Committee on Taxation reiterates that this requirement applies even if the *last* deceased spouse has no unused exclusion and even if the *last* deceased spouse does not make a timely election. Joint Committee on Taxation Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United State Senate, 52 n.57 (Dec. 10, 2010)[hereinafter Joint Committee on Taxation Technical Explanation].

6. <u>Privity Requirement</u>. A spouse may not use his or her spouse's "deceased spousal unused exclusion amount." This is sometimes referred to as the "privity" requirement. For example, assume H1 dies and W has his deceased spousal unused exclusion amount, and assume W remarries H2. If W dies before H2, H2 may then use the deceased spousal unused exclusion amount from W's unused basic exclusion amount, but may not utilize any of H1's unused exclusion amount. The definition of the "deceased spousal unused exclusion amount" has no element at all that might include a deceased person's unused exclusion from a prior spouse in determining how much unused exclusion can be used by a surviving spouse. However, the Joint Committee on Taxation Technical Explanation has an Example that appears inconsistent with this conclusion.

> "<u>Example 3</u>. [Husband 1 dies with $2 million of unused exclusion amount.] Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife

> made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife." Joint Committee on Taxation Technical Explanation at 53.

This example assumes that Wife's deceased spouse unused exclusion amount, which could be used by Husband 2, is Wife's $7 million exclusion amount (which includes the deceased spousal unused exclusion from Husband 1) less her $3 million taxable estate. This would suggest that Husband 2 *does* get to take advantage of the unused exclusion amount from Husband 1. One might argue that this is just a matter of determining whether Wife first uses her own exclusion or first uses Husband 1's unused exclusion before using her own. If she first uses the unused exclusion that she received from Husband 1, her $3 million taxable estate, less Husband's 1's $2 million exclusion, would leave $1 million of taxable estate to be offset by $1 million of Wife's basic exclusion, leaving unused exclusion of $4 million for Husband 2. However, that approach is not consistent with the statutory definition of the "deceased spousal unused exclusion amount." Under the statutory definition, the deceased spousal unused exclusion amount that Husband 2 could have from Wife is determined as follows:

Lesser of:

(1) Basic exclusion amount		$5 million
Or		
(2) Wife's basic exclusion amount	$5 million	
Less		
Wife's taxable estate plus adjusted taxable gifts	$3 million	
Item (2)		$2 million

There is nothing in the statutory definition that makes any references whatsoever to the amount of Wife's unused exclusion from Husband 1 in determining the amount of the unused exclusion that Husband 2 has from Wife. However, the Joint Committee on Taxation Technical Explanation appears to adopts a concept of first using any deceased spousal unused exclusion at the death of a surviving spouse, and the IRS might be expected to interpret the statute in that manner.

7. <u>Applies for Gift Tax Purposes</u>. Portability applies for the gift exemption as well as the estate exemption. TRA 2010 § 303(b)(1) amends I.R.C. § 2505(a)(1), which describes the "applicable credit amount" for gift tax purposes, by referring to the applicable credit amount under § 2010(c) "which would apply if the donor died as of the end of the calendar year…" (Under § 2505(a)(2), the credit amount is further reduced by the amounts of credit allowable in preceding years.) The applicable credit amount under § 2010(c) includes the deceased spousal unused exclusion amount, so that amount is also included in the gift exemption amount.

Example 1. Husband 1 dies in 2011 with a taxable estate of $1 million, leaving a "deceased spousal unused credit amount" for Wife of $4 million. If later in 2011 Wife makes a large gift, her gift exemption under § 2505(a) is the estate tax applicable credit amount under § 2010(c) that would apply if Wife died as of the end of 2011. If Wife died at the end of 2011, her estate tax applicable credit amount would be her basic exclusion amount ($5 million) plus the amount of her deceased spousal unused credit amount ($4 million), or $9 million.

Example 2 (Gift in 2011). Assume the same facts as Example 1, but assume Wife makes a taxable gift of $4 million in 2011. (Apparently, it makes no difference whether Wife makes the gift before or after Husband 1 dies — her gift exemption is determined as if she had died on the last day of the calendar year, which would be after Husband 1 died.) Does the 2011 gift utilize Wife's own gift exemption amount first, or does it utilize her deceased spousal unused exclusion amount from Husband 1 first? Example 3 in the Joint Committee on Taxation Technical Explanation might be read as saying that the deceased spousal unused credit would be used first (at least for estate tax purposes). However, there is nothing in the statutory language suggesting that either spouse's credit would be used first. It just says that Wife has a credit on $9 million of exclusion in 2011 (or $3,130,800 of credit). Her gift of $4 million generates no gift tax:

Gift tax on $4 million	$1,380,800
Less gift unified credit	- 1,380,800
Gift tax paid	0

Example 3 (Additional Gift in 2012). Assume the same facts as in Examples 1-2, assume Wife makes another taxable gift of $4 million in 2012, and assume there is no inflation adjustment to the $5 million basic exclusion amount. (If there had been an inflation adjustment, Wife's basic exclusion amount would be inflation adjusted, but the $4 million of deceased spousal unused exclusion would not be adjusted.) Wife's gift unified credit is (1) the estate tax applicable credit amount she would have if she died at the end of 2012 [§ 2505(a)(1)], less (2) the amounts allowable as credit against the gift tax for preceding years [§ 2505(a)(2)]. This amount is:

(1) Estate tax applicable credit amount if die at end of 2012 (tentative tax on basic exclusion amount ($5 million assuming no inflation adjustment) and deceased spousal unused exclusion amount ($4 million, never inflation adjusted), combined $9 million)	$3,130,800
Less (2) Amounts allowable as credit for preceding years	- 1,380,800
Available gift tax unified credit amount for 2012	1,750,000

Gift tax calculation:

Gift tax on gifts for all periods ($8 million)	$2,780,800
Gift tax on $4 million gifts in 2011	- 1,380,800
Gift tax before credit	1,400,000
Less gift unified credit	- 1,400,000
Gift tax paid	0

Available gift tax unified credit available for future years (as long as Wife has this same deceased spousal unused exclusion amount):

Credit amount on $9 million	$3,130,800
Gift credit used in 2011	- 1,380,800
Gift credit used in 2012	- 1,400,000
Remaining gift credit	350,000

(That would cover additional gifts of $1 million.)

Example 4 (Husband 2 Dies, Additional Gift in 2013). Assume the same facts as in Examples 1-3, assume Husband 2 dies in 2013 with a taxable estate of $6 million and no unused exclusion amount, assume TRA 2010 is extended to apply in 2013, and assume the estate tax basic exclusion amount has been inflation adjusted to $5,020,000. Assume Wife makes a gift of $1 million in 2013.

Wife's gift tax unified credit:

(1) Estate tax applicable credit amount if die at end of 2013 (tentative tax on basic exclusion amount ($5.02 million) and deceased spousal unused exclusion amount (0), combined $5.02 million	$1,737,800
Less	
(2) Amounts allowable as credit for preceding years (1,380,800 for 2011 + 1,400,000 for 2012)	- 2,780,800
Remaining gift credit	0

Gift tax calculation:

Gift tax on gifts for all periods ($9 million)	$3,130,800
Gift tax on $8 million gifts in 2011-2012	- 2,780,000
Gift tax before credit	350,000
Less gift unified credit	- 0
Gift tax paid	350,000

Practical Planning Pointers.

(a) There is no concept of "using Husband 1's unused exclusion first," leaving Wife with $1.0 million of her own gift exemption amount after Husband 2 died, and Wife no longer had any deceased spousal unused exclusion after Husband 2 died. However the Joint Committee on Taxation Technical Explanation Example 3 suggests that there is a concept of using the deceased spousal unused exclusion first in the estate tax context. Whether this would be extended to the gift tax context is not clear.

(b) A surviving spouse should use the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries) so that she does not lose it if the new spouse predeceases or if the basic exclusion amount is decreased (remember that the deceased unused exclusion amount is the lesser of the basic exclusion amount or the amount from the unused exclusion calculation).

(c) Under the statutory procedure there is no way that Wife can utilize her deceased spousal unused exclusion amount with out using her own basic exclusion amount. However, the Joint Committee on Taxation Technical Explanation Example 3 suggests that can be done.

(d) The recapture/clawback issue discussed in section IV.E.2-5 of this outline can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exclusion" for making gifts. If the spouse later remarries and the subsequent spouse dies, with less exclusion, the spouse will not have as much deceased spousal unused exclusion for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes will be less than for gift tax purposes when the gifts were made. This may result in additional estate taxes being due at the donor's death. The clawback issue in this context may be resolved differently than in the context of making gifts under a larger gift exemption than the estate exemption that exists at the donor's death.

8. <u>Not Apply for GST Tax Purposes</u>. Portability does not apply to the GST exemption.

9. <u>Effective Date — Decedents Dying After 2010</u>. The provision applies to the estates of decedents dying and gifts made after 2010. [TRA § 303(c)(1).] The Joint Committee on Taxation Technical Explanation takes the clear position that portability applies only if the first spouse dies after 2010. Joint Committee on Taxation Technical Explanation, at 51-52 ("Under the provision, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the 'deceased spousal unused exclusion amount'), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.")

10. <u>Planning Observations</u>.

a. <u>Heightened Significance in Light of Exemption Amount Increase</u>. Portability takes on increased importance in light of the increase of the exemption amount to $5.0 million. Marrying a poor dying person to be able to use his or her unused exemption amount (which could be close to the full $5.0 million) may yield dramatic tax savings.

b. <u>Impact on Decision to Remarry</u>. Portability may impact the decision of a surviving spouse to remarry. If the new spouse should predecease the surviving spouse, the unused exemption of the first deceased spouse would no longer be available to the surviving spouse, and the new spouse may have little or no unused exemption.

c. <u>Impact of Decision to Divorce</u>. Portability could even encourage the spouses of wealthy families to divorce, each to remarry poor sickly individuals, and not to remarry after the new poor spouses die. This could add an additional $10 million of estate and gift tax exemption available to the family.

d. Gift Tax Exclusions of Multiple Deceased Spouses. The statute itself has no limits on being able to take advantage of the exemptions from multiple deceased spouses for gift tax purposes. For example, if H1 dies with substantial unused exclusion, the surviving spouse (W) could make lifetime gifts using her own exclusion and H1's unused exclusion. (As discussed above, W would have to use her own basic exclusion amount in order to use the deceased spousal unused exclusion amount from H1 unless Example 3 of the Joint Committee on Taxation Technical Explanation is applied for gift tax purposes.) If W remarries and H2 also dies with unused exclusion, W could then make additional gifts using H2's unused exclusion (before she remarries and her next husband dies). Courts or the IRS may address a "sham marriage" concept to put some limits on using the exclusions of multiple poor sickly spouses. Also, there may be a recapture of estate tax attributable to the excess of the gift exemptions utilized with lifetime gifts over the estate exemption at the donor's death. See section IV.E.5 of this outline for a summary of the conclusions from the analysis of examples regarding the recapture issue.

Only Available Two Years. Like the rest of the estate and gift tax provisions in TRA 2010, the portability provision expires after 2012. The apparent anticipation is that Congress will extend this benefit following 2012, but there are no guarantees. In light of this, few planners may be willing to rely on portability and forego using bypass trust planning in the first deceased spouse's will. The possible exception would be if the surviving spouse intends to make gifts soon after the first spouse's death to utilize the unused exclusion — but if the spouse is willing to do that, it would seem better to just use bypass trust planning in the spouses' wills.

e. Reasons for Using Trusts Even With Portability. There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including, (a) there is no assurance that portability will apply after 2012, (b) the deceased spousal unused exclusion amount is not indexed, (c) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse, (d) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (e) there is no portability of the GST exemption, and (f) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse. On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death.

Practical Planning Pointer: Few individuals will be willing to rely on portability of the estate tax exemption in planning their estates, because of the fact that portability only exists for two years and because there are a variety of other reasons for continuing to use appropriate "bypass" planning with trusts.

D. Gift Exemption and Change in Method for Calculating Gift Tax.

1. Unification of Gift Exemption Beginning in 2011. The gift exemption remains at $1,000,000 in 2010. [TRA § 302(b)(1)(B).] Beginning in 2011, the gift exemption amount is the same as the estate tax exclusion amount, or $5.0 million, indexed from 2010 beginning in 2012. Section 2501(a)(1), as amended by TRA 2010 §§ 301(b) & 302(b)(1), provides that the unified gift tax credit is:

   "(1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year…"

   (The last phrase, beginning with "which would apply if the donor died as of the end of the calendar year" is the clause that provides portability of the gift exclusion.)

   The Baucus bill did not unify the gift and estate exclusion amounts.

   Practical Planning Pointer--Huge Implications for Future Transfer Planning Opportunities: The $5.0 million gift exclusion amount beginning in 2011 will open up a new paradigm of thinking regarding transfer planning strategies. The ability to make transfers of up to $10 million per couple without having to pay gift taxes paves the way for many transfer planning opportunities that, with leveraging strategies, can transfer vast amounts of wealth outside the gross estate. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Perhaps the notion of the estate tax being a "voluntary tax" will become reality.

2. Change in Gift Tax Calculation Method; Effect of Changed Calculation Method. For gift tax purposes, the gift tax calculation includes subtracting a unified credit, and the amount of unified credit available for a particular year is determined after subtracting the amount of credit already used from prior gifts. In calculating the amount of credit used on prior gifts, use the gift tax rate for the year of the current gift to determine the tentative tax on the applicable exclusion amount that was applicable for offsetting the gift tax on prior gifts. [TRA § 302(d)(2), amending I.R.C. § 2505(a).] (Query how to apply the rates in the current year for purposes of subtracting the gift credit amounts used in prior years when gifts were made in years before 1998 for which there was a fixed credit amount rather than an applicable exclusion amount? For example, in 1987-1997, the unified credit against gift tax was $192,800. For those years, will the actual amount of gift credit used in the prior year be subtracted under § 2505(a)(2) or will an implicit amount of exclusion attributable to the credit in that prior year be determined and then use the current year rate to determine the tentative tax on that implicit amount of exclusion?)

   The effect of this change is to "correct" an anomaly that existed under prior law. If an individual had made gifts before 2010 over $500,000, the gifts used more credit (calculated at 37% and 39% rates) than gifts would use at a 35% rate. The result was that donors who had made prior taxable gifts over $500,000 could not make additional gifts in 2010 (at a 35% rate) equal to the difference between $1 million and the prior gifts. (For example, a donor who had made taxable gifts before 2010 of $961,538.46 would not be able to make additional gifts in 2010 (calculating the credit at a 35% rate) without paying gift tax.)

Practical Planning Pointer: The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts without having to pay gift tax.

Steven Schindler, attorney in Seattle, Washington, provides this example of the effect of the amendments to § 2505(a):

> "For example, a donor who, in 2009, made her first taxable gift in the amount of \$900,000, utilized \$306,800 of credit (when \$345,800 was available). The same donor in 2010 only has \$330,800 in total credit, and, having used \$306,800 in 2009, only has \$24,000 in remaining credit to apply against 2010 gifts. At the 35% gift tax rate, this amount of credit only protects \$68,571 in taxable gifts. If the donor makes a gift of the remaining \$100,000, thinking that she has \$1 million in total lifetime exemption equivalent, the donor would owe gift tax of \$11,000 under the unamended § 2505(a).
>
> Under TRA 2010 § 302(d)(2) we would not look to the 2009 return to determine how much credit was used. Instead, we would re-determine in 2010, for purposes of calculating gift tax on any 2010 gift, the amount of credit that would have been used on the 2009 gift if the tax rates in effect in 2010 were applicable in 2009. Applying the maximum 35% rate to the \$900,000 gift, only \$295,800 in credit would have been used, leaving \$35,000 in remaining credit for 2010, permitting a full \$100,000 gift."

3. <u>Gift Tax Effects if Donor Previously Made Gifts Above \$5 Million in Prior Years</u>. If a donor has made over \$5 million of gifts in prior years, can the donor make use of the additional \$4 million of gift exemption in 2011? Yes. The donor paid gift taxes on the excess of gifts over the \$1 million exemption (or less) in prior years, and the donor can still take advantage of the additional \$4 million of gift exemption. Under § 2505(a), the donor's gift tax unified credit amount would be the applicable credit amount on the \$5 million basic exclusion less the "amounts allowable as a credit to the individual under this section for all preceding calendar periods" (which would reflect the credit amount on \$1 million of gifts, so there would be lots of unified credit left).

Example (\$5 million of Gifts in 2009). Assume Donor made \$5 million of taxable gifts in 2009, and wishes to make an additional \$4 million of gifts in 2011 (to make use of her additional \$4 million of gift exemption.)

Gift tax in 2009 on \$5 million gift:

Gift tax before credit (applying 45% rate)	\$2,130,800
Gift tax credit on \$1.0 million	- 345,800
Gift tax paid for 2009 gifts	1,785,000

Gift tax in 2011 on additional \$4 million gift:

Gift tax on aggregate gifts of \$9 million (applying 35% rate), § 2502(a)(1)(a)	\$3,130,800
Less gift tax on prior \$5 million gift (also applying 35% rate), § 2502(a)(1)(b)	- 1,730,800

Gift tax before credit		1,400,000
Less available gift unified credit (using 35% rate, even for determining amount of credit used in 2009 when the marginal rate was 45%, under § 2505(a), as amended by TRA 2010 § 302(d)(2))		
(1) Estate tax applicable credit amount on $5 million basic exclusion amount in 2011, § 2505(a)(1)	$1,730,800	
Less (2) Amounts allowable as credit for preceding years (on $1 million), using 35% highest marginal rate that applies in current year, rather than 39% highest rate that applied in 2009)	- 330,800	
Available gift credit for 2011	$1,400,000	
Gift tax for 2011 after credit		
Gift tax before credit (calculated above)		$1,400,000
Less gift unified credit		- 1,400,000
Gift tax payable for 2011		0

Practical Planning Pointer: If a donor previously made taxable gifts exceeding $1 million prior to 2011, the donor can make additional gifts of exactly $4,000,000 that will be covered by the $5 million gift exemption in 2011. Even though the gift credit on up to $1 million was previously calculated using 45% (or higher rates), in the current year calculation the amount of credit previously used is calculated using current year (35% rates) rather than the amount of credit actually applied at the higher rates.

4. <u>Gift Tax Effects if Donor Previously Made Taxable Gifts In Excess of or Less Than $1 Million Prior to 2011</u>. As illustrated by the preceding example, if the donor has previously made taxable gifts of at least $1 million prior to 2011, the client can make an additional taxable gift of exactly $4 million in 2011 without having to pay gift tax. Similarly, if the donor has made prior taxable gifts prior to 2011 of less than $1 million, the donor can make gifts of exactly $5 million less the amount of taxable gift made previously.

Example ($900,000 of Prior Gifts). Assume the donor made gifts of $900,000 in 2009.

Gift tax in 2009 on $900,000 gift:

Gift tax before credit (highest marginal rate is 39%)	$ 306,800
Gift tax credit on $900,000	- 306,800
Gift tax paid for 2009 gifts	0

Gift tax in 2011 on additional $4.1 million gift:

Gift tax on aggregate gifts of $5 million (applying 35% rate), § 2502(a)(1)(a)	$1,730,800
Less gift tax on prior $900,000 gift (also applying 35% rate), § 2502(a)(1)(b)	- 295,800
Gift tax on additional $4.1 million before credit	1,435,000

Credit on 2011 gift

Credit on $5.0 million applicable exclusion	$1,730,800	
Credit used on prior period gifts (35% rate)	- 295,800	
Credit left		$1,435,000
Gift tax payable on 2011 gift		$ 0

E. Change in Estate Tax Calculation Method Regarding Effects of Prior Gifts. The estate tax calculation method is changed to reflect the effects of changing gift tax rates. The calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits), I.R.C. § 2001(b)(1),
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The Form 706 instructions for the "Line 7 Worksheet" clarify that the gift unified credit attributable to the applicable credit amount available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year. There is uncertainty as to how this will be applied if the estate tax applicable exclusion amount has decreased below the gift exemption amount utilized by lifetime gifts, particularly if there is a sunsetting of TRA 2010 to interpret the Code as if the $5 million gift tax exemption amount "had never been enacted." In that case, will the gift unified credit amount that is subtracted in determining the amount of the reduction under Step 2 be limited to the credit amount on a $1 million exclusion? This is discussed in detail below.)
- Step 3: Subtract the applicable credit amount.

TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The gift unified credit equals--

(1) the estate tax applicable credit amount for the year of the gift (§ 2505(a)(1)), less

(2) the aggregate gift unified credits for preceding years (§ 2505(a)(2)), and as discussed above in section IV.D.2 of this outline regarding the calculation of the gift tax, TRA 2010 amends § 2505(a) to provide that in calculating the aggregate gift unified credits used in prior years under § 2505(a)(2), rates in effect for the year of each current gift are used in lieu of the actual rates of tax in effect during the preceding years.

1. General Estate Tax Effects of Prior Gifts. Generally speaking, the estate tax calculation method of § 2001(b) is designed (1) to tax the estate at the highest estate tax rate brackets, taking into consideration prior gifts (by determining the tax on the combined taxable estate plus adjusted taxable gifts and subtracting the taxes on just the adjusted taxable gifts), and (2) to reflect that the individual has already utilized unified credit that would otherwise be available at death for any taxable gifts made previously (this is done by reducing the amount of tax that is subtracted attributable to just the adjusted taxable gifts by the amount of unified credits attributable to those adjusted taxable gifts.) This is accomplished under the

rather complicated estate tax computation procedures under § 2001. A brief refresher on the estate tax computation system, building on the description above, will assist in understanding the estate tax affects of large gifts.

Step 1: Calculate tentative tax on gross estate + adjusted taxable gifts

Step 2: Subtract from that the gift tax on just the adjusted taxable gifts that would have been paid, based on the rates in effect at the date of death. This gift tax amount is reduced by unified credit used in making the gift (again based on rates in effect at the date of death). Basic math principles tells us that the "negative of a negative is a positive." Reducing the amount of gift tax that is subtracted in Step 2 by the unified credit used in the gift in effect adds the gift unified credit to the tax calculation.

Step 3: The full estate unified credit amount is then subtracted at the end of the computation.

Therefore, if a $5 million gift has been made and the estate tax exclusion amount is $5 million, the calculation effectively adds $1,730,000 (the credit amount on $5 million with a 35% top rate) in Step 2 (i.e., there is no reduction in the amount of the tentative tax by the chapter 12 tax that would be paid on the adjusted taxable gifts) and subtracts $1,730,000 in Step 3. Thus, we get the generalization that the taxable gift "uses up" the estate tax exemption amount.

2. <u>Controversial Calculation Issue: "Recapture" vs. "Clawback" If Estate Exemption Is Reduced in the Future ("Line 7 Issue</u>"). If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift exemption amount, it is not clear how Step 2 of the estate tax calculation described above will be interpreted. Following the Form 706 instructions, the hypothetical "chapter 12" offset amount (reported on Line 7 of the Form 706) is calculated using the applicable credit amount "in effect for the year the gift was made," (see the last two lines of the Form 706 Instructions, Line 7 Worksheet) which would be the credit amount for an applicable exclusion amount of $5 million. (Similarly, Letter Ruling 9250004 says that "the unified credit that would have been allowed to the decedent *in the year of the gift* is taken into account as a reduction of arriving at the gift tax payable.") That means that the gift unified credit amount would fully cover the gift and no gift tax calculated under chapter 12 would be reduced in calculating the tentative estate tax. In effect, the tentative tax (before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously.

The change under § 2001(g) says to use the date of death estate tax *rates* in calculating the gift credit amount for this hypothetical gift tax. This seems to connote that the Form 706 instructions approach would be applied by using the exclusion amount that was used in the *year of the gift* and determining a hypothetical gift credit amount using the date of death rate.

That situation, of the estate tax unified credit amount being lower than the gift unified credit amount for prior years, has never happened. It is not clear whether the Form 706 instructions would apply literally in that circumstance or not. On the other hand, if the amount of the chapter 12 tax on just the adjusted taxable gifts, to be subtracted from the tentative tax in Step 2 and reported on Line 7 of the Form 706, is calculated assuming the gift unified credit amount were determined on just the lower estate tax applicable exclusion amount, there would be chapter 12 tax that would be subtracted in Step 2, thus giving the estate the benefit of having removed the "excess" exclusion amount from the estate without gift or estate tax.

The listservs are full of comments about this issue. Some planners say that the additional estate tax is an appropriate "recapture" of using the excess exemption, and others take the position this is an unfair "clawback" of the tax benefits allowed in making gifts. The reasoning under the first position (that "recapture" should be appropriate with additional estate taxes at death on the prior gifts if the exemption amount is reduced in the future) is that this approach reflects the basic structure of the unified gift/estate tax system by adding back adjusted taxable gifts into the estate tax calculation and allowing one *unified* credit for estate tax purposes. Eric Viehman, attorney in Houston, Texas summarizes:

> "From a policy standpoint, it is hard to argue that two taxpayers dying in the same year who each made a total of $10 million of taxable transfers during lifetime and at death should pay dramatically different amounts in total tax simply because one made $5 million of lifetime gifts and the other made none… If new estate tax legislation is enacted but the post-2012 estate tax exemption is something less than $5 million, then Congress certainly might eliminate any recapture possibility, but it seems hard to make a persuasive policy argument for doing so."

The position of the unjust "clawback" group is that the taxable gifts are not part of the gross estate and are just part of the estate tax calculation procedure to tax the estate in the highest marginal brackets considering lifetime gifts.

Richard Franklin, an attorney in Washington D.C., summarizes:

> "Adjusted taxable gifts are not part of the taxable estate. Section 2001(a) imposes an estate tax on the taxable estate. Gifts are not part of the taxable estate. If the clawback analysis is correct, the total estate tax to be paid could exceed the maximum estate tax rate as a percentage of the taxable estate. I cannot think of another situation in which the total tax paid is over the maximum rate as a percentage of the taxable estate (even ignoring the applicable credit). Even the 5% surtax "bubble bracket" just took away the advantage of the lower brackets, but did not push the estate tax in excess of the maximum bracket as a percentage of the taxable estate. While I cannot say there is no risk of a clawback, the arguments against it are strong, it was not intended, it is beyond the purpose of the 2001(b) and I don't even believe the statute currently mandates that result. The 706 instructions lead to the clawback, but that arises out of the context of the IRS never envisioning the exemption upon gift being higher than at death."

Another argument of this group is that if TRA 2010 sunsets in two years and the EGTRRA/TRA sunset kicks in to apply the Code with respect to estate of persons dying after 2012 as if the EGTRRA and TRA provisions had never been enacted, then there would not have been a $5 million exemption for gift tax purposes, so the hypothetical gift tax on just the adjusted taxable gifts would be calculated assuming a gift exemption of only $1 million and there would be a big offset in the estate tax calculation. They argue that the "clawback" potential, while substantial or even likely, "doesn't 'feel right' or square with the original thought behind 'paid or payable' that actually benefitted taxpayers."

With respect to the sunsetting reasoning, keep in mind that there is the possibility that there may not be a general sunset of the EGTRRA and TRA provisions but, consistent with the sunsetting rule in TRA which leaves most of the estate and gift tax provisions of EGTRRA intact, future legislation may merely revise §2010(c)(2)(A) (as amended by TRA 2010) to say that the applicable exclusion amount is $3,500,000 (or whatever number is reached in the political discussions), and § 2505(a), which describes the gift tax unified credit amount, would continue simply to refer to § 2010(c) but without the parenthetical clause "(determined as if the applicable exclusion amount were $1,000,000)."

Here is a different way of stating the issue: One of the purposes of the estate tax calculation procedure is to reflect that using gift exemption also uses the estate exemption. Does that mean that it uses the estate exemption only to the extent of the estate exemption at death, or does it require a "recapture" to the extent that the gift exemption utilized exceeds the estate exemption?

There are indications from Congressional staffers that the "clawback" effect if the exclusion amount is reduced in future years was not intended and that there will be no clawback of the excess exemption.

In any event, the result is uncertain. One attorney has summarized it well: "One person's glitch is another's tax logic."

3. Impact of Gifts Utilizing $5 Million Gift Exemption on Later Estate Tax Calculation. In each of the following examples, the line of the calculation that is impacted by the "Line 7" issue of whether to determine the § 2001(b)(2) offset by using the gift credit amount based on the applicable exclusion amount for the year of the gift or for the year of death is italicized.

Example 1 (Gift of $5 Million; Death in 2012). Assume A has an estate of $15 million and makes a $5 million gift (ATG) in 2011, and dies in 2012 with a taxable estate (TE) of $10 million. (Because death occurs within three years, any gift tax paid would be brought back into the estate, but a gift of $5 million in 2011 will not require the payment of any gift tax.)

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million)		$5,230,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (35% top rate)	1,730,800	
Less gift unified credit on $5M exclusion (35% rate)	*- 1,730,800*	
		- 0
(3) Estate tax before unified credit		5,230,800

(4) Less unified credit on $5 million exclusion	-	1,730,800
(5) Estate tax		3,500,000

Conclusion. The total gift tax and estate tax is $3,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same $3,500,000. Even though the gift is included in the estate tax calculation, making the gift did not cost any additional tax. The simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an overall savings — without having to pay a current gift tax.

If the decedent's estate is passing to a surviving spouse or charity, so that it qualifies fully for the marital or charitable deduction, the additional estate taxes would not qualify for the marital or charitable deduction, resulting in a circular calculation of the estate taxes. However, if the estate exemption remains at $5 million, there would be no estate tax payable at the donor's death. The tentative tax on the $5 million of adjusted taxable gifts would be completely offset by the estate tax unified credit on a $5 million applicable exclusion amount. The rest of the estate qualifies for the marital or charitable deduction. There is no added tax that begins a circular tax calculation.

Example 2 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $3.5 Million and Rate Has Been Increased to 45%; Follow Form 706 Instructions). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $3.5 million and the rate is increased to 45% (the 2009 system). Assume the calculation follows the Form 706 instructions in calculating the § 2001(b)(2) "Line 7" offset for the gift taxes on adjusted taxable gifts by taking into consideration the amount of gift tax applicable credit amount in each year the gift was made but applying date of death rates (i.e., the gift credit amount using the 45% rate table on a $5 million applicable exclusion amount).

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million) (45% table rate)			$6,630,800
(2) Less gift tax on ATGs using date of death rates			
Gift tax on $5 million (45% top rate)	2,130,800		
Less gift unified credit on $5M exclusion (45% table)	*- 2,130,800*		
		-	0
(3) Estate tax before unified credit			6,630,800
(4) Less unified credit on $3.5 million exclusion		-	1,455,800
(5) Estate tax			5,175,000

Conclusion. The total gift tax and estate tax is $5,175,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same

$5,175,000. Despite the "clawback" effect, making the gift does not cost any additional tax, even if TRA sunsets and there is a later decrease in the applicable exclusion amount and increase in the gift tax rate. *Stated differently, the estate ultimately receives just the benefit of the applicable exclusion amount at the individual's death if the "clawback" applies.* However, future appreciation attributable to the gift or income taxes paid on gift assets in grantor trusts will reduce the gross estate that would otherwise be subject to estate taxes.

The estate tax on just the $10 million taxable estate would have been $2,925,000. Therefore, there is $2,250,000 ($5,175,000-$2,925,000) attributable to assets not in the taxable estate. (Check: The added $5 million x 45% = $2,250,000.) The recipients of the taxable estate will have to pay $2,250,000 of estate tax attributable to the $5 million of taxable gifts. If the taxable gifts were made to persons other than the recipients of the taxable estate, hard feelings may result (at the least). Tax apportionment issues are critically significant in light of the estate tax recapture for lifetime gifts, particularly this possible result if the estate tax exemption is decreased below the utilized gift tax exemptions. See section IV.E.4 of this outline.

If the decedent's estate is passing to a surviving spouse, so that it qualifies fully for the marital deduction, the additional estate taxes would not qualify for the marital deduction, resulting in a circular calculation of the estate taxes. The calculation results in a tax of $1,227,272.73. (Check it: The tentative tax on TE + ATG, or [$1,227,272.73 + $5 million] is $2,673,072.73. Subtracting the $1,455,800 unified credit leaves an estate tax of $1,227,272.73. More simply: [$1,500,000 + $1,227,272.73] x 45% = $1,227,272.73.)

Example 3 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $1 Million and Rate Has Been Increased to 55%; Follow Form 706 Instructions). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $1 million and the rate is increased to 55% (the pre-2001 system). Assume the calculation follows the Form 706 instructions in calculating the § 2001(b)(2) offset for the gift taxes on adjusted taxable gifts by taking into consideration the amount of gift tax applicable credit amount in each year the gift was made but applying date of death rates (i.e., the gift credit amount using 55% rate table on a $5 million applicable exclusion amount).

<u>Gift Calculation</u>. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million) (55% table rate)		$7,890,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (55% top rate)	2,390,800	
Less gift unified credit on $5M exclusion (55% table)	*- 2,390,800*	
		- 0
(3) Estate tax before unified credit		7,890,800
(4) Less unified credit on $1 million exclusion		- 345,800

(5) Estate tax	7,545,000

Conclusion. The total gift tax and estate tax is $7,545,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same $7,545,000. Making the gift did not cost any additional tax, even if EGTRRA and TRA sunset, resulting in a later dramatic decrease in the applicable exclusion amount and increase in the gift tax rate. The simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an overall savings — without having to pay a current gift tax.

The estate tax on just the $10 million taxable estate would have been $4,795,000. Therefore, there is $2,750,000 ($7,545,000-$4,795,000) of estate tax attributable to assets not in the gross estate. (Check: $5 million of ATGs x 55% = $2,750,000.)

Example 4 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $3.5 Million and Rate Has Been Increased to 45%; Limit § 2001(b)(2) Gift Tax Offset Based on Date of Death Applicable Exclusion Amount; Comparison to Example 2). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $3.5 million and the rate is increased to 45% (the 2009 system). Assume in calculating the § 2001(b)(2) offset for the gift taxes on adjusted taxable gifts that the gift tax unified credit amount is calculated by applying the 45% rate table to the applicable exclusion amount for the date of death (i.e., $3.5 million) rather than in each year that gifts were made (i.e., $5 million).

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million) (45% table rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (45% top rate)	2,130,800	
Less gift unified credit on $3.5M exclusion (45%	*- 1,455,800*	
		- 675,000
(3) Estate tax before unified credit		5,955,800
(4) Less unified credit on $3.5 million exclusion		- 1,455,800
(5) Estate tax		4,500,000

Conclusion. The total gift tax and estate tax is $4,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been $5,175,000. Making the gift saved $675,000 of estate tax (even before considering the removal of future appreciation in the gift assets from the estate). *Stated differently, the estate ultimately receives the benefit of the applicable exclusion amount at the individual's death AND removes $1.5 million from the transfer tax base ($1.5 million x 45% = $675,000 savings).*

The estate tax on just a $10 million estate would have been $2,925,000, so there is $1,575,000 of estate tax attributable to assets not in the taxable estate. (Compare this to Example 2 where there was an additional $2,250,000 of estate tax attributable to the adjusted taxable gifts. The difference is $675,000 — which is the amount attributable to the excess exemption used in taxable gifts times the estate tax rate ([$5 million - $3.5 million] x 45% = $675,000).)

If the entire estate passes to a surviving spouse that qualifies for the estate tax marital deduction, there would be no estate tax produced as a result of the $5 million of gifts under this "no clawback" approach for determining the "Line 7" offset amount.

Example 5 (Gift of $5 Million; Death in 2013 and Assume Applicable Exclusion Amount Has Been Reduced to $1 Million and Rate Has Been Increased to 55%; Limit § 2001(b)(2) Gift Tax Offset Based on Date of Death Applicable Exclusion Amount; Compare to Example 3). Assume A makes a $5 million gift in 2011 and dies with a taxable estate of $10 million in 2013. Assume the law is changed for 2013 so that the applicable exclusion amount is reduced to $1 million and the rate is increased to 55% (the pre-2001 system). Assume in calculating the § 2001(b)(2) "Line 7" offset for the gift taxes on adjusted taxable gifts that the gift tax unified credit amount is calculated by applying the 55% rate table to the applicable exclusion amount for the date of death (i.e., $1 million) rather than in each year that gifts were made (i.e., $5 million).

Gift Calculation. The gift is fully covered by the $5 million gift exemption, so no gift tax is due.

Estate Tax Calculation

(1) Tentative tax on TE + ATG ($15 million) (55% table rate)		$7,890,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $5 million (55% top rate)	2,390,800	
Less gift unified credit on $1M exclusion (55% rate)	*- 345,800*	
		- 2,045,000
(3) Estate tax before unified credit		5,845,800
(4) Less unified credit on $1 million exclusion		- 345,800
(5) Estate tax		5,500,000

Conclusion. The total gift tax and estate tax is $5,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been $7,545,000. Making the gift saved $2,045,000 of estate tax (even before considering the removal of future appreciation from the gift). *Stated differently, the estate ultimately receives the benefit of the applicable exclusion amount at the individual's death AND removes $4 million from the transfer tax base that would have been subject to estate tax at rates ranging from 41% to 55%.*

Practical Planning Pointer: Even if there is clawback of the excess gift exemption, if the estate tax is calculated under the Form 706 instructions approach, making a taxable gift merely has the effect of excluding future appreciation of the gift property from the estate as well as income tax that the donor may pay on grantor trust income if the gift is made to a grantor trust. The estate ultimately receives just the benefit of the applicable exclusion amount at the individual's death. As illustrated in Examples 2-3, if an individual makes a $5 million gift in 2011 and the applicable exclusion amount is later reduced, the individual still has the benefit of making a $5 million gift (and shifting future appreciation and income payments attributable to a grantor trust) without taking away the estate's right to take advantage of the applicable exclusion amount at death, whatever amount that might be. If the donor has not paid gift taxes, the effect is that the estate is subject to estate tax (using rates in effect at the date of death) on the combined taxable estate plus adjusted taxable gifts, with the benefit of the unified credit that applies at the date of death.

However, if there is no clawback and the estate tax is calculated by determining the Line 7 gift tax offset from adjusted taxable gifts using the applicable exclusion amount at the date of death rather than in the year of the gift, substantial tax savings are generated. In effect, the difference between the $5 million exemption utilized in taxable gifts and the date of death applicable exclusion amount is removed from the tax base.

The next examples address the effects if gift taxes have been paid during life.

Example 6 (Gift of $10 million in 2011; Death in 2012 With Same Exclusion and Rate). Assume A makes a gift of $10 million in 2011 and dies in 2012 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift).

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amount	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million)		$5,230,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (35% top rate)	3,480,800	
Less gift unified credit on $5M exclusion (35% table)	*- 1,730,800*	
		- 1,750,000
(3) Estate tax before unified credit		3,480,800
(4) Less unified credit on $5 million exclusion		- 1,730,800
(5) Estate tax		1,750,000

Conclusion. The total gift tax and estate tax is $1,750,000 gift tax plus $1,750,000 estate tax, or $3,500,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been the same $3,500,000. Making the gift did not cost any additional tax. The simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an overall savings.

Example 7 (Gift of $10 Million in 2011; Death in 2013 With Exclusion of $3.5 Million and Top Rate of 45%; Follow Form 706 Instructions). Assume A makes a gift of $10 million in 2011 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $3.5 million and has increased the top rate to 45% for 2013.

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amt	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (45% table) (at 45% top rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (45% top rate)	4,380,800	
Less gift unified credit on $5M exclusion (45% table)	*- 2,138,800*	
		- 2,250,000
(3) Estate tax before unified credit		4,380,800
(4) Less unified credit on $3.5 million exclusion		- 1,455,800
(5) Estate tax		2,925,000

Conclusion. The total gift tax and estate tax is $1,750,000 gift tax plus $2,925,000 estate tax, or $4,675,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been $5,175,000. Making the gift saved $500,000 of combined tax. (The $10 million gift had a 35% tax rate apply to $5 million — the amount of the gift not covered by the $5 million exemption. If the gift is not made, that $5 million would have been taxed at 45%. The additional 10% of the $5 million amount accounts for the additional $500,000 that would be paid if the gift were not made.)

Example 8 (Gift of $10 Million in 2011; Death in 2013 With Exclusion of $1 Million and Top Rate of 55%; Follow Form 706 Instructions). Assume A makes a gift of $10 million in 2011 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $1 million and has increased the top rate to 55% for 2013.

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amt	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (45% table) (at 55% top rate)	$7,890,800

(2) Less gift tax on ATGs using DOD rates		
Gift tax on $10 million (55% top rate)	5,140,800	
Less gift unified credit on $5M exclusion (55% table)	*- 2,390,800*	
		- 2,750,000
(3) Estate tax before unified credit		5,140,800
(4) Less unified credit on $1 million exclusion (55% top rate)		- 345,800
(5) Estate tax		4,795,000

Conclusion. The total gift tax and estate tax is $1,750,000 gift tax plus $4,795,000 estate tax, or $6,545,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been 7,545,000. Making the gift saved $1 million of combined tax. (The $10 million gift had a 35% tax rate apply to $5 million — the amount of the gift not covered by the $5 million exemption. If the gift is not made, that $5 million would have been taxed at 55%. The additional 20% of the $5 million amount accounts for the additional $1 million that would be paid if the gift were not made.)

Practical Planning Pointer: As a general rule, if a gift over the $5 million exemption amount is made and if the estate/gift tax rate is later increased, there will be savings equal to the difference in rates times the excess gift over the gift exemption amount. A change in the estate tax applicable exclusion amount alone does not result in a change of the combined estate and gift tax (if the Form 706 instructions approach is used for "Line 7"). Also, this example is designed so that there is no benefit of savings attributable to having gift taxes removed from the estate tax if the donor lives at least three years after the gift; this is on purpose to more readily compare the tax effects of making gifts attributable to changing rates and exclusion amounts. However, the advantage of having gift taxes removed from the estate is more pronounced as larger gift taxes are paid. Furthermore, this simple example neglects future appreciation and payments of income taxes. If the gift removed future appreciation or if the gift were made to a grantor trust and A paid income taxes on grantor trust income thus reducing her estate, the gift would have produced an even greater overall savings.

4. Tax Apportionment Impact. The added estate taxes attributable to the prior gifts can be substantial. How are the additional estate taxes attributable to adjusted taxable gifts apportioned among the recipients under the will and the donees of the gifts? Howard Zaritsky provides this summary:

> "There are several cases that have examined this issue, and they are split on whether state law should apportion the taxes against the donees, versus against the residuary (marital) share. In re Metzler, 579 N.Y.S.2d 288, 290 (App. Div. 1992) and In re Estate of Coven, 559 N.Y.S.2d 798, 799-800 (Sur. Ct. 1990) (taxes not apportioned to donees); In re Estate of Finke, 508 N.E.2d 158, 162 (Ohio 1987) (taxes not apportioned to donees); Shepter v. Johns Hopkins University, 637 A.2d 1223 (Md. Ct. App. 1994) (taxes apportioned to donee); Bunting v. Bunting, 760 A.2d 989 (Conn. App. Ct. 2000) (taxes apportioned to donee); Necaise v. Seay (In re Estate of Necaise), 915 So. 2d 449 (Miss. 2005) (taxes apportioned to donee).

> Virginia directly permits apportionment to donees of tax increases caused by adjusted taxable gifts. Va. Code § §64.1-160 (stating that the decedent's gross estate, for apportionment purposes, "includes any property or interest which is required to be included in the gross estate of the decedent under the estate tax law of the United States, increased by any 'adjusted taxable gifts' as defined in § 2001(b) of the Internal Revenue Code."). The state apportionment statutes of Florida and Maryland also address adjusted taxable gifts but state that the provisions for apportioning taxes to nonprobate property do not include adjusted taxable gifts. See Fla. Stat. § 733.817(1)(d) (nonprobate property subject to apportionment "does not include interests or amounts that are not included in the gross estate but are included in the amount upon which the applicable tax is computed, such as adjusted taxable gifts"); Md. Code Tax-General § 7-308 (the legislative history states that nonprobate assets subject to apportionment "specifically do not include an adjusted taxable gift of the decedent as defined in § 2001 of the Internal Revenue Code", effectively reversing Shepter, cited above).
>
> In states that have no express law, however, there is a question whether a will can even apportion estate taxes to people who are not beneficiaries of the estate. Therefore, I would recommend that, where large gifts are made in 2011 or 2012, and all or a major portion of the $5 million unified credit is used, the donor should both include an apportionment provision in his or her will, and have an agreement with the donee for the latter to bear the increased estate taxes."

What if the taxable gifts are so large that the remaining assets in the gross estate are not sufficient to pay all of the added estate tax? The entire probate estate would be applied to estate taxes (or other expenses that have priority over estate taxes), but there does not appear to be any way for the IRS to collect the remaining tax deficiency from the gift recipients except for gifts that have been made within three years of death. § 2035(c)(1)(C) (for purposes of estate tax liens the gross estate includes gifts made within three years of death). (If there is a state law apportionment statute that apportions estate taxes to donees of gifts or if there is an agreement of donees to reimburse the estate for added estate taxes, as addressed in the following paragraph, that obligation presumably would be an estate asset that the IRS could pursue for payment.)

One possible approach may be to have a net gift agreement with the donees of the gifts, so that they would agree to pay the estate tax attributable to the adjusted taxable gift inclusion in the event the exclusion amount is reduced in later years. Whether there would be any offset in determining the amount of net gift attributable to such agreement is not clear, because of the speculative nature of whether and by how much the estate exclusion might be reduced in future years. *See* McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). In McCord, the donees assumed all gift, GST and estate tax liability attributable to the transfer, specifically including potential estate tax liability under the gift tax gross-up rule of § 2035(b) if the donor were to die within three years. The Tax Court viewed that potential liability as too speculative to consider as an offset to the gift value. The Fifth Circuit reversed, viewing it as even less speculative than the "built-in gains tax" discount that has been allowed in recent years. The Fifth Circuit distinguished Armstrong Trust v. United States, 132 F. Supp.2d 421 (W.D. Va. 2001), which dealt with the donees' general transferee liability under § 6324(a)(2) for additional estate taxes under § 2035(b) if the donor died within three years of the gift. That involves much more uncertainty, because not only must the donor die within three years, but the estate must be depleted to the point that it cannot pay the additional estate tax before the donees are liable under the transferee liability rule.

However, if a reduction in the exclusion amount did occur such that the donees had to reimburse the estate for the additional estate tax, that reimbursement right would likely be an estate asset subject to inclusion in the gross estate.

If there are other bequests being made to the donees under the donor's will, the tax apportionment clause may effectively charge the estate tax against the donees, by treating the tax as an advancement against their bequests.

5. Summary of Planning Conclusions; Practical Planning Pointers.

a. How Much Can the Donor Afford to or Want to Give? While substantial additional gifts can be made without having to pay gift taxes, the initial question is how much can the donor afford to or want to give? Spouses collectively could give up to $10 million without having to pay gift taxes. Few couples can afford to give $10 million without potentially impacting their lifestyle in later years. Furthermore, the increased estate exemption may mean that the donor is not as concerned about estate taxes as in the past. However, TRA 2010 only lasts for two years and the estate exemption could be decreased in future years; alternatively, the estate exemption could be increased or the estate tax could be repealed in future years in which event the donor may have preferred to retain the gift assets.

