THE "TENNESSEE TSUNAMI" and THE FEDERAL "TAXMAGEDDON"

Presented For:

Chattanooga Tax Practitioners

on

November 14 , 2012

By

Randall D. Van Dolson
Van Dolson Law Office
6074 East Brainerd Road
Suite 200
Chattanooga, Tennessee 37421

Phone: 423.645.3478
Fax: 423.472.8945
Email: randy@vandolsonlaw.com

© 2012 Randall D. Van Dolson. All Rights Reserved.

THE "TENNESSEE TSUNAMI" and THE FEDERAL "TAXMAGEDDON"

TABLE OF CONTENTS

PREFACE	1
INTRODUCTION	2
THE TENNESSEE "TSUNAMI"	4
"TAXMAGEDDON"	14
PLANNING IN ANOTHER PERIOD OF UNCERTAINTY	18
Flipping the Tennessee Gap" Trust	18
Gifting Before Taxmageddon	19
CONCLUSION	25
VAN DOLSON LAW OFFICE – DESCRIPTION OF PRACTICE	

INTRODUCTORY NOTES

References to "§" without further explanation are to the Internal Revenue Code or the Regulations thereunder.

References to TCA are to the Tennessee Code Annotated.

PREFACE

"Taxman" lyrics

Let me tell you how it will be
There's one for you, nineteen for me
'Cause I'm the taxman, yeah, I'm the taxman

Should five per cent appear too small
Be thankful I don't take it all
'Cause I'm the taxman, yeah I'm the taxman

If you drive a car, I'll tax the street,
If you try to sit, I'll tax your seat.
If you get too cold, I'll tax the heat,
If you take a walk, I'll tax your feet.

Don't ask me what I want it for
If you don't want to pay some more
'Cause I'm the taxman, yeah, I'm the taxman

Now my advice for those who die
Declare the pennies on your eyes
'Cause I'm the taxman, yeah, I'm the taxman
And you're working for no one but me.

From The Beatles album "Revolver"
Released in the United States on August 8, 1966

In 1966, the highest United States estate tax rate was 77%, applied to estates with values in excess of $10 million. The exemption from estate tax was $60,000.

Unless Congress and the Administration act before January 1, 2013, the highest United States estate tax rate will be 55%, with a 5% surtax on taxable estate values over $10 million and up to $17.184 million. The exemption from estate tax will be $1,000,000.

INTRODUCTION

The 3 C's of Tax Politics: Consistency; Control; Cooperation

A Political Football

Constitutionally, through legislation and judicial construction, the authority to levy direct taxes and excise taxes such as death and gift taxes reposes firmly in the relevant legislature.

The tax authority of the federal executive branch effectively is limited to the president's veto power, which can be overridden by a two-thirds majority in both houses of Congress.

Although the Tennessee governor can veto laws passed by the Tennessee General Assembly (the House and the Senate), and has a line-item veto authority for individual spending items included in legislative bills, it is uncommon for the governor to exercise veto power because the veto can be overridden by a simple majority of both legislative houses.

Tax legislation, then, clearly is a "political football." And as with a real football, it can be fumbled, intercepted, or carried across the goal line.

The 3 C's

1. **Consistency:** The Governor Haslam "turnaround."

2. **Control.**

   A. Tennessee General Assembly: the majority and the "supermajority."

   B. United States Senate: the "Byrd Rule."

   Why did EGTRAA expire after 2010, resulting in a reversion to pre-EGTRRA rates, exemptions, and law? The short answer is: Senator Robert Byrd.

   Although Senator Byrd, the longest serving senator in history, died at the age of 92 on June 28, 2010, his legacy continues to affect our tax careers. In 1985 Senator Byrd sponsored an amendment to the Congressional Budget Act of 1974, making it out of order for the Senate to include any "new budget authority or outlays" in budget reconciliations. The phrase "new budget authority or outlays" includes reduction of tax receipts beyond that provided for in the pertinent budget resolution. Consequently, in the 2001 budget resolution the reduction of estate and other transfer taxes beyond 2010 would have been out of order without the "sunset clause" that restores pre-EGTRRA law beginning January 1, 2011.

Sixty senate votes are necessary to waive the "Byrd rule." Interestingly, EGTRRA passed the Senate on May 23, 2001 by a 62-38 vote, but that vote was on the bill that included the "sunset" provision. Apparently, the bill would not otherwise have achieved the 60 vote threshold.

Cooperation.

A. How it used to be: The "odd couple;" the "Blue Dogs," and the "reminiscent retirees."

B. How it is now.

THE "TENNESSEE TSUNAMI"

The Nature of a Tsunami

A tsunami generally is precipitated by an earthquake below sea level. Scientists identify and predict the size of a tsunami by the size and type of the preceding underwater earthquake, a diagnostic tool available because seismic waves travel faster that the tsunami itself.

The tsunami itself is comprised of repetitive waves, commonly referred to as a "wave train." A subsequent wave can be larger than earlier waves.

The "Tennessee Transfer Tax Tsunami"

The Seismic Waves

In late 2011 and early 2012, transfer tax "scientists" could "feel" the seismic waves that preceded the Tennessee Tsunami.

Early seismic waves included a December 2011 Forbes article titled "Where Not to Die In 2012" which featured an interactive map including the state of Tennessee, and Smartmoney's " "Estate Taxes: The Worst Places to Die" (http://www.smartmoney.com/taxes/income/estate-taxes-the-worst-places-to-die-1297801297458/?mg=com-sm), which prominently discussed Tennessee.