These questions inevitably will involve issues of whether the donor can make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. One possible approach would be to make gifts to a lifetime credit shelter trust for the donor's spouse (or even trusts created by each of the spouses for each other with enough differences so they are not treated as "reciprocal" trusts for tax purposes). Alternatively, self-settled trusts may be considered in jurisdictions that allow discretionary distributions to the settlor without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). These issues are explored further in sections X.B and X.M of this outline.

b. Can Make Gifts of Full Additional Gift Exemption Amount. The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts without having to pay gift tax.

c. Can Make Gifts of Full Additional Gift Exemption Amount Even If Made Prior Gifts Exceeding Gift Exemption Amount. If a donor previously made taxable gifts exceeding $1 million prior to 2011, the donor can make additional gifts of exactly $4,000,000 that will be covered by the $5 million gift exemption in 2011. Even though the gift credit on up to $1 million was previously calculated using 45% (or higher rates), in the current year calculation the amount of credit previously used is calculated using current year (35% rates) rather than the amount of credit actually applied at the higher rates.

d. <u>Gift Does Not Remove Gift Assets From Base For Calculating Estate Tax</u>. The adjusted taxable gifts are added to the taxable estate in making the estate tax calculation, with an offset for gift taxes that would be payable on just the adjusted taxable gifts. The gifts in effect are just an "advance" on distributions from the estate (without gift tax as long as the gifts do not exceed the exclusion amount), but the gifts are included in the transfer tax base. If there are other assets in the taxable estate utilizing all of the estate exclusion amount, the amount of the additional estate tax attributable to the taxable gifts is the amount of the taxable gifts times the estate tax rate. If there are $5 million of taxable gifts and the estate tax rate is 35%, the added estate tax is $1,750,000; if the estate tax rate is 45% the added estate tax would be $2,250,000. The total estate tax is the same whether or not the gifts are made. However, there will be estate taxes attributable to assets that have been given away and that are not in the probate estate (or in the federal gross estate) at the donor's death. Because of this effect, it is still preferable, to the extent possible, to shift value that would otherwise be in the taxable estate without making taxable gifts (e.g., using strategies such as GRATs, sales to grantor trusts, fractionalization discounts, paying income taxes on grantor trusts, etc.).

Making gifts never increases the total aggregate taxes as opposed to just retaining the assets and paying estate tax on the full amount (unless the gift assets were to depreciate, in which event it would have been better not to have made the gift or unless gift taxes are paid at a higher rate than the later estate tax rate).

e. <u>Utilization of GST Exemption</u>. Making current gifts and allocating GST exemption to the gifts means that future increases in value of the trust will also be GST exempt without having to allocate additional GST exemption. Even if there is a "clawback" for estate tax purposes if the estate tax exemption is later reduced below $5 million, there would be no clawback of the use of the $5 million GST exemption.

f. <u>Use Exemptions Now in Case They Are Later Reduced</u>. TRA 2010 affords what may eventually be a window of opportunity to make gifts of $5 million without paying current gift tax and to allocate $5 million of GST exemption. Those exemption amounts could be reduced in the future.

g. <u>Gift Advantages and Disadvantages</u>. Even though the overall transfer tax is generally the same whether or not gifts are made, other factors can make gifts advantageous from a tax perspective, including removal of appreciation/income for gift assets from gross estate (generally resulting in an eventual tax savings equal to the appreciation/income removed times the estate tax rate), utilizing fractionalization discounts, and paying income taxes on income from grantor trusts that receive gifts. If GST exemption is allocated to the gift, these advantages also apply to increase the amount in the GST exempt trust compared to funding the GST exempt trust at the individual's death. Being able to make larger gifts without paying gift taxes increases these advantages.

In addition, if gift taxes are paid and the donor lives more than three years after making the gift, the gift tax amount is removed from the gross estate. Also, if the estate tax rate is later increased, there will be tax savings generally equal to the amount of the gift subject to payment of gift taxes times the amount of the percentage rate increase.

c Those are tax advantages. Of course, the biggest advantage may be the ability to shift assets to other persons so they can enjoy, consume or otherwise use the assets currently.

Gifts can be disadvantageous from an overall tax cost perspective if a) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or b) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

h. <u>Possible Recapture/Clawback of Tax Attributable to Excess Exemption If Estate Tax Exemption Is Later Reduced</u>. If the Form 706 instructions are followed, and the Line 7 gift tax offset amount is calculated using the applicable exclusion amount for the year of the gift, the estate will pay estate tax on all of the taxable gifts, including the excess of the exclusion utilized by gifts over the estate tax exclusion amount.

The issue, stated briefly, is this: If gifts are made under a gift exclusion amount that exceeds the estate exclusion amount, does the excess amount pass free of gift or estate taxes? The amount of the potential clawback is the excess exemption times the estate tax rate. For example if a $5 million gift is made and if the estate exemption is later reduced to $3.5 million and the estate tax rate is increased to 45% (the 2009 system), the clawback would be the excess $1.5 million times 45%, or $675,000.

Legislative staffers have indicated that this "clawback" effect, if the exclusion amount is reduced in the future, was not intended and that there will be no clawback effect. One possible IRS guidance or legislative approach would be to make clear that the Line 7 gift tax offset amount is determined by applying a gift credit based on the amount of the lower estate tax exemption. This would effectively remove from the transfer tax base the difference between $5 million (if the $5 million gift exemption is used) and the estate tax exemption amount. (An alternate legislative approach would be to change the estate calculation so that it mirrors the gift tax calculation approach—determine a tentative tax on taxable estate plus adjusted taxable gifts, subtract the tentative tax on just adjusted taxable gifts, and then subtract an estate tax unified credit that has been reduced by prior lifetime uses of the unified credit.)

If the residuary estate passes to different persons than the donees of the gifts, significant conflicts of interest may arise. The client may want to consider tax apportionment alternatives, as discussed in subparagraph 5.l below.

Clients should be aware of the possibility of the additional estate tax. But clients should also realize that the combined estate/gift tax would not be greater than if no gift were made in the first place. Even if the "clawback" applies, the estate will not pay more taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value or unless gift taxes are actually paid at higher rates than the estate tax rate). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death.

i. <u>Estate Tax Recapture With Marital/Charitable Estate Beneficiaries Results in Interrelated Calculation If Exemption Amount Decreases in the Future</u>. If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax hit.

If there are $5 million of taxable gifts and if the estate tax exemption is also $5 million, there is no additional estate tax due at the donor's death if the estate passes entirely to a spouse or charity. Under the same $5 million gift with full marital/charitable estate beneficiaries scenario, if the estate tax exemption is reduced to $3.5 million and the rate is increased to 45%, the estate tax will be $1,227,272.73 if the Line 7 gift offset is determined under the Form 706 instructions approach (see Example 2). If Line 7 is determined by using the date of death exemption amount to calculate the gift credit in determining the hypothetical gift tax offset, there is no estate tax in a full marital/charitable deduction estate. In effect, the estate tax recapture is totally offset by the estate tax unified credit (see Example 4).

j. <u>Recapture of Estate Tax If Portability Exclusion Is Utilized by Gifts</u>. This recapture/clawback issue can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exclusion" for making gifts. If the spouse later remarries and the subsequent spouse dies, with less exclusion, the spouse will not have as much deceased spousal unused exclusion for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes will be less than for gift tax purposes when the gifts were made. Alternatively, if the surviving spouse makes gifts to utilize the unused exclusion from the deceased spouse and if portability is not extended in future legislation, the estate exemption available to the surviving spouse would be lower than the gift exemption utilized in lifetime gifts, raising the same "Line 7" issue. If the "Line 7" issue is resolved in favor in a taxpayer-friendly manner by allowing a gift tax offset based on the amount of estate exemption, rather than the larger amount of gift exemption at the time of the gift, and if this same approach is applied to gifts utilizing the deceased spousal unused exclusion amount, there would be substantial benefits of making lifetime gifts to utilize the amount of additional exclusion acquired from each prior deceased spouse.

k. Effects of Paying Gift Tax If Rates Stay the Same or the Rates Later Increase. If gifts are made requiring the payment of gift tax, if the donor dies within three years of the gift (so that the gift tax is brought back into the estate), and if the estate tax rate is the same as the gift tax rate, there is no reduction in the combined gift and estate tax. (See Example 6.) The gift tax merely "prepays" the transfer tax, but the advantages of making gifts described in subparagraph 5.g above would apply. By using the rates in effect at the date of death to calculate the gift tax that would have been payable on the adjusted taxable gifts, the system grants an advantage to making gifts at a lower rate than the ultimate estate tax rate. The amount of savings is generally equal to the amount of gifts in excess of the gift exclusion amount times a percentage equal to the difference between the marginal estate tax rate and the marginal gift tax rate. (See Examples 7-8.)

l. Consider Apportionment of Estate Tax Recapture. There are estate tax implications of gifts. All adjusted taxable gifts are brought into the estate tax base, and the donor may wish to have the donees pay a portion of the federal estate tax to the extent the donees have received the benefit of using up some of the donor's lifetime gift/estate exclusion amount (although that is rarely done). Furthermore, if the estate exemption is reduced below the gift exemption used in lifetime gifts, the excess exemption used by gifts over the eventual estate exemption amount may be subject to estate tax, depending on IRS interpretation of the estate tax calculation procedure.

The client could consider the taxes attributable to gifts in the tax allocation clause. Absent a state law providing for allocation of estate taxes to donees of gifts (Virginia may be the only state that does that), the testator may not be able to allocate taxes to a donee. However, if other assets are passing under the will to the donees of the gifts, the added estate taxes could be charged as an advancement against the bequest to the donees. Alternatively, a net gift type of arrangement could be used, with the donees agreeing to pay the added estate tax if there is clawback. These issues are explored further in Section IV.E.4 of this outline.

F. GST Tax — Overview of Changes. The general GST effects of the amendments in TRA 2010 are summarized below. A more detailed discussion of changes and planning implications is in section VIII of this outline.

1. GST Applicable Rate in 2010 is Zero. For all of 2010, the GST tax "applicable rate determined under section 2641(a)... is zero" for all generation-skipping transfers made in 2010. [TRA 2010 § 302(c).] This change in nomenclature makes clear that generation-skipping transfers may be made in further trust. This issue is discussed in sections VIII.B.1 and VIII.C.2 of this outline below.

2. GST Tax Applies After 2010. TRA § 301(a) in effect repeals § 2664 added by EGTRRA, which section provided that Chapter 13 would not apply to generation-skipping transfers after 2009. This change is made effective for transfers made after 2009. However, as discussed immediately above, TRA § 302(c) provides the

special rule resulting in a zero GST tax rate for generation-skipping transfers in 2010.

3. GST Exemption of $5.0 Million for 2010. The GST exemption equals the estate tax "applicable exclusion amount under section 2010(c) for such calendar year." I.R.C. § 2631(c). Because the estate tax applicable exclusion amount is changed to $5.0 million for 2010 [TRA § 302(a)(1)], the GST exemption is $5.0 million for 2010. This is important, because it clarifies that there is up to $5.0 million of GST exemption that can be allocated on a timely basis to transfers to trusts in 2010. (See section VIII.H of this outline for a more detailed discussion of the applicability of the $5 million GST exemption in 2010 and planning implications in connection with that exemption.)

4. GST Exemption in Future Years. The GST exemption for 2011 will also be $5.0 million. The $5.0 million amount is indexed from 2010, beginning in 2012. (The GST exemption amount is the same as the estate tax applicable exclusion amount, and the estate tax exclusion amount is indexed from 2010 beginning in 2012. TRA 2010 § 302(a)(1).) If the GST exemption amount is not changed by future legislation, after the TRA sunsets following 2012, the GST exemption will be $1.0 million, indexed from 1997.

5. GST Tax Rate After 2010. The "applicable rate" for determining the GST tax is the maximum estate tax rate times the inclusion ratio of the trust. I.R.C. § 2641(a). Because the maximum estate tax rate is 35%, the GST rate is also 35% (except that the rate is zero for generation-skipping transfers in 2010).

G. Section 2511(c) Deleted. Section 2511(c), added by EGTRRA, provides that transfers to non-grantor trusts are treated as gifts. That section, which has raised considerable confusion, fortunately is deleted.

H. Sunset Provision of EGTRRA. Planners have been very concerned about the unintended possible effects of the sunset provision in EGTRRA following 2010. Section 901 of EGTRRA says that the Code will be interpreted as if the provisions of EGTRRA had never been enacted with respect to estates of decedents dying after, gift made after, and generation-skipping transfers after 2010. However, there are many taxpayer favorable provisions in EGTRRA that might conceivably expire under EGTRRA § 901.

Most of these uncertainties are resolved for 2011 and 2012. TRA 2010 § 301(a) says that each Code provision amended by subtitles A or E of title V of EGTRRA "is amended to read as such provision would read if such subtitle had never been enacted." These subtitles only address the estate and GST tax repeal following 2009 and carryover basis. See section IV.B.1-2 of this outline.

All of the other provisions of EGTRRA would be given effect for 2011 and 2012, including the reduction of estate and gift tax rates (subtitle B), increase of unified credit exemption equivalent and GST exemption and setting the gift exemption at $1.0 million (except as further amended in TRA 2010) (subtitle C), replacing the state death tax credit with a state tax deduction (subtitle D), expansion of conservation easement rules for estate tax purposes (subtitle F), modifications of GST provisions, including automatic exemption allocations, retroactive allocations, qualified severances, modification of certain valuation rules, and the GST "9100 relief provisions"(subtitle G), and the relaxation of the requirements for deferred estate tax payments under § 6166 (subtitle H). This eliminates the concern about the effect of the sunset rule in EGTRRA on all of those other provisions for 2011 and 2012.

However, TRA 2010 provides for temporary tax relief (generally for just two years), and TRA 2010 § 101(a) states that Section 901 of EGTRRA is applied by replacing "December 31, 2010" with "December 31, 2012." This means that the sunset rule of EGTRRA is now delayed for two years, until following 2012. All of the uncertainties that we have had previously about the EGTRRA sunset provision remain, but are "punted forward" for two years to 2013.

V. Effective Dates

There are a variety of effective dates for the various provisions.

A. Applicable for 2010. Interestingly, some of the changes are effective retroactively for all of 2010, mainly the re-enactment of the estate tax with a $5 million exclusion amount and 35% rate (but subject to the election to have carryover basis apply instead of the estate tax), technical computational details for calculating estate and gift taxes, increasing the GST exemption to $5.0 million for 2010 with a zero rate for any generation-skipping transfers, and clarifying that direct skip transfers in trust in 2010 will not result in the application of GST taxes when distributions are later made to the beneficiaries (at least to the oldest generation of direct skip beneficiaries when the trust is created).

B. Applicable Beginning in 2011. Other changes are effective beginning in 2011. These include unification of the gift and estate exclusion amounts (by increasing the gift exemption to $5 million), and the portability of the unused estate tax exclusion amount.

C. Changes Effective For Decedents Dying Before and Generation-Skipping Transfers Before Date of Enactment. Several changes apply only to estates of decedents dying in 2010 prior to and generation-skipping transfers made in 2010 prior to the *date of enactment* (before December 17, 2010) — the provision allowing a delay in filing and paying tax until no earlier than nine months after the date of enactment. Similarly, the extended period for making disclaimers from transfers arising by the death of a decedent applies only to decedents who die in 2010 before the date of enactment.

D. No Changes Based on Date of Introduction of Bill. A very key change from the Baucus bill is that the changes to the gift tax in the Baucus bill (imposing a 45% rate) and reinstituting the GST tax on generation-skipping transfers applied to transfers after the *date of introduction* of that bill (December 2, 2010). That would have removed many opportunities for year-end transfer planning in December. Fortunately, that issue did not arise under TRA 2010.

VI. What's Left Out?

Several provisions in the Baucus bill, including some provisions that have appeared in various bills in the last several years, are not included in TRA 2010. The following provisions in the Baucus bill and several other proposals that have received some attention over the last several years were not included.

A. Farmland. Estate taxes on farmland could have been be deferred under the Baucus bill until the farmland was sold or transferred outside the family or ceased to be used for farming. The executor would have had to make a special election to exclude the farmland from the gross estate, attach a qualified appraisal of the farmland to the estate tax return, and file an agreement that provided for a never-ending estate tax recapture provision when the farmland was later sold, transferred outside the family, ceased to be used as farmland, or was encumbered by a nonrecourse indebtedness secured in whole or in part by the farmland. (There were complex provisions regarding the amount of the recapture tax payable by intervening generations, taking into account subsequent appreciation in the farmland, and requiring that "qualified heirs" file annual information returns describing whether any of the recapture triggering events had occurred.)

B. Special Use Valuation. The Baucus bill would have increased the special use valuation adjustment amount from $750,000 (indexed to $1.0 million in 2010) under current law to $3.5 million (indexed from 2009 beginning in 2011). Therefore, up to a $3.5 million (indexed) reduction in value would have been allowed for farm or business property that satisfied the special use valuation requirements. This provision was effective for estates of decedents dying after and gifts made after 2009 (and therefore applied for 2010 decedents).

C. GRAT 10-Year Minimum Term. The Baucus bill included the proposal in the President's Budget Proposal for the last two years of a GRAT 10-year minimum term. Under the proposal, grantor retained annuity trusts must have a 10-year minimum term, the annuity amount cannot decrease in any year, and the remainder interest must have a value greater than zero determined at the time of the transfer to the trust. The Baucus bill would have applied this minimum 10-year GRAT provision to *transfers after the date of enactment*.

At this point, there has been no indication whether the deletion of this provision reflects Congressional policy not to impose a 10-year minimum term on GRATs, or whether the Congressional writers are just saving this revenue raising provision for subsequent legislation. The discussions surrounding the passage of TRA 2010 did not include any element of needing revenue offsets to "pay for" the changes. Indeed, the entire package is viewed as an economy and job creation stimulus. At some point in the future, the revenue impact of legislation will again matter, and revenue raisers, such as this one, may re-emerge.

D. Consistency of Basis. The Baucus bill also included the consistency of basis proposal in the President's Budget Proposal for the last two years. The basis of property in the hands of heirs would be the same as its value as finally determined for estate tax purposes, and the basis of property in the hands of donees for purposes of determining loss would be limited by the fair market value (under § 1015) as finally determined for gift tax purposes. (This provision in the Baucus bill was retroactive, applying to "transfers for which returns are filed after the date of enactment.")

As with GRATs, the deletion of this provision may just mean that it is being saved for future legislation when revenue offsets will be needed because this is a revenue raising provision.

E. Gift Tax Separate Years for 2010 Gifts Before and After Date of Introduction. The Baucus bill would have resulted in different gift tax rates for gifts made in 2010 before and after December 2, 2010. A provision in the Baucus bill addressing the mechanics of reporting those gifts was not needed in TRA 2010.

F. Section 2704. TRA 2010 (as well as the Baucus bill) does not contain any provisions addressing § 2704 (as requested in the President's Budget Proposal the last two years). (This provision has not been included in *any* statutory proposal.)

G. State Death Tax Deduction. The extension of the estate tax provisions of EGTRRA means that the state death tax credit did not get reinstituted in January 2011 (which would have caused the re-emergence of state death taxes in many states that just have a "federal credit pick-up system" and that therefore have no state estate taxes if there is not a federal death tax credit). Furthermore, some have speculated that as a revenue raiser, Congress may at some point delete the deduction for state death taxes that now exists under § 2058. That was not done in TRA 2010.

VII. Effects on Year-End Planning

While 2010 year-end planning obviously is no longer possible, 2010 year-end planning concepts and issues are addressed because planners will be dealing with the effects of 2010 year-end transactions that were implemented to take advantage of special opportunities in the last few weeks of 2010 after TRA 2010 was passed.

A. Lack of Date of Introduction Effective Date Opened the Door to Year-End Planning. The Baucus bill would have had a major impact on year-end planning. Many individuals had been waiting until the end of 2010 to make 35% gifts, to make direct skip gifts, and to make distributions to skip persons from trusts that are non-exempt for GST tax purposes, in order to make sure that the 45% gift tax rate and GST tax were not applied retroactively. There had been no prior public discussion of making the gift and GST tax provisions effective on the date of INTRODUCTION of a bill, and the inclusion of the date of introduction effective date in the Baucus bill was quite surprising. Fortunately, TRA 2010 has no such early effective date, and year-end planning opportunities continued throughout the end of 2010.

The following is a general framework for year-end transfer planning strategies that existed in December 2010. The passage of TRA 2010 provided a substantial degree of certainty regarding various effects of year-end planning transfers for 2010.

B. No Gift Tax Advantage of Making Gifts in 2010 Unless Donor Was Willing to Pay Gift Tax. There was generally no advantage to making gifts in December 2010 rather than in 2011 if the donor did not want to pay gift tax. The rate would be the same (35%) if there is gift tax, and there is more gift exemption in 2011 to cover gift transfers in case the IRS argues for higher gift values on audit. (One exception to this general rule is deathbed planning for estates that would not owe federal estate taxes under the $5.0 million estate exemption in 2010 under TRA 2010, but would owe significant state estate taxes. In many states, pre-death gifts (even deathbed gifts) are excluded from the estate for state estate tax purposes.)

Furthermore, there could be long term benefits of making gifts in December 2010 rather than 2011 if (1) the donor had been willing to pay current gift taxes, and (2) if future legislation were to decrease the exemptions and increase the rates from the levels set in TRA 2010. There are several contributing factors to tax savings by making gifts in 2010 in order to pay larger current gift taxes than if the gift is made in January. (1) Gift taxes are removed from the gross estate if the donor lives at least three years, resulting in some of the estate being taxed on a "tax-exclusive" basis. Making the gift in December 2010 involved paying greater taxes, so this potential advantage would be larger. (2) Paying transfer taxes on a portion of the estate at rates below the ultimate estate tax rate can save overall combined transfer taxes. This would be important if the estate tax rates were to be increased in the future. Each of these factors is addressed below.

1. Taxing Portion of Estate on Tax-Exclusive Basis if Donor Lives Three Years (By Removing Gift Tax From Taxable Base). If a donor lives three years after making a gift, any gift taxes paid are removed from the gross estate. This can result in a significant overall tax savings. If a client was willing to entertain that planning strategy, making the gift in December 2010, when there was only a $1 million gift exemption rather than the $5 million gift exemption that applies in 2011, would result in a larger gift tax payment, which in turn results in a larger amount being removed from the gross estate if the donor lives at least three years after making the gift. Detailed calculations would be required to determine the overall effects of paying additional gift taxes (taking into account the assumed appreciation rate of the transferred assets, the time value of the tax payments, and the assumed future level of estate tax exemption amounts and rates).

2. Taxing Portion of Estate at Lower Rates In Case Estate Tax Rates Rise in the Future. If gifts were made in December 2010 rather than 2011, savings would result from paying gift taxes on a portion of the estate at a 35% rate if later the estate tax rate were to be increased (for example, to 45% or 55%). (See the examples in section IV.E.3 of this outline for a general discussion of the impact of gifts on later estate tax determinations.) The following examples compare making gifts in December 2010 and in 2011, assuming that the estate tax rate at the date of death increases to 45%. The examples isolate the effect of the changing rates by not including the advantage of paying some of the tax on a tax-exclusive basis by removing the gift tax from the estate if the donor lives three years after making the gift. That factor would further increase the advantage of paying larger gift tax by making the gift in December 2010 (with a $1 million exemption) rather than in 2011 (with a $5 million exemption).

Example 1 (Gift of $10 million in January 2011; Death in 2013 With Exclusion of $3.5 Million and Top Rate of 45%). Assume A made a gift of $10 million in January 2011 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $3.5 million and has increased the top rate to 45% for 2013. Assume the "Line 7" gift tax offset in the estate tax calculation is determined using the approach in the Form 706 instructions. (The "Line 7" issue is discussed in section IV.E.2-3 of this outline.)

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $5 million exclusion amt	- 1,730,800
Gift tax payable for 2011 gift	1,750,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (at 45% top rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (45% top rate)	4,380,800	
Less gift unified credit on $5M exemption (using 45% rate)	- 2,130,800	

	- 2,250,000
(3) Estate tax before unified credit	4,380,800
(4) Less unified credit on $3.5 million exclusion (using 45% top rate)	- 1,730,800
(5) Estate tax	2,650,000

Example 2 (Gift of $10 million in December 2010; Death in 2013 With Exclusion of $3.5 Million and Top Rate of 45%). Assume A made a gift of $10 million in December 2010 and dies in 2013 with a taxable estate of $5 million (including the gift tax paid, which is added to the gross estate because A did not live three years after making the gift). Assume that Congress has changed the applicable exclusion amount back to $3.5 million and has increased the top rate to 45% for 2013. Assume the "Line 7" issue is resolved the same as in Example 1, above.

Gift Calculation

Gift tax (before credit) on $10 million	$3,480,800
Less unified credit on $1 million exclusion amt	- 330,800
Gift tax payable for 2011 gift	3,150,000

Estate Tax Calculation

(1) Tentative tax on TE (incl Gift Tax) + ATG ($15 million) (at 45% top rate)		$6,630,800
(2) Less gift tax on ATGs using date of death rates		
Gift tax on $10 million (45% top rate)	4,380,800	
Less gift unified credit on $1M exemption (45% rate)	- 345,800	
		- 4,035,000
(3) Estate tax before unified credit		2,595,800
(4) Less unified credit on $3.5 million exclusion (using 45% top rate)		- 1,455,800
(5) Estate tax		1,140,000

Observations Regarding Example 2. The total gift tax and estate tax is $3,150,000 gift tax plus $1,140,000 estate tax, or $4,290,000. If the gift had not been made, the estate tax on a $15 million taxable estate would have been 5,175,000. Making the gift saved $885,000 of combined tax. The $10 million gift had a 35% tax rate apply to $9 million — the amount of the gift not covered by the $1 million exemption. If the gift were not made, that $9 million would have been taxed at 45%. The additional 10% of the $9 million amount would represent $900,000 of savings. This is offset by $15,000 of reduced savings because the gift tax credit on the $1 million of gift exemption was only in the 39% bracket. To get to the 45% bracket of credit, there would be an additional 2% of $250,000 (the $1,000,000 to 1,250,000 bracket) and 4% of 250,000 (the $1,350,000 to 1,500,000 bracket), or $15,000.)

Comparison of Examples 1 and 2.

January 2011 Gift, combined gift and estate tax: $1,750,000 + 2,650,000 = $4,400,000

Dec. 2010 Gift, combined gift and estate tax: $3,150,000 + 1140,000 = $4,290,000

Savings by making gift in 2010 rather than 2011: $ 110,000

Observe, if the donor had lived for three years after making the gift, so that the gift tax was excluded from the gross estate, resulting in paying transfer tax on a tax-exclusive basis on $9 million rather than just $5 million of the estate, there would have been even greater savings by making the gift in December rather than in January.

Practical Planning Pointer: If a donor was willing and able to pay current gift taxes, making a large gift in December 2010 rather than in 2011 could result in significant overall tax savings attributable to (1) paying a portion of the transfer tax on a tax-exclusive basis if the donor lives three years after making the gift, and (2) paying a portion of the transfer tax at a lower rate if the estate tax rate increases above 35% by the time of the donor's death. These savings would have to be offset by the lost time value of the gift tax payment as compared to paying estate tax at a later time (but the growth attributable to the retained gift tax amount would have been subject to estate tax).

C. Significant GST Opportunities. The major year-end planning opportunities relate to GST planning. Opportunities to take advantage of the GST tax not applying to generation-skipping transfers in 2010 are significant. The GST planning opportunities included (1) direct skip gifts for grandchildren (or even for great-grandchildren), (2) making distributions from non-exempt trusts to remote beneficiaries (skip person beneficiaries) without the imposition of a GST tax, or (3) terminating non-exempt trusts in 2010 and distributing assets to younger generation beneficiaries without the imposition of a GST tax. Furthermore, TRA 2010 makes clear that generation-skipping transfers can be made in trust without risking having GST tax apply to later transfers to the oldest generation level skip person beneficiaries of the trust when the transfer was made in 2010.

This opportunity could also be applied to non-married partners where one partner was more than 37.5 years older than the younger partner; transfers could have been made in 2010 to the younger partner without the imposition of the GST tax. (The GST opportunities are discussed in more detail in section VIII of this outline.)

D. Retroactive Legislation Taxing Gifts and GST Transfers in 2010 is Extremely Remote. It seems extremely unlikely that the 2011 Congress will retroactively change the estate, gift and GST tax rules back into 2010, particularly changes that would adversely impact gifts and generation-skipping transfers made in 2010. The fact that Republicans control the House and have picked up more seats in the Senate in 2011 make the likelihood of such possible retroactive legislation, effective back into 2010, so remote as to be nonexistent.

VIII. GST Planning Issues

A. Sunset Rule Uncertainties. The sunset rule changes, discussed above in section IV.H of this outline, remove many of the uncertainties about the GST tax for 2010 and about whether and how the GST relief provisions in EGTRRA (increased GST exemptions, automatic allocation, qualified severances, "9100 relief" for late allocations, etc.) would still be given effect after 2010. Unfortunately, the relief under TRA 2010 only lasts for two years, and all the uncertainty will arise again following 2012. However, TRA 2010 shows how the EGTRRA adverse effects can easily be solved by a legislative change, and making that change is not controversial at all. The sunset as to those favorable provisions will likely be further extended following 2012, and the various estate, gift and GST changes in EGTRRA (other than the repeal of the estate tax with carryover basis and the repeal of GST tax) also will likely be extended permanently. But with Congress, nothing can be certain.

B. GST Applicable Rate in 2010 is Zero. Chapter 13 applies in 2010 [TRA § 301(a)], but the GST tax "applicable rate determined under section 2641(a)... is zero" for all generation-skipping transfers made in 2010. [TRA 2010 § 302(c).]

1. Impact on Transfers in Trust. The change in nomenclature is particularly important because of its impact on direct skip gifts *in trust* for grandchildren (or more remote beneficiaries). This change clarifies that "direct skip" gifts for grandchildren *to trusts* that were made in 2010 will not result in having the GST tax apply when distributions are made from the trust to the grandchild in later years. This provision replaces § 2664 as added in EGTRRA, which section says that Chapter 13 "does not apply to generation-skipping transfers after December 31, 2009." While § 2664 resulted in a zero GST tax for direct skip gifts in 2010, saying that all of Chapter 13 does not apply raises the possibility that direct skip gifts in trusts may be subject to later GST taxation upon distribution to the beneficiary because the "move-down rule" in § 2653(a), which is in Chapter 13, would not apply. Under the new nomenclature, Chapter 13 (including the move-down rule as well as the rule in § 2642(c) saying that annual exclusion gifts to single-beneficiary vested trusts have an inclusion ratio of zero) does apply to generation-skipping transfers in 2010 (so the potential uncertainty about direct skip gifts to trusts is resolved).

   The same issue applies regarding a taxable distribution or taxable termination in 2010 that results in the assets passing to another trust. The move-down rule will apply in that situation as well, because it applies whenever there is a generation-skipping transfer (even though the rate on the generation-skipping transfer in 2010 is zero). I.R.C. § 2653(a).

2. Inclusion Ratio Is Not Automatically Zero for Generation-Skipping Transfers in 2010. Under § 2641(a), the applicable rate is the "maximum Federal estate tax rate" times "the inclusion ratio with respect to the transfer." The statutory language of TRA 2010 § 302(c), that the "applicable rate determined under section 2641(a)" is zero, does not make totally clear whether the "maximum Federal estate tax rate" is deemed to be zero or whether "the inclusion ratio" is zero. The argument could be made that if the result of the multiplication of the maximum estate tax rate times the inclusion ratio is zero, and if the maximum estate tax rate is set by statute, the inclusion ratio must, by basic mathematical principles, be zero. If the inclusion rate is zero for any generation-skipping transfers made in 2010, direct skip gifts (which would be "generation-skipping transfers") would arguably result in a trust with an inclusion ratio of zero for generations to come. However, nothing in the statutory language suggests that is the intended result. Apparently the intent is just to provide that there is no GST tax in 2010 by saying that the applicable rate is zero, without a mathematical exercise of how that is achieved under the statutory formula. The more likely interpretation is that there is no GST tax on generation-skipping transfers in 2010, but transfers to trusts in 2010 do not automatically result in a zero inclusion ratio for the trust. GST exemption would have to be allocated to the transfer to result in a zero inclusion ratio. The Joint Committee on Taxation Technical Explanation agrees that the inclusion ratio will not be zero, but that the amendment means that the highest estate tax rate that is used in the formula is zero in 2010:

> "…the generation skipping transfer tax rate for transfers made during 2010 is zero percent. The generation skipping transfer tax rate for transfers made after 2010 is equal to the highest estate and gift tax rate in effect for such year (35 percent for 2011 and 2012)." Joint Committee on Taxation Technical Explanation at 50.

In any event, the statute would have been clearer if it had stated that for purposes of § 2641(a), the "maximum Federal estate tax rate" would be deemed to be zero for generation-skipping transfers in 2010.

C. Direct Skip Gifts in Trust. Under TRA 2010, direct skip gifts made to trusts in 2010 do not risk having the GST tax apply when the trust later makes a distribution to a grandchild-beneficiary. Taking advantage of this opportunity required making a transfer that for sure was a direct skip.

1. Outright or Custodianship Gifts. A transfer directly to or to a custodianship for a grandchild (or more remote beneficiary) will clearly be a direct skip.

2. Gifts in Trust. For gifts in trust, the definitional provisions in the GST rules are important.

a. Move-Down Rule. The move-down rule of § 2653 applies if there is a generation-skipping transfer of property (a direct skip, taxable distribution or taxable termination, § 2611(a)) and the property is held in trust. The effect is that for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to one generation above the highest generation of any person who has an "interest" in the trust immediately after the transfer. (If a grandchild has an interest in the trust, the transferor assignment level will be moved down to the child-level so that a subsequent distribution to a grandchild would not be a distribution to someone two or more generations below the transferor that would generate a GST tax.)

b. Skip Person Definition. The key is that for the move-down rule to apply, there must be a distribution to a skip person (whether it is a direct skip, taxable distribution or taxable termination). Skip persons are defined in § 2613. A trust is a skip person if (1) all "interests" in the trust are held by skip persons, or (2) if no person holds an "interest" in the trust and at no time may a distribution (including distributions on termination) be made to a non-skip person. I.R.C. § 2613(a)(2). As to item (2), the regulations add that if no one holds an immediate interest in the trust, for purposes of determining whether any distribution could be made to a non-skip person, a possible distribution that has a probability that is so remote as to be negligible (applying actuarial standards showing there is less than a 5% probability) is disregarded. Treas. Reg. § 26.2612-1(d)(2).

c. Interest Definition. An "interest" in a trust is defined in § 2652(c). A person holds an interest if, at the time the determination is made, the person (1) has a right (other than a future right) to receive income or corpus from the trust, or (2) is a permissible current recipient of income or corpus. (There are other special rules if the trust is a charitable trust.) I.R.C. § 2652(c)(1). However, an interest that is used primarily to postpone or avoid any GST tax is disregarded. I.R.C. § 2652(c)(2). Also, the fact that a distribution may satisfy another person's support obligation is disregarded if such use is discretionary or is pursuant to a UGMA or UTMA transfer. I.R.C. § 2652(c)(3).

d. Application of Definitions to Trusts. Under these definitions, a trust will be a skip person (and therefore, result in application of the move-down rule) if a second generation below the transferor or more remote beneficiary has a right to receive current distributions or is a permissible current recipient of distributions and if there are no interests held by non-skip persons. If that is the case, it does not matter that non-skip persons may be contingent remaindermen or future beneficiaries. (The possibility that non-skip persons may receive benefits in the future applies under the statute and regulations only if there are no persons that hold interests in the trust when it is created (for example if no distributions can be made to anyone for a period of years).)

e. "Generation Jumping." If the distribution is made to a trust for great grandchildren only, the transferor will be moved down to the grandchild level, so that future distributions to the great grandchildren will not be generation-skipping transfers. Some planners have termed this "generation jumping.""

f. Addition of Upper Generation Beneficiaries at a Later Time. Some planners suggest that some independent party (an independent trust, a trust protector, or anyone other than the donor) could provide that upper level generations could later be added as beneficiaries without causing the trust to lose its status as a skip person trust (which is necessary for the move-down rule to apply). The older generation beneficiaries could only be added at a later time — long enough to provide comfort that such persons could not be viewed as having an interest in the trust currently. (Some planners, for example, suggest waiting five years before upper generation beneficiaries are added.) This would help to counter any argument that the non-skip person should be treated as an intended current beneficiary by implication or under some kind of application of a step transaction theory.

Another possible IRS argument is that nominally named beneficiaries can be ignored under § 2652(c)(2) if the interest is used primarily to postpone or avoid any GST tax. If the grandchild's interest in the trust at the outset is ignored, the trust would have no beneficiaries with current interests, and § 2613(a)(2) says that future contingent beneficiaries are then considered in determining whether the trust is a skip person (but the interest of any person to whom the likelihood of a distribution is so remote as to be negligible [applying actuarial standards showing there is less than a 5% probability] is disregarded, Reg. § 26.2612-1(d)(2)). The IRS may view the children as having contingent future interests, thus causing the trust not to be a skip person at the outset, which would mean that the move-down rule would not apply, so subsequent distributions to grandchildren or more remote beneficiaries would be subject to the GST tax. There is not much guidance on how the nominal interest test is applied. In Letter Ruling

9109032 the IRS applied the statute to disregard temporary absence of an interest (for one year).

Some planners even suggest that the trust agreement could provide that older generation beneficiaries would automatically become discretionary beneficiaries after a stated period of time — such as five years.) However, other planners prefer a more conservative approach of not adding upper level beneficiaries at a later time.

g. No Current Grandchildren. If an individual has no current grandchildren but wanted to take advantage of the unique opportunity in 2010 to make transfers to direct skip trusts, perhaps the individual could have made transfers to a trust for grandnieces or grandnephews (if the individual had any), or other beneficiaries who are in a generation assignment two generations below the individual. The trust could provide that any future grandchildren would also be potential beneficiaries. However, to avoid the rule disregarding nominal interests, the trust agreement might have provided certain mandatory distributions to the existing grandnieces and grandnephews (or other designated second generation individuals) to avoid an argument that the trust was really just created for the benefit of non-existent grandchildren at the time it was created.

D. Move-Down of Transferor vs. Allocation of GST Exemption to Trust. If the move-down rule applies, the transferor generation assignment is merely moved to one generation above the oldest generation beneficiary of the trust, but the trust does not become fully exempt. For example, if a direct skip is made to a trust for a grandchild, the move-down rule treats the trust as if the transferor were in the child-generation, so that a future distribution to a grandchild (one generation down from the transferor) is not subject to the GST tax. However, a distribution to a more remote beneficiary (whether on termination of the trust or during the term of the trust) would generate a GST tax if no GST exemption has been allocated to the transfer.

On the other hand, if GST exemption is allocated to the transfer, so that the trust results in having a zero inclusion ratio, all future distributions from the trust to any generation levels of beneficiaries would be GST exempt.

Donors in 2010 had to decide whether (a) to make direct skip transfers in trust (which could be unlimited in amount) and forego using up any GST exemption to allocate to the transfer, or (b) to make transfers to GST exempt trusts, which could last for as many generations as would be allowed under the applicable rule against perpetuities, but which would be limited in amounts that be covered by the $5.0 million of GST exemption available in 2010.

E. Taxable Distributions or Taxable Terminations in 2010 Could Be Made Without GST Tax. The Baucus bill would have eliminated the ability to make GST tax-free taxable distributions or taxable terminations from trusts after December 2, 2010. Under TRA 2010, distribution opportunities from non-exempt trusts remain before the end of 2010. As with direct skips, if taxable distributions or taxable terminations result in the assets being held in further trust, the move-down rule applies. Before TRA 2010, it was not clear that taxable distributions could be made in further trust for trust beneficiaries (for example under a decanting statute or pursuant to discretion granted to the trustee under the trust agreement) without the possible imposition of a GST tax when later distributions were made to those beneficiaries.

F. Timing of Actual Distribution. The direct skip or taxable distribution had to occur *during 2010* to take advantage of the special opportunity available only during 2010 to have a GST tax rate of zero. There is nothing in the statute or regulations about specifically when title must pass under state law to determine when the direct skip, taxable distribution or taxable termination occurs. However, transfers that are mandated under the instrument should be treated as occurring on that date, even if the trustee does not make the physical transfer until a later date. (Otherwise, planners could manipulate the timing of the payment of GST taxes by merely delaying mandated distributions until a later year or years.) Similarly, a specific bequest under a will of a person who dies in 2010, that is vested and is not subject to the discretion of an executor as to the amount of the bequest, should be treated as occurring as of the date of death, even if the executor delays for years in making the physical distribution of assets satisfying the bequest. However, in light of the very special treatment of generation-skipping transfers in 2010, some planners attempted to make physical distribution of the assets, if at all possible, in 2010 in order to avoid any possible argument that the direct skip did not occur in 2010.

Practical Planning Pointer: An important planning implication of the timing issue is that disclaimers in 2011 from 2010 estates that result in assets passing to grandchildren (or younger generation beneficiaries) should be treated as 2010 direct skips resulting in a zero GST tax.

Discretionary distributions, on the other hand, result in generation-skipping transfers occurring on the actual distribution date pursuant to the exercise of discretion.

A case that involved an agreement with the IRS regarding the timing of generation-skipping transfers, albeit in an unusual fact situation, is Robertson v. U.S., 97 A.F.T.R.2d 589 (N.D. Tex. 2006). That case involved a charitable lead annuity trust that passed to grandchildren at the end of the trust term. The trustee had total discretion as to what charities would receive distributions during the term of the trust, so no person held an "interest" in the trust during its stated term. The conclusion was that there was no taxable termination at the end of the stated term, because that required the termination "of an interest in property" and no person held an interest in the trust prior to the stated termination date. Therefore distributions from the trust were treated as taxable distributions. The IRS did not contest the position of the taxpayer that the taxable distributions occurred in the year following the stated termination date of the trust, and the parties stipulated that the date of actual distribution was the appropriate date for valuation of the GST amount and for applying the GST tax rate (the rate decreased in the year following the stated termination date of the CLAT). That stipulation seems to conflict with the generally accepted approach of treating transfers that are mandated in an instrument as occurring on the mandated vesting date.

G. Testamentary Transfers From 2010 Decedents. The possibility that 2010 testamentary transfers are forever exempt from the GST tax was eliminated under TRA 2010 because the estate tax would apply (or be deemed to apply) to 2010 decedents so the decedent would be a "transferor" under the GST definitions. TRA 2010 § 301(c)(last sentence). (Under the provisions of EGTRRA applicable in 2010, there was an argument that testamentary trusts created by 2010 decedents were exempt from the GST tax, because under the GST rules the "transferor" is the last person subject to a transfer tax, and decedents who die in 2010 were not subject to estate tax [before TRA 2010]. The definitions of skip persons and non-skip persons are tied to the definition of "transferors." Non-skip persons are everyone other than skip persons (§ 2613(b)), and if skip persons cannot be identified because of the lack of a transferor, perhaps the whole world would constitute non-skip persons. If so, future transfers from the trust arguably would not be subject to GST tax.) TRA 2010 clearly removes that argument that had existed under EGTRRA.

H. 2010 GST Exemption of $5.0 Million. Under TRA 2010, there is 2010 GST exemption of $5.0 million (because the estate tax exemption in 2010 is $5.0 million and the GST exemption is the same as the estate exemption, § 2631(c)). (Without this legislation, it appears that there was no GST exemption for 2010, because the GST exemption equals the estate tax applicable credit amount and in § 2010(c), as amended by EGTRRA, the table for the applicable credit amount ends with 2009; there is nothing listed for 2010 or beyond. While there was no GST exemption in 2010 under EGTRRA, in 2011 there may have been a GST exemption equal to $1.0 million, indexed for inflation since 1997, depending on how the "had never been enacted" rule was applied. See I.R.C. § 2631(c) (prior to amendment by the 2001 Act). That number was $1.34 million for 2010.

The literal wording of TRA § 301(a) leaves some ambiguity as to whether the $5 million GST exemption applies to estates that make the carryover basis election. The ambiguity arises because if the carryover basis election is made under TRA § 301(c), the "repeal of the repeal of the estate tax" under TRA § 301(a) does not apply, so literally chapter 11 does not apply to the estate. If chapter 11 does not apply, the amendment in TRA 2010 of § 2010 providing a $5.0 million applicable exclusion amount is irrelevant because § 2010 is in chapter 11 and it does not apply. An argument to the contrary is that the election for the estate tax not to apply under TRA § 301(c) applies only "with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code)," and therefore does not apply for GST purposes. Therefore, the reference in I.R.C. § 2631(c) to the "applicable exclusion amount under section 2010(c)" may continue to refer to the $5.0 million amount. The possibility of having no GST exemption for testamentary transfers in estates making the carryover basis election apparently is unintended (it certainly would be unjust to apply the GST tax scheme to testamentary transfers but not afford an opportunity to use GST exemptions). This result apparently is unintended, and the Joint Committee on Taxation Technical Explanation clearly takes the position that the $5 million GST exemption applies for 2010 decedents whether or not the carryover basis election is made:

> "The $5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules." Joint Committee on Taxation Technical Explanation at 50 n.53.

Having 2010 GST exemption of $5.0 million is very important for various reasons. First, consider electing out of automatic allocation of the 2010 GST exemption to direct skip gifts. Second, the $5.0 million of GST exemption can be allocated on timely filed returns, based on the values of gifts to trusts on the dates of the gifts in 2010.

1. Elect Out of Automatic Allocation for Direct Skip Transfers in 2010. The change in nomenclature in TRA 2010 to avoid saying that chapter 13 does not apply to

GST transfers in 2010 has two important implications for direct skip gifts in trust: (1) Automatic allocation of GST exemption to the direct skip will occur under § 2632(b)(1) to the extent necessary to result in a zero inclusion ratio for the transfer unless there is an election out of such automatic allocation; and (2) the move-down rule of § 2653(a) will apply and the zero inclusion rule under § 2642(c) for single beneficiary-vested annual exclusion gifts in trust will apply, so that future distributions to the grandchild-beneficiary of the trust will not be subject to the GST tax. These effects are discussed below.

There is generally automatic allocation of any unused GST exemption to direct skip gifts (whether or not in trust). I.R.C. § 2632(b)(1). Such automatic allocation to direct skip gifts can be avoided by electing out of automatic allocation on a timely filed gift tax return. I.R.C. § 2632(b)(3); Treas. Reg. § 26.2632-1(b)(1).

Under TRA 2010, the nomenclature that chapter 13 does not apply has been dropped, so § 2632(b)(1) would apply to all direct skips, whether or not in trust, but only "to the extent necessary to make the inclusion ratio for such property zero." Therefore, automatic allocation will apply for direct skips generally (whether or not in trust), but will not apply to annual exclusion gifts to single beneficiary-vested trusts, because the inclusion ratio for such transfers is already zero under I.R.C. § 2642(c). (Under the law before TRA 2010, the same result may have occurred for direct skips in trust, though under a much more convoluted analysis. Under EGTRRA, chapter 13 does not apply to direct skips, so the automatic allocation rule of § 2632(b)(1) would not apply. However, under the sunset rule of EGTRRA (before it was amended by TRA 2010), the Code would be interpreted as if EGTRRA had never been enacted with respect to future generation-skipping transfers, so the chapter 13 rules would be applied to have allocated GST exemption automatically to direct skip trusts when a later taxable distribution or taxable termination occurs with respect to that trust.)

TRA 2010 makes clear that the move-down rule of § 2653(a) would apply to direct skip gifts in trust in 2010. For example, if a direct skip gift is made in trust for the donor's grandchild, the move-down rule would cause the generation assignment of the transferor to be the grandchild's parent's generation, so that subsequent transfers to the grandchild-beneficiary would not cause a GST tax to apply. In that circumstance, GST exemption that is automatically allocated to the trust would have been wasted if it is likely that distributions from the trust will ultimately be made to the grandchild-beneficiary. (On the other hand, if the intent is to keep the trust intact for the grandchild's descendants, allocation of GST exemption to the trust may be appropriate and desirable.)

Practical Planning Pointer: Planners must carefully examine all direct skip gifts in 2010 (whether or not in trust and whether inter vivos or by testamentary transfers) to determine whether a timely filed tax return should be filed electing out of automatic allocation.

2. <u>Timely Allocation of 2010 GST Exemption</u>. If a timely allocation is made, the GST exemption allocation is made effective as of the date of the gift using values on that date. § 2642(b)(1)(B). Late allocations are effective as of the date of the allocation, § 2642(b)(3)(B), or as of the time the late allocation is made in 2011 (using values on that date, thus requiring allocation of GST exemption to the

appreciation occurring up to that date). A late allocation cannot be filed until April 19, 2011 at the earliest (the due date is April 18). If the donor's income tax return is extended, that automatically extends the gift tax return as well to October 15 (or October 17 in 2011). In 2011, a late return for the October deadline could not be filed until October 18, 2011. Before TRA 2010, there was no GST exemption in 2010 and it was unclear under the sunset rule whether 2010 GST exemption would be deemed to have existed with respect to generation-skipping transfers occurring after 2010. If there was no 2010 GST exemption, there would be a necessity of waiting to file a late allocation of 2011 GST exemption, based on the appreciated values at the time of the allocation. Fortunately, that potential problem has been resolved by TRA 2010.

I. 2010 Transfers Not Grandfathered. Transfers to trusts in 2010 are not grandfathered or exempt from the GST tax. Trusts with contributions in 2010 will be GST exempt only if GST exemption is allocated to those transfers.

J. Provides Clarity Regarding ETIPs. GST exemption cannot be allocated to transfers subject to an "estate tax inclusion period" (or ETIP) during which the assets would be included in the gross estate of the transferor (or his or her spouse). § 2642(f). An example is a transfer to a GRAT, because some or all of the trust may be included in the transferor's gross estate if he or she dies during the GRAT term. GST exemption can be allocated at the end of the ETIP, and indeed there are rules for automatically allocating GST exemption at the end of the ETIP in certain situations. *See* Treas. Reg. § 2632-1(c). Various uncertainties about ETIPs arose in light of the repeal of the estate tax following 2009 under EGTRRA. Prior to TRA 2010, chapter 11 did not apply under EGTRRA after 2009 so arguably ETIPs ended as of January 1, 2010 because the trust assets would not have been included in the transferor's gross estate if he or she died after 2009. There were questions as to whether the ETIP would be reinstated at the end of 2010 when the EGTRRA sunset occurred and the estate tax would again apply. If the ETIP terminated on January 1, 2010, could GST be allocated when the ETIP terminated in 2010 — even though there was no GST exemption for 2010 before TRA 2010? TRA 2010 appears to remove many of the uncertainties, at least for two years. It provides that the estate tax did continue to apply after 2009 (subject to the election of carryover basis instead). Therefore, ETIPs did not end on January 1, 2010 but continue without interruption. This result apparently is not impacted by whether the carryover basis election is made for 2010 decedents. The Joint Committee on Taxation Technical Report states that making the carryover basis election "will have no effect on the continued applicability of the generation skipping transfer tax," and the ETIP rules are part of the generation-skipping transfer tax provisions. Because TRA 2010 only applies for two years (see section IV.H of this outline), uncertainty will exist again regarding ETIPs on January 1, 2013 absent further legislation.

IX. Construction Issues

A. Formula Bequests. The change in the law raises various potential construction issues in construing formula bequests. (For an excellent discussion of similar construction issues that arose during the 2010 estate tax hiatus, see Medlin, Zaritsky & Boyle, Construing Wills and Trusts During the Estate Tax Hiatus in 2010, 36 ACTEC L.J. 273 (2010).) For example, consider the effect of TRA 2010 in construing several possible types of formulas, keeping in mind that the estate tax and the $5 million applicable exclusion amount apply from January 1, 2010.

- "Maximum amount that can pass free of estate tax" now appears to mean $5 million rather than the entire estate.
- "An amount equal to the federal estate tax applicable exclusion amount" now appears to mean $5 million rather than zero.

However, while the law seems to say that the amount passing under each of those formulas would be $5 million for decedents dying any time in 2010, there are various uncertainties. Observe that the resolution of each of these issues is a matter of state law, and as a practical matter will be determined in each separate case based on the equities of the case and what the parties can convince the court to be the testator's intent.

1. Does Decision to Make Carryover Basis Election Change Construction? Does the construction of the formula change if the executor makes the carryover basis election? In that event, TRA 2010 § 301(c) says that the "repeal" of § 2210 in TRA 2010 § 301(a) does not apply, so Chapter 11 does not apply, so the amended § 2010(c) changing the applicable exclusion amount to $5 million for 2010 does not apply. If making the carryover basis election changes the formula bequest, the executor not only has to make decisions of whether the overall tax result is better to apply carryover basis than the estate tax (which depends on a variety of factors, some of which are mentioned in section IV.B.2 of this outline) and how to treat beneficiaries fairly in implementing carryover basis and making the basis adjustments, but the executor also has to consider that the election may drastically change the amounts of the bequests passing under the will. A further complexity is that the due date of the carryover basis election is not described in the statute but will be provided in guidance from the IRS (see section IV.B.2 of this outline). It is possible the election will not be made until the fall of 2011, and the election could conceivably change the construction of the values of bequests assets passing under the will of a decedent who died perhaps over 20 months earlier.

   If there is any possibility that the election may impact the amounts of bequests under the will, attempt to get consents of all of the parties or court approval of the election decision. (Equitable adjustments among the parties may be appropriate.) One Wall Street Journal commentator observed: "There's another word for an executor who gets to choose how much money a beneficiary receives — defendant."

   Making the carryover basis election may also impact how assets pass under estate planning documents with formulas if the decedent lived in one of the twenty states with construction statutes giving guidance how to interpret formula distributions for 2010 decedents. See section IX.B of this outline for further discussion of how the election may have an impact under those statutes.

2. Do Interests Passing Under Will Vest as of Date of Death Under State Law? The change in the law could be almost twelve months after the date of death in 2010 and arguably should not change the amounts passing under the will. Some state laws provide that assets passing under a will vest as of the moment of death, subject to the administration of the estate.

3. What if Assets Have Been Distributed? Does it make a difference if bequests have already been funded? Changing the construction based on the new law, which is now effective as of January 1, 2010, may require that beneficiaries refund

previously distributed amounts. Will that change the court's interpretation of the formula bequests?

4. Practical Scenario. Assume a fairly typical scenario of a situation in which the decedent's children are not children of the surviving spouse and are hostile to the surviving spouse. Assume the will provided that the formula "tax-free" amount passes directly to the children and that the balance of the estate passes to the spouse. Assume the local court determines that amounts passing under the formula bequest depend on the carryover basis election. This means that if the executor makes the carryover basis election, in which event chapter 11 does not apply, the entire estate would pass to the children, but if the executor does not make the carryover basis election, only $5 million passes to the children and the balance passes to the surviving spouse. Assume the executor does not make the carryover basis election, so most of the estate passes to the surviving spouse. Later the children sue, and assume the court construes the formula bequest to mean that all of the estate passed to the children. That state law ruling would mean that although the estate is subject to the estate tax, nothing qualifies for the marital deduction. Furthermore, it may be too late at that point (perhaps several years later) to change the decision not to make the carryover basis election. TRA 2010 § 301(c) states that the carryover basis election

> "shall be made at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide. Such an election once made shall be revocable only with the consent of the Secretary…"

Perhaps that would be a situation in which the IRS would permit a change in the election. Does it make a difference that in this circumstance, the executor chose not to make the election so perhaps did not file anything making an affirmative election but merely filed a timely estate tax return? (The statute, quoted above, says that an election into carryover basis is revocable only with the Secretary's consent, and in this scenario there was never an election into carryover basis.)

B. Construction in States With Legislation Tying Formula Bequests to 2009 Law. Twenty states (including the District of Columbia) have statutes regarding the construction of formula "tax-free" bequest clauses for 2010. A number of those state statutes refer to estate tax rules on December 31, 2009. (Those states are Delaware, District of Columbia, Georgia, Idaho, Indiana, Maryland, Minnesota, Michigan, Nebraska, New York, North Carolina, Pennsylvania, South Dakota, Tennessee, Utah, Virginia, Washington, and Wisconsin. In addition Florida and South Carolina have "go-to-court" statutes that do not specifically apply 2009 law.) Will formula "tax-free" bequests in those states mean that $3.5 million continues to pass under the clause rather than $5 million that could pass without estate tax under TRA 2010? Most of those statue statutes say that the special construction applies only for 2010 decedents, but if the federal estate or generation-skipping transfer tax becomes effective before January 1, 2011, the statute will no longer apply as of the date the tax becomes legally effective. (A bill was introduced January 20, 2011 in Virginia providing that, among other things, [1] the formula in a will or trust would mean $5 million, whether or not the carryover basis election is made, [2] that extrinsic evidence would be admissible for 2010 decedents to determine the testator's intent in a proceeding commenced any time before January 1, 2012, even if it contradicts the plain meaning of the document, and [3] that interested persons may enter a binding agreement regarding the construction of the instrument and may seek court approval of the agreement.)

Various uncertainties will apply in these states in light of the changes by TRA 2010.

- If the state has passed a statute providing that formula bequests are construed as if 2009 law applied, will the bequest of the tax-free amount be limited to $3.5 million even though $5.0 million could pass to the bypass trust without incurring estate tax?
- Will state legislatures change their construction statutes?
- Will courts construe the formula to mean $5.0 million despite the state statute?
- For purposes of the sunsetting provision in a state construction statute, does TRA 2010 cause the federal estate tax to be legally effective as of January 1, 2010 so that the sunsetting provision applies as of January 1, 2010, meaning that the state construction statute does not apply at all?
- Does the carryover basis election change the result? (For example, if the carryover basis election is made, the estate tax does not apply so the state statute says the tax-free amount means $3.5 million, but if there is no election, the estate tax does apply as of January 1, 2010 so the state construction state does not apply and the tax-free formula means $5 million.)
- Observe the difficulty the executor faces isn addressing this uncertainty. If the tax-free formula bequest is $5 million if the estate tax applies but $3.5 million if carryover basis applies, Howard Zaritsky concludes: "Would you want to be that executor?"
- Many of statutes allow estates to bring a legal proceeding to ascertain whether the decedent intended to apply 2009 law in determining the amount passing under the formula, but require that "such a proceeding shall be commenced within 12 months following the death of the testator or grantor" (quoting the Virginia statute). For decedents who died in early 2010, that one-year limit is fact approaching. (Some states, such as Virginia as discussed above, are considering amending their statutes to allow a longer time to bring such suits, such as through the end of 2011.)

C. Formula Bequests Equal to GST Exemption Amount. The specific language used in a GST formula transfer must be closely reviewed to determine the effect of TRA 2010 on the formula for 2010 transfers. For example, if the formula transfer applies "if Chapter 13 does not apply," that clause arguably is not triggered in light of TRA 2010, because it says that Chapter 13 *does* apply for all of 2010 (but the GST rate is zero). If the formula is an "amount that can pass free of GST tax," that might be everything passing under the instrument if the distribution is a direct skip in 2010. If the formula is an "amount equal to the GST exemption," that would be $5 million in 2010 under TRA 2010. That would be the starting point of the analysis, but this is still a state law construction issue, depending on the court's interpretation of the intent of the specific instrument and the donor.

X. Planning Strategies Going Forward Regarding Untimely 2010 Gifts

A donor who made gifts in 2010 and would pay a 35% gift tax may prefer to "undo" the 2010 transfer and instead make the transfer effective in 2011 when there is a $5 million gift exemption. (If the client can afford to make gifts with other assets in 2011 to utilize the $5 million gift exemption amount, there is no real problem with having made gifts and paying gift tax in 2010. If the donor lives at least three years, there is the advantage of taxing the transfer on a tax exclusive basis.)

A. <u>Decision Tree</u>. A possible plan of attack is first to consider disclaimers, and if that is not available, consider rescission. Do not give up easily on "self-help" to undo the 2010 gift.

B. <u>Disclaimers of 2010 Gifts</u>. Is a disclaimer possible? (The extended time period for making disclaimers only applies to estates of decedents who died before December 17, 2010. It does not apply to disclaimers of gifts.)

Has the donee accepted the property so that a disclaimer is no longer available? The IRS may be more generous than in the past in determining what constitutes acceptance, in light of the totally unforeseen legislative change extending the time for the disclaimer. "Merely taking delivery of an instrument of title, without more, does not constitute acceptance." Treas. Reg. § 25.2518-2(d)(4). Perhaps depositing a check in one's account may be allowed, but receiving interest or dividends or selling the asset or spending the proceeds would not be. If the donee reverses the transfer, perhaps any purported acceptance would be negated. Look carefully at state law. File a Form 709 to report the disclaimer as a non-gift transaction. That starts the statute of limitations as to whether the transfer has gift consequences for that year. (One accountant reports that she always files Form 709s for disclaimers to report them as non-gift transactions.)

Determine where the disclaimed property will pass under local law. There may be a different result in different states. Look at all relevant states to see if there are differences of whether property would pass. If the assets do not pass back to the donor as a result of the disclaimer, a disclaimer will not "undo" the 2010 gift. Gifts to trusts are particularly suspect; the disclaimed assets may not return to the settlor but to other trust beneficiaries. *See generally* Handler & Chen, *Formula Disclaimers: Procter-Proofing Gifts Against Revaluations by Service*, 96 J. TAX'N 231 (April 2002).

Apply relevant conflict of laws principles to determine which state's law applies. (For testamentary transfers, it may be more likely that the law of the transferor's domicile would apply than for inter vivos transfers. For gifts, the law of the donee's domicile may apply.)

C. <u>Rescission</u>. If a disclaimer will not work, consider rescission of the 2010 gift. If a gift is made under a mistake of a material fact, rescission may be possible under state law if the donees have not substantially changed their position in a way that would make the rescission unconscionable.

The question is whether a business judgment of what legislation may or may not pass in the future is a mistake of fact or just an error of judgment. The most recent rescission case, *Breakiron v. Guidonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010). allowed rescission of a disclaimer from a QPRT on the basis of a mistake of law as to the effect of the untimely disclaimer. In *Neal v. United States*, 187 F.3d 626 (3rd Cir. 1999). the donor relinquished a retained power to avoid triggering the old § 2036(c), which was later repealed retroactively. *See also* Berger v. United States, 487 F. Supp. 49 (Pa. 1980) (rescinded gift not taxed); *cf.* Rev. Rul. 80-58, 1980-1 C.B. 181; Ltr. Ruls. 200613027, 200701019, 200911004 (income rulings relying on rescissions to undo transactions).

Rescissions have generally relied on a retroactive change in law or bad advice; no case has been located based on a wrong guess of what the law would be in the following year. Perhaps the mistake in *Neal* of not knowing that § 2036(c) would be repealed retroactively is analogous to not knowing that the gift exemption would be increased substantially for the following year.

The notion that rescissions are respected only if they occur in the same taxable year is an income tax concept. *See* Rev. Rul. 80-58, 1980-1 C.B. 181 (rescission occurring in same year as taxable event is respected if parties are returned to their original positions). Completing a rescission in 2011 of a 2010 transaction may still be recognized for transfer tax purposes.

XI. Estate Planning Strategies Going Forward To Utilize Increased $5 Million Gift Exemption in Light of Changed Planning Paradigm Under Under TRA 2010

The $5.0 million estate and gift exclusion amount (and GST exemption) beginning in 2011 will open up a new paradigm of thinking regarding estate planning and transfer planning strategies. The ability to make transfers of up to $10 million per couple without having to pay gift taxes paves the way for many transfer planning opportunities that, with leveraging strategies, can transfer vast amounts of wealth outside the gross estate. On the other hand, the increased estate exclusion amount may remove the motivation for many clients to do any transfer planning if their estates are lower than that amount.

A. <u>Categorizing Client Situations</u>. Planners will need to apply a triage approach to considering client situations. Taxpayers with estates well over $5 million ($10 million for couples) will probably continue to be interested in sophisticated transfer planning, and to take advantage of what may be just a window of opportunity to do transfer planning with a $5 million gift exclusion and $5 million GST exemption amount.

Married couples with estates approaching $10 million may feel that they no longer have estate tax concerns or need sophisticated estate planning. However, those clients should be cautioned that the $5 million exclusion was very contentious in this Congress and it make not be renewed in two years. Furthermore, future growth in the estate may take the client well above the estate tax threshold amount. These clients will likely be interested in transfer planning strategies but may be comfortable using simpler more straightforward strategies.

Couples with estates under $3-5 million or even more may feel comfortable that the combined exclusions of both spouses (perhaps using portability) takes them out of having estate tax concerns, particularly taking into account that the couple may anticipate depleting the estate through living expenses. They may have no interest in any transfer planning at this point. They may even decide to stop making annual exclusion gifts or to drop insurance that was acquired for paying estate taxes. They may want to “undo” prior transactions that may have the effect of creating valuation discounts because of the impact they may have on limiting a basis step-up at death. Again, those clients should be cautioned that the $5 million estate exclusion is not permanent.

Planners must counsel clients about the current law and possible changes in two years, and gauge the clients’ appetite for further planning and the level of sophistication in planning that is acceptable. Clients should be advised of the extreme degree of uncertainty in our estate tax system. If Congress comes to loggerheads again in late 2012 (like it did at the end of 2009 regarding the estate tax), there is the possibility of returning to a $1 million exemption system with a 55% rate. The next two years provide what may turn out to be a narrow window of opportunity.

B. Overview and Brief Summary of Tax Effects. The ability to move $5 million per individual ($10 million per couple) out of the gross estate opens up the possibility for many individuals to transfer as much as they would want to transfer to their descendants during life without any gift tax concerns.

The tax effects of gifts are summarized in sections IV.D-E of this outline. The following is a brief summary.

A donor can make gifts of the full additional gift exemption amount without paying gift tax. (See section IV.D.3-4 of this outline.) Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes. (See section IV.E.5.d of this outline.) Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include removal of appreciation/income of gift assets from the gross estate, utilizing fractionalization discounts, paying income taxes on income from grantor trusts to further "burn" the donor's gross estate, removing gift taxes paid from the gross estate if the donor lives three years, and the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well. (See section IV.E.5.g of this outline.)

If the estate tax exemption amount is reduced below the current gift exemption amount, there is a possible "clawback" effect of having to pay estate tax on the excess gift exemption amount. (For example, if the estate tax rate increases to 45% and if the exemption decreases to $3.5 million, the tax exposure hinging on this issue is $675,000 (i.e., $1.5 million x 45%. See section IV.E.5.h of this outline.)

If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation significantly increases the tax cost. For example if there is a $5 million gift in 2011 and the donor dies in a year in which the estate tax exemption is reduced to $3.5 million and the rate is increased to 45% and if the donor's will leave the entire estate to a surviving spouse or charity, the estate tax will be $1,227,272.73. (See sections IV.E.3.Ex.2 and IV.E.5.i of this outline.)

Even if the "clawback" applies, the estate will not pay more taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death. There is a general belief that the estate tax "clawback" will not occur. Congressional staffers have indicated that it is not intended, and IRS guidance or further congressional technical corrections could make that clear. (See section IV.E.5.h of this outline.)

If a clawback of estate tax on the excess exemption amount should occur, the additional estate taxes probably cannot be apportioned against the donees, except in a state where the state apportionment statute allows apportionment against gift donees. (See sections IV.E.4 and IV.E.5.l of this outline.) If the donor dies within three years of making the gift, IRS liens can reach the gift property. § 2035(c)(1). The donees could contractually agree to pay the additional estate tax under an arrangement similar to a net gift agreement, but that contractual obligation would likely allow the IRS to pursue the estate's claim against the donees to collect the estate tax.

If the donor pays gift taxes, the gift taxes are included in the gross estate if the donor dies within three years. Even in that situation, the gift tax merely "prepays" the transfer tax. If the estate tax rate is later increased above the gift tax rate that applied at the time of the gift, there will be savings equal to the amount of the gifts in excess of the gift exclusion amount times a percentage equal to the difference between the marginal estate tax rate and the marginal gift tax rate. (See section IV.E.5.k of this outline.) If the donor lives at least three years after making a gift, any gift taxes paid on the gift will be removed from the gross estate for estate tax purposes.

C. How Much Can the Donor Afford or Want to Give? While substantial additional gifts can be made without having to pay gift taxes, the initial question is how much can the donor afford to or want to give? The increased estate exemption may mean that the donor is not as concerned about estate taxes as in the past. However, TRA 2010 only lasts for two years and the estate exemption could be decreased in future years; alternatively, the estate exemption could be increased or the estate tax could be repealed in future years in which event the donor may preferred to have retained the gift assets.

Spouses collectively could give up to $10 million without having to pay gift taxes. Few couples can afford to give $10 million without potentially impacting their lifestyle in later years. A primary concern will be "will I have enough left to live on?" How does one define what are "discretionary" assets? That is not for the planner to define. It is not the actual ability to make a gift that matters — it is the *perceived* ability to make a gift and maintain one's standard of living into the foreseeable future that matters. As a result, donors interested in making large additional gifts may want to consider the possibility of ways to preserve direct or indirect access to gift assets in the event of a "rainy day" financial reversal (strategies are discussed below).

D. Gift Splitting. If one spouse has most of the marital wealth, the couple can still take advantage of both spouses' $5 million gift exemptions by making the split gift election. § 2513. This can achieve the advantages of gifts with respect to $10 million worth of gifts instead of just $5 million.

A consenting spouse should be aware of possible effects of consenting to the election. Indeed, it may be appropriate to compensate the spouse for consenting to split gift treatment or it might be appropriate to amend a premarital agreement. For example, in return for agreeing to the split gift treatment, the donor spouse may agree that the consenting spouse can have the residence and leave it to anyone he or she wishes.

Fortunately, the election is just effective for gift and GST purposes (*see* § 2652(a)(2)), not for the purpose of treating the consenting spouse as the transferor for applying the estate tax "string" statutes. *See, e.g.*, Rev. Rul. 82-198, 1982-2 C.B. 206; Rev. Rul. 74-556, 1074-2 C.B. 300. However, possible bad effects may result for the consenting spouse.

- At the consenting spouse's death, one-half of the gift assets will be added to the estate as adjusted taxable gifts, and the estate tax calculation operates in a manner that the consenting spouse's gift exclusion utilized in the split gift will effectively use up the consenting spouse's estate tax exclusion amount as well. (If the estate tax exclusion amount has decreased by the time the consenting spouse dies and if there is a "clawback" of the excess of the gift exemption used by the spouse over the estate exemption as discussed in sections IV.E.B and IV.E..5.h of this outline, this could result in additional estate taxes being payable by the consenting spouse's estate even if all of the estate is passing to a surviving spouse.)

- If the gift is included in the donor-spouse's gross estate under some section other than § 2035 (for example, a QPRT may be included under § 2036), both halves would be included in the donor-spouse's estate because the donor is treated as the transferor of both halves for estate tax purposes, but the consenting spouse's unified credit is not restored. If the assets are included in the donor spouse's gross estate under § 2035, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation, but that only applies if the asset is included in the estate under § 2035. I.R.C. § 2001(e).
- If the gift is included in the donor's gross estate under § 2035, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation, but the consenting spouse's gift tax unified credit is not restored for purposes of later gifts by the consenting spouse.

If there is any risk that the gift assets may be included in the donor spouse's estate under any of the string statutes, the spouse should be especially cautious about whether to consent to split-gift treatment. *See generally* Zeydel, *Gift-Splitting — A Bondage of a Bad Idea? A Comprehensive Look at the Rules*, J. Tax'n (June 2007). In light of these potential adverse affects for the consenting spouse, consider whether the consenting spouse should have separate counsel in considering whether to consent to split gift treatment.

E. <u>"Rainy Day Fund" Considerations; Lifetime Credit Shelter Trust for Donor's Spouse.</u> The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse. The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. In some ways, this is the ideal kind of trust for the spouse because the spouse is a discretionary beneficiary, can be the trustee, can have a limited power of appointment (exercisable at death or in life), and the trust may be protected against claims of both the donor's and spouse's creditors. The power of appointment could be broad enough to appoint the assets back to the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under § 2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor's spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction, as discussed in section XI.F of this outline, below. Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust, as discussed in section XI.F of this outline.) If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment. The trust could define the "spouse" to be the person to whom the grantor is married to at the time without causing estate inclusion in the donor's estate so that the trust could also be available for the benefit of a new spouse. S*ee* Estate of Tully Jr. v. United States, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§ 2036(a)(2) or 2038). With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the spouse under § 677 (unless the consent of an adverse party were required for distributions to the spouse).

F. "Rainy Day Fund" Considerations; Lifetime Credit Shelter "Non-Reciprocal" Trusts. Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. In *United States v. Grace*, 395 U.S. 316 (1969), the trust terms were identical, the trusts were created at the same time, and the trusts were of equal value. The Supreme Court said that the primary factor in determining whether trusts are sufficiently interrelated is "whether the trusts created by the settlors placed each other in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary." If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See* Estate of Levy v. Commissioner, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries). Another possible distinction would be for one trust to include the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary. For an extended discussion of the reciprocal trust doctrine in the context of spouses' creating lifetime QTIP trusts for each other, see Gans, Blattmachr & Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, 57-60 (July/August 2007).

The *Grace* case involved reciprocal interests rather than powers. Subsequent cases have differed as to whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under section 2036(a)(2) or 2038. Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to section 2036(a)(2) and 2038 powers); Exchange Bank & Trust Co. of Florida v. U.S., 694 F.2d 1261 (Fed. Cir. 1984); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see* Estate of Green v. Commissioner, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. Estate of Cole v. Commissioner, 140 F.2d 636 (8th Cir. 1944).

G. "Rainy Day Fund" Considerations; Discretionary Trusts in Self-Settled Trust States. Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering § 2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Twelve states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help alleviate concerns that § 2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential § 2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under § 2036 is tested at the moment of death, and § 2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as there is no prearrangement). *See* Tech. Adv. Memo. 199935003 (§ 2035 will apply if pre-planned arrangement).

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot revest beneficial title or change the beneficiaries. (Various cases have held that there is no completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.) The ruling also discussed § 2036. The "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." While this is only a private letter ruling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7, holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under § 2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

The ruling does not address the result if the grantor is not a resident of Alaska. There is authority supporting the view of various commentators that the analysis applies even if the grantor does not reside in the state in which the trust is created. *See* Letter Rulings 9332006 (U.S. grantors created self settled spendthrift trusts under the laws of a foreign country and IRS held no estate inclusion) & 8037116; Estate of German v. United States, 7 Ct. Cl. 341 (1985) (Maryland trust created by Florida grantor). However several bankruptcy cases have denied a discharge to grantors of a foreign situs self-settled spendthrift apparently because the law of the grantor's domicile did not permit such trusts.

The position that the self-settled trust will not be included in the gross estate of the grantor may be the strongest for self-settled trusts created in Alaska and Nevada. In all of the other self-settled trusts states, some creditors can reach the trust assets (for example, for certain family obligations such as for alimony or child support), and that may jeopardize the "no inclusion" argument. *See* Rothschild, Blattmachr, Gans & Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be In Grantor's Estate*, 37 EST. PL. 3, 11-12 (Jan. 2010).

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under § 2036 in part based on whether trust assets can be reached by any of the grantor's creditors. Estate of Uhl v. Commissioner, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under § 2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); Estate of Paxton v. Commissioner, 86 T.C. 785, 818 (1986)(self-settled trust assets included under § 2036 because grantor's creditors could reach income and corpus); Outwin v. Commissioner, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); Estate of German v. U.S., 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on § 2036(a)(1), because grantor's creditors could not reach trust assets where trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries). Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

H. Taking Advantage of $5 Million GST Exemption. There are no assurances that the GST exemption will remain at $5 million. Making a $5 million gift and allocating the $5 million of GST exemption that is currently available is one way of assuring that the full $5 million GST exemption can be used. The safest way of utilizing the $5 million GST exemption would be to make direct skip gifts, to as low a generation as is practicable. Even if the TRA 2010 provisions sunset at the end of 2012, and the Code is interpreted as to future generation-skipping transfers as if the provisions of TRA 2010 (or EGTRRA) "had never been enacted" (see section IV.H of this outline), there would be no ability to impose a GST tax retroactively on the direct skip that occurred in 2011 or 2012 when the direct skip gift was made to the trust. On the other hand, if a gift is made to a dynasty trust and $5 million of GST exemption is allocated to the trust and if TRA 2010 sunsets, it is not clear that for purposes of determining the inclusion ratio of the trust as to a generation-skipping transfer that occurs after the sunset date whether the full $5 million of GST exemption could be considered.

I. Forgiveness of Outstanding Loans to Children. Many clients will be interested in forgiving existing loans to children as an easy way of utilizing the $5 million gift exemption. A possible concern exists if there has been a repeated pattern of forgiving loan payments. If the IRS can establish an intention from the outset that the entire loan would be forgiven eventually, the IRS may treat the gift as occurring all in the year of the initial advance. *E.g.,* Letter Ruling 200603002; Field Service Advice 1999-837. Utilizing the newly granted increased gift exemption may help rebut the "original intent" implication. Typically, the forgiveness will not result in discharge of indebtedness income. Rev. Rul. 2004-37, 2004-1 C.B. 583 ("debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules").

J. Gifts to Grantor Trusts. Making transfers to grantor trusts, where the donor continues to pay income taxes on the trust income, has a huge impact on the amounts that can be transferred over time. The trust assets compound free of income tax, and the payment of income taxes by the donor further depletes his or her estate (substantially over time). Simple $5 million (or $10 million for couples) gifts to grantor trusts can move huge amounts of value out of the donor(s)' gross estates over time.

K. Gifts to Grantor Trusts Leveraged With Loans. A very simple additional strategy would be to make a $5 million (or $10 million for couples) gift to a grantor trust and then loan up to nine times that with a very low interest AFR note to the trust, substantially leveraging the amount of future income and appreciation that could be shifted to the trust.

L. Gifts and Sales to Grantor Trusts. Sales to grantor trust transactions traditionally are often complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The $5 million gift exemption ($10 million for couples) relieves many of those difficulties. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Huge estate tax savings could result over time from freezing future appreciation from coming into the estate and from "burning" the estate by making the income tax payments. The grantor trust status could be left intact until the grantor had depleted the estate as much as he or she was willing to deplete it.

If prior sale to grantor trust transactions have been structured using guarantees to provide "seed" equity to justify the sale, the clients might make additional gifts to the trust and terminate the guarantee agreements.

The sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift, but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable.

"Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze." (Mil Hatcher, Atlanta, Georgia, addressed this advantage of a "leaky" freeze over a large gift in a panel discussion at the 45th University of Miami School of Law Heckerling Institute on Estate Planning.)

M. Highly Volatile Assets; GRATs or Gift/Sales Transactions With Minimal "Seed" Gift. For highly volatile assets, a preferable approach may be to use GRATs rather than gift/sale transactions to avoid the possibility of wasting the client's gift exemption if the volatile asset becomes worthless. For highly volatile assets, the gift element in the gift/sale transaction should be minimized. This minimizes the risk of the highly volatile asset declining in value substantially, which may eliminate the value of the trust, and result in having wasted the client's gift exemption. For example, if a couple might be interested in selling $30 million of assets to a grantor trust, do not fund that trust with a $10 million gift, but only fund it with a gift of $3,333,000. Using a 9 to 1 ratio, that would still justify a sale of assets for $30 million. If the couple wants to utilize the full $10 million gift exemptions, give the remaining $6,667,000 to another trust. This approach does not expose the other $6,667,000 to the sale transaction in case the assets decline in value. (Mil Hatcher, Atlanta, Georgia, discussed this example in a panel discussion at the 45th University of Miami School of Law Heckerling Institute on Estate Planning.) (Alternatively, one grantor trust could be used, but the $3,333,000 amount needed to support the sale would be contributed to an LLC, the member interests in the LLC would be given to the trust, and the sale would be made to the LLC, thus not putting at risk the other $6,667,000 assets given to the trust.) A problem in the past was not coming up with enough seed money. In the future, the problem may be having too much seed money.

N. Basis Step-Up Flexibility; Repurchase of Assets by Grantor, Triggering "String" Provision. Consider steps to build in flexibility for achieving a basis step-up at the death of a transferor. Key to this flexibility will be making the gift to a trust rather than an outright gift.

One traditionally used method to achieve a basis step-up is for the grantor to repurchase appreciated assets from a grantor trust recipient.

Another approach is to draft the trust to give an independent trustee or other independent party the power to grant a testamentary limited power of appointment to the grantor. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from beneficiary to another. If so granted, this would cause inclusion under § 2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.

The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 35% of the excess of the date of death value over the date of gift value is less than amount equal to 15% of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an ETIP, which would preclude immediate allocation of GST exemption to the trust.

Another possible approach would be to take steps to trigger the "string" provisions of §§ 2036-2038. For example, the parent may continue living in the house in a QPRT without paying rent to trigger § 2036(a)(1). However, the IRS conceivably may not take the position in that type of circumstance that the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under § 2036(a)(1).

A further extension of this planning would be to leave the flexibility of causing the trust assets to be included in the donee-spouse's estate for estate tax purposes if there are no estate tax concerns for the donee-spouse and if a basis step-up at his or her death would be desirable. These are the same strategies that could be used in creating trusts for a spouse in the testamentary context. See section XII.B.5-7 of this outline for a discussion of specific strategies.

O. <u>GRATs</u>. GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption.* Everything else begin equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

Furthermore, for transferring hard to value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT. *See* Treas. Reg. § 25.2702-3(b)(1)(ii)(B). (However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

The 10-year minimum term provision is not included in TRA 2010. Does that mean that rolling two-year GRATs can be created within the next two years before TRA 20120 sunsets? We cannot be sure. Congressmen may have simply wanted to save the GRAT 10-year minimum term revenue raising provision for some subsequent bill in 2011 that needs a revenue raiser to offset the cost of some new bill.

P. <u>Life Insurance Transfers</u>. A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having $5 million ($10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life insurance coverage that can pass free of transfer tax to younger generations. For example, a $2 million premium can often purchase $20 million of second-to-die life insurance coverage.

Split dollar agreements have often been used in the past to help finance the payment of large premiums by an irrevocable life insurance trust where the insured could not make gifts to the trust large enough to cover the premiums without having to pay current gift taxes. If split dollar arrangements have been used in the past, large gifts (within the $5 million gift exclusion amount) could be made to the trust to roll out of the split dollar arrangement and simplify the planning.

Q. Deemed § 2519 Gifts from QTIP Trusts. One way to make use of the $5 million gift exemption is triggering § 2519 with QTIP trusts. A gift of the income interest will result in a deemed gift of the remainder interest of the QTIP under § 2519. This may be a way for a surviving spouse who is a beneficiary of a QTIP trust to make use of the $5 million gift exemption if the QTIP trust is no longer needed. A gift of a small portion of the income interest in a QTIP trust can also result in a gift of the entire remainder interest under § 2519. However, it is likely that § 2036(a)(1) would cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING ON EST. PLAN. ch. 12 ¶ 1202.3 (2010). For example, if the spouse makes a gift of 0.1% of the income interest, retaining the other 99.9%, it is likely that 99.9% of the trust assets would be included in the spouse's estate under § 2036(a)(1). A possible planning approach would be for the spouse to sell the income interest, rather than making a gift of it, to avoid § 2036(a)(1) inclusion. The spouse would continue to receive payments on that note (rather than a fluctuating income entitlement). That could result in freezing the value of the QTIP trust assets for transfer tax purposes. This was the fact situation in Letter Ruling 201024008, but a ruling on the § 2036(a)(1) issue was not requested or given. (A sale of the income interest may result in the spouse having a zero basis in the income interest under § 1001(e)(1) for purposes of determining how much gain is recognized on the sale transaction. Section 1001(e)(1) should not be triggered by a gift of some or all of the income interest.)

R. Qualified Personal Residence Trusts. One of the disadvantages of a qualified personal residence trust (QPRT) is that there is a significant (though highly discounted) gift element. The $5 million ($10 million for a couple) gift exemption may permit the transfer of even very valuable residences to a QPRT while still allowing the gift element to be covered by the gift exclusion to avoid having to pay gift taxes when the QPRT is created. (Of course, QPRTs are not as favorable in the current very low AFR environment as they are with a higher AFR.)

S. Same-Sex Couples Planning. Planning for same-sex couples is difficult because of the lack of a gift or estate tax marital deduction. The increased $5 million gift tax exclusion opens up significant possibilities for transferring assets between the partners without current gift tax consequences.

T. Equalizing Gifts to Children or Grandchildren. A frequently recurring request is to make gifts to equalize gifts to all of the children or grandchildren. The extra $4 million of gift exclusion may permit some donors to equalize gifts when they have not had enough gift exclusion to do so in the past.

U. Gifts to Save State Estate Taxes. Only several states (Connecticut and Tennessee) have state gift taxes. In other states, gifts within the $5 million gift exemption would be free of federal and state gift taxes. However, the gift assets would no longer be subject to state estate taxes (as long as there were no retained interests in or powers over the gift assets that would cause estate inclusion for state estate tax purposes). Even deathbed gifts could result in substantial state estate tax savings. See section XII.B.4 of this outline. A disadvantage is that the gift assets will not be eligible for a step-up in basis at the donor's death, but that would not be a disadvantage for a gift of high basis assets.

V. Transfers May Impact § 6166 Deferral. Closely held business interests often represent highly appreciating-high income producing assets that can be the perfect vehicle for gifts. Making $5 million ($10 million for a couple) of gifts in a closely held business may take the business interest in the estate below the 35% of adjusted gross estate level needed to qualify for § 6166 estate tax deferral.

W. Leveraging Transfers Through Valuation Discounts. If the transferred assets are discounted to reflect lack of control or marketability, the value that can be transferred via the $5 million gift exemption is further expanded. On the other hand, clients who think the estate tax will no longer apply to them (because of the $5 million estate exclusion amount) may wish to avoid transactions that will have the effect of creating valuation discounts. They may even want to dissolve partnerships, despite the non-tax advantages of the partnerships, if the loss of basis step-up for assets in the partnership is critical.

XII. Testamentary Planning Strategies Going Forward in Light of Changed Planning Paradigm Under TRA 2010

A key to testamentary planning going forward is the extreme instability and unpredictability in the transfer tax system. Over the last 10 years, exemptions and rates changed in a stable progressive way. Exemptions have exploded from $2 to $3.5 to $5 million in the last several years. How can we advise clients going forward? It is extremely difficult to predict what will happen in 2013. At some point, will Congress began worrying how to pay for tax relief? Will China stop buying US bonds, so that Congress becomes worried about deficits and deadlock occurs with nothing happening in 2012 and the estate tax returning to a $1 million exemption 55% rate system in 2013? It is hard to handicap whether there will be small exemptions, large exemptions, or estate tax repeal following 2012. We can learn from what happened at the end of 2009. We don't know what Congress will do from moment to moment, let alone in two years. This time, at least we know to warn clients that there is a tremendous amount of uncertainty, and we cannot predict exactly what will happen.

A. Increased Focus on Client's Individual Goals and Customized Drafting to Meet Those Goals in Light of Inherent Uncertainty. Previously, planners could ask clients about their goals, and then structure those goals into a fairly standardized credit shelter trust /marital share planning approach. In the future, it will be imperative to focus on client goals in light of very unpredictable tax changes, rather than just tweaking the standard tax planning structure around the client's goals.

Planners for their entire careers have used instruments driven by standard formula clauses. The academic debate has been over issues such as whether to use pecuniary versus fractional formulas, or pre-residuary versus residuary bequests of the credit shelter or marital bequests. Standardized formula clauses could be used in the past because of stability in the estate tax system. That is no longer the case. Why draft documents to leave a formula amount, which will be based upon what a small group of people in Washington decide? What client in his or her right mind will want a document with that kind of uncertainty?

The standard formula driven approach can still work in a truly harmonious family situation. The maximum exemption amount can pass to the credit shelter trust and the balance to the surviving spouse, without concern for what Congress does to the formulas.

Even then, what if Congress repeals the estate tax — what will the formulas mean then? In addition, for really wealthy clients, standard formula drafting will be sufficient. The exemption amount is just a nuisance anyway for them.

For other clients, documents will have to be customized to meet the detailed goals. The document does not necessarily have to address what happens if the exemption is $1 million, $2 million, $3.5 million, $5 million, or $10 million, but the core principles of the distribution plan must be identified to customize the plan in light of uncertain tax laws.

Planners should keep detailed notes of the client's goals in light of a variety of possible future tax law situations. Include statements of intent in estate planning documents regarding the core goals, making them sound as much like the client as possible. They will help if the court needs assistance in interpreting the document, rather than just having the sterile words of a formula.

Consider the following as an example of the type of customization using "floors and ceilings" that will be needed in the new paradigm of uncertainty. (This example was discussed by Bruce Stone, Coral Gables, Florida, in a panel discussion at the 45th University of Miami School of Law Heckerling Institute on Estate Planning.) A client with a $6 million estate has a spouse and two children by a prior marriage. The client wants to leave at least $3 million for supporting the spouse, but wants the overall estate divided so that it ultimately passes one-third to the spouse and two-thirds to the two children. Leaving $3 million outright to the spouse would leave $1 million short of the desired amount to pass eventually to the two children. The plan would be drafted to shift some of the spousal bequest to a QTIPable trust so that at least $4 million would eventually pass to the two children. The remaining $3 million would pass to the children, but not in excess of the federal estate exemption amount. If the federal exemption is less than $3 million, the difference would pass to a QTIPable trust. If there is a state estate tax with a state-only QTIP election, there could be further limits on the bequest to the children to utilize a separate QTIP trust to avoid state estate taxes at the client's death. It will no longer be possible to just explain a standard credit shelter trust and sell a document based on that model.

B. Testamentary Drafting Patterns for Building Flexibility. In this world of tremendous uncertainty regarding future tax systems, there is tension among (i) planning for federal estate tax savings, both at the first spouse's and second spouse's deaths, (ii) planning for state estate tax savings, and (ii) planning for basis step up if there are no estate tax concerns.

1. General Planning Strategy. First, make sure the federal marital deduction is available at the first spouse's death whether by an outright bequest, QTIP trust, or general power of appointment trust (state estate tax planning flexibility is increased by using "QTIPable" trusts).

Second, make sure the surviving spouse has the flexibility to shelter the assets from estate tax at his or her subsequent death. For example, an outright bequest to the spouse with credit shelter trust provisions in the event of a disclaimer can work in a homogeneous family situation, but a QTIP trust may be needed for other situations (the portion for which no QTIP election is made is not includable in the surviving spouse's estate under §2044).

Third, following the first spouse's death, leave the flexibility for causing assets to be included in the surviving spouse's estate to obtain a basis step up at his or her death if there are no estate tax concerns (generally by permitting distributions to the spouse under a very broad "best interests" standard or by granting someone the power to cause the spouse to have a general power of appointment). (Dennis Belcher, Richmond, Virginia, suggested this general planning structure in a panel discussion at the 45th University of Miami School of Law Heckerling Institute on Estate Planning.)

2. Disclaimer Approach. The simplest approach is to leave the entire estate to the surviving spouse, but provide that any disclaimed assets would pass into a trust having the spouse and/or other family members as beneficiaries. The disclaimer approach has the advantage of simplicity in a homogeneous family situation. It may become the preferred approach for "low net worth clients." If there are state estate tax concerns, the disclaimed assets should pass into a QTIPable trust if the state recognizes a state-only QTIP election. If there are no state estate tax concerns or if the state does not recognize a QTIP election, the disclaimed assets will likely pass to a trust similar to standard credit shelter trusts.

   Is a disclaimer by a surviving spouse invalidated by subsequent grant of a general power of appointment to the spouse? A possible analogy is that the IRS has approved "reverse QPRTs" where the children later decide to give the parent the right to live in the house for a period of time, if the children's decision was an independent action that was not pre-planned. However, subsequently granting the disclaimant-surviving spouse a general power of appointment over the disclaimed assets would raise the question of whether the disclaimer satisfies the "pass without direction of the disclaimant" requirement.

3. QTIP Trust Approach. An alternative approach is to leave the entire estate into a trust for which a QTIP election could be made. Marital deduction qualification at the first spouse's death is available by making the QTIP election. To the extent the election is not made, assets would not be included in the surviving spouse's gross estate under § 2044. State estate tax planning is flexible with QTIPable trusts, particularly if the state recognizes a "state-only" QTIP election. "Clayton QTIP" provisions could be included to provide that the assets would pass to a different type of trust to the extent that the federal QTIP election is not made.

4. State Estate Tax Planning. While state estate taxes are considerably lower than federal estate taxes, they are still significant. Planning for domicile of the client will still be important. Formula clauses should be reviewed in light of the increased federal exclusion amount. Some clients may have opted previously to fully fund a bypass trust even though doing so would generate some state estate tax at the first spouse's death. The client may have been willing to do that with a \$3.5 million federal exclusion but may not be willing to do that with a \$5 million federal exclusion. For example, if the state has a \$1 million exemption (which is the case for most of the states that have state estate taxes), paying state estate tax on the excess \$4 million would incur \$391,600 of state estate taxes in some states if the state tax is charged against the bypass trust (leaving a net funding of \$4,608,400) and would incur \$444,091 of state tax if the state tax is not paid out of the bypass trust. A possible strategy to avoid paying this state tax is to fund the bypass trust

with only the state exemption amount and rely on portability to take advantage of the balance of the first deceased spouse's federal exemption amount. However, as discussed in section IV.C of this outline, there are a variety of uncertainties in relying on portability (not the least of which is that the portability provisions expire in two years unless renewed by Congress).

In states that allow a state-only QTIP election, planning to accommodate the increased federal exemption amount is more flexible. For example, in states with a $1 million state exemption, the bypass trust could be funded with the state exemption amount ($1 million), and a "QTIPable" trust could be funded with the remainder of the federal exemption amount (the remaining $4 million). A state-only QTIP election would be made for the $4 million trust. In this manner, the full $5 million federal exemption is utilized without incurring state estate taxes at the first spouse's death.

Gift planning may also save significant state estate taxes, because gifts are not included in the state gross estate base. The ability to make a $5 million gift without federal gift tax means that very substantial state estate taxes may be saved via gift planning. This is particularly important for deathbed planning.

While either of the disclaimer or QTIP approaches can be used to afford flexibility in addressing federal and state estate tax planning issues at the deaths of either of the spouses, further planning is needed to afford the flexibility of basis step-up planning at the surviving spouse's subsequent death.

5. Basis Step-Up Flexibility; Broad Distribution Powers. One method of causing estate inclusion if the surviving spouse has no estate tax concerns is to give the independent trustee broad authority to make distributions to the surviving spouse, such as under a "best interests" standard. An advantage of this approach is its simplicity, but possible disadvantages are discussed below.