On December 19, 2011, The Daily Caller noted that Governor Haslam's concerns about budgetary effects of inheritance tax cuts "do not appear to be shared by the Republican-majority General Assembly, which has made clear it intends to move ahead." See http://dailycaller.com/2011/12/19/anti-death-tax-advocates-eye-victory-in-tennessee/.

Palmer Schoening, director of federal affairs at the American Family Business Institute was quoted stating, "The first domino to fall this year was the state of Ohio, which completely repealed its state estate tax in order to attract and retain more family businesses. We plan to make history by axing several other states' death taxes in 2012, starting with Tennessee."

Dr. Arthur Laffer, former advisor to the Reagan administration and popularly described as the "father of supply-side economics" joined the fray. The Laffer Center's, "The Economic Consequences of Tennessee's Gift and Estate Tax," jointly authored by Laffer and Wayne H. Winegarden, received widespread media attention. It concluded with the following indictment.

> Economics is the study of incentives. And, "Tennessee's gift and estate tax is a case study in bad economic incentives. Prosperity for all Tennesseans will be enhanced by the elimination of the state gift and estate tax.

> Tennessee's gift and estate tax is an immoral tax that hits homeowners, small business owners and farmers disproportionately hard. Furthermore, the state of Tennessee is encouraging its citizens to take their income, their jobs and their capital and move to another state that will not levy a confiscatory tax on their estate.

Laffer's claim that in the past 10 years Tennessee's inheritance tax cost the state between 200,000 and 220,000 jobs because of lost economic activity received substantial attention in the media. A scathing rebuttal by the Institute on Taxation and Economic Policy titled "Repealing Estate Tax Will Not Create An Economic Boom," concluded that repeal of the Tennessee inheritance tax would not significantly increase jobs in Tennessee, that Laffer ignored or discounted significant factors other than the inheritance tax, and that there is no statistical authority to support the study's conclusion, received significantly less publicity.

In an appearance before the Tennessee House-Senate Fiscal Review Committee on April 16, 2012, Laffer said, "I spent about two hours with Fred Smith three days ago up in Memphis, and he said he's getting' out of this state if it (the repeal of the inheritance tax) doesn't happen." The following day, Fred Smith, the president, chairman, and CEO of Federal Express, repudiated Laffer's claim, issuing the following statement through FedEx.

> With respect to the reports on the statements of Arthur Laffer to the Tennessee legislature, Mr. Laffer and Mr. Smith did meet last week. In the course of a wide-ranging conversation, Mr. Smith discussed the Hall Tax in Tennessee as well as business taxes and the need for economic growth in Tennessee. "I think my old friend Art Laffer misunderstood my comments, as I have never taken a position on the estate tax, either the federal or the Tennessee estate tax," said Fred Smith. "I have no plans to leave Tennessee."

A wide-ranging coalition that included the National Federation of Independent Business, the Beacon Center of Tennessee, the Tennessee Farm Bureau, and the advocacy group Tennesseans Against Death Taxes, continued its assault on the inheritance tax.

On March 24, 2012, *The Wall Street Journal* published an editorial titled "Death Tax Defying" in which it labeled Governor Haslam as "The main obstacle to (death tax) reform in Nashville….he now says the state needs the revenues, however imaginary they might be." The editorial quoted Laffer's study.

And on March 29, Governor Haslam fired back in a letter published in The Wall Street Journal.

> Regarding your editorial "Death Tax Defying" (March 24): In early January I proposed legislation to raise the exemption level on Tennessee's estate tax from the current rate of $1 million to the federal exemption level of $5 million during my time in office.
> Just last week, I cemented that proposal by recommending doing so in the next three years and worked with House Finance Committee Chairman Charles Sargent to completely repeal the tax in year four.

This is a thoughtful and realistic approach to eliminate a tax that chases capital out of our state as Tennessee slowly recovers from the economic downturn that we continue to carefully manage our way through.

Tennessee is a low-tax state, and I'm working with the General Assembly to lower taxes even further.

The 2012 session of the Tennessee legislature produced the following four (4) separate bills addressing elimination of the inheritance tax.

HB 0519/SB 0431. Would have phased out the inheritance tax over a two-year period, reducing the amount of tax by 50% for decedents dying in 2012 and 2013, and eliminating the tax for decedents dying after 2013.

HB 2435/SB 2286. Would have reduced the inheritance tax rate annually by 1% until the tax was completely phased out.

HB 2446/SB 2572. Would have phased out the inheritance tax over a 3-year period beginning with 2013 and ending with 2015.

HB 3760/SB 3762. Would increase the inheritance exemption incrementally over 3 years, and eliminate the inheritance tax beginning in 2016.

The Tsunami – First Wave ("Phase-out" of the Inheritance Tax)

On April 27, 2012, House Bill No. 3760, substituted for Senate Bill No. 3762, an act to amend Tennessee Code Annotated, Title 67, Chapter 8, relative to inheritance tax, passed the House by a vote of 88-8, and passed the Senate by a vote of 32-1. It was signed by Governor Bill Haslam on May 21, 2012. When the phase-out is complete, the estimated annual revenue loss is $104.1 million.

As a result, the following changes have been made to Tennessee Code Annotated.

1. Tennessee Code Annotated, Section 67-8-316(b) was amended by deleting the previous language in its entirety and by substituting instead the following.

67-8-316. Exemptions.