6. Basis Step-Up Flexibility; Independent Party With Power to Grant General Power of Appointment. The trust agreement could give an independent party the power to grant a testamentary general power of appointment to the surviving spouse. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the surviving spouse's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the surviving spouse's creditors. There are several advantages to this approach over the broad distribution authority approach. (Howard Zaritsky, Rapidan, Virginia, discussed these advantages at the 45th University of Miami School of Law Heckerling Institute on Estate Planning. He prefers this approach to the broad distribution powers approach. His new book, *Practical Estate Planning in 2011 and 2012* (Thomson-Reuters/WG&L 2011), discusses the basis flexibility alternatives in detail with sample form language. The new book will be published in March 2011.) Distributing asset outright increases the surviving spouse's probate estate. Making physical distributions to the spouse may be mechanically cumbersome, particularly in a deathbed situation. The mechanics may be much easier by merely having the independent party sign a one-page document granting the spouse a general power of appointment. The surviving spouse may be elderly and have management issues with respect to outright ownership of the assets, or may be susceptible to pressure to make transfer to

related family members or caregivers. The distributed assets can be left by the spouse to whomever he or she chooses, whereas a granted general power of appointment can be conditioned upon the consent of a nonadverse third-party to any exercise in favor of the spouse's estate or its creditors. (Howard Zaritsky suggests that the nonadverse party who can consent to the exercise of a power should be someone other than the person who grants the power because a power is not a general power of appointment if it can be exercised only in conjunction with the "creator of the power." The IRS might assert [incorrectly] that the person who granted the power was the "creator" of the power.) Furthermore, actual distributions to the spouse cannot be "undone," whereas the trust agreement could afford maximum flexibility by providing that the independent party that grants the testamentary general power of appointment could subsequently remove or limit the grant if they deem it best to do so before the spouse's death. (Rescinding the power of appointment should not be a taxable lapse or release of a general power of appointment under § 2514 as long as a *testamentary* power of appointment is rescinded before the power holder's death. *See* Treas. Reg. § 20.2041-3(b).)

7. Basis Step-Up Flexibility; Formula General Power of Appointment. One possible approach is to use formula general powers of appointment, granted to the extent that the power would not result in the payment of estate taxes. There is concern that the beneficiary could have indirect control over all of the trust assets as a result of the formula grant of the power, meaning that the beneficiary would have a general power over all of the trust assets for tax purposes. If the formula operates without regard to the availability of a marital or charitable deduction, the formula no longer accurately grants a general power to cause basis step-up even though there would be no estate tax.

8. Basis Step-Up Flexibility; Triggering "String" Provision. To build in flexibility for achieving a basis step-up at the death of a transferor, consider purchasing appreciated assets from a grantor trust prior to the transferor's death or taking steps to trigger the "string" provisions of §§ 2036-2038. Planning flexibilities in the analogous gift situation for achieving estate inclusion in the original donor's estate are discussed in section XI.M of this outline.

XIII. GST Planning Issues Going Forward in Light of Changes in TRA 2010

A. GST Exemption Allocations; Opting Out of Automatic Allocations. There is now 2010 GST exemption ($5 million) that can be allocated on a timely basis to transfers that were made in trust during 2010. It is very important to "opt out" of automatic allocations to direct skip gifts in 2010 that are intended to pass to the current beneficiary rather than to future generations. Because the GST tax rate is zero on direct skip gifts in 2010, allocating GST exemption to the transfer would waste the exemption (unless a direct skip trust will remain in existence for the life of the current beneficiary and then pass to younger generations).

While TRA 2010 provides an extended due date (to no earlier than September 19, 2011) for reporting direct skip transfers, there is no extension of time for allocating GST exemption or opting out of automatic allocation for "indirect skip" transfers to trusts (i.e., transfers to trusts that are not direct skips). (See section IV.C.4 of this outline.) If an individual has made both direct skip gifts as well as indirect skip gifts, as a practical matter both should be reported, making GST exemption allocations or opting out of automatic allocations, on the same tax return under the normal filing cycle (April 18, 2011 or October 17, 2011 if the return is extended).

B. Reporting 2010 Generation-Skipping Transfers. Should returns be filed to report 2010 generation-skipping transfers? Even though there is a zero GST rate, a return is still technically required. However, the issue of generation-skipping transfers with a zero rate has been around for twenty-five years; trusts with a zero inclusion ratio are not *exempt* from the GST tax — they just have a zero tax rate. However, as a practical matter few planners filed tax returns for zero inclusion ratio trusts, unless they were worried about what the inclusion ratio was. For direct skip gifts (or other generation-skipping transfers) in 2010, there is no uncertainty. The only purpose for filing a return would be to get the statute of limitations running, but with a zero tax rate, that does not matter. There are no penalties where no GST tax is due, because there are no information reporting penalties for GST tax returns.

C. Adding Non-Skip Beneficiaries of Direct Skip Trusts. Some planners have suggested adding non-skip beneficiaries to direct skip trusts after the lapse of some period of time (such as five years). Amounts transferred to a direct skip trust in 2010 incurred no GST tax. If non-skip persons (for example, beneficiaries at the children level) could be added at a later time, in effect, the trust could benefit children and grandchildren without any GST tax being due when distributions are made to grandchildren during the trust term or upon termination. There is some concern, however, that a court might ultimately find that to be an abusive “end-run” around taking advantage of the zero tax rate on direct skips in 2010. A key factor would seem to be whether there was an intention subsequently to add children as beneficiaries when the transfer was made to the direct skip trust. See section VIII.C.2.f of this outline.

D. Disclaimers. Disclaimers in 2011 may result in direct skips having been made in 2010 with a zero GST tax rate. For testamentary transfers, the general thinking is that direct bequests under the will are deemed to have occurred at the time of death for GST purposes. (Otherwise there would be too much possibility for manipulation of the GST tax system by indefinitely delaying the funding of bequests.) A corollary is that disclaimers also operate as of the date of death for testamentary transfers. Under this reasoning, disclaimers made in 2011 (and there is an extended period for disclaimers from estates up to September 19, 2011, see section IV.B.3.c of this outline) may result in transfers for younger generation beneficiaries that are treated as 2010 direct skips, thus qualifying for the zero GST tax rate. See section VIII.F of this outline.

XIV. Other Estate Planning Strategies Going Forward in Light of Changed Planning Paradigm Under TRA 2010

A. Roth Conversions. TRA 2010 may impact Roth conversions in several ways. First, some taxpayers who made Roth conversions in 2010 have planned not to use the special exception allowing income taxes on the Roth conversion to be paid in the 2011 and 2012 tax years, for fear that the income tax rates would be higher than in 2010. That is now not the case, and in most situations the two-year deferral approach will now be advantageous. Second, a possible advantage of a Roth conversion is that the income tax payment is removed from the taxpayer’s gross estate and can result in estate tax savings. If the increased $5 million exclusion means that the taxpayer will not pay estate tax, this is no longer a relevant factor.

B. Graegin Loans Not as Favorable. Graegin loans are not as advantageous as under prior law. The income tax rate may approach or even exceed the estate tax rate. Trading income inclusion (from the interest on the note) for an estate tax deduction may not be favorable. However, there is still the significant present value advantage of benefiting from the estate tax deduction effective as of the estate tax payment due date even though some of the income recognition may not occur for years later.

C. Powers of Attorney and Revocable Trusts. In drafting powers of attorney, explore the principal's intent regarding the ability of the agent to make gifts in light of the greatly increased gift exemption amount. Does the principal want to allow $5 million in gifts, or does the principal want to place an upper ceiling on gifts that may be made under the power of attorney? Perhaps the client has no estate tax concerns under a $5 million estate tax exclusion amount and would want to severely restrict the power of the agent to make gifts as long as the estate tax exclusion remains above a certain amount.

On the other hand, some clients will want to broaden and reinforce the ability to make gifts in order to provide flexibility to take advantage of planning opportunities in case the principal becomes incompetent or to make adjustments in case of future law changes. Indeed, for those clients, the increased gift exclusion and the inherent estate tax uncertainty that we face may be a factor favoring revocable trusts in light of the increased flexibility that the trustee could have to consider changing circumstances.

D. Non-Tax Planning Issues. A $5 million estate exclusion amount means that very few families will pay estate taxes. Planners must keep in mind the myriad other nontax issues that must be addressed in estate planning. Some of these include asset protection, special needs planning, disability planning, elder financial planning, marital planning, planning for management for beneficiaries, planning for appropriate disposition among beneficiaries, planning for disabled beneficiaries, and charitable planning.

FEDERAL TAXATION OF SERIES LIMITED LIABILITY COMPANIES

By: *Kim Szarzynski and Troy Christensen*[1]

Series limited liability companies ("LLCs") have been around since Delaware created them by statute in 1996. Although various states (including Texas as of the last legislative session) have followed Delaware in providing for series LLCs, other than a Private Letter Ruling issued by the Internal Revenue Service (the "IRS") in 2008, the IRS has never issued any formal guidance on the federal tax treatment of series LLCs. However, that changed on September 14, 2010 when the IRS issued Proposed Regulation Sections 301.6011-6, 301.6071-2, and 301.7701-1(a)(5) (the "Proposed Regulations") addressing the treatment of these entities for federal income tax purposes.

Following is a brief description of series LLCs generally and the Proposed Regulations.

Background on Series LLCs

What is a Series LLC?

A series LLC is a form of entity that allows a single LLC to establish one or more series of members, managers, membership interests, or assets, each of which has separate rights, powers, or duties related to specified property or obligations of the LLC. Each series may have a separate business purpose or investment objective. For example, LLC X, with members A and B, could form series LLC X-1 in which A and B share profits 60/40 from activity 1 and form series LLC X-2 in which A and B share profits 30/70 from activity 2.

A series LLC is expected to provide limited liability protection to the members of each series and eliminate the expense of forming multiple entities for members that want to segregate assets and liabilities of different activities. (In the example above, series LLC X-1 and LLC X-2 would not be liable for each other's debts.)

Where is it Possible to Form a Series LLC?

Currently it is possible to form a series LLC in the following nine states:

- Delaware[2]
- Illinois[3]
- Iowa[4]
- Nevada[5]
- Oklahoma[6]
- Tennessee[7]

- Texas[8]
- Utah[9]
- Wisconsin[10]

What are the Reasons for Using a Series LLC?

One of the principal benefits offered by series LLCs is administrative convenience and cost savings. Generally, one public document is filed with the appropriate state department for the series LLC. In most states, including Delaware and Texas, the members can then designate new series without any additional public filings by preparing an addendum to the series LLC operating agreement.[11] For industries that typically use separate entities for each asset or business line (e.g., real estate investors, entrepreneurs with multiple businesses, etc.), this could provide a significant cost savings. For example, in Texas, the filing fee to form an LLC is $300.[12] If a real estate investor has ten properties and he wants to separate each property for liability purposes, he can either form ten separate LLCs at a cost of $3,000 or form a series LLC with ten separate series at a cost of $300.

Some have also suggested that series LLCs can be used to avoid state transfer taxes. For example, if property is titled in the name of the series LLC, theoretically, the property could be moved from series-to-series within that series LLC without having to change title, thereby avoiding state transfer taxes. This approach, however, seems risky. First, if the title to property is held by the series LLC rather than a particular series, there is a question about whether liabilities related to that property will truly be limited to a particular series. Second, in some states, a transfer tax may be triggered on an indirect ownership change. As a result, if there are different owners for each series, transferring property from one series to another may still trigger transfer taxes.

Series LLCs can also be used in the investment fund business when a blocker entity is needed for investments by foreign or tax-exempt investors. Generally, foreign and tax-exempt investors want to avoid investing in an operating partnership so that they can avoid earning income effectively connected with a U.S. trade or business (“ECI”) or unrelated business taxable income (“UBTI”). Investment funds typically help investors avoid these “bad” categories of income by having those investors invest through a “blocker” entity that is taxed as a corporation for federal income tax purposes. The corporate “blocker” entity distributes dividends to its shareholders, which should not give rise to either ECI or UBTI. As an alternative to this structure, an investment fund could have investors invest in a series LLC. Each series within the series LLC would elect to be treated as a partnership or corporation as necessary, depending on whether the underlying investment is one that produces ECI or UBTI (i.e., if an underlying investment produces ECI or UBTI, then a series investing in that investment would elect to be treated as a corporation). This structure may provide a better alternative than setting up a single “blocker” with multiple investments because this structure provides investors with the opportunity to dispose of only one underlying investment at a time rather than just disposing of their investment in the single corporate "blocker." In addition, this structure may produce a better over-all tax result by avoiding corporate double-taxation wherever possible.

Finally, there may be additional administrative and cost savings benefits if series LLCs are able to limit securities and federal and state tax filings. With respect to securities filings, this approach is not without risk because it is not currently clear whether one securities filing is required from a series LLC or a securities filing will be required by each series of a series LLC. In addition, as discussed below, the Proposed Regulations will make it more difficult going forward to file one federal income tax return for a series LLC, rather than a return for each series within the series LLC.

What Guidance is Provided in the Proposed Regulations?

Entities to Which the Proposed Regulations Apply

The Proposed Regulations apply to series LLCs, partnerships and trusts, protected and segregated cell companies, and segregated portfolio and account companies, that establish and maintain a segregated group of assets and liabilities by agreement of the series organization pursuant to a state statute that explicitly permits: (a) members or participants (i.e., officers or directors without ownership in the series organization but with powers with respect to the series) of a series to have rights and powers with respect to the series; (b) a series to have separate rights and powers with respect to specified property or obligations; and (c) the segregation of each series' assets and liabilities such that the liabilities of a series are not enforceable against the assets of another series of the series organization.[13] In addition, the Proposed Regulations apply to foreign (i.e., non-U.S.) series entities conducting insurance businesses.[14]

Various state statutes provide that the liabilities of a series within a series LLC will not be enforceable against the assets of another series within that series LLC only if certain requirements are met, including, maintaining records that account for the assets associated with that series separately from the other assets of the series LLC or any other series and providing for such limitation on liability in the series LLC's operating agreement.[15]

The failure to comply with these state requirements will not affect the status of a series for federal tax purposes. The Proposed Regulations provide that an election, agreement, or other arrangement that permits liabilities of a series or the series LLC to be enforceable against the assets of a particular series, or a failure to comply with the record keeping requirements for the limitation on liability under the relevant series statute will be disregarded for determining whether a series will be considered a "series" under the Proposed Regulations.[16]

Separate Entity Status and Ownership of a Series

Under the Proposed Regulations, each series of a series LLC will be treated as an entity formed under local law.[17] Whether a series is recognized as a separate entity for federal tax purposes is determined under §301.7701-1 of the Treasury Regulations and general tax principals.[18] As a result, each series that is recognized as a separate entity for federal tax purposes will be classified under the "check-the-box" regulations and may make any federal tax election it is otherwise eligible to make independently of the series LLC or any other series.[19]

For example, assume LLC X is a series LLC with three members (members 1, 2, and 3). LLC X establishes series LLC X-A with members 1 and 2 as owners and series LLC X-B with member 3 as the sole owner, barring any affirmative elections, for federal income tax purposes, series LLC X-A will be a partnership and series LLC X-B will be a disregarded entity.[20]

For federal tax purposes, the ownership of a series and the assets associated with a series will be determined under general tax principles.[21] The Proposed Regulations provide that, for federal tax purposes, the series LLC will not be the owner of a series or the assets associated with a series just because the series LLC holds legal title to such assets.[22] Therefore, if a state statute does not permit a series to hold legal title to the assets associated with that series, then that series may still be considered the owner of those assets for federal tax purposes.

Segregated Liability for Taxes (Hopefully)

Because each series is treated as a separate entity formed under local law for federal tax purposes, each series should only be liable for federal income taxes related to that series. However, the IRS reserves the right to impose liability for taxes upon the series LLC or another series within such series LLC to the extent the debts of one series can be paid by the series LLC or another series within such series LLC under other provisions of local or federal law.[23]

No Employment Tax Guidance

At this time, the IRS has not issued guidance on the federal employment tax treatment of a series LLC.[24] The IRS did not issue such guidance because of a variety of open issues, including:[25]

(a) The difficulty of determining whether a series or the series LLC is the employer (e.g., if a series cannot enter into contracts in its name or sue or be sued under its state statute, then can that series be an employer?).

(b) If an employee of a series provides services to more than one series, then which series would be eligible for employer tax credits?

(c) If a series were considered the employer for federal employment tax purposes, but the series was not recognized as a separate entity under state law, then administrative problems could arise unless separate Forms W-2 were prepared for federal and state purposes.

As a result, it is possible that each series within a series LLC will be treated as a separate entity for federal income tax purposes, while the series LLC itself, as the only "employer" for state law purposes, will be treated as the only "employer" for federal employment tax purposes.

Transition Rule

A taxpayer that has been treating all series within a series LLC as one entity for federal income tax purposes may continue to do so under the Proposed Regulations (the "Transition Rule"). Generally, this Transition Rule will apply provided that the following requirements are satisfied:

(a) the series was established prior to September 14, 2010;[26]

(b) the series (independent of the series LLC or the other series within the series LLC) conducted business on and prior to September 14, 2010, or with respect to a foreign series, more than half of such foreign series' business was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies on and prior to September 14 2010;[27]

(c) if a foreign series, the series classification was relevant (as determined under section 301.7701-3(d) of the Treasury Regulations), and more than half of such foreign series' business was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies for all taxable years beginning with the taxable year that includes September 14, 2010;[28]

(d) no owner of the series treats the series as an entity separate from the series LLC or any other series within the series LLC for purposes of filing federal income tax returns, informational returns, or withholding documents in any taxable year;[29]

(e) the series and the series LLC had a reasonable basis for the classification;[30] and

(f) neither the series nor any owner of the series or the series LLC was notified on or before the date the final regulations are published in the Federal Register that the classification of the series was under examination.[31]

The Transition Rule will no longer apply if 50 percent or more of the ownership interests (i.e., a capital or profits interest, if treated as a partnership, or an equity interest measured by vote or value, if treated as a corporation) of a series LLC or any of its series are owned, in the aggregate, by persons who were not owners of that series or series LLC prior to September 14, 2010.[32]

Annual Statement

The Proposed Regulations require an annual statement to be filed by a series LLC and each of its series to provide the IRS with certain identifying information to ensure the proper assessment and collection of federal income tax.[33] The Proposed Regulations require the annual statement be filed on or before March 15 of each year beginning after the date the final regulations are published in the Federal Register.[34]

Although the information required by the annual statement is still to be determined by the IRS, some information that the IRS may require on the annual statement includes: (a) the name, address, and taxpayer identification number of the series LLC and each of its series; (b) the jurisdiction in which the series LLC was formed; and (c) an indication of whether the series holds title to its assets or whether title is held by the series LLC or another series, and if title is held by the series LLC or another series, the name, address, and taxpayer identification number of the series LLC and/or each series holding title to such assets.[35]

Comments to Proposed Regulations.

Currently, the Partnership and Real Estate Tax Committee of the Texas Tax Section (the "Committee"), a subdivision of the State Bar of Texas, is preparing comments on a number of open issues and additional questions raised by the Proposed Regulations. The following is a possible list of the issues that will be addressed in the Committee's comments:

(a) Whether a series LLC should be treated as a separate entity for federal tax purposes if it has no assets and does not engage in activities separate from its series.

(b) Whether a series can be a disregarded entity of the series LLC, and clarification of whether the series LLC will own an interest in a series.

(c) The tax treatment of a series within a foreign series LLC that does not conduct insurance business.

(d) The tax treatment of a series LLC and its series for federal employment tax purposes.

Conclusion

Because series LLCs and other types of series entities are relatively new forms of entities, there is sure to be a great deal of uncertainty with respect to their use. However, the Proposed Regulations have given practitioners some guidance with respect to their treatment for federal income tax purposes. In light of this guidance, we will, hopefully, also begin to see additional guidance under both state and federal securities laws and state tax codes. As such guidance is issued, these types of entities may be used more frequently as a result of the administrative and cost benefits described above.

---

[1] Kim Szarzynski and Troy Christensen are both associates in the Business Planning and Tax practice group at Haynes and Boone, LLP.
[2] Del. Code tit. 6, § 18-215 (2010). Note that Delaware law also provided for series limited partnerships and is currently the only state to do so. *See* Del. Code tit. 6 § 17-218.
[3] 805 Ill. Comp. Stat. § 180/37-40 (2010).
[4] Iowa Code §§ 489.1201, et. seq. (2010).
[5] Nev. Rev. Stat. §§ 86.1255, 86.161, 86.291, 86.343, 86.491, 86.343, 86.491, 86.495, 86.544 (2010).
[6] Okla. Stat. tit. 18, § 18-2054.4 (2010).
[7] Tenn. Code Ann. § 48-249-309 (2010).
[8] Tex. Bus. Org. Code § 101.601, et. seq. (2009).
[9] Utah Code § 48-2c-606, et. seq. (2010).
[10] Wis. Stat. § 183.0504 (2010).
[11] *See* Del. Code tit. 6, § 18-215 (2010) and Tex. Bus. Org. Code § 101.601, et. seq. (2009). Note that Illinois is the

exception to this general rule because it requires a Certificate of Designation to be filed for each series of a series LLC. See 805 Ill. Comp. Stat. § 180/37-40(d) (2010).

[12] Tex. Bus. Org. Code § 4.154 (2009).

[13] Prop. Treas. Reg. § 301.7701-1(a)(5)(viii), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[14] Prop. Treas. Reg. § 301.7701-1(a)(5)(ii), 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

[15] *See* Del. Code. Ann. tit. 6 § 18-215(b) (2010); and Tex. Bus. Orgs. Code Ann. § 101.602(b) (2009).

[16] Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(C), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[17] Prop. Treas. Reg. § 301.7701-1(a)(5)(i), 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

[18] Prop. Treas. Reg. § 301.7701-1(a)(5)(iii), 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

[19] *See* Prop. Treas. Reg. § 301.7701-1(a)(5)(iv), 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

[20] Prop. Treas. Reg. § 301.7701-1(a)(5)(x) Example 1, 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[21] Prop. Treas. Reg. § 301.7701-1(a)(5)(vi), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[22] *Id*.

[23] Prop. Treas. Reg. § 301.7701-1(a)(5)(vii), 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

[24] Prop. Treas. Reg. § 301.7701-1(a)(5)(ix), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[25] 75 Fed. Reg. 55699, 55705 (Sept. 14, 2010).

[26] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(1), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[27] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(2), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[28] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(3), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[29] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(4), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[30] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(5), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[31] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(6), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010).

[32] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(B), 75 Fed. Reg. 55699, 55709 (Sept. 14, 2010).

[33] Prop. Treas. Reg. § 301.6011-6(a), 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

[34] Prop. Treas. Reg. § 301.6071-2, 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010).

[35] 75 Fed. Reg. 55699, 55705 (Sept. 14, 2010).

RETURN TO TABLE OF CONTENTS

SAVE YOUR CLIENTS MONEY – PLANNING UNDER THE TEXAS MARGIN TAX

By: *Kirk Lyda and Charolette Noel*[1]

The Texas margin tax presents both pitfalls and planning opportunities for most companies. The unusual structure of the margin tax can make predicting the tax implications difficult. Many companies can benefit from a knowledgeable professional's careful review of their Texas margin tax filing methodology and related assumptions. Such reviews have lead to substantial refunds, and even more substantial ($1 million-plus) refund claims are pending. Even companies that inadvertently underreported taxes can benefit by limiting remedial costs by obtaining waivers of interest and penalties through voluntary disclosures and making certain adjustments to business activities that may be triggering excessive tax costs.

Understanding the mechanics of the Texas margin tax and how it varies from other states' business taxes can be crucial to avoid overpaying unnecessary margin taxes. This article provides an overview of the Texas margin tax and addresses some planning and refund opportunities the authors have identified in their practice.

Margin Tax Overview

The "margin tax" refers to the current version of the Texas franchise tax that applies to all entities that enjoy the privilege of liability protection. The margin tax applies not only to corporations and LLCs, but also to limited partnerships, limited liability partnerships, professional associations and business trusts.[2] A business's tax liability under the margin tax is calculated as the lesser of (i) 70 % of total revenue, OR (ii) total revenue less cost of goods sold ("COGS"), OR (iii) total revenue less compensation; the lesser amount is multiplied by the apportionment factor (Texas sales receipts/sales receipts everywhere) and then multiplied by the appropriate tax rate.

COGS generally includes all direct costs of acquiring or producing goods, certain categories of other costs, up to 4% of indirect and administrative overhead costs, reduced by certain disqualified costs.[3] Compensation generally includes wages and cash compensation plus certain types of benefits.[4]

The tax rate is 1% for all entities except those whose activities are described in wholesale or retail trades,[5] which qualify for a 0.5% tax rate.[6] In general, "wholesale trade" is described as selling merchandise to retailers or other businesses to be resold or used.[7] "Retail trade" is described as selling merchandise for personal or household consumption.[8]

The Texas margin tax requires combined reporting for all taxable entities that are: (i) part of an affiliated group; (ii) engaged in a "unitary business;" and (iii) not excluded under the "water's edge" provision.[9] A "combined group" includes all taxable entities without regard to whether the particular entity has nexus with Texas. The combined group files reports on a combined basis as a single economic unit.[10]

Netting Revenue and Expenses

"Total revenue" is computed on the basis of certain enumerated gross revenue lines from federal income tax returns.[11] In some situations, industries or companies have discretion to report a given stream of income at gross and deduct a corresponding expense elsewhere or, instead, to net the revenue against the expense and report the net amount on the federal return.[12] If such net reporting is allowable, it reduces the total revenue flowing into the Texas margin tax return, even if the corresponding expense item is otherwise not deductible.

Take, for example, an airline that sells travel packages consisting of the flight, a hotel room, and a rental car. The airline collects the total amount from the traveler, pays an amount to the hotel for the room and an amount to the rental company for the car, and retains the remainder. If the airline is permitted to report its net retained amount as total revenue on its federal income tax return, the amounts paid to the hotel and the rental company would be excluded from the airline's margin tax base because those amounts had been netted against total revenue from the customer. Those amounts would not be included in the margin tax base even though they would not qualify for a deduction under the margin tax.

Flow-Through Funds

The statute contains several provisions to address receipts that were commonly referred to as "flow-through" funds when the Texas Legislature adopted the margin tax. Under one provision, a taxable entity may deduct from total revenue "flow-through" funds that are mandated by law or *fiduciary duty* to be distributed to other entities.[13] An example is taxes collected from a third party by the taxable entity and remitted by the taxable entity to a taxing authority. These amounts may not be excluded, however, if the taxable entity belongs to an affiliated group and the amounts are paid to entities that are members of the affiliated group.[14]

While companies can usually determine if funds are mandated by law to be distributed to other entities, more careful consideration is generally required to evaluate the indicia of a fiduciary duty. Neither the statute nor the related Comptroller Rule defines the term "fiduciary duty" for this purpose. If a company receives significant funds dedicated for payment to a third party, it should consider whether a fiduciary relationship may be developed. Such planning could permit exclusion of these types of funds from the tax base. Obviously, creating a fiduciary relationship has legal implications that should be considered carefully.

Cost of Goods Sold

Taxable margin is computed (in part) by subtracting cost of goods sold.[15] COGS includes all direct costs of acquiring or producing the goods.[16] A taxable entity is allowed to capitalize a cost of good in the same manner and to the same extent as the taxable entity capitalized that cost on its federal income tax return or, alternatively, to elect to expense qualifying COGS.[17] The Comptroller's Rules provide the administrative details of making that election.[18] "Goods" includes "tangible personal property *sold in the ordinary course of business*."[19] The statutes do not define "sold" or "ordinary course of business," but other Texas tax provisions may provide helpful guidance.

For most qualifying companies, the largest deduction is COGS. According to the Comptroller, on average COGS equals approximately 82% of total revenue, while compensation equals roughly 55%. In early revenue estimates, COGS was originally envisioned as equaling about 60%-65% of total revenue. Thousands more businesses claimed the COGS deduction than the Comptroller expected. The COGS deduction is thus fertile ground for questions regarding who and what qualify for this valuable deduction. Here are some examples.

Do Lessors Qualify for COGS?

Arguably, companies leasing tangible personal property or real property (both "goods" under the statute) qualify for the COGS deduction. Such companies would then be entitled to deduct a portion of the acquisition cost of the property ratably over the life of the property, either through depreciation or by deducting a portion of the total cost against each rental payment.

Owning property means having a bundle of rights over something, such as the rights of acquisition, dominion, possession, use and enjoyment, exclusion, disposition, and access.[20] In its ordinary legal sense, "the word 'property' extends to every species of valuable right and interest."[21] The term "property" includes not only the thing owned, but every right that accompanies ownership, and is an incident thereto.[22] A "sale" of property, in turn, means any transfer of property from one to another for a valuable consideration or a transfer of something (and title to it) in return for money (or other thing of value) on terms agreed upon between buyer and seller.[23] Thus, "sale" means any of the following when done or performed for consideration: a transfer of title or possession of tangible personal property, and the exchange, barter, lease, or rental of tangible personal property.[24]

Each time a company agrees to "rent" property for a particular period in exchange for consideration, the lessor has sold the exclusive right to possess and use the property for that certain period. That is an absolute transfer of title to those rights during that applicable period. The lessee has those exclusive rights even as against the lessor. The cost associated with each sale is by statute expressly allowed to be deducted in computing the margin tax. The Tax Code allows for the recovery of those costs either through periodic depreciation deductions or through deducting a portion of the total cost that is attributable to that sale. Lessors are thus arguably entitled to deduct an applicable portion of the cost of the property over the life of the property.

What Expenses Are Deductible as Direct Costs?

Direct costs are the primary component of COGS. While the statute lists examples of direct costs, it does not define, or provide a reference point to determine, "direct costs."[25] The Texas Comptroller of Public Accounts adopted a series of administrative rules interpreting the reformed franchise tax. The applicable Comptroller Rule on Margin: Cost of Goods Sold (34 Tex. Admin. Code 3.588) largely echoes the statutory discussion of "direct cost" but does not define it. The other publicly available guidance from the Comptroller's Office similarly does not define "direct cost." From informal conversations with both a senior Comptroller franchise tax auditor and a Comptroller Assistant General Counsel responsible for administrative hearings, we understand that the Comptroller's Office has not adopted a particular definition of "direct cost" for its internal use. In many seminars on the reformed franchise tax throughout the State of

Texas, taxpayers have repeatedly asked for the definition or meaning of "direct cost." The answer has always been that there is none, leaving both taxpayers and Comptroller personnel to guess at a meaning.

There are a number of supportable definitions of "direct cost" that would encompass categories beyond those enumerated in the statute. Many definitions of "direct cost" in turn include examples of qualifying costs, including costs that should qualify for the deduction but are not specifically listed in the margin tax statute. For example, under the Federal Financial Accounting Standards, "direct costs" are those "costs that can be *specifically identified* with an output."[26] Examples of direct costs are listed, including:

> salaries and other benefits for employees who work directly on the output, materials and supplies used in the work; various costs associated with office space, equipment, facilities, and utilities that are used exclusively to produce the output; and costs of goods or services received from other segments or entities that are used to produce the output.[27]

Certain types of overhead costs that specifically relate to particular products may qualify as direct costs and be deductible without regard to the normal 4% cap on overhead items. For example, Black's Law Dictionary defines direct cost as "the amount of money for material, labor, *and overhead* to produce a product."[28] Webster's Dictionary defines direct cost as "a cost that may be computed and identified directly with a product, function, or activity and that usually involves expenditures for raw materials and direct labor *and sometimes specific and identifiable items of overhead*."[29] Various definitions and methodologies employed in cost accounting also identify certain overhead costs as "direct costs."

Federal concepts of "direct cost" in the context of contracting with the federal government are also useful. In the Code of Federal Regulations, the phrase "direct costs of processing operations" includes, but is not limited to, "all actual labor costs involved in the growth, production, manufacture, or assembly of the specific merchandise, including fringe benefits, on-the-job training and the cost of engineering, supervisory, quality control, and similar personnel; and dies, molds, tooling, and depreciation on machinery and equipment which *are allocable to the specific merchandise*."[30] The CFR definition excludes:

> costs which are not directly attributable to the merchandise concerned or are not costs of manufacturing the product, such as (i) profit, and (ii) general expense of doing business which are either not allocable to the specific merchandise or are not related to the growth, production, manufacture, or assembly of the merchandise, such as administrative salaries, casualty and liability insurance, advertising, interest, and salesmen's salaries, commissions or expenses.[31]

Another approach would look to the statute's negative inference from the definition of the term "indirect." The statute specifically lists things that are "indirect and administrative overhead costs," like "mixed service costs, such as security services, legal services, data processing services, accounting services, personnel operations, and general financial planning and financial management costs."[32] Under this approach, costs allocable to acquiring or producing goods other than the "indirect" costs specifically listed in the statute would qualify as direct costs. Some definitions of "direct cost" would support this reading, such as Kohler's Dictionary for Accountants, which defines "direct cost" as "the cost of any good or service that contributes to and is readily ascribable to product or service output, *any other cost incurred being regarded as an indirect cost*."[33]

Which Costs Are Disallowed Costs?

Companies should also avoid reading the list of specifically disallowed costs too broadly. Costs that might, on first glance, seem to be disallowed may not be. For example, the statute disallows "distribution costs, including outbound transportation costs."[34] Costs associated with moving product from one facility to another facility are transportation costs, but they may not be "outbound" transportation costs that constitute "distribution" costs. Take, for example, a company buying products from wholesalers, initially shipping the products to one distribution center and then shipping the products to a larger, regional distribution center. Arguably, no portion of such transportation cost should be disallowed because the transportation is not outbound "distribution" costs. Other similar situations exist that can minimize amounts treated as disallowed costs.

With regard to the 4% cap on the COGS deduction for "indirect and administrative overhead costs," for example, companies should carefully review their cost categories for "indirect and administrative overhead costs" that are not on the enumerated list. The statute lists examples of qualifying costs,[35] but it does not purport to be exhaustive. Other costs may qualify for the deduction even though they are not specifically listed.

Maximizing the Lower 0.5% Tax Rate

Thousands of companies beyond what the Comptroller expected have claimed the 0.5% tax rate. While the Comptroller certainly has arguments for resisting a broad reading of the applicable statute, a careful reading suggests some planning opportunities.

The Texas Tax Code provides for the following margin tax rates:

> (a) Subject to Sections 171.003 and 171.1016 and except as provided by Subsection (b), the rate of the franchise tax is one percent of taxable margin.
>
> (b) Subject to Sections 171.003 and 171.1016, the rate of the franchise tax is 0.5 percent of taxable margin for those taxable entities ***primarily engaged in retail*** or wholesale trade.
>
> (c) A taxable entity is ***primarily engaged in retail*** or wholesale trade only if:
>
>> (1) the ***total revenue from its <u>activities</u> in retail*** or wholesale trade is ***greater than the total revenue from its activities in trades other than the retail*** and wholesale trades;

> (2) except as provided by Subsection (c-1), less than 50 percent of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs; and
>
> (3) the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas.

> (c-1) Subsection (c)(2) does not apply to total revenue from activities in a retail trade described by Major Group 58 of the Standard Industrial Classification Manual published by the federal Office of Management and Budget.[36]

"Retail trade" means "the activities described in Division G of the 1987 Standard Industrial Classification [SIC] Manual published by the federal Office of Management and Budget."[37]

The Texas Tax Reform Commission (the group appointed by Governor Perry to reform business taxes in Texas) issued the following analysis of the 0.5% tax rate:

> *Rate and Computation of Tax:* In addition to increasing the number of businesses subject to the tax, the underlying base is changed to "total revenues minus certain deductions" rather than net income or net worth (capital.) As a result, the primary tax rate is lowered from 4.5% to 1%. However, taxable ***entities primarily engaged in retail*** or wholesale trade ***would pay a reduced rate*** of 0.5%, ***in recognition of the low profit margins basic to the industry***. A taxable entity is primarily engaged in retail or wholesale trade if the total revenue from these activities is greater than the total revenue from other activities. As [a] second test, a taxable entity that predominantly sells or resells products it or a member of the affiliated group produces does not qualify for the reduced rate. Retail or wholesale utilities, including telecommunications services, electricity, or gas also do not qualify for the reduced rate.[38]

These provisions indicate that some businesses that might not normally be considered retailers or wholesalers may qualify as entities "primarily engaged in retail trade or wholesale trade" under the statute and intent of the drafters. Many businesses may be described in multiple divisions of the 1987 SIC Manual. Just because a business is also described in a division besides Division G does not exclude the business from qualification under Division G of the SIC Manual. As the following examples indicate, careful parsing of the text of the statutes may indicate the lower .05% rate is allowable.

Renting Tangible Personal Property

The intent of the drafters of the margin tax was thus not to distinguish between retail sellers and retail renters. The intent of the drafters was to afford a lower tax rate to companies in a retail or wholesale trade because of lower profit margins within that industry as opposed to manufacturing.

Division G of the 1987 SIC manual encompasses the following companies:

> This division includes establishments engaged in ***selling merchandise for personal or household consumption*** and rendering services incidental to the sale of the goods. In general, retail establishments are classified by kind of business according to the principal lines of commodities sold (groceries, hardware, etc.), or the usual trade designation (drug store, cigar store, etc.). Some of the important characteristics of retail trade establishments are: the establishment is usually a place of business and is engaged in activities to attract the general public to buy; the establishment buys or receives merchandise as well as sells; the establishment may process its products, but such processing is incidental or subordinate to selling; the establishment is considered as retail in the trade; and the establishment sells to customers for personal or household use. Not all of these characteristics need be present and some are modified by trade practice.

Nothing in the Texas margin tax statutes directly excludes renting from qualifying as "retail trade."

Not Excluded by Subcategories Outside of Retail and Wholesale Trade

An entity whose activities meet the broad definitions of "retailer" and "wholesaler" should not be excluded from the 0.5% rate merely because its activities are also described in a subcategory under a different division.

For example, unlike Division G, which classifies retailers, Division I (Services) includes "establishments primarily engaged in providing a wide variety of services for individuals, business and government establishments, and other organizations." Division I, Industry Group 7359 (Equipment Rental and Leasing, Not Elsewhere Classified), however, includes "establishments primarily engaged in renting or leasing (except finance leasing) equipment, not elsewhere classified." An entity renting consumer goods thus might be described in Industry Group 7359 under Division I and may not seem to qualify for the ½% rate. However, the statute incorporates Division G, which does include selling goods to consumers, but does not incorporate subcategories under other divisions, like Division I, Industry Group 7359. At least arguably then, a consumer rental company qualifies for the 0.5% rate because its activities are described in Division G, notwithstanding the fact that its activities are also described within a subcategory under Division I.

Very Limited Nonclassifiable Entities

It is very rare for an entity to fail to qualify for the 0.5% rate because it is classified in the "nonclassifiable" category. The SIC manual provides that an entity may be treated as "nonclassifiable" only if it "cannot be classified in any other industry. Establishments which can be classified in a division should be classified in the most appropriate industry within that division." The default, then, is that a business should be classified within Divisions A–J (if possible), after which it should be assigned to the closest possible industry fit within that division.

Apportionment

The Texas apportionment rules largely remained the same in transitioning to the margin tax. The unique Texas apportionment rules, such as the "location of payor" rule for certain types of intangibles and the "location of performance" rule for sourcing services, take an even more important planning role under the margin tax. Certain features of the margin tax, such as passive entities and apportionment of revenue streams flowing up from those entities, lend themselves to careful planning.

Joyce and Nexus

The Texas "*Joyce*" apportionment methodology, which excludes from the numerator of the apportionment factor receipts of affiliated entities lacking a nexus with Texas, can also lead to less tax owed by combined groups. Under the statute, "[a] combined group shall include in its [Texas] gross receipts . . . the gross receipts of each taxable entity that is a member of the combined group and that has ***a nexus*** with this state for the purpose of taxation."[39] The statutes do not define "a nexus," but in the context of the *Bandag Licensing* decision,[40] it probably means "physical presence" in Texas. A combined group may exclude receipts from affiliates without "a nexus" or physical presence in Texas from the numerator of the group's apportionment factor, thus reducing the amount of margin apportioned to Texas. Careful nexus planning can thus play a huge role in minimizing the Texas margin tax.

Election of Entities Affiliated with Two Unitary Groups

The Texas margin tax requires combined reporting for all taxable entities that are: (1) part of an affiliated group; (2) engaged in a "unitary business"; and (3) not excluded under the "water's-edge" provision. A "combined group" includes all such taxable entities without regard to whether the particular entity has a nexus with Texas. The combined group files reports on a combined basis as a single economic unit.[41]

For purposes of defining the members of the combined group, the "affiliated group" includes one or more entities in which a controlling interest is owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member entities. A "controlling interest" is defined as follows:

> (1) for a corporation: more than 50 percent of the direct or indirect ownership of the total combined voting power of all

> classes of stock of the corporation, or of the beneficial ownership interest in the voting stock of the corporation; and
>
> (2) for a partnership, association, trust, or other entity: more than 50 percent of the direct or indirect ownership of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity.[42]

Under the Comptroller's Rule:

> [i]f the entity has a unitary relationship with more than one of those affiliated groups, it shall elect to be treated as a member of only one group. The election shall remain in effect until the unitary business relationship between the entity and the other members ceases, or unless revoked with approval of the comptroller."[43]

There are situations in which this election can significantly reduce the Texas margin tax liability of one or more affiliates.

Unitary Analysis

Members of an affiliated group are required to file a combined report only if the members also engage in a unitary business. A "unitary business" means a single economic enterprise made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.[44]

The U.S. Supreme Court has ruled that the U.S. Constitution prohibits a state from taxing income earned in another state unless the income is earned as part of a unitary business conducted within the taxing state. A state may not tax a non-domiciliary entity's income, however, if that income is derived from an unrelated business activity constituting a discrete business enterprise.[45]

The U.S. Supreme Court derived the "unitary" business principle from a series of property tax cases in the late 1800s involving multistate railroad companies. The underlying issue was how to determine and apportion the value of the rail and related assets among the states. Rather than viewing the portion of the rail located in a particular jurisdiction in isolation and attempting to value that portion separately, the Court sanctioned viewing the rail "as a unit" and allowed the jurisdictions to "ascertain the value of the whole road, and apportion the value within the county by its relative length to the whole."[46] The Court subsequently expanded the concept of a "unit rule" beyond cases in which there was a contiguous physical unity (e.g., a railroad) to cases in which there was operational unity.

For a business to be unitary, "the out-of-state activities of the purported 'unitary business' must be related in some concrete way to the in-state activities" – *i.e.*, there must be "some sharing or exchange of value not capable of precise identification – beyond the mere flow of funds arising out of a passive investment or a distinct business operation."[47] The U.S. Supreme

Court in *Allied-Signal* identified the following factors as relevant in determining whether an entity's activities are part of a unitary business:

- Functional integration (*e.g.*, transactions not at arm's length);
- Centralization of management (*e.g.*, parent management grounded in its operational expertise and operational strategy); and
- Economies of scale (*e.g.*, same line of business).

Determining whether a unitary business exists is a facts and circumstances test. Specific facts the Court has looked to in determining whether a unitary business exists include the following:

- Substantial intercompany transactions (*e.g.*, subsidiary selling exclusively to parent);
- Overlapping officers and directors;
- Centralized site selection, advertising, and accounting control;
- Centralized purchasing, manufacturing, or warehousing;
- Independent or joint financing; and
- Centralized training.

Exercise of actual control of a subsidiary, as distinguished from the legal right to control the company, is a prerequisite of a unitary business relationship.[48] States are free to take a more restrictive view of what constitutes a "unitary business" than the view of the U.S. Supreme Court. They cannot, however, take a more expansive view of what constitutes a unitary business.

Carefully defining the unitary group can lead to significant margin tax benefits. If some affiliates are engaged in two unitary groups, one group could elect the COGS deduction while the other group could elect to deduct compensation. Certain benefits associated with apportionment planning can be magnified with two or more unitary groups. Costs incurred by an affiliate (in one unitary group) to produce and sell goods to another affiliate (in a different unitary group) may qualify for the COGS deduction even if the costs would not otherwise qualify.[49] The other examples of planning in the context of two or more unitary groups are quite numerous.

Conclusion

As with any new, somewhat complicated tax, the Texas margin tax contains a number of gray areas ripe for tax planning. In the right situation, a careful review can lead to millions in refunds or tax reductions. The statute of limitations is running.

---

[1] The views expressed in this articles are those of the authors and do not necessarily reflect the opinions of any organization with which the authors are associated. Because of its generality, the information contained in this article should not be construed as legal advice on any specific facts and circumstances. The contents are intended for general information purposes only.

Kirk R. Lyda, who is a state and local tax partner in the Dallas office of Jones Day can be contacted at klyda@jonesday.com Charolette Noel, who is also a state and local tax partner in the Dallas office of Jones Day and the adjunct professor of State and Local Taxation at Southern Methodist University Dedman School of Law can be contacted at cfnoel@jonesday.com.

[2] Texas Tax Code §§ 171.001(a), 171.0002.

[3] Texas Tax Code § 171.1012.

[4] Texas Tax Code § 171.1013.

[5] Divisions F and G of the 1987 Standard Industrial Classification Manual published by the Office of Management and Budget. A business is considered primarily engaged in retail or wholesale trade if it satisfies three conditions: (1) revenue from the business's retail or wholesale trade activities is greater than the revenue from its other trade activities (nonretail and nonwholesale activities); (2) less than half of the revenue from its retail or wholesale trade activities results from the sale of products it produces or products produced by an affiliate; and (3) the business does not sell, at retail or wholesale, utilities such as telecommunications, electricity, or gas. Texas Tax Code §171.002(c). For purposes of the second element, a product is not considered to be produced if modifications made to the acquired product do not increase its sales price by more than 10%.

[6] Texas Tax Code § 171.002.

[7] Texas Tax Code § 171.0001(18).

[8] Texas Tax Code § 171.0001(12).

[9] Interestingly, unlike most other states, Texas does not have an election related to its "water's edge" provision.

[10] Texas Tax Code § 171.1014.

[11] Texas Tax Code § 171.1011.

[12] The terminology "amounts reportable as income" was added as a clarification in House Bill 3928 (2007). The statutory change states that a reference to an "amount reportable as income" on a line number on an IRS form is the amount entered on the line to the extent the amount entered complies with federal income tax law.

[13] Texas Tax Code § 171.1011(f).

[14] Texas Tax Code § 171.1011(h).

[15] Texas Tax Code § 171.101(a)(1)(B)(ii)(a).

[16] Texas Tax Code § 171.1012(c).

[17] Texas Tax Code § 171.1012(g).

[18] According to the regulations, the election is made by using one method or the other on the taxpayer's returns. The election is for the entire period on which the report is based and may not be changed after the due date. If an entity elects to expense costs, costs incurred before the first day of the period on which the report is based cannot be included in the cost of goods sold deduction. Texas Comptroller Rule 3.588(c).

[19] Texas Tax Code § 171.1012(a)(1) (emphasis added).

[20] 73 C.J.S. Property § 2.

[21] *Womack v. Womack*, 172 S.W.2d 307 (Tex. 1943).

[22] *Ft. Worth Imp. Dist. No. 1 v. City of Ft. Worth*, 158 S.W. 164 (Tex. 1913).

[23] *See, e.g., McKinney v. City of Abilene*, 250 S.W.2d 924 (Tex. Civ. App.—Eastland 1952, writ ref'd n.r.e.).

[24] Texas Tax Code § 151.005.

[25] "The cost of goods sold includes all direct costs of acquiring or producing the goods, *including* . . . ." Texas Tax Code § 171.1012(c) (emphasis added).

[26] Statement of Fed. Fin. Accounting Standards No. 4, ¶ 90 (emphasis added).

[27] *Id.*

[28] Black's Law Dictionary 389 (9th ed. 2009) (emphasis added).

[29] Webster's New Third International Dictionary 640 (3rd ed. 2002) (emphasis added).