(b) For the sole purpose of determining the net taxable estate under this part and part 4 of this chapter, there shall be allowed against the net estate a maximum single exemption against that portion of the estate distributable to one (1) or more beneficiaries of an amount to be determined by the following schedule:

In the case of a decedent dying:	Amount:
On or after July 1, 1998, but before January 1, 1999	$ 625,000
In 1999	650,000
In 2000 and 2001	675,000
In 2002 and 2003	700,000
In 2004	850,000
In 2005	950,000
In 2006 through 2012	1,000,000
In 2013	1,250,000
In 2014	2,000,000
In 2015	5,000,000

2. Tennessee Code Annotated, Section 67-8-314 that sets out the applicable tax rates was amended by designating the current language setting out the tax rates as subsection (a) and by adding the following new subsection (b).

> **(b)** In the case of a decedent dying in 2016, or in any subsequent year, no tax shall be imposed pursuant to this part; provided, however, that this subsection (b) shall not be construed to absolve liability for any tax duly levied by this section, during any year prior to January 1, 2016.

3. Tennessee Code Annotated, Title 67, chapter 8, Part 3 was amended by adding the following language as a new, appropriately designated section.

> **67-8-318. Applicability of part to decedents who die in 2016 or later.**
>
> This part does not apply in the case of any decedent who died in 2016 or in any subsequent year.

4. Tennessee Code Annotate, Title 67, Chapter 8, Part 4, which regulates the administration of the inheritance tax, was amended by adding the following language as a new, appropriately designated section.

> **67-8-425. Applicability of part to decedents who die in 2016 or later.**
>
> This part does not apply in the case of any decedent who died in 2016 or in any subsequent year.

5. Tennessee Code Annotated, Title 67, Chapter 8, Part 5, addressing disputed domicile and the inheritance tax, was amended by adding the following language as a new, appropriately designated section.

67-8-507. Applicability of part to decedents who die in 2016 or later.

This part does not apply in the case of any decedent who died in 2016 or in any subsequent year.

The Tsunami – Second Wave (Repeal of the Gift Tax)

As noted above, it is not uncommon for a tsunami to consist of more than one wave, and for a second wave to be larger and more devastating than the first. In retrospect, the seismic waves that predicted the phase-out of the Tennessee inheritance tax, did not prepare our tax community for the second wave that, shockingly, repealed the Tennessee gift tax retroactive to January 1, 2012.

The 2012 session of the Tennessee legislature produced the following bills addressing elimination of the inheritance tax.

HB 2635/SB 2572. Would have eliminated gift tax on transfers made on or after January 1, 2013.

HB 2840/SB 2777. Would have eliminated the gift tax effective January 1, 2013.

Little attention was given to these initiatives until, to the surprise of most if not all of us practitioners and our clients, Senate Bill No. 2777, substituted for House Bill No. 2840, an Act to amend Tennessee Code Annotated, Title 67, Chapter 8, Part 6; Title 67, Chapter 8, Part 1 and Title 67, Chapter 8, Part 4, relative to the gift tax, passed the House by a vote of 79-10 and passed the Senate by a vote of 30-3 on May 1, 2012 . It was signed into law by Governor Haslam on May 21, 2012. Beginning January 1, 2012, the estimated annual revenue loss is $14.9 million.

As a result, the following changes have been made to Tennessee Code Annotated.

1. Tennessee Code Annotated, Section 67-8-101(a) was amended by deleting the subsection in its entirety and by substituting instead the following.

67-8-101. Taxable transfers.

(a)(1) Except as otherwise provided by subdivision (a)(2), a tax is imposed upon the transfer by gift during any calendar year by any person of the following property, or any interest therein:

(A) When the transfer is from a resident of this state:

(i) Real property situated within this state;

(ii) Tangible personal property, except such as has an actual situs without this state;

(iii) All intangible personal property; and

(B) When the transfer is from a nonresident of this state:

(i) Real property situated within this state; and

(ii) Tangible personal property that has an actual situs within this state.

(2) No tax shall be imposed upon the transfer by gift made by any person on or after January 1, 2012; provided, however, this subdivision (a)(2) shall not be construed to absolve any taxpayer of liability for any tax duly imposed by this section, during any tax year that began prior to January 1, 2012.

2. Tennessee Code Annotated, Title 67, Chapter 8, Part 1 was amended by adding the following language as a new section.

67-8-118. Applicability.

This part does not apply to any transfer by gift made on or after January 1, 2012.

3. **(a)** Tennessee Code Annotated, Section 67-8-409(g)(1) was amended by deleting the language "decedent's lifetime" and by substituting instead the language "decedent's lifetime and prior to January 1, 2012," and (b) Tennessee Code Annotated, Section 67-8-409(g)(2) was amended by deleting the language "under § 67-8-104" and by substituting instead the language "under § 67-8-104 prior to January 1, 2012."

As a result, 65-8-409(g) now reads as follows, with *italics* showing the changes.

67-8-409. Return and inventory of estate.

(g) Any other provisions of this section notwithstanding, the following shall apply, if the gross estate of a decedent does not exceed one hundred thousand dollars ($100,000):

(1) If the decedent made no gifts during *the decedent's lifetime and prior to January 1, 2012*, in excess of the maximum single exemption allowable free of tax under § 67-8-104, the court may waive the filing of an inheritance tax return upon a statement to such effect by the personal representative or person in possession executed under penalty of perjury. It shall not be necessary for the clerk to forward a copy of the statement to the commissioner, unless requested; and

(2) If the decedent made one (1) or more gifts in excess of the maximum exemption

allowable free of tax under *§ 67-8-104 prior to January 1, 2012*, the personal representative or person in possession may provide relevant information concerning such gifts upon a short form provided by the commissioner without the necessity of reporting otherwise, unless requested by the commissioner.