[30] Direct Costs of Processing Operations Performed in the Beneficiary Developing Country, 19 CFR 10.178 (1975) (emphasis added).

[31] Id.

[32] Texas Tax Code § 171.1012(f).

[33] Eric Louis Kohler, Dictionary for Accountants 173 (6th ed. 1983) (emphasis added).

[34] Texas Tax Code § 171.1012(e)(3).

[35] The statute provides that "[a] taxable entity may subtract as a cost of goods sold indirect or administrative overhead costs, including all mixed service costs, such as security services, legal services, data processing services, accounting services, personnel operations, and general financial planning and financial management costs, that it can demonstrate are allocable to the acquisition or production of goods, except that the amount subtracted may not exceed four percent of the taxable entity's total indirect or administrative overhead costs, including all mixed service costs. Any costs excluded under Subsection (e) may not be subtracted under this subsection." Texas Tax Code § 171.1012(f).

[36] Texas Tax Code § 171.002 (emphasis added).

[37] Texas Tax Code § 171.0001(13).

[38] Texas Tax Reform Commission, Section by Section Analysis, Tax Reform Version 79S30236, Section 2.01, available at http://www.docstoc.com/docs/65224961/2006-Texas-Franchise-Tax-Report (last visited Jan. 23, 2011) (emphasis added).

[39] Texas Tax Code § 171.103(b) (emphasis added).

[40] *Rylander v. Bandag Licensing Co.*, 18 S.W.3d 296 (Tex. App.—Austin 2000, pet. denied).

[41] Texas Tax Code § 171.1014.

[42] Texas Tax Code §§ 171.0001(1) and (8).

[43] Comptroller Rule 3.590(b)(4)(F).

[44] Texas Tax Code § 171.0001(17). The Texas definition was essentially copied from the Multistate Tax Commission's definition. The interpretations of the MTC's definition may thus be relevant in interpreting the Texas definition.

[45] *See Allied-Signal, Inc. v. New Jersey*, 504 U.S. 768 (1992); *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980); *Exxon Corp. v. Department of Revenue of Wis.*, 447 U.S. 207 (1980).

[46] *State Railroad Tax Cases*, 92 U.S. 575, 608 (1875); see also Hellerstein & Hellerstein, State Taxation ¶8.07[1].

[47] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 166 (1983).

[48] *See Allied-Signal,* 504 U.S. at 770 (sufficient ownership for "potential control is insufficient").

[49] Assume, for example that (i) Company A is a member of unitary group A that lacks nexus with Texas (or Company A, while unitary with affiliated Company B, qualifies as a foreign entity based on the 80% threshold in the water's edge provision); (ii) Affiliated Company B is a member of unitary group B that has nexus in Texas; and (iii) Company A sells its goods to Company B, which in turn sells the goods to a third party in Texas. Generally, the arm's-length price Company A would charge to Company B would exceed the value of direct and indirect costs of producing the goods, by incorporating a profit margin. Company B's COGS deduction, thus could incorporate costs not permitted as a deduction by Company A. The intercompany payment would not be eliminated in this context because Company A and Company B are not in the same Texas combined group. *See, e.g.*, Texas Tax Code § 171.1012(l).

ERISA'S SAFE HARBOR EXEMPTION FOR 403(B) PLANS: A PRIMER

By: *Alison M. Sulentic, Houston, Texas*[1]

A tax-exempt organization is free to decide whether the Employee Retirement Income Security Act of 1974 ("ERISA") should regulate its Section 403(b) retirement savings program. With this freedom, however, come two fundamental questions. First, how does ERISA apply to a Section 403(b) plan? Second, what price must be paid to steer clear of ERISA?

The first question is relatively easy to answer. ERISA's rules concerning reporting, disclosure, vesting and fiduciary obligations are generally applicable to Section 403(b) plans in the same manner as to employee pension benefit plans sponsored by private sector employers.[2]

Evaluating and responding to the second question, however, is a task that has increased in complexity and urgency since 2007, when the Internal Revenue Service promulgated final regulations under Section 403(b). Both the Internal Revenue Service and the Department of Labor have recognized that an employer "may undertake…responsibilities in connection with a [S]ection 403(b) program that would…constitute establishing and maintaining an ERISA-covered plan."[3] Industry standards and participant expectations are narrowing the gap between Section 401(k) plans (which are subject to ERISA) and Section 403(b) plans (which may or may not be). In this context, a tax-exempt employer must be mindful of engaging in behavior that, although unremarkable on the part of a 401(k) plan sponsor, could unexpectedly thrust a Section 403(b) plan into ERISA's territory.

This article examines ERISA's safe harbor exemption for Section 403(b) plans and identifies several issues that will assist tax-exempt employers to determine whether the comfort of the safe harbor is worth the price of admission.

I. ERISA Boundaries

In 1974 Congress observed that employee benefit plans had become "an important factor affecting the stability of employment and the successful development of industrial relations."[4] By enacting ERISA, Congress enabled participants in employee benefit plans to rely on important new protections, including enhanced disclosure requirements, strict fiduciary standards and guarantees that retirement savings would meet minimum vesting and funding requirements. To President Ford, immersed in the first harrowing weeks of his administration, the new law signaled "a brighter future for almost all the men and women of our labor force."[5] ERISA would surely "bring some order and humanity" into the private pension system,[6] whether pensions were sponsored by for-profit corporations or tax-exempt organizations.

Order, humanity and brighter employee relations aside, however, ERISA jurisprudence has always acknowledged two clear boundaries. First, church plans[7] and governmental plans[8] operate outside the ERISA framework.[9] The identity of the plan sponsor is the driving force behind the exemption for church and governmental plans. ERISA's exemption of these plans acknowledges both ideological and pragmatic constraints on the federal government's ability to regulate churches and government employers. Second, ERISA does not attempt to regulate compensation arrangements that are not "employee benefit plans."[10] Early ERISA jurisprudence accordingly developed a taxonomy of compensation arrangements that divided compensation arrangements into "employee benefit plans" that are subject to ERISA and "other" arrangements that are not.[11] ERISA does not apply to compensation arrangements that do not meet certain structural formalities which courts have determined to be characteristic of employee benefit plans. Here, the structure of the compensation arrangement (or lack thereof) drives its exemption from regulation by ERISA.

Section 2510.3-2(f) of the Department of Labor Regulations creates a third boundary that enables tax-exempt organizations to operate Section 403(b) programs outside the scope of ERISA. Eligibility for the safe harbor exemption depends neither upon the identity of the employer (aside from its status as a tax-exempt entity) nor upon the presence or absence of a particular plan structure. Most Section 403(b) programs are not church plans or government plans and do, in fact, operate under exactly the type of administrative scheme for the payment of benefits that would otherwise subject them to regulation as an employee benefit plan within the meaning of ERISA. Instead, eligibility for the safe harbor exemption depends upon the employer's behavior with regard to the plan. Aside from two threshold requirements concerning the participant's rights,[12] the regulation focuses on whether an employer's actions amount to "establishing or maintaining" the plan.

II. Employer Actions Permitted under the Safe Harbor Exemption

The structure of the safe harbor regulation makes clear just how easy it can be for a Section 403(b) plan to fall within ERISA's grasp. Section 2510.3-2(f) does not challenge whether the term "plan" encompasses a "program for the purchase of an annuity contract or the establishment of a custodial account described in section 403(b)." Instead, the safe harbor regulation merely states the conditions in which such a program is not considered to have been "'established or maintained by an employer' as that phrase is used in the definition of the terms 'employee pension benefit plan' and 'pension plan.'"[13]

In excusing a Section 403(b) plan from compliance with ERISA, the Department of Labor's primary concern is to insure that the employer does not engage in discretionary decision-making. As a practical matter, the actions which an employer may undertake without running afoul of the safe harbor do not require an independent evaluation of what is in the "best interest" of plan participants. Instead, Section 2510.3-2(f)(3) confines the employer to (i) determining which vendors may approach employees and (ii) transmitting information and contributions between the employee and the vendor. Since the promulgation of the final Section 403(b) regulations in 2007, the Department of Labor has also acknowledged that an employer may take actions necessary to comply with the requirements of the Internal Revenue Code.[14] These actions include (i) developing a written plan document, (ii) reviewing the structure and operation of the plan to identify and correct tax compliance defects, and (iii) monitoring compliance with nondiscrimination requirements and maximum contribution limitations. An employer may also certify facts within its knowledge as an employer (such as addresses, attendance records or compensation levels).[15]

The decision to forego discretionary decision-making in order to take advantage of the ERISA safe harbor exemption has direct consequences for plan design. In theory, a safe harbor plan may provide for hardship withdrawals, plan loans and other features that require discretionary decision-making if these decisions are made by the vendor that provides the annuity contract or custodial account.[16] However, if the plan is to operate within the safe harbor exemption, the employer can play no role in the decision-making process. If the vendor declines to take on this responsibility, the plan cannot retain these features while remaining within the safe harbor exemption. The Department of Labor has also stated that an employer will exceed the limited involvement permitted by the safe harbor by appointing a third-party administrator to take on responsibility for discretionary decision-making.[17]

III. Assessing the Price of the Safe Harbor Exemption

The promulgation of the 2007 final regulations ended any illusion that *laissez-faire* could be an acceptable approach to the administration of a Section 403(b) plan. At the same time, however, a plan's safe harbor status can be jeopardized merely because the employer has taken too vigorous an interest in its operation. The employer's self-constraint is the only barrier between a Section 403(b) program and ERISA.

With this in mind, a tax-exempt organization should evaluate whether its compensation strategy enhances or detracts from its capacity to offer services in furtherance of its tax-exempt mission. For a nonprofit employer operating on a limited budget of time and resources, a safe harbor Section 403(b) plan may be an appealingly cost-efficient means of offering employees the opportunity to save for their retirement. A tax-exempt employer should nevertheless understand the practical limitations of the safe harbor regulations. The price of staying outside ERISA is the obligation to forego discretionary decision-making and, with it, some of the most attractive features of modern retirement savings plans. Employees who participate in a safe harbor plan will not have access to popular plan features such as hardship withdrawals or in-plan transfers if their employer declines to participate in discretionary decision-making and the plan vendors are unwilling to shoulder the burden. Employers should carefully examine the organization's overall compensation package to determine whether a safe harbor plan can really satisfy its own compensation strategy and its employees' expectations.

Tax-exempt employers that are considering the implementation of 403(b) plans should address the following issues in order to evaluate whether their overall compensation strategy would be best served by an ERISA plan or a safe harbor plan.

- Do employees expect that the employer will make contributions to the Section 403(b) plan? A Section 403(b) plan that accepts employer contributions must comply with ERISA.[18] A non-ERISA safe harbor plan cannot accept employer contributions.[19]

- Does the employer have the administrative expertise and resources to comply with the fiduciary obligations imposed by ERISA? ERISA fiduciaries are required to act solely in the interest of plan participants and beneficiaries, to act for the exclusive purpose of providing benefits and defray reasonable expenses, to exercise the care, skill, prudence and diligence that a prudent person acting in like capacity and familiar with such matters would exercise, and to act in accordance with Plan documents. As a practical matter, the employer would need to appoint a plan administrator or an administrative committee to take on these responsibilities. Each fiduciary and each person who handles plan assets must be bonded.

- Does the employer have the administrative and financial resources to comply with ERISA's reporting requirements? ERISA imposes certain obligations on an employee benefit plan, including, but not limited to, (i) arranging for an independent audit (unless the plan qualifies as a small plan eligible for a waiver); (ii) preparing and filing Form 5500 (annual report of employee benefit plans); (iii) preparing and updating a summary plan description of the plan terms; and (iv) providing quarterly statements to participants.

If the answer to these questions is no, then a safe harbor Section 403(b) plan may be the employer's best option. If this is the case, then the employer must be vigilant to insure that it does not engage in any discretionary decision-making that could jeopardize the plan's safe harbor status. With diligence and care, the sponsor of a safe harbor plan may just find that order and humanity may govern plans outside ERISA, too.

---

[1] Alison M. Sulentic, Baker Botts L.L.P., 910 Louisiana Street, Houston, TX 77002.
[2] For an excellent discussion of Section 403(b) plans in light of the new regulations, see David Pratt, *To (B) or Not to (b): Is that the Question? Twenty-First Century Schizoid Plans under Section 403(b) of the Internal Revenue Code*, 73 ALB. L. REV. 139 (2009).
[3] See Preamble, Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41127, 41136-37 (July 26, 2007).
[4] See ERISA, § 2(a).
[5] Gerald R. Ford, Statement on the Employee Retirement Income Security Act of 1974 (Sept. 2, 1974) in Pub. Papers 46-47 (1975).
[6] Id.
[7] See ERISA, § 3(33).
[8] See ERISA, §§ 3(32).
[9] See, e.g., ERISA, §§ 4(b)(1) (exception to coverage requirements for governmental plans) and 4(b)(2) (exception to coverage requirements for church plans).
[10] See ERISA, § 3(2).
[11] For example, *Donovan v. Dillingham* taught lawyers to identify an employee benefit plan by looking for "(1) a 'plan, fund, or program' (2) established or maintained (3) by an employer or by an employee organization, or by both, (4) for the purpose of providing…benefits (5) to participants or their beneficiaries." 688 F. 2d 1367 (11th Cir. 1982).
[12] First, participation must be voluntary. See 29 C.F.R. § 2510.3-2(f)(1). Second, rights under an annuity contract or a custodial account must be enforceable solely by the participant or his beneficiary or representative. See 29 C. F. R. § 2510.3-2(f)(2).
[13] See 29 C.F.R. 2510.3-2(f)(1).
[14] See Department of Labor, Field Advisory Bulletin 2007-02 (July 24, 2007). See also Department of Labor, Field Advisory Bulletin 2010-01 (February 17, 2010).
[15] Id.
[16] See Department of Labor, Field Advisory Bulletin 2010-01, Q&A-14 (February 17, 2010).
[17] Id., Q&A-14 and 15.

---

[18] Department of Labor, Pension and Welfare Benefits Administration Advisory Opinion 94-30A (August 19, 1994)(tax-exempt employer that formerly made contributions to annuity contracts from its own assets exceed the limited involvement permitted to an employer under the safe harbor regulation).
[19] See 29 C.F.R. § 2510.3-2(f)(1).

RETURN TO TABLE OF CONTENTS

NON-RESIDENT & RESIDENT ALIEN ISSUES
(WITH EMPHASIS ON THE EXIT TAX ON GREEN CARD HOLDERS)

By: *Rodney C. Koenig*[1]

RETURN TO TABLE OF CONTENTS

TABLE OF CONTENTS

RETURN TO TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

Page

RETURN TO TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

Page

Estate Planning for Non-Resident and Resident Aliens

I. INTRODUCTION AND HISTORY OF IMMIGRATION LAW

The world today is smaller, its citizens more transient, and international investments are increasingly the norm. From wealthy investors to international businessmen to members of the diplomatic corps, estate planning is no longer simply a matter of consulting the local family lawyer. International estate planning is complex and by its nature involves laws of jurisdictions that are foreign to the individual involved. Volumes have been written on the various aspects of international estate planning, and it would be foolhardy (if not impossible) to attempt to cover all areas here. In addition to various local laws, treaties and conventions also affect international estate planning. This presentation is limited to considerations regarding estate planning for the resident and non-resident considering the implications of the United States transfer tax laws.

Almost all of us have ancestors who came from other parts of the world. The author's family came to Texas from present-day Germany in 1845 while Texas was still a stand-alone Republic. We are a nation of immigrants. To understand immigration law, we need to understand citizenship, naturalization, immigration and expatriation.

An immigrant describes an individual who came lawfully into a country permanently, either to remain a permanent resident but non-citizen or to eventually obtain citizenship. In the U.S., a permanent resident who is a non-citizen must have authority to achieve such status and is commonly known as a “green card” holder. The terms “expatriate” and “expatriation” describes the final abandonment of one’s country and renunciation of citizenship. It is interesting to note that U.S. citizens can expatriate and long term permanent residents are deemed to expatriate when they lose their “green card” after having been a permanent resident for 8 or more out of 15 years.

For our purposes today, we must understand federal income tax and federal transfer taxes (gift, estate and generation skipping transfer taxes). In addition, some states (not Texas) have state income, state gift, state inheritance and state generation skipping taxes. U.S. citizens are subject to federal income, federal gift, federal estate and federal generation skipping transfer tax on their worldwide income and assets, whether or not they reside within the U.S. The rules which apply the federal income tax to non-citizens are mechanical and objective. If one resides within the U.S. for more than 183 days in any year, one is subject to U.S. income tax. There are a number of variations on this, but on average one must not be physically present in the U.S. for more than 120 days on average over a three year period. One who has a “green card” is subject to federal income, gift, estate and generation skipping tax without regard to days residing in the U.S. on their worldwide income and assets.

<u>Brief History</u>

Before 1798 no U.S. law prohibited anyone from coming to the U.S. The Alien and Sedition Act in 1798 authorized the U.S. President to expel any alien deemed dangerous, which remained the law only for a short while. In 1868 Congress passed the Expatriation Act of 1868 which recognized that anyone could expatriate. After the Civil War, the 14th Amendment was passed, establishing the rule of *jus soli* citizenship, where U.S. citizenship flows from birth within the borders of the U.S. Some believe this concept was deliberately left out of the original U.S. Constitution in light of slaves who lived and were born here, but the Civil War changed that. In 1891 legislation had created an administrator, called Superintendent of Immigration, who could exclude unlawful immigrants. In the early 1900's, lists of exclusion were enlarged and enunciated a positive principle, that skilled labor could be imported.

A major revision of immigration law occurred in 1917, which was seen as a limitation and in fact was vetoed by President Wilson, but passed over his veto. It imposed a literacy test, restricted immigration of Asians and provided for deportation of undesirables. Quantative restrictions and quotas were established in the Act of May 19, 1921. Other changes continued to occur. The Immigration and Nationality Act of 1952 (McCarran-Walter Act) was passed over the veto of President Harry Truman. The 1952 Act provides fundamental rules concerning exclusion and deportation, strengthened the quota system and established the preference system for familial relations and certain skills. The Immigration Act of 1990 updated and modified the law, changed rules on deportation procedures and remedies, particularly for persons involved with serious crimes.

On September 11, 2001, terrorism hit the U.S. Shortly thereafter, the USA Patriot Act of 2001 and the Homeland Security Act of 2002 were passed which substantially increased restrictions, scrutiny and penalties on persons violating U.S. immigration and criminal laws with emphasis on terrorism.

Finally on June 17, 2008, the Heroes Earnings Assistance and Relief Act of 2008 P.L. 110-245 (HEROES Act) was passed and signed by President George W. Bush, which addressed military and combat pay for military personnel and which enacted the mark-to-market departure or exit tax regime for an individual who expatriates on or after June 17, 2008, as a revenue raiser.

II. CITIZENSHIP, RESIDENCE AND DOMICILE

A. **Citizenship.** The term "alien" is generally used to refer to any individual who is not a citizen of the United States. The question of whether one is or is not a citizen for tax purposes is determined by the Constitution and the Immigration and Nationality Act. 8 U.S.C. §§ 1101 *et. seq.* The Internal Revenue Code (the "Code") or Treasury Regulations (the "Regulations") refer to "nonresident not a citizen of the United States" to mean non-resident alien and "resident" to mean resident alien.

1. **Acquisition of Citizenship.** The 14th Amendment of the Constitution states that: "All persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and the State wherein they reside." While not exhaustive, the following are some of the circumstances that may be relevant in the context of planning for resident and non-resident aliens:

a. **By Birth**. A child born in the United States of alien parents is a United States citizen unless such child is not subject to United States jurisdiction (*i.e.,* children born of diplomatic personnel and alien enemies in hostile occupation). This is true even though the child may also be a citizen of his parents' country and even though neither the parents nor the child intends that the child have United States citizenship. The child will retain this United States citizenship (and be subject to United States tax on worldwide income and assets) until renouncing it.

b. **By Parentage**. A child born outside of the United States of two United States citizen parents is a citizen if, prior to the birth, either parent resided in the United States. 8 U.S.C. §1401(c). If one parent is a citizen and the other parent is an alien, the child will be a citizen if the citizen parent lived in the United States at least five years before the child's birth, of which two were after age 14. 8 U.S.C. §1401(g).

c. **By Naturalization**. Citizenship by naturalization occurs when a decree granting citizenship has been entered by any federal district court or any state court of record having unlimited amount in controversy jurisdiction. 8 U.S.C. § 1421. An alien child under 18 becomes a citizen on the naturalization of at least one parent if the child resided in the United States in the legal and physical custody of the citizen parent pursuant to a lawful admission for permanent residence. 8 U.S.C. § 1431.

2. **Citizen Resident in a U.S. Possession.** A person who dies domiciled in a possession of the United States will not be treated as a U.S. Citizen for estate tax purposes if he acquired his citizenship solely because of his citizenship in the possession at the time the possession became a part of the United States or because of birth or residence in the possession. As a result, a person who is a U.S. citizen of a U.S. possession (e.g., Puerto Rico) because of the foregoing reasons, is classified as a non-resident alien for estate, gift and generation-skipping transfer tax purposes. See Code §§ 2208 and 2209; Code § 2501(b) and (c); and Treas. Reg. § 26.2663-2(b).

3. **Loss of Citizenship.** Under the Immigration and Nationality Act, citizenship can be lost in the following ways:

a. obtaining naturalization in a foreign country after attaining age 18, but a U.S. citizen who applies for naturalization in a foreign state does not lose U.S. citizenship until the U.S. citizen is admitted to citizenship or nationality by the foreign state (see *Lyons Est. v. Comm'r.*, 4 T.C. 1202 (1945));

b. by taking an oath of allegiance to a foreign country or a political subdivision thereof after attaining age 18;

c. by serving in a foreign army as a commissioned or non-commissioned officer, or in such an army engaged in hostilities against the United States;

d. by assuming public office or employment, after attaining age 18, under the government of a state for which only nationals of that state are eligible or for which an oath of allegiance is given;

e. by making a formal renunciation of nationality before a foreign service officer abroad;

f. by renouncing citizenship in time of war, subject to approval of the Attorney-General; or

g. by committing treason or attempting to overthrow the U.S. government.

Any of the foregoing acts will be presumed to have been done voluntarily, but such presumptions may be rebutted. 8 U.S.C. § 1481(b). Citizenship by naturalization can only be revoked by court decree when there has been fraud or concealment in obtaining naturalization. 8 U.S.C. § 1451. However, living abroad for a long and indefinite period of time does not by itself constitute renunciation of citizenship. See *Vriniotis Est. v. Comm'r*, 79 T.C. 298 (1982), where the Tax Court held that the estate of a naturalized United States citizen who died a resident in his native Greece, where he was also a citizen, was subject to estate tax on his world-wide assets, including assets in Greece, but was allowed a credit under the United States-Greece treaty for the Greek tax on Greek assets.

NOTE: United States Citizens who renounce or lose their U.S. citizenship, and certain non-citizen "Long-Term Residents" of the U.S. who cease to be U.S. residents, must file Internal Revenue Service Form 8854 Expatriation Initial Information Statement, as further discussed below.

B. **Residence and Domicile.** While there is usually no question as to whether a person is a U.S. citizen or not, there is often a problem as to whether an alien is a resident of the United States or not. Because the resident alien and non-resident alien are taxed differently for transfer tax purposes, the determination of a person's residence is critical.

1. **Internal Revenue Code Definition of Domicile.** Although Code § 7701(b) contains a detailed definition of residency for income tax purposes, the Code offers no such detailed guidance for estate and gift tax purposes. Regulations § 20.0-1(b) defines residence for estate and gift tax purposes by equating residence with domicile:

> "A resident decedent is a decedent who, at the time of his death, had his domicile in the United States.... A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal."

2. **<u>The "United States".</u>** For purposes of defining a United States resident or citizen for estate tax purposes, the "United States" includes only the 50 states and the District of Columbia. Therefore, as discussed above, a person living in Puerto Rico or the Virgin Islands or any other United States possession is a non-resident alien for estate tax purposes even though he or she might be a United States citizen within other contexts if United States citizenship was acquired solely by virtue of citizenship, birth or residence within the United States possession. Code § 2208.

3. **<u>Determination of Resident Status.</u>**

a. **<u>Two-Pronged Test</u>**. In order to establish domicile for estate tax purposes, a two-pronged test must be met:

(1) actual residence in the United States; and

(2) a demonstrated intent to remain at that residence.

Once established, domicile is not changed until both actual residence and the intent to remain indefinitely coincide in another location. *Cf., In re Will of Christman*, 350 N.Y.S.2d 468 (3d Dept. 1973).

b. **<u>Factors in Proving Residence</u>**. The fact of physical presence is easy to establish in most cases. It is the intent to remain in that place permanently that presents difficulty, particularly in an estate tax case where the decedent is no longer available to testify as to intent. Two statements by the Board of Tax Appeals give an indication of what that intent must be: "It is not a fleeting or casual or sporadic intention which controls, but a serious conception of home." *Rodiek v. Itelvering*, 33 B.T.A. 1022, 1033 (1936) "Intention involves the idea of fixity, of some degree of permanence in the new abode, and must be more than the mere intention to acquire a new domicile." *Safe Deposit & Trust Co. of Baltimore v. Comm'r*, 42 B.T.A. 145, 163 (1940), *aff'd*, 121 F.2d 307 (4th Cir. 1941), *rev'd in part on other grounds*, 316 U.S. 56 (1942). Some factors which courts have examined include:

(1) **<u>Length and Purpose of Stay in the United States</u>**. The period of time spent in a country is not in itself dispositive.

(a) In *Bank of New York & Trust Co. v. Comm'r*, 21 B.T.A. 197 (1930), *acq.* XI - 1 C.B. 4, 67, the decedent American citizen was held to be a United States resident even though she spent the last 12 years of her life in Paris and made only brief and infrequent visits to the United States. She lived in hotels and in an apartment in Paris and had consistently made declarations on her passport renewals that she was only living abroad temporarily.

(b) Conversely, in *Cooper v. Reynolds*, 24 F.2d 150 (D. Wyo. 1927), a British subject who was accidently killed only a few months after arriving in the United States was determined to be a United States resident because he had inherited land in Wyoming and had made plans to build a house there.

(2) **Location of Family Members and Close Friends**. In *Estate of Nienhuys v. Comm'r*, 17 T.C. 1149, 1160 (1952), *acq.* 1952-1 C.B. 3, the decedent, a citizen of Holland who was forced by World War II to reside in the United States for six years, was held not to be a United States resident. Among other things, the tax court pointed to the fact that the decedent had no family in the United States other than his spouse (also a citizen of Holland), and that other family members were still in Holland. The court also noted that the decedent did little entertaining and had joined no church or social organization in the community in which he was living.

(3) **Type and Cost of Dwelling Places in the United States**. Hotels and short term rentals indicate transience, while ownership of a house, particularly a large one, is more indicative of permanence. However, the decision in *Pacquette Est. v. Comm'r*, T.C. Memo 1983-571 (1983), illustrates a peculiar result. Since his retirement 25 years before his death, the decedent spent his winters in Florida and his summers in Canada. He bought a home in Florida and sold first his city house in Canada and a number of years later his Canadian country house, leaving no Canadian abode. A number of other indicia of intent were introduced at the trial showing that it was always his intent to remain a resident of Canada. The court concluded that he had never intended to live permanently in the United States.

(4) **Location of Dwelling Places**. Houses in resort areas such as Florida, Switzerland and the Riviera are less indicative of permanent residence than are houses in non-resort areas. In *Estate of Fokker v. Comm'r*, 10 T.C. 1225 (1948), *acq.*, 1948-2 C.B.2, the decedent, a Dutch citizen, established a domicile in the United States in 1927 and purchased and remodeled an elaborate house in St. Moritz, Switzerland in 1934, five years before his death. In determining that the decedent was still a United States resident and had not changed his domicile despite his purchase of the house in St. Moritz, the Tax Court noted that he still maintained a house in the United States which was even more elaborate and more expensive than the one in St. Moritz, and that the St. Moritz house was in an international resort area while the decedent's United States home was in Nyack, New York, an area without international appeal.

(5) **Address or Declaration of Intent on Legal Documents**. The probity of declarations of intent made in visa applications may be tempered by the surrounding circumstances. In *Estate of Nienhuys v. Comm'r*, *supra*, the court dismissed the evidentiary import of sworn statements made by a Dutch refugee from World War II that he was a

United States resident and intended to remain here when the surrounding circumstances indicated that such statements were motivated by fear and despair over the possibility of returning home rather than by a desire to change his domicile.

(6) **Location of Cherished Possessions**. The location of expensive and cherished personal possessions. *See, e.g., Farmers' Loan & Trust Co. v. U.S.*, 60 F.2d 618 (S.D.N.Y. 1932).

(7) **Location of Business Interests**. The location of a decedent's business interests. The question may turn on whether the business interest is owned or controlled by the alien or whether the alien is a mere employee on a temporary job assignment. *See St. Louis Union Trust Co. v. Comm'r*, 27 B.T.A. 318 (1932), acq. in part, 1933-1 C.B. and nonacq. in part, 1933-1 C.B. 19.

(8) **Immigration Status**. Until 1980, the Service took the position that an alien who held a non-immigrant visa could not be a United States domiciliary. It reasoned that the terms of the visa were such that, by accepting it, the holder agreed to leave the country when his visa expired, preventing him from forming an intention to remain here indefinitely. (Rev. Rul. 76-364, 1974-2 C.B. 321; PLR 8137027*). In 1978 the Supreme Court, in a non-tax case, *Elkins v. Moreno*, 435 U.S. 647 (1978), held that a non-immigrant alien has the legal capacity to form the requisite intent and thereby to establish domicile in the United States. Thereupon, the Service reversed its position and ruled that an alien employee of an international organization present in the United States on a G-4 non-immigrant visa at the time he died intended to remain here indefinitely and was domiciled in the United States for estate tax purposes. Rev. Rul. 80-363, 1980-2 C.B. 249 (revoking Rev. Rul. 76-364, *supra*).

In Rev. Rul. 80-209, 1980-2 C.B. 248, the government held that an illegal alien who had lived in the United States for 19 years and never made any attempt to become a citizen or lawful resident was nevertheless a United States domiciliary. The government pointed to the fact that the decedent had purchased a home in the United States and lived there with his family, and had joined several local clubs and had been actively involved in community affairs. More recently, the government succeeded in obtaining a summary judgment holding that a Canadian citizen working in the United States as a veterinarian and university professor on a "TN" temporary professional visa had the ability to form an intent to remain in the United States (and the government should have the opportunity to attempt to prove such intent) even though such an intent would be contrary to the statements made by the decedent when obtaining the visa and would violate the terms of the visa. *Estate of Jack v. U.S.*, 54 Fed. Cl. 590 (2002).

4. **Difference from Income Tax Concept of Residence.** The concept of residence for income tax purposes and the concept of residence for estate, gift and generation-skipping tax purposes are not the same. For transfer tax purposes, a foreigner

can only become a resident of the United States if he is physically in the United States and also has the intention to remain indefinitely or permanently. For income tax purposes, a foreigner can be a resident even if he has a definite intention of returning to his home country.

a. **Section 7701(b)**. The Code provides that an alien is a resident for income tax purposes if he:

(1) is a lawful permanent resident (*i.e.,* he has a green card);

(2) meets the "substantial presence test", i.e., the sum of the total number of days of the alien's physical presence in the United States during the calendar year plus one-third of the number of days of his physical presence in the United States during the first preceding calendar year plus one-sixth of the number of days of his physical presence in the second preceding year equals or exceeds 183 days — but not if (a) he was present for less than 31 days in the year in question, (b) was not present for at least 183 days during the calendar year in question and can show closer connections and a tax home in another country or (c) falls into one of several special categories, including, among others, commuter from Canada or Mexico, professional athlete and student; or

(3) elects to be classified as a resident in certain circumstances.

b. **Exemptions for Diplomats**. Days spent in the United States by individuals (and their immediate families) who are temporarily present in the United States by reason of diplomatic status do not count toward the 183-day "substantial presence" test of United States residence. Code §§ 7701(b)(3)(D)(i), 7701(b)(5)(B). Accordingly, such individuals will not acquire United States residency by virtue of their presence in the United States.

5. **Double Domicile.** It is possible that the United States could determine that an alien is domiciled in the United States, and another country could make the same determination regarding that country.

a. Perhaps the most well known cases illustrating problems of unclear domicile are the cases involving the Campbell Soup Company heir known as *In re Dorrance's Estate*, 309 Pa. 151, 163 A. 303, *cert. denied*, 287 U.S. 600 (1932) and *In re Dorrance*, 115 N.J. Eq. 268, 170 A. 601, 116 N.J. Eq. 204, 172 A. 503 (1934), *Aff'd sub nom., Dorrance v. Martin*, 13 N.J. Misc. 168, 176 A. 902, *Aff'd,* 116 N.J.L. 362, 184 A. 732, *cert. denied*, 298 U.S. 678 (1936). In the *Dorrance* cases inheritance taxes of approximately $17,000,000 were paid both to Pennsylvania and New Jersey for a total of about $35,000,000 in state death taxes out of a $115,000,000 estate. A major issue was that there were conflicting statements by Mr. Dorrance in his Will and in real estate ad valorem tax records which pointed to both states as being his domicile. We must remember that numerous statutes can apply, including the national statutes, as well as the state, province, land, parish or canton statutes. In some jurisdictions one is concerned with rules at the city, county or parish level as well as at the state, province, land, or canton level as well as at the national level. These items may impact on taxes as well as substantive law.

b. Another well known case is the dispute regarding Howard Hughes in which California and Texas (as well as Florida and Nevada) made claims on the Howard Hughes estate, with the United States Supreme Court finding it did not have power to resolve the issue. *California v. Texas*, 437 U.S. 601 (1978).

c. In *Texas v. Florida*, 306 U.S. 398 (1939), involving a dispute between Texas, Florida, New York, and Massachusetts about which state had jurisdiction to tax the estate of a Mr. Green, the Court held that there was no conflict existing between the states that would allow it to take original jurisdiction unless the duplicate findings of domicile resulted in death taxes exceeding the total value of the estate. That situation would raise a question about whether the estate was being deprived of property without due process of law under the Fourteenth Amendment.

d. If these rulings were applied in an international context, an estate could be taxed on its world-wide assets by both the United States and by the other foreign country, with only foreign tax credit rules, the possibility of settlement and the location of assets outside the reach of both countries preventing possible complete confiscation.

III. ESTATE AND GIFT TAXATION OF NON-RESIDENT ALIENS.

A. **Treaties and Conventions.** The United States presently has treaties with a number of countries regarding estate, gift, or generation-skipping transfer tax matters. The January 2009 instructions for IRS Form 706-NA list the following countries as having “death tax treaties” in effect with the United States:

Australia	Ireland
Austria	Italy
Canada*	Japan
Denmark	Netherlands
Finland	Norway
France	Republic of South Africa
Germany	Switzerland
Greece	United Kingdom

*Article XXIX B of the United States—Canada Income Tax Treaty

Some of these treaties deal with both estate and gift taxes, while others address the estate tax only. Many more countries have income tax treaties. In addition, other conventions and treaties, such as the Vienna Convention on Diplomatic Relations, affect an individual's liability for United States income, estate, gift, and generation-skipping transfer taxes. In general, estate tax treaties set out rules determining (1) who is to be classified as a domiciliary of each of the countries, (2) what property can be included in the gross estate by a country other than the country of domicile or citizenship, (3) what exemptions, deductions, and credits are available to the estate of a nondomiciliary decedent, (4) what foreign tax credits are available, (5) how estates may deal with the governments to work out special problems, and (6) what information will be exchanged between governments. Discussion of the details of these treaties is beyond the scope of this paper. The discussion that follows discusses the rules generally applicable to a non-resident alien with citizenship or domicile in a country which does not have a transfer tax treaty with the United States.

B. **Estate Tax.**

1. **Tax Imposed.** Code § 2101(a) imposes an estate tax "on the transfer of the taxable estate of every decedent non-resident not a citizen of the United States."

2. **Tax Rate.** The tax rates are the same as those imposed on the estates of residents and citizens. Code § 2101(b).

Since the estate tax rates are the same but the credit, as discussed below, is lower for a non-resident alien than for a resident or citizen, the non-resident is subject to a higher effective estate tax rate. For example, on a taxable estate of $5 million, the estate of a United States citizen or resident alien dying in 2011 will pay no estate tax, while the estate of a non-resident will pay estate tax of $1,717,800. Note that non-resident aliens with taxable estates in the highest estate tax bracket do benefit from reduction in the top marginal tax rates.

3. **Credits and "Applicable Exclusion Amount."** The unified credit amount for a non-resident alien is reduced to $13,000, so that the exempt amount is only $60,000. Code § 2102(b). A slightly increased credit is available to U. S. citizens resident in U.S. possessions who are treated as non-resident aliens for estate tax purposes. Code § 2209. The non-resident alien's estate is credited with the state death tax credit under § 2011 (subject to § 2102(b) and subject to phase out and then repeal under EGTRRA), the gift tax credit under § 2012 and the credit for prior transfers under § 2013. However, to the extent required by a treaty the estate of a non-resident alien is allowed a unified credit equal to the unified credit allowed a U.S. citizen or resident multiplied by the percentage of the gross estate situated in the United States.

4. **Gross Estate.** The gross estate of the non-resident alien is determined in the same manner as the gross estate of a resident under Code §§ 2031-2044, except that it includes only that part of the gross estate which at the time of death is *situated in the United States*. Code § 2103. A non-resident alien is not allowed to claim the reduced valuation of certain farm property allowed to citizens and resident aliens under Code § 2032A.

a. **<u>Types of Interests</u>**. A non-resident alien's gross estate, therefore, may include the value of U.S. situs property to the extent of any gifts within three years of death, any retained life estates, reversionary interests, revocable transfers, annuity interests or rights of survivorship. Code §§ 2033-2041.

b. **<u>U.S. Situs Property</u>**. Property within the United States includes:

(1) Real property located in the United States;

(2) Tangible personal property located in the United States, except certain works of art on loan for exhibition as discussed below;

(3) Stock in a domestic corporation, irrespective of the location of the certificates;

(4) Transfers subject to Code §§ 2035-2038, if the property subject to such transfer was United States situs property at the time of the gift or death;

(5) Debt obligations of which the primary obligor is a United States person (as defined in Code § 7701(a)(30) or the United States, a state or political subdivision thereof or the District of Columbia (e.g. a bond, debenture, note, account payable or written or oral promise, or a debt obligation of a U.S. person or governmental unit) (*but see* c(4) and c(5), below); and

(6) Currency located in the United States. Code § 2104 and Treas. Reg. § 20.2104-1; and Rev. Rul. 55-143, 1955-1 C.B. 465.

c. **<u>Non-U.S. Situs Property</u>**. Property outside the United States includes:

(1) Real property located outside the United States;

(2) Tangible personal property located outside the United States;

(3) Proceeds of life insurance on the life of the non-resident alien;

(4) Bank deposits with domestic banks (but not cash deposited with a brokerage firm) and certain debt obligations, but only if the interest paid on such deposits is treated as income from sources outside the United States under Code § 871(i)(1);

(5) Certain other deposits and debt obligations described in Code § 2105(b);

(6) Stock in a foreign corporation (irrespective of the location of the certificates); and

(7) Works of art on loan for exhibition. Code § 2105 and Treas. Reg. § 21.2105-1.

d. **Community Property**. In several cases, the courts have held that, where the decedent and his spouse were residents of a community property jurisdiction, only the decedent's one-half community property interest in United States situs property is includable in his gross estate. *Vanderhoeck Est. v. Comm'r*, 4 T.C. 125 (1944), *acq.* 1944-1 C.B. 29; *Simon Est. v. Comm'r*, 40 B.T.A. 651 (1939), *acq.*, 1942-1 C.B. 15. In a somewhat interesting Tax Court case, the government and the taxpayer agreed that California community property law applied and the decedent was treated as owning only a one-half community property interest in two pieces of California real estate even though the decedent died in Massachusetts and was a citizen and resident of Hong Kong and his surviving spouse was also a non-resident alien. *Est. of Fung v. Comm'r*, 117 T.C. 247 (2001), *aff'd* 58 Fed. Appx. 328, 2003 LEXIS 4054 (9th Cir. 2003) (appellate court decision not selected for publication in the Federal Reporter).

5. **Deductions.** Code § 2106(a).

a. **Expenses, Indebtedness, Taxes and Losses**. The non-resident alien's estate is entitled to a pro rata portion of the Code §§ 2053 and 2054 deductions for expenses, losses, debts and taxes, such pro rata share being the percentage of the world-wide estate that is located in the United States. It is immaterial whether the amounts to be deducted were incurred or expended in the United States. Note that taking advantage of this deduction requires that the estate disclose the value of its world-wide assets on the return. Code § 2106(b).

(1) **Mortgaged Property**. While the full value of United States situs mortgaged property is includable in the gross estate, the amount of the debt which is deductible is limited to the ratio of United States situs property to world-wide assets. However, in *Johnstone Est. v. Comm'r*, 19 T.C. 44 (1952), *acq.* 1953-1 C.B. 5, it was held that only the equity was includable in the gross estate where the note was nonrecourse. See also Treas. Reg. § 20.2053-7. Nonrecourse status is a legal determination—the deduction will be disallowed where the lender has legal recourse against the estate even if in practice lenders routinely forego deficiency actions in order to effect nonjudicial foreclosures under local law. *Est. of Fung*, 117 T.C. 247.

b. **Charitable Deduction**. The Code allows a charitable deduction identical with that allowed citizen's and resident's estates, except that bequests to corporate charities are only deductible if the corporation is incorporated under the laws of a United States jurisdiction, and bequests to trusts are deductible only if the bequest is to be used within the United States. There is no percentage limit on the deduction and no requirement that the bequest be of specific property located in the United States. The deduction may not exceed the value of the United States situs estate. Like the deduction for debts and expenses, the decedent's world-wide estate must be reported in order to claim the charitable deduction.

c. **Marital Deduction**. The estate of a non-resident alien is entitled to a marital deduction for United States property passing to a United States citizen spouse provided the requirements of § 2056 are met. If the surviving spouse is not a United States citizen, the marital deduction is available if:

(1) The spouse becomes a United States citizen before the filing of the estate tax return and has been a resident of the United States at all times since the decedent's death; or

(2) The property is transferred to a qualified domestic trust (QDOT) pursuant to § 2056A. See discussion below regarding QDOTs.

The *Estate of Fung* case cited above also included an interesting attempt at post-mortem marital deduction planning. Somewhat oversimplifying, the decedent's will left 3/8^{ths} of the residue of his estate to his surviving wife and the other 5/8^{ths} to his five sons. His estate consisted of real property in California and other assets in Hong Kong. The surviving spouse and the executor (one of the sons) initiated and then settled litigation in California whereby the surviving spouse was to receive all of the decedent's interest in the California properties in satisfaction of her right to 3/8^{ths} of the residue, and the sons received the Hong Kong assets. The wife then transferred the California property to a QDOT and the executor claimed a marital deduction. The government challenged this maneuver and the Tax Court agreed, holding that the estate had failed to prove that the claimed deduction did not exceed the value of the 3/8^{ths} interest in the residue to which the wife was entitled. The Tax Court expressly did not reach the "challenging question of will construction" regarding whether under the terms of the will and Hong Kong law the wife was in fact entitled to 3/8^{ths} of the entire residue (as asserted by the executor) or an undivided 3/8^{ths} interest in each asset (as asserted by the government). *Est. of Fung*, 117 T.C. 247.

C. **Expatriates and Long-Term Residents.**

1. **In General.** The United States imposes substantial income, estate and gift taxes on citizens who reside abroad. Congress has not only prevented citizens from escaping the U.S. tax burdens by simply leaving the country while retaining citizenship but through Code §§ 2107 and 2501(a)(3) has also prevented certain individuals who have taken the step of surrendering their U.S. citizenship from fully enjoying the estate and gift tax advantages of non-resident aliens. In addition to citizens who renounce their citizenship, the Health Insurance Portability and Accountability Act of 1996, Act Section 511(a), revised Code § 877 to impose the same types of tax burdens on certain long-term resident aliens who terminate their U.S. residence. A long-term resident alien is an individual who is a lawful permanent resident of the U.S. for eight of the fifteen years

preceding termination of residency. In June 2008, the rules regarding expatriation were drastically changed by the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEROES Act"), which was signed into law on June 17, 2008, by President George W. Bush. The Act imposes a mark-to-market tax on any unrealized gain on a covered expatriate's worldwide assets if, presuming those assets were sold for fair market value on the day before expatriation, the net gain would exceed $600,000 ($627,000 in 2010). Under Code § 2801, a transfer tax of 35% (for 2011 and 2012) is imposed on all gifts and bequests to U.S. citizens, residents, and U.S. trusts from a covered expatriate which exceed the $13,000 annual gift exemption amount (although it does allow for a reduction for any foreign gift or estate tax paid). Finally, the Act repeals for new persons who expatriate on or after June 17, 2008, the 10-year shadow period which previously resulted in a covered expatriate being taxed as a U.S. citizen for any year in which the individual spent more than 30 days in the U.S. for the ten years following expatriation. The former expatriation tax continues to apply to persons who expatriated before June 17, 2008, for tax years ending within ten years of the date of the termination of residency. It is worth noting that the 10 year period may be trumped by existing treaty.

a. German Example. Consider the example of an expatriate covered under Code § 2801 who takes up residence in Germany. More than 10 years after expatriation, the individual makes a cash gift of €300,000 (approximately $445,000) to his U.S. resident son. The German transfer tax regime imposes a tax on gifts from a German resident to a recipient, and in this case the son is considered a Class I beneficiary. The tax rate for gifts to this class of individuals is seven to thirty percent. A cumulative of €400,000 is allowed over 10 years. Assuming the transferor has sufficient exemption remaining, the €300,000 gift is excluded from the German tax. But can the U.S. impose a 35% tax on the son under Code § 2801 for the value of the gift?

The U.S.-Germany Estate and Gift Tax Treaty covers German inheritance and gift tax and U.S. federal estate, gift, and GST tax. The Treaty also applies to "any similar taxes on estates, inheritances, and gifts imposed after the treaty has been signed. Such provision covers the new Code § 2801 inheritance tax imposed on U.S. recipients of gifts from covered expatriates. Because the covered expatriate is domiciled in Germany for treaty purposes, and has made a cash gift that does not fall into a special situs category (such as real property), and the gift is made more than ten years after expatriation, the treaty awards exclusive taxing rights to Germany. Therefore the U.S. cannot tax the transfer.

It is worth noting that the U.S.-Germany Treaty allows the U.S. to continue to tax individuals who are former citizens or long-term residents for a period of only ten years. The treaty was negotiated and concluded prior to implementation of Code § 2801 which extends the ten year indefinitely. The Code § 2801 inheritance tax continues throughout the life of the covered expatriate. But the Treaty remains as is, allowing only a ten year enforcement period. In this case, the Treaty appears to trump new Code § 2801 and would bar U.S. taxation in this situation. John L.

Campbell and Michael J. Stegman, Confronting the New Expatriation Tax: Advice for the U.S. Green Card Holder, 35 ACTEC Journal 266, 275 (2009).

2. **HEROES Act.** The 2008 HEROES Act introduced a new regime of taxation which applies to "covered expatriates," *i.e.* certain individuals who give up their U.S. citizenship or terminate their status as permanent residents (green card holders). These new rules are set forth in Section 877A and 2801 of the Internal Revenue Code.

A covered expatriate is (a) a U.S. citizen and (b) a permanent resident (green card holder) who terminates his or her status after having a green card for at least 8 of the last 15 years, if such individual either

(i) has an average annual net income tax liability for the preceding 5 years that exceeds $124,000 (indexed for inflation to $145,000 in 2010) ("Tax Liability Test"); or

(ii) has a net worth of $2,000,000 or more (query, could a married couple have $4,000,000 in community property?) ("Net Worth Test"); or

(iii) has not certified under penalty of perjury that he or she has complied with all of their tax obligations for the 5 preceding tax years ("Certification Test").

Hence, one must take a Tax Liability Test, a Net Worth Test and a Certification Test. If your net worth is $2 million or less, your net income tax liability annually over the preceding 5 years is $145,000 or less, and you certify and in fact are current on your tax liabilities for the prior 5 years, then you are not impacted. Even if you are under the Tax Liability Test and under the Net Worth Test, one should file Form 8854 to meet the Certification Test.

Note that two very narrow exceptions apply. If one has been a citizen of another country all of one's life and is taxed as a resident of that country plus one had been a resident of the US for not more than 10 out of 15 years, then one may avoid being a "covered expatriate." Additionally, if one is under 18.5 years when residency is abandoned, an exception applies.

If you are impacted, then under the HEROES Act, subject individuals will be taxed on net unrealized gain in their property exceeding $600,000 (indexed for inflation to $627,000 in 2010). If your net unrealized gain is under $627,000 ($1,254,000 of community), there may be no practical impact under this portion of the HEROES Act. Additionally, the capital gains tax for 2011 and 2012 is currently at 15%, so the rate is at a historical low. However, other types of assets, such as deferred compensation or IRA's or other deferred arrangements have other rules as discussed hereafter.

3. **Basis Issues**. Since a significant portion of the exit tax is focused on unrealized gain, it becomes important for a covered expatriate to know and ascertain his adjusted basis. Essentially the normal basis rules will apply, but there is an inbound adjustment of basis available to a covered expatriate. Section 877A(h)(2) of the Code

allows having a basis of not less than the fair market value of such property on the day an individual first became a resident of the U.S. An election may be made on a property by property basis on this point.

4. **Certain Deferred Compensation**. The mark-to-market tax does not apply to the following items:

a. Eligible deferred compensation items;

b. Ineligible deferred compensation items.

c. Specified tax deferred accounts.

d. Interest in nongrantor trusts.

For any of the above items a covered expatriate must give form W-8CE to the payer of any income covered by these special rules. For eligible deferred compensation (generally a U.S. retirement plan), the payer will withhold 30% on any taxable payment to the covered expatriate. For the ineligible deferred compensation (generally all except eligible deferred compensation), the payer must notify the covered expatriate within 60 days and the covered expatriate is treated as receiving an amount equal to the present value as of the day before expatriation and taxed accordingly. For specified tax deferred accounts (generally an IRA, a section 529 qualified tuition plan, a section 530 Coverdell education savings account and a section 220 Archer medical savings account), a custodian of such account must advise the covered expatriate of the amount of the individual's entire interest in the account on the day before the expatriation date, and such amount is treated as having been distributed to the covered expatriate on the day before expatriation. For nongrantor trusts, the trustee must withhold 30% on any taxable payment made to the covered expatriate.

5. **Section 2801**. After paying the exit tax, Section 2801 of the Internal Revenue Code imposes a tax on any gift or bequest received by a U.S. citizen or resident from a covered expatriate at the highest gift or estate tax rate then in effect (currently 35% in 2011). Such tax is paid by the U.S. beneficiary and in effect imposes a federal inheritance tax. Such tax is reduced by any gift or estate tax paid to a foreign country in connection with such transfer. This Section 2801 tax does not apply to gifts that do not exceed the annual exclusion (currently $13,000) or gifts or bequests that qualify for the marital or charitable deduction, and does not apply to taxable gifts reported on form 709 (U.S. gift tax) or form 706 (U.S. estate tax).

6. **Notice 2009-85, 2009-45 IRB 598 of 10-15-2009**. The IRS has provided some guidance for Code § 877A which imposes the exit tax on covered expatriates. In this notice examples are given of how the appropriate gain is calculated and how the $600,000 ($627,000 in 2010) exclusion amount is allocated among assets. It discusses specific examples of deferred compensation and also discusses basis adjustment to fair market value as of the initial date an alien becomes a resident alien. It also explains how services performed outside the U.S. before or after expatriation are handled. For anyone

planning to expatriate, a reading of Notice 2009-85 (which is some 33 pages) is mandatory. While the HEROES Act also added new § 2801 dealing with how gifts and bequests by a covered expatriate are taxed, Notice 2009-85 clearly states that separate guidance will be issued, but such guidance has not yet been issued.

7. **Reporting Requirements.** Former United States citizens and former long term residents (non-citizens who were lawful permanent residents for at least 8 of the 15 consecutive tax years ending with the year the person ceased to be a U.S. resident) are required to file IRS Form 8854 Expatriation Initial Information Statement upon expatriation and may be required to file annual reports of income for the following 10 years. See Notice 2005-36 , 2005-19 IRB 1007.

8. **Planning Possibilities.** If a possible move to the U.S. is in the works, it may be preferable to maximize time spent in the U.S. on a visa (such as a E-1, E-2, O-1, H1-B or L-1 visa) before obtaining a green card to minimize the eight year residency which triggers the covered expatriate status. Additionally, since any portion of a calendar year counts as a year, one should delay coming to the U.S. until early January rather than coming late in a year. Coming on December 31 causes that entire year to count. Furthermore, if one is about to give up green card status, it might be good to expatriate while asset values are depressed and while capital gains rates are low. Currently rates are at 15% and are historically low.

9. **Convention Between USA and Federal Republic of Germany for Avoidance of Double Taxation, et al.** The Convention between Germany and the U.S. was signed August 29, 1989, amended by a protocol signed June 1, 2006, and subsequently amended by an exchange of notes dated August 17, 2006. Accordingly, this convention predates the HEROES Act of June 17, 2008.

While this paper does not attempt to analyze the very lengthy document, some observations may be helpful and could be pursued further if applicable. Article 13 of the Convention entitled "Gains" at paragraph 6 states the following:

> “6. Where an individual who, upon ceasing to be a resident of one of the Contracting States, is treated under the taxation law of that State as having alienated property and is taxed in that State by reason thereof, the individual may elect to be treated for purposes of taxation in the other Contracting State as if the individual had, immediately before ceasing to be a resident of the first-mentioned State, alienated and reacquired the property for an amount equal to its fair market value at that time.”

From the above language, it seems to indicate that basis in the asset in the other country will be changed to fair market value if the existing tax is paid. One should look at the various rates to see what practical effect this will have. If Germany’s rate is higher than the U.S. rate, this could be a beneficial aspect of the treaty.

D. **Gift Tax.**

1. **Taxable Gifts.** Gifts by non-resident aliens of tangible personal property located in the United States and real property located in the United States are subject to United States gift tax. Code § 2511(a). The treasury regulations make it clear that the *physical location* of the transferred property determines whether the gift tax applies. Treas. Reg. § 25.2511-3(b)(1). Gifts of foreign situs property or intangible property by a non-resident alien are not subject to United States gift tax.

2. **Tax Rate.** The tax rate is the same as applied to residents/citizens, *i.e.*, the same as the estate tax rates; however, non-resident aliens do not receive the benefit of the unified credit.

3. **Exclusions.** The non-resident alien is not entitled to any part of the gift tax unified credit, but is entitled to a $10,000 (inflation adjusted to $13,000 for 2010) annual gift tax exclusion or, in the case of a gift to a non-citizen spouse, the $100,000 (inflation adjusted to $134,000 for 2010) annual gift tax exclusion. Code § 2523(i). Gifts in the form of payments of tuition and medical expenses are also excluded. Code § 2503(e).

4. **Gift Splitting.** The election to split a gift is not available if either spouse is a non-resident alien. Code § 2513(a)(1).

5. **Deductions.** The marital deduction is available for gifts to a spouse who is a citizen at the time of the gift, but not to a non-citizen spouse regardless of residence. Code § 2523. Further, the QDOT rules do not apply for gift tax purposes. A limited charitable deduction is available for gifts to (i) U.S. corporate charities; (ii) to charitable trusts which are to use the gift within the United States; (iii) fraternal societies which use the gift within the United States for religious, charitable, scientific, literary or educational purposes; and (iv) veterans organizations organized in the United States. Code § 2522(b)

6. **Gifts by Expatriates.** A person who loses his citizenship or terminates his long-term residency may not exclude gifts of United States situs intangible property made within ten years after loss of citizenship or residency. The Code § 877 presumption of tax avoidance applies to gift transfers.

7. **Reporting Requirements.** Section 1905 of the Small Business Job Protection Act of 1996 created Code § 6039F. Code § 6039F and applicable rules provide that if the value of the aggregate foreign gifts or bequests received by a U.S. person during any taxable year exceeds $10,000 (inflation adjusted to $14,165 for 2010) from foreign corporations or partnerships, or $100,000 (not adjusted for inflation) from nonresident alien individuals or estates, the recipient shall furnish information regarding each such gift. Notice 97-34, 1997-1 CB 422. The report is made on IRS Form 3520 Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Failure to furnish information can result in the recipient being required to

pay an amount equal to 5 percent of the amount of the gift each month for which the failure to pay continues, up to a maximum of 25 percent.

E. **Generation-Skipping Transfer Tax.** The generation-skipping transfer tax is a tax on the transfer of property, whether by gift or by a transfer at death, that "skips" one or more generations. Code § 2663(2) directed the Secretary to promulgate regulations applying the generation-skipping tax to transferors who are non-resident aliens. Final regulations were issued, effective for generation-skipping transfers made on or after December 27, 1995. See Treas. Reg. §§ 26.2663-2, 26.2601-1(c).

1. **Situs of Transferred Property is Determinative.**

a. Final generation-skipping tax regulations harmonized application of generation-skipping tax with United States estate and gift taxes. Application of generation-skipping tax to transfers by non-residents is conditioned upon application of United States estate or gift taxes to such transfers. Treas. Reg. § 26.2663-2(b). Accordingly, the situs of the transferred property will generally determine whether the transferred property is subject to generation-skipping tax.

b. The generation-skipping tax applies to testamentary transfers by a non-resident alien to the extent that the transferred property is United States situs property for estate tax purposes at the time of the non-resident alien's death and such property is subject to estate tax. Treas. Reg. § 26.2663-2(b); Code § 2103.

c. The tax applies to lifetime transfers by a non-resident alien to the extent that the transferred property is situated in the United States at the time of transfer and such property is subject to United States gift tax. Treas. Reg. § 26.2663-2(b); Code §§ 2501(a)(1), 2511(a).

d. With respect to interests in trusts, the tax applies to taxable distributions and taxable terminations to the extent that the initial transfer of property to a trust by the non-resident alien was a transfer described in b or c above (*i.e.*, was subject United States estate or gift tax). Treas. Reg. § 26.2663-2(b)(2). However, taxable terminations and taxable distributions with respect to a revocable trust likely will be subject to the generation-skipping transfer tax only if the trust assets were situated in the United States either at the time of the initial transfer to the trust or at the settlor's death. Although the final generation-skipping transfer tax regulations are not clear on this point, the generation-skipping tax is likely to apply to revocable trusts only if the revocable trust assets are subject to estate tax on the settlor's death. See Treas. Reg. § 26.2611-1; T.D. 8644, 60 F.R. 66898, 66903 (Dec. 27, 1995) (preamble). The situs of revocable trust assets would be determined either at the time of the initial transfer of such assets to the trust or at the time of the settlor's death. Code § 2104(b). Thus, if United States situs assets are transferred to a revocable trust and then sold or exchanged for non-United States situs assets, such foreign situs assets will be deemed to have a Unites States situs and will be subject to United States estate tax upon the transferor's death. Moreover, the generation-skipping transfer tax would apply to taxable distributions and taxable terminations occurring thereunder.

2. **For example:**

a. If a non-resident alien grandparent makes a gift of United States situs real property to a grandchild, irrespective of whether the grandchild or the child (grandchild's parent) are citizens, residents or non-residents, the generation-skipping tax will apply to the gift (as will the gift tax).

b. If a non-resident alien grandparent transfers tangible personal property to an irrevocable trust, all the beneficiaries of which are grandchildren, and the property is not situated in the United States at the time of the transfer to the trust, neither the generation-skipping tax nor the United States gift tax will apply.

c. Assume the same facts as b above, except that (i) the transferred property is situated in the United States at the time the non-resident transferred it to the irrevocable trust and (ii) the trust beneficiaries are the non-resident's child for life, with the remainder to pass to the non-resident's grandchild. The transfer to the trust will not be subject to generation-skipping tax (although it will be subject to United States gift tax) because it does not qualify as a direct skip. However, the generation-skipping tax *will* apply to the shifting of the trust interest from the non-resident's child to the grandchild because the shift constitutes a taxable termination and the trust property had a United States situs at the time it was transferred to the trust.

d. Assume the same facts as c above, except that the transferred property is intangible personal property (*e.g.*, shares in a United States corporation). The transfer to the trust will neither be subject to United States gift tax nor generation skipping tax. Code § 2501(a)(2) (gifts of intangible personal property by a non-resident alien are not subject to United States gift tax, regardless of situs of such property); Treas. Reg. § 26.2663-2(b) (generation-skipping tax conditioned upon application of estate or gift taxes). Furthermore, because the transfer of intangible personal property was not subject to United States gift tax on the initial transfer to the trust (and will not be subject to United States estate tax upon the non-resident alien's death), there will be no generation-skipping tax upon the shifting of trust interests from the child to the grandchild. Treas. Reg. § 26.2663-2(b)(2).

e. Assume the same facts as d above, except that the trust is a revocable trust. The transfer of the intangible personal property to the trust will neither be subject to United States gift tax nor generation-skipping tax. Treas. Reg. § 25.2511-2(c) (transfer of property subject to revocation by donor is not subject to gift tax); Treas. Reg. § 26.2663-2(b) (generation-skipping tax conditioned upon application of estate or gift taxes). However, the non-resident's death will result in a deemed transfer of the property to an irrevocable trust, which deemed transfer will be subject to United States estate tax because the intangible property has a United States situs. Code §§ 2104(b), 2038(a)(1). Moreover, the generation-skipping tax will apply to the shifting of trust interests from the child to the grandchild, because the United States estate tax will have applied to the trust property. Treas. Reg. § 26.2663-2(b)(2).

IV. ESTATE AND GIFT TAX PLANNING FOR THE NON-RESIDENT ALIEN

A. Take advantage of distinctions between estate and gift tax.

1. United States situs intangible property is not subject to gift tax (other than pursuant to the expatriation provision); however, it is subject to estate tax if owned at death. Thus, a non-resident could gift a $1 million portfolio of United States securities without transfer tax, but if the same portfolio were owned at death, it would be subject to estate tax.

2. There is no unified credit against the gift tax, so to the extent taxable gifts are made, they are subject to immediate taxation. Note that the estate is "grossed up" by these lifetime taxable gifts at death, and there is a credit for the gift tax paid.

3. The $10,000 (inflation adjusted to $13,000 for 2010) or, in the case of a gift to a non-citizen spouse, the $100,000 (inflation adjusted to $134,000 for 2010) annual gift tax exclusions, are available for inter vivos transfers of United States situs real and tangible personal property.

B. Be aware of the situs of property before making a gift.

1. A foreign family who flies to the United States to visit a child in school here and gives the child during the visit a valuable piece of jewelry is making a gift of United States situs tangible personal property. The same gift by the same donors to the same donee made at home (outside the U.S.) would not have been subject to gift tax.

2. A gift of United States real estate by a non-resident is subject to gift tax; however, a gift of stock in a United States corporation which holds such real estate would not be subject to gift tax. Further, a sale of United States situs real estate followed by gifts of non-United States situs funds which are used to pay off the debt may not be subject to gift tax. See *Daires v. Comm'r*, 40 T.C. 525 (1963).

3. While bank deposits are not United States situs property, cash and checks are. Thus, a check drawn on a United States bank account and gifted by a non-resident is a gift subject to United States gift taxes. See PLR 7737063*. Also, cash in a safe deposit box is United States situs property. Rev. Rul. 55-143, 1955-1 CB 465. Cash held by a bank as trustee is United States situs property. Rev. Rul. 69-596, 1969-2 C.B. 179.

C. **Mortgaged Property.** If the non-resident alien owns real property subject to a mortgage, attempt to structure the mortgage (*i.e.*, non recourse) so that only the equity in the real property is included in the gross estate.

D. **Establish Residency.** If most or all of a non-resident's assets are located in the United States, it may be desirable to establish sufficient contacts to establish residency status for estate tax purposes in order to have available the full applicable exclusion amount for lifetime ($5,000,000) and testamentary transfers ($5,000,000 in 2011-2012).

E. **Beware of Code §§ 2035-2038 Transfers.** Transfers subject to these sections are United States situs property *if the property subject to such transfer was United States situs property at the time of the transfer*. Code § 2104(b). See TAM 9507044 which held that the entire corpus of a revocable inter vivos trust created by a decedent in 1923 was property situated in the United States even though the decedent had subsequently renounced her United States citizenship and was a citizen and resident of Spain at the time of her death. She was a United States citizen when she created the trust, and all of the assets transferred to the trust were United States situs assets. Further, she retained a lifetime right to the trust income and a testamentary power of appointment over trust assets.

F. **Interests in Trusts and Estates.**

1. The Small Business Job Protection Act of 1996 made major changes in the treatment of foreign trusts. The Act requires broad reporting of transactions involving foreign trusts.

A two-part objective test was established, to replace the prior subjective test, for determining the residency of a trust. A trust is treated as a U.S. person if (1) a U.S. court can exercise primary supervision over the administration of the trust and (2) one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. All other trusts are treated as foreign trusts. These provisions apply to tax years beginning after December 31, 1996.

A foreign person who adopts U.S. residency within five years of making a transfer to a foreign trust will be deemed to own the trust under the grantor trust rules, as will a U.S. person who makes a transfer to a U.S. trust that thereafter becomes a foreign trust. Code §§ 679(a)(4), 679(a)(5).

The Act also eliminated a technique by which a foreign grantor could create a foreign grantor trust for the benefit of a U.S. person. Such technique resulted in no U.S. tax being collected. Under the Act, the grantor trust rules apply only if the person who would be deemed to own the items of trust income and deduction is a citizen or resident of the U.S. or a domestic corporation. If the grantor of a foreign trust is a foreign person, who, but for this new rule, would be deemed to own the trust, any U.S. beneficiary of the trust will be treated as the grantor to the extent the beneficiary has made direct or indirect transfers of property to the foreign grantor. This rule applies to transfers after August 20, 1996. There are certain trusts which were in existence on September 19, 1995 to which the new rule will not apply.

The Act also increased the interest rate on accumulated distribution from a foreign trust to a U.S. beneficiary.

Regarding interests in estates, the situs of a specific bequest would be the situs of the property, and the situs of a general bequest would be residence of the Executor. The rule regarding the situs of a residuary bequest is unclear — situs of assets, residence of executor or residence of devisee?

2. Form 3520 mentioned above in connection with receipt of foreign gifts is also used to report transactions with foreign trusts. Very severe penalties now exist for failure to report transfers to foreign trusts. For example, a penalty of 35% of the gross value of any property transferred to a foreign trust is imposed on a U.S. grantor's failure to report the transfer. The same 35% penalty exists on failure of a U.S. person to report receipts from a foreign trust.

The trap which exists here is that a trust we might think of as a U.S. Trust might inadvertently become a foreign trust. An old life insurance trust with a non-citizen non-resident as trustee would be a foreign trust. If an existing U.S. Trust acquires a foreign trustee, it becomes a foreign trust. Hence, be careful of naming a non-resident alien as a primary or back up trustee. Even a resident alien trustee who became a non-resident alien would cause reporting issues.

G. **Probate Avoidance.**

1. If the non-resident has a "home base" in a state in the United States where most of his United States assets are located, the planner should look to the laws of that state to determine the form for testamentary dispositions. In many jurisdictions a simple Will naming an Independent Executor disposing of only United States situs property may be the simplest solution.

2. If the non-resident's assets are located in a number of States and/or if it is not clear where a Will should be probated, conveying all of the United States assets to a revocable inter vivos trust may be preferable. This would not affect the situs of the assets for estate tax purposes.

3. If the only asset is a United States bank account, a joint tenancy with right of survivorship may be the most efficient means of holding the property. Keep in mind that United States bank accounts are not United States situs property. However, consider the result if the joint owner predeceases.

V. ESTATE AND GIFT TAXATION OF RESIDENT ALIENS

A. **Taxed Like Citizens.** In most cases, resident aliens receive the same treatment as United States citizens for estate and gift tax purposes. They are taxed at the same estate tax rates under Code § 2001(c) and the same credits, including the unified credit, apply. As with a United States citizen, the world-wide assets of a resident alien are subject to estate tax.

B. **Exception.** A major exception to this parity of treatment is found in the marital deduction, which is only allowed where the surviving spouse is a United States citizen. This is true regardless of the citizenship or residency of the decedent spouse and applies whether or not the surviving alien spouse is a resident. Code § 2056(d). See Treasury Regulations §§ 20.2056A-1 et seq.. In Rev. Proc. 96-54, 1996-50 IRB 1, sample language has been provided by the Service which can be used in a qualified domestic trust to satisfy the requirements. See also Rev. Proc. 97-1, 1997-1 IRB 11.

C. **Estate Tax Marital Deduction.**

1. If the decedent's surviving spouse is an alien, irrespective of whether or not a resident, the marital deduction is not allowed unless:

a. The spouse becomes a citizen before filing the federal estate tax return and was a domiciliary of the United States at all times from the date of the decedent's death; or

b. The property passes to a qualified domestic trust "QDOT" that meets the requirements of Code § 2056A.

This rule applies whether the decedent is a citizen, a resident alien or a non-resident alien.

2. If the decedent leaves property to his alien spouse which would have otherwise qualified for the marital deduction and is taxed in the decedent's estate, and the spouse later dies in the United States so that the property will also be taxed in the survivor's estate, the surviving spouse's estate is entitled to a credit under Code § 2013 for the tax on the prior transfer irrespective of the amount of time that passes before the survivor's death.

3. If the decedent's surviving spouse is an alien and husband and wife had a tenancy by the entirety in real estate or a joint interest in personal property with right of survivorship, the decedent's estate will be taxed on the entire value of the jointly owned property except to the extent that the estate can show that the survivor provided the consideration or the property was given or bequeathed to them jointly by another person. Code § 2040(a).

4. Code § 2106(a)(3) allows the marital deduction for property located in the United States passing from a non-resident alien to a spouse who is a United States citizen.

5. The availability of the marital deduction to the surviving spouse is now determined solely by the citizenship of the surviving spouse. Whether or not the surviving spouse is a United States resident is irrelevant for marital deduction purposes, as is the citizenship or residency of the decedent spouse.

D. **Gift Tax Marital Deduction.** Code § 2503(b) allows an annual gift tax exclusion of $100,000 (inflation adjusted to $134,000 for 2010) in the case of gifts to non-citizen spouses. As with any other § 2503(b) gift, such a gift must be of a present interest. With respect to gifts to the non-citizen spouse, this exclusion is in place of (and not in addition to) the $10,000 (inflation adjusted to $13,000 for 2010) annual exclusion.

E. **Reasons for Changes in the Marital Deduction Rules for Aliens.** The rationale underlying the unlimited marital deduction is one of tax deferral. Any property left to a surviving spouse, except for the property consumed or given away during the survivor's lifetime, is ultimately taxed in the survivor's estate. However, the assumption that tax is only deferred may not hold true when property is left to a non-citizen spouse. A non-resident/noncitizen is subject to United States estate tax only on property situated within the United States. A noncitizen surviving spouse could give up United States residence and transfer property out of the country so that it would not be subject to United States estate tax at his or her death. A United States citizen who died within ten years of giving up United States citizenship and residency and ownership of United States assets could be subject to special estate tax imposed by Code § 2107 in the event of tax motivated expatriation prior to June 17, 2008. A long-term resident alien is also subject to these provisions. See Code § 877. See also The Heroes Earning Assistance and Relief Tax (HEROES) Act, signed into law on June 17, 2008, which changes the rules on Expatriates in a significant and harsh way. See also Notice 97-19, 1997-10 IRB, which toughened expatriation rules considerably and also extended such rules to long term U.S. residents who terminate U.S. residency. The legislature closed this loophole in the marital deduction by focusing on the citizenship status of the surviving spouse, the recipient of the property which was ultimately to be taxed, rather than on that of the decedent spouse. The statutory requirements of a QDOT are intended to ensure that property left to a non-citizen surviving spouse and for which the marital deduction has been allowed, will not escape federal estate tax.

F. **Qualified Domestic Trust (QDOT) - A Brief Overview.**

1. **<u>Requirements of a QDOT under Code § 2056A.</u>**

a. At least one trustee of the trust must be a United States citizen or domestic corporation.

b. No distribution (other than a distribution of income) may be made from the trust unless a trustee who is an individual United States citizen or domestic corporation has the right to withhold from such distribution the tax imposed by Code § 2056A(b).

c. The trust must meet Treasury Regulations as they are prescribed to ensure collection of any federal estate tax imposed with respect to the trust property.

d. The Executor must make an irrevocable election to treat the trust as a QDOT on the federal estate tax return.

e. In addition to the QDOT requirements, it is generally believed that property transferred to a QDOT must also satisfy the requirements generally applicable to the marital deduction.

f. Additional requirements added by Regulations to insure collection of the tax include the following:

(1) QDOTs holding assets over $2 million (without reduction for any indebtedness), must provide for:

(a) the appointment of a United States bank as trustee, or the appointment of a United States branch of a foreign bank provided that at least one United States trustee is also serving as a co-trustee with the foreign bank, or

(b) the posting of a bond by the United States trustee in an amount equal to 65% of the value of the trust, or

(c) furnishing an irrevocable letter of credit issued by a United States bank, a United States branch of a foreign bank, or a foreign bank and confirmed by a United States bank in an amount equal to 65% of the value of the trust.

(2) For QDOTs holding assets equal to or less than $2 million, a third option is available. If the requirements of (1) are not met, then no more than 35% of the fair market value of the QDOT may be invested in foreign real estate.

(3) For purposes of determining the $2 million threshold, up to $600,000 in value attributable to real property and related furnishings owned by the QDOT and used by the surviving spouse as a principal residence may be excluded. This exclusion must be made by written election attached to the estate tax return where the QDOT election is made.

(4) Individual trustees will be required to have a "tax home" in the United States.

(5) The requirement that all tangible and intangible personal property in the QDOT be physically located in the United States at all times during the term of the trust has been deleted.

(6) The Regulations also define a QDOT as an "ordinary trust", thereby preventing most annuity or other trust equivalent arrangements from qualifying (there are limited exceptions for certain non-assignable annuities).

2. **Tax Treatment of QDOT.** Property placed in a QDOT is not subject to estate tax until a "taxable event" occurs. Upon a taxable event, federal estate taxes are imposed on either the value of the property remaining in the QDOT or on the value of property distributed as determined by the particular taxable event:

a. **Taxable Events.**

(1) Any property remaining in the QDOT on the death of the surviving spouse is taxed at the rate which would have been imposed had such property been included in the decedent spouse's estate.

(2) At any time when the trust ceases to meet the qualifications of a QDOT, estate tax is imposed on the value of the trust assets as if the surviving spouse had died on the date the trust ceased to qualify.

(3) Generally, any distribution from a QDOT is a taxable event and is taxed at the rate at which it would have been taxed had it been included in the decedent spouse's estate. However, no tax is imposed on:

(a) income distributions to the surviving spouse (Code § 2056A(b)(3)(A));

(b) distributions to the surviving spouse on account of hardship ("hardship" is defined in the final Regulations as "an immediate and substantial financial need relating to the spouse's health, maintenance, education or support, or the health, education, maintenance or support of any person that the surviving spouse is legally obligated to support." (Code § 2056A(b)(2)(B); Treas. Reg. § 20.2056A-5(c)(1)); or

(c) distributions to reimburse the surviving spouse for any income tax on income generated by the QDOT and taxable to the surviving spouse.

(4) If a surviving spouse who was a resident at all times after the death of his or her spouse becomes a United States citizen after the establishment of a QDOT, then no tax will be imposed on QDOT distributions after the surviving spouse becomes a United States citizen.

b. Every trustee of a QDOT is personally liable for the tax due. Estate tax triggered by a taxable event is due on the fifteenth day of the fourth month following the calendar year in which the taxable event occurs.

3. **Post-mortem Transfer to QDOT.**

a. Prior to the date that the decedent's estate tax return is filed and during the time that the QDOT election can be made, the surviving non-citizen spouse (or the spouse's legal representative, if incompetent, or executor, if deceased) can transfer or irrevocably assign any property passing outright to the spouse to a QDOT and qualify that property for the marital deduction in the decedent's estate.

b. The Regulations recognize that some assets (*i.e.*, retirement plans) are not assignable and, therefore, cannot be made to qualify as QDOT property if left outright. An option is offered to qualify these assets for the marital deduction by entering into an agreement with the IRS regarding payment of estate tax with respect to these assets.

c. Drawbacks to post-mortem QDOT:

(1) Transfer by surviving spouse may result in taxable gift. Retention by the spouse of a special power of appointment over the transferred property should prevent this result.

(2) No protection to QDOT assets from spouse's creditors.

(3) QDOT is taxed as a grantor trust.

4. **<u>Economic Growth and Tax Relief Reconciliation Act Of 2001 ("EGTRRA")</u>**

a. Under EGTRRA, if a decedent dies before the estate tax repeal is effective (i.e. January 1, 2010), there will be no estate tax on distributions of principal from a QDOT made after December 31, 2020. (If the decedent dies after January 1 2010, a QDOT would not be necessary.) Further, if the surviving spouse dies after December 31, 2009, there will be no estate tax on the value of the property remaining in the trust at the surviving spouse's death. It is interesting that the assets are taxed if the spouse is living after 2010, but not if the spouse dies.

b. Insofar as basis increase under EGTRRA is concerned after proposed repeal of the estate tax in 2010, if the decedent is a non-resident alien, the aggregate basis increase is limited to $60,000, as increased for inflation in multiples of $5,000, using 2009 as the base year. Further, this amount cannot be increased by unused loss carry-overs or built-in losses. Code §§ 1022(b)(3) and (d)(4).

c. Under Code § 684, a transfer of property to a foreign estate or trust is generally treated as a sale or exchange in which the transferor recognizes a capital gain. After repeal of the estate tax in 2010, a transfer to a foreign estate or trust <u>or to a nonresident alien</u> will be treated as a sale or exchange in which the transferor recognizes capital gain. An exception to this will be § 684(b)(2) which excepts a lifetime transfer to nonresident aliens. Stated differently, a transfer to a nonresident alien at death will cause recognition of a capital gain.

VI. ESTATE AND GIFT TAX PLANNING FOR RESIDENT ALIENS.

A. **Outright Transfer.** Assets left outright to a non-citizen surviving spouse, whether probate or non-probate, may qualify for the marital deduction if the surviving spouse subsequently transfers such property into QDOT before the due date of the decedent spouse's federal estate tax return. Creditor issues exist if the QDOT is self-settled since one cannot create a "spendthrift" trust for oneself. This is a severe detriment and drawback as opposed to the QDOT created by the decedent spouse.

B. **Insurance.** Insurance can be used to avoid the inflexibility of the QDOT. The alien spouse can apply for insurance as owner and, using his or her separate property, take out a substantial insurance policy on the life of the citizen spouse with the alien spouse designated as beneficiary and owner. The citizen spouse can make annual exclusion gifts to the alien spouse to enable him or her to pay policy premiums. Because at the death of the citizen spouse the alien spouse would receive insurance proceeds which were never in the citizen spouse's estate and over which the citizen spouse had no incidents of ownership upon which inclusion in his or her estate could be based, no marital deduction would need to be claimed and the surviving alien spouse would still be left with a large amount of property which would not need to be placed in a QDOT and which could be taken offshore if desired.

C. **Gift Tax Exclusion.** Taking advantage of the $100,000 (inflation adjusted to $134,000 for 2010) gift tax annual exclusion for gifts to a non-citizen spouse is particularly important where the non-citizen spouse has the smaller estate because, unlike the QTIP and other marital deduction trusts, the QDOT cannot be used to shift the tax burden to the less wealthy spouse. However, consideration should also be given to the fact that assets transferred through lifetime gifts will have the donor's basis, while assets transferred to a QDOT will have a date of death basis. In an estate with assets with great potential appreciation, the possible tax savings of equalizing the estates should be balanced against the possible tax savings achieved by gaining a stepped up basis.

D. **Pay Estate Tax.** Although at first glance the QDOT might appear to be an automatic choice in every situation involving a non-citizen spouse, this is not always the case. The use of the QDOT to obtain the marital deduction is an appropriate device where the assets of an estate are generally income producing. However, where an estate consists primarily of assets that are growth-oriented, the estate tax due on the trust corpus at the death of the surviving spouse may actually be higher than the tax savings achieved by using the marital deduction in the decedent spouse's estate. Also, if the spouse is considerably younger and not likely to remain in the United States, it may be preferable to pay estate tax on the first death rather than unnecessarily subject the assets (which may have appreciated in value and been converted to non-United States situs property) to estate tax at the surviving spouse's death or upon distribution.

E. **United States Citizenship.** Consider applying for United States citizenship if the non-citizen has no plans to leave the United States and can qualify.

VII. ESTATE AND GIFT TAX PLANNING FOR A NON-RESIDENT ALIEN CONTEMPLATING ACQUIRING UNITED STATES RESIDENCE OR CITIZENSHIP.

A. **Pre-Residence Gifts.** An individual who is a non-resident for United States estate and gift tax purposes can remove property from his or her taxable estate before becoming a United States domiciliary or citizen by making gifts of property that do not attract United States gift tax. Of course, note the reporting under Code § 6039F discussed above. Furthermore, Code § 679 now causes a foreign person (who adopts U.S. residency within five years of making a transfer to a foreign trust) to be deemed to own the trust under the grantor trust rules.

1. **Non-Taxable Property.** Gifts of United States or foreign situs intangible property, foreign situs tangible personal property and foreign situs real estate would not attract United States gift tax. Note however that if the alien retains prohibited controls over the assets transferred (such as transfers with a retained life estate, transfers taking effect at death, and revocable transfers), such assets can still be included in the donor's taxable estate.

2. **Conversion of Tangible Property to Intangible.** A non-resident alien with United States situs real or personal property can convert such property to United States situs intangible property by, for example, contributing it to a United States corporation as capital. Provided the corporation is not a sham corporation, a later unrelated gift of shares of the corporation, while the alien is still non-resident, should not attract United States gift tax. Alternately, it may be desirable, especially in smaller estates, to postpone gifts of United States situs tangible personal and real property until after the acquisition of United States domicile or citizenship in order to obtain the benefit of the unified credit not available to non-residents.

B. **Income Tax Planning**. A non-resident alien intending to acquire United States domicile or citizenship should pay close attention to income tax planning. While such planning is beyond the scope of this article, proper planning can not only minimize the impact of United States income taxation but can also reduce the burden of United States estate, gift, and generation-skipping taxation.

VIII. FOREIGN TRUST TAX COMPLIANCE

A. **Foreign Trust Reporting.** Significantly increased reporting requirements (see Code § 6048) now exist for foreign trusts as set forth in the Small Business Job Protection Act of 1996 (H.R. 3448) which was enacted on August 20, 1996. Additionally, harsh penalties for compliance failure are imposed, the scope of Code § 679 is expanded, the grantor trust rules are contracted as they apply to trusts treated as owned by non-resident aliens, interest charges are increased on distributions of accumulated income from foreign trusts and other changes have occurred.

The increased use of offshore asset protection trusts has likely led to a concern that such trusts would not only avoid creditors, but would likely avoid the IRS as well.

Code § 7701(a)(30) and (31)(B) attempt to define a foreign trust by stating that a trust is a foreign trust unless both of the following conditions are met:

1. A court or courts within the U.S. must be able to exercise primary supervision over administration of the trust; and

2. One or more U.S. fiduciaries have the authority to control all substantial decisions of the trust.

A major problem seems to exist if a client (U.S. citizen) created a trust with U.S. assets for her U.S. children naming a U.S. Bank and her non-citizen non-resident brother as Co-Trustees, with the non-resident brother having the right to change corporate trustees and perhaps determine when the children receive their distributions from the trust fund. Since a foreign fiduciary controls a substantial decision, the new law would treat such trust as a foreign trust, subject to reporting and subject to tax under § 1491. Obviously, any designation of a non-resident non-citizen as a trustee having substantial decision power should be reviewed or the trust could be deemed to be a foreign trust. Notice 97-18, 1997-10 IRB provides guidance on reporting foreign transfers.

B. **Special Rules for Certain Canadian Retirement Plans.** A simplified reporting regime for taxpayers who hold interests in Canadian registered retirement savings plans ("RRSPs") and registered retirement income funds ("RRIFs") is effective for taxable years beginning after December 31, 2002. Notice 2003-75, 2003-50 IRB 1204.

C. **Is the Foreign Structure a "Trust" for U.S. Tax Purposes?** This can be an exceedingly complicated question. Many civil law countries do not recognize the "trust" concept, but may have other somewhat similar forms of ownership. Civil law structures such as the *usufruct*, *anstalt*, and *stiftung* have all been classified as trusts for United States tax purposes in certain circumstances, but such classification is determined on a case by case basis looking at the terms, organization, and purpose of each particular structure.

For a more detailed discussion of foreign trust classification see: Robert C. Lawrence III and Dina Kapur Sanna, *Trust Classification Times Four*, 38TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2004).

* A Private Letter Ruling ("PLR") is directed only to the taxpayer who requested it. Code § 6110(j)(3) provides that it may not be used or cited as precedent.

---

[1] This outline is not intended to be tax advice and this outline was not intended or written by the author to be used and it cannot be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Any tax advice contained in this outline may be held by Treasury or the IRS to have been written to support, as that term is used in Treasury Department Circular 230, the promotion or marketing of the transactions or matters addressed by such

advice. A taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

The views expressed in this outline are those of the author and do not necessarily reflect the position of Fulbright & Jaworski L.L.P.

Rodney C. Koenig is a partner with the Houston law firm of Fulbright & Jaworski L.L.P. Mr. Koenig has legal experience in estate planning, estate administration, creation of trusts, foundations, charitable trusts, insurance trusts, controversies, international estate planning, including qualified domestic trusts for resident and non-resident aliens.

MEXICO UNSETTLES THE MAQUILADORA INDUSTRY BY LIMITING TAX PROTECTIONS AND SCHEDULING A GENERAL TAX INCREASE

By: *John A. McLees*[1]

This article discusses complex rules that Mexico published recently to eliminate the protections and benefits of its special maquiladora tax regime for some maquiladora operations. It also discusses the need to end the uncertainty arising from the pending expiration at the end of 2011 of protection that Mexico has granted maquiladora operations until now from large tax increases under Mexico's single rate business tax (the "IETU").

Mexico relies on programs known as maquiladora or "IMMEX" programs issued to Mexican companies under its Maquiladora Decree (also now known as the "IMMEX" Decree) to create a favorable environment for foreign investment in its manufacturing sector. Mexico has implemented a multifaceted set of trade and tax rules for maquiladora operations to remove trade barriers and unacceptable tax exposures for companies engaged in export manufacturing in Mexico and their foreign affiliates, and to create the certainty that Mexico must provide to companies investing in Mexico.

Apart from the special maquiladora tax regime, which is discussed here, Mexico continues to streamline its trade rules for maquiladoras, especially those that obtain the status of a "certified company". Companies may be discouraged from operating in Mexico, in spite of these favorable trade rules, however, if they are not also protected from unacceptable tax risks and burdens in doing so.

If anything, economic and political factors will cause companies to pay closer attention than ever to extra tax risk and tax burdens, as they make their foreign investment decisions in coming years. The advantages that Mexico enjoys from its geography and from its willing and productive work force may be offset in some parts of the country by security concerns that were not a factor in past years. Also, U.S. companies emerging from the financial crisis with losses to carry forward for U.S. tax purposes will find it more important than ever to be able to implement consignment ("toll") manufacturing[2] with a Mexican affiliate operating under a maquiladora program. They need to be able to do so without Mexican tax exposures for the U.S. company and with certainty that the maquiladora will continue to benefit from the low and stable tax rates that Mexico has provided for nearly a decade to Mexican companies that engage in consignment manufacturing under a maquiladora program.[3]

Unfortunately, in spite of the general stability of those tax rules for the past several years, there continue to be conflicting pressures from some elements in the Mexican government that create periodic crises of uncertainty and result in unnecessary complexity for all companies in obtaining the benefits of the favorable maquiladora tax regime.

In 2011 the companies involved in the maquiladora industry once again face uncertainty, new waves of complexity, and new restrictions on which maquiladoras qualify for the protections and benefits of the maquiladora tax regime. For some companies the loss of tax protections and benefits will make Mexico a less attractive place to establish or maintain their manufacturing operations. For others Mexico will remain an attractive destination for foreign investment in export manufacturing if they devote the necessary resources to understanding and complying with the new conditions on obtaining the tax benefits and if they can justify a high level of confidence that Mexico will maintain its current tax and trade regime for maquiladoras and their foreign affiliates.

The entire industry will, however, be watching closely to see if Mexico acts promptly to end the profound uncertainty that currently exists as to the tax burden that all maquiladoras will face in 2012 and future years, and to clarify or modify some of the worst features of its recent attempts to restrict or eliminate the availability of the special maquiladora tax treatment for some Mexican companies and foreign companies involved in the maquiladora industry.

The Maquiladora Tax Regime

In addition to providing for temporary importation of materials, components and machinery by a maquiladora without the imposition of value added tax, Mexico has always recognized the importance of protecting a foreign principal from the imposition of nonrecoverable VAT on its payments to the Mexican company for manufacturing services under a consignment manufacturing arrangement. Therefore, the Mexican VAT law provides for a zero rate of VAT on such payments **if and only if** the Mexican party performing the consignment manufacturing is a maquiladora, i.e. a Mexican company operating under a maquiladora ("IMMEX") program.

The Mexican income tax law also provides a permanent establishment exemption for a foreign company participating in a consignment manufacturing arrangement with a company operating under a maquiladora program. This provides the protection that a U.S. company requires from exposure to Mexican tax on its profits from the sale of products processed in Mexico. The law provides that the foreign company will qualify for that permanent establishment exemption if the maquiladora either satisfies a special transfer pricing rule or meets a specified threshold for its taxable income, both of which are set forth in Article 216-BIS of the Mexican income tax law.

The permanent establishment exemption under Mexican law is derived from the mutual agreement on maquiladora taxation entered into by the United States and Mexico in 1999, currently in effect (the" Mutual Agreement"). Under the terms of the Mutual Agreement, Mexico has agreed to provide a permanent establishment exemption to any U.S. company that meets those requirements in a consignment manufacturing arrangement entered into with a Mexican company operating under a maquiladora program.

Under the terms of the mutual agreement, the United States agreed that a U.S. principal will be entitled to receive a deduction for the full amount that it is required to pay the maquiladora to satisfy the requirements now set forth in Article 216-BIS of the Mexican income tax law (i.e. that those amounts will be deemed to be in compliance with Section 482 of the Internal Revenue Code if paid to a related party), in exchange for Mexico's agreement to grant a permanent establishment exemption to a U.S. company acting as a principal under a consignment manufacturing arrangement with a maquiladora that satisfies the special transfer pricing rules or meets the safe harbor threshold for its taxable income. Because the payments needed to satisfy these requirements are by definition greater than the amounts that a U.S. company would be allowed to deduct as payments to a related part in the absence of the mutual agreement, the ability to get a deduction for these larger amounts in the United States, and the ability of a U.S. principal to choose the more favorable of two methods of determining those payments are also important elements of the maquiladora tax regime.

Since 2003 Mexico has also provided a significant income tax incentive for maquiladoras that operate in this way, under the terms of a decree issued by President Fox, through a formula that reduces a the maquiladora's income tax rate on income from its maquiladora activities from 30% to a rate between zero and 13%. A maquiladora that also engages in nonmaquiladora activity is subject to income tax at the normal rate of 30% on its taxable income from that portion of its operations.

Finally, since 2007, when Mexico enacted the IETU (which is payable to the extent the taxpayer's IETU liability exceeds it income tax payments), maquiladoras, and only maquiladoras, have benefited from a special rule that allows a maquiladora to apply the 17.5% IETU rate to the maquiladora's income tax base arising from its maquiladora activity, rather than using the normal special IETU base. That has the effect of providing a maquiladora with a total burden of income tax and IETU on its maquiladora activity equal to 17.5% of its income tax base.

In the absence of that special rule, which will expire at the end of 2011, many manufacturing maquiladoras would experience a substantial increase in their total liability of Mexican income tax and IETU, up to three time or more what it is today (i.e. 50% or more of their income tax base). This is due to the characteristics of a consignment manufacturing operation and the denial of certain deductions in determining the normal IETU tax base.

Three other elements of the maquiladora tax regime are essential to maintaining the tax system that Mexico requires to attract and retain export manufacturing operation:

- The first is the ability of a maquiladora to transfer its output to other maquiladoras or other export manufacturers in Mexico without the imposition of VAT and without losing the benefits of the other elements of the maquiladora tax regime mentioned above. This is essential because a large portion of Mexico's export manufacturing industry involves participation by more than one company in manufacturing a product that is exported from the country. Mexico has developed effective ways to facilitate these commercial arrangements, while maintaining protection from abuse of the tax and trade rules, by allowing maquiladora transfers to other companies using virtual pedimentos and other mechanisms.

- The second is the ability of multinational companies to use consignment manufacturing for their maquiladora operations, even if the maquiladora has previously operated as a buy-sell company. There are many business reasons that multinational companies prefer to use consignment manufacturing in structuring their export manufacturing operations, and this has always been the predominant business model for maquiladora operations in Mexico. Implementing consignment manufacturing is often important for a variety of reasons as manufacturing operations grow and change. In many cases the need to implement consignment manufacturing will be as simple, and as essential, as getting the administrative and operating efficiencies of combining multiple operations in Mexico or conducting multiple manufacturing operations on the same operational model.

- The third is the protection that U.S. companies and other foreign companies have enjoyed until now from having a permanent establishment in Mexico as a result of dealing with maquiladoras that have been established to facilitate export manufacturing under "service maquiladora" programs. These are maquiladoras whose programs authorize activities other than manufacturing activities. Service maquiladoras are essential to the efficient operation of corporate supply chains that are now essential to many companies in using Mexico as a export manufacturing platform. It will not be acceptable for foreign companies to be exposed to permanent establishment exposure in Mexico from their participation such operations, any more than it was acceptable for Mexico to attempt in 1998 to remove the permanent establishment protection for foreign companies involved in consignment manufacturing operations. That crisis resulted in Mexico's restoration of a permanent establishment exemption for such companies under the terms of the Mutual Agreement.

Unfortunately, as in 1998, some Mexican officials continue their campaign to limit the application of Mexico's maquiladora tax regime, perhaps to increase tax revenue, perhaps to exclude companies that they think are abusing the system, perhaps from a desire to avoid the need to audit certain maquiladora transactions under Mexico's normal tax rules. The results of this unfortunate tendency are apparent in both the recent amendments to the maquiladora decree, after a year of public deliberation, and in Mexico's failure to date to clarify whether or not it will impose a major tax increase on maquiladora companies in 2012 by failing to extend the current maquiladora tax rules for purposes of the IETU.