4. Tennessee Code Annotated, Section 67-8-605 was amended by adding the language "Notwithstanding § 67-8-118" at the beginning of the second sentence. (italics supplied)

As a result, 65-8-605 now reads as follows, with *italics* showing the changes.

67-8-605. Administrative and enforcement procedures.

To the extent not inconsistent with §§ 67-8-603 and 67-8-604, the administrative and enforcement provisions of the inheritance tax law, as stated in parts 3-5 of this chapter, shall be applicable to this part in the event the original transferor is not alive at the time of the transfer. *Notwithstanding § 67-8-118,* if the original transferor is alive at the time of the transfer, the administrative and enforcement provisions of the gift tax law, as stated in part 1 of this chapter, shall be applicable to this part. Any other administrative or enforcement provision relating to the duty and power of the commissioner of revenue to collect state taxes shall be applicable to this part to the extent not inconsistent with it.

The Tsunami – Last Wave (Realization that the Gift Tax is Phased-out, NOT Repealed)

Surprised by the first wave, stunned by the second wave, the impact of the last wave was unanticipated, problematic, … and, some have argued, inadvertent. However, whether intended or not the effects of this last wave is completely rationale.

Upon enactment of legislation repealing the Tennessee gift tax effective January 1, 2012, the general belief was that Tennessee citizens could make gifts with no Tennessee transfer tax consequences.

This consensus ignored (i) the applicable Tennessee statutory law and (ii) the rationale for a gift tax regime.

1. The statutory "problem."

As reviewed above, the Tennessee inheritance tax statute now "phases-out" the inheritance tax over the next three years, 2013, 2014, and 2015. During the "phase-out," the only effect is the increase of the Tennessee inheritance tax exemption. All other rules pertaining to the inheritance tax are intact until January 1, 2016.

Consequently, the following rule continues to apply to gifts made in 2012, 2013, 2014, and 2015.

67-8-304 (3). Taxable transfers generally.

The following transfers enumerated in § 67-8-303 shall be taxable: (emphasis supplied)

> **(3) Transfers made by gift of the decedent to the extent of the value of any interest in property transferred, by trust or otherwise, during the three-year period ending on the date of the decedent's death.** Property for purposes of this subdivision (3) shall include any property specified in § 67-8-303. **The value of the property on the date it was transferred, less the exemptions provided for under § 67-8-104, shall be includable;** provided, that the transfer of a life insurance policy shall be includable at its proceeds value on the date of death without regard to the policy's value on the date of transfer or the exemptions provided for under § 67-8-104. In addition, any Tennessee gift tax paid on the transfer of any interest in property taxable under parts 3-5 of this chapter shall be a credit against any inheritance tax payable under parts 3-5 of this chapter. The amount of the gross estate, determined without regard to this sentence, shall be increased by the amount of any tax paid under part 1 of this chapter by the decedent or the decedent's estate on any gift made by the decedent or the decedent's spouse after December 31, 1978, during the three-year period ending on the date of the decedent's death;

In other words, as long as a Tennessee inheritance tax applies, gifts made within 3 years of the donor's death will be subject to a tax at a rate equivalent to the pre-2012 gift tax that applies to Class A donees!

And, in fact, the value of gifts subject to the inheritance tax 3-year rule can be more than the value that would have applied prior to 2012!

Why? Because the repeal of the gift tax repealed the exemption amounts allowable for gifts to donees under TCA 67-8-104. Since there no longer is an exemption amount allowable under § 67-8-104, the value of the gift brought back in for Tennessee inheritance purposes by the 3-year rule will be the entire amount transferred to a donee.

And gifts to education savings accounts also will be brought back in for Tennessee inheritance tax purposes.

Also, because § 67-8-105 has been repealed, gifts to a spouse and gifts with respect to which "gift-splitting" is elected within 3 years of a decedent's death will be brought back in for inheritance tax purposes.

The cost of the "clawback" may be addressed by having the gift made by a younger spouse, insuring the gifting spouse, or making the gift to a trust that includes a contingent marital trust.

2. **The "rationale" issue.** Although various respected tax practitioners have referred to the continuation of the 3-year rule under TCA § 67-8-304(3), discussed above, as an "oversight," and

there have been rumblings about technical correction legislation to remedy this result, tax policy rationale supports including in a decedent's estate for inheritance tax purposes all gifts made within 3-years of death.

Gift tax laws are designed to prevent complete avoidance of death taxes, such as the federal estate tax and the Tennessee inheritance tax. If there is no tax on lifetime gift transfers, a dying person could give away his or her entire estate a second before dying, and avoid the applicable death tax(es). In other words, the gift tax serves as a backstop to death taxes, and a death tax system ultimately is ineffectual without such a backup.

3. The effect.

The effect of this "surprise" is that there is an inheritance tax "contemplation of death" principal applicable to Tennessee decedents dying before January 1, 2016. Consequently, gifts made before January 1, 2016 may be subject to the Tennessee inheritance tax at a rate that may have applied prior to the repeal of the Tennessee gift tax.

Ripples-Another Result

Prior to 2005, the Internal Revenue Code provided a credit against the federal estate tax for state death taxes paid, and for a credit of as much as 5% against the federal generation-skipping transfer tax for generation-skipping transfer taxes paid to a state. See Internal Revenue Code §§ 2011 and 2604.