Uncertainty

As discussed below, some of the changes in the Maquiladora Decree create unnecessary uncertainty for many maquiladoras, in part because they are unduly complex and subject to different interpretations.

Additional uncertainty arises from the expansion of the power of the tax authorities to cancel a Mexican company’s maquiladora program solely on the basis that a tax assessment has been made against the company. Given the grave consequences of the loss of a maquiladora program, companies will regard it as a serious issue that the tax authorities now have the power to cancel a maquiladora program even for a minor tax assessment and even if the tax assessment is not final or is still under review by the courts. This change in itself, and the uncertainty that it introduces, may tend to undermine the prospects for growth in the export manufacturing sector that Mexico hopes to achieve through the special trade and tax rules that it has implemented for maquiladoras and their foreign affiliates.

The most serious element of uncertainty, however, has to do with Mexico's failure to date to extend beyond the end of 2011 the protection that it now offers to maquiladora companies from the need to use the normal IETU tax base in determining their liability for IETU. Without going into all of the complexity of this issue, it is sufficient to note that, as mentioned above, the

IETU was established as an alternative tax, payable to the extent that it exceeds the taxpayer's income tax liability, and calculated at the rate of 17.5% on a different tax base that is computed without allowing several important deductions.

The denial of a deduction for the cost of compensation that is tax free to employees, in determining an employer's normal IETU tax base, typically results in IETU liability that would massively exceed income tax liability for a maquiladora that is engaged primarily in consignment manufacturing because:

- such a company's costs consist predominantly of employee compensation, and
- such a company's work force usually consists primarily of low-paid workers, for whom a relatively large portion of their total compensation is tax free to them, and thus nondeductible for the company in computing its normal IETU tax base.

The problem would be magnified for maquiladoras that own their own buildings or other assets that they acquired before January 1, 2007 because depreciation deductions are also denied in computing the normal IETU base.

When Mexico enacted the IETU in 2007, it recognized that this would have the effect of imposing an unacceptable tax burden on consignment manufacturing operations, and a massive increase in the existing tax liability on maquiladoras operating in that way. Therefore, President Calderon issued a decree that provides the elegant solution of allowing the maquiladoras, and only maquiladoras, to use the income tax base arising from their maquiladora activity for computing their IETU liability with respect to that activity. A maquiladora that also engages in nonmaquiladora activities must use the normal IETU base, with its limitations on deductions, to determine the IETU liability from that portion of its operations.

In issuing his decree, the President of Mexico recognized that such a disproportionate IETU burden was an unintended result of the way that the IETU is structured and that imposing IETU in such a disproportionate manner on Mexico's export manufacturing sector was not in the interest of Mexico. Unfortunately, however, without regard for the importance of certainty for companies that are making decisions about where to locate export manufacturing operations, the decree provided that the protection from this unreasonable tax burden expires at the end of 2011. Thus it remains to this day.

It is fair to say a tax Mexican increase of this magnitude will be of major concern for any company in the United States, Europe or Asia that takes a systematic approach in developing and implementing its plans for its international operations, and that cares about its foreign tax liability. Therefore, the uncertainty resulting from the expiration of this rule under the IETU has the potential of becoming a crisis for the industry. Mexico needs to realize that U.S. companies in particular cannot count on getting a full foreign tax credit for the IETU that they will pay under these circumstances, even if the IETU continues to be treated as a creditable foreign income tax for purposes of the U.S. foreign tax credit, and that companies are already taking this increased cost for 2012 and future years into account in making their investment decisions.

Companies and industry groups will be actively engaged in pressing the government to extend the current IETU rule for maquiladoras indefinitely to years beyond 2011 for all companies operating under a maquiladora program. These efforts deserve the active support of all of the companies in the industry. The longer Mexico delays in clarifying this issue and acting to extend this protection to future years, the more damage it will do to its ability to attract and keep export manufacturing operations in Mexico**.**

Denial of Existing Protection and Benefits

The primary purpose of the tax provisions in the recent amendments to the maquiladora decree was to deny for the first time the protections and benefits of the maquiladora tax regime, except the special VAT rules, for several broad categories of companies that continue to qualify as maquiladoras under Mexican law in that they continue operate under a maquiladora program.

Instead of establishing new standards that a company must meet to operate under a maquiladora program, i.e. to qualify as a maquiladora, the amendments to article 33 of the Decree attempt to redefine some maquiladoras as not constituting a "maquiladora" solely for purpose of their eligibility for those tax protections and benefits. In particular the amendments to the Decree purport to exclude foreign companies dealing with certain maquiladoras from permanent establishment protection granted to all such companies under Mexican law, in articles 2 and 216-BIS of the income tax law, by simply saying that these maquiladoras are not maquiladoras for purposes of those provisions only.

These new rules are of doubtful validity under Mexican law because they attempt to deny some maquiladoras the benefit of protections granted by law. Because these rules attempt to eliminate the permanent establishment exemption for some U.S. companies that act as principals in consignment manufacturing arrangements with companies that qualify as maquiladoras under Mexican law, they also appear to violate Mexico's obligations under the Mutual Agreement with the United States. As noted above, under the terms of the Mutual Agreement, Mexico agreed to grant a permanent establishment exemption to a U.S. company acting as a principal under a consignment manufacturing arrangement with a maquiladora if the maquiladora satisfies the requirements now set forth in Article 216-BIS of the Mexican income tax law, in exchange for the agreement of the United States to grant a deduction to the U.S. principal for U.S. tax purposes for the full amount that the U.S. principal is required to pay the maquiladora to enable it to satisfy those requirements.

Nevertheless it will be necessary for companies to take these rules seriously unless and until they are modified or overturned.

The maquiladoras that are subject to losing the protections and benefits of the maquiladora tax regime for themselves and their foreign affiliates under the recent amendments to the Maquiladora Decree include the following:

i) Maquiladoras operations that do not perform a transformation or repair operation using temporarily imported goods provided by a foreign resident (including service maquiladora companies and companies with a combined industrial and service maquiladora program to the extent that the services provided in the service maquiladora component are not considered as transformation in accordance with article 33 of the Decree).

ii) Maquiladoras obtaining their maquiladora program authorizations after December 31, 2009, that fail to meet new requirements regarding ownership of the machinery and equipment used in their operations, including a new minimum threshold requiring that 30% of the machinery and equipment used by the maquiladora must be owned by the foreign principal, a new requirement that a maquiladora must use equipment owned by the foreign principal that was never owned by the maquiladora itself or a Mexican related party, and a prohibition on using any equipment owned by the maquiladora itself (or equipment owned by another foreign resident or equipment leased from unrelated parties) if that equipment was ever owned by a Mexican related party of the maquiladora.

iii) Maquiladoras that were operating under a maquiladora program as of December 31, 2009 but that have not complied with the special transfer pricing rules for maquiladora operations under article 216-BIS of the income tax law, and that fail to meet the new requirements mentioned above regarding ownership of the machinery and equipment used in their operations.

iv) Maquiladoras that transfer goods resulting from a transformation or repair process for sale in Mexico if such transfers are not documented with export pedimentos.

These complex limitations are arbitrary in that they do not correspond to relevant distinctions from a business or tax perspective. The elimination of the tax protections and benefits for manufacturing maquiladoras that violate the new rules on ownership or prior ownership of machinery and equipment and for service maquiladoras that do not engage in transformation appear to target categories of maquiladoras that some Mexican officials have long wanted to exclude from the protections and benefits provided for all maquiladora operations under Mexican law. It is harder to explain the provision eliminating the tax protections for maquiladoras that transfer products to a party in Mexico using well-established methods to handle those transfers from a customs standpoint, other than a change of customs regime favored by the new rules.

Use of Virtual Pedimentos

As noted above, the flexible use of virtual pedimentos and other methods to handle customs transfers when maquiladoras send their output to other parties in Mexico is an essential feature of Mexico's maquiladora tax regime. These mechanisms allow parties to make such transfers without VAT and without incurring the prohibitive cost of carrying products that incorporate temporarily imported components to the border for a physical export and then back to their destinations in Mexico. The existing rules have protected Mexico's interest in ensuring the full application of Mexican taxes and duties for sales of goods into the Mexico market.

Until now, in addition to providing for the use of virtual pedimentos, Mexico has also allowed manufacturing maquiladoras that send their output to other parties in Mexico to use two other methods of structuring the customs transfers for those operations, which also protect

Mexico's interests with respect to any sales of goods into the Mexico market. Maquiladoras have been allowed to change the customs regime of the temporarily imported materials and components that the maquiladora has incorporated into its products to definitive importation (with payment of VAT and any applicable duties) before sending the goods to a party in Mexico. Alternatively, automotive parts manufacturers have been allowed to make the transfers to an automotive OEM using documents called *constancias de tranferencia de mercancias* ("CTMs"), which require the party receiving the goods to report back to the maquiladora as to what portion of the maquiladora's products have been incorporated into finished products that were ultimately sold into Mexico, so that the maquiladora can change the customs regime on that portion of its temporarily imported inputs.

Both of these alternative approaches are commonly used by automotive parts manufacturers in Mexico, some of whose Mexican customers have preferred those methods to the use of virtual pedimentos. Thus the new rules have the potential for needlessly disrupting important commercial relationships.

The changes published on December 24, 2010, have caused those maquiladoras suddenly to be subject to new tax liabilities starting January 1, 2011, including potentially prohibitive IETU liability for all or part of their production, and have subjected the foreign principals in their consignment manufacturing arrangements to significant exposure of having a permanent establishment in Mexico from January 1, 2011. These liabilities and contingent liabilities may be substantial, to the point of being unacceptable, and the problem is not easy to fix immediately because implementing the use of virtual pedimentos will require a change in the party to which the Mexican counterparty sends its purchase order and the party that issues it an invoice.

Thus, many companies in the automotive sector have suddenly become subject to significant additional Mexican tax burdens of uncertain magnitude and duration that will typically constitute an extra cost of doing business in Mexico because they will in many cases not be offset by a foreign tax credit in the United States.

In addition U.S. automotive parts manufacturers that have consignment manufacturing arrangements with affiliates in Mexico, and that have now lost their permanent establishment exemption starting January 1 as a result of their use of previously approved methods of transferring their production to their customers in Mexico, will also be at risk of losing a portion of their U.S. deductions for their payments to their Mexican maquiladoras if the IRS takes seriously Mexico's purported determination that the portion of the maquiladora operations involved in producing products for delivery in Mexico no longer constitutes maquiladora operations for tax purposes.

Mexico should consider eliminating these arbitrary and counterproductive limitations on the maquiladora tax regime for companies that find it commercially useful or important to use change of customs regime or CTMs instead of virtual pedimentos. Meanwhile, companies must take immediate action to minimize the tax exposures to which they have been subjected by the new requirement that they use virtual pedimentos, and to eliminate those exposures going forward if they can.

Machinery and Equipment

Among the most complex and problematic of the recent amendments to the maquiladora decree are those that purport to exclude some maquiladora operations from obtaining the protections and benefits of the maquiladora tax regime on the basis of the ownership or prior ownership of machinery and equipment used in the maquiladora operation.

This is an issue that has never been regulated before, and the new rules do not affect the status of such companies as maquiladoras, i.e. companies operating under a maquiladora program. Specifically, however, unless the maquiladora was operating under a maquiladora program on December 31, 2009 and "has complied" with the requirements under Article 216-BIS of the income tax law, the amendments to Article 33 of the Maquiladora Decree purport to require that the following conditions must be met in order for the maquiladora and its foreign affiliate to obtain the protections and benefits of the maquiladora tax regime:

- The maquiladora must use machinery and equipment that is owned by the foreign principal that has not been owned previously by the maquiladora itself or a Mexican related party,

- if the maquiladora uses machinery and equipment that is owned by another foreign resident, that is leased from an unrelated party, or that is owned by the maquiladora company itself, that machinery and equipment must never have been owned previously by a Mexican related party of the maquiladora, and

- the machinery and equipment owned by the foreign principal must represent at least 30% of the total machinery and equipment used in the maquiladora operation.[4]

These arbitrary new rules will have the effect of eliminating for some maquiladoras the flexibility that all companies operating under a maquiladora program have always had in the past to implement consignment manufacturing without unacceptable tax exposures in Mexico. In addition the new rules will create unnecessary pitfalls for all new maquiladoras and for existing maquiladoras that operate under a consignment manufacturing arrangement and do not fall within the exemption for companies that were operating under a maquiladora program on December 31, 2009 and that "have complied" with the requirements under Article 216-BIS of the income tax law.

A. Restricting the Use of Consignment Manufacturing

The ability to use consignment manufacturing without unacceptable tax risks and burdens has always been one of the most important differentiating factors that has made Mexico an attractive choice for multinational companies in locating their export manufacturing operations.

As global operations of multinational companies become more interconnected, and as competition forces companies to achieve all available cost reductions, the ability to implement consignment manufacturing has become more important than ever for more companies as a business matter, to achieve operating efficiencies and flexibility that enable them to compete and grow. These efficiencies and this flexibility are especially important in the increasingly integrated manufacturing operations in North America, as is apparent from the fact that the vast majority of the export manufacturing operations in Mexico have always been conducted using consignment manufacturing arrangements.

U.S. companies in particular can also realize significant non-Mexican tax advantages from organizing export manufacturing in Mexico using consignment manufacturing arrangements with affiliated maquiladoras. These include the ability of U.S companies to generate foreign source income, and thereby to increase its global utilization of foreign tax credits for U.S. tax purposes, by appropriately structuring its consignment manufacturing operations to benefit from the regulations under Section 863(b) of the Internal Revenue Code.

Thus, by enabling companies to engage in export manufacturing using consignment manufacturing arrangements, Mexico has facilitated the growth in its economy and its tax revenues The contribution of the Mexican tax regime for maquiladoras to increasing Mexico's tax revenues is greatly enhanced by the special rules for maquiladora transfer pricing, in particular the safe harbor alternative, set forth in the Mutual Agreement, and implemented in Article 216-BIS of the Mexican income tax law. Under the Mutual Agreement the United States has agreed to allow a U.S. company to deduct much-increased payments to a maquiladora with capital intensive operations that elects to use the safe harbor, thereby greatly increasing the net income of the maquiladora, which is subject to tax in Mexico.

This important role of Mexico's special tax regime for consignment manufacturing under maquiladora programs in enhancing Mexico's tax revenues does not appear to be well recognized by important elements in Mexico's Ministry of Finance and Tax Administration Service.

The ability to implement consignment manufacturing without artificial restrictions for new operations and existing operations is especially important for some of the multinational companies with the largest investment in the Mexican manufacturing sector. In particular this is true of companies in the automotive sector, where minimizing administrative costs and other costs is essential to the survival of the company and to the maintenance or growth of any manufacturing operation in Mexico or elsewhere.

Thus rules limiting the availability of consignment manufacturing for some maquiladoras are fundamentally at odds with Mexico's interests in maintaining and growing its export manufacturing sector and its tax revenues from that sector.

Nevertheless, by focusing on current and prior ownership of machinery and equipment, the new restrictions are undoubtedly directed at preventing maquiladoras that have operated in the past as buy-sell companies from using consignment manufacturing. These include maquiladoras that operated under the alternative PITEX decree for export manufacturing prior to its repeal in 2006. At that point the existing temporary importation programs of all such companies under the PITEX decree were automatically transformed by operation of law into maquiladora programs, governed by the Maquiladora Decree, making those companies eligible for all of the protections and benefits of the maquiladora tax regime if they implement consignment manufacturing.

Companies operating under a PITEX program could not implement consignment manufacturing operations before being covered by a maquiladora program, because only operations undertaken under a maquiladora program are eligible for the special rules under which a foreign principal dealing with a the Mexican company under a consignment manufacturing arrangement receives protection from unrecoverable Mexican VAT and from having a permanent establishment in Mexico. PITEX companies with buy-sell operations always had the opportunity to implement consignment manufacturing without such tax exposures, however, by obtaining a maquiladora program, which was routinely granted. This has been the case for all former PITEX companies since they obtained maquiladora programs by operation of law in 2006.

The transformation of a maquiladora's operations to consignment manufacturing has typically involved transfers of the ownership of machinery and equipment as well as inventory, all of which must be conducted at prices that comply with Mexican tax law and transfer pricing principles. Of course any transaction involving a Mexican company, including any transaction undertaken in implementing consignment manufacturing, is subject to audit by the Mexican tax authority to insure that it is undertaken in compliance with Mexican tax law and transfer pricing principles, including the application of IETU at the rate of 17.5% on the proceeds of a sale of machinery and equipment.

Of course it is also possible for a maquiladora to implement consignment manufacturing without any transfer of the ownership of its machinery and equipment to the foreign company. This would be adequate in many cases to meet a company's business objectives. Mexico's determination to interfere with such transactions, however, is illustrated by its introduction of the rule, which was not in the original proposals published a year ago, requiring that the foreign principal own at least 30% of the machinery and equipment used by a maquiladora that implements a consignment manufacturing arrangement.

Companies that were once PITEX companies and that became maquiladoras by operation of law (rather than by individual application) in November 2006 have continued to implement consignment manufacturing when business conditions or their global tax position makes that a more cost effective way of doing business These transactions are subject to audit by the tax authorities to determine whether they were undertaken in compliance with generally applicable tax and transfer pricing rules. Mexico has not, however, challenged the eligibility of the maquiladoras that undertook those transactions to obtain the protections and benefits of the tax regime that the law provides for all maquiladoras on the ground that maquiladoras that were once PITEX companies fail to qualify for the benefits available to all maquiladoras that implement consignment manufacturing. In fact the maquiladoras that undertook those transactions in 2006, 2007, 2008 or 2009 are covered by the exemption from the new restrictions now set forth in Article 33 of the Maquiladora Decree.

Nevertheless, Mexico now appears to be trying to disrupt the transactions of other maquiladoras that implemented consignment manufacturing in 2010 or that wish to implement those changes in the future, through an elaborate set of restrictions that are designed to force maquiladoras that happen to be operating under buy-sell transactions to continue to operate in that way, even as other companies with identical operations are able to utilize the consignment manufacturing arrangements that have always been the norm for export manufacturing in

Mexico. It is attempting to deny those companies the protections and benefits granted by law to all maquiladoras simply by saying that those maquiladoras should no longer be called maquiladoras for tax purposes.

What is less clear is how the new rules will affect such companies now and in the future. That will depend both on the interpretation of the exemption mentioned above and on the extent to which foreign-owned machinery and equipment used by a maquiladora will be subject to a requirement that it has never been owned by the maquildora itself**.** If the new rules are applied to force major participants in the Mexican manufacturing sector to maintain inefficient and inconsistent structures for their operations in Mexico, then Mexico will have unnecessarily increased the cost of doing business in Mexico**.**

One step that Mexico could take to diminish the negative impact of these rules on the legitimate business transactions of multinational companies investing in Mexico would be to issue a Miscellaneous Rule providing that a company that operated under a PITEX program prior to November 2006 will not be subject to the new requirements with respect to ownership or prior ownership of machinery and equipment, so that they would continue to be eligible for the protections and benefits of the maquiladora tax regime if they implement consignment manufacturing in compliance with applicable tax regulations. Such “temporary” regulations are often used in Mexico to fine tune the impact of Mexican laws, decrees or regulations, and they can remain in effect year after year, on a more or less permanent basis.

B. Pitfalls and Complexity

If these new restrictions on the ownership and prior ownership of machinery and equipment are upheld, they will also create pitfalls for all manufacturing maquiladoras operating under maquiladora programs granted after December 31, 2009 and for any preexisting maquiladoras that are not covered by the exemption from the application of new restrictions for companies that were operating under a maquiladora program as of December 31, 2009 and that "have complied" with the requirements of article 216-BIS.

For example, companies that are not covered by the exemption will need to maintain constant vigilance to insure that no machine or item of equipment that was ever owned by the maquiladora itself or a related Mexican party is later owned by the foreign company and made available for use by the maquiladora, if as seems likely the tax authorities take the position that the existence of a single such machine among the equipment being made available by the foreign company will cause it and the maquiladora to lose the protections and benefits of the maquiladora tax regime. Similarly companies that are not covered by the exemption will need to maintain constant vigilance to insure that no machine or item of equipment that is owned by the maquiladora was ever owned by a related party in Mexico.

In the future it will undoubtedly come as an unwelcome surprise to officials of more than one maquiladora that has not paid close attention to the new rules that under the new rules the maquiladora has lost the benefit of the special reduced rate of Mexican income tax and the permanent establishment exemption for its foreign affiliate, has been unexpectedly subject to a much increased liability for IETU, and is subject to interest, penalties and inflation adjustment on the resulting tax assessments for one or more past years, because, perhaps without the knowledge of those in the management of the company, there is a piece of equipment owned by the maquiladora that was previously owned by a related party in Mexico, or there is a piece of machinery that has been made available by the foreign affiliate for use by the maquiladora that for some reason was previously owned at some time in the past by the maquiladora itself.

The very existence of these arbitrary pitfalls that have nothing to do with the operation of the business or with Mexico's normal tax rules, and the need for companies and their advisors to give constant attention to them, is disruptive of a manufacturing business and a detriment to Mexico's competitive position in the global marketplace.

Service Maquiladoras

It will be important for a service maquiladora that engages in activities that are not defined as constituting transformation[5] (1) to determine the tax consequences for the maquiladora itself of having lost the benefits of the maquildora tax regime, and (2) to examine what steps it can take for 2011 and future years to minimize any permanent establishment exposure that has arisen for its foreign affiliates from the new rules.

The immediate impact for most service maquiladoras will be an increase in their income tax rate to 30%, effective as of January 1, 2011. They will also need to begin using the normal IETU tax base from the beginning of 2011, but that may or may not result in additional tax liability because of the characteristics of their business, which typically differ from those of an industrial maquiladora.

The most serious concern for service maquiladoras relates to the possible Mexican tax implications for their foreign affiliates. Companies need to review their service maquiladora operations carefully to identify and eliminate any significant permanent establishment risks for their foreign affiliates that arise from the current operations of the service maquiladora, in the absence of the permanent establishment exemption that they previously enjoyed.

Some companies that have used service maquiladoras to meet customer requirements for just-in-time delivery may need to restructure their operations in ways that are less efficient from a business standpoint and may be less satisfactory to their customers.

It appears that Mexico’s primary motivation in terminating the protections and benefits of the maquiladora tax regime for most service maquiladoras was to collect income tax at normal rates from those companies. In order to accomplish that objective, it should not have been necessary to expose their foreign affiliates to risks of having permanent establishment in Mexico from their normal business operations. Therefore, Mexico should be open to responding to concerns from companies from the export manufacturing sector about inefficiencies and cost increases that could be avoided by restoring the permanent establishment protection for these operations.

Partial Coverage by the Maquiladora Tax Regime

Many manufacturing maquiladoras and many service maquiladoras will now experience situations in which part of their maquiladora operations are covered by the special maquiladora tax regime and part is not. This will be true of manufacturing maquiladoras that are using change of customs regime or CTMs to document the customs transfers in sending products to customers in Mexico. It will also be true of service maquiladoras that engage in both transformation and other approved activities. It will also be true of maquiladoras whose maquiladora program has an industrial program component and a service program component that covers activities not constituting transformation.

Among other things, those companies will need to pay attention to the special rules under the 2007 Presidential Decree for determining what portion of their operations may be covered by the special rule for using the maquiladora's income tax base for calculating its IETU liability.

In summary it is important for all companies with maquiladora operations to consider the potential impact of the increase in IETU liability that they will suffer if the special IETU rules are not extended beyond 2011. Companies should also perform a detailed analysis of their current maquiladora operations, and maintain constant vigilance in the future, in order to identify, and if possible avoid, situations in which any of the recent amendments to the maquiladora decree could result in loss of the permanent establishment exemption for the foreign principal and an increase in Mexican tax liability for the maquiladora as a result of not being able to apply the tax benefits with respect to income tax or IETU.

There may be steps that a company can take to avoid being caught by the new restrictions in the future. For example, some companies may be able to minimize the potential detriment of the new 30% threshold for foreign ownership for machinery and equipment used by a maquiladora in the future by controlling the current ownership of machinery and equipment that they send to Mexico prior to implementing a consignment manufacturing arrangement.

Of course companies must also continue to pay close attention to the requirements of the applicable trade rules, including the recent changes in those rules, all of which are beyond the scope of this article.

---

[1] Mr. McLees is a Principal in the Chicago Tax Practice Group of Baker & McKenzie.

[2] Consignment manufacturing is the arrangement used widely in the maquiladora industry under which a foreign principal owns the inventory, and often most of the machinery and equipment used in a manufacturing operation conducted by the Mexican company, and pays the Mexican company a processing fee for its manufacturing services.

[3] Many profitable U.S. companies will also continue to want to use consignment manufacturing arrangements with a maquiladora in order to maximize their foreign source income for purposes of the U.S. foreign tax credit rules under the regulations issued under IRC Section **863(b**).

[4] On December 28, 2010, Mexico published rule I.13.7.1 of the Tax Miscellaneous Resolution for 2010, which provides details for calculating the portion of the machinery and equipment owned by the foreign principal in order to satisfy the new 30% threshold.

[5] Article 33 now provides that the following processes performed with goods are considered as transformation

- dilution in water and other substances;
- washing or cleaning, including the removal of oxide, grease, paint or other coatings;

- the application of conservatives, including lubricants, protective encapsulation or painting for conservation;
- adjustment; sanding, filing or cutting;
- preparation in doses:
- packing and repacking;
- testing, marking, labeling or classification;
- product development or quality improvement of products, except when related to brands, commercial notices and trade names.

SECTION OF TAXATION
State Bar of Texas

May 28, 2010

Douglas H. Shulman
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

William J. Wilkins
Chief Counsel
Internal Revenue Service
Room 3026 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Internal Revenue Service
CC:PA:LPD:PR (Announcement 2010-9)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on Proposal Regarding Uncertain Tax Positions (Announcements 2010-9, 2010-17 and 2010-30)

Dear Commissioner Shulman and Chief Counsel Wilkins:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed comments concerning the Internal Revenue Service (the "Service") proposal concerning reporting of uncertain tax positions.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL

RETURN TO TABLE OF CONTENTS

MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Service for the time and thought that has been put into preparing the proposal, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Tyree Collier
Chair, Section of Taxation
State Bar of Texas

cc: Deborah A. Butler
Associate Chief Counsel (Practice and Procedure)
Internal Revenue Service

Heather Maloy
Commissioner, Large and Mid-Size Business Division
Internal Revenue Service

Kathryn Zuba
Special Counsel
Office of Associate Chief Counsel (Practice and Procedure)
Internal Revenue Service

RETURN TO TABLE OF CONTENTS

COMMENTS ON PROPOSAL REGARDING UNCERTAIN TAX POSITIONS

These comments are presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments were Robert D. Probasco, Mark Horowitz and Bruce Bernstien. Additional contributors were Val J. Albright, David E. Colmenero, Joel N. Crouch, Brian Dethrow, Kenneth M. Horwitz and Ronald D. Kerridge. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Daniel G. Baucum is the Chair of COGS, and Emily Parker and Daniel J. Micciche reviewed the comments on behalf of COGS.

Although many of the people who participated in preparing, reviewing and approving these comments have clients who will be affected by the federal tax law principles addressed by these comments and frequently advise clients on the application of such principles, none of the participants (or the firms or organizations to which such participants belong) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the subject matter of these comments.

Contact Persons: Robert D. Probasco
Phone: (214) 969-1503
Email: robert.probasco@tklaw.com

Mark Horowitz
Phone: (713) 276-5467
Email: mhorowitz@gardere.com

Bruce Bernstien
Phone: (214) 706-0837
Email: bbernstien@plusassociates.com

Date: May 28, 2010

I. EXECUTIVE SUMMARY.

RETURN TO TABLE OF CONTENTS

The following comments are submitted in response to a request for comments made by the Service in Announcements 2010-9 and 2010-17, issued on January 26, 2010 and March 5, 2010, respectively, regarding a proposal to require certain taxpayers disclose uncertain tax positions. The Service requested comments by June 1, 2010. On April 19, 2010, the Service issued the draft schedule and instructions with Announcement 2010-30.

The following is a summary of our comments.

- Given the foreseeable pressures on Service personnel to use the reported information to propose adjustments, it will be critical to properly train Service personnel, align incentives, and monitor the program to avoid improper and excessive adjustments on audit. In addition, significant additional resources will be required to resolve the treatment of positions during audits, at Appeals and potentially in court.
- Given the potential for significant disruption resulting from implementation of the disclosure requirement, the Service should consider a long transition or pilot period during which Schedule UTP would be required only from a small group of taxpayers.
- The scope of tax positions subject to disclosure should be clarified, consistent with public pronouncements by Commissioner Shulman and LMSB Commissioner Maloy, in instructions for the schedule and any regulations to be issued.
- The Service should eliminate the requirement to report tax positions for which no reserve is recorded because of the Service's general administrative practices, and investigate alternative methods of gathering information about such tax positions.
- The Service should eliminate the requirement to provide a "concise general statement of the reasons for determining that the position is an uncertain tax position," as too likely to require the disclosure of opinion work product. The Service should also formalize a commitment that the government will not take the position that disclosures on Schedule UTP constitute a broad subject matter waiver of any privileges to which the taxpayer is entitled.
- The Service should modify its policy of restraint to renounce requests for tax accrual workpapers if the taxpayer filed Schedule UTP for the years at issue.
- The Service should establish clear guidelines regarding the substantial evidence, obtained only through methods other than reviewing the tax accrual workpapers, required to assert a penalty for failure to disclose an uncertain tax position.
- Given the inherent imprecision involved, taxpayers should not be subject to penalties merely from errors concerning the determination of the maximum tax adjustment.
- Penalties should not be draconian and should contain broad exceptions for good faith and reasonable cause. Penalties should only apply in instances of intentional disregard of the requirements.
- The Service should provide by regulation that a complete and accurate disclosure of a tax position on Schedule UTP constitutes adequate disclosure for purpose of various penalties and extensions of the statute of limitations.
- We concur that it is appropriate to rank transfer pricing and valuation issues separately instead of listing a maximum tax adjustment.
- We generally agree that the calculation of the maximum tax adjustment should relate solely to the tax period in which the position is taken and recommend that net operating

losses, excess credits and similar secondary computational adjustments should not be taken into account in determining the maximum tax adjustment.

- We recommend that the definition of a "tax position taken in a return" be modified to require reporting, for certain defined categories of tax positions that have effects in multiple years, only for the year in which the tax position arose.
- With respect to the related entity rules, it is appropriate for reserves of all relevant related entities to be included in Schedule UTP. With respect to the members of a consolidated group, generally only one disclosure schedule should be filed for the consolidated group, and all uncertain positions should be included. However, if both a parent company and a subsidiary prepare GAAP financials and the parent files a consolidated return that includes the subsidiary, we recommend that uncertain tax positions be reported on Schedule UTP for the consolidated return only if the parent company's financial statements include a reserve for the position.
- The monetary thresholds for taxpayers subject to the disclosure requirements should be permanently increased, to include fewer taxpayers.
- The Service should confirm that amendment of information concerning a previously reported uncertain tax position (for example, to revise the maximum tax adjustment) is not required.
- The Service should confirm that pass-through entities, not currently required to file Schedule UTP, will not be subject to penalties for failure to disclose if the Service later concludes the entity should have filed Form 1120 instead of Forms 1065 or 1120 S.
- If the Service later requires pass-through entities to file Schedule UTP, they should report only items that potentially affect their own tax liability, rather than the tax liabilities of their owners.
- The Service should clarify requirements for entities owning an interest in a pass-through entity to report pass-through items on Schedule UTP.
- Uncertain tax positions of disregarded entities should be included on the Schedule UTP filed by the owner of the disregarded entity.
- For tax-exempt entities, there should be no requirement to file Schedule UTP since uncertain tax positions are already disclosed on Schedule D-Part X of the Form 990.

II. BACKGROUND.

On January 26, 2010, the Service issued Announcement 2010-9 concerning a proposal to require certain taxpayers to file a new schedule with their tax returns, reporting any "uncertain tax positions." The Announcement provided general guidance concerning the intent of the new program and solicited comments, including responses to eight specific questions. On March 5, 2010, the Service issued Announcement 2010-17, extending the deadline for comments and requesting comments on three supplemental questions. Drafts of the new Schedule UTP and instructions were released with Announcement 2010-30 on April 19, 2010.

The proposal, as set forth in Announcement 2010-9 and clarified in the new schedule and instructions, would require business taxpayers with more than $10 million in total assets to report a concise description of each uncertain tax position in sufficient detail so that the Service can determine the nature of the issue, along with a concise general statement of the reasons for determining that the position is an uncertain position and the maximum amount of potential federal tax liability attributable to the uncertain tax position.

Uncertain tax positions are described as positions for which a tax reserve must be established under generally accepted accounting principles ("GAAP"). For purposes of the proposed disclosure, GAAP includes Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 ("FIN 48")[1] or other accounting standards, such as International Financial Reporting Standards ("IFRS") or a foreign country's GAAP subject to which the taxpayer issues financial statements. Uncertain tax positions also include other positions for which the taxpayer or a related entity has not recorded a tax reserve because (i) the taxpayer expects to litigate the position and prevail, or (ii) the taxpayer has determined that the Service has a general administrative practice not to challenge the position.

III. COMMENTS.

We commend the Service for the time and thought that has been put into preparing the proposal. We also appreciate the opportunity to comment on the proposal and hope that our comments prove to be helpful.

A. GENERAL COMMENTS

In addition to our responses to the specific questions posed by the Announcements, we offer the following general comments and observations.

<u>Practical Effect</u>

Tax positions are uncertain for a number of reasons. As Commissioner Shulman recognized in recent comments to the Tax Executives Institute Midyear Conference, these reasons may include ambiguity in the law and a lack of public guidance on issues. An uncertain tax position may, and often will, simply reflect the taxpayer's honest effort to apply the tax law correctly rather than an aggressive interpretation of the law in the face of contrary guidance or case law. Often, the correct resolution of an uncertain tax position will be no adjustment of the taxpayer's return position. It is clear from public pronouncements that Service management understands this and does not intend that Exam automatically propose adjustments for all disclosed uncertain tax positions. However, we have serious concerns about the practical effects of the proposed disclosure requirement.

Under FIN 48, the taxpayer generally must establish a reserve in its financial statements for part or all of the tax benefit from a return position unless it is more likely than not that the Service would *fully concede* the issue prior to litigation.[2] Based on our experience, although Appeals normally will not demand concessions based on "nuisance" value, it is unlikely that the Service will fully concede the issue unless it assesses the probability that the taxpayer would prevail in litigation as at least 80%. This is consistent with our understanding of the "strong should" degree of confidence at which accounting firms typically do not require a reserve for financial reporting purposes.

---

[1] The relevant portions of FIN 48 are now contained in FASB Accounting Standards Codification (ASC) subtopic 740-10, Income Taxes. FASB ASC 740-10.

[2] The Announcement also requires reporting for certain exceptions by which the taxpayer can avoid the need to record a reserve.

Service personnel will know, simply from the fact that a position was listed on Schedule UTP, that the taxpayer determined it probably would have to concede at least a partial adjustment if the Service challenges the position. These will appear to be easy sources of additional tax collections, based on the taxpayers' own assessments. Also, Congress, the Executive Branch, the media, and the general public may not have the same understanding as the Service that an uncertain tax position is often completely proper, and could react negatively if uncertain tax positions are not always disallowed. As a result, the Service will need to provide extensive training and align incentives to ensure that Service personnel use the information as intended and withstand the foreseeable pressure to automatically propose adjustments for virtually all reported positions.

It will also be necessary to quickly and efficiently identify and resolve common issues. Exam will have enough published guidance and other authority to resolve many of the uncertain tax positions but other positions may be uncertain because of the lack of such authority. A thoughtful review and evaluation of the latter will require extensive coordination at National Office. As with other issues identified by Exam, such coordination will help avoid wasteful duplication of effort and promote consistency. Depending on the volume of disclosures, however, the amount of time and effort required may well increase significantly.

In summary, we believe that for this disclosure process to be effective and meet the Commissioner's stated goals of certainty, consistency and efficiency, the following components of the implementation will be critical:

- Establish and conduct comprehensive training for Exam and Appeals personnel concerning the proper handling of uncertain tax positions during an audit or appeal.
- Properly align incentives.
- Carefully monitor performance to ensure training and incentives are working as intended.
- Allocate additional resources within National Office to provide timely guidance as necessary for the proper and consistent resolution of uncertain tax positions.
- Anticipate that additional resources will be needed by Appeals to properly handle a larger number of audit adjustments relating to disclosed uncertain tax positions.

Given the potential difficulties and disruption from implementation of this new requirement, we also recommend that the Service give serious consideration to delaying implementation until it can conduct a pilot program to test how the process translates from theory to practice. We believe that the Compliance Assurance Program (CAP), while similar in some respects, probably was not an adequate basis to evaluate the Service's readiness to handle the flood of new information.

<u>Scope of Tax Positions Subject to Disclosure</u>

We believe it is important to clarify the scope of tax positions subject to disclosure, particularly with respect to questions of materiality and level of aggregation. The Service has addressed these to some extent in public announcements. For example, Chief Counsel Wilkins, in a presentation to the District of Columbia Bar Tax Section, stated that the Service intended that "the schedule key[] off what the company's accounting practice is," that is, that the proposed disclosures generally would be consistent with and based on the work done for the financial reserves. He noted further that the Service would not impose any penalty for failure to report a position that the company did not reserve (other than the positions for which the taxpayer does not record a reserve because of intent to litigate or the Service's general administrative practices). Similarly, in his speech to the New York State Bar Association, Commissioner Shulman expressed his opinion that the new requirement would not impose a significant compliance burden because "[t]he work is already being done."

The draft instructions clarify that, other than with respect to the exceptions for intent to litigate and general administrative practices, only items for which a reserve is recorded need be reported and that the unit of account for the new schedule should be the same as for financial reporting. We believe that, on balance, this is an appropriate standard, although there are some associated disadvantages. For example, there may be some reduction in consistency, as identical and comparably sized transactions might be reported by a smaller taxpayer but omitted by a larger taxpayer simply as a result of the materiality limitation, and different taxpayers may aggregate differently. There are also, however, several advantages to this standard. It provides clarity, minimizes the increase to the taxpayer's compliance burden, reduces the number of positions disclosed to a more manageable number for the Service's review, and alleviates the potential unfairness of a penalty imposed because of differences of opinion concerning materiality or how to aggregate items.

The proposal in Announcement 2010-9 would require reporting of tax positions for which a company does not record a tax reserve because of intent to litigate or the Service's general administrative practices. The FIN 48 standards for level of aggregation ("unit of account") and materiality do not come into play explicitly for such positions, and in fact, taxpayers may not go through a FIN 48 analysis for such positions.

The draft instructions state that the category for administrative practice includes "a tax position for which a reserve would have been recorded in the audited financial statement but for a determination that, based upon past administrative practices and precedents of the IRS in dealing with the tax position of the taxpayer or similar taxpayers, the IRS has a practice of not challenging the tax position during an examination." We believe that the "but for" standard is appropriate and incorporates the same materiality and unit of account standards as uncertain tax positions for which a reserve is recorded. We recommend that this definition and standard be incorporated in regulations.

The draft instructions state that the category for intent to litigate includes "a tax position for which a reserve was not recorded in the audited financial statement after the taxpayer or a related party determines that, if the IRS had full knowledge of the tax position it is unlikely a settlement could be reached. For this purpose, a settlement is unlikely if the probability of settlement is less than 50%." We believe that this standard is broader than appropriate, as it could be interpreted to include tax positions for which no reserve would be necessary even absent the intent to litigate. We recommend that this definition and standard, for the instructions and regulations, follow a similar "but for" standard as used for the administrative practice category. For example, it might be defined as "a tax position for which a reserve would have been recorded in the audited financial statement but for the taxpayer's determination that it will litigate, and prevail, rather than settle the issue with the IRS."

We believe the above are appropriate standards and recommend they be incorporated in regulations as well as the instructions for Schedule UTP.

Finally, as discussed further below, we believe the Service should not require reporting on Schedule UTP for those tax positions for which the taxpayer does not record a tax reserve solely because of the Service's general administrative practices. Instead, the Service should consider alternative methods to identify and evaluate such positions.

Privilege and Waiver

We recognize and appreciate what appears to be intended to be a *de facto* compromise in requesting sensitive information from taxpayers. However, we believe some modifications of the proposal would increase taxpayer comfort with the disclosure without significantly impeding the Service's purposes in requesting the information.

We do not share the Service's apparent conclusion that the information sought is not protected by various privileges. In particular, we believe that the proposed disclosures will undoubtedly compromise the work-product privilege in many circumstances.

The Supreme Court first articulated the work-product doctrine in *Hickman v. Taylor*,[3] and the Advisory Committee incorporated it into the Federal Rules of Civil Procedure in 1970.[4] It generally protects from discovery "documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative."[5] Although that protection may be overcome on a showing of substantial need, courts are directed to "protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative."[6] In *Upjohn Company v. United States*,[7] the Supreme Court recognized that the protection is much stronger with respect to such opinion work-product[8] and some courts have held that the protection is nearly absolute.[9]

Schedule UTP primarily focuses on factual information about tax positions, rather than opinion work product often contained in tax accrual workpapers, such as the analysis of possible arguments and an overall assessment of the relative strength of the position and the hazards of litigation. However, there are aspects of the information required to be disclosed that clearly constitute opinion work product.

First, the inclusion of a tax position on Schedule UTP does not disclose the taxpayer's *exact* risk assessment, but it does demonstrate that the taxpayer assesses the risk as high enough that the Service probably would not fully concede the issue. This is a limited disclosure but it is

---

3 329 U.S. 495 (1947).

4 This provision governs discovery proceedings in federal court, but the work-product doctrine is not limited to that context. Courts have also analyzed it in IRS summons enforcement actions.

5 Fed. R. Civ. P. 2b(b)(3)(A).

6 Fed. R. Civ. P. 26(b)(3)(B).

7 449 U.S. 383 (1981).

8 *Id.* at 401-2. "[W]e think a far stronger showing of necessity and unavailability by other means . . . would be necessary to compel disclosure" of such opinion work-product.

9 *See In re Grand Jury Subpoena*, 220 F.R.D. 130, 145 (D. Mass. 2004) and cases cited therein.

RETURN TO TABLE OF CONTENTS

still opinion work product. Second, and more important, the proposal requests "a concise general statement of the reasons for determining that the position is an uncertain position." Similarly, the draft instructions include, as part of the concise description in Part III of the schedule, "the reasons for determining the position is uncertain." It is difficult to interpret this as asking for anything other than the taxpayer's assessment of the relative weaknesses of that position, since that assessment drives the decision to record a reserve for an uncertain tax position. All three examples given in the draft instructions are consistent with this interpretation. Therefore, the schedule and instructions appear to request the taxpayer's "conclusions, opinions, or legal theories," that is, opinion work product.

Taxpayers have legitimate concerns about the disclosure of information that is protected by work-product or other privileges, as well as the possibility that the Service could later argue that the disclosures constitute broad subject matter waivers of any privilege. The possibility of waiver is particularly troublesome as the waiver, if it is such, is effectively required. This could essentially eliminate the privilege altogether for any such uncertain tax positions. In the context of requests for tax accrual workpapers, taxpayer concerns over privilege and waiver often lead to costly and time-consuming litigation to resolve the dispute. Although the proposed disclosures are less intrusive than a request for tax accrual workpapers, they are also being directed at a much larger population of taxpayers. As the proposal is structured, there is a significant possibility of dramatic increases in the resources needed to litigate privilege disputes.

A substantial increase in such litigation over privileges or waiver is not in the interest of either the Service or taxpayers. Both taxpayers and the Service would expend significant time and expense and, even if the Service ultimately prevailed, the actual disclosures by those taxpayers who choose to litigate could be significantly delayed. Consequently, we recommend the following modifications to the proposal. We believe that these constitute a reasonable compromise and would alleviate most taxpayers' concerns to the point that litigation likely would be unnecessary.

First, we recommend that, in appropriate regulations, the Service confirm that the government will not take the position that Schedule UTP disclosures constitute a broad subject matter waiver of any privileges to which the taxpayer is entitled and that the disclosure requirements do not alter the otherwise applicable law relating to such privileges. We assume this is the Service's intent but believe the commitment should be formalized.

Second, we recommend that the Service modify its policy of restraint to declare that it will not request tax accrual workpapers from any taxpayer who has disclosed its uncertain tax positions on Schedule UTP. In various public statements, Service personnel have stated that the Service would not, as a result of the new program, request additional tax accrual workpapers otherwise restricted by its policy of restraint. We agree that the policy of restraint should not be loosened as a result of the new program but believe the Service should go further and explicitly modify the policy of restraint to rule out such workpaper requests if the taxpayer has filed Schedule UTP.[10] Although the Service may need additional facts about some of the uncertain tax positions, those can easily be obtained through normal channels in the course of the audit

[10] This approach relies on the taxpayer reporting all uncertain tax positions on Schedule UTP. We believe that omissions should be rare and that the Service need not review tax accrual workpapers to confirm that all uncertain tax positions have been reported. See discussion below concerning potential penalties.

once the position has been identified. The only other information in the tax accrual workpapers would be the taxpayer's analysis and risk assessment. Under ordinary circumstances, we see no legitimate purpose for the Service to have that information.

Third, we recommend that the Service eliminate from the information to be disclosed the "concise general statement of the reasons for determining that the position is an uncertain tax position" or "reasons for determining the position is uncertain." If the reasons why the return position is uncertain are factual in nature and unknown to the Service, such a request may be appropriate, but the information likely can be obtained as easily through normal channels during the audit rather than on the proposed schedule. If the reasons are legal in nature, they likely fall within the realm of opinion work product. In addition, our experience is that the Service has no difficulty, once it has the relevant facts, identifying the arguments that could be used to challenge a tax position. Even in an audit, the Service does not normally ask the taxpayer to provide a statement of why the tax position is uncertain or incorrect. Schedule UTP requests an explanation of the reasons for the taxpayer's return position, and that information should be sufficient. Accordingly, we believe a statement of why the taxpayer's position is uncertain is of minimal value to the Service, while requesting such information raises significant privilege concerns for the taxpayer. Therefore, the Service should not request a "statement of the reasons for determining that the position is an uncertain tax position" or the "reasons for determining the position is uncertain."

Transfer Pricing

As recognized in the instructions to Schedule UTP, transfer pricing issues are unique in terms of the maximum tax adjustment. We agree that it is appropriate to rank transfer pricing and valuation issues separately instead of listing a maximum tax adjustment.

We recommend that the Service consider specifying in the instructions that taxpayers should note in the "Concise Description" or elsewhere whether the issue is being considered or has been considered by the Advance Pricing Program or the United States Competent Authority. This would help avoid situations where Exam may review transfer pricing issues that are more properly addressed by other Service functions, and/or would not ultimately benefit the United States tax base.

In this regard, we recommend that the Service issue internal guidance regarding the use of Schedule UTP in these situations, in order to properly focus Exam's attention upon productive issues.

Penalties

Announcement 2010-9 states that the Service is evaluating additional options for penalties or sanctions when a taxpayer fails to make adequate disclosure of its uncertain tax positions, including legislation imposing penalties specific to the new disclosure regime and associated form. We believe that the existing penalty regimes, if extended to the new disclosure requirements, are sufficient.