Many states, including Tennessee, had laws in effect that allowed the states to "pick up" the amounts allowable as a federal tax credit for both estate and generation-skipping transfer taxes by having a decedent's estate pay the maximum federal credit to the state. Tennessee picked up the death tax credit under TCA § 67-8-204, addressing the Tennessee estate tax, and under TCA § 67-8-603, with respect to the Tennessee generation-skipping transfer tax.

Under the provisions of EGTRRA, both of these tax credits were repealed at the end of 2004. The credit for state generation-skipping transfer taxes paid was not replaced. The credit for state death taxes paid was replaced with a Federal estate tax deduction for state death taxes paid. See IRC §2058.

The effect of this repeal was tax neutral to decedent's estates as the estate and/or generation-skipping transfer taxes had to be paid either to the federal government or to the state. The "pick-up" taxes did not increase a decedent's estate and/or generation-skipping transfer taxes, they merely permitted Tennessee to share in the federal tax collections.

After 2010, all provisions of EGTRRA disappeared.

SEC. 901. SUNSET OF PROVISIONS OF ACT.

(a) IN GENERAL- All provisions of, and amendments made by, this Act shall not apply—

(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

(2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after Decemb31, 2010.

(b) APPLICATION OF CERTAIN LAWS- The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

Although TRA 2010, discussed below, extended the provisions of EGTRRA through December 31, 2012, unless EGTRRA is extended again or new legislation is enacted, effective January 1, 2013 there will be a revival of the Tennessee estate and generation-skipping transfer taxes.

Wisely, the Tennessee legislature did not repeal the Tennessee estate and generation-skipping transfer taxes. The effect of these taxes was neutral to decedent's estates since the estate and generation taxes have to be paid either to the Federal government or the state.

Consequently, EGTRRA's "sunset" may provide a minor windfall to Tennessee by permitting Tennessee to share the federal estate and generation-skipping transfer tax collections.

"TAXMAGEDDON"

Since January 1, 2002, the federal transfer tax aspects of our estate planning have been in the context of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRAA), as extended and expanded by The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010), a comfortable and progressive federal tax regime that in many instances simplified our planning while providing ascending exemptions and descending tax rates.

EGTRRA and TRA 2010 Rates and Exemptions

The contrast between the pre-EGTRAA and EGTRAA and TRA 2010 rates and exemptions are illustrated in the following chart.

Calendar Year	Estate Exclusion Amount and GST Exemption	Lifetime Gift Tax Exemption	Highest Estate, GST and Gift Tax Rates
2001	$ 675,000	$ 675,000	60%**
2002	$1,000,000	$1,000,000	50%
2003	$1,000,000	$1,000,000	49%
2004	$1,500,000	$1,000,000	48%
2005	$1,500,000	$1,000,000	47%
2006	$2,000,000	$1,000,000	46%
2007	$2,000,000	$1,000,000	45%
2008	$2,000,000	$1,000,000	45%
2009	$3,500,000	$1,000,000	45%
2010	N/A or $5,000,000	$1,000,000	gift tax only 35%
2011	$5,000,000	$1,000,000	35%
2012	$5,120,000	$5,120,000	35%
2013	$1,000,000*	$1,000,000	60%**

*GST Exemption of $1 million in 1996, indexed for inflation, is approximately $1.33 million in 2010.
**55% rate plus 5% surtax on taxable estate values over $10 million and up to $17.184 million.

Section 901 of EGTRRA provides that it would expire after December 31, 2010.

The Reprieve

As the expiration of EGTRRA loomed perilously close, almost at the last minute TRA 2010 passed the United States Senate on December 15, 2010 by a vote of 81-19, was approved by the House or Representatives shortly after midnight on December 17 by a 277-148 vote, and on the same day was signed into law by President Obama.

Generally, TRA 2010 extends all the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 by two years. This was accomplished simply by amending the "sunset" provision in §901 of EGTRRA to substitute 2012 for 2010. However, TRA 2010 also provides that the amended sunset provision applies to all estate and gift tax amendments created under TRA. See §304. Consequently, new provisions and procedures, such as tax rates, exemption, portability, will sunset after 2012, along with the original provisions of EGTRRA.

Another Reprieve?

The prospect of a late-2012 reprieve comparable to the last-minute legislation in 2010 is complicated by the results of the recent presidential and congressional elections on November 6, 2012, and the "3 C's" discussed above.

The Obama administration, and the Democratic party generally are viewed as supporting higher taxes for wealthy persons. And certain federal transfer taxes, such as the estate, gift, and generating-skipping transfer taxes, are clear examples of taxes that are imposed exclusively on the "rich."

Regardless of the effects of the Presidential and Congressional elections, all Democrats have to do is ... NOTHING!

By simply "doing nothing," Democrats can roll back the federal transfer tax rates and exemptions to pre-EGTRRA/TRA 2010 levels that are far less generous that those to which we and our clients have become accustomed.

What "Taxmageddon" Means

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), as extended and adjusted by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010) sunset as of January 1, 2013.

The effects of reverting to pre-EGTRRA rates and rules include the following. The Obama administration's proposals in the 2012 "Green Book" are cited in brackets.

Estate Tax

1. Highest rate will increase from 35% to 55%, plus a 5% surtax between $10 million to $17.184 million. [$45%]

2. Exemption will decrease from $5,120,000 to $1,000,000. [$3.5 million]

3. The portability of the estate tax exemption that was added by TRA 2010 will be lost. [Retained]

4. Over four years, 2001 through 2004, EGTRRA phased out the credit for state death taxes paid under IRC § 2011 and replaced it with a deduction under IRC § 2058. Beginning in 2013, the more valuable credit will be restored.

5. EGTRRA extended the estate exclusion of the value of land subject to a qualified conservation easements to land which is located in the United States or any of its possessions. In 2013, pre-EGTRRA geographic restrictions will be reinstated.

6. EGTRRA increased the number of partners or shareholders of a business whose interests qualified for installment payment of estate tax from 15 to 45. After 2012, the previous 15 partner/shareholder cap will apply.

Gift Tax

1. Highest rate will increase from 35% to 55%, plus 5% surtax between $10 million to $17.184 million. [45%]

2. Exemption will decrease from $5,120,000 to $1,000,000. [$1,000,000]

3. Annual exclusion of $13,000 will be $13,000, plus post-1997 inflation adjustments.

Generation Skipping Transfer Tax

1. Highest rate will increase from 35% to 55%. [45%]

2. Exemption will decrease from $5,120,000 to around $1,400,000, being an exemption of $1,000,000 adjusted for post -1997 inflation. [$3.5 million]

3. Over four years, 2001 through 2004, EGTRRA phased out the credit for state generation skipping transfer taxes paid under IRC § 2604. Beginning in 2013, this credit will be restored.

Capital Gains

The capital gains rates will change as follows.

Tax Years 2010-2012

Income Tax Rate	Short-Term Capital Gains Tax Rate	Long-Term Capital Gains Tax Rate
10%	10%	0%
15%	15%	0%
25%	25%	15%
28%	28%	15%
33%	33%	15%
35%	35%	15%

Tax Year 2013

Income Tax Rate	Short-Term Capital Gains Tax Rate	Long-Term Capital Gains Tax Rate
15%	15%	10%
28%	28%	20%
31%	31%	20%
36%	36%	20%
39.6%	39.6%	23.8%*

*Under "Obamacare," in 2013 there is a 3.8% surtax on investment income if adjusted gross income is more than $200,000, for individuals, and $250,000, if married filing jointly.

Flipping the "Tennessee Gap" Trust

Discrepancies in the amounts of the federal estate tax exemption and the Tennessee inheritance tax exemption provided a potential "trap" in designing clients' estate plans. Under EGTRRA and TRA 2010, the federal estate tax exemption increased dramatically, producing a significant difference in the value of the amount that could pass in a non-marital deduction form free of federal estate tax and the amount that could pass free of Tennessee inheritance tax. We have referred to this difference as the "Tennessee Gap."

The use of a standard "A/B" marital/non-marital trust arrangement could produce a substantial pre-payment of Tennessee inheritance tax by reason of the death of the first spouse to die.

The "Tennessee Gap" trust is a means by which all death taxes, federal and Tennessee, are deferred until the last to die of a husband and wife.

Currently practitioners can resolve the "Tennessee Gap" challenge, and defer all federal estate and Tennessee inheritance taxes for married persons until the death of the last spouse to die, by creating a three-trust format with allocations through an appropriate formula. For example, in 2011 a $7,000,000 estate would be allocated as follows to "zero-out" transfer taxes at the time of the death of the first spouse to die.

- A **fully-exempt trust** would be funded by $1,000,000, the amount exempt from both federal estate and Tennessee inheritance taxes. No part of this trust would qualify for the federal or Tennessee marital deduction.

- A **partially-exempt trust** would be funded by $4,000,000, the difference between the $5,00,000 federal estate tax exemption and the $1,000,000 Tennessee inheritance tax exemption. A qualified terminable interest property ("QTIP") election would be made with respect to this trust only for Tennessee inheritance tax purposes. As a result, this trust would be free of federal and Tennessee death taxes at the time of the death of the first spouse to die because the $4,000,000 "gap" amount would be protected from inheritance tax by the Tennessee marital deduction, and would be protected from federal estate tax by the unused portion of the $5,000,000 federal estate tax exemption.

- A **marital trust** would be funded by the remaining $2,000,000, and tax on this amount would be deferred until the death of the surviving spouse by electing to fully qualify this trust for both the federal and Tennessee marital deductions.

The Tennessee Gap arrangement, then, was intended to defer Tennessee inheritance tax until the death of the surviving spouse.

However, the unanticipated phase-out of the Tennessee inheritance tax over the next three years, and the possibility that the federal estate tax exemption will decrease significantly on January 1, 2013 presents the distinct possibility that prior to 2006 when the Tennessee inheritance tax completely phases out, we will be using the Tennessee Gap arrangement to defer federal estate, rather than Tennessee inheritance, tax!

Gifting Before Taxmageddon

As noted above, the scheduled return to pre-EGTRAA tax laws will drastically reduce the federal gift tax exemption from the current $5,120,000 to $1,000,000. As a result, there is a rush for tax-saving inclined wealthy clients to make large gifts prior to January 1, 2013 in order to lock in the transfer tax saving on values in excess of $1,000,000.

The Tools

Familiar tools to make such large gift transfers include the following.

Outright gift

Advantages

1. Simple to accomplish and does not require a complicated trust document.

Disadvantages

1. Will lose income if income producing assets are gifted.
2. May not be able to allocate generation-skipping transfer tax exemption.
3. Lose control.
4. No creditor protection for donee.
5. Carry over basis may result in capital gain tax when asset is sold.
6. Demotivates donees

Spousal limited access trust

Advantages

1. Retain income indirectly while spouse-beneficiary is living.
2. Can allocate generation-skipping transfer tax exemption.
3. Can structure trust to provide that someone has control.
4. Trust can be structured to provide creditor protection.