For example, the accuracy-related penalty of Section 6662 et seq. and other applicable penalties are sufficient to incentivize taxpayers to comply with their tax obligations. In this regard, we note that the disclosure of uncertain tax positions is not primarily intended to increase tax compliance (although that may be a significant benefit), but to reduce the fact-finding and analytical burden on the Service's Examination function and to prioritize and speed up the examination of uncertain tax issues.

However, the Service appears to be primarily concerned that there is no incentive for taxpayers to fully comply with or even file the new uncertain tax position disclosure schedule. We agree that existing penalties likely would not apply to the omission of specific tax positions from, or errors concerning the amount of a maximum tax adjustment reported on, Schedule UTP.[12] Therefore, the Service may consider a new penalty regime necessary to ensure disclosure of uncertain tax positions. We are generally concerned, however, about the proliferation and duplication of penalties under the Code.

Whether under an existing penalty provision or a new penalty regime, we recommend that the Service establish clear guidelines concerning the investigation and assertion of potential penalties for tax positions not reported on Schedule UTP. We recommend that the Service confirm that any penalty for failure to report a specific tax position on Schedule UTP will apply only if: (a) the financial statement reserves include the position; or (b) in the case of a position for which no reserve was established because of the taxpayer's intent to litigate if necessary, the position was considered during the reserve analysis and expressly excluded because of the intent of litigate. Applying penalties for a position not included in the reserves and not even considered during the reserve analysis would introduce complicated questions of whether the tax position met the requirements for disclosure on Schedule UTP.

As discussed below, we recommend the elimination of the category of tax positions for which no reserve is reported because of the Service's general administrative practice not to challenge the position on examination. If that category is not eliminated, it should be treated for penalty purposes similarly to the category of intent to litigate. That is, a penalty should apply only if the tax position was considered during the reserve analysis and expressly excluded because of the general administrative practice.

Because the obligation to report a tax position on Schedule UTP derives from its inclusion in the financial statement reserves, penalties for failure to report a tax position on Schedule UTP also raise significant concerns over taxpayer privileges and the Service's policy of restraint with respect to tax accrual workpapers. We recommend that the Service carefully consider these concerns in designing its guidelines for the investigation and assertion of such penalties. For example, the Service should develop methods of identifying whether a tax position was improperly omitted from Schedule UTP that do not involve reviewing the tax

---

11 Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (Title 26, United States Code).

12 *See* Section 6651. While the Service has argued that taxpayers who completely omit certain schedules and statements should be subject to failure-to-file penalties (see Gen. Counsel Memo. 38057), case law supports the conclusion that an honest omission of an individual item from Schedule UTP, or a mistake in calculating the maximum tax adjustment, would not subject a taxpayer to failure-to-file penalties. *See, e.g., Beard v. Comm'r*, 82 T.C. 766, 777-78 (1984), aff'd 793 F.2d 139 (6th Cir. 1986); *Schroeder v. Comm'r*, 291 F.2d 649, 654 (8th Cir. 1961).

RETURN TO TABLE OF CONTENTS

accrual workpapers.[13] We also recommend that the Service modify the policy of restraint to specifically renounce requests for tax accrual workpapers to determine whether to apply a penalty for failure to disclose a tax position on Schedule UTP.

In addition, the Service should establish clear standards regarding: (a) the substantial evidence required to assert a penalty for failure to disclose; and (b) acceptable methods for taxpayers to defend against such penalties without being required to produce tax accrual workpapers. Clearly, a significant tax adjustment related to a tax position not reported on Schedule UTP, by itself, is not sufficient basis to assert the penalty. Just as uncertain tax positions will often be correct, a disallowed tax position is not necessarily "uncertain" within the definitions in the draft instructions.

We further recommend that, given the inherent imprecision involved, taxpayers should not be subject to penalties merely from an error concerning the determination of the maximum tax adjustment, except perhaps in cases of fraudulent intent, intentional misrepresentation, or similar cases.

In the event that a separate penalty regime is established, we recommend that material penalties should only be imposed in the case of intentional disregard. Limiting any new penalty regime to intentional disregard would benefit both the Service and taxpayers. For taxpayers, imposition of a reasonable penalty regime would prevent inequitable imposition of penalties, in recognition of the difficulty and uncertainty associated with evaluating whether and to what extent, tax positions are uncertain. For the Service, imposition of a reasonable penalty regime would greatly enhance the efficacy of the new reporting requirement. A more draconian penalty regime would encourage taxpayers to protectively list more tax positions and inflate the maximum tax adjustments, preventing the Service from easily evaluating the most important uncertain tax positions.

To the extent that the penalty regime is not confined to intentional disregard of the requirements for Schedule UTP, we recommend that the penalty regime contain broad good faith or reasonable cause exceptions, for the same policy reasons outlined above.

Finally, we recommend that any penalty, for all cases other than intentional disregard or other similar situations, be either an enhancement of accuracy-related or other penalties with respect to an adjustment or a small flat fee penalty. Large penalties such as those imposed under Sections 6707 or 6707A, applicable only in circumstances that the Service considers potentially abusive, are inappropriate for a disclosure requirement applied routinely and broadly to so many taxpayers, except in the most egregious circumstances. Further, the history of strict liability penalties shows that exceptions for reasonable cause and good faith should apply.

To the extent that the penalty is percentage-based or is an "enhancement" to or related to an accuracy-related or other penalty with respect to an adjustment, such penalty should be

[13] We anticipate that omissions will be rare if the tax positions subject to disclosure are properly defined as discussed above. In extreme situations, where there are strong indications that tax positions were included in the reserves but omitted from Schedule UTP, it might be appropriate for the tax return preparer to provide the financial auditor with a copy of Schedule UTP and request confirmation that all items included in the financial statement reserves were reported. Requesting such confirmation, however, should be reserved for extreme situations rather than become part of Exam's standard operating procedure.

applied solely to the issue that was not disclosed on Schedule UTP. While this should be an obvious requirement for any new penalty regime with respect to the schedule, it is critical to ensure that non-disclosure does not result in the imposition of disproportionate penalties.

B. QUESTIONS FROM ANNOUNCEMENT 2010-9

1. How the maximum tax adjustment should be reflected on the schedule so that it provides the Service with an objective and quantifiable measure of each reported tax position (e.g., specific dollar amount or by appropriate dollar ranges).

As the Service understands, the maximum tax adjustment will not always be determinable with any real precision. The approach set forth in the draft instructions contemplates calculating the maximum tax liability as: (1) the total amount of credits claimed for the position; plus (2) the net amount of items of income, gain, loss, or deductions, multiplied by a tax rate of 35%. For valuation issues or transfer pricing issues, the maximum tax adjustment is not calculated but instead the positions within each category are ranked relative to each other, based on either the potential exposure or the amount reserved. While this approach may require some modification when the disclosure requirement is extended to pass-through entities, it appears a reasonable compromise for now. If ranking by the amount reserved were mandatory, however, this would force taxpayers to disclose, in part, their risk assessment. Therefore, it is important that ranking by the amount reserved is at the option of the taxpayer.

Based on the draft instructions, the Service appears to have rejected, at least for now, the idea of using dollar or percentage ranges rather than specific dollar amounts. As a general matter, we concur and believe that, at least initially, appropriate dollar ranges would not be a useful way to measure the magnitude of reported tax positions. If the range is used to adjust for risk assessment without disclosing the exact assessment, we believe it would be an improper, even though limited, invasion of the taxpayer's thought processes and opinion work product. It would be better not to introduce risk assessment at all. If the range is used in recognition of the inherent imprecision in measurement, it provides little if any benefit to the Service. If penalties are not imposed for erroneous but good-faith calculations of the maximum tax adjustment, as recommended above, reporting by ranges also provides little if any benefit to taxpayers. Finally, we believe that the Service's definition of appropriate ranges at this time may be premature. After it gains more experience with actual filings on Schedule UTP, the Service may be better able to define ranges that would be appropriate and useful for its evaluation.

2. What alternative methods of disclosure of the amount at issue would allow the Service to identify the relative importance of the uncertain tax positions.

The draft instructions have addressed our concerns in this area, and we have nothing further to suggest.

3. Whether the calculation of the maximum tax adjustment should relate solely to the tax period for which the return is filed or to all tax periods for which the position relates, and whether net operating losses or excess credits should be taken into account in determining the maximum tax adjustment.

We concur that the calculation of the maximum tax adjustment should relate solely to the tax period for which the return is filed, and not to all relevant tax periods. As the schedule is filed with a specific tax return and reviewed in connection with an audit of that year, it seems appropriate that the schedule primarily address issues and potential adjustments related to such year.

While we understand that the Service is concerned that the new schedule achieve its stated purpose – (prioritizing issues and increasing examination efficiency) – ending the calculation of a maximum tax adjustment to the effect in multiple years will significantly increase the administrative burden on taxpayers while resulting in little to no increase in the utility of the schedule for prioritizing issues. Specifically, it is often significantly more difficult to calculate the impact of a particular adjustment on a multiple year basis, thus increasing the compliance burden upon taxpayers.

For the Service, an accurate comparison of the uncertain tax positions on an annual basis would appear to better achieve the objective of the schedule to prioritize examination issues. Calculating the maximum tax adjustment on a multiple year basis would result in smaller multiple year issues being prioritized over larger single year issues. While this could be beneficial with respect to some issues, it could lead to focusing on issues that are (i) beyond the scope of the current examination and/or (ii) more routine and non-controversial issues (such as timing differences) over more uncertain issues. In addition, a brief analysis by Exam of the type of issue should allow the Service to gauge the effect upon multiple tax years.

We do, however, recommend some clarification or modification of the tax periods for which a tax position should be reported, based on the definition of a "tax position taken in a tax return." It is important to note the distinction between multiple-year adjustments or issues, which are properly reported in multiple years because the adjustment in each year is determined primarily by facts applicable to that year, and single-year adjustments or issues that have effects in multiple years. For example, certain credits, net operating losses (NOLs), depreciation, and various other standard tax items are determined primarily with respect to a single year, with purely computational effects on the taxation of other years. We recommend that tax positions be reported on Schedule UTP for the tax period in which they arose, and a maximum tax adjustment be calculated solely with respect to such year. The draft instructions define a "tax position taken in a tax return" as a position "that would result in an adjustment to a line item on that tax return." In the case of single-year adjustments or issues that have effects in multiple years, we believe that would inappropriately require reporting such tax positions in multiple years. There are two specific categories of such adjustments or issues that we believe warrant reporting only in a single year.

First, we see no value to the Service of reporting in multiple years certain tax positions that, if not sustained, would result in adjustments that completely offset over time (temporary differences). For example, a position with respect to the classic deduction versus capitalization issue could affect multiple years, but we recommend that the maximum tax adjustment be calculated only for the return year in which the position first arises. In the case of disallowance of immediate deduction in favor of capitalization, the maximum tax adjustment would be calculated solely for the year in which the deduction is denied. It would take into account the loss of the deduction and any applicable depreciation or amortization relative to the capitalization of the expense for that year only. If the tax position were not sustained, there would be adjustments in other years, but a maximum tax adjustment in those other years would be *negative*, reflecting that the tax liability would decrease rather than increase. Reporting the issue in the year in which it arose, combined with an indication on Schedule UTP that the tax position

RETURN TO TABLE OF CONTENTS

concerns a temporary difference, should be enough information for the Service to determine whether to examine the position.

Second, in most circumstances a secondary effect that merely shifts the increased tax liability from one year to another, because losses or credits are carried back or forward, should not be taken into account in calculating the maximum tax adjustment, because it will multiply the taxpayer's reporting requirements without providing significant benefit to the Service. For example, consider a situation with a $100 NOL carryforward that cannot be used in 2011 because 2011 has insufficient taxable income. The NOL therefore is carried forward and used in 2012. If $500 of deductions taken in 2011 are later disallowed, increasing taxable income, the NOL may now be used in 2011 and therefore is not available in 2012. The cumulative effect of the disallowance may approximate 35% of the $500 disallowed deductions. Although the disallowance of the deduction will shift an NOL or credit from 2011 to 2012, taking that shift into account when calculating the maximum tax adjustment merely changes the year in which the cumulative effect is realized and requires the taxpayer to report the uncertain tax position in *both* years. In addition, the exact determination of such secondary effects may depend on the interplay of multiple items and cannot easily be determined with respect to one particular uncertain tax position. We believe that ignoring that shift in the computation would minimize the taxpayer's compliance burden, by simplifying the calculation and requiring that the position be reported only once, in 2011. It also would focus the Service on the year in which it is most appropriate to examine the position – 2011, rather than 2012. This seems adequate for the Service's purposes in requesting the information.[14]

We believe that reporting these two types of tax positions in multiple years would be inappropriate, as taxpayers' compliance burden would far outweigh any minimal benefit to the Service. However, reporting in multiple years would appear to be required by the definition in the draft instructions of "tax position taken in a tax return" as a position that would result in an adjustment to a line item on the return if the position is disallowed. We recommend that this definition be modified to limit the reporting of such positions to the year in which they arise.

4. <u>How the related entity rules should be applied.</u>

We agree that related party rules are necessary, as the entity filing a United States tax return is not necessarily the entity that prepares financial statements and associated reserves. For entities filing a consolidated United States tax return, we recommend that – with the exception noted below – tax positions related to reserves in the financial statements of all related entities be included in the schedule attached to such return. For entities that file a United States tax return, but whose financial statements are prepared, in whole or in part, by a foreign parent, we recommend that the reserves related to the financial statements of the related entity that files a United States return be included in the schedule. For entities that do not file a United States return and whose financial statements are included in the financial statements of a related party, we recommend that the related party prepare the schedule.

---

[14] A modification to this approach might be necessary if it is clear that the loss or credit carryforwards would otherwise expire. In the example above, if the NOL carryforward instead had expired because it was not used in 2011, the taxpayer's actual maximum tax exposure with respect to the $500 deduction in 2011 is 35% of $400 rather than 35% of $500. The calculation of the maximum tax adjustment for 2011 in that case should include the effect on the NOL carryforward, as the NOL is not simply shifted between years as a result of the disallowed deduction.

In the case where both a parent company and subsidiaries prepare GAAP financials and the parent files a consolidated return that includes the subsidiaries, we recommend that uncertain tax positions be reported on Schedule UTP for the consolidated return only if the parent company financial statements include a reserve for the position. The examination and review of financial statements for all of the subsidiaries will not substantially increase the disclosed items, and to the extent additional items are listed, they are likely immaterial to the consolidated return. Therefore, this recommendation does not impact the Service's objectives with respect to the uncertain tax positions schedule. However, requiring parent companies to review subsidiary financials in detail will impose an undue compliance burden upon them. Essentially, the substantial costs outweigh the immaterial benefits.

5. <u>Whether the scope of the Announcement should be modified regarding the uncertain tax positions for which information is required to be reported (e.g., positions for which no tax reserve has been established because the taxpayer determined the Service has a general administrative practice not to examine the position).</u>

We are concerned about the requirement to report positions for which no tax reserve is recorded because of the Service's general administrative practices. FIN 48 allows taxpayers to take such practices into account in determining whether to record a tax reserves:

> When the past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities are widely understood, for example, by preparers, tax practitioners, and auditors, those practices and precedents shall be taken into account.[15]

As an example of such administrative practices, FIN 48 mentions a capitalization threshold for routine property and equipment purchases. Even though such a capitalization policy may be a technical violation of tax law, which does not prescribe capitalization thresholds, it may be widely understood that the Service would allow this position even if examined.[16]

As defined, these positions would not warrant disclosure because of the very high probability that no adjustment would be made. We understand that the Service may be uncomfortable relying on the definition in FIN 48 without knowing more about what types of tax positions might fall within this category. However, FIN 48 is applied based on a presumption that the tax position will be examined by the Service with full knowledge of all relevant information, the exception is limited to general administrative practices that are "widely understood," and the taxpayer's application of FIN 48 is subject to review by independent auditors. We therefore believe that there are few abuses of this provision and that requiring their disclosure would increase the compliance burden to taxpayers – who may normally conduct an abbreviated and informal FIN 48 analysis, if any, for such positions – without materially improving the Service's ability to enforce the tax law.

---

[15] FIN 48 ¶ 7(b), as modified in FASB ASC 740-10-25-7(b). Although the discussion of general administrative practices is included with the discussion of the recognition step of the FIN 48 process, it would also apply to the measurement step and thus the taxpayer could avoid recording a tax position based on such general administrative practices.

[16] FIN 48 ¶ A12-A13; FASB ASC 740-10-55-90 to -92, Example 2.

RETURN TO TABLE OF CONTENTS

We recommend that, instead of requiring disclosure of these positions, the Service investigate alternative methods of determining whether such positions warrant review and investigation during examinations. For example, the Service could request such information, informally as a pilot project, from a small number of taxpayers such as those involved in the Compliance Assurance Program (CAP). The Service could use data it obtains from such a pilot project to evaluate whether the benefits of requiring disclosure of such positions would warrant the additional compliance burden on taxpayers and time and effort for the Service to review.

6. <u>Whether transition rules should be used or criteria modified to either include or exclude certain business taxpayers (e.g., the proposed threshold of $10 million total assets).</u>

While it is clear that the Service has put significant thought into this initiative, the significant policy, administrative, practical, attorney-client privilege, work product, and other concerns with respect to Schedule UTP favor a long transition or pilot period, where such concerns can be monitored and addressed if necessary.

We believe that there should be a transition period of a year or longer, in which only certain taxpayers should be subject to reporting. This group could include CAP taxpayers or another small group of taxpayers where Service examination personnel have significant knowledge of the taxpayer. Alternatively, a transition period in which the schedule is prepared by only those taxpayers with assets of greater than $50 million or revenues greater than $500 million is appropriate.

In addition, we recommend that the Service consider permanently increasing the thresholds for taxpayers subject to reporting. The administrative convenience to the Service likely does not outweigh the significant compliance burden on taxpayers below a certain threshold.

Finally, we recommend that the Service require Schedule UTP only from those taxpayers who are required to routinely file GAAP financial statements with the Securities and Exchange Commission or another governmental agency. This would exempt those taxpayers who do not regularly prepare GAAP financial statements but may need to do so occasionally for a limited purpose, such as obtaining a loan. Taxpayers who are not required to file GAAP financial statements every year are less likely to have developed systems or procedures that would facilitate preparation of Schedule UTP. The reporting requirements would likely impose a significant compliance burden on the taxpayers while providing minimal, if any, benefits to the Service.

7. <u>How the new schedule should address taxpayers that initially did not record a reserve for an issue, but in later years do record a reserve.</u>

As new facts and law are frequently involved when a reserve is set up with respect to an issue where there was no prior reserve, we believe that the schedule need not address such situations directly. That is, the schedule and the instructions should address each year in context. Generally, if a reserve is in place, then disclosure is warranted, but if not, then no disclosure is warranted. The contents of the schedule must necessarily rely upon the judgment and determinations of the taxpayer and its auditors, and therefore such discrepancies will arise from year to year. Most reserves, however, are and will be identified in time for reporting currently.

RETURN TO TABLE OF CONTENTS

We do not believe that adding complexity by including tax positions taken in past returns on the current year's schedule is necessary given the relatively small number of such positions. While we do not believe that the added complexity is justified, if the Service requires taxpayer to identify positions not previously reported, the schedule should designate that the item existed, but was not disclosed, in a prior year.

In summary, we believe that the current Part II of Schedule UTP and related instructions thereto take the correct approach and generally should not be modified. However, we recommend some clarifications.

We recommend that the Service confirm that there is no duty to amend, either in Part I or Part II, information about a previously reported tax position, for example, to change the amount of the maximum tax adjustment. Once a tax position is reported, whether in Part I or Part II, the Service is on notice about the item. Taxpayers should not be required to revise or amend information provided in good faith. If inaccurate or incomplete information is reported intentionally or in bad faith, a penalty regime can address such problems, as discussed elsewhere herein.

We also recommend that the Service explicitly limit the prior tax years which have to be reported on Part II of Schedule UTP to years for which statutes of limitation for adjustments are open, and in no event more than the six prior years. While a limitation to open years is implicit in the scope of the schedule (as it relates to financial statement reserves), we believe that such a clarification is appropriate. We believe an overall limit of the six prior years, even if the statutes of limitation are still open, is also appropriate. An uncertain tax position will be reported no later than the first tax return filed at least 60 days after the decision to establish a reserve. Very rarely, if ever, will a taxpayer first identify and decide to establish a reserve for an uncertain tax position more than six years after filing the tax return on which it took the tax position.

8. Whether the list of information proposed to be included should be modified, including whether certain information should be requested in some circumstances upon examination rather than with tax return.

The inclusion of the maximum tax adjustment and a detailed description of the tax issue should be modified.

Calculating maximum tax adjustments with respect to every uncertain tax position is both imprecise and imposes a significant compliance burden. We believe that a ranking or grouping of issues may be equally useful to examination team, while reducing the compliance burden on taxpayers. In addition, as calculations of maximum tax adjustments are often inaccurate and/or misleading (as they do not take into account correlative issues), eliminating this requirement would not significantly reduce the efficacy of the schedule.

While the schedule notes that taxpayers are responsible for a "concise description" of uncertain tax positions, the examples in the instructions indicate that the description is intended to summarize the entire issue. Taxpayers are therefore left with the choice between briefly summarizing an issue, but not providing context, or providing so much information that the schedule becomes a significant compliance burden.

RETURN TO TABLE OF CONTENTS

We recommend that the description of the item be limited to one line and be in the nature of a title or heading. A brief description plus the code sections relevant to the position should be sufficient to identify the issues and prioritize examination resources. Further factual development can take place during the actual examination. It is likely that examining agents would need to perform additional development as to a position regardless of the length of the "concise description." Reducing the length of the description, therefore, would not significantly increase the Service's burden but would significantly decrease the compliance burden on numerous taxpayers.

C. SUPPLEMENTAL QUESTIONS FROM ANNOUNCEMENT 2010-17

1. <u>Do the disclosures required by the new schedule duplicate those required by other forms, thus making forms, such as the Form 8275 and 8275-R, unnecessary or redundant in some circumstances.</u>

Although the information to be requested on the new schedule does not exactly duplicate that required on other forms, there is significant overlap. The most significant overlap is probably with Forms 8275, Disclosure Statement, and 8275-R, Regulation Disclosure Statement. Taxpayers use these forms to avoid penalties by satisfying "adequate disclosure" requirements. The draft instructions state that a complete and accurate disclosure on Schedule UTP will be treated as if the taxpayer had filed Form 8275 or Form 8275-R as appropriate, and that the taxpayer need not file those forms. We concur that this is an appropriate way to coordinate with other reporting requirements.

Form 8082, Notice of Inconsistent Treatment, and Form 8886, Reportable Transaction Disclosure Statement, serve a similar purpose of alerting the Service to items on the tax return that may warrant closer review. Because not all inconsistent treatments or reportable transactions will require a reserve in financial statements, many of the items reported on these forms will not be disclosed on Schedule UTP. To the extent that an item is reported on Schedule UTP, however, we recommend that such disclosure be treated as if the taxpayer had filed Form 8082 as appropriate, and that the taxpayer need not file that form with respect to that position. Because the Service presumably will still require taxpayers to file Form 8886 with the Office of Tax Shelter Analysis, including it with the taxpayer's return, although arguably unnecessary, requires minimal additional effort.

In addition to excusing the taxpayer from filing other forms, we further recommend that the Service explicitly provide, by regulation, that a complete and accurate disclosure on Schedule UTP constitutes adequate disclosure for purposes of various penalties or statute of limitations provisions, including:

- Accuracy-related penalties, Section 6662(d)(2)(B)(ii)(I)
- Reasonable cause exception for reportable transaction understatements, Section 6664(d)(2)(A)
- Extension of statute of limitations for undisclosed listed transaction, Section 6501(c)(10)
- Extension of statute of limitations for substantial omission of income, Section 6501(e)(1)(A)(ii)

- Extension of statute of limitations for substantial omission of income, Section 6229(c)(2)[17]

Listing an item on a schedule of uncertain tax positions clearly is more than a mere clue. Even if full information about the position is not provided on Schedule UTP, listing it on the schedule would apprise the Service of something that might warrant further investigation. Even if the Service decided not to examine the item, it would have sufficient indication for an informed decision. That is enough to defeat the rationale for extending the statute of limitations and also, under appropriate circumstances,[18] to excuse penalties on any understatement related to the position.

As discussed above, we recommend that the Service not require taxpayers to disclose the reasons for concluding that a tax position is uncertain. We further recommend that the Service clarify that listing an uncertain tax position on Schedule UTP will be deemed adequate disclosure for the above purposes even if Schedule UTP does not disclose the reasons that the taxpayer considers the position uncertain. In particular, we recommend that Schedule UTP be considered adequate disclosure even without identifying the statutory or regulatory provision or ruling disregarded.[19] Once the taxpayer discloses an uncertain tax position on Schedule UTP, Exam personnel are more than capable of identifying inconsistent statutory or regulatory provisions or rulings. Alternatively, if identification of inconsistent statutory or regulatory provisions or rulings on Schedule UTP will be required to qualify as a deemed Form 8275 or Form 8275-R, the Service should clarify that requirement so that taxpayers understand what they will have to disclose to qualify for penalty protection.

2. <u>What type of uncertain tax positions should be reported by pass-through entities and tax-exempt entities.</u>

It appears from the guidance to date that no pass-through entities or tax-exempt entities will currently be subject to Schedule UTP. However, the exact scope of Schedule UTP with respect to such entities is somewhat unclear. As discussed below, we recommend clarification regarding the current scope of Schedule UTP.

In addition, we have set forth our recommendations with respect to how Schedule UTP should (or should not) apply to pass-through entities and tax-exempt entities, for the Service's consideration in development of future versions of the schedule and instructions. We understand that although pass-through entities and tax-exempt entities are generally not yet required to report uncertain tax positions on Schedule UTP, the Service is still considering how to address such uncertain tax positions and the requirements may be extended to such entities at some point in the future. Our recommendations with respect to partnerships, S corporations, and tax-exempt entities are set forth separately below.

---

17 Although this section does not specifically mention adequate disclosure as an exception to the extension of the statute of limitations, the Service has interpreted it in that manner. See FSA 199925016 and cases collected in *CC&F Western Operations Ltd. P'ship v. Comm'r*, 273 F.3d 402 (1st Cir. 2001).

18 Section 6662(d)(2)(B)(ii) also requires a reasonable basis for the tax treatment. Section 6664(d)(2) allows the reasonable cause and good faith defense only if there is adequate disclosure, substantial authority for the tax treatment, and a reasonable belief that the tax treatment was more likely than not correct.

19 See Treas. Reg. § 1.6662-3(c)(2); 1.6662-4(f).

Current Application of Schedule UTP to Pass-Through Entities

Based on the Service's pronouncements, including the draft instructions to Schedule UTP, it appears that pass-through entities are generally not subject to the disclosure requirements of the new schedule, but entities holding an ownership interest in a pass-through entity would be required to report on Schedule UTP any items related to that pass-through entity.

We recommend that the Service confirm that pass-through entities and tax-exempt entities are currently not subject to the disclosure requirements with respect to Schedule UTP. Although the draft instructions do not list Forms 990, 1065, or 1120 S among those for which Schedule UTP must be prepared, it is unclear whether the Service might later assert a penalty based on an argument that the taxpayer should have filed Form 1120 instead. For example, one common uncertain tax position recognized by FIN 48 is whether an entity was properly classified for tax purposes. Yet pass-through entities and tax-exempt entities would not, based on the current instructions, file Schedule UTP, even to report such uncertain tax positions that could result in tax liabilities at the entity level rather than the owner level. We recommend that the Service clarify that it would not assert any penalties for failure to file Schedule UTP even if the Service later determines that a pass-through entity or tax-exempt entity was misclassified and should have filed Form 1120.

With respect to owners of pass-through entities, we interpret the draft instructions as only requiring such owners to file Schedule UTP if they otherwise meet the requirements for reporting uncertain tax positions. That is, they would only file Schedule UTP if: (a) they file Forms 1120, 1120 F, 1120 L, or 1120 PC; (b) they have more than $10 million in assets; and (c) they issue GAAP financial statements including a reserve for uncertain tax positions.

Although it is implied by the draft instructions, we recommend that the Service clarify that owners need report only tax positions concerning items from a pass-through entity for which the owner establishes a reserve, or would have established a reserve but for its intent to litigate or reliance on the Service's general administrative practices, for the position. Owners may not have control over or access to the information necessary to identify potential exposure from the pass-through entity. Second guessing the owners, by requiring them to report items for which they did not establish a reserve, would be unfair in comparison to the treatment of other taxpayers.

If the owners are required to report pass-through tax positions for which they did not establish a reserve, however, we recommend that the Service establish appropriate defenses or "safe harbors" against subsequent claims by the IRS that a position was improperly omitted from Schedule UTP. In addition, because the owners of pass-through entities may have difficulty obtaining the information necessary to accurately complete Schedule UTP, we recommend that the Service should establish clear guidelines with respect to the appropriate due diligence required by owners of interests in pass-through entities to identify items for inclusion on Schedule UTP.

Entities Treated as Partnerships for Federal Income Tax Purposes

If the Service later determines to require pass-through entities to report uncertain tax positions on Schedule UTP, we believe that the basic criteria for what must be reported should be the same as for other taxpayers. That is, the reporting requirement should be limited to those entities with more than $10 million in assets and which establish reserves for one or more uncertain tax positions on GAAP financial statements they prepare.[20] Because partnerships that prepare GAAP financial statements are subject to the requirements of FIN 48 or similar standards, the determination of the items to be reported should be fairly straight-forward: the positions for which they record a reserve because of a potential adjustment to the entity's tax liability, as opposed to the owners' tax liabilities. These would include, for example, tax positions relating to the entity's qualification as a partnership rather than an entity subject to tax.

We recommend that a partnership not be required to report other tax positions that would affect only the tax liability of the partners. Although it may be most appropriate to examine such tax positions at the level of the partnership rather than the partners, there is a significant definitional problem. Because those tax positions do not affect the tax liability of the partnership, the partnership presumably will not have established a reserve in its financial statements. Thus, requiring the partnership to report such tax positions would impose a significantly higher compliance burden. For other taxpayers, the Service has stated that it does not intend to challenge the financial statements but instead would "piggyback" on them. The taxpayer need only report the items for which it established a reserve[21] and the Service will not second guess the decision of whether or not a reserve should have been established. Because the partnership presumably would not establish a reserve for a tax position that would affect only the partners' tax liabilities, requiring the partnership to report such tax positions would require difficult determinations of materiality and level of aggregation and provide no "safe harbor" comparable to that for other taxpayers. Accordingly, we believe that such tax positions should be reported, if at all, only by the partners.

S Corporations

We recommend that the treatment of S corporations be roughly comparable to that of partnerships. There would be two primary differences. First, an S corporation may be somewhat more likely to have its own uncertain tax positions to report. Not only will there be potential tax positions relating to the entity's qualification as an S corporation but there may also be tax positions relating to potential tax liability by the S corporation itself. Although partnerships do not pay tax, S corporations do under certain circumstances, such as for built-in gains when a C corporation converts to an S corporation.

Second, the shareholders in an S corporation will be, or should be, exempt from reporting any tax positions related to their pro rata share items from the S corporation. The shareholders are limited to individuals, estates, certain trusts, and certain tax-exempt entities. Individuals are not subject to reporting of uncertain tax positions. As discussed below, we recommend that tax-

---

[20] As discussed above, we recommend that the Service eliminate the category of uncertain tax positions for which no reserve is established because of the Service's general administrative practices not to challenge a position. With respect to the category of uncertain tax positions for which no reserve is established because of the taxpayer's intent to litigate, we believe this category should not apply to partnerships because the partners rather than the partnership are responsible for any federal income tax litigation. Accordingly, this category of uncertain tax positions should apply only at the partner level rather than to partnerships.

[21] Taxpayers are also required to report tax positions for which no reserve was established because of the intent to litigate or the Service's general administrative practices not to challenge a position. As noted above, supra note 20, however, we believe those other categories either would not be applicable to pass-through entities or should be eliminated from the reporting requirement.

exempt entities not be subject to the reporting requirement. We believe that estates and the trusts that are allowed as shareholders of S corporations also will not, or should not, be required to report uncertain tax positions.

Tax-Exempt Entities

Tax-exempt entities should not have to report uncertain tax positions on Schedule UTP due to the fact that these organizations are already required to report such positions on Schedule D of the Form 990—Return of Organization Exempt From Income Tax. The requirement to report uncertain tax positions under FIN 48 started with the filing of the 2008 Form 990. Requiring a tax-exempt entity to report a liability for uncertain tax positions on Schedule D and on Schedule UTP would be a duplication of a requirement already imposed on these entities in their annual filings.

The Instructions for Schedule D (Form 990) at Part X. Other Liabilities-- state the following: "Complete Part X if the organization answered Yes on Form 990, Part IV, line 11, and either reported an amount on Form 990, Part X, column (B), line 25 (Other liabilities), or had financial statements for the tax year that include a footnote addressing the organization's liability for uncertain tax positions under FIN 48. Organizations are required to separately report all liabilities for federal income taxes and amounts owed to related organizations on Part X of this schedule."

Part X of Schedule D has two lines. Line 1 requires the organization to list each type of liability not reported on lines 17 through 24 of Form 990, Part X (which is the Balance Sheet in the Form 990). The organization can use any reasonable basis to classify these liabilities. The book value of each liability must be entered and the total of all of those liabilities must be equal to Form 990, Part X, line 25—Other Liabilities on the Balance Sheet. This could include disclosed income tax liabilities.

The Instructions for Line 2—FIN 48 Footnote—require the following, "Every organization required to complete Part X must provide the text of the footnote to its financial statements, if applicable, regarding the organization's liability for uncertain tax positions under FIN 48. This includes, for example, the description of a liability for unrelated business income tax, or tax that may be assessed as a result of the revocation of exempt status. Any portion of the FIN 48 footnote that addresses only the filing organization's liability must be provided verbatim. The filing organization can summarize that portion, if any, of the footnote that applies to the liability of multiple organizations including the organization (for example, as a member of a group with consolidated financial statements), to describe the filing organization's share of the liability." The text of the FIN 48 footnote is to be included in Part XIV of Schedule D.

The draft instructions to Schedule UTP, in the Who Must File section at 2, state that the corporation assets are equal to or exceed $10 million. Corporations with less than that level of assets will not be required to attach Schedule UTP. By comparison, there is no minimum asset level in the Schedule D instructions for tax-exempt entities. Therefore, the coverage of organizations required to report uncertain tax positions on Form 990, Schedule D, is broader than the coverage of organizations required to attach Schedule UTP to the corporate tax return.

FASB Accounting Standards Update No. 2009-06 added, as FASB Accounting Standards Codification (ASC) 740-10-55-225, Example 34 that illustrates FIN 48 principles as applied to a tax-exempt organization as follows:

> Entity N, a tax-exempt not-for-profit entity, enters into transactions that may be subject to income tax on unrelated business income. Tax positions to consider include but are not limited to:
>
> a. Entity N's characterization of its activities as related or unrelated to its exempt purpose
> b. Entity N's allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income
> c. The allocation of Entity N's expenses between activities that relate to its exempt purpose and those that are allocated to unrelated business activities.
>
> Even if Entity N were not subject to income taxes on unrelated business income, a tax position it still has to consider is whether or not it qualifies as tax-exempt not-for-profit entity.

We would recommend to the Service that any changes regarding the reporting by tax-exempt entities of uncertain tax positions continue to be exclusively done by changes to Schedule D and its instructions. That would eliminate any need for these organizations to have an additional duplicate burden of addressing the disclosures that Schedule UTP will require.

3. <u>How uncertain tax positions should be reported in various related entity contexts, such as how members of a consolidated group for financial statement or tax return purposes or entities that are disregarded for federal tax purposes should report uncertain tax positions.</u>

How uncertain tax positions should be reported in various related entity contexts is also discussed elsewhere herein. With respect to the members of a consolidated group, we agree with the Service that generally only one disclosure schedule should be filed for the consolidated group, and all uncertain positions should be included. Likewise, for disregarded entities, we recommend that the uncertain tax positions of such entities be included on the Schedule UTP filed by the owner of the disregarded entity.

RETURN TO TABLE OF CONTENTS

AN INFORMATIONAL LIFELINE FOR THE FAMILY

By: *Joseph C. Sleeth, Jr. and Amanda R. Doslich*[i]

Providing a useful document to allow your client a way to inform family members of critical information can be a key element of any complete estate plan.

The following document is designed for your client to compile information which can be provided to family members where the client is non-accessible, becomes suddenly ill or upon his or her passing. We find that while clients often have taken time to complete their estate planning documents (i.e. Will, Revocable Trust, Powers of Attorney), they often fail to inform their family of the location of important documents and details about their estate. Your clients should be encouraged to complete the Personal Information Form to save their families a substantial amount of time, effort and anxiety. Your clients should keep the document in a secure place where their family members will likely find it, like a safety deposit box, or they should inform a close family member of the document's location.

RETURN TO TABLE OF CONTENTS

PERSONAL INFORMATION

Effective as of ____________________________

Full Legal Name: ______	Social Security Number: ______
Driver's License Number: ______	Passport Number: ______
Country of Citizenship: ______	Place of Birth: ______
If Citizenship not by Birth, date obtained: ______	Birthdate: ______
Permanent Address: ______	Name of Spouse: ______
______	Citizenship of Spouse: ______
Spouse Place of Birth: ______	Date Spouse obtained Citizenship: ______

Safety Deposit Box
Box Number: ______
Location of Box: ______
Location of Key: ______

Personal Safe
Location of Safe: ______
Safe Combination: ______

RETURN TO TABLE OF CONTENTS

CRITICAL DOCUMENTS

Document	Date Signed	Location	
Will			Executor:
Revocable Trust			Trustee:
Insurance Trust			Trustee:
Charitable Trust			Trustee:
Physician/Medical Directive			
Financial Power of Attorney			Agent:
Medical Power of Attorney			Agent:
Guardian Designation			Guardian:
Marital Agreement			
Divorce Decree			
Citizenship Papers			

MEDICAL INFORMATION

Name, Address and Phone Number of Primary Care Physician:	Blood Type:
	Name of Medications Taken and Dosage:
	Allergies:
	Organ Donor:

ADVISORS

Attorney	Accountant
Name:	Name:

RETURN TO TABLE OF CONTENTS

Attorney	
Address:	
Phone Number:	
Fax:	
Email:	

Accountant	
Address:	
Phone Number:	
Fax:	
Email:	

Insurance Advisor	
Name:	
Address:	
Phone Number:	
Fax:	
Email:	

Financial Advisor	
Name:	
Address:	
Phone Number:	
Fax:	
Email:	

Other	
Name:	
Address:	
Phone Number:	
Fax:	
Email:	

Other	
Name:	
Address:	
Phone Number:	
Fax:	
Email:	

ASSETS

REAL ESTATE

Primary Residence	
Address:	
Location of Deed:	
Fair Market Value:	
Mortgage:	

Secondary Residence	
Address:	
Location of Deed:	
Fair Market Value:	
Mortgage:	

RETURN TO TABLE OF CONTENTS

Mortgage Holder
Name of Holder:
Contact Person:
Address:
Phone Number:
Fax:
Email:
Online User Id:
Online Password:

Mortgage Holder
Name of Holder:
Contact Person:
Address:
Phone Number:
Fax:
Email:
Online User Id:
Online Password:

Other Real Property
Address:
Location of Deed:
Fair Market Value:
Mortgage:

Other Real Property
Address:
Location of Deed:
Fair Market Value:
Mortgage:

Mortgage Holder
Name of Holder:
Contact Person:
Address:
Phone Number:
Fax:
Email:
Online User Id:

Mortgage Holder
Name of Holder:
Contact Person:
Address:
Phone Number:
Fax:
Email:
Online User Id:

RETURN TO TABLE OF CONTENTS

Mortgage Holder
Online Password:

Mortgage Holder
Online Password:

SECURITIES AND BONDS

Financial Institution:	
Account Number:	
Contact Person:	
Address:	
Phone Number:	
Fax:	
Email:	
Online User Id:	
Online Password:	

Financial Institution:	
Account Number:	
Contact Person:	
Address:	
Phone Number:	
Fax:	
Email:	
Online User Id:	
Online Password:	

Financial Institution:	
Account Number:	
Contact Person:	
Address:	
Phone Number:	
Fax:	
Email:	
Online User Id:	
Online Password:	

Financial Institution:	
Account Number:	
Contact Person:	
Address:	
Phone Number:	
Fax:	
Email:	
Online User Id:	
Online Password:	

RETURN TO TABLE OF CONTENTS

NOTES AND MORTGAGES OWED TO YOU

Borrower:
Location of Originals:

Address:

Phone Number:
Fax:
Email:

Borrower:
Location of Originals:

Address:

Phone Number:
Fax:
Email:

BANK ACCOUNTS

Financial Institution:
Account Number:
Contact Person:
Address:

Phone Number:
Fax:
Email:
Online User Id:
Online Password:

Financial Institution:
Account Number:
Contact Person:
Address:

Phone Number:
Fax:
Email:
Online User Id:
Online Password:

Financial Institution:
Account Number:
Contact Person:
Address:

Financial Institution:
Account Number:
Contact Person:
Address:

Phone Number:	Phone Number:
Fax:	Fax:
Email:	Email:
Online User Id:	Online User Id:
Online Password:	Online Password:

INSURANCE

Car	House
Name of Insurer:	Name of Insurer:
Policy Number:	Policy Number:
Location of Policies:	Location of Policies:
Contact Person:	Contact Person:
Address:	Address:
Phone Number:	Phone Number:
Fax:	Fax:
Email:	Email:

Health	Long Term Care
Name of Insurer:	Name of Insurer:
Policy Number:	Policy Number:
Location of Policies:	Location of Policies:
Contact Person:	Contact Person:
Address:	Address:

RETURN TO TABLE OF CONTENTS

Health
Phone Number:
Fax:
Email:

Long Term Care
Phone Number:
Fax:
Email:

Disability
Name of Insurer:
Policy Number:
Location of Policies:
Contact Person:
Address:
Phone Number:
Fax:
Email:

Accidental and Dismemberment
Name of Insurer:
Policy Number:
Location of Policies:
Contact Person:
Address:
Phone Number:
Fax:
Email:

Umbrella
Name of Insurer:
Policy Number:
Location of Policies:
Contact Person:
Address:
Phone Number:
Fax:
Email:

Life
Name of Insurer:
Policy Number:
Location of Policies:
Contact Person:
Address:
Phone Number:
Fax:
Email:

Life
Name of Insurer:
Policy Number:
Location of Policies:
Contact Person:
Address:
Phone Number:
Fax:
Email:

Life
Name of Insurer:
Policy Number:
Location of Policies:
Contact Person:
Address:
Phone Number:
Fax:
Email:

RETIREMENT BENEFITS

(pensions, profit sharing plans, KEOGH, 401(k) plans, ESOPs, IRAs, etc.)

Type of Account:	
Account Number:	

Type of Account:	
Account Number:	

RETURN TO TABLE OF CONTENTS

Location of
Statements: ______________________

Contact
Person: ______________________
Addres
s: ______________________

Phone
Number: ______________________
Fax
: ______________________
Emai
l: ______________________
Online
User Id: ______________________
Online
Password: ______________________

Location of
Statements: ______________________

Contact
Person: ______________________
Addre
ss: ______________________

Phone
Number: ______________________
Fax
: ______________________
Emai
l: ______________________
Online
User Id: ______________________
Online
Password: ______________________

Type of
Account: ______________________
Account
Number: ______________________
Location of
Statements: ______________________

Contact
Person: ______________________
Addres
s: ______________________

Phone
Number: ______________________
Fax
: ______________________
Emai
l: ______________________
Online
User Id: ______________________
Online
Password: ______________________

Type of
Account: ______________________
Account
Number: ______________________
Location of
Statements: ______________________

Contact
Person: ______________________
Addre
ss: ______________________

Phone
Number: ______________________
Fax
: ______________________
Emai
l: ______________________
Online
User Id: ______________________
Online
Password: ______________________

PERSONAL PROPERTY

(include cars, boats, partnership and LLC interests, and items of unusual value such as jewelry, antiques, art, etc.)

Car	Car
Make:	Make:
Model:	Model:
Year:	Year:
Location of Title	Location of Title

Other	Other
Description of Property:	Description of Property:
Year Acquired:	Year Acquired:

Other	Other
Description of Property:	Description of Property:
Year Acquired:	Year Acquired:

RETURN TO TABLE OF CONTENTS

PET INFORMATION

Pet

Name:
Age
:
Type
:
Breed
:
Name of
Veterinarian:
Location of
Veterinarian
Location of
Vaccination Records:
Neutered/Spa
yed:
Food (Brand,
Schedule, Treats):
Medicatio
ns:
Illness/Al
lergies
Preferred
Boarder:
Location of
Boarder:

Pet

Name:
Age
:
Type
:
Breed
:
Name of
Veterinarian:
Location of
Veterinarian
Location of
Vaccination Records:
Neutered/Sp
ayed:
Food (Brand,
Schedule, Treats):
Medicatio
ns:
Illness/Al
lergies
Preferred
Boarder:
Location of
Boarder:

REWARD PROGRAMS

Airline

Carrie
r:
Account
Number:
Online
User Id:
Online
Password:

Airline

Carri
er:
Account
Number:
Online
User Id:
Online
Password:

Hotel

Account
Number:
Online User
Id:

Hotel

Account
Number:
Online User
Id:

RETURN TO TABLE OF CONTENTS

Hotel
Online Password:

Hotel
Online Password:

LIABILITIES

Credit Card
Institution:
Account Number:
Online User Id:
Online Password:

Credit Card
Institution:
Account Number:
Online User Id:
Online Password:

Credit Card
Institution:
Account Number:
Online User Id:
Online Password:

Credit Card
Institution:
Account Number:
Online User Id:
Online Password:

Other
Description:
Contact Person:
Phone Number:
Email:
Document Location:

Other
Description:
Contact Person:
Phone Number:
Email:
Document Location:

Other
Description:
Contact Person:
Phone Number:

Other
Description:
Contact Person:
Phone Number:

RETURN TO TABLE OF CONTENTS

Other	**Other**
Emai l: ____	Emai l: ____
Document Location: ____	Document Location: ____

LIABILITIES WHICH YOU GUARANTEED

Descript ion: ____	Descript ion: ____
Contact Person: ____	Contact Person: ____
Phone Number: ____	Phone Number: ____
Emai l: ____	Emai l: ____
Document Location: ____	Document Location: ____

EMPLOYMENT BENEFITS

Employ er: ____
Contact Person: ____
Addre ss: ____
Phone Number: ____
Emai l: ____
Location of Employee Booklet ____
Document Location: ____

INSTRUCTIONS REGARDING DISPOSITION OF REMAINS

Burial	**Cremation**
Cemeter y: ____	Cremato ry: ____
Plot/Drawer Number: ____	Are Expenses Prepaid: ____
Are Expenses Prepaid: ____	Location of Paperwork: ____
Location of Paperwork: ____	

RETURN TO TABLE OF CONTENTS

INSTRUCTIONS FOR SERVICES

MEMORIAL SERVICE: _____ Yes _____ No	FUNERAL SERVICE: _____ Yes _____ No
Funeral Home / Location of Memorial Service ______________________________	
Individual to Conduct Services: ______________________________	
Additional Requests: ______________________________	
______________________________	
______________________________	
______________________________	

[i] Joseph C. Sleeth, Jr. is a partner and Amanda R. Doslich is an associate with the Houston office of Fulbright & Jaworski L.L.P., where they both specialize in wealth transfer and succession planning.