Disadvantages

1. Complicated to structure and administer.
2. May lose income in event of divorce or death of spouse-beneficiary.
3. Carry over basis may result in capital gain tax when asset is sold.

Irrevocable trust for descendants

Advantages

1. Can allocate generation-skipping transfer tax exemption.
2. Can structure trust to provide that someone has control.
3. Trust can be structured to provide creditor protection.

Disadvantages

1. Complicated to structure and administer.
2. Will lose income if income producing assets are gifted.
3. Carry over basis may result in capital gain when asset is sold.

Less familiar, and more complicated, tools include, a grantor retained annuity trust, a taxable charitable lead annuity trust, a sale to an intentionally defective grantor trust, a private annuity, …AND A DOMESTIC ASSET PROTECTION TRUST. See *Ltr. Rul. 200944002*.

The Poll

1. Are a substantial number of your eligible clients actually making "large" gifts (i.e., gifts with a value equal or nearly equal to their remaining federal exemptions) in 2012?

Yes.

Ten or more, with another 5 to 10 "on the fence."

Eight to ten "in the works," and others planning or considering.

A few, being less than 5.

Over 50% of those with substantial wealth. But relatively few are making the maximum gifts. Most are keeping a little in reserve for gifts later in the year.

Several are making and considering making such gifts.

None so far, although some have expressed interest.

A substantial number are.

No, but the lack of response to my alerts about this opportunity has been surprising to me.

2. Are clients choosing to defer large gifts until the results of the presidential election are known?

Some have decided to proceed before the election results were known; others chose to wait and see. The election, however, does not appear to be a major factor.

A few, but those deferring are the exception.

A few are. In some cases the planning began in mid-summer, so execution of the documents will not be until after the presidential election. Only 2 clients have expressly decided to wait until after the election.

Maybe 25% of those considering large gifts.

No, but it will be interesting to see if the election stops any gifts that are in progress but not yet completed.

None have indicated that the unknown result of the election is a reason they are not actively pursuing the gifts. Inertia seems to be a bigger problem.

Many clients are hesitant to do more than basic estate tax planning because they are paralyzed by the volatility and unpredictability of the rules.

Many are.

That is my belief.

Most high net worth clients under 60 years of age are surprisingly less concerned about making such gifts. They seem to believe their net worth will continue to grow regardless of who wins the election.

3. Are clients concerned about income tax consequences of making "large" gifts?

For example, if a client makes a $5.12 million gift in 2012, and the federal estate tax exemption after 2012 is extended at its current rate, the gift may not have been essential. But in any event, the donee will have a carry over basis that may generate substantial capital gain tax when the gifted property is sold.

Not really. Most are concerned about avoiding estate tax.

Clients have not been concerned about income tax considerations.

Clients understand the basis issue, and are choosing assets with as high a basis as possible or making gifts of cash. Some are using properties that have not appreciated much due to the recession.

Yes, a number are reluctant to pass on the built-in gain to their beneficiaries.

The more knowledgeable clients are.

Although this issue has been explained to clients, none have expressed a reservation about making a large gift because of the future income tax consequences which will be the responsibility of the donee(s).

Some have chosen not to make gifts because of this issue.

We counsel using higher basis assets.

On the whole they have not been deterred.

4. In what form are gifts being made? Are most being made outright, through spousal limited access trusts, or to generation-skipping transfer trusts for descendants?

About 50%/50% to GST/dynasty trusts and spousal limited access trusts.

No spousal limited access trusts yet, but at lease two sales to intentionally defective grantor trusts, several contributions to existing irrevocable life insurance trusts, some gifts of fractional interests in real estate outright or to irrevocable trusts.

All gifts are being made in trust to capture the leverage of the generation-skipping transfer tax exemption.

Recommending trusts, but also discussing a substantial outright gift with a client who wants to transfer ownership of a family business to the next generation.

Gifts are being made in various forms, such as spousal limited access trusts, generation skipping transfer trusts for descendants, and grantor retained annuity trusts.

Generally through spousal limited access trusts or trusts solely for descendants.

Most are through spousal limited access trust.

Most are outright or in trusts that are not spousal limited access trusts.

Outright, or through some retained control arrangement such as an LLC or partnership.

5. Are clients using spousal limited access trusts with a testamentary power of appointment whereby the spouse beneficiary can appoint the remaining trust to another trust for the benefit of the donor's spouse.

With respect to this matter, Steve Akers at Bessemer Trust, has opined as follows.

"Giving the donee-spouse a testamentary power of appointment to appoint the assets back to the donor or to a trust for the benefit of the donor should not create inclusion problems for the donor as long as there is no express or implied agreement that the spouse would exercise the power of appointment for the donor. Do not have the spouse sign a new will exercising the power of appointment for some period of time. Make sure that the spouses understand that there really is no preconceived plan of whether the power of appointment will be exercised, but that it is just included to provide helpful flexibility."

Have not used this technique. Have discussed it, but with net worth not substantially over the $10 million mark clients have decided there is no need to use a power of appointment.

Have not used this technique, and probably would not recommend it.

Some clients are considering this.

Some of the spousal limited access trusts we create for clients may ultimately give one of the spouses a testamentary power to appoint back for the benefit of the grantor of the trust.

No.

It will be hard to show that such an arrangement is not a preconceived plan, particularly if both spouses do it.

6. Are you creating spousal limited access trusts by one spouse for the other, and vice versa, addressing the "reciprocal trust" issue.

Some clients are considering such an arrangement.

No.

Yes.

We are creating some non-reciprocal spousal limited access trusts.

Have not yet created trusts for husband and wife which would raise the reciprocal trust concern, but would do so and deal with it if the situation warranted.

Have advised against this, stressing the old adage, "pigs get fat and hogs get slaughtered."

Not yet. Other options seem more appealing.

7. Do you have any other insights about this matter.

Most high net worth clients under 60 years of age are surprisingly less concerned about making such gifts. Then seem to believe their net worth will continue to grow regardless of who wins the election. Those over the age of 60 are a little more reluctant to make gifts.

The tension is between (i) the fear of adverse tax law changes (that will not affect the client directly because estate tax will not be paid until the death of the last of a husband and wife to die, and in any event is out of the client's control) and (ii) the fear that the client will later need the wealth that would be used to fund the gift for the client's own support. Those clients who are not "mega-wealthy" tend to lean toward preserving their own personal security rather than taking advantage of tax savings for future generations.

Some clients are concerned that giving income producing property deprives them of income and flexibility. Sales to intentionally defective grantor trusts have been used to address these concerns, but care must be taken that such trusts are not "oversold" with illustrations of unrealistic returns.

Some clients are sensitive to what they perceive to be complex arrangements.

Using some grantor retained annuity trusts, although concerned that rates of return and growth may not actually pass any increased value.

I dread the last-minute calls this year if the election goes the wrong way (as far as almost all my clients are concerned). If it goes the other way I expect my procrastinating clients (seemingly being the vast majority of mine, at least) to wait and hope for complete repeal. The ones who don't want to take a chance either like the concept of maximizing the amount of the gifts through a discount arrangement and still retaining management control, such as an FLP might provide, or they are elderly "country-folk" for whom an arrangement like that is just too fancy and those are just making outright gifts. In the latter case where there are several children or other descendant-donees who get along I have suggested at least that the gifted assets be made

in joint tenancy in common, if possible, such as with real property gifts, so that some discount might apply.

Valuation of hard-to-value assets such as fractional interests in real estate, closely-held business interests such as family corporations, LLCs, limited partnerships, etc., is an issue. I suggest leaving a "cushion" to deter the IRS incentive to challenge the valuation, and to protect against revaluation that would result in tax being paid.

In most or all cases we use value-definition clauses to protect against valuation challenges, and because in many cases we will not have valuations by the end of the year.

CONCLUSION

"My Back Pages" chorus

Ah, but I was so much older then,
I'm younger than that now.

Written and recorded by Bob Dylan in 1964;
charted by The Byrds in 1967

VAN DOLSON LAW OFFICE

RANDALL D. VAN DOLSON, ATTORNEY-AT-LAW

6074 EAST BRAINERD ROAD, SUITE 200 • CHATTANOOGA, TENNESSEE 37421
TELEPHONE: 423.645.3478 • EMAIL: RANDY@VANDOLSONLAW.COM • FAX: 423.472.8945

RANDALL D. VAN DOLSON

For nearly three decades Randall D. Van Dolson practiced law with several large international and regional law firms. Recently, he has created his own boutique firm focusing on estate planning, probate, charitable gift planning, tax-exempt/nonprofit organizations, general tax matters and business entities.

After receiving a B.A. degree from Loyola University in 1970 and an M.A. degree in history from UCLA in 1972, Mr. Van Dolson attended the University of Southern California Law Center, received his J.D., with honors, from the University of Maryland in 1977, and earned a Master's Degree (LL.M) in Taxation from the Georgetown University Law Center in 1983.

Mr. Van Dolson, whose articles have appeared in such national professional journals as *Estate Planning*, *Trusts & Estates*, and *Probate & Property*, lectures at various tax conferences including the Southern Federal Tax Institute, the Duke University Estate Planning Conference, the Tennessee Federal Tax Institute, the Tennessee Society of Certified Public Accountants Federal Tax Conference, the Georgia Federal Tax Conference, the University of Alabama Annual Federal Tax Clinic, the University of Tennessee's Singleton Wolfe Federal Tax Conference, and annual meetings of the American College of Trust and Estate Counsel.

A former President of the Greater Chattanooga Planned Giving Council, Mr. Van Dolson is a past chair of the Tennessee Bar Association's Tax, Probate and Trust Law Section, and is the current chair of the Trusts and Estates Section of the Chattanooga Bar Association.

Mr. Van Dolson is a Fellow of The American College of Trust and Estate Counsel (ACTEC), a professional association consisting of approximately 2,700 lawyers from throughout the United States. Fellows of the College are selected by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching, and bar activities. Fellowship in ACTEC is widely considered to be the highest honor accorded to an estate planning attorney.

Mr. Van Dolson also is listed in *The Best Lawyers in America®* (trusts and estates), and has been awarded the highest possible rating for legal ability and ethical standards – "AV" – from Martindale-Hubbell, the world's leading guide to the legal profession. The AV rating by Martindale-Hubbell and selection for inclusion in *The Best Lawyers in America®* are based on confidential evaluations of other lawyers. By a vote of regional lawyers, Mr. Van Dolson also has been selected to be listed in *Mid-South Super Lawyers* since 2006. The Van Dolson Law Firm is listed in the top tier of *U.S. News and World Report – Best Law Firms.*

Appointed by the governor of the State of Maryland as a member of the Task Force on Long Term Planning for Disabled Persons, Mr. Van Dolson was one of the principal authors of Maryland's statutory Discretionary Trust Act, a first-of-its-kind statutory trust that provides for a disabled child's supplementary needs while preserving the child's need-based government program support.